S. HRG. 105-283

2010 AND BEYOND: PREPARING SOCIAL SECURITY FOR THE BABY BOOMERS

HEARING

BEFORE THE

SPECIAL COMMITTEE ON AGING
UNITED STATES SENATE

ONE HUNDRED FIFTH CONGRESS

FIRST SESSION

OMAHA, NE

AUGUST 26, 1997

Serial No. 105-11

Printed for the use of the Special Committee on Aging

U.S. GOVERNMENT PRINTING OFFICE

44-326 CC WASHINGTON : 1998

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-055986-3

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2010 AND BEYOND: PREPARING SOCIAL SECURITY FOR THE BABY BOOMERS

TUESDAY, AUGUST 26, 1997

U.S. SENATE,
SPECIAL COMMITTEE ON AGING,
Omaha, NE.

The committee met, pursuant to notice, at 10 a.m., in the College Center Meeting Room, College of St. Mary, Omaha, NE, Hon. Charles Grassley, (Chairman of the committee), presiding.

Present: Senators Grassley, Hagel, and Kerrey.

OPENING STATEMENT OF SENATOR CHARLES GRASSLEY, CHAIRMAN

The CHAIRMAN. Thank you, President Stevens, for your hospitality. This is a very fine auditorium here to be in, very fine facility. We thank you for accommodating the Senate Committee on Aging, the citizens of Nebraska and Iowa who are here, and our witnesses.

I am glad to be joined by my two colleagues: Senator Hagel, who takes a very leading role in the Senate Committee on Aging; and Senator Kerrey, who is here not as a member of the committee but also is very active in the issues that we are discussing today. He is a colleague of mine on the Senate Committee on Finance, which has jurisdiction over most of the authorizing programs that are being discussed at today's meeting.

So I have had an opportunity to work very closely with Senator Kerrey, as a member of that committee, and compliment Senator Kerrey on a lot of controversial issues that he has brought up for discussion before the committee and taken a very leading role on. We are here today to discuss some of these issues from the standpoint of the Senate Committee on Aging. I invited Senator Kerrey because of his leadership on these issues.

This meeting will come to order, and as chairman of the Special Committee on Aging, it is my pleasure to welcome our witnesses, as I have already welcomed my colleagues; and most importantly, I welcome the members of the public who are present here today.

One of the most important challenges that this country faces, is preparing for the transformation that will occur over the next two decades as more and more of us reach our retirement years. To do my job effectively, I must be able to bring back to Washington the insights and the opinions of people who live and work outside of the Beltway. This hearing should help you and me, all of us, for that matter, better understand the challenges that we face and most importantly how to meet those challenges.

One of the main goals, then, is to get public input and offer the public an opportunity to have questions answered by experts. To facilitate that, with such a large group as we have here, we will take written questions from you in the audience. As you came in you either received a card or there was one on your chair to write down a question. If that is not the situation, let me know.

If you have questions that you would like to have answered regarding the future of Social Security or another issue that you hear about today, please write it down. The card will be collected, and we will pose the questions to the appropriate people on the panel or to those of us in the Senate, if it is for us to answer.

We hope that this will give anyone in our audience a chance to not just listen but to participate in the legislative process as well. We have allotted about 2 hours of time for this hearing. We will have to adjourn right around 12 noon.

If time runs out before we get to your questions—I am just speaking for myself now—you will receive an answer in the mail. If my colleagues want copies of your questions, we will be glad to make sure that everybody gets copies of those as well.

It is very important that we begin to think about these issues today. We cannot wait until the last moment to act. If we do there will be few options open to us on the important question of preparing Social Security for the big surge that is going to come in people retiring after the year 2010. We could be faced, if we wait, with distasteful notions of severe increases in payroll taxes or decreases in benefits that will impact people who have had little time to plan.

I know there is a lot of uncertainty about the future of Social Security, especially among younger people. I have heard it said that young people think that they are more likely to see a UFO in their lifetime than be able to retire on Social Security. Of course, I hope that they are not right. I surely do not believe that I am going to see a UFO, but I do believe that the American people will do what it takes to keep Social Security strong.

We need to start now, then, to plan for the aging of the baby boomers. Our population will age dramatically after the year 2010. You can see from the chart here that was just put in place that we have a very dramatic increase starting in the year 2010.

Imagine that as the baby boomers retire, the Social Security roles will increase by 33 percent, and consider the impact that baby boomers have already had on our society. By virtue of sheer numbers, baby boomers have left a distinctive impression on this country at every stage of their lives.

More than 70 million babies were born in the span of just 20 years, and as children they crowded our schools; as young adults they overwhelmed colleges and then the job market. Eager to settle down, they flooded the housing market.

Now the eldest of the baby boomers are poised to retire in the next 10 years. They will need retirement income and health coverage just like today's retirees, only there is more of them. So more of that will be needed.

In 1935 when President Roosevelt signed the Social Security Act, the unemployment rate was 25 percent. One of the hardest hit segments of our population at that time was the elderly.

The new Social Security system provided a floor of financial security to keep elderly out of poverty. Millions of people depend on this program. It has been enormously successful in providing income security for older Americans.

It is estimated that in 1935 approximately 65 percent of the elderly population lived in poverty. Today, or closer to now, in 1994, that number dropped from 65 percent of people in poverty to 11 percent. So while the program has enjoyed much success in keeping elderly Americans out of poverty, we must think about how the program can do the same for people in the future.

At the time the program was created, there were plenty of workers to pay into the system; approximately 40 workers for every one retiree. Today, as you can see from the chart, there are almost four workers for every one retiree, and you are going to see that that is predicted to go down to almost two for every retiree in 20 years.

As chairman of the Aging Committee, one of my long-range goals is to ensure that tomorrow's older Americans have income security at least as good as their mothers and fathers.

Must we achieve this goal by maintaining the present structure of Social Security at all costs just the way it is today? I think all of our views must be that we have to be open-minded to all proposals that come before us. At the same time it seems to me that we should cling tightly to the goals that I have mentioned, and that is ensuring a safety net of economic security for all older Americans in each generation which follows.

Americans of all ages are filled with anxiety about their retirement years, but coming together today and starting a process of formulating or encouraging a national dialog to get to a national consensus on Social Security and Medicare, I think if we do that, we can take—be strong enough to take the proper moves in Congress to make it a secure system.

We must move forward, then, with that national consensus. It is the only rational thing to do.

I would like to now go to my two colleagues. I will call on Senator Hagel first and then Senator Kerrey for opening comments.

OPENING STATEMENT OF SENATOR CHUCK HAGEL

Senator HAGEL. Senator Grassley, thank you. I too would like to echo Chairman Grassley's thanks to the College of St. Mary, President Stevens, and all of you who have been involved with putting the hearing together. We are grateful and to our distinguished panelists, thank you for giving us your time and contributions, and we look forward to your thoughts this morning.

To my friend and colleague, Bob Kerrey, it is good to have you with us, because I think as we take on these issues, as Chairman Grassley said, we are going to need all the strong, in-depth leadership and insight that we can find not only in the Congress but across this land. Bob Kerrey has been one who has long been involved in entitlement reform, so it is good to be with Bob Kerrey as well.

Mr. Chairman, I know we all want exactly the same thing here this morning; that is to keep Social Security strong and secure. This program has been important for each generation of Americans since the 1930's, and we must insure that Social Security remains solid, dependable, and sustainable for current retirees and for generations to come.

