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PROPOSALS TO ACHIEVE SUSTAINABLE SOLVENCY, WITH OR WITHOUT PERSONAL ACCOUNTS

HEARING

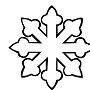
BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

APRIL 26, 2005



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PROPOSALS TO ACHIEVE SUSTAINABLE SOLVENCY, WITH AND WITHOUT PERSONAL ACCOUNTS

TUESDAY, APRIL 26, 2005

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

The hearing was convened, pursuant to notice, at 10:07 a.m., in room SH–216, Hart Senate Office Building, Hon. Charles E. Grassley (chairman of the committee) presiding.

Also present: Senators Hatch, Lott, Snowe, Kyl, Thomas, Santorum, Frist, Smith, Bunning, Crapo, 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. I would like to welcome everybody. I would like to discuss, just for a moment, our procedure for today.

Senator Baucus and I will make opening statements. We will then hear from our witnesses. Following their statements, Senators will each have 5 minutes for questions. I will start, followed by Senator Baucus. Then after Senator Baucus, we will follow the traditional early bird rule.

For Senators that have to go to other hearings, you will maintain your place on the early bird rule, so when you come back, if we have crossed your name, we will go back to you before following down the list.

For the benefits of our new members, I hope that the early bird rule has been explained to you by staff. If you have any questions about it, I would ask that you would talk to our staff about it so there is a clear understanding of how the early bird rule works.

Today's hearing is the second this year that this committee has had on the future of Social Security. Today we are going to examine specific proposals that achieve sustainable solvency for Social Security, which is probably the most popular government program ever created. Sustainable solvency means that there is a positive trust fund balance throughout the traditional 75-year projection period for Social Security, and a level of rising balance at the end of that period.

Sustainable solvency ultimately means that taxes and benefits must be roughly equal. Achieving sustainable solvency, of course, is important for a number of reasons. No one wants Social Security to be unsustainable.

Beneficiaries should not have to worry that their benefits will be reduced. Workers should not have to worry that their payroll taxes will go up, as they have 20 times. The longer Social Security's future remains in doubt, the more people will worry about their own future prospects.

A sustainable Social Security program will give everyone additional peace of mind. No one should take comfort in the fact that Social Security has been on an unsustainable path for nearly 3 decades.

Given the programmatic linkages between workers and beneficiaries and wages and benefits, there is no plausible set of assumptions under which Social Security will be able to pay 100 percent of currently scheduled benefits.

Policymakers of the past had the luxury of time. They could afford to wait and see. After all, things might have turned out differently. We might have had birth rates not declining. Real wages might have been higher, and inflation might have been lower.

But all those things were not to be. Their future is now our present, and time is running out. The retirement of the baby boomers is upon us within 3 years. It has been more than 20 years since Congress enacted major Social Security reform.

Despite the obvious need for additional reform, policymakers have refused to take further action. Instead, Social Security has become, as we all know, a political hot potato just tossed back and forth, producing motion but no progress.

If this Congress is going to muster the courage, and if we are going to accept the responsibility that we should address Social Security reform this year, we should do more than just kick the can down the road a while.

Achieving only 75-year solvency like the 1983 reform means that we have failed to fully address the problem. That means that we are just doing nothing more than passing the buck to some future Congress.

Each of the proposals presented by our witnesses today will achieve the goal of sustainable solvency. They reach this goal in a variety of different ways. Our job on the Finance Committee is to evaluate the elements of each plan and determine the best approach overall.

As Chairman, I intend to work hard to engage this committee in a sincere debate about ensuring Social Security's future solvency. I hope to bring members to the table to work in our usual bipartisan fashion. I feel strongly about the need to take legislative action this year.

Now, President Bush has lent the power of the White House to the cause of saving Social Security, and it seems like this only happens when presidents do this, as under President Carter, as under President Reagan. Under those two presidents, Congress did take some action.

Under President Clinton, he had a great national debate on the issue, but Congress did not take action. But it got a lot of bipartisan bills introduced that maybe would not have otherwise been introduced except for President Clinton's leadership. We should not waste the opportunity provided by the leadership of President Bush.

This opportunity is not likely to come again for another decade. I hope my co-sponsorship of the Bob Kerry and the John Breaux and the Judd Gregg bill in 1999, following on the leadership of President Clinton, indicates that I am not afraid as a Republican, opposite the President, to take action at that particular time.

Outside of the hearing room today we have political theater and we have dramatic attempts to polarize Social Security along partisan lines. I hope that my fellow committee members, in the tradition of the work of this committee, resist the temptation to allow such theatrics to pervade this hearing room.

I want to thank my colleague, Senator Baucus, for being very intellectually honest in his approach to this issue, even though we disagree to some extent about what we should be negotiating, or when we should be negotiating. But I follow very closely what my colleague says, and I thank you for the sincerity in how you have addressed our differences of approach.

If there is going to be a bipartisan consensus for reform, the process has to begin in this committee. We know from previous Congresses, when leaders have taken things away from this committee, they have gone nowhere. I do not expect either the Republican or Democratic leadership this time to do that, so we have an opportunity, and there is no time like the present to get started.

Senator Baucus?

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

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

I would like to begin just by thanking you for the tone in which you are approaching this subject. We have, as you mentioned, a tradition in this committee of working very much together, you and I especially. It has been a wonderful experience for me, working with you.

We almost always agree, and I think that is partly because we both have the same approach, that is, trying to find pragmatic, practical solutions based not in ideology, but on economics and what makes sense and what does not make sense.

In fact, the cooperation is so great, it has turned into personal friendship, which is quite something around here. I just want to again tell you how much I appreciate that. This is one of the very few times where we do not agree, and it is just unfortunate that we do not. You favor private accounts, I do not.

At the same time, to use that old phrase around here, which is really true, we agree to disagree agreeably. There has been absolutely no difference in the friendship between the two of us on this issue, but we just, at this point, do have different points of view. I know that, over time, we will probably find a way to resolve this one as well, although it may not be in the immediate future.

When President Roosevelt signed the Social Security Act, he said that "we have tried to frame a law which will give some measure of protection to the average citizen and to his family against poverty-ridden old age." Social Security has provided that critical measure of protection for millions of American families.

I mean, these figures are really dramatic. For 1 out of 5 seniors, Social Security is their only source of income. For 2 out of 3 seniors, Social Security provides most of their income.

People depend on Social Security and Social Security helps millions of families if a breadwinner dies or becomes disabled. Clearly, we need to address Social Security's long-run financing. Nobody disputes that. That is clear. But we do not need to make drastic changes.

The nonpartisan Congressional Budget Office, which is the official Congressional scorekeeper, one that we must go by when we pass legislation around here, projects, under current law, Social Security can pay full benefits through the year 2052. We must abide by CBO's numbers. Other estimates will be made by other people, and the administration has their own, but we in the Congress must abide by CBO.

CBO says that Social Security can pay full benefits through the year 2052. After that, CBO says, annual Social Security revenues are sufficient to pay about 80 percent of benefits. That is after 2052.

Clearly, however, we need to make changes so that that result in the year 2052 is not reached, so that full benefits are available for all Americans, all seniors who retire past that year.

We should make these changes sooner rather than later, that is clear, because the price for the solution will be much less today than if we attempt to address it years down the road.

But I want to also make clear, we do not need to privatize Social Security to save it. That is a very key point. We do not have to privatize Social Security in order to save it.

Unfortunately, the President has called for privatizing Social Security. The President proposes to allow workers to divert 4 percent of their earnings into private savings accounts.

Now, common sense teaches us that when you want to get out of a hole, first you stop digging. But the President's plan would dig Social Security into a deeper hole.

He has admitted that private accounts do not solve Social Security's problems, but he should honestly go a little bit farther and say not only do they not solve Social Security's long-term financial problems, but they also make the long-term financial problems much worse. Not only do they not help solve the problems, they make long-term problems much worse.

According to CBO, Social Security can pay full benefits, as I mentioned, until 2052. But under the President's plan, the date when full benefits can no longer be fully paid comes 11 years earlier in 2041.

Where does the money come from to put into these private accounts? Where does that money come from? Well, the Federal Government would have to borrow it, borrow more, much more, at a time when, for the second fiscal year in a row, the Federal budget deficit hit an all-time record of $412 billion.

Indeed, under the President's plan, the Federal Government would have to borrow roughly $5 trillion more during the first 20 years of its plan. Today, the entire debt held by the public is roughly $4.5 trillion. The President's plan would more than double that, to almost $10 trillion.

Now, how much is $10 trillion? What does that really mean? Well, one way to look at it, is this. That is $34,000 for every person in the United States today. $34,000 for every man, woman and child in the United States today, saddled with that $10 trillion debt.

How much of that money will be borrowed from foreign investors and foreign central banks? A lot. I think the current figure is, about 37 percent of our debt is held by foreigners and foreign central banks.

Well, someone might ask, what difference does that make? It makes a big difference. What effect will that have on American foreign policy when foreigners own so much of our debt? We start to negotiate one foreign policy issue after another.

Get a little hint from China, a little hint from North Korea, from Japan, about what their issue is and what they may or may not do with respect to their holdings of U.S. debt.

It puts us in a very precarious position, to say nothing of the precarious financial position our country would be in if those dollars are withdrawn or those securities are withdrawn by foreign governments.

We are not saying they will, but we do know there have been hints in the past where Korea, I think, and another country indicated they may pursue that. We cannot put ourselves in the position of so much national debt.

Now, the President has not publicly taken the position on how to eliminate Social Security's long-run shortfall and how to make up for the additional shortfall caused by his privatization plan.

But the President and his spokespeople have implied that there is a benefit proposal that they might support. What is it? First, as you may recall, the President, indirectly through his 2001 Social Security Commission and a memo by a high-ranking White House official, considered price-indexing initial benefits.

That proposal would deeply cut benefits for everyone and would, according to the Congressional Research Service, eventually eliminate Social Security as we know it.

As you can imagine, once those details were understood, the President and the White House stopped talking about price-indexing.

Well, more recently, the President and White House officials have praised a proposal called Progressive Price-Indexing. In a March 16 press conference, President Bush said some positive things about an idea that has been suggested by one of today's witnesses, Robert Pozen.

The President said, "One of the interesting ideas was by a fellow, by an economist, name of Pozen. He came to visit the White House. He didn't see me, but came and tossed some interesting ideas out, talking about making sure the system was progressive."

Well, under this proposal, low-income workers are left untouched, but everyone else has their Social Security benefits cut. Instead of eventually eliminating Social Security, most workers would eventually receive the same Social Security benefit, regardless of the amount of money contributed to the program.

Both of these proposals are bad policy and fundamentally alter important features of Social Security, and would result in deep

benefit cuts for middle-income and upper-middle-income folks, especially middle-income Americans.

The benefit reductions under Mr. Pozen's plan would be deep, and they would keep getting deeper as we move further into the future. According to the Center on Budget and Policy Priorities, someone who earns $59,000 in 2005 and retires on down the road—I do not have the exact date here—that person will receive a 42-percent cut in benefits. Forty-two percent. That is for persons earning $59,000 today.

So, this plan is not a compromise. The plan is not progressive. The Pozen price-indexing proposal would cut benefits deeply for retirees who rely on them.

Now, some may ask, what about the income that retirees would get from their private accounts? Would the earnings in the private account not be greater than the reductions in the benefits? The answer is no.

Even though retirees get to keep the money in their private accounts, they have to give most of it back, maybe all of it back, and maybe even more than all of it back in the form of a second cut in the Social Security benefits.

This second cut is on top of the benefit cut from switching to price-indexing. The size of the President's second cut would be equal to the contributions that were made to the workers' private accounts, plus earnings on those contributions, of 3 percent plus the rate of inflation. In effect, this second cut is a privatization tax.

Because of this privatization tax, if we adjust the projected rate of return on stocks for risk, as required by the CBO—and again, we must go by CBO numbers—participating in the private accounts would do you no good. Put another way, the private accounts do not offset any of the losses for the price-indexing plan that the President thinks is a good idea.

Well, what if stocks were not adjusted for risk? Would workers be able to make up for the cuts? Our analysis shows that the stock market would need to earn at least 10.9 percent over the next 40 years for workers to be able to make up for the cuts due to price-indexing and the privatization tax. That is in nominal terms. Most people think of the stock market in nominal terms, not real terms.

But most experts agree that a 10.9 percent return on stocks over the next 40 years is highly unlikely. Social Security actuaries assume the stocks will return 9.5 percent.

Top Wall Street economists, according to an article by the *Wall Street Journal* in February, are expecting stock returns over the next 40 years to be around 7.6 percent. Again, that is nominal. Most people think of the stock market in terms of nominal. They do not add in rate of inflation.

Let me also say a few words about the plans of our other witnesses. Peter Orszag, in conjunction with Peter Diamond, has produced a plan that would not privatize Social Security, it would make Social Security solvent beyond 75 years, but with no gimmicks.

I do not favor Mr. Orszag's plan, but I want to thank him and Mr. Diamond for constructing their plan and putting it into the debate.

In contrast, Mr. Ferrara's privatization plan sets back the debate. His plan includes enormous, but unspecified, spending cuts in the Federal budget, as well as other gimmicks. Without these spending cuts and gimmicks, his plan would raise Federal debt held by the public to $26 trillion at the end of 75 years.

Mr. Tanner's privatization plan is also extremely problematic. It includes full price-indexing for workers who choose not to have a private account, which would lead to benefit cuts of about 50 percent for an average earner retiring in 2075.

These privatization schemes, like the President's plan, would undermine that "measure of protection to the average citizen" that President Roosevelt signed into law nearly 70 years ago.

Mr. Chairman, to address Social Security's long-term financing, we need to reject this drastic privatization change. The carve-out takes money away from Social Security. It does not add to Social Security, but takes it away.

First, the President needs to leave privatization behind. He needs to stop digging that hole. Then, and only then, can we move on to strengthen that critical measure of protection that is Social Security.

The CHAIRMAN. Thank you, Senator Baucus.

As is our practice in this committee when we have Republican or Democratic leaders of the Senate on the committee, we give them an opportunity to speak when they can be here.

So, I would call on Senator Frist at this time, and then we will go to the panel.

Senator Frist?

OPENING STATEMENT OF HON. BILL FRIST, A U.S. SENATOR FROM TENNESSEE

Senator FRIST. Thank you, Mr. Chairman. I will be very, very brief.

I want to congratulate you and Senator Baucus for holding the hearing today. At the end of the week, the President's 60 days and 60 stops to discuss Social Security with the American public will come to an end.

I believe the President has made the case that we need to modernize Social Security and that we do need to do it now. I believe it is our responsibility. This important hearing today begins the second phase of this dialogue with the American public. We all know that we have a problem; now let us discuss the solutions.

This is the start of the legislative process to reform Social Security, and once again I thank the Chairman and the Ranking Member for beginning that process today. I thank all the witnesses for their contribution to this debate.

I am convinced that, within the spectrum of proposals discussed today, lie the seeds for a solution that the full Senate can consider and which will preserve retirement security for future generations to come.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Frist.

Now, to our panel. Mr. Peter Ferrara, senior fellow, Institute for Policy Innovation, director of the Social Security Project, Free Enterprise Fund, Washington, DC; Mr. Michael Tanner, director,

Project on Social Security Choice, Cato Institute, Washington, DC; Mr. Robert C. Pozen, chairman, MFS Investment Management, Boston, MA; Mr. Peter R. Orszag, Joseph A. Pechman Senior Fellow, Economic Studies, The Brookings Institution here in DC; and Ms. Joan Entmacher, vice president for Family Economic Security, National Women's Law Center, Washington, DC.

We will go in the order in which you are seated there. So, starting with you, Mr. Ferrara.

STATEMENT OF PETER FERRARA, SENIOR FELLOW, INSTITUTE FOR POLICY INNOVATION, DIRECTOR OF THE SOCIAL SECURITY PROJECT, FREE ENTERPRISE FUND, WASHINGTON, DC

Mr. FERRARA. Thank you, Mr. Chairman.

My goal is to make Social Security reform a major net gain for workers, not a loss. Personal accounts give us the opportunity to do that. In fact, if we do personal account reform right, we can achieve all the major social goals of Social Security better than the current system does today.

In fact, if you do it right, the personal accounts can be a historic, major breakthrough in prosperity for average working people.

The bill that I think does this the best, the bill I worked on very closely with members, was the bill introduced by Senator John Sununu in the Senate, and Representative Paul Ryan in the House.

The major provisions of that bill are as follows. We try to make the bill, first of all, progressive. We try to make the option progressive. So, out of the 12.4-percent Social Security payroll tax, we allow workers to take 10 percentage points on the first $10,000 of wages they earn each year, and 5 percentage points on everything above that. So, it works out to an average of 6.4, or about the employee's share.

Now, the reason we do that is because, under the current Social Security system, low-income workers get a higher rate of return than higher-income workers. So, if you just say, all right, you can just take a flat 6 percent, for example, well, then the high-income workers who have low returns on their Social Security, the market returns are flat, so high-income workers—say, if you just take a flat 6 percent—would gain an enormous amount and low-income workers would gain little, if anything, because Social Security returns are higher for low-income workers.

So when you go to the market returns, if you do not have a progressive feature in it, you just have a flat option, then the high-income workers would gain enormously and the low-income workers would gain very little.

Under our plan that we developed for this legislation, we developed that progressive option. All workers gain roughly the same amount. The high-income workers do gain, but low-income workers gain at least as much in percentage terms as high-income workers. So, we try to make this mirror the progressivity of Social Security so all workers would gain an equal amount.

Now, when you exercise the personal accounts, benefits payable from the tax-free accounts, it would substitute for a portion of Social Security benefits based on the degree to which workers exer-

cised the account option over their careers. This is how the system achieves solvency.

If you exercise the option, you substitute your account benefits for part of your retirement benefit. But this is not the Bush plan formula. We designed the formula in this plan explicitly so workers would gain a lot.

The whole idea behind this is, if personal accounts do achieve what we say they can achieve, this can be designed so workers would gain. So, the formula is designed so workers gain a lot.

Workers choose investments by picking a fund managed by a major private investment firm from a list officially approved for this purpose and regulated for safety and soundness, just like the Federal Employee Thrift System.

The accounts are backed up by a safety net, guaranteeing that workers would receive at least as much as Social Security promises under current law. This is unique to this bill. This maintains the social safety net of the current system. Any good plan should do that.

We guarantee that, if you stay in the current system, you get the promised benefits. If you choose the personal accounts, you have a safety net that guarantees you at least will get the promised benefits under current law.

Why does that work? Well, first of all, we think that accounts are so attractive, no one will stay in the old system. The returns that workers can get in these personal accounts are so much higher, the market returns are so much higher than what Social Security promises, that we think it is very unlikely that, over a lifetime of savings and investment, you could ever have returns that fall as low as what Social Security promises.

So, you see the key here. This is why this is not a privatization plan. This maintains the social safety net of the current system and maintains the social framework for investing. It makes it easy for unsophisticated investors to participate.

You see this safety net guarantee is really very critical because it maintains the defined benefits of the current system within the new structure of personal accounts. If you do not do better with the defined contribution benefit of the personal account, you still have all the defined benefits of the current system.

But we are so sure that workers are going to do better, much, much better, that we think, why not, if you truly believe that, as many personal accounts advocates say, then why not just guarantee the current benefits, which is what the system does.

The chief actuary of Social Security has scored this as achieving full and permanent solvency, and that is because it shifts so much of the benefit obligations to the accounts, that with the 6 percent still going into Social Security, it is in permanent surplus.

At the same time, workers are going to get even better benefits. Also, it was because, in this plan, there is no permanent borrowing in this plan. There is short-term borrowing, but then the system falls in a surplus.

When it falls in a surplus, the surpluses are specifically designated, set aside to pay off all the borrowing, so there is no net borrowing over the lifetime of the reform plan.

So we achieve all these goals at the end of the day with the full benefits of market returns. Workers will actually be better off. That is what we should try to achieve with this reform.

The CHAIRMAN. Thank you, Mr. Ferrara.

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

The CHAIRMAN. Now, Mr. Tanner?

STATEMENT OF MICHAEL TANNER, DIRECTOR, PROJECT ON SOCIAL SECURITY CHOICE, CATO INSTITUTE, WASHINGTON, DC

Mr. TANNER. Thank you, Mr. Chairman and members of the committee. I very much appreciate the opportunity to appear before you today. I congratulate the committee on holding this hearing, not the least because I hope it is an indication that we have moved beyond the sort of sterile and unproductive debate about whether or not Social Security is facing a crisis or just a big problem.

Because, as frightening as Social Security's financial problems are—and they truly are frightening—the program begins running a deficit in just 12 years. Overall, it is facing unfunded obligations of something like $12.8 trillion.

I believe that Social Security reform must be about more than just achieving technical solvency. Now, that is not to downplay the importance of solvency. Any responsible Social Security reform will restore the program to sustainable solvency.

But, while necessary, solvency is not sufficient. We should seize this opportunity to build a better program and one that is based on fundamental American values like ownership, inheritability, and choice.

The fact is, under the current Social Security system, you have no legal, contractual, or property rights to your benefits. What you get from Social Security at retirement is entirely up to 535 members of Congress.

But personal retirement accounts would give workers ownership and control over their retirement funds. The money in their accounts would belong to the workers, money that the politicians, with all due respect, could never take away. In short, workers would own their retirement.

And because you do not own your Social Security benefits, they are not inheritable. Millions of workers who die prematurely are not able to pass anything on to their loved ones. But personal retirement accounts would enable workers to build a nest egg of real inheritable wealth.

Finally, I believe that choice is part of the essence of America. Yet, when it comes to retirement, we are forced into a one-size-fits-all cookie-cutter retirement program, a system that cannot pay the benefits of this promise and under which we have no right to the money we paid in.

With personal retirement accounts, workers who want to remain in traditional Social Security would be free to do so. Those who do not believe that private accounts can provide better returns or better benefits could stay in the current Social Security system, but those workers who want a choice to save and invest for their retirement would have that option.

With this goal in mind, not just to restore Social Security to solvency, but to do that while building a better retirement program that gives workers ownership and control over their money, scholars at the Cato Institute have developed a comprehensive proposal for creating privately invested, personally owned accounts as part of an overall Social Security reform.

This proposal is the basis for legislation, H.R. 530, that has been introduced by Representative Sam Johnson of Texas, Representative Jeff Flake of Arizona, and at this point, I believe, about 10 cosponsors in the House.

Under this proposal, workers under the age of 55 would have the option of diverting their half of the Social Security payroll tax, 6.2 percent of wages, to an individual account.

The employer's portion of the payroll tax would continue to be paid into the Social Security system to provide survivor's and disability benefits, which would remain unchanged from the existing system, as well as to partially fund continued benefits for those already retired or nearing retirement.

Workers choosing the individual account option would forego any future accrual of retirement benefits under Social Security, the retirement portion only. However, those workers would have already paid into the existing Social Security system and their already accrued benefits would be recognized in the form of a recognition bond which they would receive which would be their property and which would jump-start their individual account.

Workers who do not choose individual accounts would be free to remain in the current Social Security system. However, these workers' benefits would be adjusted for prices, rather than as currently adjusted for wages.

This is not a benefit cut. No worker in the future would receive lower benefits on an inflation-adjusted basis than workers retiring today.

In fact, we know that the promised level of benefits in the future simply cannot be paid, so to compare any reformed Social Security plan to the promised benefits under Social Security is to compare reality to a fantasy. Those benefits cannot be paid. In fact, if Congress does nothing, those benefits, by law, will be reduced by some 26 percent.

This plan calls for establishing a new minimum benefit under Social Security equal to 100 percent of the poverty level, which is higher than the current minimum benefit under Social Security today and which would ensure that no senior ever ends up in poverty.

This plan has been scored by the Social Security Administration's Office of the Actuary as obtaining solvency, and I have included not only the actuarial memo, but also an analysis that we have released today on that scoring.

Summarizing it, however, it shows that our proposal, as embodied by the Johnson-Flake legislation, can provide large individual accounts, restore Social Security to permanent, sustainable solvency, and do so in a fiscally responsible manner.

We acknowledge that there are up-front costs to doing this, and we can discuss those in more detail. However, those costs not only

are less than for other large account plans, but they are more than offset eventually by the savings to the system.

If our goal in creating Social Security reform is not just solvency, but to give workers something that is really theirs, to allow ownership, control, inheritability, and choice, then I would suggest that that must be a crucial part of any Social Security reform.

Thank you very much.

The CHAIRMAN. Thank you very much.

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

The CHAIRMAN. Now, Mr. Pozen?

STATEMENT OF ROBERT C. POZEN, CHAIRMAN, MFS INVESTMENT MANAGEMENT, BOSTON, MA

Mr. POZEN. Thank you, Mr. Chairman, for inviting me, and thank you for holding this hearing. I believe that this hearing can be the beginning of a refocusing of the Social Security debate on solvency, which must be the main agenda.

So far, we have been talking a lot about the desserts, the personal accounts, and we have not been wanting to talk much about the spinach, the solvency, and I think it is great that we are going to get to the spinach.

Progressive indexing, in my view, is an approach to solvency, first and foremost, and I would like to explain that. Second of all, I would like to talk about some of the issues that Senator Baucus raised, some criticisms which I think could be dealt with.

Then, third of all, and probably most importantly, I'll explain how progressive indexing could be combined with a number of different approaches. It is not necessarily locked into a carve-out personal account.

So, first, progressive indexing is pretty simple. We divide the world into low-wage workers, defined as $25,000 per year or lower in average career earnings, high-wage defined as $113,000 per year and higher, and middle-wage, in between $25,000 and $113,000 per year.

We preserve the current benefits and the future benefits for all low-wage workers, all workers who are in retirement, and all workers who have not yet retired but will retire before 2012.

For the high-wage workers, we grow their benefits by price-indexing rather than wage-indexing their initial benefits, and then we have a proportional formula for the middle-wage worker in between.

What is the justification for this differential indexing? We are trying to protect low-wage workers because they need Social Security, as Senator Baucus said. For many of them, that is the only retirement income that they have. Most importantly, they do not have IRAs and 401(k)s, which obviously were not contemplated at the time Social Security was enacted.

IRAs and 401(k)s are held primarily by high-wage and middle-wage workers. These are tax-subsidized. In 2004, the tax subsidy for those accounts was roughly $55 billion.

So if we look at overall government support for retirement programs, we need to treat low-wage workers a little better in Social Security because they are more dependent on it and they do not have these other retirement programs.

From a solvency point of view, progressive indexing has been scored a variety of different ways. But I think it is fair to say that, roughly, progressive indexing alone cures about 70 percent of the long-term deficit of Social Security. It brings that deficit down from a present value of about $3.8 trillion to $1.1 trillion, and most importantly, at the end of the 75-year period, it is financially self-sustaining.

Now, second of all, let me deal with the criticisms of progressive indexing. I think some of them are well thought out, but can be dealt with.

First is the criticism that if you continue progressive indexing to the next century, you would ultimately get to a flat benefit. I think that is correct. However, I never contemplated going that long; I stopped progressive indexing at 2079, the end of the period for measuring system solvency. At that point, there is a 20-percent difference in the benefits between high- and low-wage workers.

But if you think that is not enough differential, you could stop progressive indexing at 2055, you can stop it at 2061, so you can calibrate it to maintain more of a difference between low-wage and high-wage workers. Progressive indexing already has a difference, but you can increase that difference.

A second criticism has been made about the relationship between wage and price growth over 75-year periods. If wage growth grows faster than anticipated by the Social Security actuaries, then we probably would not have to do as much in terms of price-indexing.

Again, that is probably true. If we could exactly figure out what wage growth was going to be over the next 75 years, it would be a lot easier. But we could, through legislative draftsmanship, say something like wage-indexing minus 1 percent a year for the high-wage workers. Thus, if wages went up a lot faster than prices, you would not have to have as much benefit slowdown for the high-wage workers because you would not need it.

The third criticism, and this I think is probably the most important one, is that progressive indexing allegedly involves "benefit cuts." I would agree with Michael Tanner in saying we can only have a benefit cut if someone is entitled to something which we can afford to pay. The future generations are not legally entitled to the schedule of Social Security benefits in the future, and we cannot afford to pay for this schedule.

I give as an example a median-wage worker who would get $14,400 in annual benefits if he or she retired today at 65. In 2055, under progressive indexing, in constant dollars, that worker would get $17,400.

So in terms of purchasing power, the purchasing power of the Social Security benefits of the median worker would go up. Yes, that median worker would get less than scheduled benefits, but the reality is, we do not have enough money to pay the scheduled benefits.

Finally, I want to discuss progressive indexing in combination with other approaches. If you do not want to have as much benefit slow-down (which is a more accurate term than benefit cut) as you have in progressive indexing, then you are going to have to take other measures like raising payroll taxes if you want to reach solvency. Peter Orszag has a very honest proposal, and he has ex-

plained what increases in payroll taxes would be needed to reach solvency. The question is, are we prepared to increase payroll taxes?

I am personally against the proposals that raise the base from $90,000 to $150,000 and apply to all those earnings a 12.4-percent tax rate. That is a tremendous hit on those people, and I think it is unfair because somebody making $800,000 would not bear the brunt of raising the base.

I think if we have an increase in payroll taxes, it ought to look more like the Medicare model of 2.9 percent on all earnings above the $90,000 base, and all the way up.

But then Congress and this committee will have to come to grips with what Social Security benefits would be associated with that payroll tax increase, because those people will want benefits.

One idea that I have discussed with some Senators is: if we had a payroll tax increase of 2.9 percent above the $90,000 base, we could create a personal account out of that 2.9 percent, say 2 percent, while the rest would go towards solvency. That would be a way in which you would avoid taking any existing monies out of the system; you would be taking out only new monies.

I included in my testimony how progressive indexing could work with the President's type of carve-out account. Yet there are some people who complain about the borrowing involved with carve-out accounts.

It is true: if all you do is create a carve-out personal account, you will increase government borrowing. But I think that the numbers—illustrated by a graph, Appendix B in my testimony—show that if you adopted progressive indexing along with a 2-percent carve-out account, you actually reduce long-term borrowing by about $2 trillion over the 75-year period.

My last point is that Peter Orszag has suggested a number of very good proposals for add-on accounts. This can be another approach to Social Security reform. If you adopt progressive indexing to address the solvency issue, then you could take some of the savings from this approach and put them into add-on accounts.

But again, if all we do is create or enlarge add-on accounts, if all we do is create a new "kitty" account or create a new type of IRA, these will just cost money; they will not help the solvency of the Social Security system.

The key here is to address solvency, first and foremost. I think progressive indexing is a fair and reasonable way to do that. While there are criticisms, they can be dealt with by legislative drafting. After we address solvency, then we can figure out what should be the sweeteners, what the package should look like—that is where you would get to personal accounts.

Thank you very much.

The CHAIRMAN. He got more time than the rest of you, if any of you have a minute or two and you want to add on something if we get done here.

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

The CHAIRMAN. Mr. Orszag?

STATEMENT OF PETER R. ORSZAG, JOSEPH A. PECHMAN SENIOR FELLOW, ECONOMIC STUDIES, THE BROOKINGS INSTITUTION, WASHINGTON, DC

Mr. ORSZAG. Thank you very much, Mr. Chairman.

Financial planners suggest that people need about 70 percent of what they had been living on before retirement in order to enjoy a reasonable retirement after they leave the labor force. For average workers, Social Security provides about 35 percent of previous wages, which means you need about another 35 percent on top of Social Security.

It is very important to think in terms of tiers: a core tier provided by the Social Security system which provides benefits that are protected against inflation, against financial market collapses, and that last as long as you are alive; and then a secondary tier—which, by the way, is where accounts belong, and we already have them—401(k)s and IRAs.

My first point is, I think we can make 401(k)s and IRAs work a lot better. This is something that both sides of the Social Security debate should agree on. We should come together immediately to take the common-sense steps that would make our 401(k) and IRA accounts work a lot better.

For example, evidence shows that if you are in a 401(k), unless you opt out, as opposed to having to affirmatively sign up for the plan, participation rates skyrocket, even among very low earners. For new employees with under $20,000 in earnings, you go from under 15-percent participation rates to 80 percent.

The same thing with regard to tax refunds. Tax refunds amount to more than $200 billion a year. We currently make it very difficult to get part of a tax refund into an IRA.

That should be the easiest thing in the world. You should be able to check a box on your tax return and have part of your tax refund going into an IRA. There is a lot that we can be doing. This committee can come together and get those reforms done and substantially bolster retirement security for millions and millions of Americans.

Now, although we can do a lot to bolster accounts on top of Social Security, introducing accounts within Social Security does not make any sense. First, it does not help to restore solvency, and if anything, as Senator Baucus has already pointed out, would likely harm solvency.

The way that these plans work is that you get a dollar into your account today, but then have to pay back the dollar, plus interest, at retirement through reduction in your Social Security benefit. That is effectively like a loan from the Federal Government to a worker.

In fact, in the *Wall Street Journal* this morning, Arthur Leavitt, the former SEC chairman, wrote, "Every dollar you take out of traditional Social Security and put into a PSA must be paid back out of your Social Security benefit, plus interest.

"If this sounds a lot like margin investing, it should not be a surprise, since the PSA plan is modeled on that concept. . . . To come out ahead then, an investor would have to earn a rate of return that exceeds the interest on the loan, plus expenses." The interest rate on the loan would be 3 percent, real.

Professor Robert Shiller at Yale, one of the Nation's leading financial economists, suggests that under his central projections, 70 percent of the time you would wind up worse off as a result of participating in these accounts.

Again, I want to emphasize, at best, they are actuarially neutral. Even if they were actuarially neutral over the very, very long term, furthermore, they create a huge cash flow problem, because the money goes out to a worker today and would not be repaid, for young workers, for 30, 40, or 50 years. Meanwhile, the government is out the cash. That is what creates this massive increase in debt that is associated with these plans.

Now, you could assume that cash-flow problem away, which many proponents want to do, but it is still there. Furthermore, the account proposal does not make any sense even apart from that cash-flow problem. If it were combined with progressive price-indexing, it would take the core tier of retirement income for an average earner from about 35 percent of previous wages down to below 15 percent of previous wages, and that is a bottom-layer foundation of retirement security that is just too small, in my view, to make any sense.

Now, some people have said that the accounts are a sweetener, they help the pain of restoring solvency go down. But I do not actually think that this argument is correct.

Goldman Sachs recently wrote that, "In essence, the 3 percent real rate offset on the accounts represents a loan from the Federal Government to the account holder to fund the personal account. This is not an attractive proposition."

From what I can tell, the American public agrees with Goldman Sachs. A sweetener only works if it actually helps to make the medicine go down. The accounts are not sugar. They are like trying to convince your kid to eat the spinach by offering a turnip for dessert. It is not proving to be the sweetener that everyone is suggesting that it would be.

A final point. Since accounts do not help to restore solvency, and if anything, make it worse, there are truly only two options: benefit reductions and revenue increases. Every single plan that fails to dedicate any additional revenue to Social Security necessarily means larger benefit reductions.

In that context, I want to bring up an issue that is under consideration by the Senate now, which is the estate tax. If we reformed the estate tax and froze it at its 2009 thresholds, in which $7 million per couple would be tax-free, took that revenue and dedicated it to Social Security, you would eliminate one-quarter of the long-term problem facing Social Security.

You would obviate the need for $1 trillion in benefit reductions that would otherwise be necessary. For an average 20-year-old worker today, that is $1,500 a year in benefit reductions that would no longer be necessary.

So the choice is very simple. Do you want to take that $1 trillion and increase the after-tax inheritances received by very wealthy children, or do you want to attenuate the need for benefit reductions or payroll tax increases within Social Security? Every dollar of estate tax revenue that is not dedicated to restoring Social Secu-

rity to solvency is a dollar more of benefit reductions or payroll tax increases that are necessary.

Mr. Chairman, I see that my time is up. My written testimony also goes through some of the shortcomings in progressive price-indexing, and I would be happy to answer questions about that.

Thank you very much.

The CHAIRMAN. Thank you.

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

The CHAIRMAN. Now, Ms. Entmacher?

STATEMENT OF JOAN ENTMACHER, VICE PRESIDENT FOR FAMILY ECONOMIC SECURITY, NATIONAL WOMEN'S LAW CENTER, WASHINGTON, DC

Ms. ENTMACHER. Thank you, Chairman Grassley, Senator Baucus, and members of the committee. Thank you for this opportunity to testify on behalf of the National Women's Law Center.

Social Security is not just for retired workers. It is a safety net for families at all stages of their lives. Half of all Americans who receive Social Security get benefits as disabled workers, children, spouses, and surviving spouses.

This committee is considering proposals to achieve solvency by cutting Social Security benefits, and to create private accounts within Social Security by cutting Social Security some more, and adding trillions of dollars to the national debt to do it.

Such proposals would hurt the economic security of workers when they retire, and all Americans who would be burdened by that debt. But those issues have received some attention, and Peter Orszag mentioned some of them.

My testimony will focus on the impact of such proposals on the other half of Social Security beneficiaries, who too often are overlooked in these discussions and are, overwhelmingly, women and children.

Concerning solvency, you can achieve sustainable solvency simply by cutting benefits deeply enough, but that defeats the whole purpose of Social Security. It does not fix a problem, it makes it worse for the millions of Americans who rely on Social Security.

Yet, that is essentially the approach reflected in both the price-indexing and progressive price-indexing proposals. Both would cut benefits deeper and deeper over time, both for those who choose a private account and those who do not, for average earners, and also—and this is a point that Mr. Pozen did not highlight in his testimony—for disabled workers, children, spouses, and surviving spouses. That is how his plan reduces the shortfall by 70 percent.

You may hear assurances that benefits for disabled workers and survivors will be protected under some plan, but you need to look carefully at the details of how that is to be done.

It takes money to provide that protection. Where is it coming from? Are someone else's benefits going to be cut more deeply? Social Security uses the same formula to determine all benefits, so cutting some benefits but not others raises new issues of adequacy and equity.

What would happen to spouses and surviving spouses, if Social Security is shifted to a system of private accounts, is a question of critical importance to women, yet the administration has said noth-

ing about how its plan for private accounts would affect these critical benefits.

Under the President's private accounts proposals, workers who shift payroll taxes from Social Security into a private account must pay the money back with interest out of their Social Security benefits, on top of any other benefit cut to achieve solvency.

The concept is that the worker will get the account in exchange, but Social Security benefits for spouses and widows are based on the worker's benefit. So when his retirement benefits are cut because he chose a private account, benefits for spouses and widows could be cut as well.

But under the administration's plan, it does not appear that a spouse or widow would necessarily be guaranteed anything from his account, although she is likely to get stuck paying off the debt incurred to create it.

The President has said that under his plan workers could be required to purchase an annuity to make sure that they do not spend their accounts too quickly and end up poor, but the President has not said that his plan would require a married worker to purchase an annuity with joint and survivor protection for the surviving spouse. There may be a reason for the administration's silence on that issue.

Social Security can provide spousal benefits in addition to the worker's benefit, but private accounts represent a fixed pool of assets. Buying an annuity with joint and survivor protections rather than a single life annuity would mean lower payments for the account holder, especially if the spouse is a few years younger.

And remember, these annuities would not be on top of Social Security, but a replacement for it, so there simply might not be enough in the account—very likely would absolutely not be enough in the account—to provide adequately for one worker, much less for a worker, a spouse, and any surviving children.

My written testimony also talks about the impact on benefits for young widowed mothers and spouses caring for children of disabled or retired workers. These benefits are especially important to African American and Latina women and their children.

Their Social Security would be cut under many proposals, but the small account of a worker who died or was disabled at a young age would provide little assistance to such a woman, even if, as a widow, she inherited the account, which she might not because the President has said repeatedly that accounts could be left to anyone that the worker chose.

It would be small even if she could access the assets in the account, which she might not be able to, because the President has said accounts would have to be saved for retirement.

My written testimony raises other issues and also lays out some alternative ways that Social Security could truly be strengthened. I urge the committee not to weaken this program that is so vital to American families.

Thank you.

[The prepared statement of Ms. Entmacher appears in the appendix.]

The CHAIRMAN. I would like to have the attention of the committee for a minute, particularly on the Republican side. Senator

Baucus and I have been informed, just as soon as the vote is over, that he and I are expected to attend a meeting that the leadership has called on the highway bill.

Because I do not want to adjourn the meeting and put our witnesses out of their valuable time, would somebody on the Republican side vote at 11:45, then come back and chair this while Senator Baucus and I are at our meeting? I would like to have somebody volunteer to do that.

We will have our first round of questions now. I will not name everybody, but this is the order for the first few: Baucus, Hatch, Conrad, Lott, Bingaman, Kyl, Kerry. There will be 5-minute rounds, and they will apply to the Chairman as well.

I am going to start with Mr. Pozen. In your testimony, you state—and everybody remembers your saying this—that solvency is the spinach that needs to be eaten before we get to the dessert of personal accounts.

I would like to have you further explain why you came to that conclusion.

Mr. POZEN. I think that personal accounts are ways to supplement people's retirement income. If you think of an add-on account, that is a way to supplement Social Security in retirement. If you think of a carve-out account, that is a way you are likely to get a better return on a portion of your payroll taxes than you would get under Social Security.

I have run 35-year numbers for a balanced account, a 60/40 account, which show actual returns between 1949 and 2004. If you look at 35 years, the actual nominal returns were 7.43 percent to 10.48 percent. If you subtract 3 percent for inflation, they were in the 4.5 to 6 percent range for real returns.

So in my view, you have a pretty good chance—not guaranteed—of getting more than 3 percent real through a balanced account over 35 years. So, these are all ways to use personal accounts to supplement retirement income. But I think that you must deal first with the benefit issue: we are growing benefits very quickly through wage-indexing, and we just cannot possibly afford it. We have to come to grips with the growth of benefits, and that has to be our first agenda.

I have proposed progressive indexing. Other people have suggested different approaches. There is no easy solution here. But these are not benefit cuts; these are slowdowns in the growth of benefits.

People's benefits will be growing in terms of real purchasing power. I think we have to come to grips with that. We have to decide whether there is going to be new revenue that is going to be combined with benefit reforms, and then we can figure out what sort of personal accounts would be complementary to these changes. If you do not figure out solvency first, you cannot even have a good, intelligent discussion about what should be the personal accounts.

The CHAIRMAN. Again to you, Mr. Pozen. You raised a very interesting point on page 4 of your testimony about those who criticize progressive indexing on the one hand, while advocating an increase in taxable wage base on the other hand.

As you point out, the net effect is essentially the same. However, in your opinion, if people were given a choice between paying higher taxes or receiving lower benefits, which do you think they would choose?

Mr. POZEN. I think the high-wage worker would rather have slower growth in benefits than face a tax increase. Some people criticize progressive indexing by saying that the higher-wage worker will not get enough benefits, but those are many of the same people who suggest that we should have higher payroll taxes. I think that position is a bit inconsistent.

The CHAIRMAN. Ms. Entmacher, on the first page of your testimony you state that restoring Social Security solvency by reducing promised benefits is like curing a stubbed toe by cutting off the foot.

But on page 10, you state that the Social Security financing shortfall is not a crisis because it can pay 70, 80 percent of promised benefits after the trust fund is depleted, or let us say, until the cash flow is equal to benefits, it would be 70 or 80 percent.

I would like you to explain why a gradual reduction in promised benefits for newly eligible beneficiaries is equivalent to an amputation, but a sudden 20 to 30 percent across-the-board reduction for everybody is not a crisis.

Ms. ENTMACHER. Because, as Mr. Orszag explained, the purpose of Social Security is to guarantee people a basic part of their pre-retirement income when they reach retirement age.

Right now, Social Security replaces about 40 percent of their pre-retirement income for the average earner. What progressive price-indexing, if you want to call it that, or price-indexing does is to shrink that so that workers in the future would have a lower and lower standard of living.

They could count on Social Security not for 35 or 40 percent of their pre-retirement income, but for 20, or 15, or 10 percent. Their standards of living would drop. Remember, at the same time as their wages went up, they would be paying higher and higher taxes. They would be getting less.

So, these benefit cuts that are proposed under the progressive price-indexing plan are actually deeper than the cuts that would be required if we did nothing.

And I am not suggesting that Congress do nothing. I am just saying that, to rely on cutting benefits to restore solvency to the Social Security program, undermines its fundamental purpose.

The CHAIRMAN. That brings up a point. I appreciate the fact that you are not suggesting doing nothing. But all I hear from members of Congress, and from people on the outside, is no plan.

I want to talk to people about plans. I do not even care if you do not talk to me. Those of you that are bad-mouthing every other suggestion out there, suggest your own plans. You do not have to talk to me. I am willing to do it, but we need to get some discussion going. Doing nothing is not an option, because doing nothing is a cut in benefits.

Grandpa Grassley gets Social Security, but my granddaughter, when she retires 56 years from now, if we do nothing, is going to get this cut that you are talking about. You can rationalize it all

you want to, but, by golly, she is entitled to what I got because her dad, and younger people, are paying for it.

Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman.

I think it is worth underlining that everyone in the Congress wants to address the long-term financial problems facing Social Security. I mean, that is a given.

The question is how to get there. There is a kind of tone here from some of the witnesses, at least the last three, that private accounts are a bit of a problem here.

Some called it dessert. Frankly, I do not see how it is a dessert. It is not a dessert if it makes the problem worse. Desserts, the way I think of the term, is something on top of a wonderful meal. You get a little sweetener in addition. This is not a sweetener in addition.

These work in a way which make the long-term financial problem of Social Security worse. In fact, the President has even admitted that they do not help at all. The correct analysis is that this makes it worse.

So, asking Mr. Pozen, why should we not just deal with private accounts? Let us just start talking. You mentioned yourself, the bigger issue is the long-term solvency. Why do you not just recommend that all of us agree to oppose carve-out accounts?

If we want to find a way to add on, Mr. Orszag suggested, I think, some pretty creative ways, with what is done with income tax refunds or 401(k)s, and so forth. In fact, the real problem is insufficient retirement income. We want more retirement income, not less.

So why do we not just work to try to find a way to address the long-term problems facing Social Security and not pursue this question of carve-out accounts, which make the problem worse, but rather, if we want, pursue some add-on accounts to increase retirement income?

Mr. POZEN. As I said, I am not against add-ons, but I would not be able to agree to rule out carve-outs in all cases. I think you can run all the numbers one way or another, but the numbers that I have seen show that people do have a better chance of making a higher return through a balanced account than they do under the 2- or 3-percent return they get from Social Security. I am looking at actual returns from balanced accounts over a 35-year period.

Senator BAUCUS. But my time is short. I have to use it as best I can.

Mr. POZEN. Sorry.

Senator BAUCUS. No problem. I have a chart here. It is maybe hard to see. These are just estimates, in nominal terms, of the rates of return on stocks. That is what they think, different organizations. CBO suggests it is going to be 6 percent, or 3 percent, real. That is what CBO thinks out into the future.

Over here, a Wall Street economist. This is an article in the February *Wall Street Journal.* They predict that it will be 7.6 percent. SSA actuaries say, in nominal terms, 9.5 percent of wealth in stocks over the longer term.

This is an honest calculation. I do not in any way want to fudge anything here, because that does not help anybody.

Mr. POZEN. You are looking at predictions. I am looking at what actually happened in the last 35 years.

Senator BAUCUS. Well, I know. But most people think the stock market is going to—you talk about bubbles, and this and that in the past.

Mr. POZEN. I am talking about 35 years.

Senator BAUCUS. I am talking about what people, experts, predict the future to be. We have to look at the future here. We are not going back to undo Social Security.

Mr. POZEN. I understand that.

Senator BAUCUS. We are looking at the future.

Mr. POZEN. I happen to be a person who has been very involved with investments and——

Senator BAUCUS. I appreciate that. These people, too, are very involved in this.

Mr. POZEN. I agree. There are a lot of differences of opinion on this question.

Senator BAUCUS. Those are pretty objective outfits right there. I have asked the Center on Budget to calculate what rate of return is necessary, under the President's plan, to break even? In nominal terms, they come out with 10.9 percent to break even in the future. That is what they think.

And under your plan, as I understand it, because the number is not 10.9 percent, it is actually a higher number to break even, because your privatization component is fewer percentage points, but with a greater limit, it means that more would have to be put in or the rate would have to be higher to offset the smaller amounts in the President's plan.

Mr. POZEN. By breaking even, you mean in this case that the private account would make up for the total slower growth in traditional benefits? That is not my attempt in my plan. My attempt is to have the account generate more in returns than they would receive from Social Security.

Senator BAUCUS. Right. I understand.

Mr. POZEN. Using the Social Security actuary's numbers, the account definitely winds up with a positive return. It earns back some of the slower growth of benefits, but it does not earn back all of them.

Senator BAUCUS. Let me just explain what these numbers represent. I am assuming a portfolio mix in the private account of 50/30/20, as 50 percent stocks, 30 percent corporate bonds, and 20 percent treasuries.

Mr. POZEN. That is about what I used. Correct.

Senator BAUCUS. The calculation comes out to this for the future.

Mr. POZEN. The calculation comes out on those numbers to about 4.8 percent real annual return under the Social Security actuary's numbers.

Senator BAUCUS. Well, all I am saying is, there are a lot of people who have different estimates. A lot of people have different estimates.

Mr. POZEN. All right. But I am using the Social Security actuary's estimates. If we use those estimates, they are projecting a 4.8-percent real annual return.

Senator BAUCUS. Mr. Orszag, could you comment on this discussion, please?

Mr. ORSZAG. Sure.

Mr. POZEN. And that does not make up the whole difference in slower growth of benefits.

Senator BAUCUS. Maybe you can clear up something, Mr. Orszag, here.

Mr. ORSZAG. Well, there are two points here. One, regardless of whether you believe Mr. Pozen's numbers or the 10 financial experts who were quoted in the *Wall Street Journal* showing much lower stock returns, the key thing is, does it really make sense to borrow against your future Social Security benefits to invest in the stock market, when there is so much disagreement over what that rate of return will be?

I think the answer there, clearly, is no. We should be bolstering investments in stocks and retirement security on top of a solid base, not by borrowing against it.

Senator BAUCUS. And you are also saying that these plans require a lot of borrowing.

Mr. ORSZAG. Trillions of dollars in debt.

Senator BAUCUS. Trillions of dollars, in addition.

Mr. ORSZAG. That is correct.

Senator BAUCUS. I might make one point clear, too, Mr. Orszag. I have heard people say, what is wrong with a $2-trillion down payment for an $11- or $12-trillion unfunded liability?

Is it not true that that $2 trillion is an add-on, it is in addition to the $11 trillion, and that over time the $2 trillion would get paid back, but that leaves untouched the 75-year, the 100-year, or the long-term unfunded liability of Social Security?

Mr. ORSZAG. That is absolutely right. This is a complete bait-and-switch. People talk about the cost of the accounts and then talk about the actuarial deficit in Social Security. The accounts do nothing to reduce the long-term insolvency of Social Security.

Arguing that they do is like arguing that snake oil will help to cure strep throat, because if you take snake oil along with an antibiotic, your strep throat goes away. The snake oil is not doing anything to get rid of the strep throat; the accounts are not doing anything to get rid of the $11-trillion deficit.

Senator BAUCUS. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Hatch, then Senator Conrad after that.

Senator HATCH. I welcome all of you to the committee.

Mr. Pozen, is it not true that we have made promises here that we cannot keep?

Mr. POZEN. Yes, we have definitely made a lot of promises that we cannot possibly keep.

Senator HATCH. And if we do not do something about it, future generations are going to suffer greatly?

Mr. POZEN. Yes. I agree with that conclusion. To avoid that suffering, you need something like progressive indexing or some variant which helps bring about solvency. The question is: can you do that without giving people something else to complement that? I am in favor of a number of things to complement progressive indexing.

In my view, personal accounts are something that a lot of people would perceive as positive. You have to develop a package so that the overall effect of the progressive indexing, plus carve-outs or add-on accounts, is positive.

If you just finance add-on accounts, that would increase government borrowing, and that would also hurt the deficit. What you want is a proposal that basically reaches solvency, and then you take some modest measures to make the package reasonable.

Senator HATCH. To get back to Senator Baucus's comments, it is not really quite fair, is it, to compare all this to current law?

Mr. POZEN. I agree. If we compare what progressive indexing, or, quite frankly, how any proposal comes out in terms of benefits under current law, we are comparing it against a standard that we cannot possibly meet.

Senator HATCH. And Mr. Pozen, some of the critics of progressive indexing have indicated that it is flawed because it would eventually bring the benefits of all retirees to the same amount. Is this true? If so, how long would it take for the lines to converge?

Mr. POZEN. If you extended progressive indexing beyond 2100, at some point the lines would converge. But I do not think it is necessary to do that. I stopped progressive indexing in the model I worked with in 2079, and there was still a 20 percent difference between the high- and low-wage workers. If you do not think that is enough of a differential, you can stop progressive indexing at 2060. You can calibrate that to whatever you feel is appropriate.

Senator HATCH. As you know, I am interested in your ideas on progressive indexing. But could you elaborate on your comment about possible problems in the relationship between wages and prices, and how we may need to make an adjustment, or make adjustments, if the relationship changes over time?

Mr. POZEN. The relationship between wages and prices has been pretty stable for the last 100 years. But again, we are projecting in the future, so we need to hedge a little.

I think that people have pointed out that if wages go up a lot, that will be better for Social Security, and you will not need as much reduction. If the gap between wages and pricing were, say, 2 percent rather than 1.1 percent, you would not have to have the high-wage workers be brought down all the way to price-indexing.

I think the way you could deal with that possibility is to peg the initial benefits of high-wage workers to wage-indexing minus a percentage, such as 1 percent, so you could technically work that out. If we were lucky enough to have a lot of wage productivity and to need less benefit slow-down in Social Security, we could have a self-correcting mechanism.

Senator HATCH. Mr. Orszag, you indicated that Americans seemed to prefer relying on "additional revenue" in order to solve the challenges facing Social Security.

Now, it appears that your assumption and the basis for your plan, is heavy reliance on increasing taxes. Is this assumption based on surveys? If so, do you think those who want to see higher taxes believe they or someone else will have to pay for them?

Mr. ORSZAG. Senator, two responses. First, it does come from public opinion surveys.

Senator HATCH. It is easy to see why people in the public who believe others are going to have to pay for it might be for something like that.

Mr. ORSZAG. I do not think that it necessarily comes down to narrow self-interest in terms of, someone else will pay the tax. I really think it comes down to the kind of Social Security system that people want, and what they see as fair with regard to financing.

For example, the proposals to raise the wage cap, which are apparently quite popular, I do not think come from people saying, I am not going to pay that. I think it comes from a sense of fairness that someone earning $9 million a year pays tax only on 1 percent of his or her wages, where someone earning $90,000 a year pays tax on all of her wages.

Senator HATCH. You suggest that we should consider reforming the estate tax and dedicating the revenue to shoring up the Social Security system. Has Social Security not always relied on the payroll tax and not general revenues? Do you not think that turning to general revenue breaks the relationship between workers' contributions to Social Security and the benefits that they receive?

Mr. ORSZAG. It is a good question. There is an exception in current law that income taxation of benefits, which exists under current law, is dedicated to both Social Security and Medicare, so there is a component that is already in place.

I think the key is dedicated revenue; not unspecified general revenue transfers that may not materialize, but rather a dedicated source of revenue. I do think that the estate tax is something that should be looked at in terms of mitigating the required benefit reductions to restore solvency.

The CHAIRMAN. Senator Conrad?

Senator CONRAD. I thank the Chairman. I thank the witnesses.

One of the things that struck me about this debate is that nobody questions the basic assumptions. As I looked at the basic assumptions of the Social Security actuaries, I found, as they look ahead for the next 75 years, they say the economy is only going to grow at a rate of 1.9 percent a year for the next 75 years.

Looking back, if we look at the last 75 years, the economy grew at 3.4 percent a year for 75 years. If we would have the same economic growth going forward that we had in the past, 90 percent of the Social Security shortfall would evaporate. Ninety percent of the Social Security shortfall would evaporate.

Ten years ago, the Social Security actuaries told us we had 35 years left of solvency. Now, 10 years later, they tell us, you have 35 years left of solvency. They have been wrong, and they have been wrong because they have consistently underestimated economic growth. I believe, in all likelihood, they are wrong again.

Now, does that mean we do not have a problem? I do not think so, because the thing that we know is going to happen is that the baby boom generation is going to retire. That is not a projection. They have been born. They are going to be eligible for Social Security and Medicare, and they are going to retire, and the numbers are going to increase dramatically.

As I analyze this problem, I believe we have a serious budget problem, a budget problem in part caused by Social Security, be-

cause those bonds that we all talk about have to be redeemed out of current income. That is a fundamental budget problem that we confront.

In addition, under the President's budget proposal, he is making it all much worse because he is taking Social Security money and using it to pay for other things.

Senator Hatch asked the flip of this question. He asked, is it not true, we have always used payroll taxes to support Social Security? What he did not ask is, is it not true that under the President's budget plan we are using Social Security money to pay for tax cuts, income tax cuts, and other things? That is also true. That is precisely what is being done.

Over the next 10 years, under the President's plan, he is taking $2.5 trillion of payroll tax money and using it to pay for income tax cuts and for other things. He is digging the hole deeper, when he says we have a shortfall in Social Security.

Well, it is not just there that we have a problem. We also have a problem with his plan itself, because he has nothing in his budget for his Social Security plan.

But, over the next 10 years, we know that his plan costs $750 billion, because he is diverting money from Social Security to private accounts. So that again digs the hole deeper. That is on top of the $2.5 trillion of payroll tax money that he is taking to use to pay for other things. Now he says, take another $750 billion out of payroll taxes and use it to create individual accounts.

Let me just say, I have always been somebody that thought there was a kernel of a good idea with individual accounts, but I have never thought it was a good idea to finance it by massive debt. Yet, the President's plan is precisely that. In fact, over 20 years, he says, borrow over $4 trillion to start these private accounts. Again, that just digs the hole deeper and deeper.

As I analyze it, what we have is a serious budget problem. We have record budget deficits. On top of that, we have a shortfall in Social Security, although I believe the actuaries have been overly pessimistic with respect to the projections there.

Medicare is the real 800-pound gorilla, because the shortfall in Medicare is nearly $30 trillion, according to the Congressional Budget Office, compared to $4 trillion in Social Security. So, we have a very serious budget problem that nobody seems to want to deal with around here.

I think one of the reasons is, our friends on the other side want more tax cuts, tax cuts that explode in cost beyond the 5-year budget window, that dig the hole deeper and deeper, that are taking, in effect, money from Social Security in order to fund them.

If we look at the debt of the country, at a time the President told us we would be paying down debt, instead, the debt is exploding. This is just the publicly held debt.

For the gross debt of the United States, the picture is even worse. So, what strikes me most of all is that we are avoiding the real problems. It is almost a diversion here that is going on.

The real problem is a budget problem, in part caused by Social Security, and largely caused by demographics, overwhelmingly caused by the shortfall in Medicare and the already record budget

deficits we are running. But nobody wants to deal with that set of problems, because that leads to real tough choices.

Let me just ask, I would like Mr. Orszag to answer this question. I know you are an economist. Does this debt matter? Would adding to the debt matter to the economic strength of the country?

Mr. ORSZAG. Absolutely. Let me, first, give you the argument to the contrary, but then tell you why it is not the case. People look at these loans and they say, all right, we issue another dollar of government debt today, but we have these promises that people will pay us back in 30, 40 or 50 years, and that will wash the additional debt out. Bob Rubin will tell you, financial markets are going to discount that 40-, 50-, or 60-year promise down the road heavily, in part because it relies on future Senators upholding the loan repayment.

I have very little confidence that over a 50-, 60-, 70-year period we will actually stick to a plan that is put in place. I think it is very important to look at how long debt remains elevated even if you combine accounts with solvency changes, like price-indexing, that involve deep benefit cuts.

The administration's own analysis shows that debt does not fall below the baseline, that is, fall below what it would have been without the plan, for 60 years. That would be like we put in the plan at the end of World War II, we actually stuck with it the whole time since then, and only now would we be experiencing any net reduction in debt.

The CHAIRMAN. Now, it is Senator Lott's turn.

Senator LOTT. Thank you, Mr. Chairman. I want to try to put all this in as positive language as I can this round. I will change the tone next round. [Laughter.]

But I want to thank you, Mr. Chairman, for having this hearing and getting us moving forward, and having some substantive discussions about the problem and potential solutions. So far, all we have had is media analysis of what we were doing or not doing, and political statements on both sides of the aisle, and this is a positive step forward.

I want to thank this very thoughtful panel for coming here and presenting your ideas in the way you have.

Let me try to state what I think we should be trying to do. I do believe we should be trying to preserve, protect, and improve Social Security for the future. I do not have fancy charts, but the average man and woman out there on the street working, the farmer, the highway worker, they understand when you say this: we are getting older as a population.

Longevity is going up dramatically from not 62.6, what I think it was originally, but 77, or something, now, and women even a lot longer, which I would like to think about more on a personal basis. Why are they living so much longer than men are?

But everybody understands we are living longer. That is good. Everybody understands that the baby boomers, people in my age group and right behind me, they are coming, and they are big. They are going to blow the numbers out of the water. And most people understand when you tell them what the numbers are. We have huge growth and unaffordable benefits that, in my opinion, are unfair and dishonest.

Now, if you put it to people that way, they would say, oh, yes, that is probably right. We need to do something. And this problem does not begin in 2052, it begins in 2008, probably. Besides that, I care more about 2052 than I do about 2008.

I care more about my grandchildren right now than anybody else on this earth. I also want to put this in terms of, we come up here with our charts, our numbers, and our political gobbledy-gook. Every man and woman out there is saying, what are you talking about? Well, let me explain it, because I have lived it on a personal basis.

Number one, my dad was killed in 1969 in a car wreck. He paid into Social Security all his working life. Not he, not my mother, and not I, because of circumstances, ever got a nickel of it. I do not think that is fair. My mother worked all her life, before it was cool, as a school teacher, as a bookkeeper, as a radio announcer, worked with senior citizen centers.

She worked until she was 75. Now she is 91. Her monthly income is one-half of what it takes for her to live. We have already sold her house, sold her car, used all of her savings, all of her checking, and the numbers do not add up.

Then the plot thickens. My son and my daughter think, number one, it will not be there when they get to retirement age, and if it is, it will not be worth having because it will be so infinitesimal, if they do not have all kinds of other arrangements, they will not be able to live on it anyway.

Then the worst of all, my grandchildren are going to be stuck with the bill. They are either going to have their benefits cut or they are going to pay a whole lot more. Now, that is wrong.

My mother, at 91, is a lot more worried about those great-grandchildren than she is about whether or not she is going to have it a year from now. But we are going to protect her, guaranteed. I think everybody said we cannot change the system for those who are in it, or about to get into it. So, that is kind of the outline of where I think we are.

And let me take some of my time, not for just statements, but some questions.

Mr. Pozen, I think I am closer to where you are. I do think we need to change the benefits. This huge increase over the years, we cannot justify that. And by the way, it is not as if that was done by Roosevelt and one of my predecessors, Senator Pat Harrison of Mississippi, way back in the 1930s. We changed this formula in 1977.

President Clinton, Pat Moynihan, and I all had basically agreed we should have an honest CPI, and it should be based on prices, not on wages. This was back in the 1990s. But because we could not get the House to go along, we did not get it done. So, we are going to have to deal with this.

But, while I like a lot of what you propose, I am a little concerned about this progressive formula that you talk about. Would you take just a minute to go over that again? You think we should control explosive benefit growth, not make cuts. These are explosive growths, 40 percent.

So tell me, and so the American people understand, once again, in as common-sense language as you can, how would that work?

Mr. POZEN. Taking your mother, she has a replacement ratio now of, let us say, 40 or 50 percent, And if we move completely from wage- to price-indexing, we are going to reduce her replacement ratio from something like 40 or 50 percent to something——

Senator LOTT. But not her, just future generations.

Mr. POZEN. The replacement ratio of a person in her situation would decline to something like 35 or 30 percent.

Senator LOTT. Let us make that clear. I do not want her calling me later on.

Mr. POZEN. We would definitely not reduce her benefits. We know that.

So the question is, if somebody's replacement ratio has to be reduced because we do not have enough money to go around in Social Security, who in the population has other sources of retirement income?

Social Security was passed when there were no 401(k)s or IRAs. So now, when we look at the middle- and higher-wage workers, we can say that, if the Social Security benefits for young workers in those wage categories declined over time from, let us say, 40 percent to 28 percent, then they could make up some of that replacement ratio from their private retirement plans.

In fact, we would encourage them, through a lot of measures that I think most members of the committee would support, to make up this decline through IRAs, 401(k)s, and other sources of retirement income.

But we really do not have any reason to expect that workers at $25,000 and below in annual wages will have retirement income from sources other than Social Security. In the financial services industry, we have tried to incent people at those lower wage levels to participate in 401(k)s and IRAs, but it is very difficult.

If you have a family of four and you are making $25,000, the idea that you are going to put a lot into these other retirement programs just does not seem viable.

So, therefore, in progressive indexing we preserve the scheduled benefits for all workers at $25,000 average career earnings and lower, and continue to let them have the same replacement ratio, roughly 45 percent for those low-wage workers, as they do now in the future.

But we say to middle- and high-wage workers, just looking at Social Security alone, we slow the growth of their benefits so their replacement ratios decline a little. But we are counting on them—we are encouraging them—to make up for that decline and in fact to increase their replacement ratios through 401(k)s and IRAs. That is really the basic idea.

Senator LOTT. I have questions for the rest of you, and I apologize, but I will be back on the second round.

The CHAIRMAN. I would now go to Bingaman, then Kyl, then Kerry, then Thomas. If Senator Kyl does not come back, from Bingaman we will go to Senator Kerry.

Senator Bingaman?

Senator BINGAMAN. Thank you very much.

Let me just use one of Senator Conrad's charts here and ask, first, Mr. Orszag about it. If this is right, I think Social Security trustees say the economy is going to grow at 1.8 percent, and it is

the CBO that says it is 1.9, so they are sort of in agreement there. His chart says 1.9 over the next 75 years.

If that is true, should we not expect that that will reduce the amount of return a person could expect in stocks over that period from what we have previously obtained in stocks?

I mean, I am concerned. Mr. Pozen, you have said that over the last 35 years you have calculated how much return was possible in a balanced portfolio, as I understand it.

Mr. POZEN. How much return was actually achieved?

Senator BINGAMAN. Actually achieved. We could not expect that same return going forward if we have that much less economic growth, could we?

Mr. ORSZAG. Are you asking me?

Senator BINGAMAN. I will ask either one of you.

Mr. POZEN. I will let Peter go first.

Mr. ORSZAG. I think that is one of the reasons, again, in the *Wall Street Journal* poll of financial economists and experts you saw significantly lower projected returns in the future than for the past.

Mr. POZEN. I think the Social Security actuaries have estimated, for a balanced portfolio, a real annual return, after expenses, of about 4.8 percent. So that is their projection for the future. That is lower than we have seen historically.

The answer to your question, I believe, is GE now intends to get over half its revenues from the developing world. We have a global economy. The fact that the U.S. economy would grow at a slower rate is only part of the picture. The real question is: how is the global economy going to go and what will be the global returns?

Senator BINGAMAN. The idea is, we would take our Social Security and invest it elsewhere because we are not able to grow as much as we need to.

Mr. POZEN. When we invest in GE now, we are investing half outside the U.S., though we may not want to recognize this fact. The same thing with IBM. Most of our large companies that are headquartered in the United States are looking for half of their growth in revenue from outside this country.

Mr. ORSZAG. Senator Bingaman, this is precisely why Professor Shiller at Yale suggested that there is such a high probability of losing. The international returns on stocks have historically—even if you use a historical analysis—been substantially lower than in the United States.

The United States is a huge outlier historically in terms of high returns. Shiller and others doubt that that will continue in the future for the United States. If you go internationally and again look backwards instead of forwards, you also wind up with lower returns.

Senator BINGAMAN. Let me ask on another issue. My understanding of these private accounts is that you would put money into a private account, and then at some point when you retire there is a certain amount of money in that account, and there is a thought, to the extent we understand what the President is proposing, that some or all of that is to be annuitized to ensure that you do not fall below poverty, or something, I gather.

Mr. ORSZAG. Correct.

Senator BINGAMAN. Is there not a risk if a person retires when the market is down? I mean, if I had retired back in 2000, I would have been in fat city because the stock market was way up. If I had waited a year or 18 months to retire, I would have had substantially less to be putting into an annuity, as I see it.

Mr. POZEN. This is a problem we have addressed in 401(k) plans for years. If you are worried about this problem, most people would advise what is called a risk scale-down. That is, if you had a portfolio with 60 percent in stocks and 40 percent in bonds, as you approach retirement you reduce the equity portion so that you do not have what is called an end-game problem.

Senator BINGAMAN. And as you reduce the equity, you have to expect a lower return.

Mr. POZEN. Yes. But you can reduce the risk substantially that way. Second of all, you do not have to annuitize the very day you retire. You could give people some flexibility in the timing of annuitization.

Senator BINGAMAN. Let me ask one other aspect of it and just ask Mr. Orszag, all this talk about, you are going to have a nest egg that your family inherits. I have always thought of annuities as a commitment to pay you X number of dollars per month until you die, and then it is over.

Mr. POZEN. To the extent we have required annuitization, there will not be much in the way of inheritance.

Senator BINGAMAN. Yes. There is no nest egg for anybody after you die if you bought an annuity.

Mr. Orszag?

Mr. ORSZAG. That is absolutely correct. And before retirement, remember, if you die with a spouse, the spouse would inherit the account, but also the debt back to Social Security. That could be a very mixed blessing for the spouse. You had better hope you are married to a very good investor.

If you are not married, the debt will either be extinguished, which would mean the accounts harm solvency, they are not even actuarially neutral, or, as Mr. Pozen has proposed, the government will reach into the account and pull out the payment that is owed back to Social Security, thus raising questions about the rhetoric surrounding "it is your money, the government cannot touch it."

In Mr. Pozen's proposal, the government is directly reaching into the account and reclaiming that debt that is owed back to the Social Security system.

Mr. POZEN. In my view, you would want to have a presumptive choice of annuities when you retire, but then you would want to give people the chance to opt out if they did not want to annuitize. To the extent they do annuitize, then there will not be anything left to inherit at their death.

Mr. FERRARA. But that criticism, like all the criticisms of personal accounts that have been raised, only apply to the smaller accounts that the President's commission talked about. None of these criticisms apply to Ryan-Sununu.

Ms. ENTMACHER. Well, let me jump in here, because a really critical question is whether, with the purchase of that annuity, you have to provide anything for a spouse who is likely to be paying

off the debt that was incurred to make that account out of her reduced Social Security benefits.

This is a critical question and one that you have to get an answer to. She could be left with nothing to live on. Senator Lott talked about a small Social Security benefit that his mother receives. It could be much, much smaller under these accounts and she could be getting nothing to supplement her Social Security benefit.

The other issue with annuities and women is to realize that today, in the private annuities market, annuities discriminate against women. It is also impossible to get a fully inflation-adjusted annuity in the private annuities market, which is especially important to women, because they live longer than men and have less to live on. They cannot afford to have inflation erode the value of their benefits. Social Security provides that protection.

They also do not have to worry when they purchase an annuity. When anyone purchases an annuity now, they take the risk that that private annuity company will not be around forever to pay them full benefits. Social Security gives you assurance.

Now, some of the plans that involve annuitization say, well, Congress will prohibit discrimination, and Congress will provide a guarantee that companies will not go bust, and since experts say that private annuity companies probably will not offer a product with full inflation protection, the Federal Government will probably have to intervene to make sure that there are annuities available that are protected against inflation.

But if you are going to go to all that trouble, it would be much simpler, cheaper, and safer simply to rely on Social Security.

Mr. FERRARA. Under the Ryan-Sununu bill, the annuities are all inflation-indexed and all spousal benefits are protected.

The CHAIRMAN. Senator Kerry?

Senator KERRY. Mr. Chairman, thank you. Mr. Chairman, thank you for having this hearing. I appreciate the opportunity to address it.

But I have to tell you that, frankly, I find this entire last few months and this exercise on Social Security an exercise in frustration and avoidance. It is a conversation that lacks both candor and common sense, and some real leadership.

I heard the Chairman, a moment ago, say, where is the plan? The Chairman got quite excited about the notion that we need plans and not this carping on the side. Well, where is the President's plan? There is no plan from the President. There is an idea about private accounts which does nothing for solvency. Solvency is the fundamental problem of Social Security.

Now, I listened to Senator Lott say he cares more about his grandchildren than anybody else on earth. Well, if that is true, we could solve the problem of Social Security very quickly.

This is not complicated, and we are going to solve it. Congress is going to solve it. But we have been wasting months, frankly, over this issue of the private accounts without any real discussion of solvency. Even the President himself has now admitted that private accounts do not deal with the problem of solvency.

So what is this all about? Political exercise? Strategy to separate young people? I mean, Social Security is part of a three-legged stool

of retirement. The three-legged stool is personal savings, employer-provided retirement and Social Security.

Well, Americans are not saving money today. The average take-home pay wages of the average worker is down. Pensions are squeezed and are falling apart. Legacy costs of major companies are larger than they have ever been.

And here we are talking about undoing the one component of the stool that is reliable and guaranteed and putting it out in the marketplace, at risk. It does nothing, again, to solve the problem of solvency, Mr. Chairman.

The fact is, I heard one of the witnesses say we have made promises we cannot keep. I heard Mr. Pozen say, we do not have enough money to pay the benefits. That is not true. We do have enough money to pay the benefits. The fact is, the entire 75-year shortfall is about one-fifth of making the tax cuts permanent. And we have not made the tax cuts permanent yet.

So, we are sitting here in this completely contrived atmosphere that Social Security is at risk, and we have to somehow fundamentally change it, when we have not yet done what we are about to do that guarantees you do not have the money to be able to pay.

If you just did not do the tax cut for the top 1 percent of Americans who have gotten tax cuts galore over the last years, you could pay Social Security benefits through the entire century, Mr. Chairman. It is not true to say that there is a crisis that requires this fundamental change.

Moreover, we had a hearing not so long ago in this committee where we had the top folks from Social Security and from Health and Human Services here, and they all said the real crisis and the bigger problem is Medicare and Medicaid. That is the crisis that the President ought to be leading America on.

The Medicare Part A trust fund is exhausted in 2020. We are here talking about Social Security that does not even go bankrupt. If we did nothing—and we all know we are going to do something—Social Security will still pay 80 percent of the benefits by the year 2052, and those benefits will still be more than people are getting today.

So the fundamental issue is, what do we do about solvency? Let me quote the President himself. On March 16, the President said, "Personal accounts do not solve the issue. I repeat, personal accounts do not permanently fix the solution." I suspect he meant the problem. [Laughter.] So even that statement is misleading, Mr. Chairman, because it is not that it does not permanently fix it, it weakens it.

Mr. Orszag, will you make this as clear as you can to the committee, how does this change weaken the solvency of Social Security, which is the fundamental issue that we are here to discuss?

Mr. ORSZAG. It does so in two ways, Senator Kerry. The first is that, over the 75-year period that is traditionally used to evaluate Social Security solvency, it takes out more money than those offsetting benefit reductions. So if more money is going out the door than coming back in, solvency is harmed. The current Social Security deficit over the next 75 years is 1.9 percent.

Senator KERRY. Now, the other side says, well, you have this guarantee down the road, and we are going to guarantee it.

Mr. ORSZAG. Yes.

Senator KERRY. Why does that not hold water?

Mr. ORSZAG. Now let us move to the so-called infinite horizon perspective, where you move beyond 75 years. There, the accounts could still harm solvency because there are various ways in which you are not going to get full repayment. For example, I already mentioned, for people who died before retirement, the debts back to Social Security would be extinguished.

People who work for less than 10 years under Social Security would have money going into the account and the debt repayments would not occur. High earners, if we did it with price-indexing, if we combined this proposal with price-indexing, would have too small of a traditional benefit to fully repay the loan.

So, there are all sorts of situations in which repayment will not be full, and that is even assuming that all future Senators actually stick to the deal and there is no back-sliding.

So, I think it is just completely unsound fiscal policy to issue debt today in exchange for benefit offsets or promises that there will be benefit reductions in 50, 60, 70 years, in the hope that everyone, meanwhile, will fulfill those promises. It is very unlikely to happen.

The CHAIRMAN. Senator Kerry, I have to call on Senator Thomas.

Senator KERRY. I apologize, sir.

The CHAIRMAN. And you only have 6 minutes to go vote, too, on the floor.

Senator KERRY. Thank you.

The CHAIRMAN. Senator Thomas?

Senator THOMAS. Thank you, Mr. Chairman.

The CHAIRMAN. I am going to go vote, and Senator Lott is going to come back and chair the hearing.

Senator THOMAS. You are going to miss what I have to say. [Laughter.]

The CHAIRMAN. I am sure you are not going to miss a vote either, so no hurry.

Senator THOMAS. I thank you.

I appreciate the fact that we are dealing with this, finally, to strengthen Social Security. Many changes have taken place, and we clearly need to do something. I am sorry some of my friends have left, because I wanted to say I am pleased that the President has not avoided the debate and has, in fact, brought this up.

I hope members on the other side of the aisle will stop just complaining and come up with some plans of their own, because that is kind of what we need to do.

First of all, I do not want to talk about the details, but the broader context of it, to make sure it fits into what I think has been our American philosophy all along, and that is the opportunity for people to fulfill their dreams.

This is not a retirement program, it is a supplement to the retirement program. I hope we can keep that in mind. I have introduced some bills to make it easier for people to be able to save for themselves, and I hope that we can do that.

Conceptually, Mr. Orszag, it seemed to me that when this was done initially, that President Roosevelt made it clear that the

money that would fund this would come from payroll taxes and not be taken out of other kinds of things.

Do you think this extends it on into sort of a welfare program, or does it continue to keep it as Social Security?

Mr. ORSZAG. You mean, continuing to base it on payroll revenue?

Senator THOMAS. Yes.

Mr. ORSZAG. Well, I think, actually, for the mainstay, the principal component of financing should continue to be something close to the payroll system. But that does not rule out other forms of financing.

Again, we already have it. The Congress, in 1983, and again in 1993, voted to change the system so that some portion of income taxation is dedicated both to Social Security and to Medicare.

Senator THOMAS. Well, but that does not change the concept. Should the concept in the future be that it relies on payroll taxes or should we start expanding it? Now you are going to take it out of estate taxes, as I recall.

Mr. ORSZAG. My point, Senator, is that we already rely, only in part, on an entire——

Senator THOMAS. It does not make it right, necessarily. I am asking you if you think that the concept is fair.

Mr. ORSZAG. Oh. Conceptually, I do think it makes sense to at least consider expanding the base of financing. The reason is, going back to that history, in the mid- to late-1930s, we as a society decided to provide extra-normal returns, higher benefits than would otherwise be the case, to retirees at that point. That was society's decision. It makes some sense that society as a whole now will help to contribute to the program that provided those benefits.

Senator THOMAS. I think we have to sometimes think conceptually.

Madam, what do you think? There is a high percentage of these dollars that go to disabilities, and so on. Should that be Social Security money? They should be funded, no question about that. But is this the place to fund all those programs?

Ms. ENTMACHER. Are you asking whether we should continue to use payroll taxes to fund the Social Security disability program?

Senator THOMAS. Some of those programs. A high percentage of the payments now are not in retirement, they are in disabilities and other programs.

Ms. ENTMACHER. That is true. That was precisely the point of my testimony, that Social Security enables beneficiaries to make contributions while they are working and get protection, both for themselves and their families, if they are disabled, if they die prematurely, that their families are protected.

I think it is a very powerful thing that those disabled workers and their families do not have to rely on welfare, do not have to go and spend down everything they have to qualify for our welfare programs.

Because they paid in to Social Security when they were working, they got the dignity of a Social Security benefit that they have earned as a disabled worker.

Senator THOMAS. But those, in most cases, are not sufficient. I hear, every time I go home, I am getting Social Security disability, but it is not enough.

Ms. ENTMACHER. But then I would be delighted to talk with this committee about ways to improve Social Security benefits for those people for whom the benefits are inadequate. But it should be done through the current system.

I think the proposals that are on the table would weaken the protections not only for retired workers, but as I pointed out, would cut benefits for disabled workers and survivors who are in an even worse position to try to cope with that.

Senator THOMAS. Well, we need to look at some other programs if that is not going to be satisfactory.

Mr. Tanner, how do you offset the cash flow when you do the private accounts?

Mr. TANNER. Sure. I would point out that it is a cash flow issue. Because the government operates on a cash flow accounting basis, you see the short-term costs in your 5- and 10-year budget windows.

But if this was a business and you were doing accrual accounting, you would see that moving to individual accounts actually does not change your debt at all, you are simply taking debt in the future that is sort of off the books now, putting it on the books, and moving it forward to pay it up front today.

We believe that, to the degree that you borrowed it, it would be a wash, but you would not see the economic benefits that come from reduction in overall consumption. We would like to see at least some of that shortfall financed through reductions in government spending.

In particular, I support what Senator McCain has introduced, what is called the Pork for Pensions bill, which would trade corporate welfare, establishing essentially a base closing style commission on corporate welfare, and would use the savings from that to be dedicated towards helping to fund this account.

There are some other mechanisms that we talk about in detail in our plan about, and in our paper about, how we can finance at least some of this——

Senator THOMAS. The benefit of offsets, though, are 30 years away or more.

Mr. TANNER. Under our plan, you would begin running surpluses in around 2045, under this proposal, as opposed to the continuing deficits.

Senator THOMAS. That is 40 years.

Mr. TANNER. Well, that is true. But you also have to look at, under the current Social Security system, if you go out to the 75-year window, the current Social Security system will be running shortfalls in excess of 6 percent of payroll, whereas, under the Johnson-Flake bill, it will be running surpluses in excess of 3 percent of payroll. So, you actually have to look at which way it is moving.

Senator THOMAS. Most people generally like the idea of personal accounts, but the question in my mind, and others', is the offset of cost.

Mr. FERRARA. Senator, can I address the question you just asked him about how you would deal with the offset?

Senator THOMAS. Yes.

Mr. FERRARA. It is fortunate that when we sat down to do the Ryan-Sununu bill we anticipated many of the criticisms you heard here today, and we designed it to counter those criticisms. That is why there are no benefit cuts in it.

We did not want to confuse the situation with reductions in future promised benefits of 40 percent when, if you believe in the personal accounts, it is completely unnecessary.

It is why there is a guarantee of currently promised benefits so we maintain the safety net. It is why you have inflation-indexed annuities. It is why you have no change in people on disability, and survivors are all completely protected.

I have to confess, when the people in the White House sat down to write the plan, they did not anticipate all the criticism, and they have not even proposed a specific plan yet. But their plan is not designed to deal with these criticisms, and it is unfortunate that these things were not anticipated and dealt with in advance.

But we did deal with them in the context of the Ryan-Sununu bill. In the Ryan-Sununu bill, there is no permanent debt. There is short-term borrowing, like when you have a mortgage on a house.

Senator THOMAS. What do you mean by "short-term"?

Mr. FERRARA. Well, when we are talking about Social Security, everything is very big. A trillion dollars in Social Security is really pocket change. [Laughter.]

Senator THOMAS. What do you mean by "short-term"?

Mr. FERRARA. Short-term in Social Security is 20 years. Then over the next 20 years, the thing is entirely paid off.

A key fact that needs to be recognized in this discussion, in terms of a general budget, is this is a very important factor that changes the whole perspective of what we are doing here. The Congressional Budget Office projects that, under current law, Federal spending as a percent of GDP will grow from 20 percent today to 34 percent by 2050.

Senator THOMAS. Excuse me. I have to go vote.

Mr. FERRARA. We will put it in the record and we can read it later. But it is growing from 20 percent today. Federal spending, as a percent of GDP, is going to grow from 20 percent today to 34 percent by 2050.

Therefore, when we say we want to finance part of the transition, as Mr. Tanner just said, by reducing the growth of Federal spending, we can see that there is a huge run-up of Federal spending about to occur.

People who run on fiscal restraint are going to have to recognize that their constituencies are not going to sit idly by and be perfectly happy if they see the Federal Government grow 70 percent relative to GDP.

So, in fact, we do have to get serious about some spending restraint. If we use some of that, a modest amount, we can finance the transition to accounts as large as in the Ryan-Sununu plan, or in the Cato plan. It is the large accounts where you begin to solve these problems that have enormous benefits for workers.

If you start with these little 2-percent accounts, then you are not going to achieve the full long-term goals, and you are not going to

achieve the prosperity for workers that you could achieve with the full accounts.

This has to be done on a positive basis that benefits working people. You cannot advance this with a blood-and-guts approach that just says, oh, gee, we are going to raise your taxes and we are going to cut your benefits.

That is not how we got here. We got here by talking about personal accounts. That is what people campaigned on, and we need to make good on the campaign promises and focus on the personal accounts. If we do those right, we can provide enormous benefits for working people. If we get lost in the underbrush, if we go back and say we are going to negotiate a package of tax increases and benefit cuts, well, it is going to be all negative.

It is going to be a worse deal for workers. It is not going to solve the problem. There are two problems here. There is not just a solvency problem. The program is not a good deal for working people today. The average benefit paid today for single retirees is only $920. The reason you need personal accounts is because the benefits promised today are no good. The benefits in the promised system are, in fact, too low. The rate of return is miserable compared to market rates of return. So, that is why we need the personal accounts. I would urge you to go back and focus on where we got started.

We got started in this debate with the personal accounts, and if we put more effort into designing a plan that really benefits working people and anticipates some of the criticism we heard today, we can be politically successful. We know that because we run election after election on precisely the issue framed that way. So, I would urge you to look in that direction.

Senator LOTT. We appreciate your energy and enthusiasm. [Laughter.]

Mr. FERRARA. Thank you. We need energy and enthusiasm here.

Senator LOTT. That is right. Very good.

Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman. Thank all of our witnesses.

This morning, about 50 Wall Street leaders, men and women who manage billions of investment dollars, including the head of the world's biggest hedge fund, sent a letter to Senator Frist opposing the administration's personal account proposal.

These are all individuals who would benefit personally from the President's proposal, but they believe it is unwise because they believe that the investment business they are in involves substantial risks, and that that is different than Social Security, which is about insurance.

So, their argument is really that retirement finance is about a variety of investments, but that Social Security is the one area that ought to be insulated from a substantial amount of risk.

Now, your colleague, Mr. Pozen, talked about "minimizing risk." Those were his words. But any way you cut it, to me, the President's proposal is about a substantial reallocation of risk with respect to retirement finance. I would like to ask you, Mr. Ferrara and Mr. Tanner, why you think Social Security funds ought to be redirected towards riskier asset classes.

Mr. TANNER. Well, first of all, I would hope that that letter would finally put an end to the rumor that I am in the pay of Wall Street in some way, and that this is all part of a Wall Street plot.

But an answer to your larger question is, maybe you are right. Maybe private investment is risky. I do not believe it is riskier than Social Security, which contains a substantial political risk.

The fact is, we promise benefits, we cannot deliver them. The fact is, we have repeatedly reduced or changed benefits in the past. The fact is, we do not have a legal right to any benefits whatsoever, leaving us entirely in the political system.

Senator WYDEN. My time is short. This is not about whether you favor risk in America. I vote repeatedly to cut capital gains, for example, because I am in favor of risk-taking in investment. Tell me why you favor redirecting Social Security funds towards more risk.

Mr. TANNER. I favor giving workers a choice. If workers agree with you that Social Security is safer than private investments, let them remain in the current system.

But if workers want the opportunity to earn a better rate of return, to have ownership and control, give them the choice. Do not stand in the doorway and say that we know better, for every worker, how they should control their retirement. Let us give workers a choice. What could be more American than that?

Senator WYDEN. The main thing we are giving them, Mr. Tanner, is the right to a lot of debt. I mean, that is essentially your version of the choice. That is why, to me, it is so important when 50 leaders from Wall Street who manage billions of dollars worth of funds, I mean, these are people who benefit when you tap into the American dream. They are saying there are some bigger concerns here with respect to Social Security, and that is what I hope we will address.

Mr. Orszag, did you want to comment on that?

Mr. ORSZAG. Again, there is a place for risk. I am all in favor of accounts. We already have them; let us make them work better. We could come together and get 401(k)s and IRAs to work better. The Wall Street people who signed that letter, I am sure, are all in favor of saving on top of a solid foundation. That is where we should be taking risk, and it is as simple as that.

Senator WYDEN. Mr. Ferrara, just so I can get you into this, the other reason that the Wall Street leaders are speaking out this morning is that they think that the President's proposal would have no net effect on the amount of capital available to the Nation's economy. In effect, they are saying, this just moves around the deck chairs, and in the process reallocates risk.

What would your response be to that?

Mr. FERRARA. All right. Let me respond directly to that. The answer to the question that you asked both of us is that the current system is a bad deal for workers today. Even if all of the promised benefits were paid, the real rate of return would be 1 to 1.5 percent or less for most workers; for many it would be zero or negative. People need the freedom of choice to have a better deal.

Now, see, retirement investors have an advantage over other investors because they invest over an entire lifetime. So the stock market does go up and down, but, over 75 years, I would submit to you that there is no chance that the rate of return on a portfolio

of mixed stock and bond investments could be as low as Social Security even promises today, let alone what it can pay.

But in addition, we try to anticipate your criticism in the Ryan-Sununu bill, because we put in there a flat-out guarantee. If you do not get more than the current system promises through the personal account system, we will guarantee that you will get at least what is promised today.

The reason that is in there, we think that works, is because we believe in what we are saying, that the market will provide so much higher returns than Social Security promises, that there is no possibility that it will get that low, so you can go ahead and make that guarantee and workers can get better off.

Now, I do not agree with the administration that you should finance the whole transition by borrowing. I think you can get certain benefits out of personal accounts, even with borrowing. But one of the benefits you will not get is more savings in capital investment if you just borrow the entire amount.

Again, in the Ryan-Sununu bill, we had no permanent net borrowing. We try to achieve it all and go to a fully funded system. The idea is rooted in the work of Martin Feldstein in the 1970s, who argued that we should shift from a pay-as-you-go system like Social Security today where there is no savings and investment to a fully funded system where the money is saved and invested.

So, we did it on a different model than the administration did. We did it on a fully funded model, so there is no permanent net debt out of it as a result. Again, we anticipated these sort of criticisms. Unfortunately, the White House has not fully anticipated them.

Senator WYDEN. My time has expired. I would just note, what you are suggesting is sort of like the idea that somebody can have three hot fudge sundaes a day and lose weight.

Mr. FERRARA. No. No, I am not.

Senator WYDEN. The idea that you do it without any borrowing, without any benefit cuts, I just think is pretty bizarre.

Thank you, Mr. Chairman.

Senator LOTT. Thank you, Senator Wyden.

Senator Snowe?

Senator SNOWE. Thank you, Mr. Chairman.

I want to thank all of you for being here today and for taking the time, obviously, to come up with various initiatives, whether we agree or disagree. I think the point is, it affords us the opportunity to explore some of the issues and to evaluate the implications of a variety of proposals.

Frankly, I think that we are sort of at a philosophical juncture about the Social Security program as to whether or not you really do believe in preserving the underpinning of the Social Security program, which is a defined guaranteed benefit.

Seniors have come to trust Social Security, certainly in my State, that has the Nation's oldest average population. Fifty-six percent of my population is prevented from falling into poverty as a result of Social Security.

So, it has become a bedrock of support in their retirement years, precisely because it is defined and because it is guaranteed. I think that is really the issue today and what we confront in Congress as

to whether or not we want to tamper and incorporate an element of risk into the program by introducing and carving out and diverting from the payroll tax to support a personal retirement account.

I think, at what cost and at what risk is it worth it to erode the basic traditional guaranteed benefit? So I ask you, Mr. Ferrara and Mr. Tanner, to begin with you, as to why would you think it would be worth incorporating that risk in a system that has worked exceptionally well?

Because obviously I think that with what I have seen in your proposal, I think ultimately you do not guarantee that individuals are going to meet a specific income by the time they reach retirement. There is a potential. There is an up side. But the question is, how much risk do you have to take on the down side in order to achieve what might be a net gain of 1 percent?

Mr. FERRARA. Well, in the Ryan-Sununu plan we are the ones who do have a guarantee. We put in a guarantee that you will get at least the benefits promised under current law.

We do that because of the real reason why we want to have these personal accounts, because even the returns that are promised by Social Security under current law are very low and they are a poor deal for workers.

For many workers, even if you get all the promised benefits, you get a negative real rate of return. That is like taking your money to the bank. Instead of getting interest from them, you pay the bank to hold your money.

Now, if we do some of the things that have been talked about, raise taxes or cut benefits to deal with the solvency problem, then that rate of return is going to get even lower and it is going to be negative for even more people. So, I think we clearly need to give people freedom of choice to get a better deal.

Now, I would add that the Social Security benefit is not guaranteed. The Supreme Court held in 1960 that it is not backed up by a government guarantee and that the benefits can be cut at any time.

So you can structure the system to minimize any new risks on workers and to take advantage of the market returns so that workers can get a better deal, and that is how we began, how we got into this whole personal accounting in the first place.

Senator SNOWE. But I think the Congress has a pretty good track record over 70 years in support of the program and the defined guaranteed benefit. I think the issue is, there are few and far between options when it comes to defined guaranteed benefits in the retirement world today. I think that is a fact.

There are many options for diversifying your portfolio from 401(k)s and IRAs, and so on, and so forth. The question is, do you want to maintain that foundation for our seniors today with respect to a defined and a guaranteed benefit income? That is the issue, because we have many ways in which to enhance retirement income where people can take the risk. But why incorporate that risk into a program——

Mr. FERRARA. Because the returns are so low.

Senator SNOWE. Because the returns are low. But how are you guaranteeing a return under your plan?

Mr. FERRARA. We are not guaranteeing a higher return. What we are saying is, if you look at the standard long-term market returns, they are so much higher, the margin for error is so enormous, that workers really need to have that freedom of choice, and I think workers agree with that.

Senator SNOWE. I would like to have Mr. Orszag respond. But in your plan, as I understand it, the government pays for any shortfall between the account and Social Security benefits scheduled under current law. Do you have a funding stream for that?

Mr. FERRARA. I think that is Mr. Tanner's.

Mr. TANNER. No, you guarantee.

Senator SNOWE. Do you have a guarantee?

Mr. FERRARA. We have the guarantee in the Ryan-Sununu bill. He has some kind of much more limited guarantee.

Senator SNOWE. Right. You both have a guarantee.

Mr. FERRARA. Well, you see, the thing is, the guarantee is not going to be employed because the market returns are so much higher than what Social Security promises, that you are not going to fall under that safety net.

Senator SNOWE. Mr. Orszag, can I just have you respond?

Mr. ORSZAG. Yes. Just quickly. I mean, we have heard a lot about this plan. The key thing to this plan, is it contains the mother of all magic asterisks. The slow-down in spending growth that is assumed amounts to more than $7 trillion in assumed savings from, presumably, Medicare and other programs without any specificity about how you are going to get it.

I think it would be great if you guys could come up with $7 trillion in savings somewhere, but frankly, so far there has not been a lot of evidence that you are able to. I do not think it is at all responsible to just assume that that money will be forthcoming. Without that money, the whole house of cards falls apart.

Mr. TANNER. Senator?

Senator SNOWE. Mr. Tanner?

Mr. TANNER. If I could just say, first, in terms of it being a guaranteed benefit now, as Peter pointed out, it is not legally guaranteed. It is also not financially guaranteed. By law, Social Security benefits will be reduced by 26 percent in the future when Social Security cannot pay benefits.

Actually, since that is an across-the-board benefit including people who would already be receiving benefits at that time, the reality for new workers is that they would receive an even bigger benefit cut than that 26 percent, because you are not going to cut grandma's check by 26 percent, where 1 week she is getting one check, the next week it is 26 percent lower.

What you are going to do is phase it in for new workers, and those benefit cuts are going to be reduced. Repeatedly in the past, Congress has reduced and changed benefits.

When I started work, they told me I could retire with full retirement benefits at age 65. Then they came along in 1983 and changed that, and now I have to work to age 67 before I can retire. So, there is no guarantee with the current benefits.

I would also suggest the reason why I want to make these changes is because, while I want to preserve what is good about So-

cial Security, I do not want to preserve the problems with Social Security.

That includes the fact that workers have no ownership under the current program, that Social Security benefits are not inheritable under the Social Security program, and that there is no choice about how much risk individuals want to achieve under the program, so we can make Social Security better while we make it solvent.

Senator LOTT. Senator Lincoln?

Senator LINCOLN. Thank you, Mr. Chairman.

I would like to ask unanimous consent. I was about 5 minutes late arriving for the nomination of Congressman Portman, and I would like to have my comments included in the record, please.

Senator LOTT. Without objection, it will be included.

Senator LINCOLN. Thank you.

Well, thanks to all of you panelists for your patience, and as Senator Snowe said, for your ingenuity in looking for what the solutions might be. We know we have some long-term concerns and challenges that face Social Security.

We want to make sure that we address those in a thoughtful way and a fair and balanced way for everybody that is concerned. I think we know in life there are winners and losers in almost every situation, and that would include probably some of the changes that are being proposed in Social Security, whether it is a small business owner, whether it is somebody that lives in a rural area, or what have you.

But I guess it is my job to make sure that Arkansans are not left with a disproportionate burden for any changes made to the program that has meant so much to so many of them in my home State.

With that, I would like to touch on just a couple of the areas. One, we know that workers living in rural areas, such as in my State, are more likely to be poor and they are less likely to be able to contribute to personal savings accounts.

Thirty percent of Arkansans do not even have bank accounts. So, we are talking about people who live paycheck to paycheck. I would note that the majority of the top 10 States in that category are represented on this committee here, so we share a lot of those demographics.

In addition, because of the physical nature of their jobs, it is more likely that they will need either disability benefits or early retirement benefits, which are key components to not being left out as we look at the changes.

I guess my question would be, how will private accounts impact rural Americans? I mean, Americans who are most likely not to have enough savings to make up for any reductions in their Social Security benefits and those who are least likely to be capable of paying the debt off that is going to be created from these private accounts that the President is proposing.

Mr. FERRARA. Senator, your comments show exactly why add-on accounts would not work for the people of Arkansas, because they do not have extra money on top of what they are paying. Many people do not, in your State, have extra money to pay on top of what

they are paying in Social Security payroll taxes for some other account.

What they need is the opportunity to take some of the money that is already being paid by them and their employers through the system and put that into a nest egg for themselves and their families where they would have a chance to get a better deal.

Senator LINCOLN. But the problem is, their children are going to be saddled with the debt that you create. We clearly indicated that there is no asterisk out there that is going to pay for what you want to do.

So whenever we increase debt, we are increasing taxes on someone, which is more than likely the children in the future that are going to have to be saddled with the lack of capital, the increase in inflation, interest rates, and the problems that they are going to have dealing with the debt that is created.

Mr. FERRARA. Social Security already has an $11 trillion debt. So even if you finance the transition by debt, you are just recognizing part of that debt we already owe. But in the Ryan-Sununu bill, we attempt to do the whole thing without any net new debt over the entire life of the plan, like a mortgage.

Senator LINCOLN. I have to say, in terms of personal savings, I have no problem, that as a part of the debate in Social Security, we have to be very serious about being innovative in how we encourage personal savings. But I have not heard anybody mention IDAs, which is what low-income people use.

Mr. ORSZAG. Senator, I think it is very important. The way to build savings and wealth is not by borrowing against the core tier of retirement income for those folks. It is not by leveraging or taking out a line of credit on your future Social Security benefits. We must make it easier for them to save and increase incentives for them to do so. The evidence very strongly shows that people do save, as long as it is simple and as long as there is an incentive for them to do so.

I am very confident that with some common sense reforms that this committee could do now, both sides of the Social Security debate could come together, we could boost wealth and saving for your constituents, not at the cost of borrowing against your future Social Security benefits and running up debt, but simply by adding on top of the Social Security system as it already exists.

Senator LINCOLN. With an opt-out as opposed to opting in.

Mr. ORSZAG. That is one of the very good ideas. That is right.

Senator LINCOLN. That is what you mentioned. Yes.

Yes?

Mr. TANNER. Senator, just one other point on the individual accounts in terms of low-income people that I think was neglected, and that is the fact that, under the current system, the benefits that low-income people have are not inheritable.

For millions of low-income people who died prematurely and their children are over survivors' age, they are not able to pass along any sort of wealth to their children, and that means their children will likely be poor as well. What we need to do is be able to give low-income workers a chance to build a nest egg of real wealth that they can pass down.

Senator LINCOLN. But the problem is, we have already pointed out in the President's plan, that when you get to a certain point as a low-income individual, you are going to be forced to purchase this annuity, which does not give you that.

Mr. TANNER. Under the President's plan, that may or may not be the case. Still, 1 out of 4 Americans will die before they reach retirement age. That money would be inheritable. Under our proposal, and I believe under Peter's as well, it is not required that you annuitize fully at retirement.

Senator LINCOLN. Right now they get survivors' benefits.

Mr. TANNER. We would only require that you either annuitize or take a guaranteed income stream, preserving the principal up to the poverty level, and over and above that you could take it as a lump sum, or do whatever you want.

Mr. ORSZAG. May I add?

Ms. ENTMACHER. Senator, if I could.

Senator LINCOLN. Is that all my time?

Senator LOTT. Yes. I am sorry, it is gone. Does somebody want to respond, though?

Ms. ENTMACHER. Yes. I just wanted to point out what the nature of these benefits for children, if a worker is disabled or dies prematurely, is. Because a spouse of that deceased or disabled worker can get a benefit while the children are under age 16, the children get benefits until they turn 18, 19 if they are in school, and those benefits are adjusted for inflation.

If a worker died and had a private account, you are not going to be able to equal those benefits. Even if they could inherit the account and have access to it, it is not going to protect them. It is those young children who really need the protection.

Leaving your adult children an inheritance is nice, but children really need the protection when they are young, and that is what Social Security does. It is particularly important when there is a high risk of disability.

Mr. ORSZAG. May I answer?

Senator LOTT. Senator Lincoln, we need to move along because we are getting well into the noon hour and we have a meeting we have to go to.

Senator LINCOLN. I would just like to make sure my questions, particularly regarding women, are included, so I will send those in.

[The questions appear in the appendix.]

Senator LOTT. Senator Crapo?

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

Mr. Ferrara and Mr. Tanner, I guess I would ask this question to you. We have had a lot of discussion today about the issue of disability benefits and survivorship benefits.

The discussion seems to be based, at least in large part, on the premise that they would be changed by any personal account proposal in the sense that, whatever was done with regard to personal accounts and the overall Social Security benefit, would then carry over into survivorship benefits or disability benefits.

But my understanding is that that is simply not the case. It can or cannot be done that way, depending on who puts the plan together. It is also my understanding that the President has made

it clear that he does not intend to do that. Could either of you comment on that?

Mr. FERRARA. Senator, you are exactly right. There is a lot of discussion that goes on about these additional benefits that is, frankly, disingenuous. The statements have been made over and over again that these plans would not affect disability benefits, would not affect pre-age 65 survivors' benefits, would not affect non-retirement survivors' benefits.

The Ryan-Sununu bill, for example, was introduced last year, was introduced this year. There is no change in any of those benefits. They continue to be financed, as under their current system. I believe that is true of the Johnson-Flake bill as well.

Mr. TANNER. Yes, that is correct. The Johnson-Flake bill leaves survivors and disability benefits intact. It has a funding stream of 3.3 percent of payroll that is permanently dedicated to that, so there is no change in survivors or disability benefits.

Senator CRAPO. And if that were the case, it seems to me I recall either a CBO, or some other study, that indicated, frankly, that the survivors were one of those in the categories that benefitted most from those who benefit from personal accounts.

It seems to me the reason would be that the proposals that are on the table protect their current benefits under the system and give them an inheritability factor that accounts provide with them. Is that not also correct?

Mr. FERRARA. That is exactly correct.

Mr. TANNER. Survivors' benefits, plus.

Senator CRAPO. Yes. Mr. Orszag, do you have a comment on that?

Mr. ORSZAG. Yes, I would like to. I think one of the reasons there has been some confusion about this point is, let us look, for example, at the plans that have been specified by the administration or Mr. Pozen, who has served on the President's commission.

Those plans, the President's commission plan and Mr. Pozen's plan, as scored by the Social Security actuaries, do assume a significant reduction in disability benefits and survivor benefits in the financial analyses.

So, it is natural that people think that these benefits could be under pressure. Now, the administration has, since that time, made a statement to the contrary, but again we have not seen a solvency plan.

Senator CRAPO. But you do not want to accept that statement.

Mr. ORSZAG. Given that the only plans that have been put forward by people associated with the administration assume those reductions, I want to wait and see the details, yes.

Senator CRAPO. Well, as you know, there has been a lot of discussion about whether the President should or should not, will or will not, give the details before the Congress has studied this enough to come up with alternative proposals.

But it seems to me interesting that the President not only has made it clear that he is not going to propose these changes, but that the plans that we have on the table in front of us here, at least at this hearing—I do not know about Mr. Pozen's plan, but the two plans that Mr. Tanner and Mr. Ferrara are proposing—

make it clear that they are not going to change that, yet it continues to be an issue that is thrown up.

Mr. ORSZAG. Let me give you one example of why. You can retain full disability benefits, but when people reach the so-called normal retirement age, they transfer from disability benefit to retirement benefit.

The question is, are you going to protect their higher level of benefit even after they transferred to retirement benefits? Many of the plans that ostensibly protect disability benefits do not, which means a disabled worker will have benefits protected for perhaps 10 or 15 years, then suffer a decline at the transfer.

It is that kind of detail that I think is raising a lot of the concerns around this.

Senator CRAPO. Mr. Ferrara?

Mr. FERRARA. We sat down and designed the Ryan-Sununu bill. Mr. Orszag picks up on a very important point that was raised by the Chief Actuary of Social Security when we sat down with him. We designed the bill to protect those disabled workers at that point so that they are fully protected. Again, I go back to this, we did a lot of effort in designing that bill to anticipate all these criticisms.

The point he raised just now is a very sophisticated criticism, but we anticipated it and we took care of it in the bill. But the general answer is, you are absolutely correct, disability benefits changes are off the table, in general.

Now, I urge you to be cautious about these price-indexing proposals, because he is right when he said some of the price-indexing proposals affected disability benefits. What I want to emphasize is, taxes under the payroll tax grow with wages. Taxes under the payroll tax grow with wages.

So if you are going to have the benefits grow with prices while the taxes are growing with wages, under the price-indexing scheme, what does that mean? It means the rate of return goes down every year under these price-indexing schemes.

It means the replacement rate under Social Security, the percent in pre-retirement income that you replace with Social Security, goes down every year because if your income is growing, benefits are only growing with prices but your income is growing with wages, the replacement rate declines every year. The rate of return declines every year under these price-indexing plans.

I do not want to see people get blind-sided by that during election time when it is characterized that way, because frankly a lot of things Senator Baucus said about the price-indexing, you will not be able to say, no, that is flat-out not true. You will not be able to say that, because with price-indexing, again, the taxes grow with wages.

If benefits are only going to grow with prices, that means that all these indefensible things are going to happen. That is why I urge you to focus on the personal accounts and stay away from these things like price-indexing.

Senator CRAPO. I appreciate that. I see my time is up. I just wanted to make the point clear that there is a lot of discussion going on here about disability benefits, survivorship benefits, and

so forth. Frankly, it is fair to do so because there are a lot of plans on the table, and some plans do it and some plans do not.

But I just wanted to make it clear that, at least as far as I understand the President to have said, is that he is encouraging us not to do it, which takes the issue off the table.

There are at least two plans on the table here in front of us which do exactly that, and which still work out. So, I just want to be sure we understand what it is we are attacking and defending as we discuss these issues today.

Thank you, Mr. Chairman.

Senator LOTT. Senator Santorum or Senator Bunning?

Senator SANTORUM. Go ahead, Senator Bunning.

Senator LOTT. Senator Bunning?

Senator BUNNING. Thank you, Mr. Chairman.

Senator SANTORUM. And Senator Santorum.

Senator BUNNING. And Senator Santorum. [Laughter.] Thank you. There is a question of who got here first.

Let me emphasize the fact that, in every respect, any type of personal account was always going to be considered on a voluntary basis, period.

Let me give you another for instance. How about if we started an account at birth. My child is born, $1,000 goes in. For the first 5 years from that child's birth, an additional $1,000 per year. The cost of that plan for the first 5 years is $25 billion.

The money coming for that would be new entries into the retirement plan. In other words, at 18 I would become eligible. I would put new money in, so there would not be a net loss for that account.

Can anybody here tell me what you could do with $5,000 over 60 years in an investment account?

Mr. FERRARA. I could calculate that for you, but that is going to grow to a large amount of money, much more than Social Security promises, let alone what it can pay. It is going to grow to a very large amount.

Senator BUNNING. Let me tell you what happened. This is personal, so I know this, cold turkey. In 1961, the major league baseball pension program, a defined benefit program. I do not want to think about the current salaries. The minimum salary at the major league level at that time was $5,000 per year—per year—so the benefit plan was very important.

We had a defined benefit program that was guaranteed, just like Social Security. Two players, myself and Richie Ashburn, were members of the Pension Committee. We decided we would like to put a variable annuity on top of the fixed benefit. We had owners' cooperation. We had money coming in and we had this guaranteed.

Guess what? In 2005, 20 percent of our benefit is from the fixed, 80 percent of our benefit is from the variable. That is what we are trying to talk about today for Social Security.

If you talk about 2 years down the road or 3 years down the road, yes, there are fluctuations in the market. I was in the stock market for 25 years as an account executive, so I understand the market and what is going on.

We have to be innovative. The kiddie corps thing that I talked about for $1,000 for the first 5 years, that could be incorporated

into any kind of plan we had. I just would like you to know that the amount of money on that $5,000 investment would be paid off by new initial people, and when that person became eligible to work, they would also subtract the $5,000 from their first $5,000 in taxes that they collect from that person so there would not be a big, overall $2 trillion loss to the account.

I want you to know that volunteering to do that is in the best interests of every Social Security recipient in the world. The President of the United States has made it perfectly clear that no one is going to lose any benefits if they are 55 and over. He has said it over and over. I do not know if anybody is listening or if they are not.

I think we could even go back to 50 and do the same thing. All I can tell you is, the market return over a 60-year period, or a 40-year period, is so much larger than the Social Security return, it is unbelievable.

So when we talk about doing and maintaining the solvency of the Social Security trust funds and adding benefits, additional benefits—not separate benefits, but additional—we create an ownership society, where they own part of the rock, and a better increase, particularly for women and for the poor. That is where it hits the most, not for somebody who is making $150,000.

Actually, it is just like the players today in baseball. They do not need their pension program. I mean, if you cannot save enough out of $4 million a year, shame on you. What I am saying is, this is something, when we get a final bill, that will retain solvency and add benefits.

Thank you.

The CHAIRMAN. Senator Santorum?

Senator SANTORUM. Thank you, Mr. Chairman.

I apologize for not being here for much of the testimony. I just want to review. Does anybody on the panel believe that we should wait to change the system, that it would be a good idea for us to wait longer before we make any changes to the Social Security system? Does everybody believe we should act sooner, rather than later?

Mr. TANNER. Yes.

Mr. FERRARA. Yes.

Ms. ENTMACHER. I would say, Senator, that the most important thing is to not make the problem worse. Acting for acting's sake is not a good thing if the wrong steps are taken.

Senator SANTORUM. Obviously, I would never recommend acting for acting's sake, or to act to make the problem worse. I would agree with that.

So we should act. So, everyone believes there is a problem that needs to be addressed. Does everybody agree that there is a problem that needs to be addressed, and that the problem is in the relatively short term, not 40 or 50 years from now? Does everybody agree with that?

Mr. ORSZAG. Yes. The way I would phrase it is, the problem just gradually grows worse and worse over time.

Senator SANTORUM. And so there is a problem, and we should act sooner rather than later.

Ms. ENTMACHER. But, Senator, there is not a problem in Social Security over the short term. For the last 20 years since 1983, workers have been paying more payroll taxes than were needed to fund the program.

Senator SANTORUM. I accept that. I am on short time. You have answered my question. I understand. I did not say that there is a problem today, I said that there is a problem and we should act now to avoid that.

Second, does anybody on the panel believe that repealing the Bush tax cuts would directly help the solvency of the Social Security system?

Mr. TANNER. No, I do not.

Mr. ORSZAG. Yes, if the revenue were dedicated to the program.

Senator SANTORUM. But I did not say that. Just simply repealing the Bush tax cuts, would that directly help the Social Security system?

Mr. ORSZAG. No.

Mr. TANNER. No, because it presumes you could save the money today, which Congress has already proven it cannot.

Mr. FERRARA. He is not even putting it in the system.

Ms. ENTMACHER. Senator?

Senator SANTORUM. Yes?

Ms. ENTMACHER. It would make it easier on the rest of the Federal budget to make good and pay the interest on the bonds in the trust fund and to redeem the bonds in the trust fund.

Senator SANTORUM. We would still be able to pay the interest, would we not?

Ms. ENTMACHER. But for the rest of the budget, it would make it much easier to finance Social Security.

Senator SANTORUM. So repealing the Bush tax cuts or reducing spending, or anything to reduce the budget deficit would be good, not necessarily repealing the Bush tax cuts. So the overall budget picture needs to be improved.

I think we would all stipulate to that. But whether we are increasing taxes or reducing spending, both would have the same general benefit on the Social Security system simply because of our ability to be able to pay benefits.

Mr. FERRARA. No, I would not agree with that, because I think increasing taxes would harm the economy, so it would not necessarily improve the budget situation, or would not improve it as much as reducing spending would.

Ms. ENTMACHER. And I would disagree. If you focus not on the Social Security system's books but on the beneficiaries of Social Security, those 55 and older people that everyone talks about protecting, would be hurt if we cut Medicare, would be hurt if we cut Medicaid, would be hurt if we cut the other services that are important to them in order to finance the borrowing that is needed for these accounts.

Senator SANTORUM. Obviously, if we increase taxes or reduce benefits, someone is going to be hurt. I think we can also stipulate to that.

Let me sort of step back again. We should do something now, there is a problem, and we should do something, I think all of you

have suggested, within Social Security to solve the problem for the long term. Does everybody agree with that?

[Chorus of ayes].

Senator SANTORUM. All right. So the next question I have is, obviously, what to do. The what to do is, obviously, where we sort of part company at this point. So we all agree there is a problem, we have to solve it, do it now, and try to do it within the Social Security system. The question is, how do we do that?

Let us sort of step back again and look at the issue of debt. What Mr. Orszag said which struck me as sort of interesting, was that personal accounts exacerbate the debt problem. Yet, Mr. Ferrara and Mr. Tanner say that is not the case, that this is a debt that we are simply just realizing sooner rather than later.

You disagree with that, though, Mr. Orszag.

Mr. ORSZAG. I do.

Senator SANTORUM. Can you explain to me why you disagree that an unfunded liability out there, if moved up, is not just recognizing that debt that we owe, that we will recognize at some point sooner rather than later?

Mr. ORSZAG. The reason is, implicit debt does not need to be rolled over. Those future benefit promises do not need to be rolled over and refinanced in financial markets. Explicit debt does.

I know of no country in the world that has gotten into trouble because it has a large implicit debt with benefit promises out in the future. Lots of countries have gotten into trouble rolling over their explicit debt. There is a very significant difference.

Senator SANTORUM. Can I ask this question? What if the case can be made—and I think this is the case each of them would make—that by making the debt explicit, you actually lower the overall debt burden for the country.

Mr. ORSZAG. Well, again, the analysis becomes more complicated there. But let us look at the administration's proposal. I do not think that that is actually what would occur.

Again, even for it to be neutral, you need to believe these benefit offsets that are 40, 50, 60 years out. Just to repeat what I said earlier, people like Bob Rubin think that financial markets just simply will not believe that the future Senator from Pennsylvania in 30 or 40 years will uphold those full benefit offsets.

Mr. FERRARA. May I address that?

Senator SANTORUM. Please.

Mr. FERRARA. What this criticism he raises overlooks is, first of all, there is a huge amount of money going into the markets from these personal accounts.

When the Chief Actuary of Social Security scored Ryan-Sununu, he estimated that 15 years down the road the workers would have $7.8 trillion in today's dollars in those accounts.

So when he talks about, well, they are going to borrow $2 trillion or they are going to borrow, God knows what, $7 trillion, well, they are going to have $7.8 trillion after 15 years in those accounts. It is $16 trillion after 25 years.

So even if you borrow all the money, on net, that borrowing is being offset by the increased savings and investment.

Then the other point that he has raised repeatedly here that is a very important point to address is, he is saying, well, will they really have these benefit offsets in the future?

In other words, you are substituting the personal accounts for some of your future Social Security benefits, and he is trying to raise the fear that, well, that substitution ultimately will not take place.

That is why you need large accounts, like in the Ryan-Sununu bill, or like the Cato Institute has proposed. People are getting better benefits through their accounts than Social Security, and you are not going to have a problem with that offset in the future.

Mr. TANNER. The other thing to point out is what Mr. Orszag is actually arguing, that that $12.8 trillion in unfunded obligations that the Social Security faces in the future is not really real, because you can always default on the benefits.

Mr. ORSZAG. That is not what I am arguing.

Mr. TANNER. So, in essence, he is arguing that you are going to cut those benefits in the future and not make good on every penny that is promised in future benefits, which is probably true.

It is certainly true under our plan. It has been true under his proposal. It is true under most of the proposals that are up there, that the promised level of benefits probably cannot be paid in the future.

However, it is incorrect to say that that is something that has to do with individual accounts. That has to do with, we have overpromised in terms of benefits. It has nothing whatsoever to do with the creation of individual accounts.

The CHAIRMAN. Senator Schumer is next.

Senator SCHUMER. Thank you, Mr. Chairman. I thank the witnesses as well. First, I want to thank you, Chairman Grassley, for holding this hearing and for, generally, your approach here, which has always been bipartisan and to try to bring people together.

The reason why bipartisanship is having more trouble on this issue than just about any other is because this goes not just to how to fix Social Security, I think, but to deeply held views about what government is all about and what our country is all about. It is much harder to bridge a partisan divide when things are that deep. Nonetheless, I appreciate your efforts to do it.

Now, to me, at least, there is someone missing at today's witness table, and that is the President or his representative.

Again, I appreciate the Chairman holding this hearing and the general bipartisan approach he takes, but it was the President who called Social Security a crisis, and then gummed up the works by insisting on privatization.

The only way we are going to be able to move forward in a bipartisan way is for the President to take privatization off the table, or alternatively present a detailed plan with privatization so this body can either pass it, or more likely reject it, and then move on.

Everyone should understand here what the President is proposing. Under the President's plan, someone born this year would have no guaranteed benefit when he or she reaches retirement.

The President's plan is not partial privatization, it is ultimately a phase-out of Social Security. Obviously, that takes a scenario

where the stock market does not do well at all, but that is where it could lead. That is the fundamental difference.

Mr. Ferrara keeps talking about rate of return. Well, this is an insurance program, not an investment. If you want to fundamentally change it and say it ought to become an investment as opposed to an insurance program, that is fine. But I do not buy it, and I think most of the American people do not buy it.

So there are a lot of problems here. Debt is one of them. The President wants to eliminate the death tax, but with his plan, in my judgment, creates a much larger birth tax owed by every single American.

People like Alan Greenspan have said, yes, he prefers private accounts, but with this level of debt we have, you would have to do something to deal with that before you could do it.

That will lead to my first question, which is, Mr. Ferrara, you referenced Martin Feldstein. He is a conservative, prominent Harvard economist—Harvard and conservative not being an oxymoron, I guess, in this situation—and he served as President Reagan's Chief Political Advisor.

He wrote in 2002, he recommended that President Reagan not support private accounts. His reason was, "The trust fund was empty and the overall budget was in substantial deficit. So starting to fund investment-based tax accounts would have required a tax increase, or even a larger overall budget deficit."

In other words, the early 1980s, which saw a greater crisis than we face today with Social Security—they were closer to running out of money, in any case—yet, Ronald Reagan's economist was opposed to private accounts.

Today we have financially strapped wartime expenses and large budgets. Why is it a better idea today than it was 20 years ago?

Mr. FERRARA. Well, you know, I, too went to Harvard Law School and I studied under Professor Feldstein. That is where my whole enterprise with Social Security began. I actually spoke to him just 3 or 4 weeks ago, and he said, "I very much support what the President is trying to do with personal accounts."

Now, the reason I brought him up is because the reasoning behind the Ryan-Sununu bill and what I have been trying to accomplish, what I have been advancing for many years, comes out of his original reasoning. Social Security is a pay-as-you-go system. There is no savings and investment in it. They take the money from you and they give it to him.

What he argued is, it would benefit workers, it would benefit the economy, if we changed it to a savings and investment system where you had real savings and investment, and then when you reach retirement, that supports you. That is what I am trying to accomplish with this kind of bill.

Senator SCHUMER. I understand.

Mr. FERRARA. Not everyone is trying to do that.

Senator SCHUMER. Let me ask you—and I see my time is about to go out—it is an insurance plan. Here, you do not look at rate of return, which you keep talking about, for an insurance program. In other words, I save for my kid's college.

My wife and I put money away for my kid's college education. We went to a couple of financial advisors, friends of ours, and they said, put it in bonds because you need the money there.

In other words, the down side of not having the money for something very important, whether it be insurance or college tuition, far exceeds the up side of making more money.

That is the fundamental difference that we see here. It is not, when you are 2 percent below or 2 percent above, they are even. They are not if you do not have the money for necessities. How do you address that fundamental question?

Mr. FERRARA. Let me address this. Insurance has a value if you look at the benefit that they promise you times the probability of getting the benefit. By doing that calculation, you can determine what the value of the insurance is.

Now, Social Security has a lot of insurance-type promises. When we did the first study of this when I was at Harvard, what we did is, we calculated the value of all the promises times the probability of them having to be paid, and compared that to the value of what would be paid into the system.

That is how we calculated the rates of return that are promised by the system. We found out that, for most workers, the real rate of return would be 1 to 1.5 percent or less; for many, it is zero or negative.

Now, you can cover the same things through a system of private savings and insurance. What we are doing today in the Ryan-Sununu bill is, we are focusing on the retirement part. The other, more insurance-oriented pieces like the pre-age 65 retirement benefit and the disability benefit, those are left entirely in the current system as it is.

But you can calculate a value for insurance and then determine the rate of return that way. You can design a system that takes advantage of what is good in Social Security and provides a better deal for workers. That is what we are trying to do with the whole design of the Ryan-Sununu plan from the beginning, is to do that.

Senator SCHUMER. I see Mr. Orszag shaking his head. I would just like him to respond.

Mr. FERRARA. He is always shaking his head.

Mr. ORSZAG. Only when there are incorrect statements made.

The CHAIRMAN. Senator Lott?

Senator LOTT. We are going to get second, and I guess third, rounds here.

Senator SCHUMER. Mr. Chairman, could Mr. Orszag just answer what Mr. Ferrara said?

The CHAIRMAN. Yes. Please, briefly.

Mr. ORSZAG. I think that even people who support individual accounts on the conservative side, people like Greg Mankiw and others, argue correctly that there is a way to analyze the problem and it is not the way that Mr. Ferrara is presenting things, the free lunch that solves everything, and instead actually makes the argument that the administration has made, which is that there is a trade-off.

You get the account, but you then lose something. That then speaks to what Senator Schumer was really talking about. There are a whole variety of different aspects of the program that provide

insurance, including one that is not well-appreciated, that it provides a form of lifetime earnings insurance.

Young workers today whose lives do not turn out quite as well as they expect partially make up the difference through Social Security. That is very hard to do through private markets, and it is not done in most private account plans. That is just one example.

The CHAIRMAN. Senator Lott?

Senator LOTT. Thank you, Mr. Chairman, again, for having the hearing and giving us a second round.

There are so many things that have been said today that need to be corrected, I do not hardly know where to begin, but I will just pick two to make sure the record is correct.

Senator Baucus, in his opening statement, and now just a moment ago Senator Schumer referred to these personal savings accounts as privatization, or inferred that President Bush favors privatization. He does not. The publicly run Social Security system would still be there. The President has endorsed personal savings accounts managed like the thrift savings plan, which is not privatization.

Senator Kerry argued that repealing the Bush tax cuts would solve the Social Security trust fund solvency problem. Obviously, that is inaccurate for a variety of reasons. First of all, this was not just for wealthy people, it was for a lot of working people, for families with children, middle-income people. It would have a huge negative impact on the economy.

But CBO, for instance, the non-partisan CBO—which a lot of times I disagree with—said that in 2050, the cost of extending tax cuts will be 0.7 percent of the GDP, the Social Security trust fund deficit will be 1.4 percent GDP, and that is assuming it does not cause huge problems in the growth of the economy.

Now, Mr. Orszag, first of all, thank you for being here and for the thought you have given to this. Unlike the Democrats, at least you have a plan. But I suspect yours is their plan. Now, we all know what they are against.

They are against my grandchildren being able to have more than what my mother has when they reach retirement age because they do not like personal savings accounts. They do not want people to be able to take their own money and get more from it. But let us talk about the reform side of it. Let me make sure I understand what you are suggesting.

Number one, do you propose to do anything with the age problem or situation in view of increasing longevity? Would you index it? Would you raise it? Would you do anything about age?

Mr. ORSZAG. We would not directly change the normal retirement age. We would, however, index benefits to life expectancy.

Senator LOTT. Would you do anything about controlling the rate of growth of benefits?

Mr. ORSZAG. Well, that, in part, would control the rate of growth of benefits.

Senator LOTT. So how would you do that, now? Say it again.

Mr. ORSZAG. What would happen is, the goal would be to keep lifetime benefits roughly constant as life expectancy goes up, so because people would be receiving their benefits over a longer and longer number of months——

Senator LOTT. Even though they may not have paid into it, or you can justify it, they would get these increasing benefits based on age?

Mr. ORSZAG. Benefits would still increase from one generation to the next. What we would be trying to do is insulate the system from the effect of increases in life expectancy.

Senator LOTT. What you would do, though, would be to raise more revenue for Social Security. Is that correct?

Mr. ORSZAG. That is correct.

Senator LOTT. How would you do that, now? Are you doing it in two different areas?

Mr. ORSZAG. Yes, in a few different areas. Let me give you two examples.

Senator LOTT. All right.

Mr. ORSZAG. Mr. Pozen mentioned this, and I think it is also something worth exploring. One idea is to impose something like the Medicare payroll tax, 2, 3 or 4 percent on all wages, rather than just going up to the current $90,000 a year limit.

The reason for doing that is, there is now more than $800 billion in wages above that cap that go untaxed. That more than $800 billion represents about 15 percent of total wages, which is up from about 10 percent in 1983.

In my view, it makes sense to try to walk that back. But an alternative, again, as I mentioned in my oral testimony, you could use part of an estate tax revenue dedicated to Social Security and use that to help to restore solvency.

Senator LOTT. But if we did that, of course, we would not be able to use that savings to deal with the overall government deficit, which we are being told we should do. You suggested that we have not been able to come up with a plan. Yes, we can come up with a plan, we just have not had the courage to do what is necessary to control Federal Government spending.

But again, is it fair to say that the main part of your plan is to get more revenue by raising taxes in several different ways into Social Security? Is that correct?

Mr. ORSZAG. Well, we have both some additional revenue dedicated to Social Security and then some changes on the benefit side. The reason we have additional revenue is precisely to mitigate the reductions that would otherwise be required. It is a very simple trade-off. If you are going to restore solvency, the less that you dedicate in additional revenue, the more you have to cut on the benefits side.

Senator LOTT. My impression is, your plan is a tax increase. I think that is a Democrat plan.

Mr. Ferrara, just so I can get under the wire here.

Mr. FERRARA. Yes, sir. I will wait.

Senator LOTT. Now people are already paying, both the employee and employer, 12.6 percent.

Mr. FERRARA. 12.4.

Senator LOTT. 12.4 into this program.

Mr. FERRARA. Right.

Senator LOTT. Which is very significant. The people I know, small business men and women, farmers, working people, they do not want to pay more into this. They do not want to pay more

taxes. They already think they are paying too much in taxes, from gasoline taxes, right up and down the line. So, I think it is really the most unfair tax of all, the payroll tax.

Mr. FERRARA. Mr. Orszag would both raise taxes and cut benefits, and no Democrat has introduced this plan. That cannot solve the problems of Social Security, but would make them worse because it would make it a worse deal.

It would reduce the rate of return of Social Security even more. If you raised taxes and cut benefits, more people would have a negative rate of return on the program. I think that is why you see nobody introduce that.

Mr. ORSZAG. Instead, we should cut Medicare benefits and use that money.

Mr. FERRARA. Well, whose proposal is that?

Mr. ORSZAG. Yours.

Mr. FERRARA. No. Come on. Tell the truth now.

Senator LOTT. I am for that. We should do that. In fact, we made a huge mistake in what we did 2 years ago.

The CHAIRMAN. The Senator from Oregon.

Senator WYDEN. Thank you, Mr. Chairman. Thank you for the second round, Mr. Chairman.

Mr. Ferrara, I said earlier when I looked at your proposal, no benefit cuts, no substantial risks, no major debts in terms of financing. I said it is a little like telling somebody they can have three hot fudge sundaes a day and lose weight. Throughout the course of the morning, you just keep adding to the sundae, more nuts, more cherries. It just keeps going on and on.

I want to see if I can sort some of this out. Now, I have seen one report indicating that you would pay for your program with a $6.9 trillion general revenue transfer for which unspecified cuts would be made in Federal spending.

The reason I ask about this, and you correct me if I am missing something, if the cuts are not made, then we have debt. So, I want to be clear, my reading of your proposal is that it involves a substantial amount of debt. If the cuts are made, I would be very interested, at least, in knowing where you would like to have the cuts made.

But you have made the very substantial proposal that it looks like it is all gain and no pain, and perhaps you could just walk me through this question of the financing, particularly, what happens if there are not these cuts, because by my calculus, that becomes debt at that point.

Mr. FERRARA. If there are not those cuts, then the Federal Government becomes an unbearable burden on the country. The Congressional Budget Office projects that Federal spending, as a percent of GDP, under current law will increase from 20 percent today to 34 percent by 2050.

Now, what we have under the Ryan-Sununu bill is a very modest spending restraint that would reduce that growth just 1.6 percentage points below the baseline. So in other words, Federal spending could still grow, under the spending limitation of Ryan-Sununu, from 20 percent today to 32.4 percent by 2050. That is still far too much.

What it does is, the spending restraint reduces the rate of growth of Federal spending over 8 years by 1 percentage point, for GDP minus 1 percent. You achieved more spending restraint than that during the 8 Clinton years, when Federal spending grew at GDP minus 1.8 percent.

So my point is, it is a very modest down-payment on restraining what is overwhelming growth in Federal spending. Obviously, we cannot sit here and watch Federal spending grow from 20 percent to 32.4 percent of GDP, but the spending limitation under Ryan-Sununu would still allow even that much. It is just a small down-payment on the amount of spending restraint you would need.

Senator WYDEN. Mr. Chairman, I appreciate Mr. Ferrara saying now that his notion of what would be a modest step involves $6.9 trillion. I want to just wrap up by saying, Mr. Chairman, there is no question in my mind—and I think you and I agree on this—that this is a program that needs to be modernized. The demographics are obvious. There are going to be many more older people retiring, fewer younger people.

I was one of the 10 Democrats who joined you in voting for the prescription drug bill because I thought that was a program that needed to be modernized, and I still have the welts on my back to show for that particular vote.

My concern is it is going to be very hard to modernize this program when the first step that is taken would, as the Wall Street leaders told me yesterday, be reallocating risk and threatening the safety net.

I just want to wrap up by way of saying, I am interested in working with you. I would like to see if we could find common ground, like was done with Ronald Reagan and Tip O'Neill in 1983. I am not talking about raising payroll taxes. I am not in favor of doing that. I am in favor of trying to find common ground the way Ronald Reagan and Tip O'Neill did.

My concern is, we are not going to be able to do it if the first step unravels the Social Security safety net. But I just wanted to say to you, as I said to Senator Santorum, I am interested in working with both of you, and I thank you.

The CHAIRMAN. Well, I want to say thank you. You may be one of those forward-looking Democrats I have not paid enough attention to on this issue, and I need to sit down and talk to you.

You just may be in the mold of a Judd Gregg or a Chuck Grassley when Clinton was suggesting that we needed to save Social Security first, who worked with then-Democrats who wanted to follow on with President Clinton's suggestion of saving Social Security first by working out a plan that included personal accounts.

We need to have that same bipartisanship under a Republican President Bush that follows on some examples set by Democrats and Republicans working together when President Clinton suggested saving Social Security first.

Senator WYDEN. Mr. Chairman, I think I had a minute left on my time. I just want it understood that I am concerned that personal accounts—at least everything I have heard—unravels the Social Security safety net in a way that I think is going to make it hard for us to find common ground.

But I still want to work with you, because I think we showed with the prescription drug legislation that we could modernize a program and bring it in line with the times. That was what my comment was alluding to.

The CHAIRMAN. Well, I welcome that opportunity.

Senator Santorum?

Senator SANTORUM. I would add my name to that list of folks who worked with, at that time, Larry Summers and Gene Speurle, who were advising President Clinton on Social Security.

The CHAIRMAN. I am glad. I should not have overlooked you.

Senator SANTORUM. That is all right. That is not the first time. [Laughter.] Just kidding, Mr. Chairman.

But it would be great to see some bipartisanship. I appreciate the Senator from Oregon and his willingness to offer those comments. I am hopeful. I know the Senator from New York, Senator Schumer, criticized the President for not being here, not presenting a plan. People in glass houses. The fact is, not one person, certainly in the Democratic leadership, has presented any plan.

I find it remarkable that Senator Schumer would criticize the President for not putting forth a plan, and then proceed to attack his plan and tell us how much benefits will be cut, which is, again, a remarkable sleight of hand to accuse someone of not having a plan, and then tearing a plan apart.

Senator Lott said the idea that this is privatization, which of course it is not, that is not the President's plan, I know the Senator from New York knows that.

I found it also interesting that he used the term, this is an insurance program, not an investment program. I do not know that much about insurance, but I would suggest that most insurance companies finance their benefits through investment.

I do not know of too many insurance companies who would be in business if they had a pay-as-you-go system for providing their benefits. They finance insurance through investment. Why? Because they would be in jail if they did not. So, I just wanted to throw that part out.

I want to make a couple of comments on comments that were made, and then I have a couple of questions.

First, Mr. Orszag, you said an interesting point. You said younger workers whose lives do not turn out so well end up supporting the system.

Mr. ORSZAG. No, no. Benefitting from the system. They get lifetime earnings insurance from the system.

Senator SANTORUM. No, you just said recently that younger workers who do not turn out so well, their lives who were ended prematurely, end up contributing to the system.

Mr. ORSZAG. Sorry. There are two different questions. One is, under the President's proposal, what happens to workers who die before retirement.

Senator SANTORUM. Yes.

Mr. ORSZAG. By not turning out so well, I meant that their wages were not as high as they had hoped that they would be, or that they would become disabled. Those workers benefit from the current Social Security program disproportionately.

Senator SANTORUM. All right.

Mr. ORSZAG. I am sorry if I misspoke.

Senator SANTORUM. I was not quite sure I understand that.

Mr. FERRARA. Right. He meant, they contribute to the system if they die younger, then their money goes to——

Senator SANTORUM. That is how I took it.

Mr. ORSZAG. I did not mean to say that.

Mr. FERRARA. He did say that at one point in this long and extended session.

Senator SANTORUM. You did, like about 10 minutes ago.

Mr. FERRARA. He did say that at one point

Senator SANTORUM. I clearly took that you said, well, they die younger, and therefore their money gets contributed to the system.

Mr. ORSZAG. We can make this very clear with the written record.

Senator SANTORUM. All right. Great. That is fine. I just wanted to make sure.

Mr. ORSZAG. Thank you.

Senator SANTORUM. I did not know what point you were making.

Mr. TANNER. It would be true if he had said that.

Senator SANTORUM. It would be true, but it would not be one that I would think he would make. That is why I was somewhat surprised he made it.

Ms. ENTMACHER. Yes. Well, certainly it is true that women who tend to earn less over their working lives, because of the wage gap and because they take more time out of the workforce for caregiving, do better under Social Security because it has a progressive benefit formula, and the spousal benefits. So working women, who tend to earn less over their lives, definitely benefit from the current system.

Senator SANTORUM. And I suspect that a personal retirement account system could be structured so as to structure the accounts to make sure that those who are lower income, as well as those who are in and out of the workforce, would make sure that they would have a better benefit contribution when they are in the workforce.

Mr. FERRARA. That is what we do in the Ryan-Sununu.

Senator SANTORUM. Another thing. Mr. Orszag, you said that personal retirement accounts will add to total costs because eventual savings will never be realized. Then you said that personal retirement accounts were bad because they were just loans against future benefits. Now, I do not know how you can say both of those things and be consistent intellectually.

Mr. ORSZAG. Sure. Because not all the loans will be fully repaid. That means that it is both a loan, and that the Federal Government will be out some money as a result of the loans not being fully repaid.

So for example, take a higher earner. Let us assume that we have progressive price-indexing. Take a high earner. The worker will owe—and let us just make up some numbers—back $10,000 a year.

If his or her traditional benefit is only $9,000 a year, the government is not going to reach into the worker's pocket and pull out extra money. That is a case in which the government loses money as a result of the worker participating in the accounts.

Mr. TANNER. Senator, could we lose this loan analogy once and for all? Because it is not a loan, it is simply an opportunity cost. What you have is a chance to put the money in traditional Social Security and earn that rate of return or put the money into your individual account and earn that rate of return, and you choose one or the other.

If you choose the individual account, you do not get the benefit from the traditional Social Security for that portion. If you choose the traditional Social Security for that portion, you do not get the money from the individual account.

This is sort of like saying, if you had $20,000 and you were going to go out to buy a car, and you were trying to choose between a Ford and a Chevy, if you chose the Chevy, then somehow the Ford has lent you the money, because you do not get to have both the Ford and the Chevy. The reality is, you are simply picking one set of benefits or another.

Mr. ORSZAG. Senator, Goldman Sachs has called it a loan. Actually, interestingly, the terminology surrounding the accounts is almost exactly identical to the terminology used for margin investing in financial markets. Just like investing on margin is a loan, this is effectively a loan. We can debate the semantics, but I think it provides insight.

Mr. FERRARA. The term "loan" is an academic construct that he has created. The people who analogize this to margin investing, that is only if you borrow the whole thing. But again, in the Ryan-Sununu plan, we do this without permanent net borrowing.

Senator SANTORUM. The other point I want to make, Mr. Orszag, you talked about increasing the cap because the percentage of payroll, and you picked out, I think, 1981.

Mr. ORSZAG. 1983.

Senator SANTORUM. 1983. And said it was 90 percent or 91 percent of payroll.

Mr. ORSZAG. Ninety.

Senator SANTORUM. Yes. But I think, if you look back over the history, that was the highest level it had ever been. So you picked the highest point to pick as your model of what percentage of payroll we should be covering.

As you know, back in 1968, it was 73 percent of payroll. So, I do not think it is quite forthright for you to have gone back and said, well, we can just pick this arbitrary number, 91 or 90 percent, as the top, and say that that is what it has been.

In fact, it is averaged. If you take the average percentage of payroll since 1937, has it not averaged pretty much exactly where we are today, around 85 percent of payroll?

Mr. ORSZAG. I do not have that number.

Senator SANTORUM. I do.

Mr. ORSZAG. All right. Eighty-five. But two points are worth noting. First, the reason that we picked 1983 was simply that that was the time of the last reform. Second, our plan does not actually go all the way back to 90, it only goes back to 87 percent. So, I was just holding that out as something that, implicitly, was behind the 1983 reforms, and we do not actually go all the way back there, anyway.

Senator SANTORUM. All right.

Two other points, Mr. Chairman, if you will indulge me. I appreciate it, thank you.

A question on budget deficits. Really, what we are talking about here with personal accounts, what you insist on calling a loan, is really just looking at, what is the best way to finance this system in the future? We are going to pay these benefits.

I think everyone here believes, while there is not a guarantee under the U.S. Supreme Court case that everybody insists, I understand that, but there is an implicit guarantee that the Congress is not going to reduce benefits or dramatically reduce benefits certainly of people at or near retirement in the future.

So we are going to have this obligation out there, and this obligation is not funded. I think everyone accepts that future obligations to Social Security are not funded at this point.

So the question is, how do we fund them? Do we fund them through tax increases? Do we fund them through benefit cuts? Do we fund them some way using investment as a way to pre-fund the liability?

When you do that, then you take money that you would be, under the current scenario, starting in 2017, borrowing to pay benefits. Does everyone agree, if we do not make any changes, in 2017 we are going to have to borrow to pay benefits?

So instead of borrowing 12 or 13 years from now to pay benefits, what about borrowing now to finance those benefits? You say, well, the difference is, we have an actual cost of borrowing, 15 years of borrowing costs in this case, that we would not have if we just waited a few years to borrow. True.

Can we look at it, maybe stepping back a little further, saying, what is going to be the position of the Federal Government 15, 20, 30, 40 years from now in its ability to borrow versus today in its ability to borrow?

I think what we would suggest, is that demographics—the fact that we are aging, having fewer children, and that the boomers are going to begin to retire—show that given that three of the four biggest programs in the Federal Government, Medicare, Medicaid and Social Security, that demographics are going to drive budget deficits to levels heretofore unseen.

So the question is, is it perhaps wise to have additional borrowing now, when although deficits are high, not nearly as high as they will be in the future, to finance a reduction in the deficit when deficits become problematic?

Ms. ENTMACHER. Senator, if I might. I think the reason that we have seen the growth in deficits that we have over the last few years is that the revenue base has been shrinking. The tax cuts have really diminished the amount of revenue that the Federal Government takes in, and will continue to do so if the tax cuts are made permanent. Mr. Ferrara has talked about——

Senator SANTORUM. What numbers are you using? Are you using the percentage of GDP and taxes? Is that what you are using?

Ms. ENTMACHER. Yes. The tax cuts have reduced the revenue base. As the tax cuts are made permanent, that revenue base will shrink. We will be facing——

Senator SANTORUM. I am just trying to understand. What are you basing that on? Are you basing that on, the percentage of

taxes, as a percentage of GDP, is going down if we made the tax cuts permanent?

Ms. ENTMACHER. Peter, do you have something?

Mr. ORSZAG. It is lower than it would otherwise be.

Senator SANTORUM. I understand that.

The CHAIRMAN. But do not forget, they were as high as they were in 2001 since World War II. What we are trying to do is have a tax policy in this country that keeps the revenue coming into the Federal treasury where it has been for 40 years—between 17 and 19 percent of Gross National Product.

Mr. ORSZAG. I think the problem with that is precisely the one that Mr. Ferrara has highlighted, which is, we never before in this country have faced a demographic challenge like we face going forward.

To just look at the historical period where entitlement spending was a tiny fraction of what it is projected to be, leaves out the point that entitlement spending, and that is Medicare, Medicaid and Social Security——

Senator SANTORUM. I think we are agreeing on the point that we have promised a lot of spending.

Mr. ORSZAG. Absolutely.

Senator SANTORUM. And we do not have a way to finance it. Given traditional historic tax rates, we will not be able to finance that.

Now, here is the question. Do you believe that global competition 20 years from now from China, India, and the rest of the world will be less or more rigorous?

Mr. ORSZAG. I think it will probably be more rigorous.

Senator SANTORUM. So if global competition will be more rigorous, does it make sense for us, looking forward to the quality of life that future Americans will have, that in the face of more rigorous global competition we will have much higher taxes? Would it make more sense for future generations that we avoid making promises we cannot keep, given that global competition?

Mr. ORSZAG. Senator, I think the best way that we can provide for future generations is both by investing in their education, but also by increasing our National saving rate. That is the only way in which we are going to accumulate more capital as Americans.

Senator SANTORUM. Making a case for personal retirement accounts?

Mr. ORSZAG. No, I am not. In fact, let me now quote, since we have now talked about Presidential Chief Economic Advisors, from Harvey Rosen, who is the President's Chairman of the Council of Economic Advisors. I am quoting from his new textbook: "There is no reason to believe that privatization by itself," he uses that word, not me, "would raise national saving. At the end of the day, all that takes place is a swap of public and private securities between the trust fund and private markets. No new saving is created. If you create these accounts and issue debt to finance them, you have done nothing to help future generations."

Mr. FERRARA. That is only if you borrow all the money, do you have no net savings increase. But again, I have never been an advocate of financing the entire transition by borrowing all the money. In the Ryan-Sununu bill, we try to eliminate all net debt

so that you go to the fully funded system that Martin Feldstein was originally envisioning in the 1970s.

I mean, of course if you borrow it all back, then you do not get a net increase in savings capital. There are other advantages you get, but you do not get that one. But if you do it the way we do it in Ryan-Sununu, then you get that one also.

Senator SANTORUM. I just want to make the point, and I think the point is an important point, which is, if we do not act now and do something to help pre-fund this liability, in my opinion, and simply go to increased taxes, particularly payroll taxes, which is what you are suggesting, which will make our workers less competitive in an increasingly competitive global environment, and we continue to be able to not do something about reducing spending, which, as Mr. Ferrara has said will increase from 20 percent of GDP to 32 percent of GDP, then we are in a situation that is simply unsustainable.

We will put our future generations in an economic vise they will simply have to do drastic things to get out of. Simply raising taxes, in the face of global competition, putting more burden of debt and spending on future generations, is not—is not—a desirable alternative, given what the world is going to look like 20 years from now.

I think most people will accept that. Now, we may disagree on how we have solved this problem, but I think what these gentlemen are presenting, at least in my mind, is a way around these dramatic increases in taxes, which will surely come when the boomers retire, to finance these benefits in the face of an economy that is becoming less and less competitive with the world.

Mr. ORSZAG. Senator, again, the key to Mr. Ferrara's plan is this reduction in spending that is assumed without any specificity. If there are specific ways of cutting Medicare and Medicaid spending by the amounts that are discussed, let us look at them.

Mr. FERRARA. But they are not focused on Medicare and Medicaid spending.

Mr. ORSZAG. In the absence of specificity, there is nothing there. It is a magic asterisk.

Mr. FERRARA. We specified, in several papers I wrote, far more in benefit restraint than would be necessary under Ryan-Sununu, so you should keep up with the literature.

Senator SANTORUM. Could I ask just one final question on this? Then I promise, Mr. Chairman, I will stop.

Are you suggesting that we do not need spending restraint, that looking at the Federal budget spend-out, that we can maintain this level of spending?

Mr. ORSZAG. Not at all, Senator. But what I am saying is, it is grossly irresponsible to simply assume the savings and dedicate those to Social Security, which is what is being done, without specificity.

Senator SANTORUM. Do you believe future Congresses will allow spending to increase at the rate it is scheduled to increase?

Mr. ORSZAG. I think that, unfortunately, Congress will probably not tackle this problem until a fiscal crisis is upon us, and we are coming increasingly close to having that.

Senator SANTORUM. So maybe having some plan that forces discipline now would be a good idea.

Mr. ORSZAG. Well, that would be like arguing that we should gain a lot of weight in order to force ourselves to go on a diet.

Senator SANTORUM. Not at all. What we are saying is, sometimes we need an incentive to be able to go on that diet. The incentive would be having personal savings and investment in a better, sounder retirement.

Mr. ORSZAG. This is an important point. The transfers that occur from the rest of the budget to Social Security under Mr. Ferrara's plan occur regardless of whether the spending cuts happen or not.

Senator SANTORUM. You are arguing his plan. I am not on his plan, I am arguing the general concept. But I understand, you get in the box and you have to defend it.

Mr. TANNER. Senator, could I just quickly make one point on the size of the tax increases that we are talking about here? The tax increase would be truly enormous and truly have a devastating impact, I think, on the economy and on competitiveness.

If you were to remove the cap on the wages subject to Social Security payroll tax, which I recognize——

Senator SANTORUM. Remove the cap, meaning lifting the cap, which is now at $90,000, to tax all income at 12.4 percent.

Mr. TANNER. Right. In the first 10 years alone, that would be a $1.3 trillion tax increase. It would give the U.S. the highest marginal tax rates in the world. We would have a higher marginal tax rate than Sweden or Germany.

In exchange for that, you would get precisely 7 additional years of cash flow solvency under Social Security. So you would increase taxes by $1.3 trillion and put off Social Security's cash flow deficit by just 7 years, so to solve Social Security just by raising taxes is going to take an enormous tax increase of the type that this economy simply cannot suffer.

Mr. FERRARA. Let me just say one thing, quickly, to address the mischaracterization of Mr. Orszag of the exercise I had engaged in advancing this plan. The point of the thing was to show a mathematical result: if you engage in this amount of spending restraint, this is the result.

The Chief Actuary of Social Security did the math. We went to him so he would do the math, so people who say, I cannot add and subtract, would not be able to make that criticism. It is simply a mathematical exercise. If you engage in this amount of spending restraint, then you get those results.

Now, if I was the President of the United States, I would have proposed a bill with more specificity. If he wants more specificity, well, maybe I should run. But it is an unfair criticism.

It was just a mathematical exercise to show, if you do these sorts of things, you are going to get those results. It actually ends up as a very modest spending restraint that you need to accomplish. In fact, we need to do that, and more, as a country or we are going to be in very, very deep trouble.

Ms. ENTMACHER. But Mr. Ferrara has kept saying that one of the attractive features of his plan is that it guarantees the benefits that people are counting on, the people who are poor, the people who are disabled, that all these people will be protected, and that

his plan has a guarantee. If it is only a mathematical exercise and we do not know where the funds are coming from, where is that guarantee?

Mr. FERRARA. It guarantees the benefits of Social Security. But we say over and over again, we do not guarantee the rest of Federal Government spending. Are they supposed to say it is a free lunch and it dramatically cuts government spending? Well, it cannot be both. It can only be one or the other. So, really, give me just one criticism and let us just deal with that one.

Mr. ORSZAG. Senator, I would just add, very briefly, that it is a mathematical exercise to note that if you cut 1,000 calories out of your diet, you will lose a pound about every 4 days. It does not tell you anything about how you are actually going to go about doing that.

Mr. FERRARA. But at least it shows exactly the amount of calories you need to cut. That was the important point.

Senator SANTORUM. Thank you, Mr. Chairman.

The CHAIRMAN. Yes. And I thank all of you very much. I found it very entertaining. [Laughter.] But more importantly than entertaining, dealing with a specific subject that I plan on this committee dealing with sometime this summer.

Now, I may be fooled and I may not get to that point, but I think that this is an opportunity that has been given to us. As I said before, this is so politically sensitive that somehow Congress will only talk about Social Security when forced to by presidents like Carter, Reagan, Clinton, and Bush.

I feel I should not lose that opportunity to bring about changes in Social Security, so that there is ownership and so that there is preservation of this program for our children and grandchildren.

The hearing is adjourned. Thank you all.

[Whereupon, at 1:23 p.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted for the Record

STATEMENT FOR SENATOR BUNNING
FINANCE COMMITTEE HEARING
APRIL 26, 2005
PROPOSALS TO ACHIEVE SUSTAINABLE SOLVENCY, WITH AND WITHOUT PERSONAL ACCOUNTS

Mr. Chairman, thank you for holding this important hearing today. The solvency and protection of the Social Security system is one of the most important issues that Congress must deal with this year.

Social Security is an extremely important program for millions of Americans 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, and fewer workers are paying for the benefits of current retirees. In fact, 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 2005 Social Security Trustees Report, Social Security will begin paying out more in benefits than it collects in revenue in 2017—only 12 years from now. By the year 2041, the Social Security trust funds will be depleted, and the program will be insolvent. At this time, the program will only be able to pay 74 percent of promised benefits.

These numbers show that we have a real problem on our hands. Congress must take a leadership role in fixing Social Security's solvency, instead of just hiding our heads in the sand and hoping it will go away. 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.

Any type of reform needs 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. However, personal accounts do not solve Social Security's financial problems, and Congress will have to make some tough decisions about how we provide a benefit over the long term.

The witnesses we have before the committee today have some interesting proposals for Social Security reform. I look forward to hearing from them, and I appreciate the time they have taken to be here.

This is an extremely important topic, and I hope we can work together as a body to strengthen Social Security.

Thank you.

Testimony of Joan Entmacher,
Vice President for Family Economic Security
National Women's Law Center

U.S. Senate Committee on Finance
"Proposals to Achieve Sustainable Solvency, With and Without Personal Accounts"
April 26, 2005

Chairman Grassley, Ranking Member Baucus, and members of the Committee, thank you for this opportunity to testify on behalf of the National Women's Law Center.

As this Committee considers proposals with profound implications for the future of Social Security and the tens of millions Americans who rely upon it, I would urge you to make your primary goal protecting and strengthening the safety net that Social Security represents, not just for workers when they retire, but for workers who are disabled and their spouses and children when income is lost due to retirement, disability or death. Social Security is truly a family insurance program. Half of all Americans who receive Social Security benefits do so as disabled workers (12%), children (8%), and spouses and surviving spouses (30%). Too often, discussions about how to achieve solvency and whether to create private accounts to replace Social Security in whole or part fail to consider the impact on these beneficiaries, who are overwhelmingly women and children—so they will be the focus of my remarks today.

Relying on Benefit Cuts to Achieve Solvency Would Hurt Millions of Americans

The first step in developing a proposal about the future of Social Security is to be clear about the goal—and the goal of achieving sustainable solvency is not the same as strengthening the Social Security safety net for workers and their families. Improving Social Security's solvency is important—it assures current and future workers that they will get the benefits they have earned and are counting on for themselves and their families. But achieving solvency—making Social Security's books balance over an extended period—is not an end in itself. You can achieve solvency simply by cutting benefits deeply enough. But restoring solvency to the Social Security program primarily by cutting the Social Security benefits Americans depend on is like curing a stubbed toe by cutting off a foot.

Most beneficiaries rely heavily on Social Security as the mainstay of their incomes. Social Security is the largest source of income for most Americans in retirement; two-thirds of beneficiaries receive over half their income from Social Security. And with lower earnings, more time out of the labor force for caregiving, smaller pensions and savings, but longer life spans, women are even more reliant on Social Security than men. For four out of ten single women 65 and older, including widows, Social Security is virtually all they have to live on, providing 90 percent or more of their income; six out of ten single, elderly African American and Latina women get 90 percent or more of their income from Social Security. Without Social Security, more than half of all women 65 and older would be poor. Social Security's life and disability protections can keep families hard-hit by the disability or premature death of a wage-earner out

of poverty—and these protections are especially important for the African American and Latino communities. The vast majority of Social Security beneficiaries could not bear the deep benefit cuts that are part of some proposals.

"Price indexing" initial benefits would mean deep benefit cuts for all future beneficiaries

"Price indexing," the approach recommended by President Bush's Social Security Commission, in a plan the President has referred to as a "good blueprint" for reform, would dramatically reduce future benefit levels, as initial Social Security benefits would no longer keep pace with wage growth and increases in the overall standard of living. For a child born next year, with average earnings ($36,500 in 2005 dollars), price indexing would cut benefits 45 percent from current levels by the time she retired, dropping from about $2,200 to $1,200 per month (Congressional Research Service, "Estimated Social Security Benefit Levels Under President Bush's 2005 Individual Accounts Proposal Combined with a Proposal to Price-Index Social Security Benefits, March 31, 2005; all amounts in 2005 dollars). Under the Commission's plan, which includes private accounts, this reduction—designed to achieve solvency—would apply to her benefit whether or not she contributed to a private account. In addition, the cuts due to price indexing under the Commission's plan would apply not just to retirement benefits, but to benefits for disabled workers, spouses and surviving spouses, and children.

So-called "progressive price indexing" does not protect average earners, disabled workers, children, spouses or surviving spouses from deep benefit cuts

Robert Pozen has proposed a variant of this approach, so-called "progressive price indexing." As described, the approach would shield workers in the bottom 30 percent of the wage distribution from cuts due to price indexing. But the benefit cuts for the other 70 percent of workers, and the family members who receive benefits on their record, would be substantial.

For an average wage-earner, retiring in 2055, the Congressional Research Service estimates that benefits would be cut by 28 percent under so-called "progressive price indexing." By 2080, benefits for average earners would be cut by 39 percent. (Congressional Research Service, "'Progressive Price Indexing' of Social Security Benefits," April 20, 2005.)

Moreover, the cuts from so-called "progressive price indexing" would apply to workers whether or not they contribute to a private account—and benefits for disabled workers, children, spouses and surviving spouses.

When a plan purportedly "will protect benefits for disabled workers and survivors," check the details

It is easy to give assurances that, "This proposal will protect benefits for disabled workers and survivors." But it is difficult to do so in the context of a plan that relies on benefit cuts to restore solvency and diverts the payroll taxes needed to support those benefits into private retirement accounts. So this Committee should get clear and detailed answers to a number of critical questions before accepting such assurances.

First, follow the money. What do the financial estimates assume about the plan's impact on disabled workers and family members? For example, the report issued by the President's Commission acknowledged that the deep benefit cuts in its plan would cause hardship for disabled workers and that adjustments should be made; but, it relied on the savings produced by those cuts to generate its estimates of the financial effects of its plan.

Similarly, the estimate by the Social Security actuaries that the Pozen "progressive price indexing" would close about three-quarters of the long-term shortfall assumes that in addition to cutting Social Security retirement benefits for 70 percent of future retired workers, the plan also cuts benefits for disabled workers, children, and widows. If Congress wants to protect those beneficiaries from cuts, closing three-quarters of the shortfall would require deeper cuts in someone else's benefits—such as cutting benefits for the lowest earners after all, or cutting benefits for average or higher earners more deeply—if Congress is unwilling to raise revenues.

Second, which benefits, exactly, would be protected? Does the term "survivors," for example, include only the children and widows or widowers of workers who die before retirement—but not elderly widowers or widows, who are especially reliant on income from Social Security?

Third, what new complications would be created? Social Security is an integrated social insurance program that uses the same basic formula to calculate benefits for retired workers, workers who become disabled, and family members who are eligible for benefits on a worker's record. So, for example, when a disabled worker reaches retirement age, the benefits continue seamlessly. If disability benefits were protected from cuts—but not retirement benefits—a disabled worker would face a steep cut in benefits upon reaching retirement age. On the other hand, maintaining the unreduced benefit for disabled workers throughout retirement, while benefits for retired workers who contributed to Social Security for a full working life are being cut, would raise new equity issues and create an incentive for workers to claim disability before retiring.

Creating Private Accounts Within Social Security Would Worsen Social Security's Financing and Unravel the Social Security Safety Net for Workers and Their Families

Americans are counting on the benefits they earn through Social Security to protect themselves and their families. Trying to achieve solvency by cutting benefits would deny them that protection. Adding private accounts financed by Social Security revenue, and designed to substitute for Social Security benefits, to such a proposal, far from being a "sweetener," would actually make matters worse. Private accounts would hurt the solvency of Social Security—and the rest of the federal budget—and the economic security of Americans who depend on Social Security.

Private accounts would hurt the solvency of Social Security and add trillions to the national debt

As the Administration now acknowledges, private accounts do nothing to restore solvency to Social Security even over the very long term. And over the shorter term—the next several decades, during the peak years of the baby boomers' retirement—they make the shortfall in Social Security much worse. If payroll taxes are diverted from Social Security into private

accounts, Social Security has *less* money to pay promised benefits to current and near retirees, disabled workers and their families, widows, and children. Social Security would have to start drawing on the interest it earns and the bonds it holds in the Trust Fund more than a decade earlier than it would otherwise and would exhaust its resources more quickly.

To fill the hole that private accounts would create in the Trust Fund, and make good on promises to pay benefits to current and near retirees, the Administration's and most other private accounts plans would require the transfer of trillions of dollars from the rest of the budget to Social Security. Since the general budget is already running record deficits, that money will have to be borrowed. To make matters worse, the added burden of financing the costly and prolonged transition to private accounts would hit at the same time as the government faces growing health care costs and other pressing national needs. Americans of all ages—the young especially, because the debt will be with them for their whole lives, but also those who have already retired—will have to bear the burden of paying off the added debt to finance private accounts, in the form of higher taxes, cuts in vital services such as Medicare, Medicaid, and education, and higher interest rates that make it harder to finance a home, a car, a college education.

Private accounts would undermine retirement security for workers—especially working women

There are many problems with expecting a private account to provide the kind of disability and family protections that Social Security provides, as the next section of this testimony explains. But trading the secure benefits that Social Security provides—benefits that do not fluctuate with the stock market, that cannot be outlived, and that keep pace with inflation—is also a bad deal for retired workers, especially women.

A crucial—but often misunderstood—aspect of the Administration's plan for private accounts is that they would *not* provide income on top of Social Security, the way an Individual Retirement Account (IRA) or an account with the federal employees' Thrift Savings Plan would. Under the Administration's proposal, workers who choose to contribute to an account would pay back every dollar contributed—at an interest rate of three percent above inflation—out of their remaining Social Security benefit. This pay-back requirement—sometimes referred to as the "privatization tax" or "offset"—represents a second cut in the Social Security benefit, on top of price indexing, "progressive price indexing," or any other benefit cut made to achieve solvency.

In its March 31, 2005 report, in addition to looking at the effects of price indexing on future benefits, the Congressional Research Service calculated the size of this second benefit cut for workers who chose a private account, using the three percent real interest rate specified by the Administration. This is what CRS found for a worker born this year, with average earnings, whom I'll call Jamie.

At retirement in 2071, the offset or privatization tax would reduce Jamie's $2,200 Social Security benefit by nearly $1,000 ($989) per month—on top of the $1,000 cut due to price indexing. So Jamie can look forward to receiving a check from Social Security of just over $200 per month. That represents the secure part of Jamie's retirement income—and it amounts to less than ten percent of the benefit due Jamie under current law.