This is a big challenge; one which we in Congress cannot and should not tackle alone. Public input must be the key to this process. That is why we are holding this hearing today in Omaha, to broadly and openly discuss the issues and get common sense suggestions and ideas from Nebraskans and Iowans.

Social Security is the single largest program in the Federal Government. The Congressional Budget Office estimates that in 1997 the Social Security trust funds will pay out $364 billion in benefits; almost one-fourth of total Federal outlays.

This issue is not just about numbers, as we all understand. This is about people; this is about people's lives. It is about our mothers and fathers. It is about our generations to come.

Most retired people count on their monthly social security check, and we cannot allow that security to be put in jeopardy. That is why we must act to preserve Social Security.

Today the Social Security system is solvent because it receives more income from payroll taxes than it pays out in benefits, but that soon will change. As the so-called baby boom generation, which consists of 75 million Americans born after World War II, reaches retirement age, the system will come under enormous strain. Declining birth rates and growing life expectancies will strain it even more.

The number of retired people drawing Social Security benefits is expected to nearly double over the next three decades from almost 44 million today to 81 million by the year 2030. Over that same time period, the number of workers whose taxes finance Social Security benefits is projected to grow by only 17 percent.

In 1950 there were 16 workers paying into the system for each one retiree drawing from it. Today that ratio is about three to one. By the year 2030 there will be only two active workers for each retiree. By 2012 Social Security will be taking in less in payroll taxes each year than it must pay out in benefits.

If we do not fix the Social Security system, it will be completely bankrupt at least by the year 2031. We cannot let that happen to the Social Security system. We need to fix the system, and we need to start now.

If we wait until the baby boomers start to retire, it will be too late. The only possible solution then will be big payroll tax increases, big benefit cuts or both. I believe everyone in this room believes that that is unacceptable. We need not have that as our option.

The changes should start with the retiring baby boomers. The Social Security trustees report that we must act soon so we have time to phase in changes and so younger workers can adjust retiring planning to take changes into account.

We have time to fix Social Security the right way. This is an opportunity we must not squander. We have time to do what is right for Social Security and for our people.

We must use this time to craft thoughtful, insightful, lasting solutions before a crisis is upon us. We must keep an open mind and study all the options. We must not be afraid of all the options.

Above all, this issue must be taken out of politics. If we work together with honesty and courage and leadership, we will find solutions that preserve Social Security and strengthen retirement security for generations of Americans to come. Today's hearing is an important step in the right direction.

Mr. Chairman, I want to, again, thank you and your staff for putting the hearing together. Thank you.

The CHAIRMAN. Senator Kerrey.

OPENING STATEMENT OF SENATOR BOB KERREY

Senator KERREY. Likewise, Mr. Chairman, I would welcome you to Nebraska. It is good to have you in our State. Thank you very much to you and Senator Hagel for hosting this very important hearing, and I want to thank as well Sister Mary Ann Stevens for allowing the hearing to take place here and thank all of you citizens for coming out. I look forward to the testimony and to the written and oral comments that will be delivered here today.

Social Security is a program that was created with a Federal law in 1935. It is one of the most important pieces of legislation ever to be enacted and signed by the United States President, and it has dramatically changed the lives of millions of Americans who live in America over the age of 65.

In Nebraska there are about 240,000 citizens who are beneficiaries of Social Security. Their lives are dramatically altered as a consequence.

Nearly half of Americans in 1935 over the age of 65 were living in poverty. Today it is about one in seven. There are one in seven still in Nebraska, close to 80,000 of our citizens over the age of 65, who are still in poverty. Many of them—I would argue likely all of them—have as their only source of income a Social Security check, which on average in Nebraska is $700 a month; not what I would call a huge amount of income rolling in providing people with lots of excess dollars to spend.

There are an awful lot of people in Nebraska who are still living hand-to-mouth over the age of 65 they wonder if they are going to be able to make it financially and wonder if there is going to be some illness, some problem that is going to put some burden upon not just them but their families as well.

The next point I would make about Social Security is it is a powerful, intergenerational program. This is not just about people over the age of 65. This is about their families, about their children, about their grandchildren.

I have seen the same poll Senator Grassley referred to, that more Americans under the age of 40 believe in UFOs than believe in Social Security. That does not say much for our education system, but I will leave that for another hearing.

Social Security is a program that has very strong intergenerational support. Polls show that people under the age of 30 support Social Security as much as people over the age of 65.

It is not in danger of being eliminated by Congress. Congress is every now and then accused of trying to do that. It is not the case.

Social Security has strong intergenerational support, and it is designed as an intergenerational program. In short, it is a tax on the wages of people in the work force distributed in a progressive fashion to people who are eligible either as a result of reaching a certain age. Either an early eligibility or a normal eligibility age—or as a consequence of being a survivor or as a consequence of being disabled.

There are many who believe Social Security is being used for all sorts of other things. Oftentimes Social Security is confused with Supplemental Security Income. Supplemental Security Income is paid for with general fund dollars; not with the Social Security Trust Fund. The Social Security Trust Fund is used only for individuals who are disabled, who are eligible as a result of being a survivor or who are eligible as a consequence of being designated a beneficiary.

The problem, as both Senators have indicated is that we have a large increase in the number of the people who retire versus the number of people who are in the work force. From the year 2010 and 2030—and that is the baby boom generation moment—the number of people in the work force will increase by about 5 million, and the number of retirees will increase by 22 million.

As you look at the changes in the Social Security system over the last 60 years, you can see how this decrease in the number of people working versus retirees has changed.

In 1935 the payroll tax was 2 percent on $3,000 worth of wages. Today it is 15.3. That includes hospitalization as well as old age survivors and disability; 15.3 percent on $65,400 worth of wages.

In other words, in order to be able to provide Social Security. I have got to have people in the work force I can tax. There is no trust fund that is set up over the years for individuals paying into Social Security that is then drawn down for that individual. Social Security is a collective program; a tax on wages of people who are working transferred in a progressive fashion to people who are eligible as a result of three or four different methods of eligibility.

The proposal I have made on a number of occasions, and will continue to make, is that when a person retires today, they need more than just income. They need wealth. We recently changed the law and tried to provide some relief for a thing called a tax on estates. I think all three Senators here today supported increasing the size of estate subject to the estate tax.

It was a reasonable and, I think, an important thing to do, but under 2 percent of Nebraskans who die with estates have estates over $600,000. That means 98 percent of Nebraskans die with estates under $600,000.

I would like to see Social Security become a program that not only promises to transfer income that says, "Here is some income security," but that says, "Here is some wealth security as well."

We can change Social Security to preserve and protect it over the long term, but I hope that we are able as well, in a quiet and dispassionate fashion, to say to that young person out there, as they look forward to their future, that in addition to income coming from Social Security, you are going to need security that comes from the acquisition of wealth.

I say again to you, Mr. Chairman and Senator Hagel, it is a pleasure to be with you here today. I look forward both to our witnesses and citizen testimony.

The CHAIRMAN. I thank both of my colleagues.

I am going to introduce all four speakers now, and I would ask them, without my calling on them, to then each speak in the turn in which I have introduced them and until all four are done. We would allot about 8 or 9 minutes for opening statements. Would you help me a little bit, because yesterday I just let it go on and on and on and on? We did not really have enough time for questions, so I would appreciate it to the extent to which you can help us stay within the time.

We are pleased to have with us Steven Goss, Deputy Chief Actuary for Long-Range Projections at the Social Security Administration. He is going to provide an overview of the Social Security financing system, and most importantly, he is going to review the recent Social Security Trustee's report, which came out just April this year. Steven Goss is currently Deputy Chief Actuary. He has authored numerous articles and actuarial studies on financing the Social Security system. He has worked at the Social Security Administration since 1973 and is very much for us on the Hill, in the executive branch, an established resource on issues that impact upon Social Security.

Next we are going to hear from Dr. Eugene Steuerle, senior fellow of The Urban Institute, Washington, DC. Dr. Steuerle has conducted extensive research on budget and tax policies, Social Security, health care and welfare reform. His publications include six books, more than 100 reports and articles in over 400 columns. He is also the author of an acclaimed book on the future of Social Security entitled Retooling Social Security for the 21st Century.

We will then hear from two witnesses who will discuss their views on how to restore Social Security's long-term solvency. We are pleased to welcome Helen Boosalis, the board chair of the American Association of Retired Persons. She also serves as chair of the AARP Executive Committee and serves on the National Legislative Council Board of Finance and the Board of Audit Committees. Previously Mrs. Boosalis served in a number of public offices and including a long tenure as mayor of Lincoln and director of the Administration on Aging for the State of Nebraska.

Our last witness comes from Washington, DC., Mr. Sylvester Schieber, Director of Research and Information Center for the international consulting firm of Watson Wyatt Worldwide. Throughout his career he has specialized in the analysis of public and private retirement policies and health policy issues. Recently he served as a member of the 1994–96 Social Security Advisory Board, which issued its final report in January of this year.

So we would start with Mr. Goss.

STATEMENT OF STEPHEN C. GOSS, DEPUTY CHIEF ACTUARY, SOCIAL SECURITY ADMINISTRATION

Mr. GOSS. Thank you very much, Mr. Chairman, Senator Hagel, and Senator Kerrey. I appreciate your invitation to join you today and discuss the Social Security old age survivors insurance/disability insurance programs.

I would like to provide you a little bit of background on how the trust funds operate and also to discuss, as the Chairman suggested, the status of the program as suggested in the 1997 trustee's report. Although most of OASI's and DI's current revenues are used to pay immediate expenses under the programs, excess receipts are credited to the trust funds for each program.

The excess receipts for the programs are invested in special issued United States government bonds. The yield on these bonds is set equal to the average market yield on all outstanding, long-term marketable debt of the United States. The recent yield on these holdings has been about 3 to 4 percent in real terms and is assumed, in the long-range, ultimate period, to be about 2.7 percent.

From its inception in 1935, the Social Security program has been financed on close to a pay-as-you-go basis with current costs met from current revenues and a relatively small excess amount held in the trust funds. Rather than providing a mechanism for advanced funding of future benefits obligations, the trust funds have served largely as a contingency reserve fund.

Most experts have agreed over the years that a contingency reserve fund should be equal to about 100 to 150 percent of the annual cost of the program, and that this amount should be held to assure continuation of benefits in the event of short-term, adverse circumstances arising.

The Social Security Amendments of 1977 and 1983, however, created a temporary period where the trust funds will buildup reserves beyond the level of a contingency reserve. Currently the combined OASDI trust funds are projected to peak at about 265 percent of annual program costs in the year 2011.

The 1997 trustee's report just released April this year tells us that the assets in the combined funds increased by about $71 billion from a level of about $496 billion at the end of December 1995 to a level of $567 billion at the end of December 1996.

The combined OASDI trust funds as well as each fund separately are adequately financed over the next 10-year period and meet what the trustees have deemed as the short-range test for financial adequacy. However, the combined OASDI and separate OASI and DI programs do not satisfy the long-range test of close actuarial balance.

This test essentially requires that expected income for the program be at least 95 percent of the projected cost of the program over the next 75-year period on the whole. In the 1997 trustee's report, the income of the OASDI program is projected to be about 86 percent, in fact, of the cost of the program over this long-range period.

The trustees developed three alternative sets of estimates based on during economic and demographic assumptions over the upcoming 75 years to show a range of possibilities. The estimates range from a low-cost alternative one to a high-cost alternative three.

The intermediate set of assumptions reflects the trustee's best estimate of what future experience will be. Until—under the 1997 trustee's report, intermediate assumptions, the annual combined tax income of the OASDI program, will continue to exceed annual expenditures from the trust funds by more than $30 billion each year through the year 2006. This excess will then decline until annual expenditures from the OASDI program are projected to be larger than funds combined annual tax income, beginning in the year 2012. However, total income will continue to exceed—including the interest will continue to exceed expenditures until 2019.

Thereafter, the funds will begin to decline and will become exhausted in the year 2029. Each of these three dates is the same as was reported in the last year 1995 trustee's report.

I would also like to just clarify that after the projected trust fund exhaustion in the year 2029, the scheduled taxes that would continue to be collected under law would cover, from that point forward for many years, about 75 percent of benefits that are scheduled in current law; a shortfall that will have to be met.

The estimated long-range actuarial deficit of the OASDI program changed from 2.19 percent of taxable payroll—think of that in terms of sort of the level of the tax rate that you pay—in the 1996 report to 2.23 percent of taxable payroll in the 1997 report based on the intermediate assumptions.

A number of changes contributed to the small modification. The mere passage of time; that is, changing the ending year of the long-range, 75-year period from 2070 to 2071, increased the long-range actual deficit by .08 percent of payroll because of the inclusion of the additional year 2071 with its large projected deficit. The net effect of all other changes that were incorporated in the 1997 report resulted in partially offsetting improvements to the estimated long-range actuarial balance of the 1997 report.

The last comprehensive set of amendments to Social Security, which we all recall back in 1983, were projected at that time to put the OASDI program in actuarial balance for the long-range period then ending in the year 2057. The projections in the 1983 trustee's report indicated that the trust funds would be solvent throughout that period but that the trust funds would be declining very rapidly at the end of the period and would become exhausted shortly after the year 2057.

Since 1983, however, a number of changes have been made that have on balance worsened the long-range financial projections for the program contributing to the currently estimated actuarial deficit of 2.23 percent of taxable payroll. In about equal amounts are, No. 1, the gradual change of the long-range valuation period; that is, this adding one extra year to the 75-year period each year gradually changing from 2057 to 2071.

No. 2, changing the ultimate economic assumptions used to make projections; principally a reduction of the assumed, real growth rate in the average wage for Americans from about 1.5 percent per year increase, in the 1983 report, to the current assumption of only 0.9 percent.

No. 3, increases in the disability insurance program costs largely due to higher rates of disability among women and for persons with mental impairment.

No. 4, changes in the methods used for making long-range projections, primarily improvements in the method for projecting future average benefit levels.

I would like to just add that the modifications in demographic assumptions since 1983 are principally higher-than-expected birth rates between 1994 and 1996 and the assumption that immigration will add more to the United States' population than had been thought earlier have resulted in partially offsetting improvements in the long-range OASDI actuarial balance.

In conclusion, let me suggest that the 75-year projections of the cost of the OASDI program should not be considered to be precise predictions or forecasts. Over a period this long many substantial changes will occur that cannot be predicted.