Jamie also would have access to a private account. But relying on private investment accounts to replace Social Security benefits involves real risks—as anyone who has watched the stock market over the past couple of weeks or the past five years can attest. Recognizing the risk, using the standard methodology used by the Congressional Budget Office, the Congressional Research Service estimated the risk-adjusted rate of return on the account, assuming a modest 0.3 percent allowance for administrative expenses. Converted to an annuity, as the Administration's plan would require, the account would provide Jamie with $924 per month—not enough to cover the $989 deducted from Jamie's Social Security benefit because of the choice of a private account, much less anything to counteract the effect of the first benefit cut to achieve solvency. Combining the income from the account ($924) with the reduced Social Security benefit (about $200) would give Jamie a total income of about $1,130 per month: about half (51%) of the benefit due under current law, and less than Jamie would have had without a private account.

Jamie might be a luckier investor than in this example; the Congressional Research Service calculated that with a 4.6 percent real rate of return, the combination of the account and the remaining Social Security benefit would provide income equal to 75 percent of the Social Security benefit due under current law. But remember that the Social Security Trustees and the Congressional Budget Office project that under current law with no changes, even after the assets in the Trust Fund are spent down, Social Security will be able to pay about 70 to 80 percent of promised benefits out of payroll taxes. But, to create private accounts in Social Security, the United States will have borrowed trillions—a debt which Jamie will be paying for throughout life. And the risk-adjusted projection that generates a combined income (from the account and reduced Social Security benefit) equal to just half of current law Social Security benefits is by no means the worst-case scenario. Jamie might get less than the three percent real rate of return assumed by the Congressional Research Service, or pay far more than 0.3 percent in administrative costs.

If Jamie is a woman, she could face other problems relying on a private account to replace her Social Security benefits. With a private account, the timing and size of contributions, as well as overall investment returns, affect the size of the accumulation. If Jamie took several years out of the labor force early in her working life to raise children, she will likely have a smaller account, because of the loss of compounding on contributions in the early years. In contrast, Social Security helps counteract the lifetime earnings gap between men and women, caused by women's lower wages and more time out of the labor force for caregiving, because it has a progressive benefit formula that provides lower earners with a higher percentage of their pre-retirement income, counts only the 35 highest years of earnings toward the average used to determine benefits, and makes the timing of earnings irrelevant.

In addition, unless Congress acts to overhaul the private annuity market as part of a private accounts plan, Jamie could face other problems when she tries to turn her account into an annuity that will provide income for life. Social Security pays monthly benefits on a gender-neutral basis; in the private annuity market, if a woman and man each buy an annuity with the same sum of money, the woman will get lower monthly benefits. Such gender discrimination must be prohibited in any private accounts plan in Social Security. Social Security provides annual cost

of living adjustments; this is especially important for women, to prevent the value of benefits from being eroded by inflation over the cost of a long lifetime. No private annuities currently offer full protection against inflation, and experts believe they are unlikely to offer such a product without the involvement of the federal government, even if the market for annuities expanded under a private accounts plan (See National Academy of Social Insurance, *Uncharted Waters: Paying Benefits from Individual Accounts in Federal Retirement Policy, Study Panel Final Report*, Reno, Graetz, Apfel, Lavery, and Hill, eds., 2005)(hereafter NASI, *Uncharted Waters*). Moreover, there is a risk that a private annuity company might go out of business before all benefits are paid, as in the case of the Executive Life Insurance Company (see NASI, *Uncharted Waters*). Workers will need an assurance that the annuity they purchase from a private annuity company will be there for the rest of their lives—just like Social Security. This is especially important for women, who are likely to live longer than men but whose lower incomes mean they have less in savings for retirement. According to the Employee Benefits Research Institute, among those aged 21 to 64, the typical woman's 401(k) balance is 59 percent of the typical man's ($10,000 v. $17,000); the typical woman's IRA balance is two-thirds of his ($8,800 v. $13,000); and women are less likely than men to have either a 401(k)-type plan or IRA.

In short, under a private accounts plan, it is likely that the federal government will have to play an active role in the annuities market, and probably act as a guarantor, to make sure that the annuities purchased with private accounts—which Americans would be counting on to provide their basic retirement security—are nondiscriminatory, adjusted for inflation, and secure for the rest of their lives. But Social Security does that already, and at much lower cost than could be achieved through a new system.

Private accounts would jeopardize benefits for retired spouses and widows

What would happen to spouses and surviving spouses if private accounts substituted for Social Security is a question of critical importance to women. Currently, more than half of all women receiving Social Security get a benefit as a spouse, surviving spouse, or divorced spouse. Social Security assures the spouse of a retired worker a benefit equal to 50 percent of the worker's benefit; the surviving spouse, a benefit of 100 percent, assuming both retire at full retirement age. Divorced spouses and divorced surviving spouses are entitled to the same benefits as current spouses, after a ten-year marriage. Spousal benefits are paid in addition to benefits for the worker; they do not reduce the Social Security benefit the worker receives.

The current recipients of spousal benefits include millions of women who rely entirely on the spousal benefit, because they have not been in the paid labor force for the ten years (forty quarters) necessary to earn Social Security retirement benefits on their own work record. For example, about 7.5 million women age 65 and older receive Social Security benefits as widows, and half of them do not qualify for any other benefit. Recipients of spousal benefits also include millions of women who have earned a benefit on their own work records, but—because their lifetime earnings are lower than their husband's—get a boost from the spouse or widow benefit.

In the future, because more women are working in the paid labor force, more women will qualify for benefits on their own work record. But women still earn less than men and still are more

likely to take time out of the labor force for caregiving. So their lifetime earnings are still likely to be lower than their husbands'—whom they are still likely to outlive. Thus, the Social Security actuaries project that forty years from now, about 40 percent of women will still be receiving benefits as a spouse or widow, not just on their own work records.

The Administration has provided some information since February about how its private accounts plan would operate for retired workers: what kind of investment options they would be offered; that accounts would have to be saved for retirement; that workers would have to purchase an annuity to assure themselves of monthly income above the poverty level; that workers could leave their accounts to anyone they choose. But the Administration has said almost nothing about how its plan for private accounts would affect benefits for spouses and surviving spouses.

To illustrate what substituting private accounts for Social Security might mean for wives and widows when they retire, let's consider the situation of Michael and Sarah, who marry, live on a small farm in Iowa—or perhaps a small ranch in Montana—and retire in 2071. Assume that Michael's income puts him in the average earner category. Sarah has less than ten years in the paid labor force.

What happens when they retire? Under the current system, Michael will get a retired worker benefit of about $2,200 a month (the same as Jamie in the previous example). Sarah will get a separate spousal benefit of $1,100. Together, Michael and Sarah would have a combined income of $3,300 a month. When Sarah is widowed, her benefit would go up to 100 percent of Michael's benefit, $2,200, which she would receive as long as she lived.

Now assume that Congress adopts a plan that price-indexes benefits, and includes a private accounts plan like the one the Administration has proposed.

If Michael, like Jamie, another average earner, contributed to a private account, his traditional Social Security benefit would drop to around $200 per month. Would this be the basis for determining Sarah's benefit as a spouse or widow? If so, Sarah's benefit as a spouse would be about $100 per month. Together, Michael and Sarah would have a Social Security benefit of only about $300 a month.

There are various ways the offset reduction, or privatization tax, that reduces Social Security benefits when taxes have been paid into private accounts, could be handled in the case of married couples. (See NASI, *Uncharted Waters*.) But the plans with offsets that have been developed so far have one common feature: they all would reduce Social Security benefits for a spouse or widow who receives benefits on the account holder's work record. (See NASI, *Uncharted Waters*.) In other words, Sarah, too, would end up paying for Michael's choice of a private account with a reduction in her Social Security benefit as a spouse and as a widow.

The concept of the offset or privatization tax is that a worker who chooses to put payroll taxes into a private account instead of Social Security pays back the Trust Fund with interest out of Social Security benefits—but gets the account in exchange, for better or worse. But what is a

spouse or widow assured of getting from the account in exchange for the cut in her guaranteed Social Security benefits?

When Michael retires, under the Administration's plan and most private accounts plans, he would be required to purchase an annuity with his account, because his remaining Social Security benefit is so far below the poverty level. But what kind of an annuity? If he took all the money in his account, and bought a single-life annuity to provide himself with income for the rest of his life, he, like Jamie, would receive payments of about $924 a month, using a risk-adjusted rate of return, to supplement his $200 per month Social Security benefit.

And where would that leave Sarah? Together, they would have an income of $1,230 a month to live on. But, unlike Social Security, Michael's annuity will not provide a separate, supplementary benefit to Sarah as a spouse. And what happens when Sarah is widowed? Because Michael used all the proceeds in his account to buy an annuity to provide himself with a modest income, there's nothing for Sarah to inherit. Because he bought a single-life annuity, when he dies, the payments stop. Sarah would get nothing from the account as a widow to supplement a Social Security widow's benefit that could be about $200 a month.

Could a widow be left with nothing? The President has said that his plan would require workers to purchase an annuity to make sure they don't spend their accounts too quickly and end up poor. But he has not said that his plan would require a married worker to purchase an annuity that provides a benefit for the surviving spouse. And he has repeatedly said that accounts could be left to anyone you choose; so there is no guarantee that Sarah would inherit, even if there were assets left in the account.

Given the importance of spousal benefits to women, now and in the future, it is disturbing that these benefits have received so little attention. But there may be a reason for the silence on these issues. With private accounts—which represent a finite pool of assets—there are real and difficult trade-offs involved. To provide payments for Sarah as a widow, Michael will have to accept lower payments during his lifetime for the two of them. If Sarah is a few years younger than Michael, rather than the same age, the payments will be lower still. If he also has to make provision for a minor or disabled adult child who may be eligible for Social Security payments on his work record, the account will provide even less income to him and Sarah.

Private accounts would jeopardize benefits for young widowed mothers and spouses caring for children

Social Security spousal benefits are not only important to women of retirement age. More than 182,000 young widowed mothers and 150,000 wives of disabled or retired workers caring for children receive Social Security benefits, along with over three million children. The surviving spouse of a deceased worker or the spouse of a disabled worker caring for children is eligible to receive monthly benefits, adjusted for inflation, until the children turn 16; the children of the worker receive benefits until they turn 18 (19 if in school).

For many families, Social Security provides the only life and disability insurance protection they have. And its protections are valuable: for a young family (27-year-old worker with average

earnings, a spouse, and two young children), Social Security provides the equivalent of a $400,000 life and $350,000 disability insurance policy.

These benefits are especially important to women of color and their children. For example, African American women are twice as likely as white women to be receiving benefits as a young widowed mother and three times as likely to be receiving a benefit as the spouse of a disabled worker caring for children. About 18 percent of African American beneficiaries are children, compared to only 8 percent of all beneficiaries, and African American children are almost four times more likely to be lifted out of poverty by Social Security than are white children.

These benefits are likely to be cut under a private accounts plan that relies primarily on benefit cuts to restore solvency. And private accounts themselves are likely to provide little if any assistance to these women and children. The account of a worker who dies or is disabled at a young age would be small. It would provide little additional support for a woman raising young children, even if she had access to the funds in the account when disaster struck – and she might not. The Administration has said that accounts could be left to anyone, so a young widow might not inherit. Even if she did inherit, the Administration has said that accounts must be saved until retirement, so a young widow might not have access to the funds until she retired. Moreover, a widow probably would not inherit the account free and clear; she would also inherit the obligation to repay the debt associated with the private account out of her Social Security benefits under the plan developed by the President's Commission and the so-called "progressive price indexing" proposal. (Under the Commission plan, heirs other than the surviving spouse would not be required to pay back the Trust Fund out of a reduction in their Social Security benefits; this would create an incentive for a worker to leave the account to someone other than the widow, if that was allowed.)

Dividing private accounts at divorce would involve allocating the cuts in Social Security benefits that accompany the accounts, as well as any assets

Social Security provides benefits to divorced spouses and surviving spouses who have been married for at least ten years. Benefits for divorced spouses are calculated in the same way as benefits for spouses and surviving spouses, based on the full work history of the higher-earning spouse, not just the earnings during the period of the marriage. As with other spousal benefits, they can be as much as 50 percent of the higher-earning spouse's benefit while the higher earner is alive, and 100 percent when the divorced spouse is widowed. About a million women receive benefits, at least in part, as a divorced spouse or widow, and these benefits are a crucial source of income for this economically vulnerable group of women.

To receive benefits as a divorced spouse, a woman provides documentation of the marriage and divorce to the Social Security Administration when she applies for Social Security benefits; there is no need to seek these benefits during the divorce. Moreover, the payment of Social Security benefits to a divorced spouse does not affect the benefits paid to the worker or his or her current spouse or surviving spouse, eliminating tension and disputes.

Among the many unanswered questions about private accounts is how they would be divided in case of divorce, and how the division would affect the Social Security benefits of each spouse.

The Administration has said that accounts could be divided at divorce, but it is unclear whether that division would be automatic or whether a spouse would have to get the court to divide the account(s) during the divorce. Many women already lose out on a share of their spouse's retirement plan, either because they had no lawyer and didn't know to ask, or because their lawyer was not knowledgeable about dealing with pensions. And it is unclear what would happen at divorce if only one spouse chose to contribute to a private account—especially if the spouse with the account was the lower earner.

If the divorced spouse gets a share of an account at divorce, there are likely to be other consequences. Every dollar contributed to a private account must be repaid – with interest – out of Social Security benefits. So if a divorced wife gets a share of her husband's private account, she is likely to get the debt that goes with it – which she would have to repay out of her own, probably smaller, already reduced, Social Security benefits.

Options for Strengthening Social Security

While Social Security faces a long-term financing shortfall, it hardly qualifies as a crisis. Social Security can pay 100 percent of promised benefits for over 35 to 45 more years, and 70 to 80 percent of promised benefits from payroll taxes, after the reserves in the Trust Fund have been spent down. In contrast, when Congress acted on the recommendations of the Greenspan Commission in 1983 to extend the solvency of Social Security and build up the Trust Fund, Social Security was within months of exhausting the Trust Fund and being unable to pay full benefits. To put Social Security's financing challenges into perspective: the cost of eliminating the long-term shortfall is just one-fifth to one-third the cost of making the 2001 to 2003 tax cuts permanent. So, while it is better to deal with the shortfall sooner than later, Congress has the time to get this right.

There are various options for strengthening Social Security's finances that would not require cutting benefits for working Americans and their families. For example:

Only earnings up to $90,000 are subject to Social Security taxes. A clerical worker earning $25,000 a years pays Social Security taxes on 100 percent of her wages; a manager earning a salary of $270,000 pays Social Security taxes on only a third of his. Raising the tax cap would raise revenue and improve the progressivity of Social Security.

According to the Office of the Chief Actuary of Social Security, if all wages were taxed and counted toward benefits using the current formula, 93 percent of the long-term shortfall would be eliminated. With an adjustment in the benefit formula for the very highest earners, this approach could eliminate 100 percent of the shortfall. If the tax cap was raised gradually, over the next decade, so that 90 percent of wages were subject to tax as they have been historically, 40 percent of the shortfall would be eliminated. If this change was made effective immediately, or the tax cap was raised above 90 percent, more than 40 percent of the shortfall could be closed

Alternatively, or in addition, other revenue could be dedicated to Social Security. (Note that the financing of plans for private accounts relies heavily on general revenue transfers, without specifying the source of funds.) For example, retaining the estate tax at the 2009 level—when it

will apply only to estates worth over $3.5 million for an individual, $7 million for a couple, exempting all but about 0.5 percent of estates—and dedicating the revenue to Social Security would close about 27 percent of the long-term shortfall. Rolling back the recent tax cuts for the wealthiest one percent of Americans (income above $300,000 a year) would generate about enough revenue to close the long-term shortfall. (For a discussion of these and other options, see Reno and Lavery, National Academy of Social Insurance Issue Brief No. 18, *Options to Balance Social Security Funds Over the Next 75 Years*, February 2005.)

While Social Security is running surpluses, and assets in the Trust Fund will continue to grow for another two decades, the rest of the federal budget is running huge deficits, primarily as a result of large recent tax cuts. Getting the rest of the government's fiscal house in order by restoring the revenue base will make it easier on the rest of the budget when the time comes to redeem the Treasury bonds held by the Social Security Trust Fund.

Finally, a true Social Security reform plan should consider ways to improve benefits for the most vulnerable Social Security recipients, including lifetime low earners and poor widows and widowers. These should be real improvements, not just measures that mitigate the harsh benefit cuts that are part of a private accounts plan for certain groups. In addition, Congress should consider targeted measures to increase savings among low- and moderate-income individuals and families.

Conclusion

Through Social Security, Americans contribute while they are working to earn protections for themselves and their families when income is lost due to retirement, disability, or death. Risks are shared, across the country and the generations. This system—so vital to millions of families—should not be dismantled by shifting to a system of private accounts that would leave individuals to face life's risks on their own.

Responses to Written Questions for the Record
United States Senate, Committee on Finance
"Proposals to Achieve Sustainable Solvency, With and Without Personal Accounts"

Joan Entmacher
Vice President for Family Economic Security
National Women's Law Center
May 25, 2005

Senator Smith

Unfortunately, there does not appear to be much common ground among the witnesses on ways to resolve the solvency problem. The witnesses disagree on a fundamental premise: whether the creation of accounts within Social Security would contribute to achieving solvency. Among those witnesses who (like the Administration) believe that the creation of accounts will not resolve the solvency issue, including myself, there is disagreement about whether the best approach to restoring solvency would rely primarily on revenue increases, cuts in benefits, or an equal mix of both.

Senator Rockefeller

Question #1:

For about the next 45 years, the accounts in the President's plan would divert more money from the Trust Funds than they bring in; and, even beyond this 45-year period of negative cash flow, the creation of accounts would lead to a permanent and significant increase in the public debt, because some loans would always be outstanding.[1]

Continuing to pay Social Security benefits during the transition period to retirees and other beneficiaries would add more than $1 trillion to the debt in the first decade of plan operation, and more than $3.5 trillion in the second decade.[2]

Young people would pay twice—for the retirement of those who contributed to a pay-as-you-go system and to fund their own retirement.

Question #2:

There is no real difference between the U.S. Treasury bonds held by the Social Security Trust Fund and those held by other investors. The Treasury bonds in the Trust Fund are interest-bearing securities backed by the full faith and credit of the United States, as are the Treasury bonds held by other individual and institutional investors. Workers should feel equally confident

[1] Peter Orszag, Testimony to the Senate Finance Committee, April 26, 2005.
[2] *Ibid.*

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about the U.S. Treasury bonds held in the Social Security Trust Fund and their own private retirement savings.

Question #3:

Because accounts are converted to annuities all at once, fluctuations in the stock market and interest rates would produce dramatic differences in lifetime income for workers who had saved similar amounts over their lifetimes, but purchased annuities on different days. Such disparities would raise serious equity and adequacy concerns in a system of accounts designed to replace the basic Social Security benefit. Moreover, with a system of private accounts within Social Security, there would have to be rules concerning the timing of the annuity purchase; for example, workers might be required to purchase an annuity within a limited period of time after claiming Social Security benefits. This could raise additional concerns among workers required to annuitize their accounts when the market is down.

In addition, because the current private annuities market discriminates on the basis of gender—unlike Social Security and employer pension plans—if a woman and man with identical accounts bought annuities at the same moment, the woman would receive lower monthly payments for life.

Question #4:

The U.K. experience with investment companies selling inappropriate and high cost products as part of its privatization scheme highlights the risks of substituting private accounts for Social Security as a source of basic retirement income. While steps should be taken in the United States to better protect investors from misleading sales pitches and to increase financial literacy generally—research shows that 401(k) participants often make poor choices that threaten their retirement security[3] and inappropriate financial products are being aggressively marketed to the elderly in this country[4]--these measures should be designed to help individuals save and invest wisely on top of Social Security. Social Security should be protected and strengthened as a source of income that Americans can count on, regardless of the investment choices they have made and how the market is doing when they retire.

Question #5:

The value of the disability and life insurance benefits provided by Social Security have been calculated by the Social Security actuaries to be the equivalent of a $353,000 disability insurance policy and $403,000 life insurance policy for a 27-year old worker with average earnings and a spouse and two young children.[5]

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[3] Gale, Iwry, Munnell, Thaler, "Improving 401(k) Investment Performance," An Issue in Brief, No. 26 (Center for Retirement Research, Boston College, December 2004).

[4] Gretchen Morgenson, "Who's Preying on Your Grandparents," *The New York Times*, May 15, 2005.

[5] Social Security Administration, "Present Values of Benefits to Illustrative Survivors and Disability Cases, Memorandum to Stephen Goss, Chief Actuary (July 23, 2001), cited in Reno, Graetz, Apfel, Lavery, and Hill, eds., *Uncharted Waters: Paying Benefits from Individual Accounts in Federal Retirement Policy, Study Panel Final Report* 158 (National Academy of Social Insurance, 2005).

In many cases, private coverage comparable to that provided by Social Security could not be purchased. Private disability insurance may be unavailable at any price for workers with certain pre-existing medical conditions or in dangerous occupations, and private disability policies do not provide additional payments for dependents.

Senator Lincoln

Question: How would private accounts impact women who have more sporadic work histories and lower earnings over their lifetimes?

Private accounts would be disadvantageous for women who have more sporadic work histories and lower earnings over their lifetimes because private accounts cannot match Social Security's progressive benefit formula and spousal benefits.

With private accounts, the size of the account depends on the size and timing of contributions, investment returns, and administrative costs. Women who earn lower wages would have less to contribute to a private account; while they are out of the paid labor force, women would have no earnings to contribute; and, if women take time out of the labor force while they are young (for example, for child-rearing), their contributions would have less time to compound. Some supporters of Social Security privatization have suggested dealing with the inherently regressive features of private accounts by allowing lower-income workers to contribute a higher percentage of their wages to an account. However, this approach would simply put lower-income workers at greater financial risk—and lower-income workers can least afford to take additional risks. In contrast, Social Security's progressive benefit formula replaces a higher percentage of pre-retirement income for those with lower lifetime earnings, such as women, and makes the timing of earnings irrelevant. In addition, Social Security benefits cannot be outlived and are adjusted annually for inflation; this is especially helpful for women who generally live longer than men but have less in savings and pensions.

Social Security spousal benefits provide additional economic security to millions of women with lower earnings and more sporadic work histories, as my written testimony of April 26, 2005 explains. Social Security can provide supplementary benefits for spouses, surviving spouses, and children because it is a broad-based social insurance program. Private accounts cannot match these benefits because private accounts represent a finite pool of assets—if assets are used to provide a benefit to one family member there is less for other family members. For example, if an account is divided at divorce, there will be less in the account for the worker and a subsequent spouse. (Payment of Social Security benefits to a divorced spouse does not reduce benefits for the worker or a subsequent spouse.) A worker who uses the assets in a private account to purchase a joint and survivor annuity that provides payments for a surviving spouse will get lower monthly payments than a worker who buys an annuity just for the worker's lifetime. (Social Security benefits for a worker are not reduced because benefits are available for a spouse and surviving spouse.)

Trying to provide for a surviving spouse or child out of a private account will pose significant challenges, because private accounts are unlikely to be able to make up for the cuts in Social

Security benefits under privatization--even for a single worker. The examples in my written testimony of April 26, 2005 show that a single retired worker who converts a private account to an annuity just for the worker's life is likely to end up with combined retirement income (account plus reduced Social Security benefit) substantially lower than current benefit levels. A worker who purchased a joint and survivor annuity with the account would receive even smaller annuity payments; there would be less income for the worker to live on, and, for many, insufficient income to even reach the poverty level. That may be the reason that, while the Administration has said that workers would be required to purchase an annuity to ensure that they do not exhaust their accounts and end up poor, it has so far been silent about whether a married worker with an account would be required to purchase an annuity that provides income for a surviving spouse. The cuts in survivor benefits associated with privatization would hurt women for many decades to come because, despite women's increased participation in the paid labor force, women still earn less than men, still are more likely to take time out for caregiving, and will continue to rely on spousal benefits.

Question: When it comes to your private account proposals, someone is going to get stuck with the bill—whether it's through benefit cuts or higher taxes. So, who is getting stuck with the bill?

Proposals for private accounts—because they take trillions of dollars out of Social Security that are needed to pay promised benefits to current and near retirees and other beneficiaries—involve cuts in benefits and massive borrowing that must be paid for through higher taxes, cuts in vital services, or both. All Americans would be affected by these cuts, but the impact would be particularly harsh on women and their families.

The Administration's privatization plan involves two types of benefit cuts. The sliding scale benefit cuts, described by President Bush in a press conference two days after the Senate Finance Committee hearing, would cut benefits for most workers (the 70 percent of workers earning over $20,000 per year) currently under age 55, whether or not they participated in a private account. The Administration later stated that the sliding scale benefit cuts would apply not only to retirement benefits, but also to benefits for surviving spouses and children of "middle-class" workers (over $20,000 a year),[6] despite the economic vulnerability of survivors when the wage-earner's income is lost. For those who contribute to a private account, there would be a second cut in Social Security benefits to pay back contributions to the account—with interest. This second benefit cut is very likely to apply to benefits for the spouse and surviving spouse of a worker who contributed to a private account—even though spouses and surviving spouses may not be guaranteed any benefits from the account. These benefit cuts would be especially hurtful to women, because they rely more heavily on Social Security income.

In addition, the President's plan would add about $4.5 trillion to the national debt during the first 20 years of operation.[7] All Americans would be stuck with this bill. In many ways, the burden of this debt would be greatest for younger Americans, who would be paying for it their whole lives through higher taxes, reduced public services, and higher interest rates that would make it harder to finance a college education, a car, or a home. But Americans 55 and older would also bear the

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[6] Associated Press, "Survivor Benefits Face Cut, Official Says," May 12, 2005

[7] Orszag Testimony, *supra* n. 1.

burden of this inflated debt through higher taxes and cuts in vital services such as Medicare and Medicaid, even if their Social Security benefits avoided direct cuts.

Question: Do you advocate that Congress shift the risk associated with Social Security from the federal government to the American worker?

No. At a time when fewer and fewer employers offer defined benefit pensions, it is especially important that Congress maintain Social Security as a system that provides a basic tier of retirement income that is not exposed to market risk, as well as life and disability insurance protection for workers and their families.

Question: Do any of you have any recommendations on how to encourage personal savings?

In his testimony on April 26, Peter Orszag made several positive recommendations for encouraging personal savings separate from and in addition to Social Security, especially among low- and moderate-income Americans.

Testimony of

Peter Ferrara

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USA Next

The Potential of Personal Accounts: A Revolutionary Breakthrough in Worker Prosperity

April 26, 2005

If done right, fundamental reform of Social Security based on personal accounts can produce a new, modernized system that would achieve all of the social goals of the current system better, much better, than the current system. Indeed, personal accounts can produce an historic breakthrough in worker prosperity in America, benefiting the most low and moderate income workers without significant personal savings and investment today. In the 18th century, the Homestead Act greatly expanded land ownership among working Americans. In the 19th century, the FHA greatly expanded home ownership among workers. In the 21st century, personal accounts can produce an explosion of prosperity among working people, empowering all workers across the board to accumulate major sums of personal savings and investment over their lives.

An example of how this can be done is the legislation introduced by Rep. Paul Ryan (R-WI) and Sen. John Sununu (R-NH), providing for a large personal account option for Social Security. The legislation has been scored by the Chief Actuary of Social Security as achieving full and permanent solvency in the program, without benefit cuts or tax increases. Indeed, over the long run, with the large personal accounts, workers would actually end up with higher benefits than promised under current law, and lower payroll taxes. That results because market returns on real savings and investment are so much higher than the returns that can be paid through the non-invested, purely redistributive system of the current Social Security framework.

The key point arising from the official score is that reform plans with large personal accounts like Ryan-Sununu do not need to make any changes in current law benefit provisions, such as delaying the retirement age, or price indexing, to eliminate the long term deficits of Social Security. The large accounts end up shifting so much of the current system's benefit obligations to the accounts themselves that the long term deficits are eventually eliminated through this effect alone. Sophisticated advocates of personal accounts will recognize that this is a very powerful political argument for adoption of large accounts.

Moreover, because the Ryan-Sununu bill guarantees the payment of at least the full benefits promised under current law, it offers a true prospect of winning broad, bipartisan support and passage. With that current law benefit guarantee, the proposal retains the current defined benefits of Social Security as a backup to the personal accounts. If the defined contribution benefits of the personal accounts are not higher than the current law defined benefits of Social Security, even though that is quite likely, then retirees will still get the current law defined benefits.

The current, non-invested, pay-as-you-go Social Security system cannot pay the benefits promised under current law. But the large personal accounts earning full market returns can do that, and more, much more. Indeed, the bill offers enormous, breakthrough gains in personal prosperity for working people, with a vast increase in personal wealth accumulating to $7 trillion in today's dollars in just 15 years, as well as ultimately much higher benefits and lower payroll taxes. That is why such reform should ultimately win the support of knowledgeable liberals and Democrats, as well as perceptive conservatives and Republicans.

We will first review below the key provisions of the Ryan-Sununu plan. We will then review the results of the official score of that legislation by the Chief Actuary of

Social Security. That review will include a detailed analysis and explanation of the transition financing for the reform plan.

Major Provisions of the Ryan-Sununu Plan

The major provisions of the Ryan-Sununu bill are reviewed below:

- Out of the 12.4% Social Security payroll tax, workers would be free to choose to shift to personally owned, individual accounts, 10 percentage points on the first $10,000 in wages each year, and 5 percentage points on all wages above that, to the maximum Social Security taxable income. This creates a progressive structure with an average account contribution among all workers of 6.4 percentage points

- Benefits payable from the tax free accounts would substitute for a portion of Social Security benefits based on the degree to which workers exercised the account option over their careers. Workers currently in the work force exercising the personal accounts would continue to receive a portion of Social Security retirement benefits under the current system based on the past taxes they have already paid into the program. Workers would then also receive in addition the benefits payable through the personal accounts.

- Workers choose investments by picking a fund managed by a major private investment firm, from a list officially approved for this purpose and regulated for safety and soundness, similarly to the operation of the Federal Employee Thrift Retirement System.

- The accounts are backed up by a safety net guaranteeing that workers would receive at least as much as Social Security promises under current law.

- Apart from this personal account option, there would be no change in currently promised Social Security benefits of any sort, for today's seniors, or anyone in the future. Anyone who chooses to stay in Social Security would receive the benefits promised under current law. Survivors and disability benefits would continue as under the current system unchanged.

- Social Security and the reform's transition financing are placed in their own separate Social Security Lockbox budget, apart from the rest of the Federal budget. This means the government can never raid Social Security again to finance other government spending, achieving a goal long sought by many seniors. It also means the short term transition deficits and the longer term transition surpluses would be apart from the rest of the budget, with the surpluses thereby protected and devoted to paying off all transition debt and then to reducing payroll taxes.

The Official Score of the Ryan-Sununu Bill

The official score of the bill by the Chief Actuary of Social Security showed the following:

- **The large personal accounts in the plan are sufficient to completely eliminate Social Security deficits over time, without any benefit cuts or tax increases.** That is because so much of Social Security's benefit obligations are ultimately shifted to the accounts. As the Chief Actuary stated, under the reform plan, "the Social Security program would be expected to be solvent and to meet its benefit obligations throughout the long-range period 2003 through 2077 and beyond."[1] **Indeed, the eventual surpluses from the reform are large enough to eliminate the long term deficits of the disability insurance program as well, even though the reform plan does not otherwise provide for any changes in that program.**

- The accounts achieve this not only with no benefit cuts or tax increases in Social Security. **Over time, in fact, the accounts would provide substantially higher benefits, as well as tax cuts.** The official score shows that by the end of the 75 year projection period, instead of increasing the payroll tax to over 20% as would be needed to pay promised benefits under the current system, the tax would be reduced to 4.2%, enough to pay for all of the continuing disability and survivors benefits. **This would be the largest tax cut in world history. The bill includes a payroll tax cut trigger providing for this eventual tax reduction once all transition financing and debt obligations have been paid off.**

- Moreover, as shown in a recent IPI study,[2] at standard, long term market investment returns, the accounts would produce substantially more in benefits for working people across the board than Social Security now promises, let alone what it can pay. This is the only reform proposal that achieves that result. With personal accounts of this size, at standard long term market investment returns, an account invested consistently half in corporate bonds and half in stocks would provide workers with roughly two thirds more in benefits than Social Security promises but cannot pay. An account invested two thirds in stocks and one third in bonds would pay workers over twice what Social Security promises today.

- The reform would also eliminate the unfunded liability of Social Security, currently officially estimated at $11 trillion, almost three times the current amount of national debt held by the public. This would be **the largest reduction in government debt in world history.**

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[1] Estimated Financial Effects of the "Social Security Personal Savings and Prosperity Act of 2004", July 19, 2004, Office of the Chief Actuary, Social Security Administration.

[2] Peter Ferrara, A Progressive Proposal for Social Security Personal Accounts, Institute for Policy Innovation, Policy Report 176, June, 2003, pp. 13-15.

- The reform would also greatly increase and broaden the ownership of wealth and capital through the accounts. All workers would participate in our nation's economy as both capitalists and laborers. **Under the Chief Actuary's score, workers would accumulate $7.8 trillion in today's dollars in their accounts by 2020. Wealth ownership throughout the nation would become much more equal, and the concentration of wealth would be greatly reduced.**

The reform plan would also greatly increase economic growth, through reduced taxes and increased saving and investment. The result would be more jobs, higher wages, and faster growing incomes and national GDP.

The official score includes the estimated cost of the guarantee of current law benefits in Ryan-Sununu. This cost is fully paid for in the financing provided in the bill. The Chief Actuary used the same methodology in scoring this cost as the official budget scorers do in scoring the cost of other government guarantees.

As with any guarantee, there is a moral hazard concern that those who enjoy the guarantee will take excessive risks, as they will reap the gains if they succeed, but they will be protected by the guarantee from the losses if they fail. The Ryan-Sununu bill, however, avoids this moral hazard, because the government retains complete control over what risks those with personal accounts can take. They can only choose investment funds for the personal accounts that are approved by the government for the list of personal account investment options. Moreover, even within that framework, those who choose the more risky options can still suffer a large financial penalty, as only the currently promised Social Security benefits are guaranteed. But conservative investments that just earn the average market return would provide the worker with far higher benefits.

Given this framework, the still substantial cost for the guarantee estimated by the Chief Actuary is probably overstated. Workers can only choose among safe, highly diversified, investment funds managed by highly sophisticated, professional, private sector, asset managers. In addition, since the standard market returns such investments would earn are so much higher than what the current, non-invested, pay-as-you-go, Social Security system even promises, let alone what it can pay, there is a wide margin for error before the guarantee would come into play. Individuals could earn substandard market returns and still receive higher benefits than Social Security promises under current law. Consequently, very few people are likely to fall into the safety net guarantee costing the government any money for the guarantee. This is consistent with experience with a personal account benefit guarantee in the famous reforms adopted in Chile almost 25 years ago.

Financing the Transition

Of course, any personal account reform plan involves a transition financing issue, as some of the funds that are used to pay current benefits under the present system are saved and invested in the personal accounts instead. So additional funds for Social

Security must come from somewhere to ensure the continued payment of promised benefits, until the personal accounts start taking over benefit payment responsibilities.

The Ryan-Sununu bill specifies exactly where the funds needed for the transition would come from:

1. First, the short term Social Security surpluses now projected to last until 2018 are devoted to the transition.

2. Secondly, the bill contains a national spending limitation measure that would reduce the rate of growth of total Federal spending, and devote those savings to the transition as well. The limitation would reduce the rate of growth of Federal spending by 1 percentage point per year for 8 years. The spending savings for those years are then maintained until all short term debt issued to fund the transition is paid off in full.

3. The third factor would be the increased Federal revenues resulting from increased corporate and business investment due to the accounts. The money from the accounts used to buy stocks and bonds goes to the business corporations selling the stocks and bonds. The businesses use those funds to expand their operations, start new business ventures, hire new workers, buy new plant and equipment, etc. The businesses earn returns on these new investments, on which they pay taxes. This results in increased tax revenues to the government, which can be used to pay for part of the transition to personal accounts. This factor is based on the work of Harvard Professor of Economics Martin Feldstein, Chairman of the National Bureau of Economic Research. It was first developed for personal account legislation introduced by former Sen. Phil Gramm in the late 1990s.

4. The final factor is to the extent needed in any year, excess Social Security trust fund bonds would be redeemed for cash from the Federal government, with the funds used to pay full promised Social Security benefits. This is exactly what the trust fund bonds are for, to be redeemed when needed to pay full Social Security benefits. Under the current system, those bonds are just going to be redeemed for cash from the Federal government anyway after 2018, until the trust fund is exhausted in 2042. The legislation specifies that the cash to finance these redemptions would be obtained by selling new Federal bonds to the public that would later be paid off in full out of eventual surpluses generated by the reform.

With this transition financing, the official score of the Chief Actuary shows the following:

- Under the Ryan-Sununu bill, Social Security achieves permanent and growing surpluses by 2030. Before that time, an average of about $52 billion (constant 2003 dollars) in surplus Social Security trust funds bonds would be redeemed each year for 25 years, and financed by the sale of an equivalent amount of new Federal bonds, ultimately totaling $922 billion in present value dollars. The amount of such bonds sold each year is shown in Table A.

- The amounts in Table A include bonds sold to cover part of the Social Security deficits under the current system now projected to start in 2018,

which will not be fully eliminated under the reform plan until 2030. Table B shows the net transition deficit each year that results from the personal accounts alone under the Ryan-Sununu bill, not counting the already existing Social Security deficits under current law.

- Even with the redemption of surplus trust fund bonds, the Social Security trust fund never falls below $1.34 trillion in today's dollars, or 141% of one year's expenditures, with the official standard of solvency being 100%. After 2030, the trust fund grows permanently, reaching close to 10 times one year's expenditures by the end of the projection period, or about $6 trillion in today's dollars, far too much.

- Within 15 years after 2030, the reform produces sufficient surpluses to pay off all the bonds sold to the public during the early years of the reform. **So the net impact of the reform on debt held by the public is zero.**

- Moreover, in the process of shifting benefit obligations to the personal accounts, the reform again eliminates completely the unfunded liability of Social Security, currently officially estimated at $11 trillion, which is effectively the largest reduction in government debt in world history.

The transition deficits and debt shown in Tables A and B are modest given the sweeping magnitude of the reform plan. The amount of transition debt that needs to be issued each year falls to $60 billion or less after the first 5 years of the reform. Moreover, that shorter term debt only involves borrowing back a minor portion of the savings accumulating in the accounts, which, again, grows to $7.8 trillion in today's dollars after the first 15 years, and $16.6 trillion after the first 25 years, when the borrowing stops. Again, within 15 years after that surpluses generated by the reform completely pay off even that relatively minor effective borrowing from the growing accounts.

In addition, the actual net transition deficits created by the reform itself, not counting the already existing projected Social Security deficits under current law, are even less, as shown in Table B. The deficit falls to $51 billion or less in today's dollars after the first 5 years, and is completely eliminated after 15 years, for a total of $645 billion in present value dollars over that time.

Moreover, again, the legislation creates a separate Social Security Lockbox budget apart from the rest of the budget, so even these transition deficits would not increase the deficit in the regular operating budget for the rest of the Federal government. The short term debt shown in Table A would also be separately accounted for in a Social Security Transition Sinking Fund slated to be paid off in full.

Virtually every member of Congress from both parties has supported taking Social Security off budget in a lockbox where it could no longer be raided for other government spending. That virtually unanimous support for the idea has resulted because seniors overwhelming support such a policy. This legislation finally makes good on this concept.

Separating Social Security and the personal account transition from the rest of the budget is also the most accurate accounting practice, for several reasons. Unlike the deficit in

the rest of the budget, the reform plan's net transition deficits are not adding new Federal debt and liabilities. The reform plan is instead actually reducing long term Federal liabilities dramatically, ultimately eliminating the unfunded liabilities of Social Security. The shorter term debt resulting from the reform plan, moreover, is just recognizing debt the government already owes through Social Security's unfunded liability, and even that is fully paid off under the reform plan. In fact, on our current course, we would just effectively start selling these bonds a few more years down the road anyway, to continue financing promised benefits once the current Social Security system starts running annual deficits. But on our current course, there is no plan to later pay off that debt.

In addition, again unlike the deficits in the rest of the budget, the reform plan's net transition deficits do not reflect a net drain on national savings. The debt issued to cover those transition deficits only involves borrowing back part of the savings generated through the personal accounts, quite likely producing a large increase in national savings overall.

So it would actually be quite misleading to account for the net transition deficits under the reform the same as for any deficits in the Federal government's general operating budget. The net effect of the reform and its transition deficits on the economy and the Federal debt is actually the opposite of the net effect of general Federal budget deficits.

Finally, the transition to the personal accounts under Ryan-Sununu is a one time financing project meant to liquidate an enormous Federal debt. It is not part of the ongoing operations of the Federal government and the long time liabilities they are racking up. So it would be most accurate to account for it separately from those ongoing operations.

Accounting for the transition in this way has the added benefit of protecting the later surpluses of the reform from being gobbled up in the general Federal budget process. These later surpluses would be reflected in the separate Social Security Lockbox budget, under a policy of devoting those surpluses to paying off the earlier transition debt, and then to reducing payroll taxes. Any attempt to divert that money to other purposes would be transparent, blatant, and probably politically untenable. Moreover, accounting for the short term debt in its own separate Social Security Transition Sinking Fund account would provide a scorecard to show whether that debt has, in fact, been paid off.

The Federal spending restraint provided for in the bill to help finance the transition is quite modest and achievable. Over the initial 8 year period, it would limit Federal spending to grow each year no more than its long term baseline of the rate of growth of GDP, minus one percent. Consequently, during that period, Federal spending as a percent of GDP would decline from 20% to 18.4%. The bill would then allow Federal spending to continue to grow at the old baseline rate, keeping spending only 1.6% of GDP below that baseline. Once the transition to personal accounts is financed and all short term debt issued during that transition is paid off, the spending restraint is eliminated.

The spending restraint during the first 8 years is actually less than the restraint achieved during the 8 years of the Clinton Administration, which held Federal spending growth to the rate of growth of GDP minus 1.8 percentage points each year. (Of course, the Republican Congress was a primary factor in that achievement.)

Moreover, the restraint during the first 8 years is exactly the amount of restraint we will have to achieve if we are going to balance the Federal budget while keeping the

Bush tax cuts permanent, as shown in a recent study by Larry Hunter[3]. The Bush tax cuts would leave Federal revenues over the long run at about 18.4% of GDP as well.

Both the Cato Institute and the Heritage Foundation have published extensive material documenting far more in wasteful and counterproductive spending than would be needed to achieve the spending limitation targeted in Ryan-Sununu.[4] Earlier this year, IPI published a study by Steve Moore also proposing far more in desirable spending restraint initiatives.[5] The spending restraint measure in the bill is not limited to domestic discretionary spending, or even all of discretionary spending. All of Federal spending outside of Social Security is eligible for restraint to help meet the target. Any and all other entitlement programs can be reformed to meet the target. Corporate welfare can be cut or eliminated. Ditto for long outdated agriculture subsidies. Even the military budget is not off limits. Unneeded military bases, for example, can be shut down.

Over the long run, the bill's modest spending restraint would, indeed, allow Federal spending to grow by more than 50% relative to GDP. That is because after the baby boom generation retires, the Congressional Budget Office projects that Federal spending will explode relative to GDP, eventually growing from about 20% of GDP today to over 30%. The Ryan-Sununu spending limit would just keep Federal spending 1.6 percentage points below this long term baseline, with the limitation removed completely once the funds are no longer needed to complete the transition.

The spending limitation in Ryan-Sununu, therefore, is just a modest first step. Stricter and permanent spending limits are needed to prevent a currently projected, historic, run up in Federal spending relative to the economy.

The Ryan-Sununu spending limits are enforced by new national spending limitation provisions included in the bill. These provisions reorient the whole Federal budget process around the spending limitation, and require a stiff two thirds majority of both houses to get around it. Budgetary procedures are changed to allow any member of Congress to halt a spending initiative inconsistent with the spending targets.

Yes, Congress could still override the spending limits by new legislation in the future. But that is true of any means of financing the transition to personal accounts. Tax increases for the transition can be reversed or offset by future legislation as well. The same is true for measures that attempt to help finance the transition by cutting future promised Social Security benefits.

Moreover, general Federal spending restraint enjoys broad public support. Many, many voters today believe Federal spending has been growing far too fast, and would think the Ryan-Sununu spending restraints are far too modest for general budget needs. With these public attitudes, the Ryan-Sununu spending restraint could not be easily dismissed.

In addition, the Ryan-Sununu bill would powerfully restrain Federal spending simply by taking the money off of the table for Congress to spend. With all of the money

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[3] Larry Hunter, Reducing Government Consumption, Increasing Personal Wealth: Limiting Federal Spending Growth Through Large Personal Retirement Accounts, IPI Policy Report 183, July 14, 2004. The study assumed as well that the Alternative Minimum Tax is fixed so it applies only to the highest income taxpayers as originally intended, and not to the middle class.

[4] See, e.g., Chris Edwards, Downsizing the Federal Government, Cato Policy Analysis No. 515, June 2, 2004.

[5] Stephen Moore, Putting Taxpayers First: A Federal Budget Plan to Benefit the Next Generation of American Taxpayers, IPI Policy Report No. 174, February 17, 2004.

going into personal accounts, and the unavoidable mandate to pay all promised Social Security benefits to retirees[6], Congress will be forced to spend less than it would otherwise. As Milton Friedman has long argued, the best way to restrain the Federal government's spending is just to reduce what is available for Congress to spend. The Ryan-Sununu bill does that, and so is a powerful aid in achieving future spending restraint. Congress cannot run future deficits beyond politically acceptable limits, and there are powerful political forces that work to restrain deficits and reduce the duration of deficits over the long run. These forces would further help to enforce the Ryan-Sununu spending limits.

Finally, the Ryan-Sununu bill changes the political dynamics of Federal spending. Basic public choice analysis shows that the beneficiaries of Federal spending largesse have a concentrated interest in maintaining and expanding their particular share of the Federal spending pie. But the general public doesn't have enough of an interest in any one spending program to provide the resources to overcome the special interests benefiting from it.

That fully explains the stubborness of corporate welfare, for example. The XYZ corporation can have enough direct financial interest in a multibillion dollar Federal subsidy program to hire legions of lobbyists and publicists to promote its cause. But individual members of the general public do not have enough of a financial stake in that one program to provide the resources to counter the predatory corporate welfare boondoggle.

This is why Federal spending restraint can ultimately only be achieved by a general Federal spending restraint as in Ryan-Sununu. Individual members of the public do have enough of a stake in such a general restraint to get involved in providing the necessary political support to adopt and enforce it. Ryan-Sununu adds to this by tying the spending restraint to a very popular large personal account option for Social Security. That greatly increases the likelihood that such a restraint can be adopted, and that it will be maintained over time. Indeed, under the bill workers are enjoying every dollar of spending restraint with that money effectively going into their direct personal accounts instead.

The bottom line is that Congress can avoid running up debt to finance the transition under Ryan-Sununu simply by following the reasonable and moderate spending restraint provided in the bill. If it chooses more spending and debt instead, that would result only because Congress decided that was more desirable.

The third factor in the Ryan-Sununu transition financing, the increased tax revenues resulting from investment of the personal account funds, is again based on the work of Harvard Professor of Economics Martin Feldstein, Chairman of the National Bureau of Economic Research. The methodology for scoring this impact was first developed by the Chief Actuary of Social Security in consultation with Feldstein for legislation introduced in the late 1990s by former Sen. Phil Gramm. That same methodology was used for the scoring of the Ryan-Sununu bill.

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[6] The Ryan-Sununu bill ensures that Social Security will be taken care of in any event and all promised benefits to current retirees would continue to be paid. The bill provides that the Federal government would transfer general revenues to Social Security each year equal to the amount of annual spending restraint provided in the bill, regardless of what Congress actually does in regard to spending. It is then up to Congress to implement the spending restraint, or find the money elsewhere, or affirmatively choose to run larger general deficits.

This revenue feedback is available for the scoring of any personal account reform plan, because it flows automatically from the operation of the personal accounts. Failing to include it would reflect only an incomplete understanding of the economics of personal accounts.

Moreover, this revenue feedback as scored takes into account just one of the positive economic effects of the reform, which the work of Feldstein and others shows would be far more extensive.[7] The large personal accounts in the Ryan-Sununu plan are effectively an immediate enormous reduction in payroll taxes on labor of 6.4 percentage points on average. That is because that money is now going into personal accounts directly owned and controlled by each worker, like a 401k plan, and not to the government as a tax to be redistributed to others. The legislation also provides for further payroll tax relief in later years. This tax relief would provide another major boost to the economy and labor market efficiency, which would result in higher tax revenues.

Increased savings and investment through the accounts would also produce higher wages, as greater capital increases productivity which results in increased wages. These higher wages would also produce higher tax revenues. The higher retirement benefits produced by the personal accounts would also result in higher tax revenues, as those benefits are either spent or saved and invested again.

Feldstein estimates that the present value of the combined economic growth effects of personal account reforms would be $10 to $20 trillion.[8] So many conservative assumptions went into that calculation that the ultimate effect would probably be substantially higher. But, in any event, these full economic growth effects of personal account reform are going to produce substantially more in increased revenues than scored by the Chief Actuary for the Ryan-Sununu bill.

Indeed, Hunter calculates that just an increase in the economic growth rate of one half of one percent due to these personal accounts, still leaving the long term economic growth rate assumed by the Chief Actuary in his score 40% less than the long term growth rate of the economy over the last 50 years, would produce a higher revenue feedback than reflected in the Ryan-Sununu score. If the personal accounts just raised economic growth to the long term growth rate of the last 50 years, the revenue feedback would dwarf the feedback in Chief Actuary's score of Ryan-Sununu.

With the large accounts in Ryan-Sununu, we are shifting close to 20% of the whole Federal government from a redistribution system to a savings and investment system, with large reductions in taxes to boot. Such an enormous, dramatic change in Federal economic policy cannot be plausibly evaluated without taking at least some of these economic growth effects into account.

Finally, the transition financing provided by this revenue feedback and the spending restraint involves $7.1 trillion (present value dollars) in general revenues provided to Social Security over the life of the transition. Some erroneously argue that the amount of general revenues used in a reform plan is the measure of how much a reform plan costs. In another IPI study, this is shown to be fallacious.[9]

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[7] Peter Ferrara and Michael Tanner, A New Deal for Social Security, Washington, DC: Cato Institute, 1998, Chapter 6.

[8] Martin Feldstein, "The Missing Piece in Policy Analysis: Social Security Reform" American Economic Review, Vol. 86, p.1 (May 1996).

[9] Peter Ferrara, The Cost of Personal Accounts.

About 54% of the general revenues used for the Ryan-Sununu plan come from the increased revenue feedback. These general revenues were generated by the reform plan itself. They would not exist without the reform. Consequently, they cannot logically be considered part of the net cost of the reform plan. Quite to the contrary, these additional revenues are a benefit of the reform plan, used to offset, and hence reduce, the net transition financing burden. This leaves the net general revenues used for Ryan-Sununu at $3.8 trillion.

Moreover, to the extent the spending restraint in Ryan-Sununu produces reductions in wasteful or counterproductive Federal spending, those reductions would also not represent a cost. Again, quite to the contrary, those reductions would, in fact, be another benefit of the reform plan, used to offset, and hence reduce, the net transition financing burden.

Conclusion

The Ryan-Sununu bill would produce dramatic, historic, breakthrough gains in personal prosperity for working people, including the following:

- The long term Social Security financing crisis would be completely eliminated, without cutting benefit or raising taxes. This includes the disability and survivors portion of the program as well as the retirement portion, because the long term surpluses resulting from the personal accounts for retirement benefits are large enough to eliminate the deficits for disability and survivors benefits as well.

- Indeed, because capital market returns are so much higher than the returns that can be paid by the current non-invested, merely redistributive Social Security framework, workers would receive through the large accounts in Ryan-Sununu much higher benefits than Social Security even promises today, let alone what it can pay. At standard market investment returns, the personal accounts would pay roughly two thirds to 100% more in benefits than Social Security now promises workers in the future.

- In addition, instead of increasing the payroll tax from 12.4% today to close to 20%, as would ultimately be necessary to pay all promised benefits under current law, Ryan-Sununu would ultimately reduce the payroll tax to 4%. The bill includes an automatic payroll tax cut trigger to achieve this goal. **This would amount to the largest reduction in taxes in world history.**

- Moreover, in the process of this reform, the current unfunded liability of Social Security would be eliminated. That unfunded liability is currently estimated at about $11 trillion, about three times the amount of Federal debt currently held by the public. **This would consequently amount to the largest reduction in government debt in world history.**

- By shifting Social Security retirement benefits to be paid through the personal accounts, and financing part of the transition through Federal spending restraint, the Ryan-Sununu bill would ultimately reduce Federal spending as a percent of GDP by about 6.5 percentage points. The bill gains control over runaway Federal spending through a comprehensive national spending limitation measure.

- Through the Ryan-Sununu personal accounts, for the first time workers at all income levels would be accumulating substantial personal savings and investment. Indeed, after just the first 15 years of reform, the Chief Actuary estimates that the personal accounts would accumulate to $7.8 trillion in today's dollars. This would dramatically broaden the ownership of wealth and greatly reduce the concentration of wealth.

- The personal account reform would produce major long term increases in economic growth. This would translate into more jobs and higher wages for working people.

The tradeoff for this enormous, historic benefits is the transition financing burden, which is financed under Ryan-Sununu by:

(1) devoting the short term Social Security surpluses to the transition;

(2) devoting to the transition the funds obtained by restraining the rate of growth of Federal spending by one percentage point a year for each of 8 years, and maintaining those savings until the transition financing is completed;

(3) devoting to the transition the increased revenues resulting from the investment of the personal account funds at the corporate and business level;

(4) to the extent the first three are not sufficient in any one year, redeeming excess Social Security trust fund bonds financed by selling new Federal bonds to the public, with those bonds to be paid off out of the later surpluses of the reform.

Trying to distort this tradeoff with scary, out of context, 75 year summary numbers in 2003 dollars, or by emphasizing irrelevant comparisons based on general revenue transfers, does not advance understanding of personal account reform, and only delays the ultimate success of such reform. Such numbers games do not change the fact that the above summary discussion is an accurate presentation of the tradeoffs involved in the reform as proposed. The enormous, historic, breakthrough benefits discussed above seem quite easily worth the above transition financing burden, and the public is quite likely to see it as so.

The Ryan-Sununu reform plan truly modernizes and expands the Social Security framework, to bring in real personal savings and investment for a new financial foundation for the program. Such reform really just makes good on the original promise

of Social Security, when everyone thought they were really going to have individual accounts with the government that would be saved and invested. Moreover, the guarantee of current law benefits in Ryan-Sununu keeps the current social safety net in place. The bill also maintains a social framework to make personal account investing for even unsophisticated investors.

With this modernization, Social Security's financial difficulties will be ended for good, and workers will be able to gain sharply higher benefits, much lower taxes, and the accumulation of substantial personal wealth for their families. What it all adds up to is an historic breakthrough in the personal prosperity of working people.

Finance Committee Hearing
"Proposals to Achieve Sustainable Solvency, with and without Personal Accounts"
Statement of Senator Blanche Lincoln
April 26, 2005

Mr. Chairman, thank you for bringing us together to discuss a program that has been a vital safety net for our nation's elderly, sick, widowed and disabled for 70 years. It has been an enormously important program that has ensured our workers social insurance against poverty. It is a program we can be proud of. I am proud of the commitment our country made all those years ago both to themselves and future generations by establishing this social insurance program. Like all of you, I am concerned about the long-term challenges this program now faces. I am eager to work with all of my colleagues to address this.

Throughout this debate, I have been guided by the needs of Arkansans. My state of Arkansas faces significant challenges and relies heavily on Social Security. Arkansas ranks third in the percentage of the population receiving Social Security. Nationwide, 30 percent of all Social Security benefits go to disabled and survivors. In Arkansas, almost 40 percent of all Social Security benefits go to persons who are disabled and survivors. The state economy also depends on Social Security benefits. In 2003, $5 billion flowed into the Arkansas economy through Social Security benefits.

In addition, Arkansans are disproportionately low income. In 2003, close to 80% of individuals in Arkansas had adjusted gross incomes of less than $50,000. Without Social Security, 58% of those over the age of 65 would have incomes below the federal poverty line. These statistics are even more staggering for women. Two-thirds of the elderly women in Arkansas would be poor without Social Security.

Finally, Arkansas is rural. Rural seniors are more dependent on Social Security because they are disproportionately lower income and they are less likely to be able to contribute to personal accounts. Rural Americans also have a greater need for Social Security's disability safety net. Because of the physical nature of their jobs, it is more likely that they will need either disability benefits or early retirement benefits. Additionally, many rural communities are becoming significantly older because younger people tend to leave them at a higher rate.

Those are the facts that are shaping the way I'm addressing this important issue. And Arkansas is not alone in the challenges it faces. They can be applied to much of our country, especially as the population continues to age. In fact, it is worth nothing that many of my colleagues on this committee represent states with similar challenges.

There are three issues we should address in this debate. Number one is the solvency of the Social Security trust fund. Number two is encouraging personal savings outside of the current Social Security framework. I am extremely interested in looking at ways to encourage individuals to save more for their retirement. We are at the lowest savings rate in our nation's history and that is why financial literacy must be a part of this discussion.

We must cultivate a nation of savers, not borrowers. The third issue we should address is health care and long term care. Medicare and rising health care costs present more pressing financial challenges than Social Security and it's our obligation to address them.

I do believe that Social Security faces long term funding challenges but to call it a crisis is disingenuous. If there is a crisis out there, it is the national budget. The President's private accounts proposal would only make the budget situation and our nation's historic debt worse. We have substantial national debt right now and we shouldn't do anything that would exacerbate this situation and potentially jeopardize relationships with our nation's global partners.

I believe we have a tremendous opportunity here. Social Security is on the forefront of our national agenda. People of all ages and all over the country are beginning to talk about the importance of savings and retirement security. We must capitalize on this momentum and proceed in a thoughtful way. I am committed to doing all I can for my own state of Arkansas and for the people of our great nation. Mr. Chairman, thank you for bringing us here today.

Social Security Reform

Peter R. Orszag[1]
Joseph A. Pechman Senior Fellow in Economic Studies
The Brookings Institution

Senate Committee on Finance
April 26, 2005

Mr. Chairman and other members of the Committee, thank you for inviting me to testify before the Committee this morning. Social Security provides the foundation of retirement income, but must be combined with other saving to achieve full retirement security. Retirement income should thus be viewed in terms of tiers, with Social Security delivering a core tier of protection upon which additional retirement income must be built. Figure 1 illustrates these tiers assuming a target for retirement income equal to 70 percent of pre-retirement wages, a replacement rate that is often recommended by financial planners.

Figure 1: The tiers of retirement income

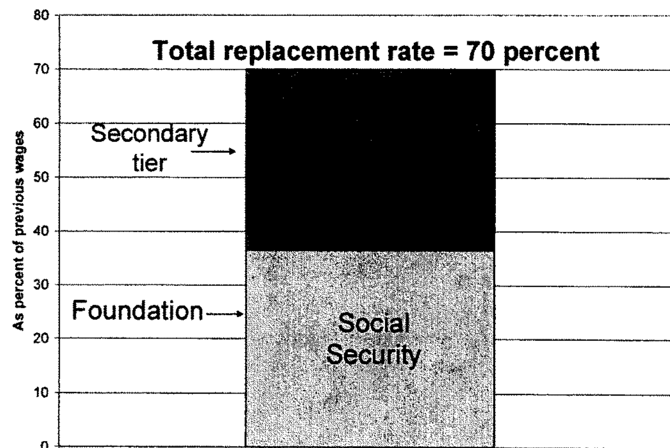

Figure 1 shows initial replacement rates at retirement (that is, retirement income relative to previous wages) for medium-earning worker claiming benefits at age 65 in 2054

Both tiers of retirement security face challenges. In that context, my testimony makes four main points:

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[1] The views expressed here are those of the author alone. This testimony draws upon joint work with Peter Diamond, Jason Furman, William Gale, Robert Greenstein, and Mark Iwry. I also thank numerous other colleagues for helpful discussions and comments.

- **Retirement security can be significantly enhanced by improving 401(k)s and IRAs through commonsense reforms that both sides of the Social Security debate should embrace.** The individual accounts we already have -- in the form of 401(k)s and IRAs -- can be substantially improved and strengthened through a series of commonsense reforms that would make the pension system easier to navigate and more rewarding for American families. In the face of the difficult choices presented by the current system, many people simply procrastinate, which dramatically raises the likelihood that they will not save enough for retirement. Disarmingly simple concepts -- such as changing 401(k) plans so that workers are automatically enrolled unless they opt out, and making it easy to save part of an income tax refund -- have the potential to strengthen retirement security significantly. Both sides of the Social Security debate should agree on the straightforward steps necessary to improve 401(k)s and IRAs, and should come together to enact the changes immediately.

- **Although improving the accounts we already have on top of Social Security makes sense, introducing accounts within Social Security does not.** Under the Administration's proposal for accounts *within* Social Security, workers receive payroll revenue today, but pay the payroll revenue back, plus interest at a 3 percent real rate, at retirement through a reduction in traditional Social Security benefits. In effect, the individual accounts represent a "Social Security line of credit." Workers drawing upon that line of credit have payroll revenue deposited into their individual account today, but then owe the funds back, plus interest, once they retire. The system is thus similar to a loan from the government to workers.

  At best, assuming that all the loans carry the government's borrowing rate and are fully repaid, the accounts do nothing to improve solvency within Social Security over the long term -- as even the White House has acknowledged. A more likely scenario is that some of the loans will not be repaid in full, in which case the accounts harm solvency, even over an infinite horizon. And even if they are actuarially neutral over the long term, the accounts create a massive cash-flow problem in the meanwhile.

  Some argue that the accounts would facilitate other changes -- especially benefit reductions for higher earners -- that would help to restore long-term balance to Social Security. But it is hard to see why, unless they were subsidized, the loans should be particularly attractive, especially to higher earners. Indeed, a Goldman Sachs analysis recently concluded that, "In essence, the 3% real rate offset represents a loan from the federal government to the accountholder to fund the personal saving account. This is not an attractive proposition."[2] Higher earners who typically already own a mix of stocks and bonds should find little or no value in unsubsidized loans from the government. And if the accounts were subsidized to make them more attractive to higher earners, their direct effect would be to *expand* the Social Security deficit. Increasing stock ownership among moderate and lower earners is desirable, but not by encouraging them to borrow against their future Social Security benefits. Instead, a better approach to increasing equity ownership and retirement saving for such households are the commonsense changes to 401(k)s and IRAs described above.

[2] Goldman Sachs, "Daily Financial Market Comment," February 23, 2005.

Reducing traditional Social Security benefits to make room for individual accounts would also be unsound for society as a whole, since it would decrease the core tier of retirement income that is protected against financial market fluctuations, inflation, and the risk of outliving one's assets. Furthermore, whatever the initial rules for the accounts, there is likely to be considerable pressure over time for liberalizing pre-retirement access to the funds -- which is precisely what has occurred with 401(k)s and IRAs, along with the Thrift Savings Plan. Such access may make sense in the upper tier of retirement income, but not within the core tier because it undermines the preservation of funds for retirement.

- **Failing to dedicate additional revenue to Social Security means that larger benefit cuts would be necessary to restore solvency. For example, dedicating the revenue from a reformed estate tax to Social Security could eliminate the need for more than $1 trillion in benefit reductions over the next 75 years. Every dollar of estate tax revenue dedicated to Social Security is a dollar less of benefit reductions or payroll tax increases necessary to address Social Security's projected deficit.** Despite the claims of some advocates, the Administration's proposal for individual accounts makes brutally clear that such accounts do not directly help to restore solvency. Since accounts do not directly improve solvency and may well impair it, the only available policy options to restore solvency are reductions in benefits or increases in dedicated revenue. A fundamental tradeoff thus exists: Proposals that fail to dedicate additional revenue to Social Security will necessarily involve larger benefit reductions than plans that do dedicate additional revenue to the program. When push comes to shove, Americans seem to prefer relying on additional revenue -- or some combination of additional revenue and benefit reductions -- to mainly relying on benefit reductions.

As just one example of the tradeoffs, taking the revenue from a reformed version of the estate tax and dedicating it to Social Security could close a substantial share of the projected deficit. For example, the revenue from an estate tax with a $3.5 million exemption per person ($7 million per couple) and a 45 percent tax rate on estates above that exemption would eliminate at least one-quarter of the projected 75-year deficit. That would obviate the need for more than $1 trillion in benefit reductions over the next 75 years. For a 20-year-old medium-earning worker today, it could mean avoiding $1,500 per year in benefit reductions. As a further illustration of the tradeoffs, retaining the same exemption level but reducing the tax rate on large estates to 15 percent would avoid only about $300 billion in benefit reductions over the next 75 years. In other words, with the revenue from a reformed estate tax dedicated to Social Security, reducing the tax rate to 15 percent would increase the benefit reductions required to address Social Security's deficit by $700 billion over the next 75 years. We as a society must decide whether this $700 billion is better used to provide larger after-tax inheritances to wealthy children or to reduce any benefit reductions necessary to restore solvency to Social Security. Every dollar of estate tax revenue dedicated to Social Security is a dollar less of benefit reductions or payroll tax increases necessary to eliminate Social Security's deficit.

- **Recent "progressive price indexing" proposals are seriously flawed because they rely excessively on benefit reductions, cut benefits *more* if future productivity growth turns out to be faster than currently expected, and treat workers earning $900,000 or even $9 million a year the same as those earning $90,000.** The recent "progressive price indexing" proposal involves surprisingly and excessively large benefit reductions for average workers. In addition, it reduces benefits *more* if productivity growth turns out to be higher than we currently expect, exactly the opposite of the appropriate response because the underlying 75-year actuarial deficit would be *smaller* with faster productivity growth. As the Congressional Research Service recently noted, "somewhat paradoxically, if real wages rise *faster* than projected, price indexing would result in *deeper* benefit cuts, even as Social Security's unfunded 75-year liability would be shrinking."[3] Finally, the proposal treats someone earning $900,000 or even $9 million the same as someone earning $90,000; a sound reform plan would instead differentiate between the two. To be sure, imposing proportionately larger reductions in monthly benefits on higher earners compared to lower earners is sensible, in part because higher earners are increasingly living longer than others. "Progressive price indexing," however, is not the right way to accomplish that goal: It would make far more sense simply to adjust the current benefit formula directly to achieve the desired degree of protection for lower earners.

The rest of my testimony examines these points in more detail.

I. Improving 401(k)s and IRAs

The trend over the past two decades away from traditional, employer-managed plans and toward saving arrangements directed and managed largely by employees themselves, such as 401(k)s and Individual Retirement Accounts (IRAs), is in many ways a good thing. Workers enjoy more freedom of choice and more control over their own retirement planning. But for too many households, the 401(k) and IRA revolution has fallen short.

To address the problems with 401(k)s and IRAs, policy-makers and corporate leaders should make saving for retirement easier and increase the incentives for households to save for retirement. Let me give four specific examples of how this can be done.[4]

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[3] Patrick Purcell, "'Progressive Price Indexing' of Social Security benefits," Congressional Research Service, April 22, 2005.

[4] For further information on these and other commonsense reforms to bolster retirement security, see www.retirementsecurityproject.org.

A. Automating the 401(k)

A 401(k)-type plan typically leaves it up to the employee to choose whether to participate, how much to contribute, which of the investment vehicles offered by the employer to select, and when to pull the funds out of the plan and in what form. Workers are thus confronted with a series of financial decisions, each of which involves risk and a certain degree of financial expertise. Many workers shy away from these decisions and simply do not choose. Those who do choose often make poor choices.

To improve the design of the 401(k), we should recognize the power of inertia in human behavior and enlist it to promote rather than hinder saving.[5] Under an automatic 401(k), each of the key events in the process would be programmed to make contributing and investing easier and more effective.

- Automatic enrollment: Employees who fail to sign up for the plan -- whether because of simple inertia or procrastination, or perhaps because they are not sufficiently well organized or are daunted by the choices confronting them -- would become participants automatically, although they would preserve the option of declining to participate.

- Automatic escalation: Employee contributions would automatically increase in a prescribed manner over time, for example raising the contribution rate as a share of earnings whenever a worker experiences a pay increase, again with an option of declining to increase contributions in this fashion.

- Automatic investment: Funds would be automatically invested in balanced, prudently diversified, low-cost vehicles, whether broad index funds or professionally managed funds, unless the employee makes other choices. Such a strategy would improve asset allocation and investment choices while protecting employers from potential fiduciary liabilities associated with these default choices.

- Automatic rollover: When an employee switches jobs, the funds in his or her account would be automatically rolled over into an IRA, 401(k) or other plan offered by the new employer. At present, many employees receive their accumulated balances as a cash payment upon leaving an employer, and many of them spend part or all of it. Automatic rollovers would reduce such leakage from the tax-preferred retirement saving system. At this stage, too, the employee would retain the right to override the default option and place the funds elsewhere or take the cash payment.

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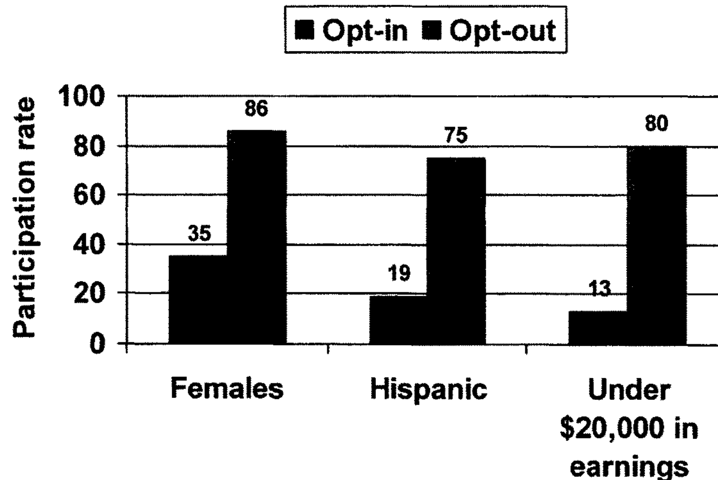
[5] William G. Gale, J. Mark Iwry, and Peter R. Orszag, "The Automatic 401(k): A Simple Way to Strengthen Retirement Savings," Retirement Security Project Policy Brief No. 2005-1, March 2005.

In each case – automatic enrollment, escalation, investment, and rollover – workers can always choose to override the defaults and opt out of the automatic design. Automatic retirement plans thus do not dictate choices any more than does the current set of default options, which exclude workers from the plan unless they opt to participate. Instead, automatic retirement plans merely point workers in a pro-saving direction when they decline to make explicit choices of their own.

These steps have been shown to be remarkably effective, as research by Richard Thaler and others has demonstrated. For example, one of the strongest empirical findings from behavioral economics is that automatic enrollment boosts the rate of plan participation substantially (Figure 2).[6] As the figure shows, automatic enrollment is particularly effective in boosting participation among those who often face the most difficulty in saving.

Figure 2: Effects of automatic enrollment on participation rates



Source: Madrian and Shea

Despite its demonstrated effectiveness in boosting participation, automatic enrollment is relatively new – and a small but growing share of 401(k) plans today include this feature. According to a recent survey, about one-tenth of 401(k) plans (and one-quarter of plans with at least 5,000 participants) have switched from the traditional "opt-in" to an "opt-out" arrangement.[7] Since automatic enrollment is a recent

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[6] Brigitte Madrian and Dennis Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," Quarterly Journal of Economics 116, no. 4 (November 2001): 1149-87; and James Choi and others, "Defined Contribution Pensions: Plan Rules, Participant Decisions, and the Path of Least Resistance," in Tax Policy and the Economy, Vol. 16, edited by James Poterba (MIT Press, 2002), pp. 67-113.

[7] Profit Sharing/401(k) Council of America, 47th Annual Survey of Profit Sharing and 401(k) Plans (2004).

development, it may become more widely adopted over time even with no further policy changes. But policymakers could accelerate its adoption through several measures. Some of these policy measures would be appropriate only if automatic enrollment were adopted in conjunction with other features of the automatic 401(k), especially automatic escalation:

- First, the laws governing automatic enrollment could be better clarified. In some states, some employers see their state labor laws as potentially restricting their ability to adopt automatic enrollment. Although many experts believe that federal pension law preempts such state laws as they relate to 401(k) plans, additional federal legislation to explicitly confirm that employers in all states may adopt this option would be helpful.

- Second, some plan administrators have expressed the concern that some new, automatically enrolled participants might demand a refund of their contributions, claiming that they never read or did not understand the automatic enrollment notice. This could prove costly, because restrictions on 401(k) withdrawals typically require demonstration of financial hardship, and even then the withdrawals are normally subject to a 10 percent early withdrawal tax. One solution would be to pass legislation permitting a short "unwind" period in which an employee's automatic enrollment could be reversed without paying the normal early withdrawal tax.

- Third, Congress could give plan sponsors a measure of protection from fiduciary liability for sensibly designed, low-cost default investments. If workers are automatically enrolled, their contributions have to be invested in something – and some firms are worried about fiduciary liability for these default investments. A targeted exemption from fiduciary responsibility given a prudent default would provide meaningful protection under the Employee Retirement Income Security Act of 1974 (ERISA), thus encouraging more employers to consider automatic enrollment. Defining a range of prudent defaults would enhance this safe harbor.

- Fourth, Congress could establish the federal government as a standard-setter in this arena by incorporating automatic enrollment into the Thrift Savings Plan, the defined contribution retirement saving plan covering federal employees. The Thrift Savings Plan already has a high participation rate, but if automatic enrollment increased participation by even a few percentage points, that would draw in tens of thousands of eligible employees who are not currently contributing. The Thrift Savings Plan's adoption of automatic enrollment, along with other elements of the automatic 401(k), would also serve as an example and model for other employers.

In sum, a growing body of evidence suggests that the judicious use of default arrangements -- arrangements that apply when employees do not make an explicit choice

on their own -- holds substantial promise for expanding retirement saving. Retooling America's voluntary, tax-subsidized 401(k) plans to make sound saving and investment decisions more automatic, while protecting freedom of choice for those participating, would require only a relatively modest set of policy changes—and the steps taken thus far are already producing good results. Expanding these efforts will make it easier for millions of American workers to save, thereby promising greater retirement security.

B. Allowing part of a tax refund to be deposited into an IRA

Most American households receive an income tax refund every year. For many, the refund is the largest single payment they can expect to receive all year. Accordingly, the more than $200 billion issued annually in individual income tax refunds presents a unique opportunity to increase personal saving.

Currently, taxpayers may instruct the Internal Revenue Service to deposit their refund in a designated account at a financial institution. The direct deposit, however, can be made to only one account. This all-or-nothing approach discourages many households from saving any of their refund. Allowing taxpayers to split their refund so that *part* of the refund could be directly deposited into an IRA could make saving simpler and, thus, more likely. The Administration has supported split refunds in each of its last two budget documents, but the necessary administrative changes have been delayed. More aggressive implementation is needed.

C. Strengthening the Saver's Credit

The vast majority of our current tax preferences for saving are problematic in two important respects. First, they reflect a mismatch between subsidy and need. The tax preferences provide the smallest benefits to lower-income families, and thus provide minimal incentives to those households who most need to save for basic needs in retirement. Instead the tax preferences give the strongest incentives to higher-income households, who are the least likely to need additional saving to achieve an adequate living standard in retirement.

Second, as a strategy for promoting national saving, the subsidies are poorly targeted. Higher-income households are disproportionately likely to respond to the incentives by shifting existing assets from taxable to tax-preferred accounts. To the extent such shifting occurs, the net result is that the pensions serve as a tax shelter, rather than as a vehicle to increase saving. In contrast, moderate- and lower-income households, if they participate in pensions, are most likely to use the accounts to raise net saving.[8]

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[8] See, for example, Eric M. Engen and William G. Gale, "The Effects of 401(k) Plans on Household Wealth: Differences Across Earnings Groups," Working Paper 8032 (Cambridge, Mass.: National Bureau of Economic Research, December 2000), and Daniel Benjamin, "Does 401(k) Eligibility Increase Saving? Evidence from Propensity Score Subclassification," *Journal of Public Economics* 87, no. 5-6 (2003): 1259-90.

The Saver's Credit, enacted in 2001, was expressly designed to address these problems. It is the first and so far only major federal legislation directly targeted toward promoting tax-qualified retirement saving for moderate- and lower-income workers, thereby helping to level the playing field of saving tax incentives. IRS data indicate that about 5 million tax filers claimed the Saver's Credit in 2002 and 2003. Despite the credit's promise, several steps are necessary to ensure that it fulfills its potential:

- First, in order to reduce the apparent revenue cost, Congress stipulated that the Saver's Credit would sunset at the end of 2006. It should be extended, which would cost between $1 billion and $2 billion a year. This cost should and could be offset in various ways.

- Second, tens of millions of moderate-income workers are unable to benefit from the credit because it is nonrefundable. Extending the intended saving incentive to most lower-income working families would require making the Saver's Credit refundable in some manner, perhaps directly into a retirement saving account.

- Third, another set of possible expansions to the Saver's Credit would extend eligibility to additional middle-income households. The credit could be expanded in this way along three dimensions: changes to the credit rate, the income limit, and the manner in which the credit is phased out.

In the context of evaluating ways of strengthening the Saver's Credit, it is worth noting that a research team (of which I am part) has just finished a path-breaking experiment with H&R Block exploring the effect of match rates on IRA saving. The project, undertaken under the auspices of the Retirement Security Project funded by the Pew Charitable Trusts, represents the first large-scale randomized experiment of how varying match rates affect retirement saving. The results should be ready soon.

D. Reducing the implicit taxes on retirement saving imposed by asset tests

The asset rules in means-tested benefit programs penalize any moderate- and low-income families who do save for retirement, by disqualifying them from the means-tested benefit program. The asset tests thus represent a substantial implicit tax on retirement saving.

The major means-tested benefit programs, including food stamps, cash welfare assistance, and Medicaid either require or allow states to apply asset tests when determining eligibility. Similarly, the Supplemental Security Income applies such an asset test. The asset tests may force households that rely on these benefits—or might rely on them in the future -- to deplete retirement saving before qualifying for benefits, even when doing so would involve a financial penalty. As a result, the asset tests not only penalize low-income savers but may also actually discourage retirement saving in the first place.

Asset tests in means-tested programs, as currently applied, thus constitute a barrier to the development of retirement saving among the low-income population. Modifying or even eliminating these asset tests, or disregarding saving in retirement accounts when applying the tests, would allow low-income families to build retirement saving without having to forgo means-tested benefits at times when their incomes are low during their working years.[9]

II. Individual accounts within Social Security

Although the individual accounts we already have on top of Social Security are crucially important and can be improved, the core tier of retirement income provided by Social Security is not the right place for a new set of accounts. Building ownership and wealth should not come at the expense of mortgaging future Social Security benefits -- which is precisely how the Administration's proposal for accounts *within* Social Security is structured. Nor should Social Security reform be associated with a significant increase in public debt, which results from the cash-flow problems created by individual accounts inside Social Security.

Accounts as loans

Under the Administration's proposal, the individual account system would involve two components: the individual account assets, which would contain a worker's deposits and the accumulated earnings on them, and a "liability account." If a worker chose to participate in the individual account system, four percentage points of payroll taxes (initially up to a limit of $1,000, with the limit gradually eased over time) would be diverted into the account, accumulate during the worker's career, and be available to the worker upon retirement.[10] Since the revenue diverted to this account would reduce the financing available to the traditional Social Security system, a "liability account" would also be created. The liability account would determine the debt owed back to Social Security at retirement because of the diverted funds.

In effect, the individual accounts proposed by the Administration represent a "Social Security line of credit." Workers drawing upon that line of credit receive payroll revenue in their individual account today, but must pay back the funds, plus interest at a 3

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[9] A forthcoming paper from the Retirement Security Project will examine these changes in more detail. Policy-makers considering introducing accounts within Social Security should also be careful to ensure that such accounts would not be counted under the asset tests included in various means-tested benefit programs.

[10] The limit would increase by $100 above wage inflation, at least through 2015. The Office of the Chief Actuary, in its memorandum on the proposal, indicated that the parameters of the system past 2015 had not been specified. It is noteworthy, however, that the White House Fact Sheet indicates that: "Under the President's plan, personal retirement accounts would start gradually. Yearly contribution limits would be raised over time, eventually permitting all workers to set aside 4 percentage points of their payroll taxes in their accounts." Given this statement, the analysis in this testimony assumes that the threshold would continue to increase more rapidly than wages until all workers could contribute 4 percent of taxable earnings. None of the qualitative conclusions are affected by this specific assumption.

percent real annual rate, at retirement. Indeed, margin investing has similar mechanisms and even similar terminology to the proposed accounts.