These changes serve rather as a basis for considering the implications of the provisions of current law if economic and demographic assumptions and trends follow the patterns that are deemed most likely by our trustees. Due to the great uncertainty in the future, a range of assumptions, as I mentioned earlier, has developed and indicate what might occur if trends turn out to be more favorable or less favorable than expected.

Under the intermediate projections the Social Security program will continue to receive more in taxes than it pays out through 2011, and the accumulation of this excess budget authority will allow the program to continue paying benefits in full through 2028.

Before 2029, however, changes will be necessary. Early enactment of changes will allow the changes to be phased in more gradually and will allow for more advanced notice to all of the workers and beneficiaries who will be affected so they can more effectively adjust their plans for retirement.

Thank you very much, again, for the invitation, and we will be happy to address any questions later.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Goss follows:]

FOR RELEASE ON DELIVERY

STATEMENT ON THE STATUS OF THE SOCIAL SECURITY OLD-AGE, SURVIVORS, AND DISABILITY INSURANCE TRUST FUNDS

By

STEPHEN C. GOSS
DEPUTY CHIEF ACTUARY
SOCIAL SECURITY ADMINISTRATION

BEFORE THE
SENATE SPECIAL COMMITTEE ON AGING

August 26, 1997

Mr. Chairman and Members of the Committee:

I appreciate your invitation to discuss the status of Social Security's Old Age and Survivors Insurance (OASI) and Disability Insurance (DI) Trust Funds. I plan to provide some background on how the trust funds operate and to discuss the 1997 Trustees Report.

Background on Trust Funds

Social Security cash benefits are paid under two programs enacted as title II of the Social Security Act. The programs are Old-Age and Survivors Insurance (OASI) which pays monthly benefits to retired workers and their dependents and to survivors of deceased workers, and Disability Insurance (DI), which pays benefits to totally disabled workers and their families. OASI and DI are financed from Social Security payroll taxes (now 6.2 percent each on employers and employees) and self-employment taxes (12.4 percent), from interest on investments, and from the proceeds of income taxation of Social Security benefits.

Although most of OASI's and DI's current revenues are used to pay for immediate expenses, excess receipts are credited to the trust fund for each program. The excess receipts of the OASI and DI Trust Funds are invested in special issue United States Government bonds. The yield on these special issue bonds equals the average return on all outstanding long-term debt of the United States. The recent yield in real terms has been between 3 and 4 percent, and is assumed to average 2.7 percent in real terms over the long run.

The restriction in the law limiting investments of excess Social Security receipts to interest-bearing obligations of the United States or obligations whose principal and interest are guaranteed by the United States has traditionally been justified as ensuring the most safety of principal and stability of interest. This policy has also been viewed as a way of avoiding intrusion into private markets or the affairs of State or local governments.

From its inception in 1935, the Social Security program has been financed on close to a pay-as-you-go basis, with current costs met from current revenues and relatively small excess amounts held in the trust funds. Rather than providing a mechanism for advance funding future benefit obligations of the system, the trust funds have served largely as a contingency reserve, an accounting of excess obligational authority on the books of the Treasury.

Most experts have agreed over the years that this contingency reserve should equal about 100 to 150 percent of the following year's annual expenditures in order to assure continuation of benefits in the event of short-term adverse circumstances, of either an economic or non-economic nature, that might create unanticipated revenue shortfalls or benefit expenditures.

The Social Security Amendments of 1977 and 1983 have created a temporary period where the Trust Funds will build up reserves beyond the level needed for a contingency reserve. Currently, the combined OASI and DI Trust Funds are projected to peak at 265 percent of annual program cost in the year 2011.

The 1997 Trustees Report

The 1997 Trustees Report tells us that the assets of the combined funds increased by $70.9 billion, from $496.1 billion at the end of December 1995 to $567.0 billion at the end of December 1996. In 1996, the Social Security trust funds took in $424.5 billion and paid out $353.6 billion. In addition, the combined assets of the OASI and DI Trust Funds are expected to increase from the current level of about $600 billion to over $2 trillion in 2011, or from about 160 percent of annual expenditures to about 265 percent of annual expenditures. Thus, the combined OASI and DI Trust Funds, as well as each fund separately, are adequately financed and meet the short-range test for financial adequacy for the next ten years.

The Trustees also assess the actuarial status of the trust funds over the next 75 years, the period which is considered long range for program evaluation purposes. The OASI and DI programs are out of actuarial balance for the period ending in 2071. Actuarial balance is essentially the difference between annual income and costs summarized over a given period. If the balance is negative, as it is now, the fund has an actuarial deficit.

The deficit is generally expressed in terms of a percentage of taxable payroll rather than dollars because the value of a dollar changes over time. The deficit in this year's Report for the OASDI program changed very little from last year's Report, rising from 2.19 percent of taxable payroll to 2.23 percent.

In addition, the combined OASDI and separate OASI and DI programs do not satisfy the long-range test of close actuarial balance. This test essentially requires that the expected income for the program be at least 95 percent of the expected cost of the program over the 75-year period as a whole. In the 1997 Trustees report, the income of the OASDI program is projected to be about

86 percent of the cost of the program over the long-range period.

As has been true throughout the program's history, administrative expenses for the OASDI program were small in relation to benefits. Administrative expenses actually decreased by $0.2 billion compared to last year and amounted to $3.0 billion in 1996, or about 0.9 percent of benefits paid during the year.

Interest earnings on the invested assets of the combined OASI and DI Trust Funds were $38.7 billion in 1996. This represented an effective annual interest rate of 7.6 percent earned by the combined assets during the year. During the same period, the average interest rate on new securities purchased by the trust funds was 6.6 percent.

The Trustees develop three alternative sets of estimates based on varying economic and demographic assumptions to show a range of possibilities regarding the financial condition of the trust funds. These estimates range from low cost (alternative I) to high cost (alternative III). Alternative II, the intermediate set of assumptions, reflects the Trustees' best estimate of what future experience will be. The projections take into account fertility rates, mortality rates, net immigration rates, productivity increases, unemployment rates, cost of living increases, and other factors, all of which are difficult to predict with very much certainty.

Under the 1997 Trustees Report's intermediate assumptions, the annual combined tax income of the OASDI program will continue to exceed annual expenditures from the funds by more than $30 billion each year through 2006. This excess will then decline, until annual expenditures from the OASI and DI Trust Funds are projected to become larger than the funds' combined annual tax income for 2012. However, total income, including interest, would continue to exceed expenditures until 2019. The funds would begin to decline in 2019 and would be exhausted in 2029. Each of these three dates is the same as was estimated in last year's Report.

Thus, tax income alone is more than enough to pay benefits in full through the year 2011, and, with the help of the accumulated trust funds, benefits are projected to be payable in full through 2028. Even if no action were taken between now and the year 2029, and the combined trust funds were allowed to become exhausted, continuing payroll taxes and income from taxes on benefits would be expected to generate more than $600 billion in revenues (in constant 1997 dollars) for the Trust Funds in 2029. This is enough income to pay approximately 75 percent of benefit obligations. Even with projected further increases in the cost of the OASDI program throughout the long-range period, the tax income under present law would still be enough to pay over two thirds of benefit obligations in the year 2071.

The Trustees concluded, ". . . there is ample time to discuss and evaluate alternative solutions with deliberation and care. The size of the long-range deficit is such that long-range balance could be restored within the framework of the present program, or through plans that involve some structural change. Nonetheless, the impact of any required changes will be less disruptive the sooner they are enacted." Addressing the long-range financial imbalance of the OASDI program soon will allow changes to be phased in more gradually and with more advance notice for those affected, allowing more time to make any desired changes in planning for retirement.

Changes from the 1996 Trustees Report

As mentioned earlier, the estimated long-range actuarial deficit of the OASDI program changed from 2.19 percent of taxable payroll for the 1996 Report to 2.23 percent of payroll for the 1997 Report, based on intermediate assumptions. A number of changes contributed to this small change. The mere passage of time, changing the ending year of the long-range period from 2070 to 2071, increased the long-range actuarial deficit by 0.08 percent of taxable payroll, because of the inclusion of the large annual deficit projected for the year 2071.

The net effect of all other changes resulted in partially offsetting improvements to the estimated long-range actuarial balance for the 1997 Report. These changes include (1) modifications based on the latest demographic and economic data, (2) changed CPI- and wage-growth assumptions related to changes made by the Bureau of Labor Statistics in 1995 and 1996 in the measurement of prices for the CPI, (3) new regulations that distribute the date for payment of benefits throughout the month, and (4) an increase in the assumed ultimate real interest rate on long-term United States government securities.

Changes from the 1983 Trustees Report

The last comprehensive amendments to the Social Security program, enacted in 1983, were projected at the time to put the OASDI program in actuarial balance for the long-range period ending

2057. The projections in the 1983 Trustees Report indicated that the trust funds would be solvent throughout the period, but would be declining rapidly toward the end of the period and would become exhausted almost immediately after 2057.

Since 1983, a number of changes have been made that have, on balance, worsened the long-range financial projections for the program. Contributing to the currently estimated actuarial deficit of 2.23 percent of payroll in about equal amounts are (1) the gradual change in the long-range valuation period from the period ending with 2057 to the current period ending with the year 2071, (2) changes in ultimate economic assumptions, principally a reduction in the assumed real growth rate in the average wage from 1.5 percent in the 1983 Report to the current assumption of 0.9 percent, (3) increases in the cost of the Disability Insurance program, largely due to higher rates of disability among women and for persons with mental impairments, and (4) changes in the methods used for making long-range projections, primarily improvements in the method for projecting future benefit levels. Modifications in demographic assumptions since 1983, principally higher than expected birth rates between 1984 and 1996 and the assumption that immigration will add more to the United States population, have resulted in partially offsetting improvements in the long-range OASDI actuarial balance.

Conclusion

Clearly, 75-year projections of the cost of the OASDI program should not be considered to be precise predictions or forecasts. Over a period this long, many substantial changes will occur that cannot be predicted. These projections serve rather as a basis for considering the implications of the provisions in current law if economic and demographic trends follow patterns that are deemed to be most likely by the Trustees. Due to the great uncertainty for the future, a range of assumptions is developed to indicate what might occur if trends move in directions that are favorable or unfavorable to the financing of the program.

The favorable, or low-cost, assumptions result in projections where the OASDI program would be well financed into the indefinite future. No change in the program would be needed. The unfavorable, or high-cost, assumptions would result in exhaustion of the combined OASI and DI Trust Funds in 2018, 11 years earlier than under the intermediate assumptions.

Under the intermediate projections, the Social Security program will continue to receive more in taxes than it pays out through 2011. The accumulation of this excess budget authority will allow the program to continue paying benefits in full through 2028. Before 2029, changes will be necessary. Early enactment of changes will allow the changes to be phased in more gradually, and will allow for more advance notice to the affected workers and beneficiaries, so that they can effectively adjust their plans for retirement.

Dr. Steuerle.

STATEMENT OF C. EUGENE STEUERLE, Ph.D., SENIOR FELLOW, THE URBAN INSTITUTE

Dr. STEUERLE. Thank you, Senator Grassley, Senator Hagel, Senator Kerrey and thank you members of the audience here at the College of St. Mary, because in the end you are the ones who are going to decide what type of reform is allowed to take place in Social Security and in Medicare—the type of reform that these representatives will be able to vote for.

I say you will decide what type of reform, because reform is inevitable. It has been conveyed not only in the figures that have been given to you by our illustrious panel here but also by the figures given to you by Steve Goss.

The promises of ever-rising benefits made by past legislatures simply are way in excess of expected revenues. In fact, the tax rate on young people would almost have to double to meet the promises that are now in current law.

Sometimes it is hard to put into law a parameter or rule that is going to guide our policy for the next 10, 20, 50 years, as we have attempted to do in Social Security and Medicare.

I am reminded a little bit of a story about the Constitutional Convention. When one of the members of that convention moved that as part of the Constitution the United States should never have a standing Army of more than 5,000 troops at any one time, George Washington apparently said he could support such an amendment only on one condition: that all foreign governments agree never to invade with more than 3,000 soldiers.

I think it is important to put Social Security issues into perspective. During the past half-century, maybe even a little longer, we have been on a path of devoting increasingly larger shares of our national income and wealth not simply through the government but through the private sector as well, toward years of retirement.

The average span of retirement years has now stretched on average to about one-third of our adult lives. But an inevitable side effect of this trend is that we have devoted increasingly smaller shares of our national income and wealth to needs in other periods of life ranging from childhood to middle age. Now that we stand on the brink of the next century, we are forced again to make a decision on how to spend the benefits of future economic growth to meet the needs and opportunities of that century.

The problems posed by Social Security, especially as already discussed by Steve Goss, extend far beyond the adequacy of the trust funds.

In the early 1950's expenditures on retirement, disability and health occupied less than 10 percent of Federal expenditures. As you can see from Figure 1 we have jumped to a point where we spend more than 50 percent of our Federal expenditures on retirement, health, and disability, as I say, in contrast to 10 percent merely about 40 years ago.

When the baby boomers begin to retire in the first third of the next century, the next graph shows you that the Federal Government could devote almost all of its revenues to their needs; that is, it could devote almost all of its revenues to retirement and health programs to the exclusion of everything else. That is what is scheduled in current law.

Now, this Nation, I believe, is committed to taking care of its most disadvantaged citizens as well as trying to ensure a basic retirement living for the elderly. Our current budget, however, automatically allocates larger and larger shares every single year—this year, next year, the following year—toward retirement and health, and smaller and smaller shares toward educating our youth, helping children who have the highest poverty rate in the population, preventing crimes or simply allowing individuals to keep more of their tax dollars. We are on a path, I believe, that almost no one would choose; not even as a compromise.

Social Security also schedules the very early withdrawal from the work force of many extraordinarily talented people. It increasingly favors consumption over savings, and it actually does a mediocre job of taking care of the very old, who are the poorest among the elderly population. It is also very unfair toward second earners in families.

Despite these problems, reform can still ensure that almost all future retirees receive equal or greater benefits than those who retired before them. There really is no issue as to whether current retirees are going to have reduced benefits. It is the growth in benefits, the growth in benefits ordained in current law that must be slowed.

Now, there are a variety reasons for past and future growth in Social Security benefits, but three dominate. First, annual benefits are scheduled to grow forever. They are scheduled to grow forever in real terms in current law without any vote from the Congress.

Second, we live a lot longer and retire a lot earlier. As I mentioned before, most of us can now expect to spend approximately one-third of our adult lives in retirement, and that number—that fraction—is growing.

The large number of retirement years is due partly to an increase in life expectancy, as shown here in Figure 3, but it is also due to the fact we retire several years earlier than we did a few decades ago. Most of us make it to retirement, while we did not just a few decades ago.