Upon retirement, the worker's debt to the Social Security system would be repaid by reducing his or her traditional Social Security benefits – that is, the monthly check paid to a retiree. Specifically, the monthly benefit reduction would be computed so that the present value of the reduction would equal the accumulated balance in the liability account. In other words, the reduction in monthly benefits would be just enough, in expected present value, to pay off the accumulated debt to the Social Security system. As Greg Mankiw, former Chair of the Council of Economic Advisers under President Bush, has written, "When a person signs up for a voluntary personal account, the government puts, say, $1,000 in his or her account. In exchange, that person agrees to receive lower benefits from the traditional defined-benefit system, by an amount equal to $1,000 in present value."[11]

This system is quite similar to a loan: As under a loan, the worker receives cash up-front and can invest the money. The worker pays back the borrowed funds, with interest, later. The specific form of the repayment, through a reduction in traditional Social Security benefits, does not alter the underlying nature of the transaction.

Actuarial and cash-flow effects

The 3 percent real rate is equal to the expected real interest rate on government bonds projected by the Social Security trustees in their intermediate cost assumptions. Since the interest rate on the loans is equal to the interest rate that the Social Security system is assumed to earn on its own funds, the system is held harmless on each individual loan, under the trustees' assumptions, as long as the loans are repaid in full.[12] Two crucial points are worth noting:

- First, even the Administration acknowledges that the accounts do *nothing* directly to reduce the long-term deficit in Social Security.[13] In other words, individual

[11] N. Gregory Mankiw, "Personal Dispute: Why Democrats Oppose Bush," *The New Republic*, March 21, 2005.

[12] Note that because of administrative costs, it is impossible for the worker to break even while holding government bonds *and* for the government to be held harmless on the transaction. The reason is that one party or the other must bear the administrative costs of the investment. Under the Administration's assumptions, for example, the real interest rate on government bonds is 3 percent per year. Under that assumption, the system would hold the government harmless as long as the worker reached retirement and paid back the loan (the government would be held harmless since the loan carries the same real interest rate as the projected government borrowing rate). The worker, however, would be worse off if she opted for an account and held government bonds in it. Such an account would have a *net* real yield of 2.7 percent per year (the 3 percent real return on government bonds minus the assumed 0.3 percent per year in administrative costs), leaving the worker with a net reduction in retirement income.

[13] A senior Administration official was quoted on February 2 as saying, "So in a long-term sense, the personal accounts would have a net neutral effect on the fiscal situation of the Social Security and on the federal government." A reporter than asked: "And am I right in assuming that in the way you describe this,

accounts are simply a non-answer to the question of how the deficit in Social Security will be addressed.

- Second, the accounts are actually likely to impose a negative effect on Social Security's solvency. The reason is simply that there are several likely situations in which the loan repayment back to Social Security (through reduced Social Security benefits) would be insufficient to offset the cost of the diverted revenue. Only if repayment is always made in full will the accounts be actuarially neutral over an infinite horizon. If repayment is incomplete in some circumstances, the accounts not only fail to reduce the Social Security deficit, they actually widen it. For example, if a worker dies before retirement without a living spouse, the amount in the individual asset account may be distributed to heirs, but the amount in the individual liability account could be extinguished. As a result, some "loans" are not paid off – and the system is thus made financially worse off.[14] (A married worker who dies before retirement would leave her account, but also her debt repayment owed back to Social Security, to her surviving spouse.) It is worth noting that a recent proposal by Robert Pozen, a member of President Bush's Social Security commission in 2001, would avoid the actuarial hole created by pre-retirement deaths of non-married workers by having the government directly reclaim part or all of the account upon the death of such a worker.[15]

Even if the proposal were actuarially neutral over an infinite horizon, it would still generate a large cash-flow problem. Substantial revenues would be diverted from Social Security to individual accounts long before Social Security would receive the associated "debt repayments" from the liability accounts, since the "debts" would not be repaid until workers retired and their traditional Social Security benefits were reduced.

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because it's a wash in terms of the net effect on Social Security from the accounts by themselves, that it would be fair to describe this as having -- the personal accounts by themselves as having no effect whatsoever on the solvency issue?" The senior Administration official replied: "That's a fair inference." Transcript of briefing as posted on Washington Post website: http://www.washingtonpost.com/ac2/wp-dyn/A59045-2005Feb2?language=printer.

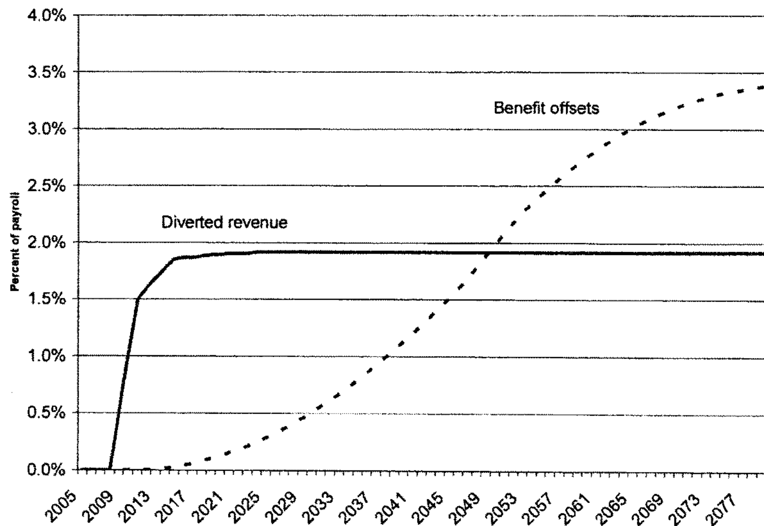
[14] As another example, the benefit reductions necessary to pay back Social Security -- especially if combined with additional benefit reductions to restore long-term solvency -- may be so large that they could prove politically untenable over time. Finally, even without political pressure to reduce loan repayments, some repayments may be curtailed simply because the traditional defined benefit component of Social Security is too small to pay back the loan in full. This is particularly troubling since the progressive benefit formula implies that those with higher earnings are more likely to be in a position in which traditional benefits are insufficient to repay the loan. These effects mean that even over the problematic infinite horizon preferred by the Administration, the accounts may harm solvency.

[15] As the actuarial memorandum on a plan put forward by Mr. Pozen notes, "If there are no survivors, and the worker dies before such benefit entitlement, their estate would receive the balance in their IA at death minus an offset that would be paid to the Trust Funds to compensate for their earlier allocations of a portion of their payroll taxes to their IA." See "Estimated Financial Effects of a Comprehensive Social Security Reform Proposal Including Progressive Price Indexing, February 10, 2005—a proposal developed by Robert Pozen, member of the 2001 President's Commission to Strengthen Social Security," available at http://www.ssa.gov/OACT/solvency/RPozen_20050210.pdf.

To examine the time profile of the aggregate cash flows, I follow the Administration's assumption that two-thirds of workers would participate in the accounts.[16] Figure 3 shows the cash-flow effects. (The unusual pattern of the diverted revenue over the next few years reflects the phase-in rules for the accounts.) The cash flow from the individual accounts is negative over a period of about 45 years, because the diverted revenue exceeds the benefit offsets until about 2050.

Currently, roughly 85 cents of every dollar in non-interest Social Security revenue is used to pay benefits during the same year. If revenue were diverted into individual accounts, the reduced cash flow would drive the trust fund balance to exhaustion sooner than currently projected, requiring either some source of additional revenue to continue paying benefits or a reduction in current benefits to offset the reduced revenue flow. Indeed, the net cash outflow shown in the figure causes the trust fund to be exhausted more than a decade earlier than in the absence of the accounts – 2030 rather than 2041. Figure 4 shows the trust fund relative to Social Security's costs each year, with and without the account proposal. As the figure shows, at each point in time, the trust fund is lower than it would have been in the absence of the accounts, because there are always some outstanding "loans" made to workers.

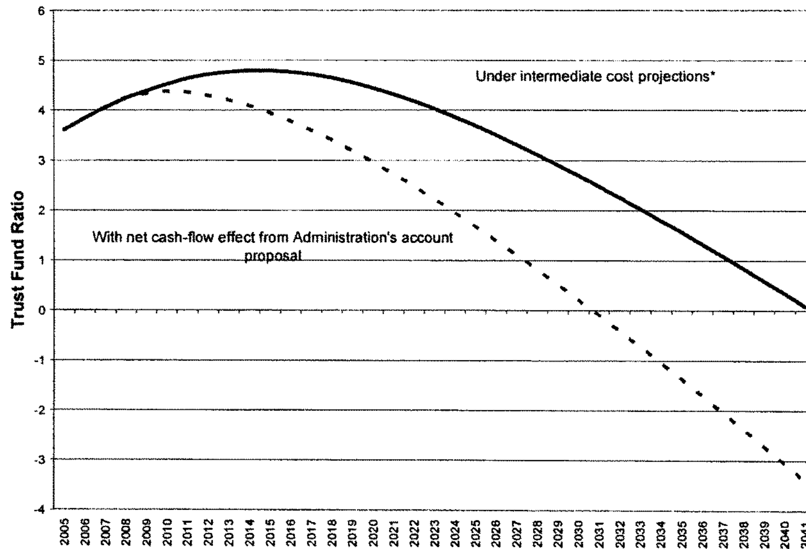
Figure 3: Cash-flow effect from Administration's individual account plan



[16] To compute the benefit offsets, I combine the figures calculated by the Office of the Chief Actuary for Model 1 from the President's Commission to Strengthen Social Security, which assumed a 3.5 percent real interest rate for the benefit offsets, and for Model 3, which assumed a 2.5 percent rate. I thank Jason Furman for sharing some of his spreadsheets about the Administration's plan.

Another perspective on the impact of the proposed accounts comes from the effect on the 75-year actuarial balance, the traditional measure used to evaluate solvency. While no official projection is available for the full 75-year projection period, in part because the Administration has not formally stipulated how it would handle these cash flow problems, the actuarial deficit caused by the accounts over the next 75 years would amount to about 0.6 percent of payroll. To put this in context, the actuarial deficit is currently projected to be 1.9 percent of taxable payroll; if we add the Administration's individual accounts, the deficit over the next 75 years increases to about 2.5 percent of payroll.[17]

Figure 4: Trust Fund ratio under Administration's individual account plan



The cash-flow problems created by the accounts manifest themselves in publicly held debt. Over the first ten years that they were in existence (2009-2018), the accounts

[17] To avoid having the individual accounts accelerate the exhaustion of the trust fund, private accounts plans – including two of the plans put forward by the President's Commission – would transfer substantial amounts from the general budget to Social Security. Relying on such a transfer from the rest of budget would be a major departure from the principles that have guided Social Security for its first 70 years. To date, all of the funding has come from *dedicated* revenue sources, serving thereby to keep Social Security out of the annual budget process. This is an attractive feature for a program that should neither be changed frequently nor without adequate notice.

would raise publicly held debt by more than $1 trillion; during their second decade (2019-2028), they would raise publicly held debt by more than $3.5 trillion.[18]

The loan analogy helps to explain this increase in debt, and it also provides insight into a surprising result: The debt increase would be *permanent.* To finance a loan to a worker (provided in the form of revenue deposited into an individual account) under the Administration's proposal, the government borrows funds. If the worker repays the loan, the additional government debt on that transaction is extinguished, so public debt returns to the same level as if that worker had not opted for an account. But note that at any point in time, *even if all loans were eventually repaid,* some loans would always be outstanding. As a result, public debt would forever remain higher with the accounts than without them.

Even if the accounts were combined with proposals to eliminate the underlying deficit in Social Security, the increase in debt is likely to be extended and substantial. For example, the leading proposal from the President's Commission to Strengthen Social Security in 2001 would have changed the determination of individual benefits to incorporate what is commonly -- but somewhat misleadingly -- referred to as "price indexing." The change may sound innocuous, but as explained below, it would dramatically reduce benefits over time. For the immediate purpose, note that price indexation is sufficient by itself to more than eliminate the long-term deficit in Social Security. Yet even if the accounts proposed by the Administration were combined with this price indexing proposal, debt held by the public would remain higher than in the absence of the combined proposal for roughly five decades.[19]

Effects on tiers of retirement income

The cash-flow and publicly held debt problems highlighted above are not the only downsides to introducing individual accounts within Social Security. Reducing traditional Social Security benefits to make room for individual accounts would be

[18] Such increases in debt would occur even if the maximum account size were capped at its (wage-adjusted) 2015 level, rather than continuing to be increased more rapidly than wages after 2015 to ensure the White House goal that all workers could eventually contribute 4 percent of payroll to the accounts.

[19] Some advocates of the Administration's plan argue that the debt merely creates "explicit debt" in exchange for "implicit debt" that the government has already incurred (in the form of future Social Security benefits). From this perspective, advocates argue that the loan transactions merely trade more explicit debt for a reduction in implicit debt, since the loan repayments will reduce future Social Security benefits. The argument is then put forward that these two types of debt -- "implicit debt" and "explicit debt" -- are essentially the same, so that converting one into the other does not represent an increase in federal liabilities and should not raise concerns. This argument is, however, seriously flawed. The two types of debt are *not* equivalent. The explicit debt that the government would incur as a result of the Administration's proposal for individual accounts would have to be purchased by creditors in financial markets. When the additional debt matured, it would have to be paid off or rolled over. By contrast, the implicit debt associated with future Social Security benefit promises does *not* have to be financed in financial markets now. A government with a large explicit debt thus has less room for maneuver and is more vulnerable to a lessening of confidence on the part of the financial markets than a government with a large implicit debt. Converting implicit debt into explicit debt is thus problematic.

unsound for society as a whole because it would substantially erode the core tier of retirement income.

Figure 5 shows the tiers of retirement income under the Administration's proposal for individual accounts if it were combined with the proposal for "progressive price indexing" that is discussed further below. As the figure shows, the core tier of retirement income provided in the form of traditional Social Security benefits would be dramatically reduced – from about 35 percent of previous wages to well under 15 percent for a medium-wage earner retiring at age 65 in 2054. Such a dramatic reduction in the foundation of retirement income raises a number of significant concerns, and the observation that the worker's individual account could replace part of the reduced income does little to attenuate these concerns.

Figure 5: Tiers of retirement income with accounts and "progressive price indexing"

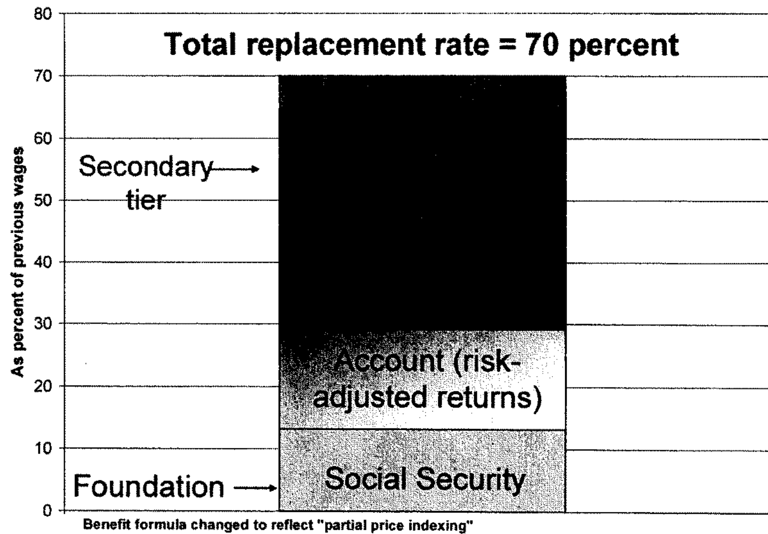


Figure shows initial replacement rates at retirement for medium-earning worker claiming benefits at age 65 in 2054

- Retirement benefits under Social Security provide an assured level of income that does not depend on what happens in financial markets. Benefits are related to the beneficiary's average lifetime earnings and when the beneficiary chooses to retire. With an individual account, by contrast, benefits during retirement depend on the value of the assets accumulated in the account, which likewise depends in part on lifetime earnings and retirement timing, but also on how well one has invested and on how financial markets happened to perform during one's career. It is entirely appropriate and indeed beneficial for most individuals to accept the risks of investing in financial markets as part of their overall retirement portfolio; it

does not, however, make sense to incur such risks as a way of providing for a base level of income during retirement, disability, or other times of need. *Individual accounts thus belong on top of Social Security, not instead of it.*

- Retirement benefits under Social Security are protected from inflation and last as long as the beneficiary lives. Individual accounts could, in principle, achieve similar protections by requiring account holders, upon retiring, to convert their account balances into a lifelong series of inflation-adjusted payments (that is, an inflation-indexed annuity). The Administration's proposal for individual accounts does not include such a requirement in full, however. Even if it did, any such requirement might not be politically sustainable. Individual accounts have been promoted on the grounds that they would enhance "personal wealth" and "ownership" of one's retirement assets; this seems inconsistent with maintaining substantial restrictions on how accountholders may access and use their accounts. Moreover, the goal of "bequeathable wealth," an explicit selling point of the account proposal, is in direct conflict with financing benefits that last as long as the beneficiary lives. One cannot use the same assets to both maximize benefits during one's own lifetime and leave something for one's heirs.

- The Social Security benefit formula replaces a larger share of previous earnings for lower earners than for higher earners. This provides a form of lifetime earnings insurance that is not available through private markets. For the nation, it helps reduce poverty and narrow income inequalities; for the individual, it provides security. As proposed, the individual accounts do not contribute to this form of lifetime earnings insurance.

- No political pressure exists to give earlier access to Social Security benefits. In contrast, there is likely to be considerable pressure for individual accounts to mimic 401(k)s and IRAs that allow pre-retirement access through loans and early withdrawals. Such access could undermine the preservation of funds for retirement.

- Social Security provides other benefits in addition to basic retirement income. Some of these, such as disability benefits, would be difficult to integrate into an individual accounts system.

- Individual accounts would require certain administrative costs to maintain, costs that the present structure of Social Security avoids. The higher these costs, the less generous the benefits that a given history of contributions can finance.

One final argument is worth exploring. Some advocates for accounts claim that although the accounts do not directly help to reduce the Social Security deficit, they help indirectly by serving as a "sweetener" to facilitate the necessary changes, especially among higher earners. Several points about this argument should be noted:

- The accounts are supposed to be the political deal offered to middle and higher earners, in exchange for their accepting substantial benefit reductions to restore solvency.[20] Again, though, the account proposal is effectively an unsubsidized loan from the government to the worker at the government bond interest rate projected by the Social Security actuaries – which, as already noted, should not be a particularly attractive offer for most higher earners.[21] It is therefore incumbent upon proponents of the "sweetener" argument to show that the accounts do indeed serve the political purpose suggested for them (i.e., to sugar-coat benefit reductions or revenue increases).

- If the loans were subsidized, by carrying an interest rate lower than the government bond rate, they may become more attractive to higher earners. But in that case, their direct effect would *impair* long-term solvency, requiring further benefit reductions or revenue increases simply to avoid imposing harm. In this case, the net effect of the so-called "sweetener" would be beneficial to solvency only if the other changes it facilitated somehow *more* than offset its direct harm. Also note that in this case, those not participating in the accounts would, in effect, be paying the subsidies for the workers who did participate in the accounts.

- Encouraging more equity ownership and asset accumulation among moderate and lower earners is a sound policy objective, but the right approach to building ownership and assets is not by borrowing against future Social Security benefits. Instead, the types of reforms discussed in the first section of my testimony would expand ownership and asset accumulation on top of Social Security among moderate and lower earners.

In sum, the sweetener argument is typically framed as helping higher earners accept the necessary structural changes to Social Security. Yet it is unclear why such higher earners (who tend to already own a mix of stocks and bonds) should value accounts that are effectively loans at the government bond interest rate.

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[20] For example, Robert Pozen writes: "While the Social Security benefits of most middle and high earners would still rise under progressive indexing, they would grow more slowly than under the current system. To make this package politically attractive, Congress should offer all workers the chance to offset most of this slower growth in traditional benefits by allowing them to invest two percentage points out of the 12.4% in payroll taxes they pay on all wages up to an annual maximum ($90,000 in 2005 and rising yearly)." Robert Pozen, "The route to real pensions reform," *The Economist*, January 6, 2005.

[21] For workers who already own both stocks and bonds, the ability to borrow more at the government bond rate should be of little or no value: Rather than borrowing at the government bond rate and buying stocks, such workers could undertake virtually the same financial transaction at lower transaction costs simply by selling some bonds and buying some stocks. Many average and higher earners already own a mix of stocks and bonds. For example, data from the 2001 Survey of Consumer Finances indicate that 45 percent of workers earning at least $40,000, and more than 50 percent of workers earning at least $60,000, live in families that own both stocks and bonds (either in retirement accounts or in non-retirement accounts).

III. Solvency tradeoffs

Since individual accounts do not reduce Social Security's deficit and indeed are likely to expand it under realistic assumptions, eliminating the long-term deficit in Social Security must involve some combination of revenue increases and benefit reductions. Given this fundamental tradeoff, failing to dedicate additional revenue to Social Security increases the required benefit cuts.

When push comes to shove, Americans seem to prefer mainly relying on additional revenue -- or some combination of additional revenue and benefit reductions -- to mainly relying on benefit reductions.[22] That preference is sound, since failing to dedicate additional revenue to Social Security would substantially reduce the foundation of retirement income shown in Figure 1. To maintain a solid core tier of retirement income, the solvency proposal that I designed with Professor Peter Diamond of MIT combines revenue and benefit changes, rather than relying solely on benefit reductions (as many alternative plans have done).[23] The plan does not affect benefits for workers who are 55 years old or older this year. It protects the most vulnerable beneficiaries, asks average earners to accept modest sacrifices in reform, and asks higher earners to play a somewhat larger role in reaching long-term balance. It contains no accounting gimmicks and has been scored as restoring long-term sustainable solvency to Social Security by both the Social Security actuary and the Congressional Budget Office.

Dedicating the revenue from a reformed estate tax to Social Security is an alternative way of attenuating the pressure on benefit reductions. For example, the Chief Actuary of the Social Security Administration has estimated that maintaining the estate tax at its 2009 levels -- with a $3.5 million exemption per person and a 45 percent top rate -- and dedicating the revenue to Social Security would cover more than one-quarter of the shortfall in the Social Security Trust Fund over the next 75 years. With an exemption of $3.5 million per person, Tax Policy Center estimates suggest that only 0.3 percent of all persons expected to die in 2011 would be taxable in 2011. Only 50 taxable estates in the entire nation would contain a small farm or small business (those valued at less than $5 million) that comprised a majority of the estate. Yet, if the remaining deficit were closed solely on the benefit side, the revenue collected from the reformed estate tax would obviate more than $1 trillion in benefit reductions that would otherwise be required to restore solvency over the next 75 years.[24] For a 20-year-old medium-earning worker today, it could mean avoiding about $1,500 per year in benefit reductions.

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[22] For example, in a survey conducted by economists Alan Blinder and Alan Krueger of Princeton University, 30 percent said they would prefer to eliminate the Social Security deficit "mainly by raising the payroll tax." Another 5 percent responded "mainly by reducing Social Security benefits," while 34 percent responded "both." Alan S. Blinder and Alan B. Krueger, "What Does the Public Know about Economic Policy, and How Does It Know It?" *Brookings Papers on Economic Activity 1:2004,* pp. 327-87.

[23] Peter A. Diamond and Peter R. Orszag, *Saving Social Security: A Balanced Approach* (Brookings: 2004).

[24] The $1 trillion figure is in present value, since it cumulates benefit changes over a 75-year period. The $1,500 annual figure cited for the 20-year-old medium earner is in inflation-adjusted dollars.

If instead the tax rate on large estates were reduced to 15 percent, the revenue collected would fall dramatically. As a result, the dedicated revenue would be sufficient to close less than 10 percent of the projected 75-year deficit, and the benefit reductions obviated would amount to only $300 billion in present value. In other words, with the revenue from an estate tax dedicated to Social Security, reducing the tax rate on large estates to 15 percent would increase the benefit reductions required to eliminate Social Security's deficit by $700 billion over the next 75 years. We as a society must decide whether this $700 billion is better used to provide larger after-tax inheritances to wealthy children or to reduce any benefit reductions necessary to restore solvency. Every dollar of estate tax revenue dedicated to Social Security is a dollar less of benefit reductions or payroll tax increases necessary to eliminate Social Security's deficit.

IV: The flaws in "progressive price indexing"

This final section of my testimony examines a recent proposal to adopt "progressive price indexing" for computing initial benefits at retirement. Despite its apparent popularity in some circles, the proposal is deeply flawed. It involves an excessive reliance on benefit reductions, it would cut benefits *more* if productivity growth turns out to be higher than we currently expect, and fails to ask any more of the nation's very highest earners than those with high earnings.

To understand the problems with progressive price indexing, it is first necessary to understand full "price indexing." Although it sounds innocuous, price indexing would reduce benefits far more than appears on the surface. For example, had this rule been fully in effect by 1983, at the time of the last major reform to Social Security, benefits for newly eligible retirees and disabled workers now would be almost 20 percent lower and continuing to decline relative to current law.

Under current law, benefits for new retirees roughly keep pace with wage growth. Successive generations of retirees thus receive higher benefits because they had higher earnings -- and paid higher payroll taxes -- during their careers. This feature of the Social Security system makes sense, since a goal of Social Security is to ensure that a worker's income does not drop too precipitously when the worker retires and ceases to have earnings. A focus on how much of previous earnings are replaced by benefits (the "replacement rate") recognizes the real-world phenomenon by which families, having become accustomed to a given level of consumption, experience difficult adjustment problems with substantial declines in income during retirement.

The price-indexing proposal would alter the current system so that in determining the initial benefit level, benefits would be reduced by the cumulative difference between wage growth and price growth from the time the proposed system were implemented to the retirement of a given generation. In other words, under "price indexing," if average real wages were ten percent larger after ten years, the roughly ten percent benefit growth to keep pace with this wage growth would simply be removed. Since real wage growth is

positive on average, compared to currently scheduled benefits, the change would reduce initial benefit levels and the size of the reduction would increase over time.[25]

A recent proposal, often called "progressive price indexing," would apply "price indexing" of initial benefits for higher earners while continuing to use wage indexation for lower earners.[26] Specifically, the current benefit formula would continue to apply to workers in the bottom 30 percent of the wage distribution. The full price indexation proposal would be used to determine benefits for those whose wages equal or exceed the maximum taxable earnings base ($90,000 in 2005). Workers with wages in between these two would receive some combination of the benefit under the current formula and the benefit under the price indexation formula.

The progressive price indexing proposal is seriously flawed for several reasons.[27] First, progressive price indexing imposes surprisingly large benefit reductions on average earners. The reason is that it attempts to close too much of the actuarial deficit on the benefit side. Other plans, such as the Diamond-Orszag one, dedicate additional revenue to Social Security, mitigating the need for benefit reductions while still achieving long-term financial balance. For example, progressive price indexing would reduce annual benefits for a medium-earner who is 25 today and retires in 2045 by 16 percent; Diamond-Orszag reduces benefits for such a worker by less than 9 percent (Table 1). The difference amounts to almost $1,500 per year (in 2005 inflation-adjusted dollars).

Second, progressive price indexing imposes *more* substantial benefit reductions on average earners and higher earners the higher productivity growth is, even though that higher productivity reduces the 75-year actuarial imbalance in Social Security. Consider, for example, the benefit reductions for maximum earners. A medium-earning 25-year old at the time of legislation would have benefits reduced by about 15 percent under the proposal if real wage growth is 1 percent annually. The benefit reduction for the 25-year-old is significantly larger, about 25 percent, if real wage growth is 2 percent per year (Table 2), even though the 75-year Social Security shortfall would be smaller in that case. The differences are even more substantial for higher earners.

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[25] The 2005 Trustees Report projects long-run growth of prices of 2.8 percent per year and long-run growth of taxable wages of 3.9 percent per year, resulting in a growth of real wages of 1.1 percent per year. But real wage growth may turn out to be larger or smaller than this amount.

[26] For further analysis of the proposal, see Jason Furman, "An Analysis of Using 'Progressive Price Indexing' to Set Social Security Benefits," Center on Budget and Policy Priorities, March 21, 2005.

[27] The Social Security actuaries have estimated that this proposal would reduce the actuarial deficit over the next 75 years by 1.4 percent of payroll, compared to the projected deficit of 1.9 percent of payroll. In other words, more than a quarter of the gap would remain. Thus the proposal, by itself, does not restore solvency to Social Security. Furthermore, the actuarial estimates assume that progressive price indexing applies to *all* benefits – including disability and survivor benefits. If the plan were changed to conform with the widespread consensus that disability and pre-retirement death survivors benefits should be protected, its actuarial saving would be even smaller.

Table 1: Benefit reductions for workers claiming benefits at age 65 in 2045

	Progressive price indexing		Diamond-Orszag	
	Benefit (2005 dollars)	% change from current benefit formula	Benefit (2005 dollars)	% change from current benefit formula
Scaled low earner *($16,428 in 2005)*	$12,041	0%	$11,945	-1%
Scaled medium earner *($36,507 in 2005)*	$16,584	-16%	$18,052	-9%
Scaled high earner *($58,411 in 2005)*	$19,858	-25%	$22,935	-13%
Scaled maximum earner *($90,000 in 2005)*	$22,829	-29%	$25,755	-20%

Source: Calculations by Jason Furman, based on memos from the Office of the Chief Actuary

Table 2: Effect of progressive price indexing on benefits for medium earners

Age when implemented	1% real wage growth	2% real wage growth
55	0	0
45	-5%	-10%
35	-10%	-19%
25	-15%	-25%
15	-19%	-31%

Note: Calculated as $0.5647*(.99^{55-age}-1)$ and $0.5647*(.98^{55-age}-1)$ respectively. The 0.5647 factor reflects the relative percentage benefit reduction for the scaled medium earner compared to a steady maximum earner under the proposal, until the benefit formula becomes flat for the top 70 percent of workers.

Any method of automatic indexing should be designed to help keep revenues and expenditures closer to balance in the future. Progressive price indexing, though, does the reverse. Even if they are the best possible set of projections currently available, it is virtually certain that current projections of the next 75 years (let alone thereafter) will prove to be incorrect in one direction or the other. Such uncertainty is not an excuse for failing to act, but it does strongly suggest that policy changes should be adopted with an eye toward how they will perform when the future turns out to be different than we currently expect. Yet under progressive price indexing, if real wage growth is more rapid than expected, benefit cuts are *larger*. If real wage growth is more rapid, though, the underlying 75-year actuarial deficit (in the absence of this provision) is smaller. The larger actual real wage growth turns out to be, the smaller the need for benefit reductions but the larger those reductions actually are under progressive price indexing.

Third, progressive price indexing treats workers earning $90,000 the same as workers earning $900,000 or even $9 million. The Diamond-Orszag proposal, along with other recent proposals, instead asks the very highest earners to bear more of the burden in restoring solvency. At the higher end of the earnings distribution, "progressive price indexing" is not actually progressive.

Finally, "progressive price indexing" ultimately leads to a flat benefit level for the top 70 percent of earners. That is, most workers within a given generation would receive the same dollar benefit even though their earnings have varied substantially (as have the payroll taxes they paid). Under the current benefit formula and under the Diamond-Orszag plan, higher earnings translate into higher benefit levels. Ultimately, progressive price indexing leads to a system in which higher earners receive the same benefit as moderate earners. The reason is that progressive price indexing reduces benefits for higher earners while not reducing them for lower earners. As a result, the benefit level for the highest earner evolves toward the level of that for the worker at the 30th percentile. Breaking the linkage between earnings and benefits in this fashion moves the system from a focus on replacement rates to one of a minimum benefit level, which in turn may undermine political support for the program. Furthermore, if the proposal were combined with individual accounts of the type the Administration has proposed, many higher earners may ultimately receive *no* check from the defined benefit component of the program because the offset associated with the accounts would more than consume their monthly benefit.

In summary, the "progressive price indexing" approach shows clearly the implications of trying to close the long-term Social Security actuarial deficit primarily by benefit reductions. Although it fails to restore solvency by itself and incorporates only one particular pattern of how benefits could be reduced for workers born in different years, it illustrates the broader implications of closing the actuarial deficit excessively on the benefit side. Not surprisingly, such an approach involves dramatic reductions relative to scheduled benefits.

It is worth emphasizing that the apparent objective behind progressive price indexing -- to attenuate the burden of restoring solvency on lower earners -- is sound. One motivation for this objective is that the extent to which people with higher earnings and more education tend to live longer than those with lower earnings and less education has increased significantly over the past several decades.[28] This increasing gap in life expectancy exacerbates Social Security's financing shortfall and makes the system less progressive on a lifetime basis (since higher earners will collect benefits for an increasingly larger number of years, and thus enjoy larger lifetime benefits, relative to lower earners). For this reason along with others, it makes sense to adjust the monthly benefit formula in a manner that imposes larger proportionate reductions on higher earners than lower earners. Rather than adopting the flawed progressive price indexing

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[28] See, for example, Jonathan Skinner and Weiping Zhou, "The Measurement and Evolution of Health Inequality: Evidence from the U.S. Medicare Population," NBER Working Paper No. 10842, October 2004; Irma Elo and Kirsten P. Smith, "Trends in Educational Differentials in Mortality in the United States," presented at the Annual Meeting of the Population Association of America, May 2003; and Gregory Pappas, Susan Queen, Wilbur Hadden, and Gail Fisher, "The Increasing Disparity in Mortality between Socioeconomic Groups in the United States, 1960 and 1986," *New England Journal of Medicine,* vol. 329, no. 2 (July 8, 1993), pp. 103-09, and the correction that appeared in the October 7, 1993, issue.

approach, however, policy-makers should simply make direct adjustments to the benefit formula to accomplish this objective.

Conclusion

Individual accounts can and should be strengthened on top of Social Security, where they belong. The Administration's proposal to introduce individual accounts within Social Security would substantially increase debt, while failing to reduce the projected Social Security deficit and likely increasing it. Progressive price indexing involves unnecessarily large benefit reductions, is poorly designed in the face of significant uncertainty over future productivity growth rates, and does not ask enough of the nation's very highest earners in helping to restore solvency to Social Security. Policy-makers should instead explore ways of restoring solvency that combine revenue and benefit changes; protect the most vulnerable beneficiaries; do not involve accounting ploys or magic asterisks; and, since current projections are virtually certain to be wrong in one direction or the other, sensibly adjust to future events as they unfold.

Responses to Questions From Senator Baucus

DEEP BENEFIT CUTS

Question: An analysis of Mr. Pozen's plan by the Office of the Chief Actuary of the Social Security Administration was released on February 10th of this year. According to tables B1 and B2 of that analysis, a person who is born 5 years from now, who retires at age 65, and has career earnings that are 60 percent greater than the national average defined by the Social Security Administration—but which is still only $59,000 this year—would have their benefits cut by about 40 percent relative to current law. Isn't that a deep benefit cut?

A worker who is born 5 years from now, retires at age 65 and who has career earnings at the national average as defined by the Social Security Administration—only $36,000 of earnings this year—would have their benefits cut by 28 percent. Isn't that a deep benefit cut?

These benefit cuts are not limited to those retiring in 2075. A worker who is 25 years old today with career earnings 60 percent above the national average—only $59,000 this year—and who retires *in 2045* would receive a benefit cut of 24 percent. Isn't that a deep benefit cut?

Answer: As my written testimony notes and as your question emphasizes, progressive price-indexing imposes surprisingly large benefit reductions on average and higher earners. The reason is that it attempts to close too much of the actuarial deficit on the benefit side. Other plans dedicate additional revenue to Social Security, mitigating the need for benefit reductions while still achieving long-term financial balance within the program.

PRICE-INDEXING AND WAGE-INDEXING

Question: In an article Mr. Pozen has written, he includes an example of the impact of his "progressive price-indexing" proposal. The example is for someone who has earnings that are 50 percent between the maximum earnings subject to tax and the earnings level where wage-indexing ceases. He says that this person would have their benefits half wage-indexed and half price-indexed. Isn't this assertion that half the benefit would be price-indexed and half would be wage-indexed wrong? What is the correct analysis?

Answer: Mr. Pozen's analysis is incorrect. A 25-year-old worker who is earning $20,000 today (and whose wages increase in line with average wage growth in the future) would experience no reduction in benefits under the progressive price-indexing proposal. A 25-year-old worker who is earning $90,000 today would experience a benefit reduction of 29 percent. Yet a 25-year-old worker with earnings half-way in between these two workers—with earnings of $55,000 per year—would experience a benefit reduction of more than 23 percent. Mr. Pozen's incorrect claim would suggest instead that the worker would experience a reduction of only 14.5 percent (the average of 29 percent and 0).

INFINITE HORIZON

Question: For the last couple of years, the Social Security trustees have made projections over the infinite horizon. Several of the witnesses at today's hearing have made similar statements about their proposals over the infinite horizon. Do you think the infinite horizon is helpful in the public policy debate about Social Security?

Answer: Infinite horizon projections may provide useful information to analysts, but they should not play a prominent role in the policy debate. The American Academy of Actuaries has expressed particularly strong concerns about infinite horizon projections. In particular, the Social Insurance Committee of the American Academy of Actuaries wrote that such projections "provide little if any useful information about the program's long-range finances and indeed are likely to mislead anyone lacking technical expertise in the demographic, economic and actuarial aspects of the program's finances into believing that the program is in far worse financial condition than is actually indicated. . . ."[1] As a result, such infinite-horizon projections should not be emphasized in policy discussions.

COST OF DELAYING REFORM

Question: President Bush recently claimed that delaying action on Social Security by ". . . just 1 year adds $600 billion to the cost of fixing Social Security." Other administration officials have used the same figure. My understanding is that this

[1] *See http://www.actuary.org/pdf/socialsecurity/tech_dec03.pdf.*

$600 billion figure is not at all what it seems to be. I thought that the latest trustees' report, in essence, made that point. Can you comment on this issue?

Answer: The $600 billion figure, which reflects the change in the infinite-horizon deficit from 1 year to the next, is misleading for many reasons. First, it is based on an infinite horizon calculation, as discussed above. Second, it does not adjust for inflation or the size of the economy. As a share of the projected economy, the projected infinite-horizon deficit has not increased. As the Social Insurance Committee of the American Academy of Actuaries has emphasized, "The infinite-time-horizon unfunded-obligations estimate [in dollar terms] increases each year. . . . The public, seeing annual large increases in unfunded obligations, is likely to be misled into believing that the program's financial situation is deteriorating and the cost of restoring actuarial balance is increasing, even if this is not the case." Finally, the figure is not put into the context of other policy choices. For example, applying the same misleading methodology to the administration's tax cuts as the administration applies to Social Security shows that the tax cuts "cost" about $1 trillion per year, because their effect on the infinite-horizon fiscal gap increases by roughly that amount each year.

INCREASING SAVINGS

Question: Let's focus on lower-income taxpayers. Your testimony shows that 401(k) plan participation rates skyrocket among those earning less than $20,000 when automatic enrollment is added to the program: from 13 percent to 80 percent.

- Does this increase translate directly to increased personal savings?
- Most low-income taxpayers don't have access to an employer-sponsored plan. Are any of the other options you discussed as effective as automatic enrollment in boosting savings for low-income taxpayers?

Answer: Automatic enrollment has been shown to increase participation rates in 401(k) plans, and automatic escalation has been shown to raise contribution rates and accumulations within 401(k)s over time. It is theoretically possible that participants respond to automatic enrollment by decreasing their savings or increasing their borrowing outside of the plan, which would diminish or eliminate any positive effect on personal saving. It is likely, however, that the net effects on both personal and national savings would be positive. Workers who become contributors through automatic enrollment tend to be younger and have lower incomes and less education than other participants. Evidence from the pension and 401(k) literature suggests that a significant portion of contributions by households with these characteristics is a net addition to personal and national savings.

SAVER'S CREDIT

Question: You recommend strengthening the Saver's Credit. We obviously need to make this credit permanent. You suggest we also should make it refundable, and extend the credit to more middle-income households.

- First, which of the two—refundability or extension to more middle-income households—will be most effective in actually increasing personal savings?
- And second, do you have an opinion as to whether the credit should be refunded to the individual, or be transformed into a matching contribution and deposited to the saver's IRA or 401(k) plan?

Answer: Outside of 401(k) plans, the same logic of making saving easier could be applied—which would be especially beneficial if combined with steps to increase the incentive to save. For example, most American households receive an income tax refund every year. For many, the refund is the largest single payment they can expect to receive all year. Accordingly, the more than $200 billion issued annually in individual income tax refunds presents a unique opportunity to increase personal saving. If this opportunity were combined with a stronger incentive for households to save, the benefits could prove substantial. Recent research undertaken through the Retirement Security Project strongly suggests that the combination of a clear and understandable match for saving, easily accessible savings vehicles, the opportunity to use part of an income tax refund to save, and professional assistance could generate a significant increase in retirement saving participation and contributions, even among moderate- and low-income households.[2]

The research referenced above suggests an effective way to increase saving would revamp the Saver's Credit by simplifying its structure and changing the way in which it is presented to tax filers. In my view, simplification is more likely to arise

[2] Esther Duflo, William Gale, Jeffrey Liebman, Peter Orszag, and Emmanuel Saez, "Saving Incentives for Low- and Middle-Income Families: Evidence from a Field Experiment with H&R Block," Retirement Security Project Policy Brief 2005–5, May 2005.

from making the tax provision refundable than by extending it further up the income distribution. Furthermore, the evidence is suggestive that transforming the credit into a matching contribution would make it more effective, in part by changing the way it is viewed by tax filers. This may be because of how a credit is perceived, relative to a match of the same economic value. The 50 percent *credit* rate for gross contributions under the Saver's Credit, for example, is equivalent to having the government *match* after-tax contributions on a 100-percent basis.[3] Experimental work has shown that credit rates are much less effective than equivalent match rates to induce people to contribute to charities.[4] Similarly, in the context of the Saver's Credit, it is possible that a 100-percent match rather than a 50-percent credit could have a large effect on take-up.

RESPONSES TO QUESTIONS FROM SENATOR SMITH

Question: You each presented divergent views on how Social Security ought to be reformed to resolve the solvency problem. For a moment, would you set aside your preferred proposals and consider where the other panel participants are on this issue. And taking this broader perspective, can you tell the committee where you perceive there to be the common ground in resolving the issue?

Answer: I unfortunately found little common ground across the witnesses invited to testify. I do, however, believe there are at least some areas of common ground with Mr. Pozen and Ms. Entmacher. It is my understanding that we all agree that carve-out accounts do not directly reduce the projected actuarial deficit. We also seem to agree that some combination of benefit and revenue changes is necessary to address the deficit, although Ms. Entmacher appears to prefer addressing the projected deficit on the revenue side and Mr. Pozen appears to lean more heavily on the benefit side.

Question: Mr. Orszag, you criticize the idea of progressive price-indexing. But, you also acknowledge that we will need to increase taxes and/or constrain benefits. If we are to protect the poor in any action we take to shore up the Social Security system, what constraint option then would you suggest?

Answer: Progressive price-indexing is deeply flawed because the future is certain to differ from what we currently project it to be. Policy changes should be adopted with an eye toward how they will perform when the future turns out to be different than we currently expect; progressive price-indexing fails this test miserably. Under progressive price-indexing, if real wage growth is more rapid than expected, benefit cuts are larger. But if real wage growth is more rapid, the underlying 75-year actuarial deficit (in the absence of this provision) is smaller. The larger actual real wage growth turns out to be, the smaller the need for benefit reductions but the larger those reductions actually are under progressive price-indexing. Therefore, under progressive price-indexing, the *severity* of the benefit cuts is inversely proportional to the *need* for the benefit cuts. I have put forward many other ideas for changing the benefit formula, including many detailed proposals contained in my book with Peter Diamond (*Saving Social Security: A Balanced Approach,* Brookings 2004).

RESPONSES TO QUESTIONS FROM SENATOR ROCKEFELLER

Question: How long would it take to fully transition from the current pay-as-you-go Social Security program to a universally available private accounts system?

How much would it cost to continue to pay retiree benefits during this transition period?

Isn't it true that young people in their 20s and 30s would pay twice? They would be paying for the retirement of their parents and grandparents who participated in a pay-as-you-go system, but then these young workers would also be expected to fund their own private accounts.

Answer: Under the administration's proposal for accounts, the cash flow from the accounts is negative over a period of roughly 45 years. Some have termed this period the "transition" to individual accounts. The adverse effect on the public debt from the accounts, however, is *permanent.* The reason is that, to finance a loan to

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[3] Consider an individual who contributes $2,000 to a 401(k) plan or IRA. The saver's credit reduces Federal income tax liability by $1,000, which is 50 percent of $2,000. The net result is a $2,000 account balance that costs the individual only $1,000 after taxes (the $2,000 contribution minus the $1,000 tax credit). This is the same result as occurs if the net after-tax contribution of $1,000 were matched at a 100-percent rate: the individual and the government each effectively contribute $1,000 to the account. Similarly, the 20-percent and 10-percent credit rates are equivalent to a 25-percent and 11-percent match, respectively.

[4] Catherine Eckel, and Philip J. Grossman, "Rebate versus Matching: Does How We Subsidize Charitable Contributions Matter?" *Journal of Public Economics,* 87(3–4), 681–701, 2003.

a worker (provided in the form of revenue deposited into an individual account under the administration's proposal), the government borrows funds. If the worker repays the loan, the additional government debt on that transaction is extinguished, so public debt returns to the same level as if that worker had not opted for an account. But note that at any point in time, *even if all loans were eventually repaid,* some loans would always be outstanding. As a result, public debt at any point in time would forever remain higher with the accounts than without them. The additional, ongoing higher level of debt in the long term is substantial: the administration's accounts involve a sustained increase in outstanding public debt of more than 30 percent of GDP; this increase is only somewhat smaller than today's level of publicly held debt relative to GDP (38 percent).

Question: Recently, President Bush traveled to Parkersburg, WV to visit the office that stores the paper certificates for the government bonds held by the Social Security trust fund. He made fun of these bond certificates, saying essentially that there is "nothing" in the Social Security trust fund. He implied that little slips of paper could not secure Americans' retirement.

And yet, the President has repeatedly assured people that one of their investment options in a private account would be government bonds. He has said that people who are uncomfortable with the risks associated with investing in stocks would still be able to invest in safe Federal bonds.

I would like to know if there is any real difference between the government bonds in the Social Security trust fund that the President made fun of and the government bonds that the President claims workers should feel confident purchasing for their private accounts?

Answer: The Social Security trust fund currently holds more than $1.5 trillion in Treasury securities. These assets are backed by the full faith and credit of the U.S. Government, which is widely respected in the global financial markets as providing the benchmark of security for any financial asset. The Treasury bonds held by the Social Security trust fund are every bit as "real" as the Treasury bonds held by private investors. Indeed, if anything, the vast bulk of the bonds held by the Social Security trust fund are *more* valuable than tradeable government bonds because the "special purpose" bonds held by the trust fund carry special features not available on other government bonds.

The discussion of the "meaning" of the trust fund often conflates two issues: whether the bonds held by the trust fund are assets to the Social Security system, and whether they are assets for the government as a whole. The first question is unambiguous: the bonds held by the trust fund are an asset to the Social Security system because they earn interest income and, if necessary, can be redeemed to pay benefits. The fact that these bonds are "paper" assets does not in any way reduce their value. *All* pension funds hold paper IOUs; so would the individual accounts that the commission favors. The value of all paper assets depends on the willingness of someone to redeem them. The bonds held by the trust fund are, if anything, *more* secure than other paper assets, given their U.S. Government backing. The second issue, whether the accumulation of the trust fund assets has improved the capacity of the U.S. government as a whole to meet future obligations, is more subtle. In my view, the surpluses in the Social Security program have reduced the public debt that would otherwise have been issued, contributed to national saving, and thereby made it easier for the government to meet its future obligations.

Question: The President has suggested that retirees would be protected from mismanaging their retirement funds, because they would be required to purchase an annuity upon their retirement. The annuity would provide a steady stream of income, at least at the poverty level. However, the annuity market is very sensitive to market conditions.

Isn't it true that workers with identical amounts in their accounts could receive very different monthly benefits based on the level of the stock market on the day they bought their annuities?

(Note: CRS examined two hypothetical workers who each had $200,000 in their accounts and retired on different days in 2003. The worker who retired and bought his annuity at the market peak on December 31st would get a $2,002 monthly annuity [$24,024 yearly], but the worker who bought his annuity on the lowest day of the market, March 11, would only get $1,395 [$16,740 yearly].)

Is this fair? How would retirees know when to buy their annuities?

Answer: Yes. As the CRS report study has shown, and as has been emphasized in research by my colleague Gary Burtless, the pricing of annuities varies signifi-

cantly across generations because of fluctuations in interest rates.[5] It may make sense for workers to bear this type of risk on top of a solid foundation of retirement income; it does not make sense for workers to face this type of risk within the core tier of retirement income.

Question: When the United Kingdom gave workers the option of private accounts, there was a huge problem with investors taking advantage of workers and selling them poor long-term investments. How should consumers be protected?

Answer: The U.K. experience should be carefully studied, since it vividly illustrates the problems that can arise when workers are not equipped with enough information to make wise choices regarding individual accounts. Ensuring that workers have adequate information and financial education to manage their individual accounts could be expensive, effectively adding to the administrative costs imposed under such a system.

Question: Most proposals for private accounts require reductions in traditional Social Security benefits to offset the worker's payroll taxes that were diverted to fund the private account. Some people have called this a privatization tax.

I am interested in understanding how such a privatization tax would be collected on the account of someone who dies young, before retirement.

In such a case, would the worker's survivors lose some of their anticipated Social Security benefits to pay the government back for the private account?

Answer: A *married* worker who dies before retirement would leave her account, but also her debt repayment owed back to Social Security, to her surviving spouse. In other words, the surviving spouse would indeed lose some of their anticipated Social Security benefits to pay the government back for the individual account.

If a worker dies before retirement *without* a living spouse, the amount in the individual asset account may be distributed to heirs, but the amount owed back to Social Security could be eliminated under the administration's proposal. (The administration has not clarified whether the amount owed back to Social Security would be cancelled, but the proposals from the President's commission in 2001 made this assumption.) If these amounts owed back to Social Security were extinguished, the system would be made financially worse off because of the accounts. A recent proposal by Robert Pozen, a member of President Bush's Social Security commission in 2001, would avoid the actuarial harm created by pre-retirement deaths of non-married workers by having the government directly reclaim part or all of the account upon the death of such a worker.[6]

Question: I am also interested in understanding how workers would pay back the government if they were disabled early in their career.

President Bush often talks about a worker building up a large private account over the course of his career and then being able to enjoy a more prosperous retirement as a result of investment growth.

However, right now, about 40 percent of West Virginians who depend on Social Security are receiving either disability or survivors benefits.

If someone becomes severely disabled at age 30 and is never able to work again, what kind of balance would he be expected to have in his private account?

And how would his traditional Social Security benefits be reduced to pay for this private account?

Answer: Under the administration's approach, disabled workers who had not yet reached retirement would be prohibited from withdrawing any funds from whatever accounts they had accumulated before becoming disabled. Similarly, the loan repayment associated with the account would not occur until retirement. In many cases, the accounts accumulated by disabled workers would be very modest.

RESPONSES TO QUESTIONS FROM SENATOR LINCOLN

Question: Mr. Orszag, can you explain what would happen to the account of someone who dies young, before retirement—under the President's plan or Mr. Pozen's plan?

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[5] *See, for example,* Gary Burtless, Testimony Before the Subcommittee on Social Security of the House Committee on Ways and Means, Hearing on Social Security and Pension Reform: Lessons From Other Countries, July 31, 2001.

[6] As the actuarial memorandum on a plan put forward by Mr. Pozen notes, "If there are no survivors, and the worker dies before such benefit entitlement, their estate would receive the balance in their IA at death minus an offset that would be paid to the Trust Funds to compensate for their earlier allocations of a portion of their payroll taxes to their IA." *See* "Estimated Financial Effects of a Comprehensive Social Security Reform Proposal Including Progressive Price Indexing, February 10, 2005—a proposal developed by Robert Pozen, member of the 2001 President's Commission to Strengthen Social Security," available at *http://www.ssa.gov/OACT/solvency/RPozen_20050210.pdf.*

Answer: A *married* worker who dies before retirement would leave her account, but also her debt repayment owed back to Social Security, to her surviving spouse. In other words, the surviving spouse would indeed lose some of their anticipated Social Security benefits to pay the government back for the individual account.

If a worker dies before retirement *without* a living spouse, the amount in the individual asset account may be distributed to heirs, but the amount owed back to Social Security could be eliminated under the administration's proposal. (The administration has not clarified whether the amount owed back to Social Security would be cancelled, but the proposals from the President's commission in 2001 made this assumption.) If these amounts owed back to Social Security were extinguished, the system would be made financially worse off because of the accounts. A recent proposal by Robert Pozen, a member of President Bush's Social Security commission in 2001, would avoid the actuarial harm created by pre-retirement deaths of non-married workers by having the government directly reclaim part or all of the account upon the death of such a worker.

Question: I'm sure you all have heard retirement referred to as a three-legged stool. One leg is private savings, one leg is employee benefits/pensions, and the last leg is Social Security. American workers bear the risk for the first two legs but Social Security is supposed to be the one leg of the stool that is stable, without risk.

I believe that one of the key points in today's discussion is who should bear the risk when it comes to Social Security—the government or the American worker. It is my belief that the leg of the stool representing Social Security should remain stable. It seems to me that privatization would shift the risk of retirement savings to the American worker, leaving millions of workers no secure source of retirement income—with three shaky legs of the proverbial stool.

This is especially concerning for our Nation's farmers. Farmers already subject themselves to so much risk: the weather, trade pressures. This is an additional burden that will have a negative impact on them.

Do you advocate that Congress shift the risk associated with Social Security from the Federal Government to the American worker?

Answer: As my written testimony emphasizes, I do not believe that the Federal Government should shift additional risk to individuals within the core tier of retirement income.

Question: I believe that encouraging personal savings is a key component of this debate. I am extremely interested in looking at ways to encourage individuals to save more for their retirement. We are at the lowest savings rate in our Nation's history, and that is why financial literacy must be a part of this discussion. We must cultivate a nation of savers, not borrowers.

Do you have recommendations on how to encourage personal savings?

Answer: My written testimony also highlights several specific steps we could take to boost household saving for retirement. In particular, retirement security can be significantly enhanced by improving 401(k)s and IRAs through commonsense reforms that both sides of the Social Security debate should embrace. In the face of the difficult choices presented by the current system, many people simply procrastinate, which dramatically raises the likelihood that they will not save enough for retirement. Disarmingly simple concepts—such as changing 401(k) plans so that workers are automatically enrolled unless they opt out, and making it easy to save part of an income tax refund—have the potential to strengthen retirement security significantly. Both sides of the Social Security debate should agree on the straightforward steps necessary to improve 401(k)s and IRAs, and should come together to enact the changes immediately. More details on the required steps can be found at *www.retirementsecurityproject.org.*

TESTIMONY ON PROGRESSIVE INDEXING
before the Senate Finance Committee
April 26, 2005

by Robert C. Pozen
Chairman
MFS Investment Management

Mr. Chairman and Committee Members:

Thank you for the opportunity to present my proposal for reforming Social Security called "Progressive Indexing". As explained below, progressive indexing is a fair and workable approach to returning the Social Security system to solvency. In my view, the Congressional debate needs to focus first on solvency, and only then on personal accounts. Solvency is the "spinach" that needs to be eaten before we get to the "dessert" of personal accounts.

It bears emphasis that progressive indexing can address the solvency issue without additional reforms. It would close the long-term deficit of Social Security by over 70%—from a present value of $3.8 trillion to roughly $1.1 trillion. Progressive indexing of Social Security benefits would not begin until 2012, in order to preserve the scheduled benefits of current retirees and those nearing retirement.

Progressive indexing can also be combined with other types of benefit reforms such as moving back the retirement age, or it can be combined with revenue raisers such as increasing the wage base subject to payroll taxes. In addition, progressive indexing can be combined with personal accounts – either carve-outs such as 2% per year from the 12.4% payroll tax, or add-on accounts such as enhancements to Individual Retirement Accounts (IRAs).

This testimony will begin by explaining how progressive indexing works, next it will rebut the key arguments against progressive indexing, and then it will describe how progressive indexing might be combined with other approaches to Social Security reform.

I. Progressive Indexing

After workers retire and begin to receive Social Security benefits, these benefits are increased each year by cost of living adjustments (COLAs) – reflecting increases in consumer prices each year. This is called price indexing. By contrast, when the initial Social Security benefits of workers are set at the time of their retirement, their average career earnings are adjusted upward by the rate at which American wages have increased during their careers. This is called wage indexing.

Progressive indexing means the continuation of wage indexing for all workers retiring in 2012 and later years whose career earnings average $25,000 per year or less (indexed to wages over time). All these low-wage workers would receive the Social Security benefits they are presently scheduled to receive under present law (scheduled benefits). Most of these low-wage workers do not have sources of retirement income other than Social Security – for example, 401(k) plans or IRAs. As mentioned previously, progressive indexing would also maintain current schedules for Social Security benefits for all retirees and all those retiring before 2012.

The initial benefits of all workers with career earnings above $113,000 per year in 2012 (the maximum wage base subject to FICA taxes in that year) would be increased by price indexing – the rise in prices during their working careers. These workers are relatively well off; most receive retirement income from 401(k) plans and IRAs in addition to Social Security benefits. The initial benefits of workers above $25,000 per year and lower than $113,000 per year in average career earnings would be increased by a proportional mix of wage and price indexing. For example, a worker with career earnings in the middle of the range would have his or her Social Security benefits adjusted upward approximately 50% by wage indexing and 50% by price indexing.

Progressive indexing is illustrated by the chart in Appendix A. The continuous line shows the path of Social Security benefit growth under wage indexing, which would apply to workers with average career earnings of $25,000 per year and below. The

hyphenated line shows the path of Social Security benefit growth under price indexing, which would apply to workers with average career earnings of $113,000 per year and above. The dotted line shows the path of Social Security benefit growth under a blend of half-wage indexing and half-price indexing, which would apply to workers with career earnings in the middle of this range.

II. Arguments Against Progressive Indexing

There are several arguments that have been made against progressive indexing. In my view, none of these arguments is well founded.

A. "Too Favorable" for Low-Wage Workers

Progressive indexing has been criticized as "too favorable" for low-wage workers because it provides them with faster growth of Social Security benefits than middle or high earners. For this purpose, low-wage workers mean workers with $25,000 per year or less in average career earnings; these workers constitute roughly 30% of all workers in the United States.

As mentioned above, these low-wage workers have minimal participation in IRAs and 401(k)s; they depend almost entirely on Social Security for retirement income. By contrast, most middle and high earners participate in these private retirement programs, which are heavily subsidized under the federal tax code. In 2004, for example, the tax subsidies for IRAs were approximately $55 billion. Thus, from the perspective of overall government support of retirement income, progressive indexing of Social Security benefits is needed to bring about even-handed treatment of all wage groups.

B. "Benefit Cut" for Middle Earners

Progressive indexing has been criticized as imposing a "benefit cut" for middle-wage workers because their Social Security benefits would grow more slowly under progressive indexing than under the current schedule. While their

benefit growth will be slower, this should not be considered a "benefit cut" for two reasons. First, according to the United States Supreme Court, future retirees have no legal entitlement to the current schedule of Social Security benefits. (Under progressive indexing, all Social Security benefits are preserved for any worker already in retirement or retiring before 2012).

Second, more practically, the purchasing power of the Social Security benefits received by the middle earner under progressive indexing will still increase over time. For example, under the current schedule, a scaled middle earner retiring at age 65 in 2005 would receive approximately $14,400 per year in initial Social Security benefits. Under progressive indexing, a scaled middle earner retiring at age 65 in 2055 would receive approximately $17,400 per year in initial Social Security benefits, as compared to $21,770 per year under the current schedule (all figures expressed in constant 2004 dollars). Thus, although the yearly benefits for middle earners would grow more slowly under progressive indexing than under the current schedule, the purchasing power of their benefits would increase by over 20% from 2005 to 2055 (from $14,400 to $17,400 in constant 2004 dollars).

C. Lose "Political Support" of High Earners

Progressive indexing has been criticized for reducing the Social Security benefits of high earners to the point where the Social Security benefits of all wage groups are the same. While progressive indexing would produce a flat benefit if it continued beyond 2100 that is neither necessary nor contemplated. Progressive indexing as modeled stops at 2079; it can be stopped before 2079 in order to retain a larger differential in Social Security benefits among wage groups.

Moreover, some of these critics of progressive indexing are inconsistent in their political analysis of high-wage workers. On the one hand, these critics express fears that high-wage workers will no longer "politically support" Social

Security if the benefits of these workers grow more slowly than scheduled. On the other hand, these same critics often advocate increased payroll taxes for high-wage workers with minimal extra Social Security benefits for them. In my view, the political support of high-wage workers will depend on what they receive in Social Security benefits relative to what they contribute in payroll taxes.

D. Relationship Between Wages and Prices

Wages have grown on average 1.1% per year faster than prices during the twentieth century in the United States. Critics of progressive indexing have pointed out that the historic relationship between wage and price growth may change over the next 75 years in the United States. On one hand, wages might grow faster than prices by more than 1.1% per year, or the gap between wage and price growth might narrow over time.

This is a reasonable criticism, which should be addressed by careful legislative draftsmanship. For example, instead of using price indexing, Congress could define the indexing applicable to the calculation of the initial benefits of high wage workers as annual wage growth minus 1.1% per year.

III. Combinations with Progressive Indexing

Progressive indexing can be implemented alone or combined with other approaches to Social Security reform. Set forth below are a few examples of such combinations.

A. Combined with Normal Retirement Age

As mentioned above, it would be feasible to stop progressive indexing at a date before 2079 (i.e., return to wage indexing only for years after that date) in order to retain larger differences in Social Security benefits among various groups of earners. In that scenario, it might make sense to move back normal retirement age (NRA) after the year when progressive indexing is stopped in order to continue moving the Social Security system toward the goal of permanent solvency.

For example, if progressive indexing of Social Security were stopped in 2061, it would be feasible to move back NRA gradually to age 68 ½ from 2061 to 2079 (at a rate of one month in NRA for every calendar year during this 18-year period). Although changes in NRA may not be popular among voters, they may be politically acceptable if instituted in distant time periods.

B. Combined with Carve-out Accounts

Since progressive indexing would slow the growth of Social Security benefits for some workers, it could be combined with a personal retirement account (PRA) involving a voluntary allocation of a modest portion – such as 2% – of 12.4% in payroll taxes. Any worker who made such an allocation to a PRA would have to accept a lower traditional Social Security benefits since he or she would be paying in lower amounts to the traditional system. The PRA would be presumptively invested in a low-cost balanced account, comprised 60% of an equity index fund and 40% of a bond index fund, which would have a good chance of earning higher returns than the Social Security system over 30 to 35 years – the entire careers of these workers.

Critics have pointed out that carve-out PRAs would not improve the solvency of the Social Security system and would increase government borrowing. As illustrated by the chart in Appendix B, however, a combination of progressive indexing and a carve-out PRA with a 2% allocation (limited to $3,000 per year with the limit indexed to prices) would make Social Security solvent by the end of the standard 75-year period used to measure the system's solvency. No government borrowing would be needed until 2030 and such borrowing would be completed before 2079. Moreover, the government borrowing needed to finance this combination would be $2 trillion lower than the government borrowing needed to finance the current Social Security system over the next 75 years.

C. **Combined with Add-on Accounts**

For those who oppose carve-out PRAs, progressive indexing could be combined with various forms of add-on accounts in a legislative package. Again, add-on accounts themselves will not make Social Security solvent and would increase the budget deficit. However, a combination of progressive indexing with modest expenditures for add-on accounts could be designed to substantially improve the solvency of Social Security.

In my view, the most efficient way to pursue add-on accounts is to enhance the existing structure of IRAs, rather than to create an entirely new set of accounts. One possibility would be to transform the low-income tax credit for IRA contributions into a partially refundable tax credit. This would make the tax credit effective for families with incomes below $40,000 per year, who often do not pay federal income taxes. Another possibility would be to remove the income ceiling from the Roth IRA, which currently starts to phase out for families with incomes over $120,000 per year. The removal of the income ceiling would be a political quid pro quo for high wage earners with the slowest growth Social Security benefits under progressive indexing.

D. **Combined with Raising Payroll Tax Base**

For those who insist on increasing the payroll tax base, this can be combined with progressive indexing (and perhaps a new type of personal account). In my view, it would be unfair to raise the payroll tax base from $90,000 to $150,000 or $200,000 per year. This would impose a huge tax increase on workers in these brackets, while not touching most of the earnings of the workers with very high wages. A fairer approach, based on the Medicare model, would be to impose a 2.9% payroll tax on earnings above $90,000 per year without an earnings limit.

If such a 2.9% incremental tax above the current maximum earnings base were implemented, what would be the Social Security benefits associated with this 2.9% incremental payroll tax? To maintain the framework of social insurance, Congress would

have to grant substantial benefits for that incremental tax. On the other hand, there might be a public outcry against very large monthly checks from Social Security to millionaires. A possible compromise would be to allow 2% of the 2.9% incremental tax to be invested in a PRA, while dedicating 0.9% to increasing the solvency of Social Security.

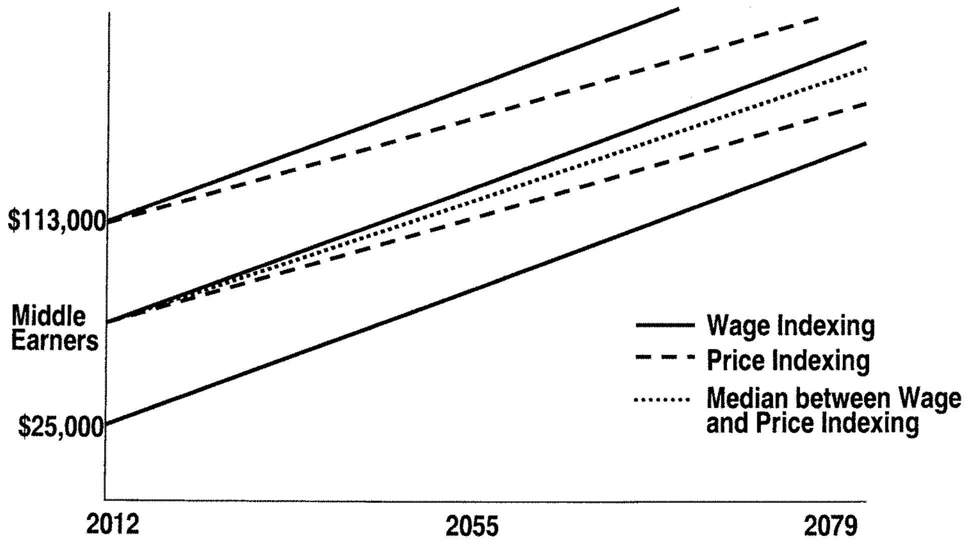
Conclusion

Progressive indexing provides a fair and workable foundation for legislative efforts aimed at improving the solvency of Social Security system. Progressive indexing is flexible with regard to the date it is implemented and the date it is stopped. Moreover, progressive indexing can be combined with various forms of political "sweeteners" to make a viable legislative package.

I would be happy to answer any questions that any Senator might have about progressive indexing. Thank you again for the opportunity to testify on this very important subject.

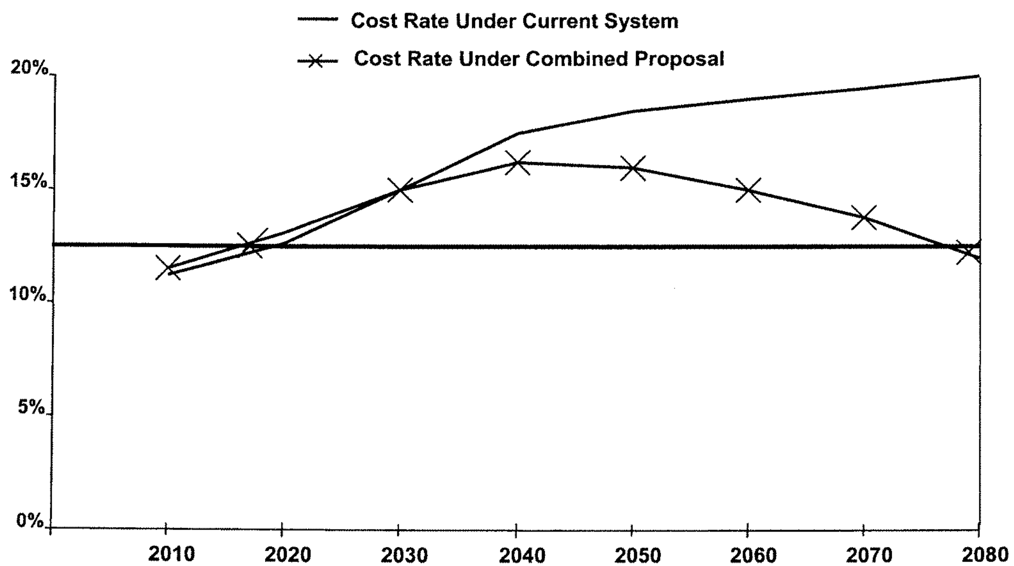
Appendix A

Slower Benefit Growth for Middle and High Earners



Appendix B

Income and Cost Rates



Answers to Questions Submitted for the Record to
Robert C. Pozen after the Senate Finance Committee Hearing on April 27, 2005

Senator Baucus

Deep Spending Cuts: An analysis of your plan by the Office of the Chief Actuary of the Social Security Administration was released on February 10 of this year. According to Tables B1 and B2 of that analysis, a person who is born 5 years from now, who retires at age 65, and has career earnings that are 60 percent greater than the national average defined by the Social Security Administration—but which is still only $59,000 this year—would have their benefits cut by about 40 percent relative to current law. Isn't that a deep benefit cut?

A worker who is born 5 years from now, retires at age 65 and who has career earnings at the national average as defined by the Social Security Administration—only $36,000 of earnings this year—would have their benefits cut by 28 percent. Isn't that a deep benefit cut?

These benefit cuts are not limited to those retiring in 2075. A worker who is 25 years old today with career earnings 60 percent above the national average—only $59,000 this year—and who retires in 2045, would receive a benefit cut of 24 percent. Isn't that a deep benefit cut?

Response

In the first example, you point out that under progressive indexing a worker earning 60 percent greater than the national average would receive a reduction in scheduled benefits of 40 percent when retiring in 2075. In the second example, you make a similar point about someone who earns the national average, retires in 2075 and receives 28 percent less than scheduled benefits. In both cases, you ask: "Isn't that a deep benefit cut?"

While these represent "deep cuts" relative to scheduled benefits, there are other relevant ways to evaluate progressive indexing or other plans for Social Security reform. First, since we cannot afford scheduled benefits, there will be an automatic, across-the-board reduction of 26 percent from scheduled benefits in 2041 unless Congress enacts major reforms in Social Security. Second, for both the workers at the national average and at 60 percent above the national average, they would receive a substantial increase in the purchasing power of their benefits under progressive indexing. Third, we would expect that middle and high earners would participate in tax-subsidized retirement plans that would replace a significant portion of the nominal decline in their scheduled benefits.

Price-Indexing and Wage-Indexing: In an article you have written, you include an example of the impact of your "progressive price-indexing" proposal. The example is for someone who has earnings that are 50 percent between the maximum earnings subject to tax, and the earnings level where wage-indexing ceases. You say that this person would have their benefits half wage-indexed

and half price-indexed. Do you still believe that half the benefit would be price-indexed and half would be wage-indexed? If not, what do you now think is the correct analysis?

Response

In an early article, I did mistakenly estimate that workers at the midpoint of the scale between $25,000 and $113,000 would have their benefits half wage-indexed and half priced-indexed. However, I publicly corrected that mistake a month before the Senate Finance Committee hearing. I now estimate that the initial benefits of a worker with average career earnings of roughly $50,000 in 2012 would be subject half to wage-indexing and half to price-indexing under progressive indexing.

Senator Smith

You each presented divergent views on how Social Security ought to be reformed to resolve the solvency problem. For a moment, would you set aside your preferred proposals and consider where the other panel participants are on this issue. And taking this broader perspective, can you tell the committee where you perceive there to be the common ground in resolving the issue?

Response

You asked whether there are common grounds for Social Security reform. I believe there are several:

1. The benefit structure for Social Security should be made more progressive (though there is disagreement on how much).

2. The reform of Social Security should take into account the incentives for private retirement programs, which should be enhanced in the legislative package.

3. A milder form of progressive income could be combined with some increase in normal retirement age in the out years (past 2030 and perhaps past 2050).

4. Constraints on benefit reforms could be combined with a modest increase in the payroll tax base, and some portion of that increase could be allocated to an add-on account (such as a Roth IRA).

Senator Rockefeller

Question #1: How long would it take to fully transition from the current pay-as-you-go Social Security program to a universally available private accounts system?

How much would it cost to continue to pay retiree benefits during this transition period?

Isn't it true that young people in their 20s and 30s would pay twice? They would be paying for the retirement of their parents and grandparents who participated in a pay-as-you-go system, but then these young workers would also be expected to fund their own private accounts.

Response

I can answer these questions only with respect to a proposal scored for me by the Chief Actuary of Social Security: a combination of progressive indexing and a voluntary personal account equal to 2 percent of FICA earnings, subject to an annual limit of $3,000 (with the limit indexed to price inflation). Under that combined proposal, government borrowing for Social Security benefits would not begin until 2030 and would end before 2079, at which time the Social Security system would be solvent and financially self-sustaining. During this period, the total borrowings under progressive indexing would be roughly $2 trillion—approximately half of the government borrowings that would be required if we tried to finance scheduled benefits through 2079.

Question #2: Recently, President Bush traveled to Parkersburg, West Virginia to visit the office that stores the paper certificates for the government bonds held by the Social Security trust fund. He made fun of these bond certificates, saying essentially that there is "nothing" in the Social Security trust fund. He implied that little slips of paper could not secure Americans' retirement.

And yet, the President has repeatedly assured people that one of their investment options in a private account would be government bonds. He has said that people who are uncomfortable with the risks associated with investing in stocks would still be able to invest in safe Federal bonds.

I would like to know if there is any real difference between the government bonds in the Social Security trust fund that the President made fun of and the government bonds that the President claims workers should feel confident purchasing for their private accounts?

Response

The U.S. Treasury bonds held by the Social Security trust fund and the U.S. government bonds held in private accounts would both be valid debt instruments that will be paid in full by the U.S. government as they come due. However, the U.S. Treasury bonds held by the Social Security trust are a form of intergovernmental debt, in contrast to the publicly held debt that would be acquired by private accounts. Such intergovernmental debt represents a claim by the Social Security trust fund that can be met only if another governmental entity (*i.e.*, Congress) makes an appropriation out of its budget or issues new debt to the public.

Question #3: The President has suggested that retirees would be protected from mismanaging their retirement funds, because they would be required to purchase an annuity upon their retirement. The annuity would provide a steady stream of income, at least at the poverty level. However, the annuity market is very sensitive to market conditions.

Isn't it true that workers with identical amounts in their accounts could receive very different monthly benefits based on the level of the stock market on the day they bought their annuities?

[Note: CRS examined two hypothetical workers who each had $200,000 in their accounts and retired on different days in 2003. The worker who retired and bought his annuity at the market peak on December 31 would get a $2,002 monthly annuity ($24,024 yearly), but the worker who bought his annuity on the lowest day of the market, March 11, would only get $1,395 ($16,740 yearly)]. Is this fair? How would retirees know when to buy their annuities?

Response

There could be substantial differences in the annuities purchased by workers with similar contributions to their personal accounts depending on the timing of that purchase and the market conditions at that time. These differences could be reduced (but not eliminated) by not requiring workers to apply all of the monies in their accounts to the purchase of an annuity at the date of retirement. For instance, the annuities could be purchased in four annual installments starting in the year of retirement.

Question #4: When the United Kingdom gave workers the option of private accounts, there was a huge problem with investors taking advantage of workers and selling them poor long-term investments. How should consumers be protected?

Response

The United Kingdom followed what I call the IRA model—allowing workers to choose any financial institution and any investment product they wanted for their personal accounts. This led to high account costs and undiversified investments.

We can avoid these problems by requiring all personal accounts to be invested in a narrow range of balanced accounts administered centrally by the trustees of the Federal Thrift Plan. This plan offers a limited number of index funds at a very low cost (less than 7 basis points per year). Personal accounts could be presumptively invested in a balanced and diversified portfolio comprised 50 percent of stock index funds and 50 percent of bond index funds.

Senator Lincoln

Risk Shifting for Social Security: I'm sure you all have heard retirement referred to as a three-legged stool. One leg is private savings, one leg is employee benefits/pensions, and the last leg is Social Security. American workers bear the risk for the first two legs, but Social Security is supposed to be the one leg of the stool that is stable, without risk.

I believe that one of the key points in today's discussion is who should bear the risk when it comes to Social Security—the government or the American worker. It is my belief that the leg of the stool

representing Social Security should remain stable. It seems to me that privatization would shift the risk of retirement savings to the American worker, leaving millions of workers no secure source of retirement income—with three shaky legs of the proverbial stool.

This is especially concerning for our Nation's farmers. Farmers already subject themselves to so much risk (the weather, trade pressures). This is an additional burden that will have a negative impact on them.

Do you advocate that Congress shift the risk associated with Social Security from the Federal Government to the American worker?

Response

Social Security should provide an income floor to all workers, which should be guaranteed by the Federal Government. However, we should not expect the Federal Government to guarantee all the retirement income of middle and high earners. For a portion of their retirement income, these two groups can afford to assume the moderate investment risks associated with long-term investing in a balanced portfolio of diversified, low-cost funds.

Encouraging Personal Savings: I believe that encouraging personal savings is a key component of this debate. I am extremely interested in looking at ways to encourage individuals to save more for their retirement. We are at the lowest savings rate in our Nation's history, and that is why financial literacy must be a part of this discussion. We must cultivate a nation of savers, not borrowers.

Do you have recommendations on how to encourage personal savings?

Response

I have several recommendations to encourage personal savings.

1. Allow Federal income tax refunds to be directly invested, in part or in whole, in IRAs.

2. Require all employers above a certain size to automatically enroll all employees with salaries above a certain level in a defined contribution plan, provided by a qualified financial institution, subject to an opt-out by the employees.

3. Enhance the low-income savers credit to provide a partially refundable matching credit for IRA contributions by low-income workers.

4. If the growth of Social Security benefits is limited to price-indexing for workers with average career earnings over $113,000 per year, they should be encouraged to replace those retirement benefits by lifting the income ceiling on Roth IRAs (which begins to phase out above $120,000 per year).

Senator John D. Rockefeller IV
Opening Statement – Finance Committee: Social Security
April 26, 2005

Mr. Chairman, I truly appreciate your holding this hearing on Social Security. This is a vital program from 45 million Americans, including 405,000 West Virginians. It is a successful social insurance that protects seniors in retirement so they do not spend their golden years in poverty. It also supports workers who become disabled and children and surviving spouses in times of a tragic early death.

Given the importance of this program, and its historical success, I believe our first priority should be: Do No Harm.

Despite efforts to panic seniors and push the public to accept a "quick fix" by suggesting that Social Security is in an immediate crisis, the reality is that we have time to thoroughly debate all the issues, and do this right – in a thoughtful non-partisan, or bipartisan way. There is no need to rush to a quick mark-up. The Social Security Trust Funds will maintain our current system until at least 2041.

We do need to make some modest reforms to Social Security for long- term solvency and for the next generation. But we should do so thoughtfully and carefully.

The President, and others, are suggesting private accounts. I wonder why, since private accounts to not address the fundamental question of long-term solvency. In fact, private accounts aggravate the long-term solvency problem rather than fix it. Private accounts also would create trillions of dollars in additional debt over a 20 to 40 year transition period which our economy cannot afford. Our children should not inherit overwhelming debt and a risky, inadequate social insurance program, as suggested by the Administration's private accounts as a replacement for a guaranteed, secure Social Security benefits.

This issue is fundamental for West Virginians. My state relies on Social Security more than any other state. 58% of seniors would be in poverty without Social Security. Over 26,000 children are secure despite the loss of their parent, thanks to the Social Security survivor benefits. 94,000 disabled workers and their families survive, thanks to the disability benefits. We must ensure that the same secure benefits and social insurance are in tact for the next generation, without enormous debts.

I have been hosting roundtables throughout my state. Seniors are nervous. People are skeptical, and that skepticism will grow as the stock market tumbles. My sense is that people are also confused by the President's talk of reform, because he has never laid out any specifics of how he would finance private accounts and make the Social Security system solvent.

The President made the situation more confusing recently by claiming that the Social Security Trust Fund is meaningless. To suggest that the Social Security Trust Fund bonds, in Parkersburg West Virginia, are meaningless slips of paper is irresponsible because it draws into question the full faith and credit of U.S. government securities. Our country has never – ever – defaulted on government securities, and it will not.

Mr. Chairman, I am pleased that the Committee will have this opportunity to hear from experts about possible Social Security reforms. It is time to have a serious debate about proposals, and have an opportunity to get answers to the many questions that private accounts raise.

My guiding principle, as we consider ways to change the Social Security system will be: First, we should do no harm.