In addition to growth in real annual benefits, and in addition to retiring for more and more years, there is a third source. That is once the baby boomers retire, there will be a reduction in the work force. This reduction in the work force is going to have an impact far beyond Social Security, and in economic terms is equivalent to reducing our work force, or increasing the unemployment rate by about 10 percentage points. That is, the impact of the baby boomers retiring has the equivalence of increasing the unemployment rate by about 10 percentage points.

While this last source of pressure cannot be avoided entirely, the other two sources of pressure can be placed more under control. Growth and real benefits per person can be pared, as can the number of promised years of support, which now average about 18 years for an individual. For a couple, if you think of their annuity as lasting until the longer living of them dies, the typical annuity now lasts 25 years.

The simple fact is that when I retire, I am on the leading edge of the baby boom population. My cohort of individuals, when in their sixties or even early seventies, will not be old by traditional standards of having short expected life spans.

The committee also asked me to focus on other aspects of a framework for guiding future action. Because of time constraints, I have given in my testimony a number of examples of principles and processes, I believe, that ought to be adopted, but I will only give a few examples here.

One principle of Social Security is that a governmental system of elderly support is primarily aimed to help those in the last years of life maintain more than poverty level income. Social Security success here has been remarkable, and it should not be abandoned.

One principle of budget policy, that I believe, should be followed is that it should avoid excessive promises. Ownership of government should be reserved for each generation not simply as a matter of right or justice but because we, again, are humble enough to admit we do not know all of the circumstances that would arise tomorrow. I believe that much of the disenchantment of the young with government today is due to the fact that expenditures for the next 5, 10, 15, 20 years are already ordained in law; even those expenditures that derive from the revenues provided by economic growth.

A process guideline that I favor is that reform ought to center on long-run structural reform and not on short-term cash-flow problems. One implication is that reform should begin as soon as possible.

Finally, a comprehensive view of Social Security requires looking beyond annual costs toward the value of expected lifetime benefits—the amount of money it would take for households to buy a private insurance policy that provided equivalent benefits.

As you can see in this last graph, for an average income one-earner couple retiring in 1960, total Social Security cash benefits were in today's dollars worth about $100,000. Today those benefits for a couple are worth about a quarter of a million dollars. For a couple retiring in about 25 years, those lifetime Social Security benefits rise to a third of a million dollars. If we add in Medicare, the numbers would be even larger.

Added together, an average-income couple retiring today is promised benefits of about a half a million dollars of Social Security and Medicare. Due largely to the significant number of years of receipt, that number grows to $800,000 by the year 2030. If we take some high-income couples retiring at that time, the value of Medicare and Social Security benefits in today's dollars approach a million dollars in terms of lifetime benefits.

In summary I would like to give an anecdote, a little dream I sometimes have. Sometimes I dream that I am appearing before a panel such as this one, and suddenly there comes out of the audience someone from the National Institutes of Health or perhaps a researcher here at the College of St. Mary who shouts, "Eureka! We found a cure, though expensive, for cancer!"

All the members of the audience stand up and cheer; they are happy. This is a good thing that has happened to us in society. We are better off in society because of increased longevity, this increased possibility of better health care.

Then I look up behind the podium at people who are testifying and the Members of Congress, and they are all wiping their brows and sweating and commiserating among themselves. I say, "What is happening?" Suddenly I realize, it is the way we have enacted current laws that the benefits of longevity, the benefits of better health care, those good things that are happening to society are becoming in our budget an albatross of increasingly higher cost because we have more and more years of retirement and more health-care expenses.

So I would like you to think about our problem as a good one. Let us think of this as an opportunity for thinking how we set our policy, how we spend our increased income and wealth in the century to come.

Thank you.

[The prepared statement of Dr. Steuerle follows:]

EVALUATING SOCIAL SECURITY REFORM OPTIONS

Statement before the Special Committee on Aging
United States Senate

Omaha Nebraska
August 26, 1997

C. Eugene Steuerle
Senior Fellow

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Mr. Chairman & members of the Committee:

This nation will soon attempt major reform of its government retirement and health programs. We know that changes will occur because the promises of ever rising benefits made by past legislatures are way in excess of the available revenues. I think it important, however, to put these issues into perspective. Like citizens of other nations, during the last half-century we have devoted increasingly larger shares of our national income and wealth toward years of retirement and withdrawal from the labor market. This trend is neither inevitable nor forever sustainable. In earlier periods of history, we were more likely to spend the benefits of growth in other ways, such as on better shelter or shorter work weeks.

The modern shift is reflected primarily in increased leisure, consumption, and health care during a span of retirement years that has now stretched, on average, to one-third of our adult lives. We have made this decision collectively. We have changed the very nature of both public and private retirement and health care systems in the process. And, as an inevitable side effect, we have devoted increasingly smaller shares of our income and wealth on needs during other periods of life, ranging from childhood to middle age. Now, at the turn of the century, we are about to embark on yet another stage of our journey, one where we are likely to spend the benefits of future economic growth in ways that are unique -- different not just from the past half century but from all previous periods. It is within this broader societal setting that Social Security issues must be considered.

Is Social Security a "Problem?"

Defining Social Security as a problem in some ways is like defining a cancer cure as a problem. Unlike crime rates, educational test scores, or children begetting children, most of our budgetary problems in the fields of health and retirement come from gains to society -- not from a deterioration of conditions which may require new resources to redress. This should warn us that Social Security's budgetary "problem" derives more from an excessive set of promises than from new and unexpected needs.

As has been made quite clear by the trustees of the various Social Security trust funds, the promises of benefits within the Old Age, Survivors, and Disability Insurance (OASDI) are significantly in excess of the payroll taxes and other income sources available to the trust funds. You have received testimony on these issues and I will not dwell on them here. The problems posed by Social Security, however, extend far beyond mere adequacy of trust fund balances. In the early 1950s, expenditures on retirement, disability, and health occupied less than 10 percent of federal expenditures. Today they comprise almost 50 percent, and the number is continually rising (Figure 1). Social Security by itself represents over one-quarter of all federal expenditures other than interest on the debt. When the baby boomers begin to retire in the first third of the next century, the federal government could devote most of its revenues simply to Social Security and Medicare, and almost all its revenues to all retirement and health programs to the exclusion of almost everything else (Figure 2).

This nation, I believe, is committed to taking care of its most disadvantaged citizens, as well as trying to ensure a basic retirement living for our elderly. Nonetheless, needs compete for limited resources. We must choose wisely which additional dollars of resources can best be used to meet which additional needs. The current unsustainable *growth* in retirement and health expenditures, in my view, is helping to support a disinvestment in our nation's and our children's future. Our current budget, through rules that often operate automatically, effectively allocates larger shares toward retirement and health and smaller shares toward educating our youth, helping children who now have the highest poverty rates in the population, preventing crime, restoring promise and order in some of our central cities, or simply allowing individuals to keep more of their tax dollars. I don't mean to imply that making other budget choices is easy. We are on a path, however, that almost no one would choose, not even as a compromise.

Social Security and other government programs for the elderly and near-elderly have several related problems that go beyond their impact on the federal budget:

- They schedule a huge decline in the use of our human capability and capital. The very early withdrawal from the workforce of many extraordinarily talented people reduces enormously the productive capacity of the nation.

- They increasingly favor consumption over saving. Smaller shares of the budget are devoted to investment, while there is good reason to believe that Social Security may reduce societal saving.

- Despite substantial resources, they are very inflexible. They do a mediocre job of taking care of the poor and very old, they are very unfair toward second earners in families.

Although resolving these problems requires some difficult and fundamental decisions to be made in the near future, it does not mean that these decisions need to have a large impact on the elderly. With adequate forethought and preparation, *reform can still insure that almost all future retirees receive equal or greater lifetime benefits than those who retired before them.* Benefits generally can be maintained; it is the *growth* in benefits foreordained in current law that must be slowed.

The Basic Sources of Budgetary Pressures

There are a variety of reasons for the past and future growth in the cost of Social Security. Three dominate. First, annual benefits are scheduled to grow *forever* in real terms for each succeeding cohort of retirees. Second, we live a lot longer and retire a lot earlier. *Most of us can now expect to spend approximately one-third of our adult lives in retirement*, during which period we will be primarily dependent upon younger taxpayers for our income and health care support. This large number of retirement years is due partly to an increase in life expectancy (Figure 3) and partly to retirement at earlier ages. Without increasing early and normal retirement ages in Social Security, the fraction of our lives during which we would receive government support would rise even more. Third, once the baby boomers start retiring, there will be a reduction in the workforce that is equivalent in its economic impact to an increase in the unemployment rate of over 10 percentage points.

This last source of pressure can be mitigated but not avoided. No matter how we define "old age" -- for example, by a given life expectancy -- the proportion of the population that is closer to death will soon rise dramatically, with most of the change occurring during about a twenty year period when the baby boomers become "old." Needs of the very "old" will increase during this period and require adjustments in federal outlays.

The two other sources of pressure, however, could be placed more under control. Growth in real benefits per person can be pared, as can the number of years of promised support. After taking into account earlier retirement, remember that the typical annuity for an individual now lasts about 18 years and for a couple about 25 years. Some combination of a lower rate of growth of benefits, a lower rate of growth in years of retirement, and an actual paring of years alone could bring the Social Security system into budgetary balance.

The simple fact is that future cohorts of individuals in their 60s and even early 70s will not be "old" by traditional standards of having short expected life spans. As a whole, moreover, this age group is already among the richest and most capable of all age groups, while our societal standard -- both public and private -- is to treat them as unproductive and create incentives to move them out of the workforce.

The pressure put on younger workers is already significant, with about $1 in $5 of their cash earnings already being taxed to support federal programs for the elderly and near elderly, and additional amounts going to state and local programs for the elderly and near-elderly. Under current law, the effective federal tax rate is projected almost to double in coming decades due to a scheduled drop in number of workers to retirees and the lack of control over health costs.

You have asked me to focus on a framework for guiding future action. Let me suggest that it begin, as I have attempted above, with a nonpartisan historical perspective on the issue of Social Security. In the remainder of this testimony I suggest that this framework also contain a set of principles that should undergird both current and future Social Security policy; some process guidelines; and a comprehensive measurement system that emphasizes the lifetime value of benefits and taxes under Social Security and other programs for the elderly and near-elderly. I don't mean to imply that this framework will lead to unanimous consensus over what should be done. It can, however, lay out in clearer fashion the benefits and costs of various actions and remove from consideration options that fail to address basic problems or that unnecessarily violate fundamental principles.

First Principles

Dealing with these various issues and problems can be done best, I believe, by reference to basic principles and then making appropriate trade-offs among them.

Principles of Social Security

The first set of principles relates to the fairness and efficiency of Social Security itself:

1) *Addressing Fundamental Needs.* The basis purpose of a governmental system of elderly support is to help those in their last years of life to maintain more than poverty level income and insure that they receive a basic level of health services. Social Security's success here has been remarkable and should not be abandoned wantonly.

2) *Equal Treatment of Equals.* All law should promote equal justice - - in the case of Social Security, avoid any arbitrary or capricious difference in taxes or benefits among those who are more or less equally situated.

3) *Efficiency.* As much as is reasonable, the system should not distort work, saving, or other individual behavior.

4) *Individual Equity.* Individuals have the right to receive a fair return on their transactions.

The first principle almost inevitably requires some redistribution in society -- from young to old and from rich to poor -- and hence conflicts with the third and fourth principles. Alternative reform proposals place different emphasis on different principles. Nonetheless, once the redistributive function has been accomplished, the government should be guided as much as possible by the latter principles in allocating its resources.

In a society providing minimum levels of benefits to individuals, moreover, each individual carries some responsibility to avoid relying upon others. If you and I have equal lifetime incomes, but you save and I spend during our earning years, then in a simple welfare system you would end up paying for my retirement, as well as your own. Social insurance, therefore, carries along with it obligations to pay as well as rights to receive.

Principles of Budget Policy

A second set of principles applies more broadly to budget policy, which seeks over time to allocate scarce resources to the greatest needs and demands of society:

(5) *Ownership of Government.* Future voters and generations have a right to some ownership of government and to a say in how to allocate the additional tax resources that accompany economic growth.

(6) *A Level Budget Playing Field.* Different items in a budget should not arbitrarily be divided into those that grow rapidly with only minority support and those that decline unless they can obtain the backing of a supermajority. (By minority support, I refer to the ability of a majority of one in either house or a President by himself to block changes favored by a majority; by supermajority, I refer to the need to obtain a majority in both houses of Congress and Presidential approval.)

(7) *A Comprehensive Budgetary Perspective.* To promote both equity and efficiency, when different programs have related goals, they need to be considered as a whole.

These latter issues are often ignored when budgetary decisions are taken one at a time or put into strict compartments. In the United States today, as well as much of the industrial world, programs for health and retirement have begun to dominate other budget items and are scheduled automatically to absorb more than all of the revenue growth that accompanies an expanding economy. The uneven playing field of the budget -- the so-called entitlement problem -- means that over the long-run items such as education and the environment receive smaller shares of funding so as to support significant growth in expenditures for retirement and health. Put another way, our government resources are increasingly and automatically devoted to consumption in old age and early retirement relative to education, greater crime prevention, a fixing up of our central cities, and simply getting our youth off the streets after school and during summers.

Good budget policy, therefore, tries to avoid excessive promises even if rising incomes in theory make such promises affordable. Ownership of government is reserved for each future generation not simply as a matter of right or of justice, but because we are humble enough to admit that we do not know today all the circumstances that will arise tomorrow. Perhaps programs for the elderly should be even larger than anyone contemplates, maybe taxes will have to be devoted instead to problems not even anticipated. To lock into law benefit and tax increases for the future that can only be overturned by a future supermajority, however, borders on being an act of distrust in democracy itself.

Any set of proposals for Social Security reform should be assessed by reference to this type of set of fundamental principles.

Process Guidelines

In addition to basic principles, it is important that any reform effort begin with some process guidelines. Let me suggest three that are important for Social Security.

First, **Social Security reform must bring long-run revenues and expenditures into line and not depend upon perpetual, long-term, deficit financing within Social Security itself.** We cannot consider our problems solved if we merely reach 75-year balance of receipts and expenditures, a traditional Social Security goal. Such a balance implies that after a few years of surplus in the current period, due largely to the relatively small birth cohort now retiring, Social Security can run perpetual deficits that will be financed by the general taxpayer, who pays for the interest or redemption of principal of moneys attributed to the trust funds. This is foolhardy. Long-run expenditures and sources of funds must also be brought into line.