Statement of Senator Gordon Smith
Hearing on Social Security:
Proposals To Achieve Sustainable Solvency, With and Without Personal Accounts
Committee on Finance
United States Senate
April 26, 2005

Mr. Chairman, thank you for putting this hearing together today. With the heightened interest that the President and others have brought to the financial problems confronting Social Security, the public is now becoming much better informed about the necessity to take action soon. We are fortunate to hear from the witnesses you have brought before us today, for as a group they illustrate a broad spectrum of the possible approaches that can be taken to shore up the system. This isn't a Republican hearing or a Democratic hearing. It is a Social Security hearing. And the wide range of proposals that will be presented by our witnesses shows your desire to reach out for the broadest possible political consensus on how to deal with the issues of this vital program.

Social Security has become the most enduring social experiment in American history. It has changed the lives of countless Americans over the past 65 years, and its success has undoubtedly surpassed that which its founders could have imagined or hoped for under the most optimistic of their expectations. For those who have toiled for two-thirds or more of their lives, it now means the difference between living with self respect in their advanced years and living with the stigma of welfare. At the program's inception in 1935, half or more of the nation's elderly were on the dole or dependent on family members to scrape out the most meager levels of subsistence. With numerous improvements in coverage and benefits over the past half century, Social Security now provides 40 percent of the income of the nation's seniors, making it their largest source of retirement income. For the disabled and survivors of deceased workers, its insurance value is hard to match and means the difference between a reasonable standard of living and scanty public assistance payments, poor housing, inadequate health care, and bad nutrition. And while we tend to view Social Security as a program for the aged, few realize how significant it is as source of support for children—children disadvantaged by the death or disablement of a parent—or for young widows trying to hold a household together after the loss of their spouse. Today 48 million people—nearly one in six Americans—receives its benefits... benefits provided as a matter of right... not the benevolence of government. They have the dignity of knowing that those benefits have been paid for—by themselves, a spouse, or a parent through taxes they paid over an entire work life.

Even as we debate its future, Social Security provides a payment that people can count on. The government won't go out of business... it won't run out money... and with cost-of living-adjustments rarely found elsewhere in retirement programs, the benefits Social Security furnishes to today's retirees, widows, divorced spouses, and aged parents won't diminish as they grow old.

In a democracy, the political system reacts to the needs and desires of its people. Social Security's future is not in doubt. Its future is not conditioned on the status of its trust funds, but on the will of the people. Social Security has become an institution that Americans value and want to preserve. While we may debate its form and content, its future is secure because it has become an institution that Americans have found to be vital to their well being.

TESTIMONY OF

MICHAEL TANNER

DIRECTOR, CATO INSTITUTE PROJECT ON SOCIAL SECURITY CHOICE

before the

SENATE COMMITTEE ON FINANCE

April 26, 2005

Mr. Chairman, Members of the Committee

I would hope that at this point we are well beyond debating whether or not Social Security needs to be reformed.

We can become forever embroiled in semantic debates over what does or does not constitute a "crisis." However, we cannot deny the fundamental facts.

Social Security will begin to run a deficit in just 12 years—that is, it will begin to spend more money on benefits than it brings in through taxes. At that point, in order to continue to pay promised benefits, it will have to draw on the Social Security Trust Fund. We have seen much debate about the Trust Fund recently, with some suggesting that it guarantees Social Security's solvency until 2041, or even 2052. However, as Congressional Budget Office director Douglas Holtz-Eakin has noted "[The Trust Fund] has no real economic resources....The key moments for Social Security are in 2018. Cash-flow benefits will equal cash-flow payroll taxes, and then after that, the Social Security Administration will have to come back to the rest of the budget for additional resources to pay promised benefits."

Or as the Clinton Administration made clear in its FY2000 budget:

> "These Trust Fund balances are available to finance future benefit payments...but only in a bookkeeping sense.... They do not consist of real economic assets that can be drawn down in the future to fund benefits. Instead, they are claims on the Treasury that, when redeemed, will have to be financed by raising taxes, borrowing from the public, or reducing benefits or other expenditures. The existence of Trust Fund balances, therefore, does not by itself have any impact on the government's ability to pay benefits."

This is not to say that the Federal government will default on the bonds in the Trust Fund. I am not doubting the "full faith and credit" of the U.S. government. However, that does not relieve the Federal government from the obligation to find the money with which to redeem those bonds, currently $1.6 trillion in present value terms. To put it in perspective, think of it this way. In 2018, the first year after Social Security begins running a deficit, the shortfall will be roughly as much as the Federal government spends on such programs as Head Start and the WIC program. The cost rises rapidly thereafter. By roughly 2023, the cost of redeeming enough Trust Fund bonds to pay all the promised Social Security benefits would be nearly as much as the cost of funding the Departments of Interior, Commerce, Education, and the Environmental Protection Agency. By 2038, well before the theoretical exhaustion of the Trust Fund, you can add the Departments of Veterans Affairs, Energy, Housing and

Urban Development, Justice, NASA, and the National Science Foundation. Simply redeeming the Trust Fund will begin to squeeze out all other domestic spending priorities.

Beyond 2042, once the Trust Fund is exhausted, the deterioration in Social Security's finances only increases—and never gets any better. Overall, the present value of Social Security's unfunded obligations run to nearly $12.8 trillion (approximately $1.6 trillion to redeem the Trust Fund, and $11.1 trillion in unfunded benefits thereafter).

Quite simply, Social Security cannot pay the promised level of Social Security benefits with its current level of revenues. Therefore, it is improper to compare benefits under a reformed Social Security system with today's promised level of benefits. Those promises are simply a fantasy. In fact, by law, Social Security will have to reduce its benefits by approximately 27 percent, once it is unable to fund those benefits. This will occur regardless of whether or not individual accounts are created. As former Senator Bob Kerry has said, doing nothing is the same as a 27 percent benefit cut.

However, as troubling as these numbers may be, I believe that the debate over Social Security reform should not solely—or even primarily—be a discussion of solvency. Yes, solvency is important, and any responsible Social

Security reform plan should restore the program to solvency, not just short-term actuarial solvency, but permanent, sustainable solvency.

But solvency is not enough. Instead, Social Security reform should strive to build the best possible retirement system for our children and our grandchildren. Thus, Social Security's current situation should not be seen as either a crisis or a problem, but as an opportunity to build a new and better program, based on the fundamental American values of ownership, inheritability, and choice.

Under the current Social Security system you have no legal, contractual, or property rights to your benefits. What you get receive from Social Security is entirely up to the 535 members of Congress. But personal retirement accounts would give workers ownership and control over their retirement funds. The money in your account would belong to you—money the politicians (with all due respect) could never take away. In short, they would own their retirement.

Because you don't own you Social Security benefits, they are not inheritable. Millions of workers who die prematurely are not able to pass anything on to their loved ones. But personal retirement accounts would enable workers to build a nest egg of real, inheritable wealth.

Choice is part of the essence of America. Yet when it comes to retirement, Congress forces all Americans into a one-size-fits-all, cookie-cutter retirement program, a system that cannot pay the benefits it has promised and in which we have no right to the money we pay in. With personal retirement accounts, workers who want to remain in traditional Social Security could do so. But younger workers who want a choice to save and invest for their retirement would have that option.

With this goal in mind, not just to restore Social Security to solvency, but to build a better retirement program that would give workers more ownership and control over their money, scholars at the Cato Institute drew on our 25 years of experience studying Social Security, and developed a comprehensive proposal for creating privately invested, personally owned accounts as part of an overall reform of the Social Security system. This proposal became the basis for legislation introduced, on July 19, 2004, by Rep. Sam Johnson (R-Tex.), along with 18 original co-sponsors.[i] Rep. Johnson, together with Rep. Jeff Flake and 10 co-sponsors, reintroduced the bill in the 109th Congress, on January 21, 2005.[ii]

Under this proposal, workers under the age of 55 would have the option of diverting their half of the Social Security payroll tax (6.2 percent of wages) to an individual account. The employer's portion of the payroll tax would continue to be paid into the Social Security system to provide survivors and disability

benefits, as well as to partially fund continuing benefits for those already retired or nearing retirement. Workers choosing the individual account option would forgo any future accrual of Social Security retirement benefits. However, those workers who have already paid into the current Social Security system, and therefore have accrued benefits, would receive credit for those benefits in the form of a recognition bond. This fully tradable bond would be a zero coupon note maturing on the date of the recipient's normal retirement age.

Workers who do not choose the individual account option would continue to pay into and receive benefits from the current Social Security system. However, for these workers, the initial Social Security benefit formula will be adjusted to reflect price-indexing rather than the current wage-indexing.[iii] The result will be to restore Social Security benefits to a level payable with Social Security's available revenue, while ensuring that future retirees continue to receive the same level of benefits as those retiring today, on an inflation-adjusted basis. (This change will be phased in over a 35-year period, beginning in 2014.)

The plan also called for establishing a new minimum Social Security benefit equal to 100 percent of the poverty level, providing a significant increase over the current minimum benefit. I have attached the original Cato study setting out the details of the proposal and their rationale.

The plan has been scored by the Social Security Administration's Office of the Actuary (OACT), which concluded that it would eliminate Social Security's long-range actuarial deficit" and would restore the system to permanent "sustainable solvency." I have attached a study that the Cato Institute released today exploring OACT's findings in detail, as well as a copy of OACT's original actuarial memo. However, to summarize, OACT found that:

- The "transition cost" (in present value) would be approximately $6.5 trillion. This is roughly half the $12.8 trillion unfunded liability of the current system. That is, the "6.2% Solution" ultimately saves taxpayers $6.3 trillion.

- The legislation also compares very favorably to other Social Security reform plans. In terms of giving workers more control and ownership of their retirement funds, the "6.2% Solution" clearly provides the most "bang for the buck."

- On a cash-flow basis, the legislation does require significant short-term transfers of General Revenue. However, by 2046, the system would begin running surpluses, allowing any short-term debt to be repaid. Indeed, by the end of the 75-year actuarial window, the system would be running surpluses in excess of $1.8 trillion (in constant $2005)

- Much of the short-term cash-flow shortfalls are due to the redemption of recognition bonds, not to the diversion of payroll taxes to the individual accounts. These recognition bonds convey many benefits in terms of ownership as well as speeding the date at which Social Security changes from deficit to surplus. They are essentially a prepayment of future Social Security benefits, and not a new expense. The Johnson-Flake bill is the only Social Security reform bill with recognition bonds. The costs of Johnson-Flake also include the cost of increasing the minimum Social Security benefit to 100% of poverty, a significant increase over the current minimum Social Security benefit.

- Individual accounts would eventually accumulate assets in excess of $38 trillion (in constant $2005). That would lead to substantial new savings, new investment, and economic growth.

- Once short-term debt is paid off, the employer portion of the payroll tax could be reduced to 3.04%. This would pay for disability and survivors' benefits.

In short, the SSA analysis shows that Johnson-Flake can provide large individual accounts while restoring Social Security to permanent sustainable solvency, and can do so in a fiscally responsible manner. While the up front costs will be significant, they will be less than for other big account plans, and eventually those costs will be more than offset by the savings to the system.

In addition, younger workers who chose the individual account option could receive retirement resources substantially higher than what traditional Social Security can actually pay them. (It is important to remember that comparison of benefits under a reformed plan with the currently scheduled or promised level of benefits is essentially meaningless, because those benefits cannot be paid by the current system. The far more accurate comparison is between benefits under a reformed system and the payable level of benefits under the current system).

Finally, Johnson-Flake gives workers ownership and control over their retirement income. It would give low- and middle-income workers the opportunity to build a nest egg of real, inheritable wealth. It provides younger workers with greater choice. In short, if we measure a Social Security program not just as a matter of dollars and cents, but as a matter of human liberty and individual dignity, Johnson-Flake provides a better way to take care of our retirement.

Thank you.

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[i] HR 4895.

[ii] HR 530.

[iii] Although the Cato Plan and HR 350 apply the wage-index/price-index change to al income levels, I would be open to applying the blended approach advocated by Mr. Pozen.

CATO PROJECT ON

Social Security Choice

February 17, 2004 SSP No. 32

The 6.2 Percent Solution

A Plan for Reforming Social Security

by Michael Tanner

Executive Summary

For the past several years there has been a growing consensus about the need to reform Social Security. Now, however, the debate has advanced to the point where it becomes important to move beyond generalities and provide specific proposals for transforming Social Security to a system of individual accounts. The Cato Project on Social Security Choice, therefore, has developed a proposal to give workers ownership of and control over their retirement funds.

Under this proposal:

- Individuals would be allowed to divert their half (6.2 percentage points) of the payroll tax to individually owned, privately invested accounts. Those who chose to do so would agree to forgo all future accrual of retirement benefits under the traditional Social Security system.
- The remaining 6.2 percentage points of payroll taxes would be used to pay transition costs and to fund disability and survivors' benefits.
- Workers who chose the individual account option would receive a "recognition bond" based on the accrued value of their lifetime-to-date benefits. Those bonds, redeemable at the worker's retirement, would be fully tradable in secondary markets.
- Those who wished to remain in the traditional Social Security system would be free to do so, accepting a level of benefits payable with the current level of revenue.

We expect this plan to restore Social Security to long-term and sustainable solvency and to do so at a cost that is less than the cost of simply propping up the existing program. And it would do far more than that.

Younger workers who chose the individual account option would receive benefits substantially higher than those that could be paid under traditional Social Security. At the same time, the plan would treat women and minorities more fairly and allow low-income workers to accumulate real wealth.

Most important, this proposal would reduce Americans' reliance on government and give individuals greater ownership of wealth, as well as responsibility for and control over their own lives. It would be a profound and significant increase in individual liberty.

Michael Tanner is director of the Cato Institute's Project on Social Security Choice and editor of Social Security and Its Discontents: Perspectives on Choice *(forthcoming).*

We expect this proposal to restore Social Security to long-term and sustainable solvency and to do so at a cost less than the cost of simply continuing the existing program.

Introduction

For the past several years there has been a growing consensus about the need to reform Social Security. As the debate has developed, the Cato Institute has provided studies and other information on the problems facing Social Security and the advantages of individual accounts as a way to reform the system. But until now we have not suggested a specific plan for reform.

Now, however, the debate has advanced to the point where it becomes important to move beyond generalities and provide specific proposals for transforming Social Security to a system of individual accounts. The Cato Project on Social Security Choice, therefore, has developed a proposal to give workers ownership of and control over their retirement funds.

This plan would establish voluntary personal accounts for workers born on or after January 1, 1950. Workers would have the option of (a) depositing their half of the current payroll tax (6.2 percentage points) in an individual account and forgoing future accrual of Social Security retirement benefits or (b) remaining in the traditional Social Security system and receiving the level of retirement benefits payable on a sustainable basis given current revenue and expenditure projections.

Workers choosing the individual account option would have a variety of investment options, with the number of options increasing as the size of their accounts increased. The initial default option would be a balanced fund, weighted 60 percent stocks and 40 percent bonds. Workers choosing the individual account option would also receive bonds recognizing their past contributions to Social Security.

At retirement, workers would be able to choose an annuity, a programmed withdrawal option, or the combination of an annuity and a lump-sum payment. The government would maintain a safety net to insure that no senior would retire with income less than 120 percent of the poverty level.

We expect this proposal to restore Social Security to long-term and sustainable solvency and to do so at a cost less than the cost of simply continuing the existing program. And it would do far more than that.

Workers who chose the individual account option could accumulate retirement resources substantially greater than those that are currently payable under traditional Social Security. They would own and control those assets. At the same time, women and minorities would be treated fairly, and low-income workers could accumulate real wealth.

Most important, this proposal would reduce Americans' reliance on government and give individuals greater responsibility for and control over their own lives. It would provide a profound and significant increase in individual liberty.

The Social Security Crisis

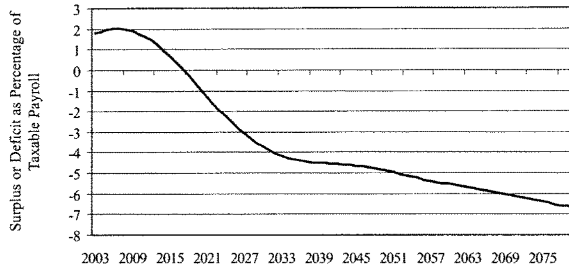
Social Security as we know it is facing irresistible demographic and fiscal pressures that threaten the future retirement benefits of today's young workers. Although Social Security is currently running a surplus, according to the system's own trustees, that surplus will turn into a deficit within the next 15 years.[1] That is, by 2018 Social Security will be paying out more in benefits than it takes in through taxes (Figure 1).

In theory, Social Security is supposed to continue paying benefits after 2018 by drawing on the Social Security Trust Fund. The trust fund is supposed to provide sufficient funds to continue paying full benefits until 2042, after which it will be exhausted. At that point, by law, Social Security benefits will have to be cut by approximately 27 percent.[2]

However, in reality, the Social Security Trust Fund is not an asset that can be used to pay benefits. Any Social Security surpluses accumulated to date have been spent, leaving a trust fund that consists only of government bonds (IOUs) that will eventually have to be repaid by taxpayers. As the Clinton administration's fiscal year 2000 budget explained it:

> These [Trust Fund] balances are available to finance future benefit payments and other Trust Fund expenditures—but only in a bookkeeping sense. . . . *They do not consist of real economic assets that can be drawn down in the future to fund benefits.* Instead, they are claims on the Treasury that, when redeemed, will have to be financed by raising taxes, borrowing from the public, or reducing benefits or other expenditures. The existence of large Trust

Figure 1
Social Security's Payroll Tax Surplus or Deficit



Source: *2003 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*, table IV.B1.

> Fund balances, therefore, does not by itself have any impact on the Government's ability to pay benefits.[3]

Even if Congress can find a way to redeem the bonds, the trust fund surplus will be completely exhausted by 2042. At that point, Social Security will have to rely solely on revenue from the payroll tax—but that revenue will not be sufficient to pay all promised benefits. Overall, Social Security faces unfunded liabilities of nearly $26 trillion.[4] Clearly, Social Security is not sustainable in its current form.

There are few options for dealing with the problem. That opinion is held by people who are not supporters of individual accounts as well as by those who are. As former president Bill Clinton pointed out, the only way to keep Social Security solvent is to (a) raise taxes, (b) cut benefits, or (c) get a higher rate of return through private capital investment.[5] Henry Aaron of the Brookings Institution, a leading opponent of individual accounts, agrees. "Increased funding to raise pension reserves is possible only with some combination of additional tax revenues, reduced benefits, or increased investment returns from investing in higher yield assets," he told Congress in 1999.[6]

The tax increases or benefit cuts would have to be quite large. To maintain benefits in the first year after Social Security starts running a deficit, the government must acquire revenues equivalent to $197 per worker. By 2042, the additional tax burden increases to $1,976 per worker, and by 2078 it reaches an astounding $4,193 per worker (in constant 2003 dollars).[7] And it continues to rise thereafter. Functionally, that would translate into either a huge increase in the payroll tax, from the current 12.4 percent to as much as 18.9 percent by 2077, or an equivalent increase in income or other taxes.[8]

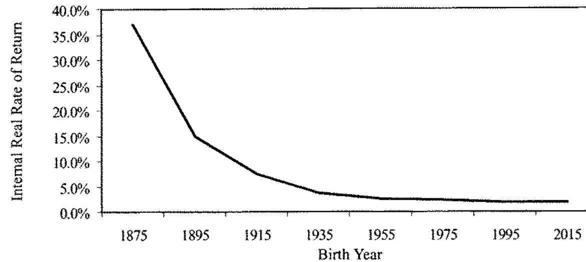
A Declining Rate of Return

Social Security taxes are already so high, relative to benefits, that Social Security has quite simply become a bad deal for younger workers, providing a low, below-market rate of return. As Figure 2 shows, that return has been steadily declining and is expected to be less than 2 percent for most of today's workers.

The poor rate of return means that many young workers' retirement benefits will be far lower than if they were able to invest their payroll taxes privately.[9] On the other hand, a system of individual accounts, based on private capital investment, would provide most workers with significantly higher returns. Those higher returns would translate into higher retirement benefits, leading to a more secure retirement for millions of seniors.

As Bill Clinton pointed out, the only way to keep Social Security solvent is to raise taxes, cut benefits, or get a higher rate of return through private capital investment.

Figure 2
Inflation-Adjusted Internal Real Rate of Return from OASI



Source: Dean Leimer, "Cohort-Specific Measures of Lifetime Net Social Security Transfers," Social Security Administration, Office of Research and Statistics, Working Paper no. 59, February 1994.

Savings and Economic Growth

Social Security operates on a pay-as-you-go (PAYGO) basis; almost all of the funds coming in are immediately paid out to current beneficiaries. This system displaces private, fully funded alternatives under which the funds coming in would be saved and invested for the future benefits of today's workers. The result is a large net loss of national savings, which reduces capital investment, wages, national income, and economic growth. Moreover, by increasing the cost of hiring workers, the payroll tax substantially reduces wages, employment, and economic growth.

Shifting to a private system, with hundreds of billions of dollars invested in individual accounts each year, would likely produce a large net increase in national savings, depending on how the government financed the transition. That would increase national investment, productivity, wages, jobs, and economic growth. Replacing the payroll tax with private retirement contributions would also improve economic growth because the required contributions would be lower and would be seen as part of a worker's direct compensation, stimulating more employment and output.

If all Social Security payroll taxes were privately invested, that investment would produce a net benefit of from $10 trillion to $20 trillion in present value.

In 1997 Harvard economist Martin Feldstein estimated that, if all Social Security payroll taxes were privately invested, that investment would produce a net benefit of from $10 trillion to $20 trillion in present value.[10] That is his estimate of the present value of the improved economic performance that would result from the reform. Most of that net benefit would probably come in the form of higher returns and benefits earned for retirees through the private investment accounts. But some would also come in the form of higher wages and employment for working people.

Helping the Poor and Minorities

Low-income workers would be among the biggest winners under a system of privately invested individual accounts. Private investment would pay low-income workers significantly higher benefits than can be paid by Social Security. And that does not take into account the fact that blacks, other minorities, and the poor have below-average life expectancies. As a result, they tend to live fewer years in retirement and collect less in Social Security benefits than do whites. Under a system of individual accounts, by contrast, they would retain control over the funds paid in and could pay themselves higher benefits over their fewer retirement years, or leave more to their children or other heirs.[11]

The higher returns and benefits of a private investment system would be most important to

low-income families, as they most need the extra funds. The funds saved in individual retirement accounts, which could be left to the children of the poor, would also greatly help families break out of the cycle of poverty. Similarly, the improved economic growth, higher wages, and increased jobs that would result from an investment-based Social Security system would be most important to the poor. Moreover, without reform, low-income workers will be hurt the most by the higher taxes or reduced benefits that will be necessary if we continue on our current course. Averting a financial crisis and its inevitable results would consequently be most important to low-income workers.

In addition, with average- and low-wage workers accumulating huge sums in their own investment accounts, the distribution of wealth throughout society would become far broader than it is today. That would occur not through the redistribution of existing wealth but through the creation of new wealth, far more equally held. Because a system of individual accounts would turn every worker into a stockowner, the old division between labor and capital would be eroded. Every laborer would become a capitalist.

Ownership and Control

After all the economic analysis, however, perhaps the single most important reason for transforming Social Security into a system of individual accounts is that it would give American workers true ownership of and control over their retirement benefits.

Many Americans believe that Social Security is an "earned right." That is, they think that, because they have paid Social Security taxes, they are entitled to receive Social Security benefits. The government encourages this belief by referring to Social Security taxes as "contributions," as in the Federal Insurance Contributions Act (FICA). However, the U.S. Supreme Court has ruled, in the case of *Flemming v. Nestor*, that workers have no legally binding contractual or property right to their Social Security benefits, and those benefits can be changed, cut, or even taken away at any time.[12]

As the Court stated, "To engraft upon Social Security a concept of 'accrued property rights' would deprive it of the flexibility and boldness in adjustment to ever changing conditions which it demands."[13] That decision built on a previous case, *Helvering v. Davis*, in which the Court had ruled that Social Security is not a contributory insurance program, stating that "the proceeds of both the employer and employee taxes are to be paid into the Treasury like any other internal revenue generally, and are not earmarked in any way."[14]

In effect, Social Security turns older Americans into supplicants, dependent on the political process for their retirement benefits. If they work hard, play by the rules, and pay Social Security taxes their entire working lives, they earn the privilege of going hat in hand to the government and hoping that politicians decide to give them some money for retirement.

In contrast, under a system of individual accounts, workers would have full property rights in their private accounts. They would own their accounts and the money in them the same way they own their individual retirement accounts (IRAs) or 401(k) plans. Their retirement benefits would not depend on the whims of politicians.

Principles for Reform

In developing a proposal for Social Security reform, we relied on five basic principles:

Solvency Is Not Enough

The goal of Social Security reform should be to provide workers with the best possible retirement option, not simply to find ways to preserve the current Social Security system. After all, if solvency were the only goal, that could be accomplished with tax increases or benefit cuts, no matter how bad a deal that provided younger workers. A successful Social Security reform will of course result in a solvent system, not just in the short run, but sustainable over time as well. And it will also improve Social Security's rate of return; provide better retirement benefits; treat women, minorities, and low-income workers more fairly; and give workers real ownership of and control over their retirement funds.

Don't Touch Grandma's Check

Although there is no legal right to Social Security benefits, workers who have relied on the program in good faith should not become

The goal of Social Security reform should be to provide workers with the best possible retirement option, not simply to find ways to preserve the current Social Security system.

scapegoats for the government's failures. Workers who are retired today or who are nearing retirement should not have their benefits reduced or threatened in any way.

More Investment Is Better Than Less

You don't cut out half a cancer. Many proposals for Social Security reform would allow workers to privately invest only a small portion of their payroll taxes; they would continue to rely on the existing PAYGO Social Security system for the majority of Social Security benefits. But small account proposals will not allow low- and middle-income workers to accumulate real wealth or achieve other objectives of reform. Individual accounts should be as large as feasible.

Individuals, Not Government, Should Invest

Small account proposals will not allow low- and middle-income workers to accumulate real wealth or achieve other objectives of reform.

The only way to increase Social Security's rate of return is to invest in private capital assets. This should be done through the creation of individually owned accounts, not by allowing the government to directly invest Social Security surpluses. Individual accounts would give workers ownership of and control over their retirement funds, allowing them to accumulate wealth and pass that wealth on to their heirs; it would also give them a stake in the American economic system. Government investment would allow the federal government to become the largest shareholder in every American company, posing a potential threat to corporate governance and raising the possibility of social investing. And government, not workers, would still own and control retirement benefits.

Be Honest

The American people can handle an open and honest debate about Social Security reform. Individual accounts will create a better, fairer, and more secure retirement system. But they cannot create miracles. They will provide higher retirement benefits than Social Security can pay. But they will not make everyone a millionaire. They will help solve Social Security's financial crisis and save taxpayers trillions of dollars over the long run. But there is no free lunch. There are short-term costs that will require the president and Congress to make tough choices.

Promised vs. Payable Benefits

Opponents of individual accounts frequently suggest that the creation of such accounts would result in cuts in the promised level of Social Security benefits. Those critics are confusing changes necessary to restore the system to balance with changes resulting from individual accounts. As noted above, Social Security faces unfunded liabilities of nearly $26 trillion. Quite simply, unless there is a substantial increase in taxes, the program cannot pay the promised level of benefits.

That is not merely a matter of conjecture; it is a matter of law. The Social Security Administration is legally authorized to issue benefit checks only as long as there are sufficient funds available in the Social Security Trust Fund to pay those benefits. Once those funds are exhausted, in 2042 by current estimates, Social Security benefits will automatically be reduced to a level payable with existing tax revenues, approximately 73 percent of the current benefit levels.[15]

This, then, is the proper baseline to use when discussing Social Security reform. Social Security must be restored to a sustainable level regardless of whether individual accounts are created.

As the Congressional Budget Office puts it:

> A number of recent proposals to reform Social Security call for changes in the program's benefits. The effects of those proposals are frequently illustrated by comparing the new benefits to those expected to arise under the policies put in place by current law—showing whether they would be higher or lower and by how much. However, because of scheduled changes in benefit rules, a growing economy, and improvements in life expectancy, the benefits prescribed under current law do not represent a stable baseline. Their value will vary significantly across future age cohorts. Thus, focusing on differences from current law will not fully portray the effects of proposed benefit changes.[16]

It is wrong, therefore, to attribute to individual accounts benefit cuts that would be needed to bring the system into balance irrespective of whether individual accounts are created.

It is clear, in fact, that individual accounts by themselves do not cause any reduction in total retirement benefits (defined as the combination of account accumulations and traditional Social Security benefits). The best illustration of this concept is the first of three plans proposed by the President's Commission to Strengthen Social Security. That plan would create individual accounts (2 percent of payroll is used for illustrative purposes) but make no other changes to bring Social Security into solvency. The result is that Social Security remains insolvent (although the plan does improve financing by 8 percent), but the combined benefit received by workers is higher than benefits currently promised by Social Security.[17]

Because one goal of this reform plan is to bring the Social Security system into balance and eliminate the system's unfunded liabilities, changes are made to bring the system's finances into balance in a sustainable PAYGO system. Those changes are separate from the creation of individual accounts.

Therefore, in comparing benefit levels, payable benefits is the appropriate baseline.

A Proposal for Individual Accounts

Current workers should be given a choice. Beginning January 1, 2005, workers born on or after January 1, 1950, would have two options: Those who wish to remain in the traditional Social Security system would be free to do so, accepting a level of benefits payable with existing levels of revenue. Those workers would continue to pay the full 12.4 percent payroll tax and would continue to receive Social Security benefits as under current law. However, beginning in 2012, the formula used to calculate the accrual of benefits would be adjusted to index them to price inflation rather than national wage growth.[18]

That change would have no impact on people who are already retired, since benefits after retirement are already adjusted according to inflation (that's what cost-of-living adjustments, or COLAs, are). Nor would it reduce benefits for those nearing retirement. However, for younger workers, benefits would gradually be adjusted to a level sustainable under the current level of payroll taxation.

At the same time, those workers who wished to enter the new market-based system would be allowed to divert their half of the payroll tax (6.2 percentage points) to individually owned, privately invested accounts.[19] Those choosing to do so would agree to forgo all future accrual of retirement benefits under traditional Social Security. The remaining 6.2 percentage points of payroll taxes would be used to pay transition costs and to fund disability and survivors' benefits. Once transition costs were fully paid, this portion of the payroll tax would be reduced to the level necessary to pay survivors' and disability benefits.

Although they would forgo future benefits under traditional Social Security, workers who chose the individual account option would receive a bond in recognition of their past contributions to Social Security. That bond would be a zero-coupon bond calculated to provide a benefit based on accrued benefits under the current Social Security system as of the date that the individual chose an individual account.[20] The bonds would be fully tradable on secondary markets, but all proceeds would have to be fully redeposited in the worker's individual account until the worker became eligible to make withdrawals.

The recognition bonds may be valued at something less than the full present value of accrued benefits because we believe that workers will attach a value to receiving a tangible asset, making them willing to accept a discount in the face value of the bond. Indeed, polls show that a third of younger workers would opt out of Social Security even if they didn't get back a cent of the payroll taxes they've put in.[21] In addition, because the recognition bonds would be tradable, workers who wished to do so could sell them and allocate the sale price among higher-earning assets in the same way they do other contributions (see below). Finally, because the accrued benefits are calculated against current law, for some younger workers the level of those benefits would be higher than the level of benefits that would be payable under a sustainable PAYGO system. Those workers, therefore, receive something of a windfall through recognition bonds.

Workers would be allowed to divert their half of the payroll tax (6.2 percentage points) to individually owned, privately invested accounts.

The system should adopt a "hold harmless point," such that once an individual can purchase an annuity equal to 120 percent of the poverty level, he or she can opt out of the system altogether and stop paying the 6.2 percent individual account contribution.

Workers would also have the option of depositing up to an additional 10 percent of their earnings in their accounts on a voluntary basis (that is, over and above the 6.2 percent payroll tax or contribution). Voluntary additional contributions would be made on an after-tax basis, and their investment, buildup, and distribution would be treated identically to the 6.2 percent account contribution discussed above.

Funds deposited in individual accounts would be invested in real capital assets under a three-tiered system.

Tier I

Collection of payroll taxes, including individual account contributions, continues to be handled by the employer in much the same way as today. A worker's employer sends payroll taxes to the U.S. Treasury. The employer tells Treasury how much of the total payment is from employees who have chosen the personal retirement account option. Treasury then transfers that portion to a private-sector custodian bank, which invests the total amount in a money market fund that is always priced at one dollar, a standard industry convention. The following year, when the contribution is reconciled to the individual's name using the W-2 form, the fund's shares representing his contributions and interest credit are distributed to each worker and electronically transferred to the default account as specified under Tier II.

Tier II

Workers initially have a choice of three investment options. As soon as a worker's contributions are reconciled, they are electronically deposited in one of three balanced funds, each highly diversified and invested in thousands of securities. The default portfolio, where one's money is invested if no choice is made, has 60 percent stocks and 40 percent bonds. The two other funds have the same asset classes but with different weights. For younger workers one fund with a higher concentration of stocks is created, and another, more geared toward less-volatile bonds, is created for those near retirement. Workers can move their funds from the default portfolio to either of the other two options.

Tier III

Once a worker has accumulated some "trigger" level of funds, the worker is free to participate in a much larger range of investment options, closely approximating the options currently available under traditional 401(k) plans.[22]

The institutions and providers managing funds under Tier III may choose to offer additional goods and services, such as retirement planning software, to attract assets from Tier II. Each worker can allocate his assets at will among Tier III providers. This ensures stiff competition as each provider strives to meet investors' needs. Costs would most likely be greater than in Tier II, but they would be incurred only if an individual chose to shift to Tier III.[23]

At retirement workers are able to choose an annuity, a programmed withdrawal option, or the combination of an annuity and a lump-sum payment. They can choose to annuitize their entire account holdings, or they can choose programmed withdrawals from the principal of their account, based on twice their life expectancy. If they choose the latter option, funds in their accounts will remain invested under the same provisions as before retirement. If a worker choosing the programmed withdrawal option dies before his assets are exhausted, those assets become part of his estate and are fully inheritable in the same way as any other asset. Finally, workers can choose to purchase an annuity providing annual income equal to 120 percent of the poverty level and take any funds available above this level as a lump sum.

Further, we believe that the system should adopt a "hold harmless point," such that once an individual can purchase an annuity equal to 120 percent of the poverty level, he or she can opt out of the system altogether and stop paying the 6.2 percent individual account contribution. For married couples, the hold harmless point would occur when the couple had accumulated sufficient combined funds to purchase a family annuity equal to 240 percent of the single-adult poverty threshold.

Contributions to individual accounts are on a posttax basis. Interest, dividends, and capital gains accruals on investments within individual accounts, and all eligible withdrawals from the accounts, are exempt from income taxes. In most ways, individual Social Security accounts resemble Roth IRAs.[24]

Finally, the federal government provides a safety net insuring that no worker's retirement income falls below 120 percent of the poverty level. Workers whose accumulations under the private investment option fall below the amount required to purchase an annuity at that level receive a supplement sufficient to enable them to purchase such an annuity.[25] This safety net is funded from general revenues rather than from the Social Security payroll tax.

Some proposals for Social Security reform provide much higher benefit guarantees; some guarantee that no one will ever receive less than payable or even promised Social Security benefits. Aside from the obvious expense of such guarantees, this approach is flawed in two respects. First, it seems wrong to make taxpayers responsible for guaranteeing investments by high-income workers who do not depend on Social Security for their retirement income. Should a factory worker really be on the hook to guarantee Bill Gates's investment choices? Second, guarantees inevitably create a "moral hazard" issue. Workers would be encouraged to speculate and make risky investment choices, knowing that they would reap the potentially higher gains from such investments and be protected from any possible losses. This is very similar to the type of moral hazard that led to the savings-and-loan crisis of the 1980s.[26]

Finally, although the individual account option is completely voluntary for current workers, it will eventually become mandatory for those workers who have not yet entered the labor force. As a result, the PAYGO Social Security system will eventually be replaced entirely by a market-based one.

Paying for the Transition

Although moving to a system of individual accounts will save money in the long run, there will almost certainly be a short-term requirement for additional revenues.[27] That is because, to the degree that workers choose the individual account option, payroll tax revenues are redirected from the payment of current benefits to personal accounts. But because most of the workers who choose accounts are likely to be young, it will be many years before the accounts result in significant savings to the traditional system.

Where, then, will the transitional financing come from? Ultimately, this is a decision for Congress, which will have to weigh the utility of various financing mechanisms, including debt, taxes, and reductions in current government spending.

However, three sources are worth special note. First, the portion of taxes on Social Security benefits currently used to fund Medicare should be redirected back to Social Security. That would provide an estimated $8.3 billion annually in additional revenue.[28]

Second, the Cato Institute has identified more than $87 billion annually in corporate welfare, roughly defined as "any government spending program that provides payments or unique benefits and advantages for specific companies or industries."[29]

Sen. John McCain (R-AZ) and Rep. Richard Gephardt (D-MO) have called for a commission to pinpoint and eliminate corporate subsidies. Congress should take this idea a step further and earmark the savings for individual accounts. Senator Graham has proposed such a commission as part of Social Security reform legislation that he has introduced.[30]

Third, to the degree that they actually represent an increase in national savings, contributions to individual accounts may, in themselves, prove to be a source of additional revenue for the federal government, revenue that could be used to help finance the transition.

It works in this way: The return on investment received by individuals is not the actual return earned by a given investment. A portion of the returns is actually taxed away through corporate taxes before returns are realized at the level of the individual investor. Therefore, a portion of the funds diverted to individual accounts is actually "recaptured" and available to help fund the transition.[31] The Social Security Administration estimates that this revenue recapture would provide "a substantial and growing source of income to the OASDI program."[32]

In a 1999 memo to Sen. Phil Gramm, the Social Security Administration estimated that, to the degree that contributions to individual accounts represent a net increase in savings, the recapture would be equal to 31.4 percent of the real, before-tax return on investments. This is based on an assumed average corporate tax rate of 35 percent applied against an assumed net

Should a factory worker really be on the hook to guarantee Bill Gates's investment choices?

new savings of 68.4 percent of assets invested through individual accounts.[33]

After using the three financing sources discussed above, we believe that any remaining transition could be financed through reductions in other wasteful government spending.[34] Simply restraining the projected growth in nondefense discretionary spending by 1 percent would generate more than $20 billion per year.[35]

We recognize that it may be necessary to issue some new debt to cover short-term year-to-year cash shortfalls. If that should become necessary, we believe that the issuance of such debt should be honest, explicit, and on budget. At the same time, we should understand that this would not really be new debt; it would simply be making explicit an already existing implicit debt.

It is also important to remember that the financing of the transition is a one-time event that actually serves to reduce the government's future liabilities. The transition moves the government's need for additional revenue forward in time, but—depending on the transition's ultimate design—it does not necessarily increase the amount of spending necessary. In fact, it will likely reduce the total cost of Social Security. In effect, it is a case of pay a little now or pay a lot later.

Financing the transition is a one-time event that actually serves to reduce the government's future liabilities.

Why 6.2 Percent Accounts?

Some proposals for creating individual accounts as part of Social Security reform keep most of the traditional PAYGO Social Security structure in place and offer only very small accounts, allowing workers to privately invest just 2–3 percentage points of payroll taxes.

People who support plans with small individual accounts generally do so for one of three reasons:

- A political calculation that small accounts will avoid charges of "privatizing" Social Security;
- A desire to diversify risk by splitting responsibility for retirement income between markets and government, combining defined-contribution and defined-benefit programs; or
- Concern over short-term annual cash deficits.

However, given the clear advantages of larger accounts, none of those reasons holds up.

First, small account size seems unlikely to protect supporters from political attack. The recent Medicare reform debate provides a useful example. Despite rollbacks of attempts to introduce market competition to Medicare (the final bill contained only a handful of "demonstration projects" that don't begin until 2010), the bill was still attacked as an attempt to "privatize" Medicare. Opponents of individual ownership can be expected to be just as vociferous in their denunciations of 2 percent accounts as they would be in attacking 6.2 percent accounts.

At the same time, small account proposals may prove politically counterproductive by dissipating the enthusiasm of grassroots activists and others who support reform and failing to engage the attention of young workers. Opponents of individual accounts are entrenched and well organized. Washington politicians are fearful and reluctant to take on an issue of this magnitude. It will take strong public support to make reform happen.

Generating a sufficient level of support, particularly among generally apathetic younger voters, will require a reform proposal that makes clear how much those voters have to gain from reform. Bold colors, not pale pastels, will be needed to generate that kind of support.

The advantages of larger individual accounts are not lost on voters. A poll conducted by Zogby International for the Cato Institute asked voters how much of their Social Security taxes they wished to invest. A plurality of voters (27.9 percent) chose the full 12.4 percent. Only a slightly smaller group (26.5 percent) chose 6.2 percentage points, as provided for in this proposal. Only 11 percent of voters preferred 2–3 percent accounts. Support for large accounts was consistent across all political, ideological, and demographic groups, with younger voters showing particular support for bigger accounts[36] (Table 1).

Second, although risk diversification is generally a good thing, continued reliance on a government-provided benefit may actually increase the overall risk to workers. Those making this argument generally attach the most risk to the market-based component of a reformed Social Security system (individual accounts) and less or even no risk to the portion provided by government. In reality, however, this misreads both market and political risks.

Table 1
Portion of Taxes to Be Invested

		Political Preference			Age			
	Overall	Democrat	Republican	Independent	18–29	30–49	50–64	65+
6.2%	26.5	26.7	21.7	32.5	41.3	29.9	29.2	11.5
2% or 3%	11.0	13.6	9.0	9.6	11.9	12.9	8.8	10.3
12.4%	27.9	22.0	36.2	25.9	32.6	40.2	27.5	11.8
None	20.4	23.2	17.4	20.4	8.4	11.2	22.3	35.4
Not sure	14.2	14.6	15.7	11.6	5.8	5.7	12.1	31.0

Given the long-term investment horizon envisioned for workers choosing individual accounts under this proposal, market investment is remarkably safe. In fact, over the worst 20-year period of market performance in U.S. history, which included the Great Depression, the stock market produced a positive real return of more than 3 percent. At the same time, we know that, even under the best of conditions, Social Security will provide below-market returns. As Figure 3 shows, even with recent stock market declines, a worker investing all of his payroll taxes in stocks would receive benefits 2.8 times greater than he would receive had he "invested" the same amount of money in Social Security.[37]

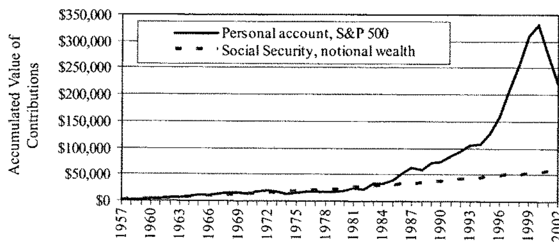
Mixing private investments with traditional Social Security is therefore mixing a good investment (private accounts) with a bad investment (Social Security). That's not diversification, it's just bad investment policy.

Moreover, given the lack of property or other legal rights to Social Security benefits, and the program's enormous unfunded liabilities, traditional Social Security has political risks over and above its poor rate of return.

Besides, the proposed individual account plan provides an opportunity to diversify risk. The proposed default portfolio consists of both stocks and bonds. Risk-averse investors can opt for a portfolio even more heavily weighted toward bonds.

Traditional Social Security has political risks over and above its poor rate of return.

Figure 3
Even after Market Drops, Personal Accounts Would Pay Higher Returns Than the Traditional System



Source: Andrew Biggs, "Personal Accounts in a Down Market: How Recent Stock Market Declines Affect the Social Security Debate," Cato Institute Briefing Paper no. 74, September 10, 2002.

Finally, the truly risk averse can avoid private investment altogether. They can choose to remain entirely within the current Social Security system.

People concerned with short-term annual cash flows acknowledge that large accounts would save money in the long run, but they are equally concerned with maintaining the program's financial balance on an annual basis. This concern is due in part to the size of projected annual budget deficits and in part to skepticism about the ability of the federal government to use money saved in the future to repay debt incurred during the transition, rather than for tax cuts or new spending programs. In all honesty, Congress's recent spending habits give some cause for concern.

However, focusing only on short-term cash flows may be penny-wise and pound-foolish. It is much like paying only the minimum payment on a credit card, neglecting the opportunity to pay off the long-term debt altogether. Large account plans do incur greater short-term costs, but they also result in greater long-term savings.

Focusing only on short-term cash flows may be penny-wise and pound-foolish. If system finances were the only issue, we could simply raise taxes or cut benefits.

More important, Social Security reform is about more than finances. Indeed, if system finances were the only issue, we could simply raise taxes or cut benefits. True Social Security reform must also provide increased rates of return and higher benefits; correct the inequities of the current system so as to treat working-women, African Americans, and others more fairly; and give low-income workers a greater opportunity to own and accumulate real wealth. By those measures, large accounts do a far better job of achieving true reform.

For example, increasing attention is being paid to the benefits of individual accounts as a way to give low-income workers an opportunity to build wealth. Although any increase in wealth should be encouraged, we should also be honest enough to admit that for low-wage workers 2 percent of their wages is not enough to allow for the accumulation of a real nest egg. Given that their Social Security accounts may often be the only form of savings that low-income workers have, the more we enable them to save, the better.

Finally, small accounts do little to advance the fundamental goals of reducing reliance on government and giving individuals greater responsibility for and control over their lives.

Of course, one might ask, if big accounts are better than small, then why not allow workers to privately invest the full 12.4 percent payroll tax, or at least the roughly 10 percentage points used for OASI benefits?

Although there is no doubt that even bigger accounts would provide higher benefits than those envisioned under our plan, accounts of 10 percent or more may actually result in too much forced savings for many workers.

Most high- and middle-income individuals do not rely solely on Social Security for their retirement income. In fact, the wealthiest fifth of retirees receives only 20 percent of its income from Social Security.[38] Those workers have other (non–Social Security) forms of saving and investment, including IRAs, 401(k) plans, and even individual equity ownership and other investments. Indeed, we can assume that many of those workers have already achieved the level of retirement savings that they desire. Forcing them to save more through Social Security accounts may simply result in their saving less through their other investments. Moreover, in most cases, the non–Social Security investments take place in a less regulated and less constrained environment than that envisioned for individual accounts under Social Security. The end result of excessively large accounts, therefore, might actually be a perverse decrease in the freedom to invest.

Finally, some people have suggested progressive accounts, with low-income workers able to invest a higher proportion of their payroll taxes than those with higher incomes.[39] Such an approach has a great deal of appeal. It would maximize the benefits of individual accounts to low-income workers while holding down overall transition costs and avoiding the problems of oversaving by higher-income workers.

However, there are serious practical and implementation problems with such an approach. In particular, proposals for progressive accounts would appear to shift compliance and administrative costs to employers. The additional record keeping could become a significant burden, particularly for small businesses.

Consider, for example, a worker who holds two jobs. During the day, he works at a well-paid manufacturing job. At night, he supplements his income as a minimum wage bartender. How would his two employers reconcile

his total income to determine the amount that he is able to contribute to his individual account?

One last point: we believe that 6.2 percent accounts are a very easy concept to explain to the average worker. The worker can privately invest his half of the 12.4 percent payroll tax, while the employer's half is used to finance the transition (and fund survivors' and disability benefits). Of course we recognize that, from an economic point of view, there is no difference between the employer and the employee share of the tax. The employee ultimately bears the full cost, but most workers make the distinction in their own minds. A 6.2 percent account proposal, then, becomes clear, concise, and easy to understand in an age of eight-second sound bites.

Conclusion

More and more Americans agree on the importance of allowing younger workers an opportunity to privately invest their Social Security taxes, but advocates of individual accounts are divided over how large those accounts should be. Some proposals that call for large accounts have very large transition costs, which makes their political viability suspect. Other proposals are relatively less expensive but give workers control over and ownership of only a small portion of their retirement funds. We believe that it is possible both to have large accounts and to be fiscally responsible. This proposal is designed to meet that goal.

The proposed Social Security reform would restore Social Security to long-term and sustainable solvency and would do so at a cost less than that of simply propping up the existing program. It would also do far more than that.

Younger workers who chose the individual account option could receive retirement resources substantially higher than under traditional Social Security. At the same time, women and minorities would be treated more fairly, and low-income workers would be able to accumulate real wealth.

Most important of all, this is a proposal that would give workers ownership of and control over their retirement income. It is a plan that puts people, not government, first. It is a plan that is fiscally responsible and protects future generations of workers and taxpayers.

Notes

1. *2003 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*, ftp://ftp.ssa.gov /pub/OACT/TR/TR03/tr03.pdf. Cited hereafter as *2003 Trustees' Report*.

2. Ibid.

3. Executive Office of the President of the United States, *Budget of the United States Government, Fiscal Year 2000, Analytic Perspectives*, p. 337. Emphasis added.

4. *2003 Trustees' Report*.

5. William Jefferson Clinton, Speech to the Great Social Security Debate, Albuquerque, NM, July 27, 1998.

6. Henry Aaron, Testimony before the Senate Committee on Finance, 106th Cong., 1st sess., January 19, 1999.

7. Author's calculations, derived from *2003 Trustees' Report*.

8. Ibid., p. 16.

9. See Michael Tanner, "The Better Deal: Estimating Rates of Return under a System of Individual Accounts," Cato Institute Social Security Paper no. 31, October 28, 2003.

10. Martin Feldstein, "Privatizing Social Security: The $10 Trillion Opportunity," Cato Institute Social Security Paper no. 7, January 31, 1997.

11. See Michael Tanner, "Disparate Impact: Social Security and African Americans," Cato Institute Briefing Paper no. 61, February 5, 2001.

12. *Flemming v. Nestor*, 363 U.S. 603 (1960). For a fuller discussion of this issue, see Charles Rounds, "Property Rights: The Hidden Issue of Social Security Reform," Cato Institute Social Security Paper no. 19, April 19, 2003.

13. *Flemming v. Nestor* at 616.

14. *Helvering v. Davis*, 301 U.S. 619 (1937), quoted in *Flemming v. Nestor* at 616.

15. In practice, rather than reduce each check sent to beneficiaries, the Social Security Administration would stop sending out checks altogether until it accumulated sufficient funds to pay "full" benefits. When those funds were exhausted, checks would again be withheld until sufficient funds accumulated, leading to checks starting and stopping several times over the course of a year. The net effect would

be that total annual benefits would be reduced by the same amount as if each month's benefits had been proportionally reduced.

16. David Koitz, "Measuring Changes to Social Security Benefits," CBO Long-Range Fiscal Policy Brief no. 11, December 1, 2003.

17. The President's Commission to Strengthen Social Security, *Strengthening Social Security and Creating Personal Wealth for All Americans* (Washington: Government Printing Office, December 2001). For an analysis, see Andrew Biggs, "Perspectives on the President's Commission to Strengthen Social Security," Cato Institute Social Security Paper no. 27, August 22, 2002.

18. This is by no means the only method of reducing promised Social Security benefits to a level actually payable under a sustainable PAYGO system. There is a fairly lengthy menu of such proposals, including means testing, adjusting the retirement age, adding an additional bend point to the formula for determining benefits, and changing spousal benefits. See Michael Tanner, "No Second Best: The Unappetizing Alternatives to Individual Accounts," Cato Institute Social Security Paper no. 24, January 29, 2002. However, we believe that changing from wage to price indexing is one of the fairest ways to restore Social Security to PAYGO solvency. For a more in-depth discussion of the benefits of price indexing, see Matthew Miller, *The 2% Solution: Fixing America's Problems in Ways Liberals and Conservatives Can Love* (New York: Public Affairs, 2003), pp. 198–207. In addition, it would be possible to offer workers the choice of receiving the full level of *promised* benefits but requiring them to pay the level of payroll taxes necessary to support those benefits. Such a mechanism has been included in legislation proposed by Sen. Lindsey Graham (R-SC). See the Social Security Solvency and Modernization Act of 2003.

19. Technically workers currently contribute 5.3 percent toward Old-Age and Survivors Insurance (OASI) and 0.9 percent to Disability Insurance (DI). Under our proposal, the employer would assume responsibility for the entire DI contribution (1.8 percent) and would continue to pay 4.4 percent of capped payroll toward the OASI portion of Social Security.

20. The face value of recognition bonds would be calculated by applying the existing Social Security benefit formula (AIME/PIA) to the worker's past covered earnings. The actuarial present value of this accrued-to-date benefit would then be calculated using a discount rate equal to the long-term opportunity cost to government of capital (essentially the 30-year bond rate), or roughly 3.5 percent, and current age- and gender-specific expected mortality rates.

21. Polling conducted by Rasmussen Research Corporation, July 1999.

22. The advisory committee was not able to reach a consensus on what level should constitute the trigger for permitting movement from Tier II investments to Tier III. Several members favored a dollar amount, such as accumulations of at least $5,000. Others preferred a time-based trigger, for example three years. Still others suggested an accumulation equal to 120 percent of the poverty level. Any of those options would ultimately be acceptable.

23. Workers could also move some or all of their Tier III assets back to Tier II, a platform with fewer features but lower costs. The competition among Tier III providers, and between Tiers II and III, would ensure that workers received the greatest amount of goods and services at the lowest possible cost. For more information on how this three-tiered structure of investments would work, see William Shipman, "How Individual Social Security Accounts Would Work," *Investor's Business Daily*, December 1, 2003.

24. Counterintuitively, saving on a posttax basis, with accumulation and payout tax-free, benefits middle- and low-income individuals more than proposals that would make contributions tax-free but payouts taxable. For further discussion, see Jagadeesh Gokhale and Laurence Kotlikoff, "Who Gets Paid to Save?" *Tax Policy and the Economy* 17 (2003): 112–39.

25. The determination of eligibility for this safety net will take place at the normal retirement age, 67 for most workers covered under our plan, with workers at that age receiving the full subsidy, although payment would not take place until the worker annuitized his account. Workers choosing early retirement would have the amount of their subsidy reduced in much the same way as workers choosing early retirement have their current Social Security benefits reduced.

For married couples, the determination of the federal guarantee would take place at the time that the older spouse reached retirement age. The government would take into consideration the combined accrued assets in both accounts and provide sufficient additional funds to purchase both spouses an individual annuity equal to 120 percent of the poverty level for a single adult.

26. See Andrew Biggs, "The Archer-Shaw Social Security Plan: Laying the Groundwork for Another S&L Crisis," Cato Institute Briefing Paper no. 55, February 16, 2000.

27. The Cato Institute is currently preparing detailed cost projections for this proposal. Those results will be presented in a forthcoming paper.

28. *2003 Annual Report of the Board of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds* (Washington: Government Printing Office, 2003), table I.C.1, p. 3. In overall budgetary terms, of course, this does not produce a net gain, since it would ultimately increase Medicare shortfalls. But it seems fair to use Social Security funds for Social Security. Medicare will ultimately require its own reform to remain solvent, but that is an issue for another day.

29. Stephen Slivinski, "The Corporate Welfare Budget: Bigger Than Ever," Cato Institute Policy Analysis no. 415, October 10, 2001, p. 6.

30. The Social Security Solvency and Modernization Act of 2003.

31. For a full discussion of "revenue recapture," see Peter Ferrara and Michael Tanner, *A New Deal for Social Security* (Washington: Cato Institute, 1998), pp. 62-64, 180-81.

32. Stephen C. Goss, chief actuary, Social Security Administration, Memorandum to Sen. Phil Gramm, April 16, 1999.

33. Ibid. SSA also uses this method in calculating revenue feedback under a Social Security reform proposal offered by Peter Ferrara. Stephen C. Goss, Memorandum to Peter Ferrara, December 1, 2003.

34. See, for example, Andrew Taylor, "House Panels Identify 'Waste, Fraud and Abuse,' But Are Unlikely to End Them," *CQ-Today*, October 2, 2003.

35. See Peter Ferrara, "To Get Spending under Control," *Washington Times*, January 6, 2004. Ferrara notes that such spending restraint would still result in a government 59 percent larger than it is today.

36. The survey of 1,204 likely voters was conducted in July 1999 and has a margin of error of +/- 3.0 percent. http://www.socialsecurity.org/zogby/fullreport.pdf.

37. Andrew Biggs, "Personal Accounts in a Down Market: How Recent Stock Market Declines Affect the Social Security Debate," Cato Institute Briefing Paper no. 74, September 10, 2002.

38. Neil Gilbert and Neung-Hoo Park, "Privatization, Provision, and Targeting: Trends and Policy Implications for Social Security in the United States," *International Social Security Review* 49 (January 1996): 22.

39. See, for example, Peter Ferrara, "A Progressive Proposal for Social Security Accounts," Institute for Policy Innovation Policy Report no. 176, June 2003. Progressive accounts are also a feature of the Social Security Solvency and Modernization Act, sponsored by Sen. Lindsey Graham, and of the President's Commission to Strengthen Social Security's Model 2.

A Better Deal at Half the Cost

SSA Scoring of the Cato Social Security Reform Plan

by Michael Tanner

No. 92 April 26, 2005

Executive Summary

The Social Security Administration's Office of the Actuary has officially "scored" the Individual Social Security Investment Program Act (HR 530), introduced by Reps. Sam Johnson (R-TX) and Jeff Flake (R-AZ). That legislation is based on the Cato Institute's 6.2 Percent Solution. (There are slight differences between the Cato plan and the final draft of the legislation, but these would not significantly change the scoring.)

According to SSA's actuaries, the 6.2 Percent Solution would eliminate Social Security's long-range actuarial deficit and restore the system to permanent "sustainable solvency." The legislation compares very favorably to other Social Security reform plans. In terms of giving workers more control and ownership of their retirement funds, the 6.2 Percent Solution clearly provides the most "bang for the buck." By 2046, the system would begin running surpluses, allowing any short-term debt to be repaid. Indeed, by the end of the 75-year actuarial window, the system would be running surpluses in excess of $1.8 trillion (in constant $2005).

The SSA analysis shows that the 6.2 Percent Solution can provide large individual accounts while restoring Social Security to permanent sustainable solvency, and can do so in a fiscally responsible manner.

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Under this proposal, workers under the age of 55 would have the option of diverting their half of the Social Security payroll tax to individual accounts.

Introduction

On February 17, 2004, the Cato Institute published "The 6.2 Percent Solution: A Plan for Reforming Social Security," a comprehensive proposal for creating privately invested, individually owned accounts as part of an overall reform of the Social Security system.[1]

Under this proposal, workers under the age of 55 would have the option of diverting their half of the Social Security payroll tax (6.2 percent of wages) to individual accounts. The employer's portion of the payroll tax would continue to be paid into the Social Security system to provide survivors' and disability benefits, as well as to partially fund continuing benefits for those already retired or nearing retirement. Workers choosing the individual account option would forgo any future accrual of Social Security retirement benefits. However, those workers who have already paid into the current Social Security system would receive credit for accrued benefits in the form of a recognition bond. This fully tradable bond would be a zero-coupon note that would mature on the date of the recipient's normal retirement age.

Workers who do not choose the individual account option would continue to pay into and receive benefits from the current Social Security system. However, for those workers, the initial Social Security benefit formula would be adjusted to reflect price indexing rather than the current wage indexing.[2] The result would be to restore Social Security benefits to a level payable with Social Security's available revenue, while ensuring that future retirees continue to receive the same level of benefits as those retiring today, on an inflation-adjusted basis. (This change would be phased in over a 35-year period, beginning in 2014.)

The plan also called for establishing a new minimum Social Security benefit providing a significant increase over the current minimum benefit.

This proposal became the basis for legislation introduced on July 19, 2004, by Rep. Sam Johnson (R-TX), along with 18 original cosponsors.[3] Johnson, together with Rep. Jeff Flake and 10 cosponsors, reintroduced the bill in the 109th Congress, on January 21, 2005.[4] The legislation was submitted to the Social Security Administration for official scoring as to its impact on the federal budget and Social Security solvency. On February 15, 2005, the SSA's Office of the Actuary (OACT) issued its report, concluding that the Johnson-Flake bill would restore Social Security to permanent, sustainable solvency.[5] The results of OACT's report are reflected below.

(There are slight differences between the Cato plan as originally written and the Johnson bill. These are noted where relevant, but would not significantly change the scoring.)

Scoring Assumptions

Scoring of the 6.2 Percent Solution was done using actuarial assumptions consistent with the 2004 report of the Social Security Trustees. While there were minor changes in methodology between that report and the 2005 Trustees Report, most major demographic and economic assumptions (including fertility rates, death rates, immigration, productivity, inflation, wage-covered employment, unemployment, and Trust Fund interest rates) remained the same.[6] Therefore, the scoring results are likely to remain substantially consistent with the new report (the comparisons herein use Social Security assumptions from the 2005 Trustees Report).

In scoring the proposal, OACT did make a number of specific assumptions that affected the final outcome. Among these:

Although the Cato plan calls for a default portfolio of 60 percent stocks and 40 percent bonds (and the Johnson bill calls for a default portfolio of 65 percent stocks and 35 percent bonds), OACT nevertheless scores the bill using a 50/50 stock/bond portfolio. They base their decision on an assumption that, since both the Johnson-Flake bill and Cato plan would eventually completely replace Social Security's defined benefit with a

defined contribution system, workers would be inclined to move their investments away from the default portfolio and into a more conservative one.[7]

The rates of return estimated for the investments were assumed to be 6.5 percent for equities, 3 percent for government bonds, and 3.5 percent for corporate bonds.[8] Although this is slightly below the historic return on equities, it is reasonable given evidence of a declining risk premium.[9] Administrative costs are estimated to be 25 basis points (one quarter of 1 percent of assets managed).

OACT assumes that workers make their decision as to whether to participate in the individual account option on a more or less rational basis. That is, if they will receive higher benefits from the traditional Social Security system (as adjusted for wage/price indexing), they will remain in the current system. If they can do better under individual accounts, they will choose them. Approximately 10 percent of workers age 54 are expected to choose individual accounts, with 100 percent participation among those age 40 and younger. Those between the ages of 54 and 40 participate in gradually increasing amounts.[10]

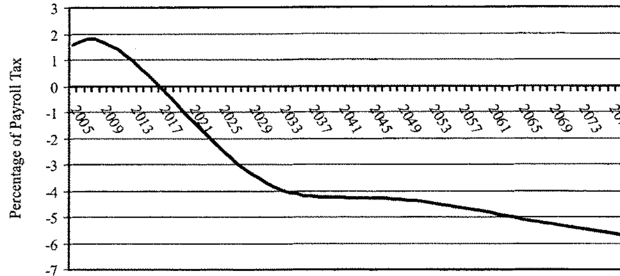
Differences between the Cato Plan and the Johnson-Flake Bill

There are some small differences between the original Cato plan and the Johnson bill as introduced. These include the following:

- ***Additional Contributions.*** Under the Cato plan, workers would be allowed to contribute an additional 10 percent of their wages to their accounts on a voluntary basis. However, under the proposed legislation, there are no provisions for additional contributions to the individual account.
- ***Recognition Bonds.*** The Cato plan called for the face value of the recognition bonds to be calculated by applying the existing Social Security benefit formula (AIME/PIA) to the workers past covered earnings. The actuarial present value of this accrued-to-date benefit would then be calculated using a discount rate equal to the long-term opportunity cost of funds to the government (essentially the 30-year bond rate), or roughly 3.5 percent, and current age- and gender-specific expected mortality rates. The Cato plan also envisioned that "the recognition bonds may be valued at something less than the full present value of accrued benefits," but did not specify the methodology for achieving this reduction. The Johnson-Flake bill uses the Social Security disability formula to calculate a worker's accrued benefits (in effect, acting as though the worker became disabled as of the date that the worker chooses the individual account option). The value of the bond is slightly reduced by using a 40-year calculation period in determining the AIME, rather than 35.
- ***Transition Financing.*** The Cato plan prescribes three measures for covering transition costs. First, the plan proposes redirecting all of the taxes on Social Security that currently fund Medicare back to the Social Security program. Second, Cato has identified $87 billion in corporate welfare that, if eliminated from the budget and saved, could be used to finance the transition. Finally, the Cato plan notes that any funds "recaptured" through corporate taxes before profits go to the investor could be used to offset the costs of the transition. The Johnson-Flake bill does not specify sources of transition financing, but indicates that general revenue transfers will pay for the transition.[11]
- ***Age of Participation.*** Under the Cato plan, workers "not currently in the labor force" must go into the new individual account system. Under the Johnson bill, workers under age 22 must go into the new individual account system.
- ***Investment Options.*** The Cato plan calls

The proposal saves taxpayers some $6.3 trillion.

Figure 1
Social Security's Payroll Tax Surplus or Deficit



Source: The 2005 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.

for a default investment option of a 60/40 stock/bond fund. The Johnson-Flake bill offers a default 65/35 stock/bond fund.

Fiscal Impact of the 6.2 Percent Solution

The fiscal impact of Cato's Social Security reform plan must be looked at in the context of Social Security's current financial status. According to the intermediate projections of Social Security's trustees, the program will begin running deficits—annual expenditures exceeding revenues—by 2017, with perpetually increasing cash shortfalls thereafter (Figure 1). Those shortfalls reach 4 percent of payroll within 30 years and rise to more than 6 percent by the end of the 75-year actuarial period. Thereafter, they continue to grow outside the actuarial window. Overall, the deficits total $12.8 trillion on a present-value basis (using a perpetuity measure).[12]

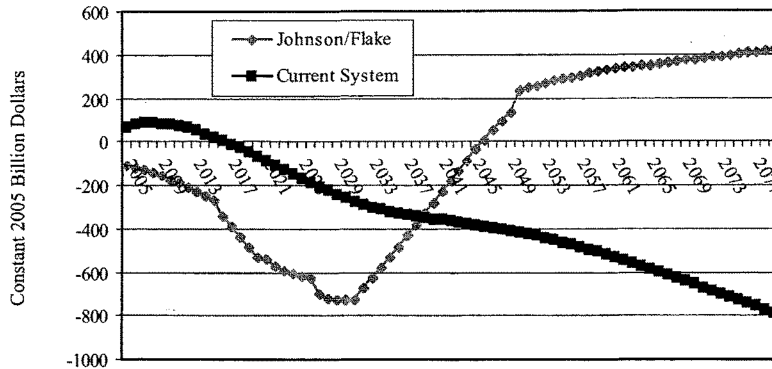
Compared to the current system, the 6.2 Percent Solution would increase cash-flow shortfalls in the short term, but after 2045, the program's cash-deficit would be eliminated and the program would begin running permanent surpluses (Figure 2). Indeed, by the end of the standard 75-year actuarial window, the system would have accumulated surpluses of $1.8 trillion.[13] Those surpluses would continue to grow outside the actuarial window. In short, under the 6.2 Percent Solution, Social Security would achieve permanent sustainable solvency. As OACT says, "The program would be expected to remain solvent throughout the 75-year projection period and for the foreseeable future beyond."[14]

Under the 6.2 Percent Solution, Social Security would achieve permanent sustainable solvency.

As calculated by OACT, the cost of moving to this system of individual accounts, commonly referred to as the transition cost, would be approximately $6.5 trillion. While at first—and even second—glance, that looks like a great deal of money, the current unfunded obligations faced by Social Security run to $12.8 trillion. In short, the 6.2 Percent Solution restores Social Security to permanent sustainable solvency—and it does so at roughly half the cost of preserving the current system. That is, the proposal saves taxpayers some $6.3 trillion.

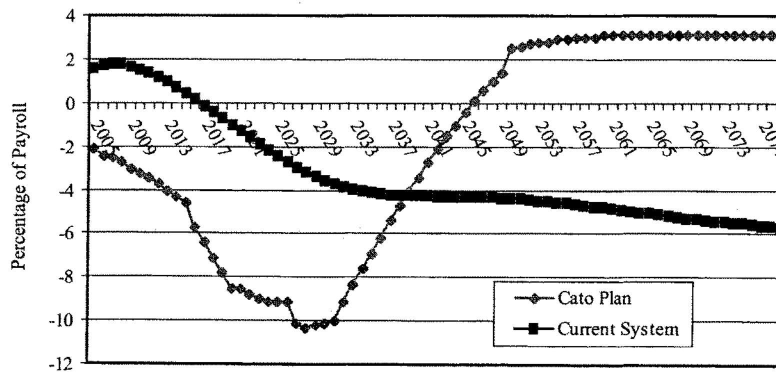
Another way to see how the proposal improves system finances is to look at the burden on future generations as measured by

Figure 2
Social Security Surplus/Deficit (in constant 2005 billions of dollars)



Source: The 2005 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds. Memorandum from Stephen C. Goss and Alice H. Wade to Representative Sam Johnson, "Estimated Long-Range OASDI Financial Effects of a Proposal for Individual Social Security Investment Program Act of 2005 (H.R. 530)," February 15, 2005.

Figure 3
Social Security Surplus/Deficit (percentage of payroll)



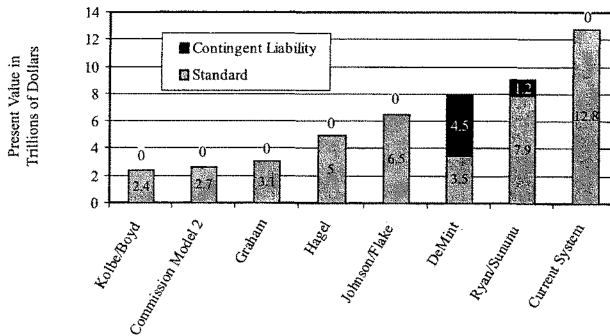
Source: The 2005 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds. Memorandum from Stephen C. Goss and Alice H. Wade to Representative Sam Johnson, "Estimated Long-Range OASDI Financial Effects of a Proposal for Individual Social Security Investment Program Act of 2005 (H.R. 530)," February 15, 2005. Memorandum from Stephen C. Goss to Representative Paul Ryan, "Estimated Financial Effects of the 'Social Security Personal Savings and Prosperity Act of 2004,'" July 19, 2004.

Funds would become available to pay back any borrowing incurred during the transition.

the level of Social Security expenditures as a percentage of payroll. As Figure 2 shows, under the current system, Social Security's burden on future taxpayers is expected to rise from its current 11.13 percent of taxable payroll to 19.08 percent by 2078, and continue to rise thereafter. However, under the proposed individual account plan, the tax burden peaks at 17.06 percent of payroll in 2028, eventually declining to just 3.11 percent, an amount necessary to continue providing survivors' and disability benefits. Because at that point Social Security's expenditures would be below anticipated revenues (continuing at 6.2 percent of payroll), funds would become available to pay back any borrowing incurred during the transition.

A further breakdown of the costs of the 6.2 Percent Solution is also informative. Roughly 62 percent of the up-front cost of the proposal is brought about not by allowing workers to redirect their payroll taxes to individual accounts, but because of the redemption of the recognition bonds.[15] In fact, it is the recogni-

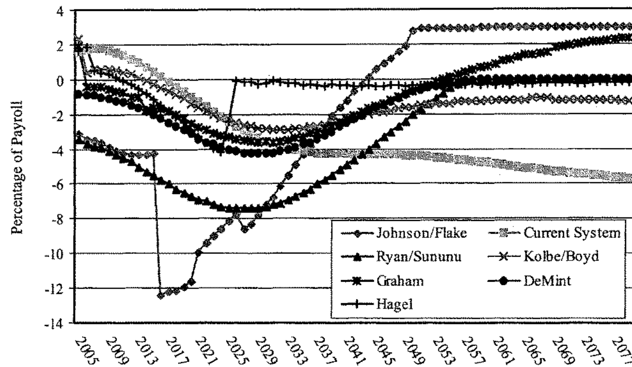
Figure 4
Net Cash Flow from the General Fund of the Treasury to OASDI Trust Funds (infinite horizon)



Source: The 2005 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds. Memorandum from Stephen C. Goss and Alice H. Wade to Representative Sam Johnson, "Estimated Long-Range OASDI Financial Effects of a Proposal for Individual Social Security Investment Program Act of 2005 (H.R. 530)," February 15, 2005. Memorandum from Stephen C. Goss to Representative Paul Ryan, "Estimated Financial Effects of the 'Social Security Personal Savings and Prosperity Act of 2004,'" July 19, 2004. Memorandum from Stephen C. Goss, Alice H. Wade, and Chris Chaplain to Representative Jim Kolbe and Representative Charles Stenholm, "Estimated OASDI Financial Effects of the 'Retirement Security Act,'" February 11, 2004. Memorandum from Chris Chaplain and Alice H. Wade to Stephen C. Goss, "Estimated OASDI Financial Effects of 'Social Security Solvency and Modernization Act of 2003' introduced by Senator Lindsey Graham," November 18, 2003. Memorandum from Stephen C. Goss to Representative Jim DeMint, "Estimated Financial Effects of H.R. 3177, the 'Social Security Savings Act of 2003,'" September 26, 2003. Memorandum from Stephen C. Goss and Alice H. Wade to Senator Chuck Hagel, "Estimated Financial Effects of 'The Saving Social Security Act of 2005,'" March 10, 2005. Memorandum from Stephen C. Goss and Alice H. Wade to Daniel Patrick Moynihan and Richard D. Parsons, "Estimates of Financial Effects for Three Models Developed by the President's Commission to Strengthen Social Security," January 31, 2002.

Note: Contingent liabilities refers to the cost of benefit guarantees if account investments underperform projections.

Figure 5
Social Security Surplus/Deficit



Source: The 2005 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds. Memorandum from Stephen C. Goss and Alice H. Wade to Representative Sam Johnson, "Estimated Long-Range OASDI Financial Effects of a Proposal for Individual Social Security Investment Program Act of 2005 (H.R. 530)," February 15, 2005. Memorandum from Stephen C. Goss to Representative Paul Ryan, "Estimated Financial Effects of the 'Social Security Personal Savings and Prosperity Act of 2004,'"July 19, 2004. Memorandum from Stephen C. Goss, Alice H. Wade, and Chris Chaplain to Representative Jim Kolbe and Representative Charles Stenholm, "Estimated OASDI Financial Effects of the 'Retirement Security Act,'" February 11, 2004. Memorandum from Chris Chaplain and Alice H. Wade to Stephen C. Goss, "Estimated OASDI Financial Effects of 'Social Security Solvency and Modernization Act of 2003' introduced by Senator Lindsey Graham," November 18, 2003. Memorandum from Stephen C. Goss to Representative Jim DeMint, "Estimated Financial Effects of H.R. 3177, the 'Social Security Savings Act of 2003,'" September 26, 2003. Memorandum from Stephen C. Goss and Alice H. Wade to Senator Chuck Hagel, "Estimated Financial Effects of 'The Saving Social Security Act of 2005,'" March 10, 2005.

tion bonds that cause the sudden large cost increase that Figure 3 shows beginning in 2018. In this context, it important to understand that recognition bonds cannot in any way be considered a new cost. They are simply the prepayment of already accrued Social Security benefits. An additional 1 percent of the cost can be attributed to providing the new minimum benefit.[16]

"More Bang for Your Buck"

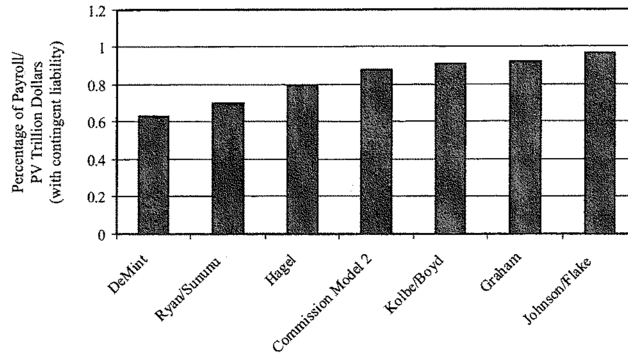
As Figure 4 shows, the 6.2 Percent Solution is less expensive than other large-account plans, especially those plans that contain significant contingent liabilities as a result of guaranteeing benefit levels. Of course, plans with smaller accounts have lower short-term costs, but over the long run the 6.2 Percent Solution achieves substantially higher savings (Figure 5).[17]

Moreover, the 6.2 Percent Solution gives workers far more ownership and control than plans with smaller individual accounts. Indeed, Figure 6 shows that measured in terms of account size per trillion dollars of transition cost, the 6.2 Percent Solution achieves the most "bang for your buck."

The size of individual accounts—the amount of payroll taxes that workers are

The 6.2 Percent Solution gives workers far more ownership and control than plans with smaller individual accounts.

Figure 6
Bang for Your Buck: Account Size Compared to General Revenue Transfers



Source: The 2005 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds. Memorandum from Stephen C. Goss and Alice H. Wade to Representative Sam Johnson, "Estimated Long-Range OASDI Financial Effects of a Proposal for Individual Social Security Investment Program Act of 2005 (H.R. 530)," February 15, 2005. Memorandum from Stephen C. Goss to Representative Paul Ryan, "Estimated Financial Effects of the 'Social Security Personal Savings and Prosperity Act of 2004,'" July 19, 2004. Memorandum from Stephen C. Goss, Alice H. Wade, and Chris Chaplain to Representative Jim Kolbe and Representative Charles Stenholm, "Estimated OASDI Financial Effects of the 'Retirement Security Act,'" February 11, 2004. Memorandum from Chris Chaplain and Alice H. Wade to Stephen C. Goss, "Estimated OASDI Financial Effects of 'Social Security Solvency and Modernization Act of 2003' introduced by Senator Lindsey Graham," November 18, 2003. Memorandum from Stephen C. Goss to Representative Jim DeMint, "Estimated Financial Effects of H.R. 3177, the 'Social Security Savings Act of 2003,'" September 26, 2003. Memorandum from Stephen C. Goss and Alice H. Wade to Senator Chuck Hagel, "Estimated Financial Effects of 'The Saving Social Security Act of 2005,'" March 10, 2005. Memorandum from Stephen C. Goss and Alice H. Wade to Daniel Patrick Moynihan and Richard D. Parsons, "Estimates of Financial Effects for Three Models Developed by the President's Commission to Strengthen Social Security," January 31, 2002.

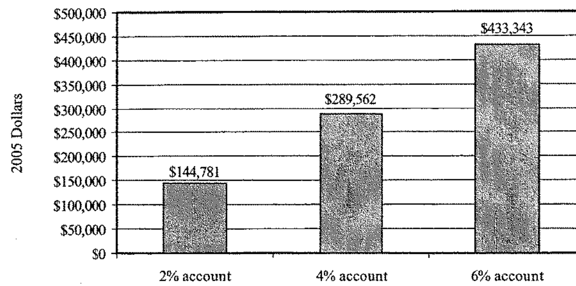
Social Security reform is about more than finances.

allowed to save and invest—is extremely important. Social Security reform is about more than finances. Indeed, if system finances were the only issue, we could simply raise taxes or cut benefits. True Social Security reform must also provide for increased rates of return and higher benefits, correct the inequities of the current system so as to treat working women, African Americans and others more fairly, and give low-income workers a greater opportunity to own and accumulate real wealth. By these measures, large accounts do a far better job of achieving true reform.

For example, increasing attention is being paid to the benefits of individual accounts as a way to give low-income workers an opportunity to build wealth. While any increase in wealth should be encouraged, we should also be honest enough to admit that for low-wage workers, very small individual accounts, such as the 2 percent of wages called for under some proposals, is simply not enough to allow for the accumulation of a real nest egg.

You can see the difference by considering the case of a 22-year-old worker earning $35,000 per year (the current median wage).

Figure 7
Individual Account Value at Normal Retirement Age for a 22-Year-Old Medium-Wage Earner (65/35 stock/bond portfolio)



Source: Cato Institute calculations.

A two percent account would allow the worker to accumulate just under $145,000 by retirement. Four percent accounts, as suggested by President Bush, would double that to nearly $290,000. However, 6.2 percent accounts would give the worker more than $433,000 (Figure 7).[18] Given that these Social Security accounts may often be the only form of savings that low-income workers have, the more they are able to save, the better.

Finally, small accounts do little to advance the fundamental goals of reducing reliance on government and giving individuals greater responsibility for and control over their lives. However, under the 6.2 percent plan, government's role would eventually be limited to providing survivors' and disability benefits and ensuring a safety net that prevents seniors from falling into poverty. The vast majority of workers would be saving for their own retirement, taking control over their own lives.

Benefits under the 6.2 Percent Solution

Opponents of individual accounts frequently suggest that the creation of such accounts would result in cuts in the promised level of Social Security benefits. In doing so, these critics are confusing changes necessary to restore the system to balance with changes resulting from individual accounts. As noted above, Social Security faces unfunded liabilities of nearly $12 trillion. Quite simply, unless there is a substantial increase in taxes, the program cannot pay the promised level of benefits.

That is not merely a matter of conjecture, but a matter of law. SSA is legally authorized to issue benefit checks only as long as there are sufficient funds available in the Social Security Trust Fund to pay those benefits. Once those funds are exhausted, in 2041 by current estimates, Social Security benefits will automatically be reduced to a level payable with existing tax revenues, approximately 74 percent of current benefit levels.[19] The gap between promised and payable benefits will continue to grow thereafter, reaching a 32 percent benefit reduction by the end of the actuarial period (Figure 8).[20]

Social Security must be restored to a sustainable level regardless of whether individual accounts are created. The proper baseline to use when discussing Social Security reform,

Small accounts do little to advance the fundamental goals of reducing reliance on government and giving individuals greater responsibility for and control over their lives.

Average-wage workers who are roughly age 45 or younger today could expect higher benefits under the 6.2 Percent Solution than Social Security would otherwise be able to pay.

therefore, is not benefits as scheduled, but the level of benefits that Social Security will actually be able to pay in the future.

As the Congressional Budget Office has put it:

> A number of recent proposals to reform Social Security call for changes in the program's benefits. The effects of those proposals are frequently illustrated by comparing the new benefits to those expected to arise under the policies put in place by current law—showing whether they would be higher or lower and by how much. However, because of scheduled changes in benefit rules, a growing economy, and improvements in life expectancy, the benefits prescribed under current law do not represent a stable baseline. Their value will vary significantly across future age cohorts. Thus, focusing on differences from current law will not fully portray the effects of proposed benefit changes.[21]

As scored by OACT, average-wage workers who are roughly age 45 or younger today could expect higher benefits under the 6.2 Percent Solution than Social Security would otherwise be able to pay. Older average-wage workers would not fare as well and presumably would not choose the individual account option, though higher-wage workers would still exceed payable benefits. Low-wage workers are a special case, since most would be covered under the new minimum benefit.

However, two assumptions that SSA uses in scoring the plan lead it to understate the proposal's benefits. First, constrained by Social Security's accounting rules, the actuaries assume that Social Security will pay full scheduled benefits until the Trust Fund is exhausted in 2042, after which benefits would be immediately reduced by 27 percent

Figure 8
Payable vs. Promised Benefits

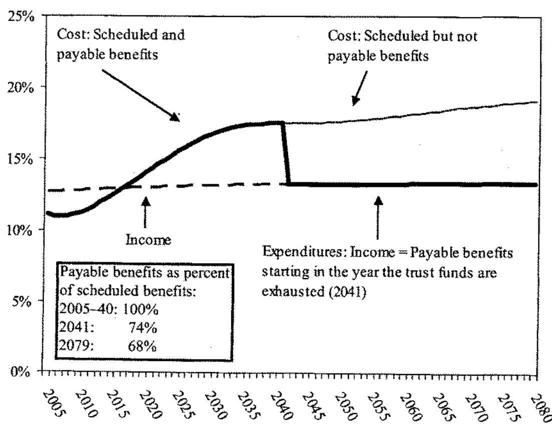
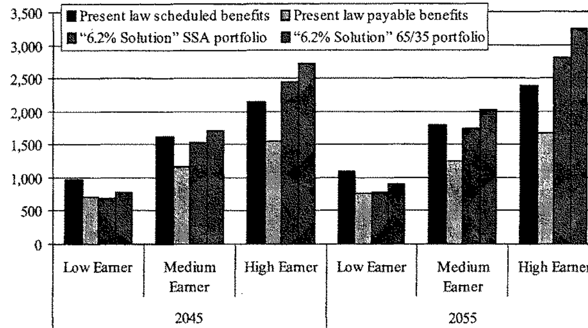


Figure 9
Monthly Retirement Benefits: Present Law vs. 6.2 Percent Solution (constant 2004 dollars)



Note: Benefits for one spouse of a two-earner couple (spouse is same age with similar earnings).

to reach payable levels. But Congress is very unlikely to allow such an abrupt benefit reduction. Changes in benefits are much more likely to be phased in slowly, meaning that the "payable" baseline would be a much earlier basis for comparison.[22]

Second, as mentioned above, SSA scores the returns from individual accounts assuming a 50/50 stock/bond portfolio mix. It does this even though the Johnson bill calls for a default portfolio of 65/35 stocks to bonds. Substantively, the SSA assumptions result in the accounts earning approximately 11 percent lower returns than if the default were used for workers retiring in 2055; that is, those who would be contributing over their entire working lifetime. For those retiring earlier, the differential would be smaller, but would still matter.

SSA assumes that workers will transfer their funds out of the default portfolio in search of less risky investment options. That is a debatable assumption. Those low- and middle-income workers most concerned about risk are also those least likely to be involved in the active management of their portfolios. It seems likely that a large percentage would leave their funds in the default portfolio out of simple inertia. Moreover, low-wage workers would be substantially protected from risk through the new minimum benefit. Indeed, many observers have criticized benefit guarantees precisely because they encourage workers to take on additional risk, creating a "moral hazard."

If benefits were scored using the default portfolio, the monthly benefit would, as noted, be about 11 percent higher than estimated by SSA, making the advantage of individual accounts over traditional Social Security even more apparent (Figure 9).

Conclusion

Cato's proposed Social Security reform, as reflected in legislation by Reps. Sam Johnson and Jeff Flake, would restore Social Security to long-term and sustainable solvency, and would do so at roughly half the cost of sim-

Cato's proposed Social Security reform would restore Social Security to long-term and sustainable solvency, and would do so at roughly half the cost of simply propping up the existing program.

This is a proposal that would give workers ownership and control over their retirement income. It is a plan that is fiscally responsible and protects future generations of workers and taxpayers.

ply propping up the existing program. But it would also do far more than that.

Younger workers who chose the individual account option could receive retirement resources substantially higher than under traditional Social Security. At the same time, it would treat women and minorities more fairly, and allow low-income workers to accumulate real wealth.

Most importantly of all, this is a proposal that would give workers ownership and control over their retirement income. It is a plan that is fiscally responsible and protects future generations of workers and taxpayers.

Notes

1. Michael Tanner, "The 6.2 Percent Solution: A Plan for Reforming Social Security," Cato Institute Social Security Paper no. 32, February 17, 2004.

2. Currently the formula for determining initial Social Security benefits is adjusted to reflect national wage growth. Because wages generally grow faster than prices, each year's retirees receive higher benefits (after adjusting for inflation) than those retiring the year before. The 6.2 Percent Solution would change the formula so that it is adjusted by prices, or inflation, instead. This means that every group of retirees would receive the same initial benefits as previous retirees, adjusted for inflation, but not the benefit increases above inflation that are currently promised.

3. HR 4895.

4. HR 530.

5. Memorandum from Stephen C. Goss and Alice H. Wade to Rep. Sam Johnson, "Estimated Long-Range OASDI Financial Effects of the Individual Social Security Investment Program Act of 2004 (HR 530)," February 15, 2005. There is a debate about whether "sustainable solvency" necessarily involves "sustainability." The latter is permanent; the former is not. However, the Cato plan generates large surpluses beyond the 75-year horizon.

6. 2005 Report of the Board of Trustees of the Federal Old Age and Survivors Insurance and Disability Insurance Trust Funds, March 2005, Tables II.C.1., p. 6, and II.D.2., p. 13; 2004 Report of the Board of Trustees of the Federal Old Age and Survivors Insurance and Disability Insurance Trust Funds, May 2005, Table II.C.1, p. 6.

7. Goss and Wade, p. 7.

8. Ibid.

9. Michael Tanner, "The Better Deal: Estimating Rates of Return under a System of Individual Accounts," Cato Institute Social Security Paper no. 31, October 28, 2003.

10. Goss and Wade, p. 6.

11. Specification of transition financing sources, while interesting and perhaps politically important, has no impact on scoring, which concerns itself only with general revenue transfers.

12. 2005 Trustees Report. This measure does not count the Social Security Trust Fund as an asset, because the Trust Fund is also a liability of the federal government.

13. Goss and Wade, p. 12.

14. Ibid., p. 1.

15. Ibid., Tables 1B, 1C.

16. Ibid., Table 1A.

17. 2005 Trustees Report; Goss and Wade; Memorandum from Stephen C. Goss to Rep. Paul Ryan, "Estimated Financial Effects of the 'Social Security Personal Savings and Prosperity Act of 2004,'" July 19, 2004. Memorandum from Stephen C. Goss, Alice H. Wade, and Chris Chaplain to Reps. Jim Kolbe and Charles Stenholm, "Estimated OASDI Financial Effects of the 'Retirement Security Act,'" February 11, 2004. Memorandum from Chris Chaplain and Alice H. Wade to Stephen C. Goss, "Estimated OASDI Financial Effects of 'Social Security Solvency and Modernization Act of 2003' introduced by Senator Lindsey Graham," November 18, 2003. Memorandum from Stephen C. Goss to Rep. Jim DeMint, "Estimated Financial Effects of H.R. 3177, the 'Social Security Savings Act of 2003,'" September 26, 2003. Memorandum from Stephen C. Goss and Alice H. Wade to Sen. Chuck Hagel, "Estimated Financial Effects of 'The Saving Social Security Act of 2005,'" March 10, 2005. Memorandum from Stephen C. Goss and Alice H. Wade to Daniel Patrick Moynihan and Richard D. Parsons, "Estimates of Financial Effects for Three Models Developed by the President's Commission to Strengthen Social Security," January 31, 2002.

18. Of course, with smaller individual account proposals workers would continue to receive benefits under the traditional Social Security system in addition to the accumulations in their individual accounts. Therefore, the disparity in monthly benefits would not be as great as implied here. However, we are talking about the amount of accumulation that would be the worker's property, and, therefore, fully inheritable. This is what

one actually thinks of when one speaks of wealth.

19. In practice, rather than reduce each check sent to beneficiaries, the Social Security Administration would stop sending out checks altogether until it accumulated sufficient funds to pay "full" benefits. When those funds are exhausted, checks would again be withheld until sufficient funds accumulate, leading to checks starting and stopping several times over the course of a year. The net effect would be that total annual benefits would be reduced by the same amount as if each month's benefits had been proportionally reduced.

20. 2005 Trustees Report, p. 8, Figure II.D2.

21. David Koitz, "Measuring Changes to Social Security Benefits," CBO Long-Range Fiscal Policy Brief no. 11, December 1, 2003.

22. The cited benefit reductions are across the board, affecting not just new retirees, but also those who have been receiving Social Security checks for some time. If Congress were to try to avoid a political outcry by limiting the cuts to new retirees, the benefit reductions would be much greater.

SOCIAL SECURITY

MEMORANDUM

Date: February 15, 2005 Refer To: TCA

To: Representative Sam Johnson

From: Stephen C. Goss, Chief Actuary
Alice H. Wade, Deputy Chief Actuary

Subject: Estimated Long-Range OASDI Financial Effects of a Proposal for Individual Social Security Investment -- **INFORMATION**

This memorandum presents long-range estimates of the financial effects of the plan you have developed for individual investment accounts that would provide retirement income under the Social Security program. This memorandum includes a description of the plan, reflecting the intent of and specifications for the plan, as provided by Kathleen Black of your staff. While the provisions of the plan described in this memorandum are consistent with the intent of your recently introduced bill *Individual Social Security Investment Program Act of 2005* (H.R. 530), some of the effective dates in the plan description below are based on your earlier bill (H.R. 4895 submitted to the 108th Congress). Some of these effective dates differ by one or two years from those now specified in HR 530. In the interest of providing timely analysis, we are providing estimates with these qualifications. The estimates should be regarded as preliminary, but provide a good indication of the nature of the plan and its potential effects. All estimates are based on the intermediate assumptions of the 2004 Trustees Report, as well as additional assumptions described below.

The plan would offer to workers under age 55 on January 1, 2005 a combination of recognition bonds based on accrued benefit obligations plus an individual account contribution of 6.2 percent of future taxable earnings redirected from the OASDI payroll tax. For those who do not choose this option, current law benefits will continue, but will be based on a price indexed benefit formula. Older workers will remain in the current program without change, and future workers will be automatically enrolled in the individual account program. A minimum benefit financed with general revenue would be available to those participating in the individual account program. In addition, disability and young survivor benefits for these participants would continue unchanged. General revenue transfers would be provided as needed to maintain trust fund solvency during the period of transition. Enactment of this plan would eliminate the Social Security long-range actuarial deficit and meet the criteria for sustainable solvency. The program would be expected to remain solvent throughout the 75-year projection period and for the foreseeable future beyond.

Estimates for this proposal reflect the development of several innovations in our methods and substantial work by Chris Chaplain, Jason Schultz, and others from the Office of the Chief Actuary. Further development and refinement of these methods will allow for improvements in the estimates in the future.

1. Description of Proposal

Individual Account (IA) Program – Participation

Beginning January 1, 2005, the proposal specifies that:

- Individuals born in 1949 and earlier (those 55 or older as of January 1, 2005) would stay in the current system and receive full scheduled benefits.
- All individuals eligible for disabled worker and young survivor benefits as of January 1, 2005 would stay in the current system and receive full scheduled benefits.
- Individuals born in years 1950 through 1982, who are not eligible for disabled worker or young survivor benefits as of January 1, 2005, would be offered the following choice:
  - **a.** Stay with the current OASDI program, subject to a CPI-indexed PIA formula starting with those eligible for benefits in 2012, or
  - **b.** Participate in the IA program. For these individuals, a recognition bond would be granted for the accrued retired worker benefit obligation earned as of January 1, 2005 and an individual account (IA) would be established, with contributions of 6.2 percent of OASDI taxable earnings starting in 2005.
- All individuals born in 1983 and later (those 21 or younger as of January 1, 2005) would participate in the IA program, with contributions of 6.2 percent of OASDI taxable earnings starting in 2005.

IA Program – Recognition bonds

Recognition bonds will be issued on January 1, 2005, for those individuals born in years 1950 through 1982 who choose to participate in the IA plan. The recognition bond will be a zero-coupon Treasury bond maturing on the date of attaining the normal retirement age (NRA)[1] for the original recipient of the bond. The redemption value of the bond at maturity will be explicitly stated on the bond in dollars. It will be calculated using the present value (discounted at the trust fund yield rate to the redemption date or NRA) of expected retired worker benefit obligations accrued prior to January 1, 2005 *assuming the worker will survive to the NRA and retire at that time*. The accrued benefit obligation would be based on a computation of the Primary Insurance Amount (PIA) that would be payable for entitlement to a disabled-worker benefit as of January 1, 2005, increased by assumed growth in the average wage thereafter up to the redemption date. To reflect the fact that the worker would have only contributed for a

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[1] The normal retirement age is the age that full benefits are payable. This age is 66 for those born in 1950 to 1954; is 66 and 2 months for those born in 1955; is 66 and 4 months for those born in 1956; is 66 and 6 months for those born in 1957; is 66 and 8 months for those born in 1958; is 66 and 10 months for those born in 1959; and is 67 for those born in 1960 and later.

portion of the potential full career as of January 1, 2005, the PIA used for computing the recognition bond value would be multiplied by:

(Worker's age at the beginning of 2005 minus 22) / 45.

The actual redemption value of the recognition bond would be set equal to the expected amount (present value as of NRA) of future retired worker benefits based on this adjusted PIA assuming the worker survives to NRA with certainty, using unisex mortality, wage and CPI increases, and trust-fund yields at the levels projected for the current Trustees Report at bond issuance.

Three specifications for the calculation of the recognition bond redemption value described above are particularly notable. First, the recognition bond value will be based on potential retired worker benefits only. Spouse, widow(er) and child benefits that may be payable based on the worker's earnings under current law would not be reflected in the recognition bond redemption value. Second, the redemption value of the recognition bonds will be fixed on January 1, 2005 assuming all workers at that time will survive to reach their NRA and receive retirement benefits starting at that time. Some workers who would receive a recognition bond in 2005 will die before attaining their NRA, but the bond will retain its full redemption value in any case. Third, the redemption value will be set in 2005 based on the then current assumptions for future wage growth and future mortality rates after reaching NRA. Actual wage growth (and interest rates) may turn out to be substantially different from what is assumed in 2005, and the life span of individuals will vary considerably. Thus, the redemption bond value will only approximate the actual value of specified benefits based on earnings prior to January 1, 2005 and the difference will vary significantly.

Recognition bonds would, upon issuance, be deposited in the worker's individual account. The recognition bond would be marketable in a regulated secondary market; the proceeds of sale of the bond would be required to be retained in the individual account. No payment would be made by the Federal Government prior to the redemption date of each bond. The value of redemption bonds in the secondary market would be determined by market forces with a full understanding that precisely the face value of the bond would be paid to the holder upon maturity. The bonds would not be indexed in any way to reflect actual wage growth, CPI changes, or interest rates between issuance and redemption.

IA Program –Financing & IA accounts

The OASDI combined payroll tax rate would remain at 12.4 percent. However, for those who choose to participate in the IA program (and all workers born after 1982), 6.2 percent of OASDI taxable earnings (the employee portion) would be deposited in an IA beginning in 2005. The portion not directed to an IA would be retained for the trust funds to cover recognition bond redemptions and OASDI benefits. Transfers from the General Fund of the Treasury would be provided to reimburse the trust funds for the cost of providing a minimum benefit (described below) starting in 2012. Additional revenue needed for the OASDI Trust Funds in the early decades after implementation would be provided in the form of transfers from the General Fund of the Treasury, on an as needed basis. The amount transferred from the General Fund of the Treasury to the OASDI Trust Funds in any year would be determined as the amount needed to

ensure that the combined trust fund assets do not at any time within the year fall below 100 percent of annual OASDI program cost.

Individual account contributions redirected for any year to the IAs of a married couple, both of whom are participating, would be combined, and then divided equally between them for deposit in their separate individual accounts. Allocations during marriage would be unaffected by divorce; divorce would terminate all connection between the future IA contributions of previously married couples.

IA accumulations are assumed to be held in accounts with record-keeping by a central administrative authority (CAA) that will offer options for investment, maintain individual records, interface with account holders, and combine assets of all accounts for the purpose of making investments with private investment companies (such as Fidelity, Vanguard, etc.). This approach is important for the purpose of keeping the cost of administering the accounts as low as possible.

The default portfolio allocation for accounts would be 60 percent in broad indexed equity funds and 40 percent in corporate bond funds. However, given the uncertainty and volatility of investments in equity and bond markets, we assume that many workers will choose an investment portfolio that is less heavily weighted toward equities (see assumptions below). A variety of index funds would be offered by the CAA with annual options by the account holder to alter the portfolio.

IA Program – IA disbursement & benefit payments

For those participating in the IA program, a minimum monthly annuity/benefit equal to a specified percent of poverty (before any reduction for retirement before normal retirement age, NRA) would apply for all workers becoming eligible for benefits after 2004. The specified percent of poverty would equal 100 percent for workers with 35 years or more of work (quarters of coverage equal to at least 3.5 times the number of elapsed years), decreasing to 0 percent for workers with 10 years of work (quarters of coverage equal to the number of elapsed years). The poverty level is that for aged individuals, increased by the CPI thereafter. The annual poverty level for aged individuals is $8,825 in 2003. This minimum guarantee, referred to as a minimum PIA, would require purchase of a CPI-indexed life annuity at retirement with all IA assets, including any recognition bond. If an individual's IA assets are not enough to provide the minimum monthly annuity/benefit, then the difference would be provided by the OASDI Trust Funds. However, the General Fund of the Treasury would reimburse the OASDI Trust Funds for the cost of this payment.

The minimum targeted life annuity is 100 percent of poverty. IA accumulations in excess of what is needed to purchase a life annuity equal to 100 percent of poverty would be available to the retiree for any desired purpose. IA contributions are accumulated tax free. Upon distribution, IA balances, including recognition bond amounts, are exempt from taxation. In addition, if at any age, the CPI-indexed life annuity that could be purchased at age 62 with the *current* assets in an individual's IA account is expected to be greater than 100 percent of poverty (assuming the IA assets were thereafter invested solely in Treasury bonds), then the individual

would no longer be required to contribute 6.2 percent of taxable earnings to the IA. At that point the individual would no longer contribute to the OASDI program, but the employer would continue to contribute 6.2 percent of the employee's taxable earnings. Self employed workers would pay one half of the tax rate. Additionally at this point in time, the individual would be required to purchase an annuity equal to 100 percent of poverty or to invest the cost of this level annuity in a fixed-income portfolio of assets, i.e. bonds.

For those in the IA plan, present law scheduled disabled worker benefits would be payable up to NRA, with the minimum PIA applying to those who become eligible for benefits in 2012 and later. Auxiliary benefits to children and spouses with child in care would be paid on the account of a disabled worker. Young survivor benefits (child and spouse with child in care) would also be payable based on present law scheduled benefits, with the minimum PIA applying for those who become eligible for benefits in 2012 and later. However, no spouse or non-disabled child benefits would be payable on the accounts of retired worker beneficiaries or accounts of deceased workers (except for the young survivor benefits mentioned above).

At attainment of NRA, disabled worker beneficiaries would convert to retired worker status. Those participating in the IA plan would then be required to purchase a CPI-indexed life annuity not less than the value of the continuation of the disabled-worker benefit (disability benefit prior to conversion with cost-of-living adjustment). If the individual's IA accumulations, including any recognition bond, are insufficient for the purpose, then the OASDI Trust Funds would provide the difference. The OASDI Trust Funds would be reimbursed from the General Fund of the Treasury for the portion of any individual's benefit attributed to providing the minimum PIA.

IA accumulations including any recognition bonds are transferred to the individual account of the surviving spouse (if any) upon death of a worker. A portion of this transfer will be reserved to pay for any potential young survivor benefits. If there is no surviving spouse, then the IA accumulation, less any reserve for potential child survivor benefits, goes to the worker's estate.

CPI-indexed life annuities purchased with IA accumulations (including recognition bonds) are assumed to be provided through the CAA.

Individuals not in the IA program

All individuals born in 1949 and earlier (those 55 or older as of January 1, 2005), as well as those currently entitled to disabled worker or young survivor benefits on January 1, 2005, would remain in the current OASDI program and receive full scheduled benefits in current law. For those individuals born in 1950 through 1982 who remain in the current OASDI program (do not choose to participate in the IA program), all benefit payments (including disability and young survivors) would be subject to a CPI-indexed PIA formula starting for those eligible for benefits in 2012. The benefit formula would modify the primary insurance amount (PIA) formula factors (90, 32, and 15) starting in 2012, reducing them successively by the measured real wage growth in the second prior year. Modified PIA factors would be applicable for OASDI beneficiaries becoming eligible for benefits in 2012 and later. This provision would result in increasing benefit levels for individuals with equivalent lifetime earnings across generations (relative to the average wage level) at the rate of price growth (increase in the CPI), rather than at

the rate of growth in the average wage level as in current law. Calculation of the average indexed monthly earnings (AIME) used in computing the PIA would be unaffected by this provision. In addition, the minimum PIA would not apply to these individuals.

2. Assumptions Used for Financial Estimates

The estimates presented in this memorandum are based on the intermediate assumptions of the 2004 Trustees Report plus several additional assumptions relating to specific provisions of this proposal.

Participation in the Individual Account Program

Workers who are at ages 22 through 54 and are not disabled on January 1, 2005 will have the option of choosing to participate in the individual-account/recognition-bond plan. The default option is to remain in the current OASDI program. For the oldest of these workers, most will receive more total benefits from staying in the current system than from switching to the IA plan. This is particularly true for those who are in good health and have potential family members who may become eligible for an auxiliary benefit based on the workers earnings record. The recognition bond reflects an expected accrued benefit for the worker only after reaching NRA and does not include any amount corresponding to potential auxiliary benefits. Moreover, the recognition bond amount is computed with a factor to diminish the normal PIA computation by approximately 11 percent to recognize a longer potential work history than under the current system. Thus, even workers with no family members who are relatively healthy (as will be most of this group as the disabled are not included) and relatively old would expect more benefits from the current system for past contributions than from the recognition bonds.

These factors suggest that workers at age 54 on January 1, 2005 will be relatively unlikely to select the IA/recognition-bond option. We assume that 10 percent of those at this age will opt for the IA plan. For younger workers, however, recognition bonds will represent a smaller and smaller portion of their expected future benefit; the CPI-indexed benefit formula will present a smaller and smaller potential benefit from the current system; and potential IA contributions will have longer and longer to accumulate. Thus, we assume that younger workers will be increasingly likely to opt for the IA plan and that 100 percent participation will occur for those under age 41 on January 1, 2005. Participation rates for workers between ages 40 and 54 are assumed to be decline linearly from 100 to 10 percent.

Individual Account Investments

As indicated above, the default portfolio allocation for individual accounts would be 60 percent in broad indexed equity funds and 40 percent in corporate bond funds. However, given the uncertainty and volatility of investments in equity and bond markets, we assume that many workers will choose an investment portfolio that is less heavily weighted toward equities.

This proposal would replace retirement and aged survivor benefits from the current system completely with the IA and recognition bond accumulations. For many workers this account will represent their primary or only potential source of income in retirement. As a result we expect that workers participating in the IA plan will invest somewhat more conservatively on average than indicated in the default portfolio. We assume that the average portfolio will be 50 percent in equity funds, 30 percent in corporate bond funds, and 20 percent in government (Treasury) bonds. Due to the relatively large size of IAs under this proposal and the specification that accounts and annuities will be managed through a central administrative authority, we assume that administrative expenses will be relatively low, ultimately averaging about 0.25 percent of assets per year. The *"expected"* average annual real yield on IA investments before retirement is assumed to be 4.65 percent (6.5 X 0.5 + 3.5 X 0.3 + 3.0 X 0.2 – 0.25).

Note that for estimates reflecting a *low-yield* assumption we assume that all investments will have an average real yield equal to that expected for long-term treasury bonds, or 3 percent in real terms. Therefore, the assumed net real yield after administrative expenses would be 2.75 percent. These estimates provide projections on a *"risk-adjusted"* basis. Risk-adjusted returns omit any expected return in excess of that for Treasury bonds, because the excess reflects the premium demanded by the market for taking on the increased volatility associated with equities and corporate bonds.

CPI-indexed life annuities purchased from the central administrative authority are assumed to provide an average annual expected real return of 3 percent net of administrative expenses. For the low yield assumption, the net real yield is assumed to be 2.75 percent. For the purpose of illustrations of individual account and annuity assets in this memorandum, we assume that all IA assets will be used to purchase annuities. While the proposal allows for much of the account to be disbursed in other ways for many workers, this variation would not affect the financial estimates presented in this memorandum.

Future returns on IA assets will vary considerably depending both on individual portfolio choices and variation in future returns on specific investments. The average annual real return on long term Treasury bonds is assumed to be 3 percent, consistent with the 2004 Trustees Report. Corporate bonds are assumed to have an average real yield that is about 3.5 percent.

The expected long-term ultimate average annual real yield for equities is assumed to be 6.5 percent. This is somewhat lower than the historical real equity yield over the last several decades. A consensus exists among economists that equity pricing, as indicated by price-to-earnings ratios, may average somewhat higher in the long-term future than in the long-term past. This is consistent with broader access to equity markets and the belief that equities may be viewed as somewhat less "risky" in the future than in the past. Equity pricing will vary in the future as in the past. Price-to-earnings ratios were very high through 1999, and are now lower. The average ultimate real equity yield assumed for estimates in this memorandum is consistent with an average ultimate level of equity pricing somewhat above the average level of the past.

The assumption for an ultimate real equity yield of 7 percent that was used by the Office of the Chief Actuary until 2001 was developed in 1995 with the 1994-6 Advisory Council. At that time, the Trustees assumption for the ultimate average real yield on long-term Treasury bonds

was 2.3 percent. Real yields on corporate bonds are believed to bear a close relationship to Treasury bond yields of similar duration. The 2004 Trustees Report includes the assumption that the ultimate real yield on long-term Treasury bonds will average 3 percent, or 0.7 percentage point higher than assumed in 1995. This increase in the assumed bond yield is consistent with a reduction in the perceived risk associated with equity investments.

It should be noted that the precise effects on the yields of equities and corporate bonds is not clear when implementing a plan that would result in a large demand for these securities. This demand would likely be at least partially offset by reductions in demand for other investment mechanisms. For the purpose of these estimates, it is assumed that there will be no net dynamic feedback effects on the economy or on the financial markets.

3. Benefit Levels under the Proposal

Tables B1 and B2 show projected potential benefits under the proposal for two-earner and one-earner married couples, respectively. While a range of potential benefit levels is shown, actual investment returns and total benefit levels could vary considerably, reaching levels both well above and below the range presented.

Table B1 presents monthly benefit levels for one spouse of a two-earner couple. Table B2, however, presents monthly benefit levels for the total married one-earner couple. Effects for single workers (never married) would be more similar to those of the two–earner couples. Potential benefits include both OASDI benefit payments and potential annuity payments based on IA accumulations (including recognition bond values). For these illustrations, it is assumed that workers will retain their recognition bonds essentially until maturity, although some may be expected to sell the bonds on a secondary market even at a relatively young age and invest the proceeds in some other financial security. For simplicity, recognition bonds are assumed to be available for annuitization at age 65. In fact this would be possible by selling the bonds on the secondary market.

Benefits are illustrated for workers retiring at age 65 with various lifetime earnings patterns. These patterns include average career indexed earnings at about 45 percent of the level of the SSA economy wide average wage for the scaled low earner, 100 percent of this level for the scaled medium earner, 160 percent for the scaled high earner, and earnings steadily at the level of the OASDI taxable maximum for the maximum earner[2].

The first three columns provide projected benefits scheduled under current law (column 1), payable under current law (column 2), and scheduled under the proposal for those who do not participate in the IA plan (column 3). In 2045, the CPI-indexed benefit under the proposal for non-IA participants would be close to the level payable under current law for two-earner couples.

[2] Actuarial note 2004.3 provides details about the calculation of the scaled earner factors. Actuarial note 2004.3 is located at the following internet site: http://www.ssa.gov/OACT/NOTES/ran3/an2004-3.pdf.

The next 5 columns develop the expected total retirement payment under the proposal prior to application of the guaranteed minimum for those in the IA plan. The projected annuity based on the recognition bond would be progressively smaller for subsequent generations who would have had fewer potential work years prior to 2005. Potential IA annuities assuming full annuitization are shown with both an IA accumulation at a low (risk-adjusted) yield and the expected yield for the expected average portfolio. These amounts are summed to show total payments prior to application of the minimum benefit under both investment return assumptions.

The final three columns show the available minimum benefit payment (100 percent of poverty), and the total potential payments under the proposal expressed as a percentage of the current-law scheduled benefit level. For the scaled low earner, the proposal minimum benefit would be expected to provide an increment for retirees at age 65 through 2035. Proposal expected total benefits for the scaled low two-earner couple would decline from 94 percent of current-law scheduled benefits for those retiring at age 65 in 2015, to 72 percent for those retiring at age 65 in 2055. For the low-earner one-earner couple, proposal expected benefits would decline from 90 to 66 percent of the present-law scheduled level.

Medium and higher two-earner couples with expected IA returns would fall short of the CPI-indexed PIA initially, but would exceed that level starting with those retiring in 2035. Older workers would be expected to strongly consider staying in the current program, consistent with our assumption of low participation by the older eligible workers.

While benefits for a scaled medium earner who experienced the low yields consistent with risk adjusted returns would fare little if any better than the CPI-indexed alternative benefit, the scaled high earner retiring in 2045 and later and experiencing the low yields would beat the CPI-indexed benefit. In addition, by 2055 the maximum earner retiree would even beat the present-law scheduled benefit.

Table B2 shows that benefit levels for the one-earner couple would be considerably lower than those for the two earner couple. Only for the one-earner steady maximum couple retiring at 65 in 2055 would expected returns exceed the present-law scheduled benefit.

4. Financial Effects of the Proposal

Tables 1, 1a, 1b, 1b.c, 1c, and 1d illustrate the expected financial implications of enactment of the proposal under the assumptions described above. These effects are described briefly below. Additional tables 2, 2a, 2b, 2b.c, 2c, and 2d provide similar estimates using the low-yield (risk-adjusted) returns on individual account assets described above.

The proposal would replace OASDI retirement and aged survivor benefits with an individual account that would be financed with one half of the payroll tax rate (6.2 percent). This change would apply to all workers under age 22 on January 1, 2005, and to others under age 55 on that date who choose to accept a recognition bond in place of the benefit obligation based on past contributions. Disability and young survivor benefits would be retained as in current law through the normal retirement age. A minimum benefit (PIA) guarantee equal to a specified

percent of the poverty level (100 percent for those with at least 35 years of work) would be financed through reimbursements from the General Fund of the Treasury. Those, who do not choose to participate in the IA program, would remain in the current program and be subject to a CPI-indexed PIA formula that provides slower growth in benefits across generations than does the current wage-indexed benefit formula.

Cash Flow and Solvency

In part because the recognition bonds for voluntary participants would mature on the date each worker would attain their normal retirement age, substantial general revenue transfers would be needed to maintain solvency of the OASDI Trust Fund. Table 1 indicates that transfers are expected to be needed from 2013 through 2045, peaking at 9.7 percent of payroll in 2028, and totaling $6.8 trillion in present value (see table 1a.)

After 2045, the OASDI program would be expected to operate with substantial annual positive cash flow (see annual balance on table 1 and the first four columns of table 1c). Table 1 shows that the OASDI Trust Fund would grow at an increasing rate as a percentage of annual program cost after 2045. The large and rising trust fund ratios[3] reflect both the small residual amount of payments made from the OASDI program, and the increasing size of trust fund assets. The OASDI program would clearly satisfy the criteria for sustainable solvency under the proposal.

Relative to current law, net cash flow from the OASDI Trust Fund to the General Fund of the Treasury would be substantially diminished through 2038. After 2038, however, cash flow from the trust funds to the Treasury would be increased over the current program modified to permit borrowing.[4] The proposal is expected to produce positive cash flow from the trust funds beginning 2046.

Total System Assets

Table 1a provides estimates of expected OASDI Trust Fund assets under the proposal in column 5, and estimated individual account (and annuity) assets in column 6. All IA assets are assumed to be fully annuitized in a CPI-indexed life annuity for the purpose of these illustrations. For the purpose of these illustrations, married individuals are assumed to choose a joint & 2/3 survivor annuity[5]. The sum of these amounts may be referred to as total system assets under this proposal. By 2078, expected total system assets are expected to reach over $70 trillion in constant 2004 dollars, or more than double the size of the OASDI Trust Fund ($27 trillion), if all transfers expected under the proposal were provided to current OASDI program (see column 9).

Table 2a, with low-yield assumptions (risk-adjusted) shows that total system assets under the proposal would be over $50 trillion. This amount is still higher than the assets under the current

[3] The trust fund ratio for a year is calculated as (1) the level of assets at the beginning of the year divided by (2) program cost during the year, excluding recognition bonds.
[4] Without this modification to permit borrowing, the current program would presumably operate with reduced benefits based on available tax revenue after the OASDI Trust Funds exhaust in 2042.
[5] Two-thirds of the benefit level continues to the survivor.

OASDI program with the same general revenue transfers as under the proposal ($28 trillion). This is because of the gradual reduction and eventual elimination under the proposal of retirement benefits other than the individual account annuities.

Recognition Bonds and Effects on the Unified Budget

Tables 1b, 1b.c, 2b, and 2b.c show expected effects on the unified budget of the Federal Government from enactment of this proposal. It should be noted that these effects are not comparable to the effects that would be estimated by the Office of Management and Budget (OMB) and the Congressional Budget Office (CBO), at least in part because the Trustees assumptions used for estimates presented here differ from those of OMB and CBO.

Column 1 shows the projected IA contributions redirected from the trust funds starting in 2005. These contributions, along with distributions upon maturity of recognition bonds starting in 2016 (column 2) represent increased expenditures from the unified budget. Generally lower benefit payments from the OASDI program are reflected in column 3 and would be reductions in expenditures. These changes are combined to produce the net change in unified budget annual cash flow in column 4.

The implications for the size of the federal debt held by the public are shown in column 5. Debt would be increased substantially through the 75-year period, but the increment would be decreasing toward the end of the period.

The net effect on annual unified budget balances, including the debt service from prior year effects on cash flow, is shown in column 6. Negative effects on unified budget balances would gradually decline and reverse to positive changes starting in 2070 under the expected yield scenario and starting in 2072 under the low yield scenario.

Change in Long-Range Trust Fund Assets/Unfunded Obligation

Tables 1d and 2d provide estimates of the amount of assets in the combined OASI and DI Trust Funds at the end of each year, in present discounted value. Negative values do not indicate levels of trust fund assets as the program does not have borrowing authority. Instead, negative values reflect the magnitude of the unfunded obligation of the program through the end of the year. The first column presents these estimates under present law, where the unfunded obligation is $3.7 trillion through 2078, the end of the 75-year long-range period.

Columns 2 through 5 show the annual effects of the components of the proposal that move the OASDI program to elimination of the unfunded obligation. These include:

- The change in the OASDI basic benefits,
- IA contributions redirected from the trust funds to the individual accounts,
- Recognition bond payments from the trust funds to the individual accounts, and
- General Fund transfers needed to reimburse the trust funds for providing the minimum benefit level and to maintain solvency in 2013 through 2045.

The combination of the annual effects in columns 2 through 5 is accumulated in column 6, showing effect on projected trust fund assets, or on the unfunded obligation, through the end of each year. Column 7 shows the resulting trust fund asset levels projected under the proposal. The overall effect of the proposal is to transform the projected $3.7 trillion long-range unfunded obligation for the program under current law into an expected positive trust fund balance of $1.8 trillion at the end of the period.

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Table 1 Johnson Proposal: IA for <55 on 1-1-2005. RB for 21-54 on 1-1-2005

Phased Participation | Ult Real TF Int Rate of 3.00 | Individual Account Contribution Rate: 6.2% | Benefit Offset: 0.0%
No Taxation | Ult Real IA Yld Rate of 4.65
of RB or IA | Annuity Net Real Yld Rate of 3.00
Distributions

Year	Cost Rate	Income Rate	Annual Balance	TFR[1] 1-1-yr	General Revenue Reimbursement for Minimum Benefit	"Effective" Change in OASDI Contribution Rate	"Effective" OASDI Contribution Rate	General Revenue Transfer Solvency	Individual Account Contribution Rate
2004	11.07	12.71	1.64	306			12.40		0.00
2005	10.87	8.72	-2.15	325	0.00	-4.005	8.40		4.00
2006	10.77	8.36	-2.41	310	0.00	-0.373	8.02		4.38
2007	10.75	8.23	-2.51	290	0.00	-0.142	7.88		4.52
2008	10.80	8.14	-2.65	267	0.00	-0.127	7.75		4.65
2009	10.95	8.01	-2.94	241	0.00	-0.125	7.63		4.77
2010	11.08	7.91	-3.18	214	0.00	-0.122	7.51		4.89
2011	11.25	7.83	-3.41	184	0.00	-0.126	7.38		5.02
2012	11.43	7.75	-3.68	154	0.00	-0.110	7.27		5.13
2013	11.67	9.18	-2.50	121	0.00	1.403	8.67	1.5	5.23
2014	11.89	11.98	0.09	100	0.00	2.787	11.46	4.4	5.34
2015	12.12	12.21	0.08	100	0.01	0.212	11.67	4.7	5.43
2016	13.12	13.03	-0.09	100	0.01	0.809	12.48	5.6	5.53
2017	13.77	13.65	-0 12	100	0.01	0.618	13.10	6.3	5.61
2018	14.41	14.28	-0.13	100	0.01	0.624	13.72	7.0	5.69
2019	15.03	14.82	-0.21	100	0.01	0.537	14.26	7.6	5.75
2020	15.59	15.36	-0.23	100	0.01	0.541	14.80	8.2	5.81
2021	15.54	15.25	-0.30	100	0.02	-0.121	14.68	8.1	5.88
2022	15.80	15.45	-0.36	100	0.02	0.207	14.89	8.4	5.93
2023	16.00	15.60	-0.40	100	0.02	0.157	15.04	8.6	5.97
2024	16.06	15.65	-0.40	100	0.02	0.061	15.10	8.7	6.02
2025	16.02	15.61	-0.41	100	0.02	-0.029	15.08	8.7	6.05
2026	15.98	15.37	-0.61	100	0.02	-0.229	14.85	8.5	6.08
2027	16.94	16.43	-0.51	100	0.03	1.077	15.92	9.6	6.10
2028	17.06	16.49	-0.56	100	0.03	0 083	16.01	9.7	6.12
2029	16.95	16.36	-0.59	100	0.03	-0.114	15 89	9.6	6.14
2030	16.74	16.13	-0.61	100	0.03	-0.210	15.68	9.4	6.15
2031	16.63	16.00	-0.63	100	0.03	-0.108	15.58	9.3	6.16
2032	15.74	15.17	-0.57	100	0.03	-0.805	14.77	8.5	6.16
2033	14.95	14.45	-0.50	100	0.04	-0.704	14.07	7.8	6.17
2034	14.15	13.63	-0.53	100	0.04	-0.804	13.26	7.0	6.17
2035	13.41	12.90	-0.51	100	0.04	-0.704	12.56	6.3	6.18
2036	12.69	12.18	-0.51	100	0.04	-0.706	11.85	5.6	6.19
2037	11.94	11.45	-0.49	100	0.04	-0.705	11.15	4.9	6.19
2038	11.22	10.83	-0.39	100	0.04	-0.605	10.54	4.3	6.20
2039	10.50	10.04	-0.45	100	0.04	-0.769	9.77	3.5	6.20
2040	9.81	9.43	-0.38	100	0.04	-0.599	9.17	2.9	6.20
2041	9.14	8.81	-0.33	100	0.04	-0.600	8.57	2.3	6.20
2042	8.50	8.17	-0.34	100	0.04	-0.630	7.94	1.7	6.20
2043	7.92	7.58	-0.34	100	0.05	-0.570	7.38	1.1	6.20
2044	7.36	6.96	-0.41	100	0.05	-0.610	6.77	0.5	6.20
2045	6.74	6.47	-0.27	100	0.05	-0.470	6.30	0.1	6.20
2046	6.23	6.41	0.18	100	0.05	-0.050	6.25		6.20
2047	5.75	6.40	0.66	109	0.04	0.000	6.24		6.20
2048	5.30	6.39	1.09	130	0.04	0.000	6.24		6.20
2049	4.89	6.39	1.50	163	0.04	-0.001	6.24		6.20
2050	3.85	6.38	2.54	209	0.04	-0.001	6.24		6.20
2051	3.73	6.38	2.64	286	0.04	-0.001	6.24		6.20
2052	3.64	6.37	2.73	369	0.04	-0.001	6.24		6.20
2053	3.56	6.36	2.81	460	0.04	-0.001	6.24		6.20
2054	3.49	6.36	2.87	556	0.04	-0.001	6.24		6.20
2055	3.43	6.36	2.92	657	0.04	-0.001	6.24		6.20
2056	3.38	6.35	2.97	763	0.04	-0.001	6.24		6.20
2057	3.34	6.35	3.01	873	0.04	-0.001	6.24		6.20
2058	3.30	6.35	3.04	987	0.04	-0.001	6.24		6.20
2059	3.27	6.34	3.07	1,105	0.03	-0.001	6.23		6.20
2060	3.22	6.34	3.12	1,235	0.03	-0.001	6.23		6.20
2061	3.21	6.34	3.13	1,355	0.03	-0.001	6.23		6.20
2062	3.21	6.34	3.13	1,476	0.03	-0.001	6.23		6.20
2063	3.20	6.34	3.13	1,599	0.03	-0.001	6.23		6.20
2064	3.20	6.33	3.13	1,722	0.03	-0.001	6.23		6.20
2065	3.20	6.33	3.13	1,847	0.03	-0.001	6.23		6.20
2066	3.20	6.33	3.13	1,975	0.03	-0.001	6.23		6.20
2067	3.20	6.33	3.13	2,106	0.03	-0.001	6.23		6.20
2068	3.19	6.33	3.14	2,242	0.02	-0.001	6.22		6.20
2069	3.19	6.33	3.14	2,378	0.02	-0.001	6.22		6.20
2070	3.19	6.33	3.14	2,514	0.02	-0.001	6.22		6.20
2071	3.19	6.33	3.13	2,652	0.02	-0.001	6.22		6.20
2072	3.19	6.33	3.13	2,792	0.02	-0.001	6.22		6.20
2073	3.20	6.32	3.13	2,934	0.02	-0.001	6.22		6.20
2074	3.20	6.32	3.13	3,077	0.02	-0.001	6.22		6.20
2075	3.20	6.32	3.12	3,223	0.02	-0.001	6.22		6.20
2076	3.20	6.32	3.12	3,371	0.02	-0.001	6.22		6.20
2077	3.20	6.32	3.12	3,522	0.02	-0.001	6.22		6.20
2078	3.21	6.32	3.11	3,676	0.02	-0.001	6.22		6.20
2079	3.21	6.32	3.11	3,832	0.01	-0.001	6.21		6 20

	Summarized OASDI			
	Cost Rate	Income Rate	Actuarial Balance	Change in Actuarial Balance
2004 - 2078	10.15	10.99	0.84	2.73

[1]TFR computed as TF assets divided by annual cost excluding RB payments

Based on Intermediate Assumptions of the 2004 Trustees Report With Ultimate Real Trust Fund Interest Rate of 3.00

Office of the Actuary
Social Security Administration
February 11, 2005

Table 1a Proposal GF Transfers, OASDI Trust Fund Assets, Individual Account Assets, and Theoretical OASDI Assets

Calendar Year	Proposal General Fund Transfer(GF)/Reimburse: Transfers for Solvency (1)	Reimburse Minimum Benefit (2)	Total in Constant 2004$ (3)	Accumulated as of End of Year (4)	Total OASDI Trust Fund Assets at End of Year (5)	Expected Individual Account Assets[1] at End of Year (6)	GDP (7)	Theoretical Social Security[2] with Borrowing Authority: Net OASDI TF Assets End of Year: Without GF Transfer (8)	With GF Transfer (amount for Prop) (9)
	Billions PV as of 1-1-2004		Billions of Constant 2004$		Billions of Constant 2004 Dollars				
2004	0.0	0.0	0.0	0	1,684	0	11,544	1,684	1,684
2005	0.0	0.0	0.0	0	1,647	195	11,911	1,840	1,840
2006	0.0	0.0	0.0	0	1,581	423	12,246	1,998	1,998
2007	0.0	0.0	0.0	0	1,498	673	12,562	2,156	2,156
2008	0.0	0.0	0.0	0	1,399	943	12,870	2,315	2,315
2009	0.0	0.0	0.0	0	1,279	1,237	13,171	2,473	2,473
2010	0.0	0.0	0.0	0	1,141	1,555	13,466	2,631	2,631
2011	0.0	0.0	0.0	0	983	1,899	13,752	2,790	2,790
2012	0 0	0.0	0 0	0	804	2,266	14,024	2,944	2,944
2013	62.0	0.1	82.9	83	684	2,656	14,285	3,091	3,174
2014	179.9	0.1	247.1	332	708	3,072	14,547	3,230	3,563
2015	189.8	0.2	268.3	610	732	3,514	14,804	3,360	3,970
2016	223.3	0.3	324.7	952	747	3,983	15,061	3,478	4,431
2017	247.8	0.4	371.0	1,351	761	4,479	15,322	3,584	4,935
2018	271.5	0.4	418.7	1,810	775	5,003	15,586	3,675	5,486
2019	290.4	0.5	461.3	2,326	785	5,552	15,842	3,750	6,076
2020	308.6	0.5	505 0	2,901	793	6,128	16,100	3,805	6,706
2021	301.6	0 6	508.4	3,496	797	6,730	16,354	3,841	7,337
2022	306.4	0.6	532.0	4,133	797	7,357	16,610	3,857	7,990
2023	308.6	0.7	552.0	4,809	794	8,010	16,861	3,851	8,660
2024	307.1	0.7	565.9	5,519	790	8,689	17,117	3,823	9,342
2025	302.1	0.8	573.5	6,258	786	9,392	17,372	3,773	10,031
2026	290.3	0.8	567.9	7,014	766	10,119	17,634	3,700	10,714
2027	322.6	0.9	649.9	7,874	753	10,871	17,903	3,604	11,478
2028	320.7	0.9	665.4	8,776	736	11,647	18,174	3,486	12,262
2029	312.2	1.0	667.5	9,707	715	12,446	18,451	3,346	13,053
2030	300.8	1.0	662.6	10,661	691	13,267	18,733	3,184	13,845
2031	292.9	1.0	664.6	11,645	666	14,110	19,022	3,000	14,646
2032	263.5	1.1	616.1	12,611	643	14,974	19,319	2,796	15,406
2033	237.9	1.1	573.5	13,562	624	15,859	19,622	2,570	16,133
2034	210.2	1.1	522.2	14,491	601	16,764	19,929	2,325	16,817
2035	186.2	1.1	476.9	15,403	579	17,687	20,243	2,062	17,465
2036	163.0	1.2	430.3	16,295	556	18,629	20,564	1,780	18,075
2037	140.4	1.2	382.3	17,166	532	19,588	20,892	1,481	18,647
2038	121.3	1.2	340.7	18,022	516	20,562	21,226	1,165	19,187
2039	98.1	1.2	284.3	18,847	493	21,551	21,562	833	19,680
2040	80.1	1.2	239.9	19,652	475	22,552	21,904	485	20,137
2041	62.7	1.2	194.3	20,436	461	23,564	22,252	120	20,556
2042	45.1	1.2	144.8	21,194	445	24,585	22,605	-262	20,932
2043	29.5	1.2	98.9	21,929	428	25,613	22,961	-662	21,267
2044	13.4	1.2	48.2	22,635	405	26,647	23,322	-1,080	21,555
2045	1.3	1.1	8.2	23,322	392	27,682	23,687	-1,516	21,806
2046	0.0	1.1	4.0	24,026	419	28,719	24,055	-1,972	22,053
2047	0.0	1.1	4.0	24,751	491	29,755	24,426	-2,449	22,302
2048	0.0	1.1	4.0	25,497	606	30,788	24,799	-2,946	22,551
2049	0.0	1.0	4.0	26,266	763	31,812	25,174	-3,465	22,801
2050	0.0	1.0	4.0	27,058	1,027	32,822	25,552	-4,008	23,050
2051	0.0	1.0	4.0	27,874	1,311	33,817	25,936	-4,577	23,297
2052	0.0	0.9	4.0	28,714	1,616	34,797	26,324	-5,172	23,542
2053	0.0	0.9	3.9	29,579	1,941	35,768	26,721	-5,795	23,785
2054	0.0	0.9	3.9	30,470	2,286	36,730	27,123	-6,447	24,024
2055	0.0	0 8	3.8	31,388	2,651	37,683	27,528	-7,130	24,259
2056	0.0	0.8	3.8	32,334	3,035	38,625	27,939	-7,845	24,489
2057	0.0	0.8	3.7	33,308	3,438	39,556	28,354	-8,594	24,714
2058	0.0	0.7	3.7	34,311	3,862	40,476	28,775	-9,378	24,933
2059	0.0	0.7	3.6	35,343	4,305	41,383	29,204	-10,196	25,147
2060	0.0	0.7	3.5	36,407	4,771	42,279	29,639	-11,052	25,355
2061	0.0	0.6	3.5	37,503	5,256	43,162	30,078	-11,946	25,557
2062	0.0	0.6	3.4	38,631	5,760	44,032	30,526	-12,880	25,751
2063	0.0	0.6	3.3	39,794	6,285	44,890	30,978	-13,857	25,937
2064	0.0	0.5	3.2	40,991	6,829	45,736	31,438	-14,876	26,114
2065	0.0	0.5	3.1	42,224	7,394	46,570	31,906	-15,940	26,283
2066	0.0	0.5	3.0	43,493	7,981	47,431	32,379	-17,050	26,443
2067	0.0	0.5	3.0	44,801	8,590	48,284	32,861	-18,208	26,594
2068	0.0	0.4	2.9	46,148	9,224	49,127	33,359	-19,414	26,734
2069	0.0	0.4	2.8	47,535	9,881	49,962	33,859	-20,670	26,865
2070	0.0	0 4	2.7	48,964	10,563	50,790	34,366	-21,978	26,986
2071	0.0	0.4	2.6	50,435	11,270	51,612	34,882	-23,340	27,096
2072	0.0	0.3	2 5	51,951	12,003	52,427	35,404	-24,756	27,195
2073	0.0	0 3	2.4	53,512	12,762	53,238	35,931	-26,230	27,282
2074	0.0	0.3	2.3	55,120	13,550	54,044	36,464	-27,762	27,357
2075	0.0	0.3	2.2	56,775	14,365	54,848	37,006	-29,356	27,419
2076	0.0	0.3	2.2	58,481	15,210	55,649	37,555	-31,014	27,467
2077	0.0	0.2	2.1	60,237	16,086	56,450	38,112	-32,736	27,501
2078	0.0	0.2	2.0	62,047	16,993	57,249	38,677	-34,527	27,520
2079	0.0	0.2	1.9	63,910	17,932	58,049	39,245	-36,387	27,523
Total 2004-78	6,791.1	48.4							

Based on Intermediate Assumptions of the 2004 Trustees Report

[1] Including annuity assets, assuming all annuitize fully.

[2] Theoretical Social Security is the current Social Security program with the assumption that the law is modified to permit borrowing from the General Fund of the Treasury.

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Table 1b Proposal Effects on Unified Budget

	Individual Account Contribution Rate: 6.2% Benefit Offset: 0.0%					
				Change in		
	Amount(%) Contributed to IA by Fed Gov: **100** (1)	Recognition Bond Distributions (2)	Other Changes in OASDI Cashflow[1] (3)	Annual Unified Budget Cashflow (4)=(3)-(1)-(2)	Debt Held by Public (EOY) (5)	Annual Unified Budget Balance (6)
Year	*(Billions of $, Present Value on 1-1-2004)*					
2005	175.8	0 0	0.0	-175.8	175.8	-175.8
2006	191.2	0 0	0.0	-191.2	367.0	-200.2
2007	196.5	0.0	0.0	-196.5	563.4	-215.3
2008	201.0	0.0	0.0	-201.0	764.4	-230.2
2009	205.2	0.0	0.0	-205.2	969.6	-245.2
2010	208.9	0.0	0.0	-208.9	1,178.5	-260.1
2011	212.5	0.0	0.0	-212.5	1,391.0	-275.2
2012	214.8	0.0	2.6	-212.2	1,603.2	-286.6
2013	216.1	0.0	3.4	-212.8	1,815.9	-298.8
2014	218.4	0.0	4.7	-213.7	2,029.6	-311.8
2015	219.4	0.0	6.8	-212.6	2,242.2	-323.1
2016	220.3	33.9	12.6	-241.6	2,483.8	-364.4
2017	220.7	55.7	21.3	-255.0	2,738.8	-392.1
2018	220.6	77.9	31.2	-267.4	3,006.2	-419.6
2019	219.8	99.6	42.3	-277.2	3,283.4	-444.2
2020	218.8	120.1	54.6	-284.3	3,567.6	-466.7
2021	217.7	117.2	66.4	-268.5	3,836.1	-466.7
2022	216.3	128.5	80.3	-264.5	4,100.6	-477.7
2023	214.4	138.3	95.0	-257.7	4,358.3	-485.6
2024	212.3	144.9	110.4	-246.8	4,605.1	-489.0
2025	210.0	149.3	126.5	-232.7	4,837.8	-488.6
2026	207.6	154.8	142.7	-219.7	5,057.5	-488.5
2027	205.1	197.5	161.7	-240.9	5,298.4	-521.9
2028	202.3	210.6	178.8	-234.2	5,532.6	-528.6
2029	199.6	216.5	195.0	-221.1	5,753.7	-528.5
2030	196.7	220.4	211.5	-205.7	5,959.4	-525.5
2031	193.9	226.5	226.3	-194.1	6,153.5	-525.2
2032	191.0	210.0	241.6	-159.4	6,312.8	-501.3
2033	188.2	194.9	253.8	-129.2	6,442.1	-480 0
2034	185.4	180.2	264.7	-100.9	6,542.9	-458.9
2035	182.7	167.3	274.6	-75.4	6,618.4	-439.0
2036	180.1	154.9	283.0	-52.0	6,670.3	-419.8
2037	177.5	141.8	290.3	-29.0	6,699.4	-399.7
2038	174.9	129.5	296.4	-8 0	6,707.4	-380.3
2039	172.2	116.8	301.3	12.3	6,695.1	-360.4
2040	169.5	105.0	305.4	30.8	6,664.3	-341.2
2041	166.9	93.5	308.7	48.2	6,616.0	-322.1
2042	164.4	82.6	311.2	64.3	6,551.7	-303.3
2043	161.8	72.8	313.0	78.5	6,473.3	-285.6
2044	159.3	63 5	314.0	91.3	6,382.0	-268.4
2045	156.8	54.7	316.9	105.4	6,276.6	-249.3
2046	154.3	46.3	316.9	116.3	6,160.3	-232.5
2047	151.8	37.8	316.0	126.4	6,033.9	-216.0
2048	149.4	29.8	314.3	135.2	5,898.8	-200.1
2049	146.9	21.8	311.8	143.1	5,755.7	-184.7
2050	144.5	0.1	310.1	165.5	5,590.2	-154.3
2051	142.2	0.0	308.2	166.0	5,424.2	-144.7
2052	139.9	0.0	306.0	166.2	5,258.1	-135.3
2053	137.6	0.0	303.6	166.1	5,092.0	-126.1
2054	135.3	0.0	301.1	165.7	4,926.3	-117.2
2055	133.1	0.0	298.3	165.2	4,761.1	-108.5
2056	130.9	0.0	295.5	164.6	4,596.4	-100.0
2057	128.7	0.0	292.6	163.9	4,432.6	-91.6
2058	126.6	0.0	289 5	162.9	4,269.7	-83.4
2059	124.5	0.0	286.3	161.8	4,107.9	-75.5
2060	122.5	0.0	283.5	161.0	3,946.9	-67.3
2061	120.4	0.0	279.9	159.5	3,787.4	-59.9
2062	118.5	0.0	276.5	158.0	3,629.4	-52.5
2063	116.5	0.0	273.1	156.6	3,472.9	-45.1
2064	114.6	0.0	269.6	155.0	3,317.9	-38.0
2065	112.7	0.0	266.0	153.3	3,164.5	-31.0
2066	110.8	0.0	262.5	151.7	3,012.8	-24.1
2067	109.0	0.0	259.1	150.2	2,862.6	-17.2
2068	107.2	0.0	255.8	148.6	2,714.0	-10.4
2069	105.4	0.0	252.4	147.0	2,567.0	-3.8
2070	103.7	0.0	249.0	145.3	2,421.7	2.6
2071	102.0	0.0	245.5	143.5	2,278.2	9.0
2072	100.3	0.0	242.1	141.8	2,136.4	15.2
2073	98.7	0.0	238.8	140.1	1,996.3	21.4
2074	97.0	0.0	235.4	138.4	1,857.9	27.5
2075	95.4	0.0	232.1	136.7	1,721.2	33.5
2076	93.8	0.0	228.9	135.1	1,586.1	39.4
2077	92.3	0.0	225 7	133.4	1,452.7	45.3
2078	90.8	0.0	222.6	131.8	1,320 9	51.1
2079	89.2	0.0	219.5	130.2	1,190.6	56.8

Based on the Intermediate Assumptions of the 2004 Trustees Report
With Ultimate Real Trust Fund Interest Rate of 3.0%
Ultimate Real IA Yield Rate of 4.65%
Annuity Net Real Yield Rate of 3.0%

[1] Excluding GF transfers and reimbursement

Office of the Actuary
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Table 1b.c. Proposal Effects on Unified Budget

	Individual Account Contribution Rate: 6.2% Benefit Offset: 0.0%					
	Amount(%) Contributed to IA by Fed Gov: **100**	Recognition Bond Distributions	Other Changes in OASDI Cashflow[1]	Change in Annual Unified Budget Cashflow	Change in Debt Held by Public (EOY)	Change in Annual Unified Budget Balance
	(1)	(2)	(3)	(4)=(3)-(1)-(2)	(5)	(6)
Year			*(Billions of Constant 2004 $)*			
2005	188.0	0.0	0.0	-188.0	191.2	-193.1
2006	211.5	0.0	0.0	-211.5	411.7	-227.4
2007	223.6	0.0	0.0	-223.6	649.4	-251.6
2008	234.7	0.0	0.0	-234.7	904.1	-276.1
2009	245.9	0.0	0.0	-245.9	1,177.2	-301.9
2010	257.1	0.0	0.0	-257.1	1,469.5	-328.9
2011	268.5	0.0	0.0	-268.5	1,782.1	-357.5
2012	278.9	0.0	3.3	-275.6	2,110.9	-382.6
2013	288.5	0.0	4.5	-284.0	2,457.8	-410.0
2014	299.8	0.0	6.5	-293.3	2,824.9	-440.0
2015	309.7	0.0	9.6	-300.2	3,210.5	-469.0
2016	320.0	49.2	18.3	-350.9	3,660.1	-544.5
2017	329.9	83.3	31.9	-381.3	4,155.3	-603.2
2018	339.7	120.0	48.0	-411.7	4,697.8	-664.8
2019	348.6	158.0	67.0	-439.6	5,284.9	-725.0
2020	357.4	196.1	89.2	-464.4	5,914.7	-784.5
2021	366.3	197.2	111.8	-451.7	6,550.6	-808.1
2022	374.8	222.8	139.2	-458.4	7,212.3	-851.8
2023	382.7	246.9	169.5	-460.1	7,895.6	-892.0
2024	390.4	266.3	203.0	-453.8	8,593.0	-925.1
2025	397.6	282.7	239.6	-440.6	9,298.0	-952.1
2026	404.9	301.9	278.3	-428.5	10,011.9	-980.6
2027	412.0	396.8	324.9	-484.0	10,803.4	-1,079.0
2028	418.7	435.9	370.0	-484.6	11,619.3	-1,125.6
2029	425.4	461.5	415.7	-471.2	12,446.1	-1,159.2
2030	431.9	484.0	464.2	-451.7	13,277.9	-1,187.0
2031	438.5	512.1	511.8	-438.8	14,121.6	-1,222.1
2032	445.0	489.0	562.8	-371.2	14,921.9	-1,201.5
2033	451.5	467.5	608.9	-310.0	15,684.2	-1,185.0
2034	458.1	445.2	654.2	-249.2	16,407.7	-1,166.7
2035	465.0	425.8	698.8	-192.0	17,094.8	-1,149.7
2036	472.1	406.0	741.9	-136.2	17,745.9	-1,132.2
2037	479.2	383.0	783.8	-78.4	18,357.8	-1,110.5
2038	486.5	360.1	824.2	-22.4	18,931.3	-1,088.4
2039	493.3	334.6	863.2	35.3	19,463.4	-1,062.4
2040	500.2	309.8	901.0	91.0	19,955.0	-1,035.9
2041	507.3	284.2	938.0	146.5	20,404.9	-1,007.3
2042	514.4	258.4	974.2	201.4	20,812.7	-977.0
2043	521.6	234.7	1,009.2	252.9	21,180.4	-947.6
2044	528.9	210.8	1,042.8	303.1	21,508.2	-917.3
2045	536.2	187.3	1,083.8	360.4	21,787.7	-877.4
2046	543.5	163.0	1,116.3	409.8	22,025.4	-842.7
2047	550.9	137.3	1,146.7	458.6	22,220.8	-806.3
2048	558.3	111.2	1,174.7	505.2	22,374.7	-769.7
2049	565.7	83.8	1,200.3	550.7	22,487.0	-731.8
2050	573.1	0.2	1,229.6	656.2	22,495.6	-629.7
2051	580.7	0.0	1,258.6	677.8	22,482.6	-608.0
2052	588.3	0.0	1,287.3	699.0	22,447.7	-585.5
2053	596.1	0.0	1,315.6	719.5	22,390.9	-562.3
2054	603.9	0.0	1,343.5	739.6	22,312.0	-538.4
2055	611.8	0.0	1,371.3	759.5	22,210.6	-513.3
2056	619.8	0.0	1,399.2	779.4	22,085.9	-487.0
2057	627.8	0.0	1,426.9	799.1	21,937.5	-459.5
2058	636.0	0.0	1,454.2	818.2	21,765.3	-431.2
2059	644.3	0.0	1,481.2	837.0	21,568.8	-401.9
2060	652.6	0.0	1,510.5	857.8	21,345.3	-369.0
2061	661.1	0.0	1,536.4	875.3	21,097.3	-338.0
2062	669.7	0.0	1,562.9	893.3	20,823.6	-305.2
2063	678.3	0.0	1,590.1	911.7	20,523.0	-270.3
2064	687.1	0.0	1,616.7	929.6	20,195.3	-234.4
2065	696.0	0.0	1,643.2	947.2	19,839.8	-197.3
2066	705.0	0.0	1,670.5	965.4	19,455.2	-157.9
2067	714.2	0.0	1,698.4	984.2	19,040.0	-116.3
2068	723.6	0.0	1,726.9	1,003.3	18,593.0	-72.6
2069	733.1	0.0	1,755.2	1,022.1	18,113.5	-27.3
2070	742.7	0.0	1,783.0	1,040.3	17,601.1	19.3
2071	752.4	0.0	1,811.2	1,058.8	17,054.6	68.0
2072	762.2	0.0	1,839.6	1,077.4	16,472.8	118.9
2073	772.1	0.0	1,868.4	1,096.3	15,854.3	172.1
2074	782.1	0.0	1,897.6	1,115.5	15,197.8	227.8
2075	792.2	0.0	1,927.3	1,135.1	14,501.8	286.0
2076	802.5	0.0	1,957.4	1,154.9	13,764.7	346.8
2077	812.8	0.0	1,988.0	1,175.1	12,985.0	410.4
2078	823.3	0.0	2,019.0	1,195.7	12,161.0	476.8
2079	833.9	0.0	2,050.6	1,216.7	11,291.0	546.3

Based on the Intermediate Assumptions of the 2004 Trustees Report
With Ultimate Real Trust Fund Interest Rate of 3.0%
Ultimate Real IA Yield Rate of 4.65%
Annuity Net Real Yield Rate of 3.0%

[1] Excluding GF transfers and reimbursement

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Table 1c OASDI Cash Flow to General Fund of the Treasury--- Proposal vs. Theoretical OASDI

	Proposal				Theoretical Social Security with PAYGO Transfers			
	Net Amount of Cash-Flow from the OASDI Trust Funds to the General Fund of the Treasury During the Year [1]				Net Amount of Cash-Flow from the OASDI Trust Funds to the General Fund of the Treasury During the Year [1]			
	Percent	Billions of Dollars			Percent	Billions of Dollars		
Year	of Payroll	Current $	1/1/2004 PV	Const 2004 $	of Payroll	Current $	1/1/2004 PV	Const 2004 $
2004	1.4	65	63	65	1.4	65	63	65
2005	-2.1	-102	-94	-101	1.9	89	82	87
2006	-2.4	-122	-106	-118	1.9	97	85	94
2007	-2.5	-132	-110	-125	2.0	105	87	99
2008	-2.7	-147	-115	-135	2.0	109	86	100
2009	-3.0	-171	-127	-152	1.8	105	78	93
2010	-3.2	-193	-136	-168	1.7	103	73	89
2011	-3.4	-217	-145	-183	1.6	101	67	85
2012	-3.7	-244	-154	-200	1.4	91	58	75
2013	-4.0	-277	-166	-221	1.1	79	47	63
2014	-4.3	-312	-177	-243	0.9	65	37	50
2015	-4.6	-349	-187	-264	0.6	48	25	36
2016	-5.7	-450	-228	-331	0.3	27	14	20
2017	-6.4	-529	-253	-379	0.0	4	2	3
2018	-7.1	-613	-277	-427	-0.3	-22	-10	-15
2019	-7.8	-700	-299	-474	-0.6	-51	-22	-35
2020	-8.5	-789	-318	-520	-0.9	-84	-34	-55
2021	-8.5	-824	-314	-528	-1.2	-119	-45	-76
2022	-8.8	-890	-320	-555	-1.5	-155	-56	-97
2023	-9.0	-953	-324	-578	-1.8	-195	-66	-118
2024	-9.1	-1,005	-322	-593	-2.1	-236	-76	-139
2025	-9.1	-1,047	-317	-601	-2.4	-279	-85	-160
2026	-9.1	-1,092	-312	-609	-2.7	-324	-93	-181
2027	-10.1	-1,261	-341	-685	-3.0	-370	-100	-201
2028	-10.3	-1,334	-340	-705	-3.2	-416	-106	-220
2029	-10.2	-1,380	-333	-709	-3.4	-463	-112	-238
2030	-10.1	-1,413	-322	-706	-3.6	-510	-116	-255
2031	-10.0	-1,460	-314	-710	-3.8	-558	-120	-271
2032	-9.1	-1,390	-282	-658	-4.0	-606	-123	-287
2033	-8.3	-1,327	-254	-611	-4.1	-653	-125	-300
2034	-7.6	-1,256	-228	-562	-4.2	-699	-127	-313
2035	-6.9	-1,185	-203	-516	-4.3	-744	-127	-324
2036	-6.2	-1,110	-179	-470	-4.4	-788	-127	-334
2037	-5.4	-1,022	-156	-421	-4.4	-831	-127	-343
2038	-4.7	-929	-134	-372	-4.5	-873	-126	-350
2039	-4.0	-824	-112	-321	-4.5	-915	-124	-357
2040	-3.4	-716	-92	-272	-4.5	-956	-123	-363
2041	-2.7	-602	-73	-222	-4.5	-1,000	-121	-369
2042	-2.1	-484	-55	-174	-4.5	-1,045	-120	-375
2043	-1.5	-367	-40	-128	-4.5	-1,091	-118	-381
2044	-1.0	-246	-25	-84	-4.5	-1,139	-116	-387
2045	-0.4	-98	-9	-32	-4.5	-1,189	-115	-393
2046	0.1	34	3	11	-4.6	-1,241	-113	-399
2047	0.6	171	15	53	-4.6	-1,297	-112	-405
2048	1.0	307	25	93	-4.6	-1,355	-110	-412
2049	1.4	446	34	132	-4.6	-1,417	-109	-419
2050	2.5	798	58	230	-4.6	-1,483	-108	-427
2051	2.6	867	59	243	-4.6	-1,555	-107	-435
2052	2.7	934	60	254	-4.7	-1,634	-106	-445
2053	2.8	1,000	61	265	-4.7	-1,717	-105	-455
2054	2.8	1,066	62	275	-4.8	-1,805	-104	-465
2055	2.9	1,132	62	284	-4.8	-1,899	-104	-476
2056	2.9	1,198	62	292	-4.9	-1,999	-103	-487
2057	3.0	1,265	62	300	-4.9	-2,104	-102	-499
2058	3.0	1,333	61	308	-5.0	-2,214	-102	-511
2059	3.0	1,402	61	315	-5.0	-2,328	-101	-522
2060	3.1	1,483	61	324	-5.1	-2,447	-100	-534
2061	3.1	1,549	60	329	-5.1	-2,574	-100	-547
2062	3.1	1,615	59	334	-5.2	-2,709	-99	-560
2063	3.1	1,683	58	338	-5.2	-2,854	-98	-574
2064	3.1	1,753	57	343	-5.3	-3,003	-98	-587
2065	3.1	1,825	56	347	-5.3	-3,157	-97	-600
2066	3.1	1,901	55	352	-5.4	-3,319	-96	-614
2067	3.1	1,981	54	356	-5.4	-3,489	-96	-628
2068	3.1	2,068	54	362	-5.5	-3,665	-95	-641
2069	3.1	2,156	53	367	-5.5	-3,847	-94	-655
2070	3.1	2,245	52	372	-5.6	-4,037	-93	-669
2071	3.1	2,337	51	377	-5.6	-4,235	-92	-682
2072	3.1	2,433	50	381	-5.7	-4,442	-92	-696
2073	3.1	2,532	49	386	-5.7	-4,660	-91	-710
2074	3.1	2,634	48	391	-5.7	-4,888	-90	-725
2075	3.1	2,741	48	395	-5.8	-5,127	-89	-740
2076	3.1	2,853	47	400	-5.8	-5,377	-88	-755
2077	3.1	2,969	46	405	-5.9	-5,640	-87	-770
2078	3.1	3,090	45	410	-5.9	-5,915	-87	-785
2079	3.1	3,215	44	415	-6.0	-6,203	-86	-801
Total 2004-78			-6,545				-5,225	

[1] Equals net investment in special Treasury Bonds by the Trust Funds less the Amount of General Fund transfers specified in the proposal or in the theoretical plan (PAYGO Transfers)

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Table 1d Change in Long-Range Trust Fund Assets / Unfunded Obligation

Individual Account Contribution Rate: 6.2% Benefit Offset: 0.0%

Year	Present Law OASDI Trust Fund Assets or if Negative, Unfunded Obligation Through EOY (1)	Basic Changes in OASDI Cash flow (2)	Amount(%) Contributed to IA by Fed Gov: **100** (3)	Recognition Bond Distributions (4)	General Fund Transfers[1] (5)	Total Change Through EOY (6)=(2)-(3)-(4)+(5)	Proposal OASDI Trust Fund Assets/ Unfunded Obligation Through EOY (7)
			(Billions of $, Present Value on 1-1-2004)				
2005	1,674.6	0.0	175.8	0.0	0.0	-175.8	1,498.9
2006	1,759.0	0.0	191.2	0.0	0.0	-367.0	1,392.1
2007	1,845.5	0.0	196.5	0.0	0.0	-563.4	1,282.1
2008	1,930.8	0.0	201.0	0.0	0.0	-764.4	1,166.4
2009	2,008.4	0.0	205.2	0.0	0.0	-969.6	1,038.8
2010	2,080.8	0.0	208.9	0.0	0.0	-1,178.5	902.3
2011	2,148.0	0.0	212.5	0.0	0.0	-1,391.0	757.0
2012	2,205.6	2.6	214.8	0.0	0.0	-1,603.2	602.4
2013	2,252.4	3.4	216.1	0.0	62.1	-1,753.8	498.6
2014	2,289.0	4.7	218.4	0.0	180.0	-1,787.5	501.5
2015	2,314.3	6.8	219.4	0.0	190.0	-1,810.1	504.2
2016	2,327.9	12.6	220.3	33.9	223.6	-1,828.1	499.8
2017	2,329.7	21.3	220.7	55.7	248.2	-1,835.0	494.7
2018	2,319.7	31.2	220.6	77.9	271.9	-1,830.4	489.3
2019	2,297.6	42.3	219.8	99.6	290.9	-1,816.7	480.9
2020	2,263.7	54.6	218.8	120.1	309.1	-1,791.9	471.9
2021	2,218.5	66.4	217.7	117.2	302.2	-1,758.1	460.3
2022	2,162.6	80.3	216.3	128.5	307.0	-1,715.6	446.9
2023	2,096.4	95.0	214.4	138.3	309.2	-1,664.1	432.3
2024	2,020.7	110.4	212.3	144.9	307.8	-1,603.1	417.6
2025	1,936.1	126.5	210.0	149.3	302.8	-1,533.0	403.1
2026	1,843.3	142.7	207.6	154.8	291.1	-1,461.5	381.8
2027	1,743.3	161.7	205.1	197.5	323.5	-1,378.9	364.4
2028	1,637.0	178.8	202.3	210.6	321.6	-1,291.5	345.4
2029	1,525.4	195.0	199.6	216.5	313.2	-1,199.4	326.0
2030	1,409.4	211.5	196.7	220.4	301.8	-1,103.3	306.1
2031	1,289.5	226.3	193.9	226.5	293.9	-1,003.5	286.0
2032	1,166.5	241.6	191.0	210.0	264.5	-898.3	268.2
2033	1,041.2	253.8	188.2	194.9	239.0	-788.5	252.7
2034	914.6	264.7	185.4	180.2	211.3	-678.0	236.5
2035	787.2	274.6	182.7	167.3	187.4	-566.1	221.2
2036	659.9	283.0	180.1	154.9	164.1	-453.9	206.0
2037	533.0	290.3	177.5	141.8	141.6	-341.4	191.6
2038	407.2	296.4	174.9	129.5	122.5	-226.9	180.3
2039	282.7	301.3	172.2	116.8	99.2	-115.4	167.4
2040	159.8	305.4	169.5	105.0	81.3	-3.2	156.6
2041	38.4	308.7	166.9	93.5	63.9	109.0	147.4
2042	-81.4	311.2	164.4	82.6	46.2	219.6	138.2
2043	-199.5	313.0	161.8	72.8	30.7	328.7	129.1
2044	-316.0	314.0	159.3	63.5	14.5	434.5	118.5
2045	-430.8	316.9	156.8	54.7	2.4	542.3	111.4
2046	-544.1	316.9	154.3	46.3	1.1	659.7	115.6
2047	-655.8	316.0	151.8	37.8	1.1	787.2	131.4
2048	-766.0	314.3	149.4	29.8	1.1	923.4	157.5
2049	-874.8	311.8	146.9	21.8	1.0	1,067.6	192.7
2050	-982.4	310.1	144.5	0.1	1.0	1,234.1	251.6
2051	-1,089.0	308.2	142.2	0.0	1.0	1,401.0	312.0
2052	-1,194.8	306.0	139.9	0.0	0.9	1,568.2	373.4
2053	-1,299.7	303.6	137.6	0.0	0.9	1,735.1	435.4
2054	-1,403.9	301.1	135.3	0.0	0.9	1,901.7	497.9
2055	-1,507.4	298.3	133.1	0.0	0.8	2,067.8	560.4
2056	-1,610.3	295.5	130.9	0.0	0.8	2,233.2	622.9
2057	-1,712.7	292.6	128.7	0.0	0.8	2,397.9	685.2
2058	-1,814.4	289.5	126.6	0.0	0.7	2,561.5	747.2
2059	-1,915.3	286.3	124.5	0.0	0.7	2,724.0	808.7
2060	-2,015.6	283.5	122.5	0.0	0.7	2,885.6	870.1
2061	-2,115.1	279.9	120.4	0.0	0.6	3,045.8	930.6
2062	-2,214.1	276.5	118.5	0.0	0.6	3,204.4	990.2
2063	-2,312.6	273.1	116.5	0.0	0.6	3,361.5	1,048.9
2064	-2,410.5	269.6	114.6	0.0	0.5	3,517.1	1,106.6
2065	-2,507.7	266.0	112.7	0.0	0.5	3,670.9	1,163.3
2066	-2,604.1	262.5	110.8	0.0	0.5	3,823.1	1,219.0
2067	-2,699.9	259.1	109.0	0.0	0.5	3,973.8	1,273.8
2068	-2,794.9	255.8	107.2	0.0	0.4	4,122.8	1,327.9
2069	-2,889.1	252.4	105.4	0.0	0.4	4,270.2	1,381.1
2070	-2,982.5	249.0	103.7	0.0	0.4	4,415.9	1,433.4
2071	-3,075.0	245.5	102.0	0.0	0.4	4,559.8	1,484.8
2072	-3,166.6	242.1	100.3	0.0	0.3	4,701.9	1,535.3
2073	-3,257.4	238.8	98.7	0.0	0.3	4,842.3	1,584.9
2074	-3,347.3	235.4	97.0	0.0	0.3	4,981.0	1,633.7
2075	-3,436.4	232.1	95.4	0.0	0.3	5,118.0	1,681.6
2076	-3,524.7	228.9	93.8	0.0	0.3	5,253.3	1,728.6
2077	-3,612.1	225.7	92.3	0.0	0.2	5,387.0	1,774.9
2078	-3,698.7	222.6	90.8	0.0	0.2	5,519.0	1,820.3
Total 2004-2078		14,897.9	12,023.9	4,194.9	6,839.5		

Based on the Intermediate Assumptions of the 2004 Trustees Report
With Ultimate Real Trust Fund Interest Rate of 3.0%
Ultimate Real IA Yield Rate of 4.65%
Annuity Net Real Yield Rate of 3.0%

[1] Include reimbursement for minimum benefit

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Table 2 Johnson Proposal: Sensitivity Analysis--Low Yield=LT Treasury Bond

Phased Participation Ult Real TF Int Rate of 3.00
No Taxation Ult Real IA Yld Rate of 2.70
of RB or IA Distributions Annuity Net Real Yld Rate of 2.70

Individual Account Contribution Rate: 6.2% Benefit Offset: 0.0%

Year	Cost Rate	Income Rate	Annual Balance	TFR[1] 1-1-yr	General Revenue Reimbursement for Minimum Benefit	"Effective" Change in OASDI Contribution Rate	"Effective" OASDI Contribution Rate	General Revenue Transfer Solvency	Individual Account Contribution Rate
2004	11.07	12.71	1.64	306			12.40		0.00
2005	10.87	8.72	-2.15	325	0.00	-4.005	8.40		4.00
2006	10.77	8.36	-2.41	310	0.00	-0.373	8.02		4.38
2007	10.75	8.23	-2.51	290	0.00	-0.142	7.88		4.52
2008	10.80	8.14	-2.65	267	0.00	-0.127	7.75		4.65
2009	10.95	8.01	-2.94	241	0.00	-0.125	7.63		4.77
2010	11.08	7.91	-3.18	214	0.00	-0.122	7.51		4.89
2011	11.25	7.83	-3.41	184	0.00	-0.126	7.38		5.02
2012	11.43	7.75	-3.68	154	0.00	-0.110	7.27		5.13
2013	11.67	9.18	-2.50	121	0.00	1.403	8.67	1.5	5.23
2014	11.89	11.98	0.09	100	0.00	2.787	11.46	4.4	5.34
2015	12.13	12.21	0.08	100	0.01	0.212	11.67	4.7	5.43
2016	13.12	13.03	-0.09	100	0.01	0.809	12.48	5.6	5.53
2017	13.77	13.65	-0.12	100	0.01	0.618	13.10	6.3	5.61
2018	14.41	14.28	-0.13	100	0.01	0.624	13.72	7.0	5.69
2019	15.03	14.82	-0.21	100	0.01	0.537	14.26	7.6	5.75
2020	15.59	15.37	-0.23	100	0.01	0.541	14.80	8.2	5.81
2021	15.55	15.25	-0.30	100	0.02	-0.120	14.68	8.1	5.88
2022	15.81	15.45	-0.36	100	0.02	0.208	14.89	8.4	5.93
2023	16.00	15.70	-0.30	100	0.02	0.257	15.15	8.7	5.97
2024	16.06	15.65	-0.41	100	0.02	-0.039	15.11	8.7	6.02
2025	16.02	15.52	-0.51	100	0.02	-0.129	14.98	8.6	6.05
2026	15.99	15.37	-0.62	100	0.03	-0.128	14.85	8.5	6.08
2027	16.95	16.43	-0.51	100	0.03	1.077	15.93	9.6	6.10
2028	17.07	16.50	-0.57	100	0.03	0.084	16.01	9.7	6.12
2029	16.96	16.37	-0.59	100	0.04	-0.113	15.90	9.6	6.14
2030	16.76	16.14	-0.62	100	0.04	-0.209	15.69	9.4	6.15
2031	16.65	16.11	-0.53	100	0.04	-0.006	15.68	9.4	6.16
2032	15.76	15.19	-0.58	100	0.04	-0.903	14.78	8.5	6.16
2033	14.97	14.40	-0.57	100	0.05	-0.762	14.02	7.7	6.17
2034	14.18	13.64	-0.54	100	0.05	-0.742	13.28	7.0	6.17
2035	13.44	13.02	-0.42	100	0.05	-0.602	12.67	6.4	6.18
2036	12.72	12.20	-0.53	100	0.06	-0.804	11.87	5.6	6.19
2037	11.98	11.50	-0.48	100	0.06	-0.673	11.20	4.9	6.19
2038	11.27	10.85	-0.41	100	0.07	-0.632	10.57	4.3	6.20
2039	10.55	10.14	-0.41	100	0.07	-0.696	9.87	3.6	6.20
2040	9.87	9.49	-0.38	100	0.07	-0.636	9.23	3.0	6.20
2041	9.21	8.85	-0.36	100	0.08	-0.626	8.61	2.3	6.20
2042	8.58	8.28	-0.30	100	0.08	-0.556	8.05	1.8	6.20
2043	8.00	7.66	-0.34	100	0.09	-0.606	7.45	1.2	6.20
2044	7.45	7.09	-0.37	100	0.09	-0.556	6.89	0.6	6.20
2045	6.84	6.58	-0.26	100	0.10	-0.495	6.40	0.1	6.20
2046	6.34	6.47	0.13	100	0.10	-0.095	6.30		6.20
2047	5.87	6.47	0.60	108	0.10	0.004	6.30		6.20
2048	5.43	6.46	1.03	127	0.11	0.004	6.31		6.20
2049	5.03	6.46	1.44	156	0.11	0.004	6.31		6.20
2050	3.99	6.46	2.47	199	0.12	0.004	6.32		6.20
2051	3.89	6.46	2.57	270	0.12	0.004	6.32		6.20
2052	3.80	6.46	2.66	347	0.12	0.004	6.32		6.20
2053	3.73	6.46	2.73	430	0.13	0.003	6.33		6.20
2054	3.67	6.46	2.79	518	0.13	0.003	6.33		6.20
2055	3.62	6.46	2.84	610	0.13	0.003	6.33		6.20
2056	3.58	6.46	2.88	705	0.13	0.002	6.33		6.20
2057	3.54	6.46	2.92	805	0.14	0.002	6.34		6.20
2058	3.51	6.46	2.95	908	0.14	0.002	6.34		6.20
2059	3.48	6.46	2.98	1,014	0.14	0.001	6.34		6.20
2060	3.43	6.46	3.02	1,130	0.14	0.001	6.34		6.20
2061	3.43	6.46	3.03	1,238	0.14	0.000	6.34		6.20
2062	3.42	6.46	3.03	1,347	0.14	0.000	6.34		6.20
2063	3.42	6.46	3.03	1,458	0.14	-0.001	6.34		6.20
2064	3.42	6.46	3.03	1,570	0.14	-0.001	6.34		6.20
2065	3.42	6.45	3.03	1,684	0.14	-0.002	6.34		6.20
2066	3.42	6.45	3.03	1,800	0.14	-0.002	6.34		6.20
2067	3.42	6.45	3.03	1,921	0.13	-0.002	6.33		6.20
2068	3.41	6.45	3.04	2,046	0.13	-0.003	6.33		6.20
2069	3.40	6.44	3.05	2,172	0.13	-0.003	6.33		6.20
2070	3.40	6.44	3.04	2,299	0.12	-0.003	6.32		6.20
2071	3.39	6.44	3.04	2,428	0.12	-0.003	6.32		6.20
2072	3.39	6.43	3.04	2,560	0.12	-0.004	6.32		6.20
2073	3.39	6.43	3.04	2,694	0.11	-0.004	6.31		6.20
2074	3.38	6.43	3.04	2,831	0.11	-0.004	6.31		6.20
2075	3.38	6.42	3.04	2,971	0.11	-0.004	6.31		6.20
2076	3.37	6.42	3.04	3,114	0.10	-0.004	6.30		6.20
2077	3.37	6.41	3.04	3,259	0.10	-0.004	6.30		6.20
2078	3.36	6.41	3.04	3,409	0.09	-0.004	6.29		6.20
2079	3.36	6.40	3.04	3,561	0.09	-0.004	6.29		6.20

Summarized OASDI

	Cost Rate	Income Rate	Actuarial Balance	Change in Actuarial Balance
2004 - 2078	10.21	11.03	0.82	2.70

[1]TFR computed as TF assets divided by annual cost excluding RB payments

Based on Intermediate Assumptions of the 2004 Trustees Report With Ultimate Real Trust Fund Interest Rate of 3.00

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Table 2a Proposal GF Transfers, OASDI Trust Fund Assets, Individual Account Assets, and Theoretical OASDI Assets

Calendar Year	Proposal General Fund Transfer(GF)/Reimburse: Transfers for Solvency (1)	Reimburse Minimum Benefit (2)	Total in Constant 2004$ (3)	Accumulated as of End of Year (4)	Total OASDI Trust Fund Assets at End of Year (5)	Low Yield Individual Account Assets[1] at End of Year (6)	GDP (7)	Theoretical Social Security[2] with Borrowing Authority: Net OASDI TF Assets End of Year: Without GF Transfer (8)	With GF Transfer (amount for Prop) (9)
	Billions PV as of 1-1-2004		Billions of Constant 2004$		Billions of Constant 2004 Dollars				
2004	0.0	0.0	0.0	0	1,684	0	11,544	1,684	1,684
2005	0.0	0.0	0.0	0	1,647	193	11,911	1,840	1,840
2006	0.0	0.0	0.0	0	1,581	416	12,246	1,998	1,998
2007	0.0	0.0	0.0	0	1,498	656	12,562	2,156	2,156
2008	0.0	0.0	0.0	0	1,399	912	12,870	2,315	2,315
2009	0.0	0.0	0.0	0	1,279	1,185	13,171	2,473	2,473
2010	0.0	0.0	0.0	0	1,141	1,477	13,466	2,631	2,631
2011	0.0	0.0	0.0	0	983	1,789	13,752	2,790	2,790
2012	0.0	0.0	0.0	0	804	2,117	14,024	2,944	2,944
2013	62.0	0.1	82.9	83	684	2,461	14,285	3,091	3,174
2014	179.9	0.1	247.1	332	708	2,823	14,547	3,230	3,563
2015	189.8	0.2	268.3	610	732	3,203	14,804	3,360	3,970
2016	223.3	0.3	324.7	952	747	3,599	15,061	3,478	4,431
2017	247.8	0.4	371.1	1,352	761	4,014	15,322	3,584	4,935
2018	271.5	0.4	418.7	1,811	775	4,446	15,586	3,675	5,486
2019	290.4	0.5	461.3	2,326	785	4,894	15,842	3,750	6,076
2020	308.6	0.5	505.0	2,901	793	5,356	16,100	3,805	6,706
2021	301.6	0.6	508.5	3,496	797	5,833	16,354	3,841	7,337
2022	306.4	0.7	532.1	4,133	797	6,324	16,610	3,857	7,990
2023	312.1	0.7	558.5	4,816	800	6,828	16,861	3,851	8,667
2024	307.1	0.8	566.1	5,527	796	7,345	17,117	3,823	9,350
2025	298.6	0.9	567.1	6,259	785	7,874	17,372	3,773	10,032
2026	290.3	0.9	568.1	7,015	766	8,414	17,634	3,700	10,715
2027	322.6	1.0	650.2	7,876	752	8,964	17,903	3,604	11,480
2028	320.7	1.1	665.8	8,778	734	9,525	18,174	3,486	12,264
2029	312.2	1.2	667.9	9,709	713	10,094	18,451	3,346	13,055
2030	300.8	1.2	663.1	10,664	689	10,673	18,733	3,184	13,847
2031	296.0	1.3	672.3	11,656	670	11,259	19,022	3,000	14,656
2032	263.5	1.4	616.8	12,622	647	11,852	19,319	2,796	15,418
2033	236.1	1.5	569.9	13,571	622	12,452	19,622	2,570	16,141
2034	210.2	1.5	523.2	14,501	599	13,058	19,929	2,325	16,827
2035	189.2	1.6	485.6	15,422	583	13,669	20,243	2,062	17,484
2036	163.0	1.7	431.7	16,316	558	14,286	20,564	1,780	18,096
2037	141.3	1.8	386.2	17,192	536	14,906	20,892	1,481	18,673
2038	121.3	1.9	342.6	18,050	518	15,530	21,226	1,165	19,215
2039	100.0	1.9	292.0	18,884	499	16,157	21,562	833	19,717
2040	80.9	2.0	244.8	19,695	482	16,785	21,904	485	20,180
2041	62.7	2.1	197.0	20,483	465	17,414	22,252	120	20,603
2042	46.9	2.2	153.7	21,251	452	18,042	22,605	-262	20,989
2043	30.3	2.2	104.8	21,993	435	18,669	22,961	-662	21,331
2044	15.4	2.3	58.9	22,712	415	19,295	23,322	-1,080	21,632
2045	2.5	2.4	16.9	23,410	403	19,917	23,687	-1,516	21,894
2046	0.0	2.5	8.7	24,121	426	20,535	24,055	-1,972	22,149
2047	0.0	2.5	9.2	24,854	493	21,150	24,426	-2,449	22,406
2048	0.0	2.6	9.7	25,610	602	21,758	24,799	-2,946	22,664
2049	0.0	2.7	10.2	26,388	754	22,360	25,174	-3,465	22,923
2050	0.0	2.7	10.7	27,191	1,011	22,951	25,552	-4,008	23,182
2051	0.0	2.7	11.2	28,017	1,288	23,533	25,936	-4,577	23,441
2052	0.0	2.8	11.7	28,870	1,585	24,106	26,324	-5,172	23,698
2053	0.0	2.8	12.2	29,748	1,902	24,673	26,721	-5,795	23,953
2054	0.0	2.8	12.6	30,653	2,238	25,234	27,123	-6,447	24,206
2055	0.0	2.8	13.1	31,586	2,592	25,789	27,528	-7,130	24,456
2056	0.0	2.8	13.5	32,547	2,966	26,339	27,939	-7,845	24,701
2057	0.0	2.8	13.8	33,537	3,358	26,883	28,354	-8,594	24,943
2058	0.0	2.8	14.2	34,557	3,769	27,422	28,775	-9,378	25,180
2059	0.0	2.8	14.5	35,609	4,200	27,955	29,204	-10,196	25,412
2060	0.0	2.8	14.8	36,692	4,652	28,483	29,639	-11,052	25,640
2061	0.0	2.7	15.0	37,807	5,123	29,006	30,078	-11,946	25,861
2062	0.0	2.7	15.2	38,957	5,613	29,524	30,526	-12,880	26,077
2063	0.0	2.6	15.3	40,141	6,122	30,038	30,978	-13,857	26,284
2064	0.0	2.6	15.4	41,360	6,650	30,548	31,438	-14,876	26,484
2065	0.0	2.5	15.4	42,616	7,199	31,055	31,906	-15,940	26,676
2066	0.0	2.4	15.4	43,910	7,768	31,558	32,379	-17,050	26,860
2067	0.0	2.3	15.3	45,243	8,360	32,059	32,861	-18,208	27,035
2068	0.0	2.3	15.2	46,615	8,975	32,557	33,359	-19,414	27,202
2069	0.0	2.2	15.1	48,029	9,613	33,054	33,859	-20,670	27,359
2070	0.0	2.1	14.9	49,485	10,276	33,550	34,366	-21,978	27,507
2071	0.0	2.0	14.7	50,984	10,963	34,045	34,882	-23,340	27,645
2072	0.0	1.9	14.5	52,528	11,676	34,539	35,404	-24,756	27,772
2073	0.0	1.8	14.2	54,118	12,415	35,034	35,931	-26,230	27,888
2074	0.0	1.7	13.9	55,756	13,181	35,530	36,464	-27,762	27,993
2075	0.0	1.6	13.6	57,442	13,975	36,027	37,006	-29,356	28,085
2076	0.0	1.5	13.2	59,178	14,799	36,525	37,555	-31,014	28,165
2077	0.0	1.5	12.9	60,967	15,652	37,025	38,112	-32,736	28,230
2078	0.0	1.4	12.5	62,808	16,536	37,528	38,677	-34,527	28,281
2079	0.0	1.3	12.1	64,704	17,452	38,033	39,245	-36,387	28,317
Total 2004-78	6,805.1	118.3							

Based on Intermediate Assumptions of the 2004 Trustees Report

[1] Including annuity assets, assuming all annuitize fully.

[2] Theoretical Social Security is the current Social Security program with the assumption that the law is modified to permit borrowing from the General Fund of the Treasury.

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Table 2b Proposal Effects on Unified Budget

	Individual Account Contribution Rate: 6.2%			Benefit Offset: 0.0%		
	Amount(%) Contributed to IA by Fed Gov: **100** (1)	Recognition Bond Distributions (2)	Other Changes in OASDI Cashflow[1] (3)	Change in Annual Unified Budget Cashflow (4)=(3)-(1)-(2)	Change in Debt Held by Public (EOY) (5)	Annual Unified Budget Balance (6)
Year	*(Billions of $, Present Value on 1-1-2004)*					
2005	175.8	0.0	0.0	-175.8	175.8	-175.8
2006	191.2	0.0	0.0	-191.2	367.0	-200.2
2007	196.5	0.0	0.0	-196.5	563.4	-215.3
2008	201.0	0.0	0.0	-201.0	764.4	-230.2
2009	205.2	0.0	0.0	-205.2	969.6	-245.2
2010	208.9	0.0	0.0	-208.9	1,178.5	-260.1
2011	212.5	0.0	0.0	-212.5	1,391.0	-275.2
2012	214.8	0.0	2.6	-212.2	1,603.2	-286.6
2013	216.1	0.0	3.4	-212.8	1,815.9	-298.8
2014	218.4	0.0	4.7	-213.7	2,029.6	-311.8
2015	219.4	0.0	6.8	-212.6	2,242.3	-323.1
2016	220.3	33.9	12.6	-241.6	2,483.8	-364.5
2017	220.7	55.7	21.3	-255.0	2,738.9	-392.1
2018	220.6	77.9	31.1	-267.4	3,006.3	-419.6
2019	219.8	99.6	42.2	-277.2	3,283.5	-444.3
2020	218.8	120.1	54.5	-284.3	3,567.8	-466.8
2021	217.7	117.2	66.4	-268.5	3,836.3	-466.8
2022	216.3	128.5	80.2	-264.6	4,100.9	-477.8
2023	214.4	138.3	94.9	-257.8	4,358.7	-485.7
2024	212.3	144.9	110.3	-246.9	4,605.7	-489.2
2025	210.0	149.3	126.4	-232.8	4,838.5	-488.8
2026	207.6	154.8	142.5	-219.9	5,058.4	-488.8
2027	205.1	197.5	161.4	-241.2	5,299.6	-522.3
2028	202.3	210.6	178.5	-234.5	5,534.1	-529.0
2029	199.6	216.5	194.7	-221.4	5,755.5	-529.0
2030	196.7	220.4	211.0	-206.2	5,961.7	-526.0
2031	193.9	226.5	225.8	-194.6	6,156.3	-525.9
2032	191.0	210.0	241.0	-160.0	6,316.3	-502.1
2033	188.2	194.9	253.1	-129.9	6,446.2	-480.9
2034	185.4	180.2	263.9	-101.7	6,547.9	-459.9
2035	182.7	167.3	273.6	-76.4	6,624.3	-440.2
2036	180.1	154.9	282.0	-53.0	6,677.3	-421.1
2037	177.5	141.8	289.1	-30.2	6,707.5	-401.3
2038	174.9	129.5	295.1	-9.3	6,716.8	-382.1
2039	172.2	116.8	299.9	10.9	6,706.0	-362.4
2040	169.5	105.0	303.8	29.3	6,676.7	-343.4
2041	166.9	93.5	306.9	46.5	6,630.2	-324.5
2042	164.4	82.6	309.3	62.4	6,567.8	-306.0
2043	161.8	72.8	311.0	76.4	6,491.4	-288.6
2044	159.3	63.5	311.8	89.0	6,402.3	-271.7
2045	156.8	54.7	314.4	102.9	6,299.4	-252.8
2046	154.3	46.3	314.3	113.7	6,185.7	-236.4
2047	151.8	37.8	313.2	123.6	6,062.1	-220.2
2048	149.4	29.8	311.3	132.2	5,929.9	-204.7
2049	146.9	21.8	308.7	140.0	5,789.9	-189.6
2050	144.5	0.1	306.9	162.3	5,627.7	-159.5
2051	142.2	0.0	304.8	162.6	5,465.1	-150.1
2052	139.9	0.0	302.5	162.7	5,302.4	-141.0
2053	137.6	0.0	300.0	162.4	5,140.0	-132.2
2054	135.3	0.0	297.3	162.0	4,978.0	-123.6
2055	133.1	0.0	294.5	161.4	4,816.5	-115.2
2056	130.9	0.0	291.6	160.7	4,655.8	-106.9
2057	128.7	0.0	288.7	159.9	4,495.9	-98.8
2058	126.6	0.0	285.5	158.9	4,337.0	-90.9
2059	124.5	0.0	282.3	157.8	4,179.2	-83.2
2060	122.5	0.0	279.4	157.0	4,022.3	-75.3
2061	120.4	0.0	275.9	155.5	3,866.8	-68.0
2062	118.5	0.0	272.5	154.0	3,712.7	-60.8
2063	116.5	0.0	269.2	152.7	3,560.1	-53.7
2064	114.6	0.0	265.7	151.2	3,408.9	-46.7
2065	112.7	0.0	262.2	149.6	3,259.3	-39.9
2066	110.8	0.0	258.9	148.1	3,111.3	-33.1
2067	109.0	0.0	255.6	146.6	2,964.7	-26.3
2068	107.2	0.0	252.4	145.2	2,819.5	-19.6
2069	105.4	0.0	249.1	143.6	2,675.9	-13.0
2070	103.7	0.0	245.7	142.0	2,533.9	-6.7
2071	102.0	0.0	242.4	140.4	2,393.4	-0.4
2072	100.3	0.0	239.2	138.8	2,254.6	5.8
2073	98.7	0.0	235.9	137.2	2,117.4	12.0
2074	97.0	0.0	232.7	135.7	1,981.7	18.0
2075	95.4	0.0	229.6	134.1	1,847.6	24.0
2076	93.8	0.0	226.5	132.6	1,714.9	29.9
2077	92.3	0.0	223.4	131.1	1,583.8	35.8
2078	90.8	0.0	220.4	129.6	1,454.2	41.6
2079	89.2	0.0	217.4	128.2	1,326.1	47.3

Based on the Intermediate Assumptions of the 2004 Trustees Report
With Ultimate Real Trust Fund Interest Rate of 3.0%
Ultimate Real IA Yield Rate of 2.75%
Annuity Net Real Yield Rate of 2.75%

[1] Excluding GF transfers and reimbursement

Office of the Actuary
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Table 2 b.c. Proposal Effects on Unified Budget

	Individual Account Contribution Rate: 6.2% Benefit Offset: 0.0%					
				Change in		
	Amount(%) Contributed to IA by Fed Gov: **100**	Recognition Bond Distributions	Other Changes in OASDI Cashflow[1]	Annual Unified Budget Cashflow	Debt Held by Public (EOY)	Annual Unified Budget Balance
	(1)	(2)	(3)	(4)=(3)-(1)-(2)	(5)	(6)
Year	*(Billions of Constant 2004 $)*					
2005	188.0	0.0	0.0	-188.0	191.2	-193.1
2006	211.5	0.0	0.0	-211.5	411.7	-227.4
2007	223.6	0.0	0.0	-223.6	649.4	-251.6
2008	234.7	0.0	0.0	-234.7	904.1	-276.1
2009	245.9	0.0	0.0	-245.9	1,177.2	-301.9
2010	257.1	0.0	0.0	-257.1	1,469.5	-328.9
2011	268.5	0.0	0.0	-268.5	1,782.1	-357.5
2012	278.9	0.0	3.3	-275.6	2,110.9	-382.6
2013	288.5	0.0	4.5	-284.0	2,457.8	-410.0
2014	299.8	0.0	6.5	-293.3	2,824.9	-440.0
2015	309.7	0.0	9.6	-300.2	3,210.6	-469.0
2016	320.0	49.2	18.3	-350.9	3,660.2	-544.5
2017	329.9	83.3	31.9	-381.4	4,155.4	-603.2
2018	339.7	120.0	48.0	-411.7	4,697.9	-664.8
2019	348.6	158.0	67.0	-439.7	5,285.1	-725.1
2020	357.4	196.1	89.1	-464.5	5,915.0	-784.6
2021	366.3	197.2	111.6	-451.8	6,551.0	-808.2
2022	374.8	222.8	139.0	-458.5	7,212.9	-852.0
2023	382.7	246.9	169.3	-460.2	7,896.4	-892.2
2024	390.4	266.3	202.7	-454.0	8,594.0	-925.4
2025	397.6	282.7	239.3	-440.9	9,299.4	-952.5
2026	404.9	301.9	277.9	-428.9	10,013.7	-981.1
2027	412.0	396.8	324.3	-484.5	10,805.8	-1,079.7
2028	418.7	435.9	369.3	-485.3	11,622.5	-1,126.4
2029	425.4	461.5	414.9	-472.0	12,450.2	-1,160.2
2030	431.9	484.0	463.2	-452.6	13,283.0	-1,188.3
2031	438.5	512.1	510.6	-440.0	14,128.1	-1,223.6
2032	445.0	489.0	561.3	-372.6	14,930.1	-1,203.3
2033	451.5	467.5	607.2	-311.7	15,694.4	-1,187.2
2034	458.1	445.2	652.1	-251.2	16,420.2	-1,169.3
2035	465.0	425.8	696.4	-194.3	17,110.0	-1,152.9
2036	472.1	406.0	739.2	-139.0	17,764.3	-1,135.9
2037	479.2	383.0	780.7	-81.6	18,380.0	-1,114.9
2038	486.5	360.1	820.6	-26.0	18,957.8	-1,093.4
2039	493.3	334.6	859.0	31.1	19,494.9	-1,068.1
2040	500.2	309.8	896.4	86.3	19,992.1	-1,042.5
2041	507.3	284.2	932.7	141.3	20,448.5	-1,014.8
2042	514.4	258.4	968.3	195.4	20,863.7	-985.6
2043	521.6	234.7	1,002.6	246.3	21,239.6	-957.4
2044	528.9	210.8	1,035.3	295.7	21,576.7	-928.4
2045	536.2	187.3	1,075.5	352.1	21,866.7	-889.9
2046	543.5	163.0	1,107.1	400.6	22,116.2	-856.8
2047	550.9	137.3	1,136.6	448.5	22,324.5	-822.0
2048	558.3	111.2	1,163.6	494.1	22,492.8	-787.1
2049	565.7	83.8	1,188.3	538.8	22,620.7	-750.9
2050	573.1	0.2	1,216.8	643.4	22,646.3	-650.7
2051	580.7	0.0	1,244.8	664.1	22,651.8	-630.9
2052	588.3	0.0	1,272.5	684.2	22,636.9	-610.5
2053	596.1	0.0	1,299.9	703.8	22,601.7	-589.5
2054	603.9	0.0	1,326.9	723.0	22,546.0	-567.7
2055	611.8	0.0	1,353.8	742.0	22,469.4	-544.9
2056	619.8	0.0	1,380.7	760.9	22,371.2	-521.0
2057	627.8	0.0	1,407.6	779.8	22,250.9	-495.8
2058	636.0	0.0	1,434.2	798.2	22,108.4	-469.9
2059	644.3	0.0	1,460.5	816.2	21,943.2	-443.1
2060	652.6	0.0	1,489.1	836.4	21,752.7	-412.8
2061	661.1	0.0	1,514.5	853.4	21,539.2	-384.3
2062	669.7	0.0	1,540.5	870.9	21,301.5	-353.9
2063	678.3	0.0	1,567.3	889.0	21,038.4	-321.5
2064	687.1	0.0	1,593.7	906.6	20,749.5	-288.1
2065	696.0	0.0	1,620.0	923.9	20,434.2	-253.4
2066	705.0	0.0	1,647.1	942.0	20,091.2	-216.5
2067	714.2	0.0	1,674.9	960.7	19,718.9	-177.4
2068	723.6	0.0	1,703.5	979.9	19,316.1	-136.1
2069	733.1	0.0	1,731.8	998.7	18,881.9	-93.3
2070	742.7	0.0	1,759.8	1,017.1	18,416.2	-49.2
2071	752.4	0.0	1,788.2	1,035.8	17,917.4	-2.9
2072	762.2	0.0	1,817.0	1,054.7	17,384.5	45.5
2073	772.1	0.0	1,846.1	1,074.0	16,816.0	96.3
2074	782.1	0.0	1,875.7	1,093.6	16,210.6	149.4
2075	792.2	0.0	1,905.8	1,113.6	15,566.8	205.1
2076	802.5	0.0	1,936.4	1,133.9	14,882.9	263.4
2077	812.8	0.0	1,967.5	1,154.7	14,157.5	324.5
2078	823.3	0.0	1,999.2	1,175.9	13,388.9	388.4
2079	833.9	0.0	2,031.4	1,197.5	12,575.2	455.2

Based on the Intermediate Assumptions of the 2004 Trustees Report
With Ultimate Real Trust Fund Interest Rate of 3.0%
Ultimate Real IA Yield Rate of 2.75%
Annuity Net Real Yield Rate of 2.75%

[1] Excluding GF transfers and reimbursement

Office of the Actuary
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Table 2c OASDI Cash Flow to General Fund of the Treasury--- Proposal vs. Theoretical OASDI

	Proposal				Theoretical Social Security with PAYGO Transfers			
	Net Amount of Cash-Flow from the OASDI Trust Funds to the General Fund of the Treasury During the Year[1]				Net Amount of Cash-Flow from the OASDI Trust Funds to the General Fund of the Treasury During the Year[1]			
	Percent	Billions of Dollars			Percent	Billions of Dollars		
Year	of Payroll	Current $	1/1/2004 PV	Const 2004 $	of Payroll	Current $	1/1/2004 PV	Const 2004 $
2004	1.4	65	63	65	1.4	65	63	65
2005	-2.1	-102	-94	-101	1.9	89	82	87
2006	-2.4	-122	-106	-118	1.9	97	85	94
2007	-2.5	-132	-110	-125	2.0	105	87	99
2008	-2.7	-147	-115	-135	2.0	109	86	100
2009	-3.0	-171	-127	-152	1.8	105	78	93
2010	-3.2	-193	-136	-168	1.7	103	73	89
2011	-3.4	-217	-145	-183	1.6	101	67	85
2012	-3.7	-244	-154	-200	1.4	91	58	75
2013	-4.0	-277	-166	-221	1.1	79	47	63
2014	-4.3	-312	-177	-243	0.9	65	37	50
2015	-4.6	-349	-187	-264	0.6	48	25	36
2016	-5.7	-450	-228	-331	0.3	27	14	20
2017	-6.4	-529	-253	-379	0.0	4	2	3
2018	-7.1	-613	-277	-427	-0.3	-22	-10	-15
2019	-7.8	-701	-299	-474	-0.6	-51	-22	-35
2020	-8.5	-789	-318	-520	-0.9	-84	-34	-55
2021	-8.5	-824	-314	-528	-1.2	-119	-45	-76
2022	-8.8	-891	-320	-555	-1.5	-155	-56	-97
2023	-9.0	-953	-324	-578	-1.8	-195	-66	-118
2024	-9.1	-1,005	-323	-593	-2.1	-236	-76	-139
2025	-9.1	-1,048	-317	-601	-2.4	-279	-85	-160
2026	-9.2	-1,092	-313	-610	-2.7	-324	-93	-181
2027	-10.2	-1,262	-341	-685	-3.0	-370	-100	-201
2028	-10.3	-1,335	-341	-705	-3.2	-416	-106	-220
2029	-10.2	-1,381	-333	-710	-3.4	-463	-112	-238
2030	-10.1	-1,415	-322	-707	-3.6	-510	-116	-255
2031	-10.0	-1,462	-314	-711	-3.8	-558	-120	-271
2032	-9.1	-1,394	-283	-659	-4.0	-606	-123	-287
2033	-8.4	-1,331	-255	-612	-4.1	-653	-125	-300
2034	-7.6	-1,260	-228	-564	-4.2	-699	-127	-313
2035	-6.9	-1,191	-204	-518	-4.3	-744	-127	-324
2036	-6.2	-1,116	-180	-473	-4.4	-788	-127	-334
2037	-5.5	-1,029	-157	-424	-4.4	-831	-127	-343
2038	-4.8	-938	-135	-376	-4.5	-873	-126	-350
2039	-4.1	-835	-114	-325	-4.5	-915	-124	-357
2040	-3.4	-729	-94	-276	-4.5	-956	-123	-363
2041	-2.8	-617	-75	-227	-4.5	-1,000	-121	-369
2042	-2.2	-500	-57	-179	-4.5	-1,045	-120	-375
2043	-1.6	-386	-42	-135	-4.5	-1,091	-118	-381
2044	-1.1	-268	-27	-91	-4.5	-1,139	-116	-387
2045	-0.5	-123	-12	-41	-4.5	-1,189	-115	-393
2046	0.0	5	0	2	-4.6	-1,241	-113	-399
2047	0.5	138	12	43	-4.6	-1,297	-112	-405
2048	0.9	271	22	82	-4.6	-1,355	-110	-412
2049	1.3	405	31	120	-4.6	-1,417	-109	-419
2050	2.3	754	55	217	-4.6	-1,483	-108	-427
2051	2.4	818	56	229	-4.6	-1,555	-107	-435
2052	2.5	880	57	240	-4.7	-1,634	-106	-445
2053	2.6	941	58	249	-4.7	-1,717	-105	-455
2054	2.6	1,002	58	258	-4.8	-1,805	-104	-465
2055	2.7	1,062	58	266	-4.8	-1,899	-104	-476
2056	2.7	1,123	58	274	-4.9	-1,999	-103	-487
2057	2.8	1,185	58	281	-4.9	-2,104	-102	-499
2058	2.8	1,247	57	288	-5.0	-2,214	-102	-511
2059	2.8	1,310	57	294	-5.0	-2,328	-101	-522
2060	2.9	1,385	57	302	-5.1	-2,447	-100	-534
2061	2.9	1,446	56	307	-5.1	-2,574	-100	-547
2062	2.9	1,507	55	311	-5.2	-2,709	-99	-560
2063	2.9	1,571	54	316	-5.2	-2,854	-98	-574
2064	2.9	1,635	53	320	-5.3	-3,003	-98	-587
2065	2.9	1,703	52	324	-5.3	-3,157	-97	-600
2066	2.9	1,775	52	328	-5.4	-3,319	-96	-614
2067	2.9	1,851	51	333	-5.4	-3,489	-96	-628
2068	2.9	1,934	50	339	-5.5	-3,665	-95	-641
2069	2.9	2,019	49	344	-5.5	-3,847	-94	-655
2070	2.9	2,105	49	349	-5.6	-4,037	-93	-669
2071	2.9	2,195	48	354	-5.6	-4,235	-92	-682
2072	2.9	2,288	47	359	-5.7	-4,442	-92	-696
2073	2.9	2,386	46	364	-5.7	-4,660	-91	-710
2074	2.9	2,487	46	369	-5.7	-4,888	-90	-725
2075	2.9	2,593	45	374	-5.8	-5,127	-89	-740
2076	2.9	2,703	44	379	-5.8	-5,377	-88	-755
2077	2.9	2,819	44	385	-5.9	-5,640	-87	-770
2078	2.9	2,940	43	390	-5.9	-5,915	-87	-785
2079	2.9	3,066	42	396	-6.0	-6,203	-86	-801
Total 2004-78			-6,678				-5,225	

[1] Equals net investment in special Treasury Bonds by the Trust Funds less the Amount of General Fund transfers specified in the proposal or in the theoretical plan (PAYGO Transfers)

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Table 2d Change in Long-Range Trust Fund Assets / Unfunded Obligation

Individual Account Contribution Rate: 6.2% Benefit Offset: 0.0%

Year	Present Law OASDI Trust Fund Assets or if Negative, Unfunded Obligation Through EOY (1)	Basic Changes in OASDI Cash flow (2)	Amount(%) Contributed to IA by Fed Gov: **100** (3)	Recognition Bond Distributions (4)	General Fund Transfers[1] (5)	Total Change Through EOY (6)=(2)-(3)-(4)+(5)	Proposal OASDI Trust Fund Assets/ Unfunded Obligation Through EOY (7)
	(Billions of $, Present Value on 1-1-2004)						
2005	1,674.6	0.0	175.8	0.0	0.0	-175.8	1,498.9
2006	1,759.0	0.0	191.2	0.0	0.0	-367.0	1,392.1
2007	1,845.5	0.0	196.5	0.0	0.0	-563.4	1,282.1
2008	1,930.8	0.0	201.0	0.0	0.0	-764.4	1,166.4
2009	2,008.4	0.0	205.2	0.0	0.0	-969.6	1,038.8
2010	2,080.8	0.0	208.9	0.0	0.0	-1,178.5	902.3
2011	2,148.0	0.0	212.5	0.0	0.0	-1,391.0	757.0
2012	2,205.6	2.6	214.8	0.0	0.0	-1,603.2	602.4
2013	2,252.4	3.4	216.1	0.0	62.1	-1,753.8	498.6
2014	2,289.0	4.7	218.4	0.0	180.0	-1,787.5	501.5
2015	2,314.3	6.8	219.4	0.0	190.0	-1,810.1	504.2
2016	2,327.9	12.6	220.3	33.9	223.6	-1,828.1	499.8
2017	2,329.7	21.3	220.7	55.7	248.2	-1,835.0	494.7
2018	2,319.7	31.1	220.6	77.9	271.9	-1,830.4	489.2
2019	2,297.6	42.2	219.8	99.6	290.9	-1,816.8	480.9
2020	2,263.7	54.5	218.8	120.1	309.2	-1,791.9	471.8
2021	2,218.5	66.4	217.7	117.2	302.2	-1,758.2	460.2
2022	2,162.6	80.2	216.3	128.5	307.0	-1,715.8	446.8
2023	2,096.4	94.9	214.4	138.3	312.9	-1,660.7	435.7
2024	2,020.7	110.3	212.3	144.9	307.9	-1,599.8	420.9
2025	1,936.1	126.4	210.0	149.3	299.5	-1,533.2	402.9
2026	1,843.3	142.5	207.6	154.8	291.3	-1,461.8	381.5
2027	1,743.3	161.4	205.1	197.5	323.6	-1,379.4	363.9
2028	1,637.0	178.5	202.3	210.6	321.7	-1,292.1	344.9
2029	1,525.4	194.7	199.6	216.5	313.4	-1,200.2	325.2
2030	1,409.4	211.0	196.7	220.4	302.0	-1,104.3	305.1
2031	1,289.5	225.8	193.9	226.5	297.3	-1,001.6	288.0
2032	1,166.5	241.0	191.0	210.0	264.8	-896.7	269.8
2033	1,041.2	253.1	188.2	194.9	237.6	-789.1	252.2
2034	914.6	263.9	185.4	180.2	211.7	-679.0	235.6
2035	787.2	273.6	182.7	167.3	190.8	-564.5	222.7
2036	659.9	282.0	180.1	154.9	164.7	-452.8	207.0
2037	533.0	289.1	177.5	141.8	143.0	-340.0	193.0
2038	407.2	295.1	174.9	129.5	123.2	-226.2	181.0
2039	282.7	299.9	172.2	116.8	101.9	-113.3	169.4
2040	159.8	303.8	169.5	105.0	83.0	-1.1	158.7
2041	38.4	306.9	166.9	93.5	64.8	110.2	148.6
2042	-81.4	309.3	164.4	82.6	49.1	221.8	140.4
2043	-199.5	311.0	161.8	72.8	32.5	330.7	131.1
2044	-316.0	311.8	159.3	63.5	17.7	437.5	121.4
2045	-430.8	314.4	156.8	54.7	4.9	545.3	114.5
2046	-544.1	314.3	154.3	46.3	2.5	661.6	117.5
2047	-655.8	313.2	151.8	37.8	2.5	787.7	131.9
2048	-766.0	311.3	149.4	29.8	2.6	922.5	156.6
2049	-874.8	308.7	146.9	21.8	2.7	1,065.2	190.4
2050	-982.4	306.9	144.5	0.1	2.7	1,230.2	247.8
2051	-1,089.0	304.8	142.2	0.0	2.7	1,395.6	306.5
2052	-1,194.8	302.5	139.9	0.0	2.8	1,561.0	366.3
2053	-1,299.7	300.0	137.6	0.0	2.8	1,726.3	426.6
2054	-1,403.9	297.3	135.3	0.0	2.8	1,891.2	487.3
2055	-1,507.4	294.5	133.1	0.0	2.8	2,055.5	548.1
2056	-1,610.3	291.6	130.9	0.0	2.8	2,219.1	608.7
2057	-1,712.7	288.7	128.7	0.0	2.8	2,381.9	669.2
2058	-1,814.4	285.5	126.6	0.0	2.8	2,543.6	729.3
2059	-1,915.3	282.3	124.5	0.0	2.8	2,704.2	788.9
2060	-2,015.6	279.4	122.5	0.0	2.8	2,864.0	848.4
2061	-2,115.1	275.9	120.4	0.0	2.7	3,022.2	907.1
2062	-2,214.1	272.5	118.5	0.0	2.7	3,179.0	964.9
2063	-2,312.6	269.2	116.5	0.0	2.6	3,334.3	1,021.7
2064	-2,410.5	265.7	114.6	0.0	2.6	3,488.0	1,077.5
2065	-2,507.7	262.2	112.7	0.0	2.5	3,640.1	1,132.5
2066	-2,604.1	258.9	110.8	0.0	2.4	3,790.6	1,186.5
2067	-2,699.9	255.6	109.0	0.0	2.3	3,939.6	1,239.6
2068	-2,794.9	252.4	107.2	0.0	2.3	4,087.0	1,292.1
2069	-2,889.1	249.1	105.4	0.0	2.2	4,232.8	1,343.7
2070	-2,982.5	245.7	103.7	0.0	2.1	4,376.9	1,394.4
2071	-3,075.0	242.4	102.0	0.0	2.0	4,519.4	1,444.4
2072	-3,166.6	239.2	100.3	0.0	1.9	4,660.1	1,493.5
2073	-3,257.4	235.9	98.7	0.0	1.8	4,799.2	1,541.8
2074	-3,347.3	232.7	97.0	0.0	1.7	4,936.6	1,589.3
2075	-3,436.4	229.6	95.4	0.0	1.6	5,072.4	1,635.9
2076	-3,524.7	226.5	93.8	0.0	1.5	5,206.5	1,681.9
2077	-3,612.1	223.4	92.3	0.0	1.5	5,339.1	1,727.0
2078	-3,698.7	220.4	90.8	0.0	1.4	5,470.1	1,771.4
Total 2004-78		14,764.5	12,023.9	4,194.9	6,923.4		

Based on the Intermediate Assumptions of the 2004 Trustees Report
With Ultimate Real Trust Fund Interest Rate of 3.0%
Ultimate Real IA Yield Rate of 2.75%
Annuity Net Real Yield Rate of 2.75%

[1] Include reimbursement for minimum benefit

Office of the Actuary
Social Security Administration
February 11, 2005

Table B1. Monthly Retirement Benefits at Age 65 Under Sam Johnson Proposal

Benefits for one spouse of a two-earner couple -- Spouse same age with similar earnings

Constant 2004 Dollars

Year Attain Age 65	Present Law Scheduled Benefit	Present Law "Payable" Benefit	Proposal without IA CPI-Indexed Benefit	Proposal Recognition Bond Annuity	IA Annuity with Low (risk adj) IA Yield (2.75 real)	IA Annuity with Expected IA Yield (4.65 real)	Proposal Total Annuity Without Minimum: with Low (risk adj) IA Yield (2.75 real)	Proposal Total Annuity Without Minimum: with Expected IA Yield (4.65 real)	Proposal Worker Minimum Annuity-- Up to 100% of Poverty at NRA[1]	Proposal Total Annuity Including Minimum as % of PL Sched Ben: with Low (risk adj) IA Yield (2.75 real)	Proposal Total Annuity Including Minimum as % of PL Sched Ben: with Expected IA Yield (4.65 real)
					Scaled Low Earner						
2015	772	772	764	560	58	64	618	624	724	93.8	93.8
2025	796	796	708	362	158	195	520	557	672	84.5	84.5
2035	885	885	708	204	289	397	493	602	672	76.0	76.0
2045	986	710	709	47	435	661	482	708	672	68.2	71.8
2055	1,099	769	*710 NA*	0	507	791	507	791	672	61.2	72.0
					Scaled Medium Earner						
2015	1,272	1,272	1,259	923	129	142	1,051	1,065	724	82.7	83.7
2025	1,311	1,311	1,167	596	351	434	947	1,030	672	72.2	78.6
2035	1,458	1,458	1,166	337	641	883	978	1,220	672	67.1	83.7
2045	1,625	1,170	1,168	78	966	1,469	1,044	1,546	672	64.3	95.2
2055	1,810	1,267	*1,170 NA*	0	1,127	1,757	1,127	1,757	672	62.3	97.1
					Scaled High Earner						
2015	1,687	1,687	1,669	1,224	206	228	1,430	1,452	724	84.7	86.1
2025	1,739	1,739	1,547	791	562	695	1,352	1,485	672	77.8	85.4
2035	1,933	1,933	1,546	447	1,026	1,413	1,472	1,860	672	76.2	96.2
2045	2,155	1,551	1,549	103	1,546	2,350	1,649	2,453	672	76.5	113.9
2055	2,400	1,680	*1,551 NA*	0	1,803	2,812	1,803	2,812	672	75.1	117.2
					Steady Maximum Earner						
2015	2,042	2,042	2,020	1,481	369	405	1,850	1,887	724	90.6	92.4
2025	2,124	2,124	1,889	966	871	1,062	1,837	2,028	672	86.5	95.5
2035	2,365	2,365	1,891	546	1,550	2,111	2,096	2,658	672	88.6	112.4
2045	2,634	1,896	1,894	126	2,462	3,773	2,588	3,899	672	98.3	148.0
2055	2,928	2,050	*1,893 NA*	0	2,972	4,724	2,972	4,724	672	101.5	161.3

Based on the intermediate assumptions of the 2004 Trustees Report
IA is assumed to be invested 50% in equity index fund, 30% in Corporate Bond fund, 20% Treasury Bonds, 25 basis points annual administrative cost
Expected equity yield is 6.5 percent real, Corporate bond yield 3.5 percent real, Treasury Bond yield 3 percent real
IA annuities are assumed to be joint and 2/3 survivor life annuities, CPI indexed, 3% net expected real yield (2.75% net risk adjusted real yield)
Recognition Bonds are assumed to be equivalent to the present value at NRA of the retired worker benefit times (age on 1-1-2005 - 22)/45

[1] *For 35-year (140 QC) workers. Scales to 0 for 40 QCs. Assume 140 QCs for example.*

OCACT/SSA February 5, 2005

Table B2. Monthly Retirement Benefits at Age 65 Under Sam Johnson Proposal

Total benefits for one-earner married couple

Constant 2004 Dollars

Year Attain Age 65	Present Law Scheduled Benefit	Present Law "Payable" Benefit	Proposal without IA CPI-Indexed Benefit	Proposal Recognition Bond Annuity	IA Annuity with Low (risk adj) IA Yield (2.75 real)	IA Annuity with Expected IA Yield (4.65 real)	Proposal Total Annuity Without Minimum: with Low (risk adj) IA Yield (2.75 real)	Proposal Total Annuity Without Minimum: with Expected IA Yield (4.65 real)	Proposal Worker Minimum Annuity-- Up to 100% of Poverty at NRA[1]	Proposal Total Annuity Including Prop Minimum as % of PL Sched Ben: with Low (risk adj) IA Yield (2.75 real)	Proposal Total Annuity Including Prop Minimum as % of PL Sched Ben: with Expected IA Yield (4.65 real)
					Scaled Low Earner						
2015	1,152	1,152	1,139	560	58	64	618	624	724	89.7	90.0
2025	1,195	1,195	1,063	362	158	195	520	557	672	78.0	79.6
2035	1,310	1,310	1,048	204	289	397	493	602	672	70.1	74.3
2045	1,460	1,051	1,050	47	435	661	482	708	672	62.5	70.3
2055	1,627	1,139	*1,051 NA*	0	507	791	507	791	672	56.9	65.6
					Scaled Medium Earner						
2015	1,897	1,897	1,877	923	129	142	1,051	1,065	724	65.9	66.3
2025	1,969	1,969	1,752	596	351	434	947	1,030	672	58.2	60.3
2035	2,159	2,159	1,727	337	641	883	978	1,220	672	53.8	59.4
2045	2,406	1,732	1,730	78	966	1,469	1,044	1,546	672	49.6	64.3
2055	2,680	1,876	*1,732 NA*	0	1,127	1,757	1,127	1,757	672	46.1	65.6
					Scaled High Earner						
2015	2,516	2,516	2,489	1,224	206	228	1,430	1,452	724	57.2	57.7
2025	2,612	2,612	2,323	791	562	695	1,352	1,485	672	51.8	56.9
2035	2,862	2,862	2,289	447	1,026	1,413	1,472	1,860	672	51.4	65.0
2045	3,190	2,297	2,294	103	1,546	2,350	1,649	2,453	672	51.7	76.9
2055	3,553	2,487	*2,297 NA*	0	1,803	2,812	1,803	2,812	672	50.7	79.1
					Steady Maximum Earner						
2015	3,044	3,044	3,012	1,481	369	405	1,850	1,887	724	60.8	62.0
2025	3,190	3,190	2,837	966	871	1,062	1,837	2,028	672	57.6	63.6
2035	3,502	3,502	2,801	546	1,550	2,111	2,096	2,658	672	59.9	75.9
2045	3,900	2,808	2,804	126	2,462	3,773	2,588	3,899	672	66.4	100.0
2055	4,336	3,035	*2,803 NA*	0	2,972	4,724	2,972	4,724	672	68.5	108.9

Based on the intermediate assumptions of the 2004 Trustees Report
IA is assumed to be invested 50% in equity index fund, 30% in Corporate Bond fund, 20% Treasury Bonds, 25 basis points annual administrative cost
Expected equity yield is 6.5 percent real, Corporate bond yield 3.5 percent real, Treasury Bond yield 3 percent real
IA annuities are assumed to be joint and 2/3 survivor life annuities, CPI indexed, 3% net expected real yield (2.75% net risk adjusted real yield)
Recognition Bonds are assumed to be equivalent to the present value at NRA of the retired worker benefit times (age on 1-1-2005 - 22)/45

[1] *For 35-year (140 QC) workers. Scales to 0 for 40 QCs. Assume 140 QCs for example.*

OCACT/SSA February 5, 2005

Finance Committee Hearing
"Proposals to Achieve Sustainable Solvency, with and without Personal Accounts"
Questions Submitted for the Record
Michael Tanner
April 27, 2005

Senator Smith

You each presented divergent views on how social security ought to be reformed to resolve the solvency problem. For a moment, would you set aside your preferred proposals and consider where the other panel participants are on this issue. And taking this broader perspective, can you tell the committee where you perceive there to be the common ground in resolving the issue?

RESPONSE: The currently promised level of Social Security benefits is unsustainable without a significant tax increase. Faced with this, there has been a consensus going all the way back to the Kerry-Danforth Commission in 1994, extending through President Clinton's Social Security Advisory Council in 1997 and finally to President Bush's Bipartisan Commission to Strengthen Social Security, that there would have to be some effort to restrain future benefit growth. Current and near retirees would be held harmless, their benefits would not change, but younger workers would not receive all the benefits currently promised. The mechanism for adjusting benefits (wage-price indexing, changes in retirement age, means-testing, etc) is debatable, but the need for benefit restraint is not. Second, since the change in benefits will significantly reduce the rate of return on Social Security for younger workers, there has been a general consensus that those workers should be allowed to offset any such changes by having the option to privately invest a portion of their Social Security taxes through personal accounts. The details of personal account proposals aside, all reflect this general consensus.

Senator Rockefeller

Question #1:

How long would it take to fully transition from the current pay-as-you-go Social Security program to a universally available private accounts system?

RESPONSE: Adding personal accounts to Social Security would create immediate short-term deficits in the Social Security system. Depending on the proposal, it could take up to 40 years before Social Security would move into permanent surplus, although it would only be about 20 years before the deficits under personal account proposals are smaller than deficits expected under the current system. It is also important to recognize that once the current system goes into deficit, in 2017, those deficits are permanent and grow

constantly larger. The present value of those deficits is roughly $12.8 trillion. On the other hand, the present value of deficits under the personal account proposals range from $1 to 8 trillion, significantly less, and once surpluses start they are permanent.

How much would it cost to continue to pay retiree benefits during this transition period?

RESPONSE: Depending on the proposal, from $1-8 trillion. Under the plan that I prefer, Johnson-Flake, the cost would be $6.8 trillion. This represents a considerable savings compared to the current system's $12.8 trillion unfunded liability.

Isn't it true that young people in their 20s and 30s would pay twice? They would be paying for the retirement of their parents and grandparents who participated in a pay-as-you-go system, but then these young workers would also be expected to fund their own private accounts?

RESPONSE: Yes, but no more than they will have to do so under the current system. The current system is unfunded by $12.8 trillion. Without changes to the current system, these younger workers will face enormous tax increases. There is no free lunch. But moving to a system of personal accounts is less expensive over the long-term than maintaining the current system.

Question #2:

Recently, President Bush traveled to Parkersburg, West Virginia to visit the office that stores the paper certificates for the government bonds held by the Social Security trust fund. He made fun of these bond certificates, saying essentially that there is "nothing" in the Social Security trust fund. He implied that little slips of paper could not secure Americans' retirement.

And yet, the president has repeatedly assured people that one of their investment options in a private account would be government bonds. He has said that people who are uncomfortable with the risks associated with investing in stocks would still be able to invest in safe federal bonds.

I would like to know if there is any real difference between the government bonds in the Social Security trust fund that the president made fun of and the government bonds that the president claims workers should feel confident purchasing for their private accounts?

RESPONSE: As President Clinton said in his FY2000 Budget:

> These Trust Fund balances are available to finance future benefit payments...but only in a bookkeeping sense....They do not consist of real economic assets that can be drawn down in the future to fund benefits. Instead, they are claims on the Treasury that, when redeemed, will

> have to be financed by raising taxes, borrowing from the public, or reducing benefits or other expenditures. The existence of Trust Fund balances, therefore, does not by itself have any impact on the government's ability to pay benefits.

Changing the bondholder from the government to individuals would not change the government's financial picture. It would still owe that money. However, it would provide workers with a property right-based guarantee of benefits that they currently do not have.

Question #3

The President has suggested that retirees would be protected from mismanaging their retirement funds, because they would be required to purchase an annuity upon their retirement. The annuity would provide a steady stream of income, at least at the poverty level. However, the annuity market is very sensitive to market conditions.

Isn't it true that workers with identical amounts in their accounts could receive very different monthly benefits based on the level of the stock market on the day they bought their annuities?

(Note: CRS examined two hypothetical workers who each had $200,000 in their accounts and retired on different days in 2003. The report is attached. The worker who retired and bought his annuity at the market peak on Dec. 31st, would get a $2,002 monthly annuity ($24,024 yearly), but the worker who bought his annuity on the lowest day of the market , March 11, would only get $1,395 ($16,740 yearly). Is this fair? How would retirees know when to buy their annuities?)

RESPONSE: You are correct. Workers could receive very different levels of retirement income depending on their date of retirement and investment choices. One solution would be not to require full annuitization on the date of retirement.

Question #4:

When the United Kingdom gave workers the option of private accounts, there was a huge problem with investors taking advantage of workers and selling them poor long term investments. How should consumers be protected?

RESPONSE: Full regulatory safeguards should be put in place including criminal penalties for fraud. It is worth noting that the British system was extremely poorly designed and does not represent a good model for personal accounts.

Senator Lincoln

Between the 1990 and the 2000 Census, the Hispanic population increased 337% in Arkansas (faster than any other State in the nation). I believe Hispanics will be more affected by the proposals to reform Social Security because they will make up a greater proportion of the people paying payroll taxes. Given the fact that Hispanics as a group, tend to be younger and to have lower paying jobs, how will they benefit from private accounts?

I'm sure you all have heard retirement referred to as a three-legged stool. One leg is private savings, one leg is employee benefits/pensions, and the last leg is Social Security. American workers bear the risk for the first two legs but Social Security is supposed to be the one leg of the stool that is stable, without risk.

I believe that one of the key points in today's discussion is who should bear the risk when it comes to Social Security – the government or the American worker. It is my belief that the leg of the stool representing Social Security should remain stable. It seems to me that privatization would shift the risk of retirement savings to the American worker, leaving millions of workers no secure source of retirement income - with three shaky legs of the proverbial stool.

This is especially concerning for our nation's farmers. Farmers already subject themselves to so much risk [the weather, trade pressures]. This is an additional burden that will have a negative impact on them.

Do you advocate that Congress shift the risk associated with social security from the Federal Government to the American worker?

RESPONSE: There are different types of risk. The current system exposes workers to political risk: Retirees have no legal right to benefits and nothing prevents Congress from changing the benefit levels at any time. And the system is unfunded by $12.8 trillion, meaning Congress cannot pay all promised future benefits. Thus the risk of being in the stock market must be weighed against the political risk of a program that provides no legal rights to participants.

I believe that encouraging personal savings is a key component of this debate. I am extremely interested in looking at ways to encourage individuals to save more for their retirement. We are at the lowest savings rate in our nation's history and that is why financial literacy must be a part of this discussion. We must cultivate a nation of savers, not borrowers.

COMMUNICATIONS

Senate Committee on Finance **May 10, 2005**
Attn. Editorial and Document Section
Room SD-203
Dirksen Senate Office Building
Washington, DC 20510-6200
re: Social Security Reform / Private accounts

Gentlemen:

Per your instructions on the committee web site I wish to take this opportunity to present my thoughts,opinions, and suggestions to the committee on the referenced subject. The accompanying documents had been developed over a period of years and I personally feel them to be very sound and constructive. They have been submitted to various individuals and offices including the White House (see list at end). They are concise and have been vetted by professionals in the field and have been deemed to be fiscally and practically sound. I truly hope that this information is reviewed for consideration by the committee and not just inserted "in the record". I am already collecting Social Security and have further reviewed this with my children in their 30s early 40s. They are enthusiastic for some kind of change in this vein, they see it as something extremely beneficial to their children. Please see that these thoughts get a proper review and consideration.

Sincerely,

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December 9, 2004

President George W. Bush
1600 Pennsylvania Ave., N.W.
Washington D.C., US 20500
202-456-1414 / Fax: 2461
E-Mail: president@whitehouse.gov

Mr. President:

Hopefully the attached comments on Social Security privatization will be reviewed and given in depth consideration for use in developing your Social Security improvements. The below distribution list reflects others who have been provided with similar material.

Good luck with this agenda item. I think it is very important and worthy of implementation.

Sincerely,

Daniel Victor Bienko
A.I.A. N.C.A.R.B.

/kak

Attachment

PRIVATIZATION OF SOCIAL SECURITY

I am among the majority in the electorate that is glad you will have another four (4) years to pursue your agenda for America. With that said, over the years I have been supportive of your goal to improve Social Security and offer an opportunity to use "a portion" of the employee's Social Security Tax in a long term **dedicated (401k type) Fund Account**. I can assure you that my three (3) children and my five (5) grandchildren would jump at the chance to opt out of Social Security under the right conditions. With those comments, I have developed some food for thought that would go a long way toward accomplishing your goals, which I wish to share with you. I believe they are well founded in fact and reality, as well as undergoing **scrutiny** by the appropriate **experts on your staff**.

First: To demonstrate the improved worth of steady, long-term investing, I include a chart of growth and performance of a fund, which I am personally benefiting from (with far superior results than Social Security).

This fund is Keystone K-2 (Evergreen Family) (A **broad-based** mutual **fund** not a **narrow sector fund**, which is more vulnerable to market pressures).

The assets in the fund are not lost upon death as Social Security (particularly if death is prior to retirement) is, but becomes inheritable by my wife/children.

All of this "**Pro-forma**" can be **validated** by your **economic experts** and subject to fine-tuning of results.

The key component to the success of this savings for retirement is **faithful/regular contributions**. Therefore, a **mandatory requirement** is that the employer automatically make **payroll deductions** from weekly pay with the designated dollars submitted monthly/quarterly to the Fund **selected by owner** from an **approved list** of fiscally sound Funds under continuous Treasury Department scrutiny.

This insures against the human frailty of not making regular deposits to grow with the economy.

Second: The terms of the program should preclude draw downs from the fund until the owner reaches at least 65. With long-term savings there is no need to age advance draw down date beyond current level (67).

Third: Current Social Security program needs support till it can be **phased out** over 3 or 4 generations, thus the following:

A.) Participants **50 years of age** at time of enactment will not be included but continue in current program with its yearly COLA adjustment component. **Both 7.5%** contributions from employee/employer to **continue** into Social Security Fund.

B.) Participants between **40 & 50** will commit to **freezing their benefits** in light of having nominally 15 to 25 years of growth/accumulation till 65 even though their benefit under Social Security may not start till 67 plus by virtue of current rules. They will continue to contribute a **portion* of their 7.5%** to phase out current Social Security obligations along **with employer 7.5%**.

C.) Participants between **30 & 40** will commit to **reducing (to 75%)** and **freezing** their scheduled benefits in light of having nominally **25 to 35** years of growth/accumulation to 65 **thus reducing burden on Social Security system** till phase out.

They will continue to contribute a **portion* of their 7.5%** to **phase out** current Social Security obligations along with **employer 7.5%.**

D.) Participants between **20 & 30** will commit to reducing (**to 50%**) and **freezing** their scheduled benefits in light of having nominally **35 to 45** years of growth/accumulation to 65 **thus reducing burden on Social Security system** till phase out.

They will continue to contribute a **portion* of their 7.5%** to **phase out** current Social Security obligations along with **employer 7.5%.**

E.) Participants **under 20** will be allowed to **<u>opt out only</u> if committed to 5%** regular **contributions** through employer deduction till 65 into their **(401k) Fund**. The **employer** will **continue** his **7.5%** until such time as current Social Security has **no more obligations/participants** (40 plus years).

Fourth: The Pro-forma was based on a monthly contribution of $60.00 per month (obviously more per month would yield a larger benefit at 65). Currently a $30,000 yearly salary yields

7.5% employee =	$ 2,250.00	Contribution
7.5% employer =	2,250.00	Contribution
	4,500.00	Total
***Less 12 months x $60.00 =**	**< 720.00>**	*
	$ 3,780.00	Net Contribution . . .

. . . to current Social Security System **per $30,000.00** thus supporting the phase out of existing system, with reduced eligible participants per above phase out schedule.
* **This amounts to 3% of employer's 7.5%.**

Fifth: Participant can direct employer to deduct/invest in designated Fund **additional dollars beyond $60.00** minimum as his total income allows thus further **enhancing** his **retirement fund assets** at 65 (more in / more out).

Sixth: Based on current information from Social Security Administration since starting work at age **15 to-date** my employers and I have contributed approximately **$250,000** to the Social Security Fund.

At the current rate, my wife and I are receiving benefits we will (disregarding COLA) need to receive a check for the next **8-9 years** to recapture our input.

Based on the above **Pro-Forma**, if we invested the **full 7.5% or $125,000±** we could be looking at a net retirement worth approximately **$800,000±**.

If Fund growth was only **50% of their historical performance** ($400,000 ÷ 9 years (108 months) yields **$3,700±** per month vs. $2,400.

If Fund draw down were same **$2,400 (Social Security)** the Funds would last almost **14 years or to the age of 80**, plus residue at death is passed on thru estate - all with no burden on future generations.

Seventh: Current Social Welfare drags on Social Security need to be eliminated and/or otherwise financed.

ACTUAL HISTORICAL PERFORMANCE PRO-FORMA

YR	Date	$ In	Units	Dividend $	New Units	Run Units	Year End Net Worth
1	1967	1,410.00	126.956	138.38	19.791	154.420	1,207.57
2	1968	720.00	91.959	266.51	37.499	283.878	2,154.64
3	1969	760.00	128.638	39.21	6.601	409.17	2,356.82
4	1970	989.00	218.655	61.78	12.686	630.511	3,070.59
5	1971	640.00	105.477	29.04	4.840	740.828	5,096.90
6	1972	660.00	83.589	0	0	824.417	6,438.70
7	1973	660.00	105.398	27.52	4.602	932.493	5,343.19
8	1974	762.00	162.136	108.00	25.775	1120.404	4,582.46
9	1975	470.00	92.992	108.35	20.367	1233.763	6,431.02
10	1976	720.00	135.85	178.05	35.26	1404.873	7,136.76
11	1977	720.00	142.86	278.60	56.29	1604.023	7,795.56
12	1978	720.00	133.34	434.34	86.01	1823.373	8,952.77
13	1979	720.00	125.00	526.06	98.33	2046.703	11,359.21
14	1980	720.00	115.20	534.96	254.98	2416.883	14,839.67
15	1981	720.00	102.28	1,385.54	199.36	2718.523	19,953.96
16	1982	720.00	120.00	1,845.04	290.56	3129.083	20,339.04
17	1983	720.00	117.08	2,272.32	363.58	3609.743	22,560.90
18	1984	720.00	117.84	2,832.97	469.04	4196.623	25,767.27
19	1985	720.00	98.63	2,362.39	325.85	4621.03	33,918.90
20	1986	720.00	97.56	7,578.61	990.67	5709.333	44,361.52
21	1987	720.00	125.22	8,110.03	1329.52	7164.073	40,548.66
22	1988	720.00	117.08	1,674.67	269.68	7550.833	47,645.76
23	1989	720.00	101.41	3,290.47	445.26	8097.503	59,840.55
24	1990	720.00	117.65	5,422.00	871.71	9086.863	56,520.29
25	1991	720.00	110.94	9,105.83	1333.21	10,531.013	71,926.82
26	1992	720.00	96.91	4,570.10	615.08	11243.003	87,358.14
27	1993	720.00	94.24	8,753.11	1145.70	12482.943	98,989.74
28	1994	720.00	97.96	11,700.24	1591.87	14172.773	103,036.06
29	1995	720.00	93.88	13,838.66	1804.26	16070.913	127,603.05
30	1996	720.00	89.44	16,806.77	2087.80	18248.153	149,269.90
31	1997	720.00	82.29	24,379.49	2786.23	21116.673	196,385.06
32	1998	720.00	79.04	28,402.26	3117.71	24313.423	249,212.59
33	1999	720.00	65.04	10,482.92	910.77	25289.653	$ 291,083.91

$ 24,351.00 Total cash out of pocket over 33 years.

VS.

Net worth of $291,083.91 yields growth of $266,732.91 based on $60 per mo.

Note also that if taxes are paid yearly, cashing out results in no tax exposure.
Further, no pre-determined take down is required, i.e. lump sum or $2900/mo. for 100 mos. (8 yrs.)
Finally, should death occur before cash out, money reverts to estate not evaporating as with Social Security. Residue after cash out also reverts to estate after death.

HR 4895 REVIEW

I have just struggled through a review of the text of **HR 4895** which is a step in the right direction but has **too much governmental involvement** which is counter productive and wasteful.

A) It keeps the new system under government/**bureaucratic control**, which is **bad** and invites **"budget raiding"** with the same Government Bonds/Notes used to fund the current general/pork expenditures that have contributed to the **current deficit budgets**.

B) The only government involvement should be **limited to oversight on employers to insure regular dedicated/enforced contribution to owner dedicated/controlled 401k type retirement fund** (i.e. owner sets up program with all funds locked up until the age of 60-65 (starting at the age of 20 yields 40-45 years growth).

C) The governmental involvement in **bulk investing** for the "**Tier**" concept tends to **skew** the **markets** by the **magnitude** of their **input**. With numerous funds available the competition for investors would result in better/cost effective growth/accumulation. **Do not implement** the **Tier concept, use Direct employer** to fund monthly **contributions** and **eliminate** the heavy hand of **government**. Funds report direct to owner not thru government bureaucracy. Many **employers** are already **geared up to making 401k contributions**, make it universal, in fact, allow converting (as an option) all IRA's to 401k.

D) Leave withdrawal (lump sum or periodic) to the discretion of the owner, **forget** the complexities of **Section 256**, let the owner determine with fund management most beneficial distribution monthly/yearly/lump sum/annuity.

The long and the short is that this privatization would be a **mandatory 401k program** with **mandatory and periodic** (monthly) **contributions** effected as **payroll deductions** by employers to insure adequate accumulation/growth/dividend (**must be reinvested until 65**).

Last minute observation the president needs the **line item veto** to allow for budget **control** of **"pork barrel"** amendments added to a base bill that has merit and needs implementation. According to Senator McCain, those pork line items in the next budget/pending bills amounts to **14,000 plus or minus pieces** of wasteful congressional pandering to special interest groups/voters. See attached Cal Thomas article.

CAL THOMAS

Republican Congress must cut spending

Citizens Against Government Waste has compiled a list of nearly $23 billion in pork projects it found in appropriations bills for fiscal 2004.

The just concluded "lame duck" session of Congress should have been labeled the "goose that laid the golden egg session" for the federal goodies it dispensed.

Sen. Mitch McConnell, Kentucky Republican, told me he is pleased that Congress has reduced the "rate of the increase in spending." Is this why we have a Republican congressional majority, so that they can increase spending less than Democrats?

While it is true that the massive $388 billion spending bill reduces spending increases for some things, like education and the environment, there is still too much pork for healthy fiscal living. The bill will be finetuned further early next month before going to the president for his signature, but no one expects any of the wasteful spending to be curtailed.

Rep. Jeff Flake, Arizona Republican, compared the lame duck session to the movie "Groundhog Day" where the events of one day are repeated the next day and for days after that. "Every year, it's the same thing," said Flake. "Congress passes spending bills loaded with pork projects. In fact, this year ... Congress spent $100,000 for the Punxsutawney Weather Museum in Pennsylvania."

Other "golden eggs" laid by the Congressional geese include $450,000 for the Baseball Hall of Fame, $200,000 for the Dennison Railroad Depot Museum in Ohio, $350,000 for the Rock and Roll Hall of Fame, $1.5 million for the Anchorage Museum/Transit intermodal depot in Alaska, $250,000 for the Country Music Hall of Fame, $100,000 for the Municipal Swimming Pool in Ottawa, Kan., $35,000 for the Alabama Sports Hall of Fame, $300,000 to build the Great Falls parking garage in Auburn, Maine, and $1.5 million for departing Congressman Richard Gephardt's archive at the Missouri Historical Society.

Wasteful spending

There is no mandate in the Constitution, or anywhere else, for unnecessary and wasteful spending at any time, much less in a time of record deficits and debt.

President Bush has promised to spend some of the political capital he believes he's earned following the election. He should work to save some of the real capital forked over to government by taxpayers. Federal Reserve Chairman Alan Greenspan caused the stock market to take a dive last week when he warned that foreign investors might be reluctant to continue financing American debt and the widening trade gap.

Citizens Against Government Waste (www.cagw.org) has compiled a list of nearly $23 billion in pork projects it found in appropriations bills for fiscal 2004. CAGW has also recommended 592 ways to reduce spending it estimates could save taxpayers $217 billion in fiscal 2005 and $1.65 trillion over the next five years. Among the recommendations are limiting the terms of committee chairpersons, passing a Taxpayer Bill of Rights, enforcing procedural rules and passing a line-item veto.

CAGW believes the tax cuts should be made permanent and the Internal Revenue Service and indecipherable tax code scrapped and replaced with a national sales or flat tax, thus closing large numbers of loopholes and ridding the system of unfairness. Reforms in Social Security and health care, along with tort reform, would also reduce the cost and size of the federal government.

The Bush Administration should make reform a hallmark of its second term, saving taxpayers billions. It might resurrect former Sen. William Proxmire's "Golden Fleece Award," embarrassing members who waste our money.

One place to start might be the Sikorsky Aircraft Corporation. Sikorsky is bidding for a $1.6 billion Pentagon contract to replace the president's aging helicopter fleet. Sikorsky is the company that promised, but failed to deliver, a previous fleet of helicopters known as the Comanche.

After taking 21 years and spending $8 billion on an aircraft that never took off — Defense Secretary Donald Rumsfeld finally axed it last February — Sikorsky wants to make another run. It makes you pine for the days of $600 toilet seats and $171 hammers of former Pentagon budgets.

If it was their own money they were spending, not ours, perhaps Congress would be more frugal. The president should use his veto and shame the Republican Congress into spending less and guarding the taxpayer's purse. As the president said during the 2000 campaign, it isn't the government's money, it's your money.

Tribune Media Services

Bush privatization plan faces tough opposition

Some reject plans to put funds into private investment accounts.

WASHINGTON (AP) — President Bush will confront formidable hurdles in Congress as he pursues an overhaul of Social Security, the New Deal program known as the untouchable third rail of politics. Add soaring budget deficits to the debate, and his effort becomes even more difficult.

Republicans, eyeing the 2006 midterm elections, have made clear they want a heavy political hand from the White House on the issue. Democrats are trying to hold tight in opposition, aided by troubled financing for the project.

"I fully recognize it's going to require a bipartisan effort to address the issue," Bush said, ruling out payroll tax increases to help pay for an estimated $2 trillion in start-up costs.

Compounding Bush's effort is opposition from the largest advocacy group for seniors, AARP, which is gearing up for a major fight.

"I don't see anything yet that would indicate a bipartisan approach," said John Rother, legislation and public policy director for AARP, which has 35 million members.

Former Rep. Bill Frenzel, R-Minn., a member of Bush's 2001 Social Security commission on partial privatization, said Social Security remains "the third rail" of U.S. politics.

That's because older people vote. Seniors age 60 and older were 24 percent of the electorate in November's presidential election. Voters age 45 to 59 made up 30 percent. Bush polled slightly ahead of Democratic challenger John Kerry among these age groups, according to Associated Press exit polls.

Current benefits

Creating investment accounts alone will not fix the future shortfall. Cuts in benefits are required, and investments are expected to make up the losses. AARP wants a wide-ranging debate on improving the system's finances.

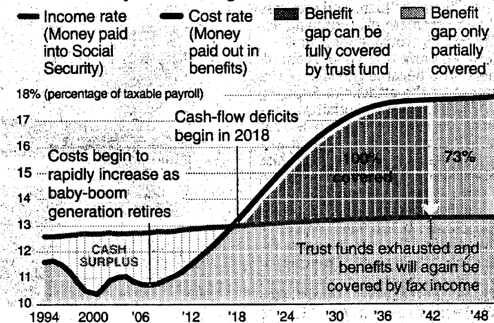
"Private accounts are kind of a diversion," Rother said. "There are many ways to fix the system. If all this debate is about is private accounts, then it's going to deteriorate with little chance of actual success in meeting the problem."

AARP, which was heavily criticized by its members for backing Bush's Medicare prescription drugs plan, opposes any partial-privatization proposal that diverts money from the current system into accounts.

That's what Bush wants to do.

SURPLUS OR DEFICIT | *Looking ahead*

Social Security's annual cash surplus will begin a rapid decline in 2007 as the baby boomer generation begins to retire, according to the Social Security Administration. With current rates, deficits are expected to begin in 2018.



Source: Social Security Administration

AP

Though he hasn't offered specifics, he says younger workers should be allowed, if they choose, to divert a portion of their payroll taxes into accounts. The problem? The 12.4 percent in taxes deducted from paychecks, split by workers and employers, helps fund current retirees benefits.

Bush promises that benefits will not be cut for retirees or those nearing retirement. But he must come up with about $2 trillion, depending on the size of the investment accounts, to continue paying retiree benefits.

"If there's one issue our members are united on, this is it," Rother said, adding that AARP will be "very visible and very aggressive" on the debate, expected to start when Congress returns in late January.

Deficit concerns

Republican leaders hope to pass legislation by the end of next year. But former House Ways and Means Committee Chairman Bill Archer, R-Texas, cautioned that a bill will take time, especially with a growing concern about deficits.

"I don't think Social Security will be as quick in the Congress, and will depend on when the president sends up his recommendations," he said, adding that some lawmakers were politically skittish. "They want the president to take the heat and the resistance and the pushback before they go to work on it," he said.

Some Senate Republicans proposed raising or removing the limit on income subject to the payroll tax. The maximum level of earnings that can be taxed now is $87,900, and will rise to $90,000 next year.

But Bush's opposition to raising payroll taxes leaves borrowing as the only real option since further raising the retirement age is not being considered. The administration is considering some creative accounting that will not count borrowed funds in the budget as part of the skyrocketing deficit. Supporters view borrowing as a prepayment, comparing it to paying off a 30-year mortgage loan early.

But that could hurt efforts to get moderate Democrats and some Republicans on board.

Continued borrowing is a big concern to Sen. Ben Nelson, D-Neb., who supported Bush's tax cut packages, which expanded the deficit, said spokesman David DiMartino.

"It would have to be a pretty solid plan of repayment to get back to a balanced budget for the senator to put that much at risk," DiMartino said.

Leadership needed

Though some Democrats were willing to hold their fire to see what Bush proposes, others were critical.

"Ultimately, hiding the truth about benefit cuts or fleecing the public on massive borrowing would have a disastrous effect on the economy, not to mention betray the trust of the American people," said Rep. Bob Matsui of California, the top Democrat on the Social Security subcommittee.

Asks Frenzel: "Will the Congress be willing to suffer the risk of electrocuting itself at the president's request?"

DISTRIBUTION LIST:

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John McCain (http://mccain.senate.gov)
Zell Miller (http://miller.senate.gov)
John G. Breaux (http://breaux.senate.gov)
John D. Rockefeller IV (http://rockefeller.senate.gov)
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New York Times (oped@nytimes.com) (editorial@nytimes.com)
Chicago Tribune (jzieleny@tribune.com)
Washington Post (www.washpost.com)
LA Times (letters@latimes.com)
USA Today (editor@usatoday.com)
Rush Limbaugh (rushlimbaugh.com)

Committee for Economic Development

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May 6, 2005

The Honorable Charles E. Grassley
Chairman, Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, DC 20510-6200

Dear Chairman Grassley:

On behalf of the Committee for Economic Development (CED), we would like to submit a statement for the record of the Committee's hearing on "Proposals to Achieve Sustainable Solvency, With and Without Personal Accounts," held on April 26, 2005. CED is a non-profit, non-partisan, public policy research institute led by 200 senior corporate executives and university presidents.

CED commends President Bush for making Social Security reform a priority and for leading the national discussion on the need for reform. We also applaud your leadership in pursuing action on this issue in a bipartisan manner. We agree that Social Security faces problems, and that reform must be initiated now so that changes can be made gradually and so that workers have sufficient time to make appropriate adjustments in their retirement planning.

In undertaking Social Security reform, policymakers must be cognizant of its effect on the federal budget. Responsible reform would not only strengthen Social Security, but also could improve the long-term prospects for the federal budget. On the other hand, "reform" that adds to an already unsustainable budget deficit would be disastrous.

CED recommends creating a two-tier system that would both restore the fiscal solvency of Social Security and convince young contributors who perceive a low and diminishing return on their contributions that Social Security will provide a meaningful benefit to them. The first tier would return the current basic system to long-term fiscal solvency through relatively modest adjustments. The second tier would "add-on" a new system of individually controlled personal retirement accounts to increase the rate of return for younger workers.

CED believes that adding personal accounts to the basic system is necessary to maintain the relevance of the program to younger workers who are less risk-averse and more comfortable with investing in the stock market. At the same time, we recognize that personal accounts alone cannot restore solvency to Social Security. CED rejected a "carve-out" approach to personal accounts because it would deplete the resources needed to maintain Social Security's foundation for retirement security, and thus would undermine the fundamental character of the program. Furthermore, the transition costs of a carve-out program would significantly worsen the already bleak federal budget picture. CED's approach would boost the national savings rate, while a carve-out approach would not.

We welcome the current debate over the direction of Social Security and support responsible efforts to strengthen the system for the challenges that lie ahead.

Sincerely,

Charles E.M. Kolb
President
CED

Patrick W. Gross
Chairman, The Lovell Group
Co-Chair, CED Research & Policy Committee

Bruce K. MacLaury
President Emeritus, The Brookings Institution
Co-Chair, CED Research & Policy Committee

Social Security and the Emerging Budget Crisis

The latest federal budget projections indicate that the deficit is worsening, not improving, despite continuing economic growth – at a time when the retirement of the baby-boom generation, with its adverse long-range budget pressures, is just a few years away. Under current policies and proposals, there is a significant danger that the nation's debt will continue to grow faster than its income (that is, its gross domestic product, or GDP), and that there will be no time for policymakers to right the budget before the rapid aging of the population cuts off our best options.

Evidence continues to mount that sustained large budget deficits will erode U.S. investment, productivity growth, and prosperity for years and even decades to come. Deficits will either increase U.S. interest rates, or they will continue to increase U.S. indebtedness to foreigners, making our nation poorer and more beholden to our overseas creditors. Deficits could also threaten economic stability. The severe decline in the value of the dollar against major free-floating currencies around the world should sound a warning: A continuation of today's large deficits would be so corrosive of U.S. prosperity that no prudent public official would risk that outcome.

There is no silver bullet to stop the deficit. Each apparent opportunity for budget savings suggests other needs for greater spending. There are hopes for obtaining efficiencies in health-care delivery; but there are also obvious cases of under-use, there are under-served persons without health-insurance coverage, and there is the march of new and valuable but often expensive technology. Some believe that there can be savings from the standing military force; but against that, there is continuing high-intensity conflict in Iraq, there is organized terrorism elsewhere around the world, and there are needs for homeland security. There are always hopes for savings in domestic appropriations; but the total of domestic appropriations last year was less than the deficit; the President has requested substantial increases for an international AIDS initiative; and such priorities as the No Child Left Behind Act are now under-funded.

Nor can we assume that more-rapid economic growth will rescue us. Tax revenues have not responded sufficiently to past efforts to stimulate faster growth through tax cuts, and the adverse consequences of a failure of further experiments now would be far too great.

Two overriding conclusions follow from these facts: first, we will need every tool in the budget to bring the deficit under control; and second, it would be irresponsible in the extreme to engage in deficit-increasing policies now, in the vain hope that as-yet unspecified substantial savings will be found later to erase the problem. The deficit is already far too large, and there is far too little time to correct our course before the demographic tidal wave breaks upon us.

Thus, budget policymaking this year will be important if not critical to our future prosperity. And by all accounts, the major item on the policy agenda this year will be Social Security reform.

Social Security is of vital importance in its own right, but also this year because it can have a critical impact on the nation's overall fiscal policy. So beyond maintaining the main safety net for the elderly, the disabled, and survivors of deceased younger workers, Social Security legislation could make or break the budget.

Social Security is a significant underpinning of the nation's now-crumbling fiscal structure; it must not be weakened, but rather its reform should contribute to the strengthening of our budgetary standing. For at least the next 13 years, Social Security will be an important source of support for the otherwise deteriorating remainder of the federal budget. After that time, Social Security itself will begin to drag the total budget down. Policies to strengthen Social Security's long-run balance could make an important, and possibly essential, contribution to the overall budget picture for the next three to four decades, and could increase the insufficient flow of total savings for the prosperity of the nation as a whole. On the other hand, policies that hope to strengthen Social Security in the still more distant long run, but in the meantime weaken its finances for the foreseeable future, could cause fiscal collapse before the future savings could ever materialize.

-More-

We believe that ***the nation must not worsen the budget by borrowing still more money today, in the name of saving Social Security in the far-distant future.*** The federal budget is in dire straits already, adding to the public debt faster than the growth of the nation's income; there are inestimable risks to allowing the budget to grow even worse. We cannot argue too strongly against policies that supposedly make Social Security solvent ***when measured over an unrealistically long or even infinite time horizon.*** Substantial net budgetary costs for several decades must not be sanctioned in the hope of far-distant savings. We find such an approach extraordinarily risky – especially when world financial markets already have begun to question the nation's ability and will to control a public debt that already is growing faster than the economy.

Such policies – which generally would divert payroll taxes to fund personal retirement accounts, with the lost revenues replaced through increased public debt – would impose a substantial burden on young workers, who would be required simultaneously to fund both their own retirements and the retirements of current retirees (and older workers who would remain under the current program). It is no favor to those younger workers that the transition costs are postponed; the resulting deficits and debt would burden them for the rest of their lives. The transition costs would continue to mount for decades, and they would bear interest into the even more distant future.

The inescapable reality is that federal deficits place a burden on young – and even future – workers. In fact, it would be entirely fair to say that additional large deficits are tantamount to a delayed tax increase. There are no accounting devices that would negate these very fundamental ill effects of mounting debt. The issue is not what different budget measures are called. Debt is debt; the federal government must pay interest on all new debt, whatever the motivation of its underlying costs. Furthermore, debt incurred today reduces the federal government's flexibility to address other contingencies that might arise tomorrow – including war and other threats to the national security. In our judgment, debt-financed Social Security restructuring would be irresponsible, with potentially catastrophic consequences, and a risk of failure that is far too high.

Nor would such an approach increase the nation's pool of saving. If the federal government borrows a dollar, and gives it to an individual who saves every cent of that dollar, then the nation's total saving does not increase at all; it is precisely unchanged. If the individual spends any of that dollar – perhaps because receiving the dollar makes him or her feel wealthier – then the nation's total saving is decreased, not increased. Thus, a Social Security restructuring plan financed by debt would miss a rare opportunity to ***increase*** the nation's deficient savings; it would most likely actually ***worsen*** the savings rate.

Finally, such a substantial increase in the public debt would threaten financial stability. It is unclear that the financial markets would accept a further ballooning of the federal debt, even if it would be numerically offset by millions of small increases in holdings of equities and bonds in personal accounts. The risks to financial stability are focused on the creditworthiness of the largest borrower, the federal government.

In sum, borrowing to establish personal retirement accounts, especially with the budget already in serious deficit, is extraordinarily risky. Success would require that the financial markets accept planned, substantial and sustained increases in the federal debt with an air more relaxed than in any episode on record. On top of the existing budgetary problems, and fiscal uncertainties ranging from life expectancies through retirement choices; to advances in health care technology and utilization; to productivity growth, inflation, and energy prices; to war, terrorism, and the aftermath of the 1990s stock market bubble and revenue boom, the nation cannot afford an outlook of decades of financial uncertainty of our own creation. Markets cannot wait that long for confirmation of the success of a Social Security reform; there would always be the risk of a sudden adverse reaction and a rush for the financial exits hanging over every business decision, no matter how large or how small. No responsible public official should accept such a risk.

America stands at a fiscal crossroad. As businessmen and women with a concern for the prosperity and security of our customers, employees and shareholders, we urge policymakers to begin now, working across the entire range of the budget, to turn the deficit around so that we do not enter the retirement of the baby boom with a public debt already growing faster than our ability to repay it. And viewing the budget agenda for this year, our most urgent message is that we must avoid a borrow-now-pay-later approach to Social Security restructuring that puts a fragile financial outlook even further at risk.

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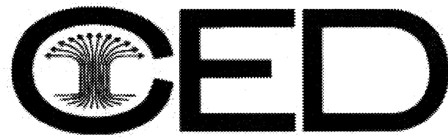

Fixing Social Security: A CED Policy Update

MAY 2005

An Update of a Policy Statement by the Committee for Economic Development's Research and Policy Committee

THE PURPOSE OF THIS UPDATE

At the President's urging, the first and most prominent item on the legislative agenda for this year is Social Security reform. Social Security is of vital importance both in its own right, and because it has substantial impact on the nation's overall fiscal policy. CED is concerned today that a misguided approach to Social Security restructuring might not only endanger the accomplishments of that program, but also miss an important opportunity to turn the nation's fiscal policy back in the right direction. Such an approach could even do still further damage to our financial standing at home and in the international marketplace. In short, Social Security legislation could make or break the nation's essential safety net, and the budget.

CED issued a report, *Fixing Social Security*, in 1997, and we believe that the principles and policy recommendations are as pertinent today as they were then. This brief statement explains why that proposal remains highly relevant today, in terms of both fiscal policy and retirement policy.

INTRODUCTION

Like most Americans, we believe that Social Security, more formally known as Federal Old-Age, Survivors and Disability Insurance (OASDI), is one of the most successful social programs in U.S. history. The basic objective of Social Security—to protect the economic security of retirees—is sound, and the nation must not falter in its commitment to it. Social Security also provides an important safety net for survivors of younger workers, and for the disabled, saving their families from severe financial distress. It provides financial security for those who live very long lives, with inflation protection that is virtually impossible to obtain from the private sector. The decline in poverty rates for the elderly is strong evidence of the overall beneficial effects of this program. Social Security fulfills all of these functions at minuscule administrative cost. These virtues must be preserved through any proposed reform.

Still, because of the challenge posed by the aging of the U.S. population, substantial change in the Social Security system is inevitable. When the baby-boom generation begins to retire, the system's current operating surplus will begin to decline, after which the trust fund balances will be drawn down at a rapid rate. If no action is taken, the system will be forced to impose a very large, inequitable and economically inefficient increase in the tax burden on future workers, and/or sharp and disruptive cuts in benefits, in an approximate range of from 2018 (the time when Social Security tax revenues fall short of benefits, according to the Social Security actuary) to 2052 (when the Social Security Trust Fund is exhausted, according to the Congressional Budget Office). But the problems of the system should not be exaggerated; under current economic and demographic assumptions, and with no additional sources of revenue, Social Security can continue to pay somewhere in an estimated range of from about 73 percent (according to the Social Security actuary) to about 78 percent (according to the Congressional Budget Office) of currently promised benefits in perpetuity.

CRITERIA FOR REFORM

Given the Social Security funding shortfall, reform will be a collection of unpleasant steps, chosen to minimize the overall pain. Even in instances where the goal of reform is to improve some aspect (such as the balance of relative benefits across generations) of the current system, progress will be constrained by the actuarial deficit in the system. Agreement on the fundamental objectives of Social Security and its relation to the broader issue of national retirement policy would help the nation to spread the discomfort fairly across the population.

Considering the important role that Social Security plays in our society, CED recommends the following criteria for evaluating proposed changes in the system.

- Social Security should provide a minimum retirement income—that is, a safety net—for all workers and their families. The lack of an adequate retirement foundation would result in hardship among the population (especially those with persistent low incomes or who suffer economic setbacks), and persuasive demands for relief through other federal, state, and local programs, which would be less equitable, more administratively costly, and demeaning to the elderly.
- The Social Security benefit structure should retain an element of progressivity, whereby the ratio of benefits to contributions is higher for lower-income workers.
- Participation in the Social Security system by workers should be universal, because the burden of supporting the redistribution and insurance elements of Social Security should be shared as broadly as possible.
- Social Security reform should strive for greater equity between generations and for better returns on contributions than the present system will provide for future retirees. When the program's funding runs short a few decades from now, future workers and retirees will face higher taxes or lower benefits, or both; and some privatization plans would in effect burden those workers with funding both their own retirements and those of the baby-

boom generation. Hiding such burdens through massive borrowing would do those younger and future workers no favor. Timely reform should aim to minimize this inequity through increased saving and investment, and also through higher returns for younger and future workers.

- Reform should also seek greater equity among current participants, particularly between workers with nonworking spouses and other retirees.
- A fundamental objective of Social Security reform is to increase national saving, so that the burden of supporting rising numbers of elderly is made less onerous by more rapid capital accumulation and economic growth.
- Social Security reform should not derail the critical economic objective of eliminating deficits in the federal budget. With deficits far too large and with prospects for sufficient improvement dim, Social Security reforms should reduce, not increase, deficits and borrowing in the coming years. (CED also advocated improvements in the federal budget process to ensure that these budget savings are protected, and not immediately spent. See *Exploding Deficits, Declining Growth: The Federal Budget and the Aging of America*, Committee for Economic Development, March 2003.)
- Reform measures should minimize disincentives for labor force participation by the elderly, and encourage private saving.
- Changes that have a continuing positive effect on the system's actuarial balance and provide automatic responses to changed circumstances (such as a larger-than-anticipated increase in life expectancy) are preferable to one-time changes that merely postpone insolvency.
- Reform measures should be administratively feasible, should not raise administrative costs significantly, and every effort should be made to minimize costs arising from investments in private assets.
- Changes in Social Security benefits should be enacted promptly and phased in gradually. Those in or close to retirement must be protected. Current workers need reasonably accurate information concerning expected Social Security income in order to make informed decisions about retirement saving and retirement age, and they require adequate lead time to plan and adjust their behavior to any changes in the system.

Of course, no reform proposal can fully satisfy all these criteria, because there are unavoidable tradeoffs. For example, cuts in benefits would be likely to increase both public and private saving, but would also reduce the economic security of retirees.

To balance these tradeoffs, CED believes that Social Security should be divided into two components: (1) a defined benefit that includes both a safety net for low-income and disabled workers and survivors, and insurance against the loss of retirement income; and (2) a mandatory personal retirement account (PRA), which provides retirement benefits from contributions accumulated in the account. Such a dual system would satisfy most of the reform criteria favored by CED, as explained below.

SUMMARY OF POLICY RECOMMENDATIONS
Reforming the Existing System

With respect to the existing defined benefit, the CED reform program would gradually phase in changes in the Social Security system and thereby avoid serious disruptions in labor markets and in the lives of retirees. It would protect the economic security of lower-income retirees, and over time further reduce poverty among the elderly. It would achieve the fairest possible balance of burdens across generations. Present retirees and older workers would experience little or no change in benefits from the existing system (though the portion of benefits subject to taxation would rise for some). The particular policy steps enumerated below would both eliminate Social Security's 75-year actuarial shortfall, and reduce inequities between retired married couples with non-working spouses and other retirees.

- **Reduce the Growth in Initial Benefits.** CED's plan would reduce the system's costs by gradually reducing initial benefits for new upper- and middle-income retirees, but not for low-wage workers. (This step would have no effect on current retirees). Technically speaking, the most direct and equitable way gradually to trim the growth of prospective benefits is to reduce the growth in the primary insurance amount (PIA), which is the first-year benefit received by an individual who retires at the normal retirement age (NRA). CED's plan would gradually reduce replacement rates for the two higher-wage brackets in the PIA formula, thereby reducing the growth of future benefits in the existing defined benefit program for middle- and upper-income participants, but not for low-wage workers.

  The growth of initial benefits would be reduced further by increasing the number of years of wages included in the PIA formula from 35 to 40 years. Currently, those who contribute for only 35 years are eligible for benefits as high as for those who contribute for a longer period.

- **Reduce the Growth in Lifetime Benefits by Raising the Normal Retirement Age.** The normal retirement age long remained at 65, without adjustment to compensate for the large increase in life spans in the last half century. This raised the cost of Social Security dramatically. In 1983, Congress enacted legislation providing for a gradual increase in the NRA to 67, which only partially offsets the rise in average life spans. To further compensate for past and expected increases in life expectancy, CED's plan would raise the normal retirement age by two months per year until it reaches 70 years. Thereafter, the NRA would rise in line with increases in life expectancy. The earliest eligibility age, currently 62 years, would be increased to 65 over the same period and subsequently similarly indexed.

- **Tax Social Security Benefits.** CED recommends that the income tax apply to all Social Security benefits in excess of the contributions made by the worker. (This result would be approximated by taxing 85 percent of benefits for all workers. Taxation of benefits derived from a worker's own contributions would constitute double taxation.) With this change, Social Security would be taxed like other contributory programs. Low-income recipients would not be affected because they are exempted from income taxation through the personal exemption that is available to all potential taxpayers, and a special higher standard deduction for the elderly.

- **Reduce Spousal Benefits.** At present, a spouse is entitled to a retirement benefit equal to his or her own benefit or 50 percent of the other spouse's benefit, whichever is higher. Consequently, the rate of return on contributions is much higher for couples with a nonworking spouse than for others. To reduce costs and to improve equity between working and nonworking spouses, CED recommends that retirement benefits for the nonworking partner of a retired couple be reduced gradually until they reach 33 percent of the worker's PIA. CED does not recommend any reduction in the non-worker's survivor benefits, which may be as high as 100 percent of the worker's PIA.

- **Expand Coverage to Include State and Local Employees.** The Social Security system redistributes income from high-income retirees to low-income retirees. CED favors continuation of a

redistribution element in the Social Security program. However, CED believes that as a matter of equity, the burden of redistribution must be widely shared, and therefore that coverage should be universal. Consequently, CED recommends that all new state and local employees be required to become participants in the Social Security system, and that current employees be permitted to join Social Security on a voluntary basis.

The CED proposal builds in a margin for projection error. The policy proposals were selected in 1997 to over-achieve 75-year solvency for the program, with a safety margin of more than one third of the then-measured deficit. Thus, enactment of the CED reforms could result in a substantial long-run surplus in the retirement program. Consequently, if experience confirms this projection, it may eventually be possible to terminate the phase-in of further cuts in benefits, or to reduce payroll tax contributions.

The Second Tier: Personal Retirement Accounts

CED believes that all employees and employers should be required to contribute to personal retirement accounts (PRAs). CED believes that the PRA system should be an "add-on" to the current system. Payroll tax revenues should not be "carved out" and contributed to private accounts, because existing payroll taxes are needed to finance benefits even under the reformed and newly solvent Social Security program, which would maintain the basic safety net. We believe that so-called "carve out" proposals, which divert payroll taxes to private accounts, would increase the budget deficit dangerously.

The PRAs favored by CED would have the following characteristics:

- PRAs would be funded by mandatory contributions totaling 3.0 percent of covered payroll, with payments split equally between employees and employers. (The self-employed would contribute the entire 3.0 percent of covered payroll.)
- PRAs would be owned by individuals and directed by them. Contributions could be invested only in a limited number of broad-based funds that hold private-sector financial securities.
- Contributions to PRAs would receive tax-preferred treatment similar to that accorded to 401(k)s. Individual and employer contributions would be made from before-tax income, and earnings would accumulate on a tax-deferred basis. Individuals would pay taxes only on future benefits derived from PRAs.
- The accumulated balances in PRAs would be part of the estates of deceased workers in the event of death before retirement.
- We recognize that some mandated business participants and their employees, as well as many self-employed, do not have hands-on experience with retirement saving accounts. Therefore, to protect these groups, special rules for PRAs will be needed to assure appropriate communications, prudent investment alternatives, reasonable fees, and preservation of funds for retirement. In providing appropriate safeguards for PRAs, maximum use should be made of existing regulations governing private pensions and 401(k) and IRA saving plans (revised as needed) to minimize the need for new regulatory or supervisory bodies.
- To assure that PRAs would be used for their specific intended purpose—to provide retirement income for the full lifetimes of the participant and spouse—CED favors rules applicable to PRAs that (1) prohibit withdrawals or borrowing of PRA funds before retirement, and (2) ensure that funds are withdrawn gradually over the life of the participant after retirement. (This would occur, for example, if PRA fund balances were annuitized at retirement.) Employers that already manage pension funds for their employees may find it necessary to create separate "side-car" accounts for PRA contributions to comply with the additional restrictions applicable only to PRAs.

The PRAs would also generate a sizable increase in private (and national) saving. Of course, some individuals and businesses will finance contributions to PRAs by reducing present contributions to private pensions, 401(k)s, etc. To the extent that this form of substitution occurs, there will be less increase in private

saving, labor costs will be unaffected by PRA contributions, and retirement saving created by PRAs will be partially offset. Moreover, if tax-sheltered PRAs are substituted for saving that is not entitled to tax preference, federal revenues would be reduced, thereby offsetting some of the improvement in private saving. However, a large number of workers, including most contingent and part-time workers, are not currently covered by discretionary employer retirement plans, and many workers have little or no personal savings to shift into the new PRAs. For those with little or no saving, the creation of mandatory PRAs will undoubtedly generate a large increase in saving. Furthermore, for some, the experience of owning such assets may encourage additional saving.

The creation of PRAs will help to restore the confidence of young people in the Social Security system by offering an opportunity for a higher return on contributions and giving workers a sense of ownership. Although contributions to PRAs would be mandatory and, in many cases, would raise business costs, these contributions should not be considered taxes because no revenue is received by any government agency and the funds are personally owned and privately invested.

CED acknowledges that the requirement for compulsory savings will be difficult for workers at the lowest income levels. However, the alternatives of increased payroll tax rates while still employed or inadequate benefits while retired would be totally unacceptable.

CONCLUSION

Thus, the CED plan would create a two-tier system: (1) a fiscally balanced basic benefit—that is, the present "defined benefit" program with spending growth cut sufficiently to make the system sustainable; and (2) a new "defined contribution" program that would involve mandatory contributions to PRAs. If this two-tier system is enacted promptly, the economic safety net now provided by Social Security can be preserved without overburdening future workers. The economic well being of low-income retirees would be protected because most of the benefit reductions in the current system (though not the increase in the retirement age) would be limited to middle- and upper-income participants. PRAs, which would provide an additional source of retirement income for all retirees, would be particularly valuable for those whose benefits from the defined benefit system are cut. Intergenerational equity would be improved by increasing the importance of benefits derived from a funded system, and by offering an opportunity for younger people to receive adequate investment returns on their contributions. This CED plan provides a retirement saving program for workers not covered by a retirement plan, including part-time and contingent workers who frequently do not have access to private retirement programs.

Finally, and importantly, the CED program would generate a substantial increase in national saving that would help to boost long-term economic growth and thereby make it easier for the nation to support the growing elderly population. Without such reform, the nation will confront the very unpleasant choice of a substantial reduction in the economic status of the elderly or an economically damaging and unfair burden on future generations of workers. In contrast, most of the proposals for converting Social Security to a privatized pension pay for at least a part of the transition costs by increased federal borrowing. With deficits already too large and the beginning of the retirement of the baby-boom generation just three years away, such a strategy would seem risky in the extreme.

In sum, CED's approach to Social Security reform would seem more in tune with widely accepted principles of social cohesion and fiscal prudence. We urge policymakers to consider this alternative. ■

Senate Committee on Finance
Attn. Editorial and Document Section
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Washington, DC 20510-6200

Statements for the Record concerning *Proposals to Achieve Sustainable Solvency, With and Without Personal Accounts* hearings held on April 26, 2005, at 10:00 a.m. in 628 Dirksen Senate Office Building.

Statements submitted by: Houston Young Republicans, P.O. Box 130621, Houston, Texas 77219, Will Hickman – Policy Director:

Houston Young Republicans (HYR) would like to thank the Senate Committee on Finance for the opportunity to submit our comments regarding this critical subject. We are now at the point in the process where everyone agrees that Social Security has serious long term financing problems, and those in the legislative process are beginning to craft solutions.

We feel that possible approaches could be to:

1. Deny there is a problem and do nothing. This approach would lead to bankruptcy of the system in the near future and serious benefit cuts starting in 2041.

2. Kick the can down the road. Such an approach would postpone the problem, and allow a future generation in Congress to have this debate again.

3. Fix the problem. A permanent solution to the problem seems like the only common sense alternative. While each of the proposed solutions has costs and drawbacks, we need to make short term sacrifices so that the system can survive.

We will first make comments regarding each of the panelist's proposals, and then suggest some slight changes.

Mr. Robert Pozen, Chairman, MFS Investment Management:

Pozen suggested a progressive indexing approach for wage indexing for those whose average career earnings are $25,000 or less, price indexing for those whose average career earnings are $113,000 or more, and a combined approach for those in the middle.

Pozen stated that the " ... debate needs to focus first on solvency, and only then on personal accounts." However, he later states that a personal account is intimately intertwined with solvency, as a retiree's burden on the system is reduced as the size of her personal account grows. His example of "a combination of progressive indexing

and a carve-out PRA with a 2% allocation would make Social Security solvent by the end of the standard 75-year period."

Pozen's progressive indexing strategy alone would take the second approach of kicking the can, as he states that some changes to Social Security, " ... may be politically acceptable if instituted in distant time periods." While such an approach is politically appealing, it merely shifts the burden to the backs of future laborers and does not fix the problem. However, a combined progressive indexing strategy with a "carve-out" PRA does solve the solvency problem.

Mr. Michael Tanner, Director, Project on Social Security Choice, Cato Institute:

Tanner first recognized the problem and stated that the "do nothing" approach is the same as a 27% benefit cut. He stated that PRA's provide ownership, control, inheritability, and choice, providing workers " ... a nest egg of real, inheritable wealth."

Tanner's proposal is an option of diverting half of taxes (6.2%) to a PRA, and the remaining employer's portion (6.2%) going to the Social Security "trust fund" to pay benefits for survivor's, retirees, and the disabled.

Tanner set forth a new minimum Social Security benefit, realizing that younger workers who chose an individual account option would be able to realize higher benefits than under traditional Social Security.

Mr. Peter Ferrara, Senior Fellow, Institute for Policy Innovation, Director of the Social Security Project, Free Enterprise Fund

Ferrara recognized that the solvency problem can be solved with large personal retirement accounts, which at the same time allow all workers to accumulate personal savings and large investments. Ferrara's proposal would shift from a pay as you go system to an individual worker ownership system. All this could be achieved with no benefit cuts or tax increases.

The basic premise is to shift the retirement obligations of the system from the current trust fund to private accounts, with a minimum benefit guaranteed by the trust fund if the individual accounts are not large enough. This is accomplished through a 6.4% investment into a personal account. Over time, as existing obligations of the trust fund are reduced, payroll taxes are reduced.

Ferrara finances the transition with a national spending limitation measure, additional taxes resulting from increased business activities financed by the personal account investments, and borrowing a portion of the personal accounts in the form of government bonds.

Mr. Peter R. Orszag, Joseph A. Pechman Senior Fellow, Economic Studies, The Brookings Institution

First, Orszag's logic of comparing personal accounts to a loan from the government is completely backwards. In reality, workers would pay less of their money into the system, and put a portion into their own personal account, rather than fund the trust fund. We were confused as to how the government could loan us our own money. He did state that stock ownership for all earners is desirable, but not by borrowing against or "mortgaging" future benefits. Instead, we contend that the personal accounts replace traditional benefits.

Second, Orszag's statement that "the accounts do nothing to improve solvency within Social Security" is also logically flawed. To make that statement, Orszag assumes that at best, the personal accounts will only earn the government's borrowing rate. In contrast, every proposal regarding personal accounts includes a mix of bonds and equities that would far outperform the government's borrowing rate.

To solve the financing problem, Orszag proposes increasing the estate tax. This is actually the opposite of other proposals with personal accounts which create ownership, as the death tax destroys ownership between generations. We would encourage Orszag to raise income taxes and corporate taxes as well, as there is no logical connection to funding social security with an increase in the estate tax.

Orszag does recognize the benefits of ownership and control in the context of 401(k) and IRA's. He also extols the benefits of an automatic 401(k), such as enrollment, escalation, investment, and rollover, which would be beneficial to apply to the Social Security system.

Ms. Joan Entmacher, Vice President for Family Economic Security, National Women's Law Center

Entmacher argues against price indexing, as it would provide substantial benefit cuts. Next, she argues that personal accounts would do nothing to restore solvency. To solve social security's mere "financing shortfall," she proposes increasing payroll taxes for those making over $90,000, increasing income taxes, and increasing the estate tax. This approach of punishing successful workers is the opposite of the reward provided by a personal account.

Houston Young Republicans' Proposal

Rather than reinventing the wheel, HYR proposes taking pieces of the above proposals to achieve a workable solution to the current problems faced by Social Security.

Some parameters we applied to our analysis are to maintain existing benefit levels for current retirees and those soon to retire, have no increase in payroll taxes, provide a minimum benefit for younger workers and future generations of at least the current benefit levels, and investigate the use of personal retirement accounts.

We found that Social Security has a ratio problem, where the ratio of workers to beneficiaries is bad and getting worse. The ratio was above 40 in 1945, is currently 3.3 in 2005, and will drop to less than 2 in 2060. This decreasing ratio causes costs to increase faster than income, such that by 2017, costs will exceed income and Social Security will be heading for a deficit, and by 2041, the trust fund will be exhausted, and benefits will have to be substantially reduced.

Several approaches are available to fix the ratio problem: Increase payroll taxes; decrease benefits; or "fix" the ratio by increasing the number of workers - or - decreasing the number of beneficiaries.

We think the best approach is to decrease the number of beneficiaries by replacing young worker's traditional benefits with a self-funded personal account. These workers' Social Security benefits will be self-funded, and they will not need benefits paid from the trust fund. We propose that all workers be allowed the option to participate in the personal account option.

A minimum benefit level for survivors, disabled, and retirees would remain, based on the current benefit amounts adjusted by wage and not price indexing, although the proposal could easily be adjusted by incorporating Pozen's progressive indexing to the minimum benefit level.

The proposal is very similar to Tanner's and Ferrara's discussed above, with slight modifications. We propose keeping taxes at 12.4% of payroll, while gradually increasing the portion going into a personal account over the next 50 years, such that during the years:

2005 – 2015 – workers invest 3% into a personal account;

2015 – 2025 – workers invest 4% into a personal account;

2025 – 2035 – workers invest 5% into a personal account;

2035 – 2045 – workers invest 6% into a personal account;

2045 – 2055 – workers invest 7% into a personal account;

2055 and on – workers invest 8% into a personal account, with the remaining portions of payroll taxes paid into the Social Security trust fund.

Our preliminary analysis suggests that, starting in 2030, as workers born after 1965 start to retire, benefit costs begin to decrease to a manageable level. Social Security retirement benefits are eventually entirely self-funded out of personal accounts, with a minimum benefit remaining for disability, survivor, and low-income beneficiaries.

In the personal accounts, each worker will invest a minimum of 10% into each of the five funds government bond, private bond, large cap equities, small cap equities, and foreign equities (based on Thrift Savings Plan). A default allocation of 60% Government bond, and 10% each in private bond, large cap equities, small cap equities, and foreign equities will be created for each work. Workers will have an annual opportunity to readjust their personal account portfolio. By 2040 over $20 trillion will have been invested in personal accounts, with over $12 trillion in government bonds (based on the default portfolio), which is more than enough to fund the transition from traditional trust fund benefits to personal accounts.

We agree with Tanner and Ferrara that large personal accounts can solve the solvency problem by replacing traditional benefits with self-funded accounts. We prefer a gradual phase in of the personal accounts, and in lieu of a tax reduction, prefer increasing the size of the personal accounts after the baby boomers have retired.

Pozen's progressive indexing strategy could be incorporated into our proposal, by creating a smaller minimum benefit for higher income individuals.

We disagree with Orszag's proposals to increase the estate tax, and his assertion that personal accounts would actually worsen Social Security's solvency. We feel that his proposals for an automatic 401(k), such as enrollment, escalation, investment, and rollover, would be beneficial to apply to the Social Security system

Similarly, we disagree with Entmacher's proposal to increase payroll taxes for those making over $90,000, increase income taxes, and increase the estate tax. In order to address Entmacher's concerns about security, we have proposed a minimum benefit level based on current benefits as a safety net for all retirees, disabled, and survivors. In addition, Entmacher recognized that more women are now working. Under the current system, they could receive either their own benefits or survivor benefits if their spouse died. With personal accounts, they could receive their own benefits and inherit their spouse's personal account.

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April 28, 2005

Senate Committee on Finance
Attn. Editorial and Documentation Section
Rm. SD-203
Dirksen Senate Office Building
Washington, D.C. 20510-6200

Subject: Social Security

Dear Senators:

I am an independent voter who votes for individual candidates based on all issues, not any single issue. Enclosed is a copy of a letter that was somewhat recently written to the President.

I am appalled at the fact that the President traveled to sixty cities to promote his ideas on Social Security under the guise of appearing at "town hall" type meetings. The only people who were allowed to attend these "town hall" type meetings were hand selected by the local Republican Party. The local Republican Party should reimburse the Federal Treasury. Until that occurs, the President and the local Republican Party have stolen my tax dollars. Hand selecting individual citizens to attend these "town hall" type meetings is not my idea of democracy. It may not be illegal but it is morally wrong and goes against my values of fair play.

If there is a problem with Social Security as presently structured, by all means you should be looking at ways to making it secure for all generations. However, private accounts have absolutely nothing to do with fixing Social Security. They are two entirely and separate issues and should be treated as such.

I offer some suggestions for your consideration.

All citizens should be under one system. There should not be separate systems for federal employees, nor for the "elite".

Money that is collected for Social Security should be untouchable and used strictly for benefit payouts. The fund should not be allowed to be borrowed against for any purposes with the possible exception a written declaration of war.

There should be no cut off of withholding at any salary level.

Those wealthy Americans who do not need Social Security should be asked to voluntarily to waive their rights to those funds. Should their financial situation change, their waiver may be withdrawn.

David C. Humes

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Social Security should be applied to items that are not a complete necessity to conducting business, yet have value and worth. Such items could include but not be limited to; luxury companies cars, limousines, first class air travel, and corporate aircraft. It should also be applied to such items as meetings held away from corporate headquarters, stock options. There are employees who derive benefits from these luxury items.

I am sure that all of you as individuals are both nice and intelligent men and women. I am sure that you sought life in public service to help people. I hope that you all will remember the reasons that you sought your current position. From where I stand, all too often, I see two Parties that are interested in either the "credit game" or the "blame game". Your first, and only, loyalty should be to your constituencies. All too often I see Parties that have become more interested in power for power's sake.

The sooner that you can take money out of the equation, the sooner you can do the jobs that you wish to do. Eliminate all PACs. Eliminate all lobbyists. Make it illegal for any Congressperson to have any charitable fund. Make it illegal to make campaign contribution from one candidate's election fund to that of another. Contributions to such funds corrupt the process .

I hope that you will do the right thing, for the right reason.

Respectfully,

David C. Humes

Enc.

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March 8, 2005

Mr. George W. Bush
President
1600 Pennsylvania Ave. NW
Washington, D.C. 20205

Dear Mr. President:

There has been much talk about proposals regarding Social Security. Personally, I will keep an open mind and not rule anything out.

As best I can understand, there is a "broad concept" for private accounts. The Republicans are getting after the Democratic for criticism and saying nothing has been finalized. (I don't know why the Democrats don't get after the Republicans for supporting something that doesn't yet exist. That would be the "flip" side.) All this tells me is that the same old partisan politics is enveloping the matter and nothing will get done.

If I am to believe that anyone is serious about bolstering or fixing Social Security, there is a logical first step. If Social Security is not good enough for you, 535 members of Congress and who knows how many federal employees then it shouldn't be good enough for me. Again the "flip" side is, if Social Security is good enough for me, it is surely good enough for all federal employees. The first step is to put ALL citizens in the same program. Unless everyone is in the same program it will be hard for me to believe that anyone is really serious.

As far as privatization is concerned, the reason for its consideration is due to the fact that the return on Social Security is not great enough. If all of the considerable resources of the federal government cannot find a way to get a great return, how is this possible that ALL individual investors will be able to do better? Some may due better managing their own money. Most will not.

When I hear about any pending legislation I ask myself the questions, "Who benefits?" Will the Mom and / or Dad making minimum wage benefit from privatized accounts? I find that hard to believe. When I think about the median income of $ 33,000, I don't believe individuals or families earning that amount will benefit. As far as I can see, the majority, the average citizen, is not really benefiting. If the majority is not benefiting either the plan is wrong or it is time to find another plan.

Respectfully submitted,

David C. Humes
C: Sen. Arlen Specter, Sen. Rick Santorum, Rep. Curt Weldon, Party Leadership

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April 26, 2005

Mr. Kolan Davis
Majority Staff Director
Senate Finance Committee
Room 219
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Davis:

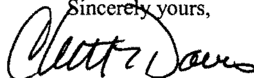
As the debate in Congress begins to address workable solutions on Social Security, I thought you might be interested in a two part series of articles I wrote for *Investment News*. Most of the articles discuss how the debate will unfold.

As you deliberate the solution phase, review my suggestions at the end of the second article where I've highlighted an approach. I point out that taxpayers have had a form of personal savings accounts for thirty years (they're IRAs) but only 40% of households use them. Going further, I suggest an effective approach to funded savings accounts would be to allow all taxpayers to have an account with an optional checkoff of 1%, 3% or 5% of annual income, with a default set at 3%.

I hope the articles are helpful; if you consider my suggestions for savings accounts, you may have a way to resolve an important part of the overall debate.

Best regards and good luck on this important legislative initiative.

Sincerely yours,



Christopher L. Davis
President

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InvestmentNews
The Weekly Newspaper for Financial Advisers

February 28, 2005

The political sparring over Social Security

By Christopher L. Davis

First of two parts

In his quest for historic reform of the Social Security system, President Bush has set his sights on a goal with enormous political risk. Members of Congress refer to Social Security as "the third rail of American politics" for good reason: Even the suggestion that you might touch it has been enough to end a political career.

So the reward for success for Mr. Bush will be equally significant: a place in history as the first president since Franklin D. Roosevelt to structurally change this most trusted of American institutions.

The coming political fight may well be won or lost in Round 1: determining who controls public perceptions of the issue. Most modern American political fights are essentially over semantics, so the side coining the catchphrase that indelibly defines the issue in the minds of the public scores heavily.

For Republicans, the debate is all about the building of an "ownership society" that moves citizens away from dependence on the federal government and gives them more control over their economic destiny.

According to their argument, Social Security reform is a necessity because of the impending "crisis" brought about by the system's inherent instability and looming "bankruptcy." And a key part of the solution is "personal savings accounts," financial instruments that will transform workers into shareholders, shaping their own destinies.

The Democratic side has already countered with its own glossary of terms: "gambling," "roulette," "scheme," "risk," "privatization," "$2 trillion cost" and "benefit cuts," to name a few. Driving its opposition is the effort to preserve the most successful social program in the country's history — a program that is at the heart of the party's identity.

And the Democrats seem to have the momentum. The president's opponents have the edge early in Round 1 simply because it is easier to argue against change in the absence of a detailed plan as to how that change would be accomplished.

The "unknown" and its consequences are easy targets.

Also shaping the battle are differences in how Social Security is viewed. Is it a malfunctioning "retirement system," as Mr. Bush and his supporters see it, or a lifeline, extended by FDR to a desperate populace, that has survived for 70 years with periodic shoring up?

The outcome of Round 2 will be determined by who will provide the details of a viable reform plan.

In deciding to stick with generalities in his State of the Union address, Mr. Bush sought to give GOP congressional leaders considerable flexibility in filling in the details. We know from the president that his plan is voluntary, involves personal savings accounts, is directed at the young, will have built-in safety measures, won't increase payroll taxes, will allow the transfer of wealth to one's heirs and won't affect anyone 55 or older.

Now it is a race to fill in the blanks.

There are a number of GOP proposals circulating on Capitol Hill that would reform the system, almost all with personal savings accounts at the foundation but with other planks ranging from changing the way we finance all benefit programs, to converting benefit formulas based on the relationship of the wage index to the price index, to cutting benefits and raising the maximum level of income subject to Social Security taxes.

In the absence of a White House plan, GOP leaders can cherry-pick what works and drop what is most problematic.

And let's not forget the Democrats. While their minority status would surely doom any of their reform plans, the party will indeed have a plan that they say will fix what they term the "challenges" to the system. That will provide the party with cover from the coming GOP allegations that in the Democratic party's opposition to the president, it has become the "do nothing party."

But whatever the details, the GOP plan's first measure of success will be whether it gives a sense of unity to the Republicans in Congress, and silences internal critics. In short, a detailed plan will finally allow Mr. Bush to get his GOP ducks in a row.

In the absence of such a plan, there has been enough grumbling from GOP Senate voices alone to signal the magnitude of this task.

Of course, the future of any plan will

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likely meet its fate in Round 3 Whatever the content of the proposed reforms, it will come down to this simple equation: 55 Republican votes plus five others equals the magic 60 necessary to overcome a Democratic filibuster and bring any plan to a vote in the Senate.

At this advanced stage of the political fight, there will be numerous factors at play.

Those include: How much of his "political capital" is the president willing to expend on this one issue? What sort of "political cover" can he offer a GOP-controlled Congress that must face its own elections next year? Will the president's second-term status embolden GOP senators with their own aspirations for 2008 to become political "free agents" in the debate? Will any "red state" Democratic senators up for re-election next year decide to support the president? And most importantly: Where and how does he get those five votes?

The answers will help bring a resolution to this grand debate.

History teaches that on epic legislation, compromise produces a supportable resolution with neither side delivering nor suffering a knockout punch. By offering merely an options list from which Congress may assemble a plan, Mr. Bush should be able to claim a win in the end, saying that Congress acted to address the problem, and take credit for the good parts of whatever legislative pact is reached.

Building a better nest egg

In Washington, walking away with a partial victory can be just as good as the real thing. The politics of the next few weeks will likely decide the politics of the next few years.

The current thinking among the reform movement embodied by Mr. Bush and some GOP leaders in Congress is that Social Security is a "retirement system" that isn't functioning properly. Once that assumption is made, it is quite logical that these reformers will set off down a path that seeks to build a better retirement plan.

Thus, the argument becomes one of how a personal savings account will "build a better nest egg" for a beneficiary's retirement years. And it logically follows that once you favor the "nest egg" approach, you begin to talk about structural changes to the system (e.g., a move from wage indexing to price indexing) that will in turn place even more reliance on the "nest egg" solution as the key to resolving the problem.

Moving from "reform" to "change," then to "structural change" is an enormous leap in Washington.

Before we set off down that path, I am suggesting that we pause to remember what brought Social Security into being in the first place. The Depression decimated whole families, taking jobs and pensions, wiping out savings and throwing seniors in particular into a desperate poverty they had never known.

The voices of desperate people reached out in vast numbers to the federal government for a lifeline. That had never happened before.

In devising a solution to that problem, the Roosevelt administration followed the president's wishes: Create a program that functions like a private insurance plan; keep it "simple"; make sure it isn't a "welfare" program; and above all, ensure that the elderly can be assured of a safety net that will protect them from poverty in their retirement years. The system created to answer the original "crisis" wasn't about building a nest egg, passing wealth on to one's heirs or encouraging citizens to "save."

Given the context in which it was born and the original intent of its authors, it isn't hard to see why Social Security has essentially remained unchanged, except for some minor tinkering, over the past 70 years. In fact, adjustments to the system in the 1970s and early '80s suggest a course of action today.

Many economists are now arguing that a conservative approach, such as raising the Social Security tax to 12.6%, from 12.4%, raising the cap on taxable income above the current $90,000 and slowly extending the age of full retirement to 67 years, would take care of the system's problems well beyond the foreseeable future — in effect "tinkering" as opposed to "structural change."

Today, Democrats stand publicly united in their opposition to attempts to make structural changes to the Social Security system.

But privately, there are a number of Democrats who would be open not only to the "tinkering" approach to fix Social Security but also to establishing some form of co-existing personal savings accounts, as long as their creation didn't interfere with the system's promised benefits.

Just a few years ago, moderate Senate Democrats such as Bob Kerrey of Nebraska and the late Daniel Patrick Moynihan of New York were making much the same argument. The challenge for the Bush administration is to get from the "here" of the current deadlock to the "there" of a working compromise that will at once secure the system and take it into a new era.

In politics, being able to "pivot" an argument takes a lot of skill. It requires a mastery of the terms of that argument and the ability to manipulate them in order to change public perceptions.

But first must come the realization that furthering the current argument is a losing proposition. In other words, the first step is coming to grips with the fact that it is time to use the lemons you are stuck with to make lemonade.

Perhaps a first move for Mr. Bush is a step back from the path that takes him to defining Social Security as something that it isn't. A reiteration of the system's basic purpose might begin to bring both sides back to the table.

Next: Reforming the system and providing for increased savings

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Christopher L. Davis is executive director of The Money Management Institute in Washington, which represents the separately managed account and wealth management industries. He served in the White House as special assistant to the president during the Carter administration and has been a participant in public-policy debates for more than 30 years.

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InvestmentNews
The Weekly Newspaper for Financial Advisers

March 21, 2005

OTHER VIEWS

Bush's best bet on Social Security: Strategic retreat

By Christopher L. Davis

Second of two parts

Members of Congress, particularly House Republicans, have one eye on the Social Security reform debate unfolding this year and the other on next year's midterm elections.

Such elections, coming as they do at the end of the second year of a president's term, are not only a contest for control of Congress but also a barometer of how the administration is perceived. In the current situation, with the same political party in control of both the White House and Congress, their political fates are inexorably tied. If the president begins to lose much popular support, voters could send a message by taking it out on the GOP in November 2006. If the GOP loses control of Congress or sees its numbers reduced significantly, it will make it that much harder to move what's left of the president's agenda through the legislature in 2007 and 2008, when, for all political purposes, the president will likely be viewed as a lame duck.

This brings us to the reality of the political time frame available to this administration to do something as radical as its proposal to change structurally the Social Security system. While most Americans would say that President Bush's second term in the White House "just got started," we in Washington see it a bit differently. It really started long before the inauguration in late January — in late November when the White House intimated what would likely be the issue focus of a second term.

Time running out

Now as Washington welcomes spring, the term is at fast gallop, at least from a domestic-policy standpoint, toward a window that will likely close sometime by early fall. That's pretty much the cutoff date for a Congress that operates under that oldest of Washington maxims: If you're going to take on any controversial issues, you do it in the odd year. The premise is that with the electorate's notoriously short-term political memory, any public upset will be deadened with the passage of time. Given the time frame between now and the fall of this year, Congress' political nerves will only get more, not less, frayed.

Pardon the political-science lesson, but I bring all this up to put the current situation concerning Social Security reform in context. Whatever your feelings about the wisdom or merits of the president's proposal, the stark political reality is that as things now stand, it's not going to happen — at least not in the way the president imagined in his State of the Union speech just a few weeks ago.

Why? Number one, the president is still looking for that most elusive of political animals, a Senate Democrat (or a handful of them) willing to break ranks and prevent the reform question from getting stalled in filibuster gridlock. There are still no signs that even one of the Democrats targeted by the White House (i.e., a moderate Democratic senator up for re-election next year in a "red state" that the president carried this past November) is considering breaking party ranks. Democrats, positioned as the protectors of the most successful government program ever, are in the catbird seat. Second, there are a number of prominent GOP senators uncomfortable with the possible effects of the president's plan both in terms of the Social Security system and in terms of what it could mean for already-bulging budget deficits. And third, most GOP insiders recognize that for this to be a bipartisan effort, public opinion will have to take a huge shift toward supporting the president's plan.

Those party insiders are frank in their estimation that the only way for that to happen is to wage a huge public-information campaign that would take many months. They also know that the campaign currently being undertaken by the White House, GOP congressional leaders and third-party sur-

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rogates is just not long enough or strong enough to do the job.

So what's to be done? In Washington, there are two ways to win: the traditional way (actually beating the other party) and the Washington way (walking away to avoid being perceived as having lost). Through these past months of debate on the problems of Social Security and possible solutions, there is an undercurrent of consensus that the current system could be fixed without imposing any new structural change such as "private savings accounts." At the same time, there's a desire for taking the system forward, if only it could be done without setting off alarms among current and future beneficiaries.

Fixing the current system without permanently changing its structure would please Democrats. Offering an innovation such as private savings accounts on top of the current system, while not thrilling the administration and GOP leaders in Congress, is probably a scenario they could live with, particularly if it would allow them to portray the outcome as at least one cautious step toward their vision of an "ownership society." And more important, it would be non-threatening to Democrats, who could position their support of the innovation as proof that they are not stuck in the past and are open to new approaches to getting Americans to save. Such a solution could get us to a win-win scenario for both sides.

I propose that we save the current system through some combination of steps that a host of economists from both sides say will stabilize Social Security for the foreseeable future. Those steps could include some combination of raising the cap on taxable income from the current $90,000 (the president has already suggested this possibility, and Sen. Lindsay Graham, R-S.C., is floating a plan to raise the cap to $200,000), raising the payroll tax by less than 2 percentage points, cutting rates of future benefits for future retirees and cutting some benefits to wealthy retirees. These steps would solve the system's problems.

Once a formula for the above has been agreed upon, I would introduce an innovation that should be acceptable to all sides, the check-off plan. This would enable citizens to have private savings accounts dedicated to their retirement years that they would use in addition to their traditional Social Security benefits. Just as each taxpayer has the ability to designate the number of withholding allowances on their W-4 form, a new space would be added for them to check off the amount of after-tax dollars they wanted to be placed into their new private savings account. Each would be given the choice of checking off 1%, 3% or 5% of after-tax dollars, with a minimum of 1% going into the account, and a default of 3% for those failing to make the choice.

The check-off money would be invested in stable portfolios, and the program would be managed by the Social Security Administration in Baltimore. A structure would be put in place to ensure that workers had the option of investment styles suitable to their age at the start of the program — more aggressive investing for those under 50, more conservative for those 50 and over. The money held in this account would accumulate tax free and be accessible on that basis to each individual at retirement.

This solution would accomplish several things at once. First, Social Security would be stabilized. Would we have to address the system's problems again in another 20 years? Quite possibly. But as with the adjustments made in 1977 and 1983 to tweak the system, the above solutions would bring stability for many years to come. Second, the new savings accounts would not only encourage individuals to save, they would also go a long way toward providing a real retirement nest egg for many people who otherwise would not have one. It would offer the individual an opportunity to make a real choice about their future retirement planning, an option that the current Social Security system does not, and should not, provide. Finally, it would ensure actual funding. For 30 years now, American workers have had something akin to private savings accounts — the individual retirement account — but only 40% of U.S. households use them. Under my proposal, every worker would have such an account, and these accounts would be funded.

Face saver

What's in it for both sides of the current debate? Two words: saving face. There are many well-intentioned people on both sides of this issue who sincerely believe that their way is best for the American people. But it's also a public-policy debate that has become boxed in by the political interests at stake for both sides. When this happens in Washington, the best way out is a compromise solution allowing both sides to declare victory. My check-off plan fits that bill, is relatively painless, would ensure funded personal accounts, and moves the entire debate to a workable resolution.

Christopher L. Davis is executive director of The Money Management Institute in Washington, which represents the separately managed account and wealth management industries. He served in the White House as special assistant to the president during the Carter administration and has been a participant in public-policy debates for more than 30 years.

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National Committee to
Preserve Social Security
and Medicare

Barbara B. Kennelly
President &
Chief Executive Officer

Senate Committee on Finance
Hearing on
Proposals to Achieve Sustainable Solvency,
With and Without Personal Accounts
Statement of Barbara Kennelly, President
National Committee to Preserve Social Security and Medicare
April 26, 2005

Mr. Chairman and Members of the Committee:

Earlier this month, the Senate engaged in an extended debate on an issue of great concern to millions of Americans: the privatization of Social Security. During that debate on the Senate Floor, it was stated: "this isn't a debate about Social Security's solvency; it's a debate about Social Security's legitimacy".

I believe this statement accurately describes both the nature of the policy debate before us as well as its importance to the American people. For many of us, the drive toward privatizing Social Security is not, at its core, a question of the program's finances. This debate is actually about what kind of society we believe in.

The National Committee to Preserve Social Security and Medicare represents over 4 million members and supporters who are united in their opposition to the privatization of Social Security and Medicare. The members of the National Committee understand better than anyone the importance of Social Security. Every day, over 47 million Americans – one out of every four households – experience the success of Social Security firsthand. This great program is the single largest source of retirement income in the United States, and each year it keeps 12 million seniors out of poverty. Social Security, unlike virtually any other financial instrument, provides a sound, basic income that is adjusted for inflation and that lasts as long as you live.

The members of the National Committee are seniors who have long experience with the unpredictability of life. They understand the true value of Social Security not just for themselves, but for their children and grandchildren.

My members fervently believe in Social Security. They have experienced firsthand the "hazards and vicissitudes" of life, and believe in a collective societal sharing of risk to guard against them. They also truly believe carving private accounts out of Social Security will ultimately result in the dismantling of Social Security as we know it.

The problems with replacing Social Security with a system that incorporates private accounts are many. First and foremost is the issue of cost. Because any projection of the program's solvency necessarily requires uncertain predictions of

economic growth, experts can disagree about the financial strength of Social Security over the long term. While there may be long-term demographic issues Congress should address to strengthen the program, it is by no means facing a financial crisis. Any system that is dependent on economic projections decades into the future will inevitably require adjustments from time to time, because no one can accurately predict that far in advance.

Completely apart from the reliability of long-term estimates, it is clear that diverting payroll taxes out of the Social Security program and into private accounts accelerates insolvency. How quickly the revenue flows go negative and the Trust Funds are unable to pay 100 percent of benefits depends on a number of factors, most significantly the amount allowed to be diverted and the number of workers who opt into the accounts. For example, allowing 4 percent of payroll taxes to be diverted into private accounts can drain the Trust Funds so quickly that today's surpluses are converted to deficits almost immediately, and the Trust Funds are unable to pay full benefits by 2030, a full decade earlier than the current Trustees' estimates.

In addition to the direct impact on Social Security, the creation of private accounts requires a massive infusion of resources spanning multiple generations. These costs are often obscured but are unavoidable in such a vast systemic change. Today, Social Security is a pay-as-you-go program, which means the payroll taxes paid by today's workers go to pay the benefits of today's retirees. Under privatization, however, today's workers must also fund their own accounts.

The result of privatization is that most workers end up paying twice – once to pay the benefits that have already been earned by current retirees, and then again to fund their own benefits, whether through borrowing, tax increases, cuts in future benefits, or some combination. A study conducted for the National Committee in 1997 concluded that every single generation living at the time of privatization would end up worse off financially than if nothing had been done to strengthen Social Security at all. More recent projections by other organizations, including the Congressional Budget Office, have reached similar conclusions.

The magnitude of the cost of privatization is evident in any private account plan. Those plans will necessarily incorporate deeper benefit cuts and/or dramatically larger borrowing to compensate for the money being diverted. These benefit cuts and the amount borrowed will be substantially larger than the amounts that would be needed to simply restore solvency to the existing program.

Plans that purport to create private accounts without benefit cuts or borrowing rely on unsubstantiated projections of economic growth that are unlikely to materialize. Minimum benefit levels guaranteed by some plans without also providing funding for these benefits cannot be relied upon to deliver these promises, particularly after the additional borrowing required to set up the private accounts.

Two such examples are the plans before you today presented by Michael Tanner and Peter Ferrara. In order to achieve solvency, these plans envision massive transfers of general revenues, the sources of which Social Security's actuaries accept without question or further analysis. The Ferrara plan, for example, would require transfers of more than $68 trillion over 75 years – funds which would be generated by a combination of implausibly large cuts in federal spending and unsubstantiated increases in corporate revenues. If these revenues fail to materialize, Mr. Ferrara simply reverts to additional federal borrowing to cover the shortfall. This system of financing private accounts was labeled by a senior advisor to the Concord Coalition as "the most wondrous perpetual-motion discovery in financial history".

The specific cost of the conversion will differ with the details of the plan, but clearly trillions of dollars will be required over time, much of it borrowed. Some proponents of private accounts describe these trillions of dollars of additional borrowing as nothing more than pre-paying a mortgage that is already owed. What they forget is what happens when you pre-pay the mortgage by borrowing money, which is what our current deficit situation will require. You end up paying a whole lot more by the time you are done.

The borrowing required to privatize Social Security is also the reason privatization is so bad for our younger generation. Proponents of privatization have spent the last decade trying to convince young people that Social Security will not be there for them when they retire, as a way of persuading them that they should not care about the dramatic benefit cuts that will necessarily be part of any plan that includes private accounts. For those who have been convinced they will not receive a benefit at all, a 50 percent cut in benefits does not seem like such a bad deal.

In reality, however, the younger generation is the one that will be hurt the most by privatizing Social Security. Because they are destined to spend the most time in the workforce under a privatized system, they will bear the brunt of the double costs. These costs are popularly described as "transition costs". We would argue that label is misleading because transition costs imply something that lasts a short time and then is gone. In contrast, the costs of this borrowing will last for generations. My twin 3-year-old granddaughters will still be paying off this debt when they reach middle age, as will the grandchildren of millions of the National Committee's members.

The impact of trillions of dollars in additional borrowing on financial markets is also unclear, with miscalculation potentially resulting in catastrophic consequences. Acceptance of the additional borrowing requires lenders to rely on assurances by current legislators that their successors 50 years in the future will follow through on the dramatic benefit cuts privatization plans will require.

Creating private accounts is so expensive, the trillions of dollars of borrowing must also be supplemented with deep benefit cuts. This aspect of privatization is only now becoming understood by the public. Most plans, including Plan 2 proposed by the President's Social Security Commission, anticipate two different layers of benefit cuts. The first one – a change in the indexation formula from wages to prices – is mandatory for

everyone eligible for a private account, whether they opt into an account or not. Over time, economists project this change alone will cut benefits by almost one-half.

Those who try to recoup some of these losses through investing in private accounts will then face a second round of cuts in addition to the first one. Though the mechanics differ from plan to plan, in effect the amounts invested in the private accounts are treated as though they were borrowed from the government in order to be invested, much like charging an IRA contribution to a credit card. When a worker retires, he is expected to pay all of that money back to the government, plus 3% interest *above inflation*, irrespective of his actual account balances. Even a low-inflation environment like today's still generates about 3% inflation, so in order to come out ahead, accounts today would have to earn over 6%. That is a pretty steep earning curve for accounts that are going to be limited to index funds, particularly if the Trustees' projections of dramatically lower economic growth in the future prove to be accurate. Again, economists project that over time, this so-called "clawback" or "offset", will eliminate the remaining half of a retiree's guaranteed benefit.

To summarize the benefit cuts, the indexation change takes away about one-half of the guaranteed benefit for everyone under the age threshold, and the "clawback" takes away the remaining half of the benefit for those who opt into private accounts – leaving those retirees entirely at the mercy of the stock market in retirement. Charts used by proponents of privatization in the recent Senate Floor debate show exactly the same outcome.

The Congressional Research Service confirmed this impact in a recent report. According to their analysis, today's 41-year-old would experience a cut in benefits of about 30 percent. A child born this year with lifetime earnings of about $35,000 a year (in 2004 dollars) – which represents an average worker – would face a 91 percent cut in benefits. If that same child earned $56,000 a year or more, he or she would have his or her Social Security benefit reduced to zero.

The indexation plan proposed by Robert Pozen presents a similarly difficult set of issues. While his proposal shields the lowest income retirees from cuts, middle-income workers will see their Social Security benefits cut drastically. Over 75 percent of Social Security's funding shortfall is closed through this single indexation change, much of which will fall on workers with annual incomes under $60,000. By breaking the link between earnings and benefits, blended indexation ultimately results in a single, flat benefit for all workers that is unrelated to their earnings or contributions. And because benefit levels are compressed down to the lowest earnings levels, over time the benefit will provide little more than a poverty-level income of little value to the average worker.

An additional issue to consider is that of risk. At a time when everyone's 401(k) accounts are still recovering from the bursting of the technology bubble, those who support privatization have found it prudent to adjust their proposals in ways that minimize risk, even though such accounts necessarily provide lower rates of return. Most of these plans envision a system of accounts that mirror the Thrift Savings Plan available to federal employees. There are a number of points that need to be made in this context. First, it must be mentioned that the Thrift Savings Plan does not replace Social Security for federal

workers; it is a supplement to a full Social Security benefit, in addition to a modest defined benefit plan. The result, a reasonable balance of Social Security, employer-sponsored pension, and individual savings, mirrors the traditional "three-legged stool" that makes up the ideal retirement funding mix.

It is my experience that most Americans do not understand this important distinction. Federal workers are not required to give up a single penny of their Social Security benefit as a trade-off to money in their Thrift Savings Plan account when they retire. This allows Members of Congress and other federal employees to receive both a full Social Security benefit as well as the full amounts accumulated in their Thrift Savings accounts when they retire. Most privatization plans do not operate in this way. Non-federal workers who opt into TSP-like private accounts will be required to "offset" their contributions into the private accounts by accepting dramatically lower Social Security benefits.

In effect, they will be subject to a tax on retirement collected from their Social Security benefit – a tax that is imposed simply because they have retired. Instead of being given the opportunity to fully participate in both retirement plans like Members of Congress and other federal employees, average Americans will only receive half a loaf – they will be allowed to take on the risks of a private account without the same backstop of full Social Security that protects the federal workforce.

The second point to remember is that the Thrift Savings Plan is essentially a collection of index funds in which workers can invest. While investing in index funds can be less risky than investing in the stock of a single company, there is nothing magical that shields them from risk entirely. When the market goes down, by definition so do index funds, and any federal worker who was relying on a specific balance in their Thrift Savings Plan account in order to retire 5 years ago has yet to reach their target.

Any system based on private accounts will necessarily place a tremendous burden of timing on future retirees. Looking at markets averaged out over the long-term masks the dramatic fluctuations accounts experience on a daily basis, and the imposition of a requirement to annuitize adds an additional variable to an already complex calculation. As a result, workers with exactly the same salary histories will inevitably be subject to dramatically different incomes from their private accounts based entirely on their date of retirement.

A third point relating to the Thrift Savings Plan is related to the issue of costs and how much they will impact rates of return. In order to make private accounts look attractive, proponents use projected future rates of return that are completely inconsistent with the assumptions about economic growth incorporated into the Trustees Report. To further pump up that return number, they also assume extremely low administrative costs.

This question of the administrative burdens of private accounts is a "sleeper issue" that is absolutely critical to how much money workers can expect to have with which to retire. In example after example of foreign countries that have experimented with

privatized retirement systems, the administrative costs ballooned out of control. Retirees in Chile and Great Britain, for example, saw costs in the 20% range decimate their account balances, leaving them without enough money to stay out of poverty. Some proponents of privatization claim they can avoid this problem by designing private accounts that mimic the Thrift Savings Plan. But Francis X. Cavanaugh, the person who designed the Thrift Savings Plan, has explained the many reasons the model will not work in the Social Security context, leaving the government, employers, or retirees with significantly higher costs.

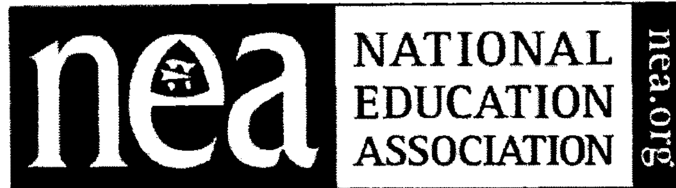
The last issue I would bring to the Committee's attention is the impact of private accounts on current retirees. Many proponents of private accounts seem to believe that seniors are mostly motivated by self-interest and, if they can simply be convinced their own checks are not at risk, they would sit this battle out.

In my conversations with seniors, I find two schools of thought. First, there are a number of seniors who do not believe the Administration's assurances that they will not be impacted by private accounts. These seniors look at the long-term impact of the required borrowing and reach the conclusion that even if they are "held harmless" initially, carrying that amount of debt simply is not sustainable over time. They believe once budgetary pressures build high enough, budget cutters will necessarily look for deeper cuts in programs such as Social Security, Medicare and Medicaid. The current budget debate in Congress only serves to confirm their suspicions. Few seniors have other sources of income, so any reductions in these programs would have a dramatic impact on them.

But even those who believe they will be protected are not heading for the sidelines. That is because they truly believe in this program – in its guaranteed benefits, in its progressivity, in its insurance elements. And they believe in the program so passionately, they want to preserve it for their children and grandchildren. I have seen this passion to protect Social Security at every town hall meeting in which I have participated. Senior's opposition to privatization is not dissipating – if anything, it is growing stronger.

Private accounts that replace Social Security's guaranteed benefits do not supplement Social Security, they undermine it. The more people realize the trade-offs required to restructure Social Security, the more their support for privatization drops. Through their opposition, the American people are stating loud and clear they prefer strengthening the current system to entrusting their retirement security to the uncertainties of the investment markets. Because of this, Congress should renounce private accounts and focus instead on strengthening the current program for future generations.

Thank you, Mr. Chairman.



Great Public Schools for Every Child

STATEMENT OF

THE NATIONAL EDUCATION ASSOCIATION

SUBMITTED TO

FINANCE COMMITTEE

UNITED STATES SENATE

ON

SOCIAL SECURITY PRIVATIZATION

APRIL 26, 2005

Chairman Grassley and Members of the Committee:

The National Education Association (NEA) respectfully submits the following comments for inclusion in the record of the Finance Committee hearing on Social Security privatization.

NEA represents 2.7 million educators working in America's public schools. Many of our members, along with millions of other public employees, rely on Social Security to help ensure a secure retirement. Teachers and education support professionals, like the majority of middle class Americans, rely on Social Security for their future. Educators are particularly vulnerable in their retirement security, both because of their comparatively low salaries and increasing attacks on their pension plans.

NEA has three priorities for any Social Security legislation moving through Congress:

- Opposing any efforts to privatize Social Security;
- Ensuring that public employees who are enrolled in and have paid into other retirement security plans are not mandated to participate in Social Security; and
- Repealing unfair offsets – the Government Pension Offset and Windfall Elimination Provision – that deny earned Social Security benefits to many public employees.

THE CASE AGAINST PRIVATIZATION

NEA strongly opposes any privatization of Social Security. Social Security is the cornerstone of the social safety net for America's retired workers and should not be subject to risky, unproven schemes. Privatization carries great risk and will jeopardize the secure retirement of many Americans.

Private Accounts Lack the Important Social Insurance Properties of Social Security
Social Security adjusts for inflation; is guaranteed to last an entire lifetime, no matter how long; is shielded from stock market losses; and is payable to multiple beneficiaries across generations (e.g., to surviving family members for their lifetime). Private accounts and defined contribution pension plans have none of these protections. Workers investing in private accounts will assume responsibility for the risks that are currently covered by Social Security protections. This could lead to many retired employees needing extra support in their elderly years – a time when they should live with a sense of peace and security.

Private Accounts Would Turn Social Security into an "Individual Insecurity" Program
Rather than just shifting "ownership" of retirement assets from the government to workers, Social Security privatization shifts an inordinate amount of risk away from the government and onto American workers. The United States' experience with defined contribution pensions and 401(k) plans shows that many people fail to understand even the most basic aspects of investment and that many make bad investment decisions (e.g., failing to diversity their investments). Unfortunately, many people simply do not have adequate financial experience, training, or time to do a good job managing their own accounts.

THE IMPACT OF PRIVATIZATION

Impact on Women

Women comprise over three-quarters of NEA's membership. Therefore, NEA has a particular concern about the impact of Social Security privatization on women. Women traditionally have lower lifetime earnings than their male counterparts, and women in the education profession face comparatively lower salaries than many other professionals.

Although privatization proposals say that participation in private accounts would be voluntary, the benefit cuts in the plan would be mandatory for everyone. These cuts would be devastating for women, who rely more on Social Security than men do. Nationally, 20 percent of adults receive Social Security benefits, including 22 percent of women and 18 percent of men. About 24 million women, 18 million men, and 3 million children rely on Social Security benefits. Women comprise 58 percent of all Social Security beneficiaries aged 65 and older.

According to the National Women's Law Center, without Social Security, more than half of women over 65 would be poor. Social Security helps level the playing field for women, who on average earn less then men and have fewer years in the workforce. In contrast, privatization would provide benefits based only on worker contributions, disproportionately penalizing women for time spent out of the workforce for childcare and care of the sick and elderly.

Social Security pays benefits that cannot be outlived, with annual cost-of-living adjustments. These features are particularly important to women because they tend to live longer than men but have fewer assets when they reach retirement. Savings in individual accounts could be drained by health costs, bad luck, or misjudgment in investments, or simply outliving one's savings.

Finally, women are much more likely than men to receive Social Security benefits as family members when a worker dies, retires, or becomes disabled. For a young family, Social Security provides the equivalent of a life insurance policy worth over $400,000 and a disability insurance policy worth over $350,000, according to the Social Security actuaries.

Impact on Ethnic Minority Communities

NEA has a diverse membership serving an increasingly diverse population. Some ten percent of NEA members are African Americans. Representation in the education profession of Hispanics is also growing. Ethnic minority students in our nation's schools have risen from 30 percent in the late 1980s to almost 40 percent today. Over the next twenty years that percentage may well reach 50 percent.

Given the diversity of our membership and the students and communities they serve, NEA has a strong interest in the impact of policy decisions on minority communities. In fact, NEA is currently engaged in an outreach project designed to strengthen partnerships with minority communities in support of public education. We are, therefore, deeply concerned about the impact of privatizing Social Security on populations such as African Americans and Hispanics.

Impact on African Americans
Proponents of Social Security privatization have claimed that the current program is unfair to African Americans. For example, President Bush has asserted that "African-American males die sooner than other males do, which means the system is inherently unfair to a certain group of people." However, while it is true that the current life expectancy for African American males at birth is only 68.8 years, this does not mean that an African American man who has worked all his life can expect to die after collecting only a few years' worth of Social Security benefits. African Americans' low life expectancy is largely due to high death rates in childhood and young adulthood. African American men who make it to age 65 can expect to live, and collect benefits, for an additional 14.6 years.

Due to certain demographic trends, African American communities benefit from the Social Security program in several ways:

- Social Security is the only source of retirement income for 40 percent of African American seniors. In 2002, the average monthly benefit for African American men receiving retired worker benefits was $850, and for women was $683. The Social Security Administration estimates the poverty rate for elderly blacks would more than double – from 24 percent to 65 percent – without Social Security.

- Social Security survivors insurance provides significant help to African American children who would otherwise find themselves poor because of a parent's death. African Americans make up approximately 13 percent of the American population. Twenty three percent of all children receiving Social Security survivor benefits in 2002 were African American. A recent study by the National Urban League Institute for Opportunity and Equality showed that the benefit lifted one million children out of poverty and helped another one million avoid extreme poverty (living below half the poverty line). The National Urban League study also found that an African-American man dying in his thirties would only have enough in his private account to cover less than two percent of the survivors' benefits now provided by Social Security to his widow and children.

- African American families benefit from disability insurance. In 2002, 13 percent of the population was African American; however, 17 percent of disabled workers receiving benefits were African American.

- African American women in particular rely disproportionately on the non-retirement aspects of the program because they have a higher rate of disability than whites of either sex. African American women often survive deceased husbands. While African Americans make up 9 percent of all female beneficiaries, African American women constitute 18 percent of female disabled worker beneficiaries.

Impact on Hispanics
Like African Americans, Hispanics benefit from Social Security in a number of ways;

- Social Security is the only source of retirement income for 41 percent of elderly Hispanics. In 2002, the average monthly benefit for Hispanic men receiving retired worker benefits was $859, and for women was $619.

- The guaranteed benefit and cost-of-living adjustments of Social Security are important to Hispanics. An important feature of the Social Security system is its provision of a guaranteed benefit for workers and their spouses, which continues until death, with a cost-of-living adjustment (COLA) each year to index for inflation. Social Security beneficiaries cannot outlive the income, and their purchasing power does not erode over time. Because Hispanics tend to have higher life expectancies at age 65 than the majority of the population, elderly Hispanics will live more years in retirement and benefit from Social Security's cost-of-living protections. Hispanic men who were age 65 in 2004 can expect to live to age 85, compared to age 81 for all men. Hispanic women who were age 65 in 2004 can expect to live to age 88, compared to age 85 for all women.

- Social Security disability benefits are important to Hispanics. Hispanics have a higher work disability rate than other Americans. While disability data from the Census show that the overall work disability rate was 11.9 percent in 2000, the work disability rate for Latinos was 16.7 percent. Thus, Hispanics are more likely to be in need of the disability benefits that the Social Security system provides. Private accounts would not provide disability protection.

THE CASE AGAINST MANDATORY COVERAGE

NEA opposes mandating participation of all public employees in the Social Security system. Educators in twelve states (Alaska, California, Colorado, Connecticut, Illinois, Kentucky, Louisiana, Maine, Massachusetts, Missouri, Nevada, and Ohio) as well as selected districts in three additional states (Georgia, Rhode Island, and Texas) do not pay into Social Security. Instead, these states maintain separate retirement systems for educators. Some Social Security reform proponents have suggested requiring Social Security participation for all public employees as a means of strengthening the system.

A federal mandate for public employee participation in the social security system would be detrimental to teachers and other public employees and would create financial burdens for states and city governments. Mandatory coverage would weaken existing state and local retirement plans that often offer benefits superior to Social Security. Mandatory coverage would also increase the tax burden on public-sector employers, eventually leading to reductions in the number of new hires, limits on employee wage increases, reduced cost-of-living increases for retirees, and reductions in other benefits such as health care. Mandating coverage of public employees will not solve the social security system's financial difficulties. In fact, the amount of money gained by mandating coverage would be relatively small and would not solve the long-term Social Security crisis.

REPEAL OF SOCIAL SECURITY OFFSETS

NEA strongly supports full repeal of both the Government Pension Offset (GPO) and the Windfall Elimination Provision (WEP), both of which unfairly reduce earned Social Security benefits of some public employees. The GPO reduces public employees' Social Security spousal or survivor benefits by two-thirds of their public pension. The WEP reduces the earned Social Security benefits of an individual who also receives a public pension from a job not covered by Social Security.

The offsets penalize people who have dedicated their lives to public service by taking away benefits they have earned. Nine out of ten public employees affected by the GPO lose their entire spousal benefit, even though their spouse paid Social Security taxes for many years. The WEP causes hard-working people to lose a significant portion of the benefits they earned themselves. The loss of income forces some people into poverty. Some 300,000 individuals lose an average of $3,600 a year due to the GPO – an amount that can make the difference between self-sufficiency and poverty. Impacted people have less money to spend locally and sometimes have to turn to expensive government programs like food stamps to make ends meet.

The impact of the GPO and WEP is not just felt in those states in which public employees are not covered by Social Security. Because people move from state to state, there are affected individuals everywhere. The number of people impacted across the country is growing every day as more and more people reach retirement age.

Finally, the GPO and WEP discourage people from entering/staying in the profession. Individuals who worked in other careers are less likely to want to become teachers if doing so will mean a loss of earned Social Security benefits. The GPO and WEP are also causing current educators to leave the profession, and students to choose courses of study other than education. Non-Social Security states are going to find it increasingly difficult to attract quality educators as more folks learn about the GPO and WEP.

NEA supports the Social Security Fairness Act (S. 619), introduced by Senators Feinstein and Collins. This bipartisan legislation would correct the inequities in the current system by fully repealing both the GPO and the WEP.

CONCLUSION

NEA urges Congress to:

- Reject efforts to privatize Social Security;
- Oppose mandatory Social Security coverage for public employees; and
- Repeal the Government Pension Offset and Windfall Elimination Provision.

Thank you for the opportunity to submit these comments.

John L. Smith
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May 24, 2005
856-234-9227

Senate Committee on Finance
Attn: Editorial & Document Section
Room SD – 203
Dirksen Senate Office Building
Washington, D.C. 20510- 6200

Dear Senators:

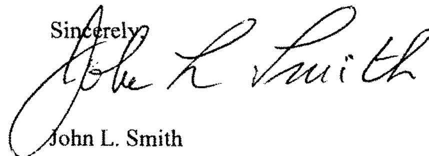
I consider the problem of the future of Social Security so important I am taking this opportunity to send a copy of my very simple and effective solution to this complex problem to you, members of the pivotal Senate Finance Committee.

As a professor of Economics, still teaching at the age of seventy-six and a social security recipient, I am writing to you on behalf of my son, thousands of my past, present and future students and millions of my fellow Americans.

This cover letter is purposefully very brief to allow you to devote your valuable time to digesting the attached suggestion.

Should you be intrigued by my suggestion or if you have any questions and want more input, please contact me. Thank you.

Sincerely,

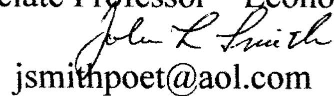


John L. Smith

Associate Professor, Economics.

A Novel Way for the Future Financing Of the United States Social Security System

By & ©

John Leslie Smith
Associate Professor – Economics

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May 22, 2005

Introduction

The original, ill-conceived plan of providing continuing income to the citizens of the United States upon retirement is beginning to show its weakness in that future cash receipts of the fund will not cover the promised cash disbursements. This is because the future social security recipients will fiscally greatly outnumber the number of future, concurrent contributors.

Current administration proposals for addressing this national catastrophe involve changing the social security pension format from the ***present guaranteed pay-out*** to a ***guaranteed pay-in,*** in which the prospective pensioner is held responsible for devoting much time to manipulating her or his individual social security contributions in a personal account to provide for the retirement years. ***The latter system does not guarantee any level of retirement income and, as such, is not a realistic alternative to the current system.***

As a professional economics and business educator, with considerable knowledge of stock markets, ***I can vouch that a decision I made over thirty years ago to apportion my input dollars partially into bonds, partially into stocks, has resulted in the fact that a dollar invested in bonds has barely maintained its purchasing power over that period when judged against the inflation over that period of time, while a dollar invested in stocks has earned a four to six-fold increase in purchasing power. This clearly indicates the danger of an unsophisticated investor faces when making the most important decision of her or his life.*** I have devoted very little time to policing my portfolio, yet I have been successful. Happily, I chose to be stock heavy, as compared to being bond light.

Proposal:

My suggestion is that the employer/employee contributions of each social security participant be invested into a **National Mutual Stock Fund** on the **collective behalf of the nation's social security contributors and recipients.** The process would be as follows:

1. An ***Administrative Agency,*** held at two arms lengths from the Federal Government, called the **National Mutual Stock Fund Administration,** be established by an **Act of Congress,** whose single purpose would be the sole trustee of the Social Security contributions and payments; that is to be the fiduciary guardian of these funds as received and described in the following paragraphs to create the **Mutual Fund** as described below.

2. **The National Mutual Stock Fund Administration** [NMSFA] would become the non-tradable, holding corporation whose stockholders are contributors and recipients, for a private, mutual fund owned, by the citizens of the United States and by other contributors/recipients, held at double [yes, double!] arm's length from the Federal Government, with the sole purpose is to provide the funds for the purposes envisaged in the original Social Security Act. Significant actions by the Trustees of the NMSFA could only be authorized by a national referendum of the citizenry.

3. The ***Management*** of the NMSFA would be by a revolving consortium of three or four, qualified and vetted financial management institutions whose members ***do not serve concurrent terms, and are chosen by competitive bidding.*** The service terms of the consortium ***would not coincide*** with the presidential election office cycle

4. ***Corporations:*** Each corporation would pay its social security contributions in the form of its authorized, but undistributed, preferred or common stock, based upon the ***mean*** of the close-of-trading stock prices, of that stock, on the first and third Wednesday of the month, when the payment contribution is due.

5. ***The National Mutual Fund,*** owned collectively by the social security participants, would be created from these stocks and would reflect the corporate structure of all corporations [domestic and international] doing business in the United States and employing Americans overseas.

6. ***Non-corporate, non-profit and public sector employers***, to pay their social security contributions by electronic cash, to the **National Mutual Stock Fund Administration - Mutual Fund [NMSFA-MF]**, which each month would buy from the open market [in such diverse, random daily amounts so as not to grossly and predictably affect the market], a selection or basket of corporate stocks proportionally representative of the stocks paid in by corporations; see # 4, above and deposit such stock acquisitions into the **National Mutual Stock Fund Administration's – Mutual Fund.**

7. **The employees' contributions [or a part thereof]** could continue to be directed to meet the current social security fund payment obligations, until such time as the **NMSFA-MF** is able to pick up that burden, at which time these employee payments would be invested as in # 6, see above.

8. **When the fund has sufficient strength,** through ongoing stock contributions, stock value enhancement, stock splits and retained dividends, to sustain future foreseeable payout commitments, consideration would gradually be made to participants who are deceased after, or before, starting to collect from the fund. Such participants who have surviving children and/or spouses would receive, through her/his estate, ongoing payments or a one-time, lump-sum payment whichever is deemed best for the survivors.

9. **Significant actions** by the **Trustees of the NMSFA** could only be authorized by a national referendum of the citizenry through a voting of shares held by each participant.

10. **Fiscal misdemeanors,** or worse, on the part of corporate and non-corporate officers that substantially and negatively affect their corporate stock in the Mutual Fund, would be elevated to the Federal Courts jurisdiction and be subject to penalties commensurate with the levels of fiduciary misbehaviors.

11. **The daily activity and status of the Mutual Fund** would become public property via the media and the Internet, thus creating a much greater public awareness and interest in its financial future.

Advantages of the proposal:

1. The positive synergism of every sector and individual working and investing in the entire United States and global economy.
2. Ease of collecting and disbursing funds for, from and within the system.
3. The legislated isolation of social security assets from use for other purposes.
4. The most efficient use of such large financial assets and cost-effectiveness in maintaining and expanding the social security system.

5. The diffuse nature of the mutual fund portfolio would cushion failures in a corporation's or an industry's poor showing.
6. A sense of ownership/stakeholdership in the national economy by every citizen
7. No investor/social security member would be left behind.
8. Federal level social security support will obviate the need for states to pick up the short-fall at the federal level.
9. Given a base-line expectation from the system, the more financially ambitious social security members would seek out the private services of the management consortium for additional private retirement investments.
10. Proof positive of our nation's belief in ***collective and compassionate capitalism.***
11. Provide a model for the developed, developing and lesser-developed countries to address their growing social welfare problems.

Disadvantage of the proposal:

1. If the economy goes belly-up, we would all be in trouble. But so would most individual, self-directed investors and all levels of government; with state and local governments bearing additional well-fare costs disproportionately.

P.S. Should you have any questions, please contact the author and originator at:

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P. P.S. Should you wish to learn more about the author of this proposal, a lad born into the English working–class and an American resident/citizen from the fifties, you could visit his poetry website:

http://www.authorhouse.com/BookStore/ItemDetail.aspx?q3=kKnSju67dQQ%253d

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Senate Committee on Finance
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My Uncle Henry is crazy. We keep him in the cellar when anyone visits, but otherwise he has a pretty nice lifestyle. Nice clothes, good car, travels a lot. Surprising, because he doesn't make a lot of money. What really amazed me, though, was to find out he had a great retirement plan. "Yep", he told me, "been putting lots of money away regularly for over forty years." Wow, I said, how could you do that and live so well at the same time? "Promise not to tell anyone?", he asked. Turns out he borrows from his retirement funds. Gives himself interest bearing promissory notes. "Good as gold", he says. "When it's time to retire, I'll just redeem those notes and keep on living the good life. Tell me, is that a good plan or what?"

Uncle Henry figured if it's a good plan for our Social Security system, it's a good plan for him.

You know, he's got a point. We send all that payroll tax money to Washington every payday. They use some of it to pay our retirees and "borrow" the rest to help pay for all the other stuff they buy: bombers, foreign aid, homeland security, free beer for congressmen (just kidding). But, we're told, we have notes for all that money. "They" have to pay it back.

Well, to paraphrase Pogo: "We have met the folks who have to pay it back to us, and they are us."

Has Social Security been a good program, and is it still? Yes and yes. Is there a real problem and is our debate excluding a discussion of that real problem? Unequivocally and unequivocally. Is there an easy and fair solution to the problem. Yes. Is there a "trust fund"? Not really, but the good news is that there doesn't have to be one.

We hear a lot about the "trust fund" being depleted by 2041 or so. True, but not very meaningful. Since the early '80s, annual payroll taxes have exceeded the payouts by increasing amounts. As has been well publicized, starting in about 2018, the payouts will be larger than the payroll taxes received.

What's not being discussed is that in just three years from now (2008) the annual surplus will peak at about $108 billion and then start getting smaller. For a federal spending machine that's totally and absolutely running amok (up 7% this year through February), that's when things start to get even scarier. Starting in 2009, after the retirees are paid, our

president and congress will have less money available from payroll taxes each year than they had the year before. So each year, they'll have to cut spending more, raise taxes more, borrow more, or more of some combination. I mean, other than borrowing, are they good at any of these things?

There's never been a real "trust fund", Virginia, unless you believe in the tooth fairy or Andy Rooney's file drawer that President Bush recently visited. The Supreme Court ruled in 1937, and again in 1960, that there is no real connection between payroll taxes and Social Security benefits. Payroll taxes are no different than income taxes once they reach the Treasury. It all goes into the same pot. Social Security benefit payments come out of that one pot, as do purchases of battleships, federal aid to education, and congressional inspections of beach erosion in Hawaii.

We're all taught in school that our income tax system is progressive, that the more one earns, the higher percentage our taxes. As a citizenry, however, we've allowed ourselves to buy into a genuine sham regarding payroll taxes. Not only are they regressive (everyone pays the same percentage), worse yet, the high earners stop paying after they reach $90 thousand. The person earning $200 thousand, or $2 million, pays the same amount as someone earning $90 thousand. About $1.5 trillion of such above-the-cap annual wages are not taxed. I mean, is this a great country for high earners or what?

Further, as many as six million workers (mostly state and local employees) do not pay this tax. That's another $240 billion of earnings that get a free payroll tax ride each year.

Solution? Apply the 12.4% payroll tax rate to all earnings, just as we do with the Medicare payroll tax. There's absolutely no reason anyone should pay less in SSI payroll tax percentage than anyone else. This action alone would more than cover the forecast "gap". Let's not even begin to tinker with retirement ages, benefits, or other tax rates until this major unfairness is corrected.

I mean, who's crazier, Uncle Henry or us?