Second, **reform of programs for the elderly, as much as possible, ought to be considered as an integral whole**. There are very important interactions among Social Security, Supplemental Security Income (SSI), and Medicare, among others. For example, if Social Security and Medicare were considered together, I believe that we would be less likely to continue the trend toward increasing Medicare benefits relative to cash benefits. Some worthwhile trade-offs would become more apparent, such as increasing cash benefits for some poor elderly in exchange for more tightly controlled Medicare expenditures. As another example, transfers to the poor through SSI or Social Security should be integrated.

Third, **reform ought to center on long-run structural, not short-term cash flow, problems. To achieve this goal, reform should begin as soon as possible.** When the baby boomers begin retiring, the fiscal impact of paying off the many new unfunded promises made to them hits with a bang. The longer we continue to delay dealing with Social Security's problems, the more likely legislation will be centered on cash flow fixes, rather than long-term reforms. For instance, increasing tax rates or cutting back on cost-of-living adjustments can add quickly to trust fund balances. Raising the retirement age, reducing the rate of growth of unfunded benefits for each new cohort of retirees, or gradually building up private funds and saving, on the other hand, occur only gradually over time. One reason for gradual implementation of the latter reforms is to avoid large differences in benefits between new retirees from one year to the next. While the cash flow revisions add quickly to trust fund balances, they often fail to deal with the issue of how Social Security should be structurally designed for the long-term.

Finally, **any accounting system should be complete**. It should account not only for what is happening to Social Security, but to the government budget as a whole, and to private individuals as taxpayers, recipients, and savers. As one example, it is important to beware of magic money that derives from incomplete accounting. Attempts to let government borrow at a 2 percent real interest rate and then encourage government accounts or private accounts that supposedly grow at a stock market rate of, say, 6 percent are misleading, if not dangerous. Orange County writ large. If government can win by arbitrage, then someone else is losing. If one really believes that all government has to do is to arbitrage some money to solve its long-term problems, then let's simply increase government borrowing even more and then invest that money, or force private savers to put money aside, in the stock market! Magic money is being used by some to argue that hard choices don't have to be made. That is, it is tempting to promise continued huge increases in the elderly and near elderly's share of the national pie simply by having their money grow faster than the economy -- that is, faster than income and consumption of everyone else. Not only is magic money often involved, but even if available it doesn't solve many of the longer term problems associated with the waste of our human capital or capabilities.

Measuring Lifetime Benefits and Taxes

Social Security reform discussions often start with too narrow a focus -- the value of annual benefits for particular sets of beneficiaries. While this measure is adequate for some purposes, a more comprehensive way of viewing Social Security requires looking beyond annual costs toward the value of expected lifetime benefits -- the amount of money it would take for households to buy a private insurance policy that provided equivalent benefits.

With a lifetime perspective, it is easier to view many of the trade-offs comprehensively. For example, recent debates over cost of living adjustments have focused on their impact on annual benefits. If one wants to reduce lifetime benefits by 10 percent, however, it may be better to cut back on benefits of the young elderly than on the old elderly, who are most affected by cost of living adjustments.

Lifetime benefits allow one to consider more directly the choice made between higher annual benefits and more years of support. For a couple retiring at age 62 today, annuity payments can be expected to last for one-quarter of a century on average. That is, because Social Security operates like an insurance policy with a right of survivorship, the longer living of the two partners will on average receive 25 years worth of Social Security benefits. For any lifetime benefit package, reducing years of expected support allows one to maintain higher annual benefits.

The combination of real growth in annual benefits, combined with more years of retirement support, has led over time to a significant increase in lifetime benefits. For an average-income one-earner couple retiring at age 65 in 1960, for instance, total Social Security cash benefits were worth about $99,000 (in 1993 dollars). Today those benefits cost about $223,000. In another 25 years, the Social Security pensions of new retired couples with average incomes will have a value of about $313,000 (Figure 4). Remember again that one reason these lifetime costs are this high is that benefits are scheduled to last for more than two decades.

Until recently, almost all recipients--whether rich or poor--received more in benefits than they paid in taxes and the interest they could have earned on those taxes. Those who were richer, moreover, consistently received transfers (benefits in excess of taxes) as large, if not larger, than those who were poorer. To take an example, low-income couples retiring in 1980 paid into the system about $27,000 in taxes and got back $150,000--a net transfer of $123,000. High-income couples retiring in that year paid in about $83,000 in taxes, but got back $316,000--a net transfer of $233,000. Only now and in the future will that situation gradually begin to reverse itself--and even then low-income households will sometimes receive fewer net OASI transfers than those with higher incomes.

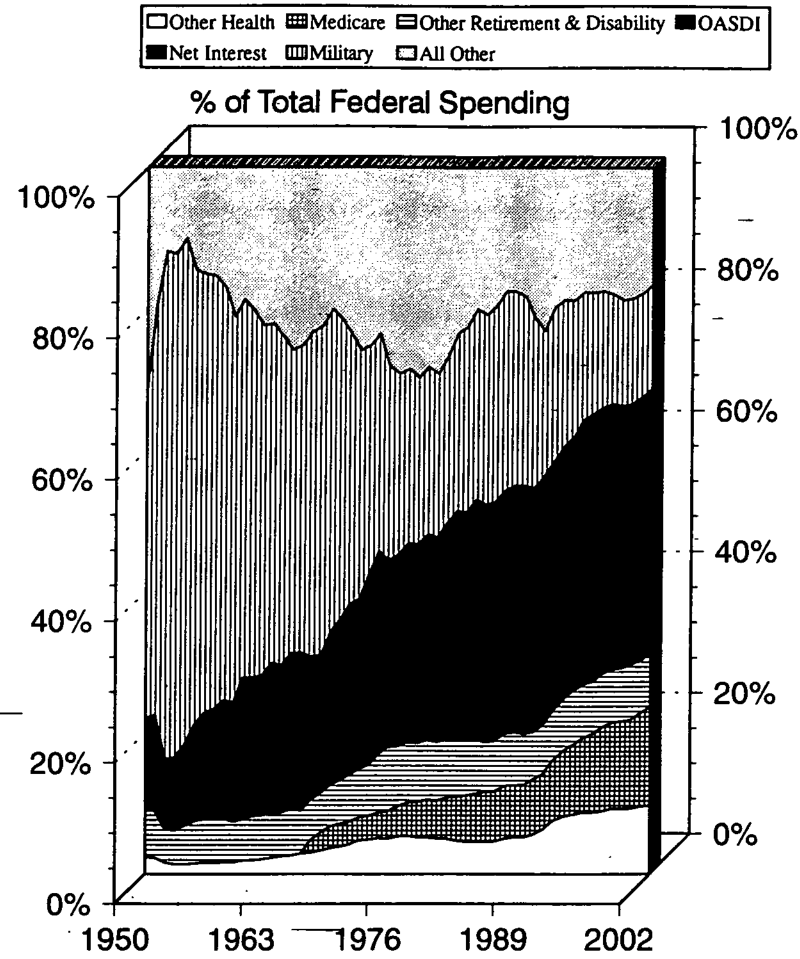
When Social Security and Medicare benefits are added together, an average-income couple retiring today is promised benefits not ~~far~~ from 1/2 million dollars -- growing toward

$800,000 by the year 2030 (Figure 4). For some high-income couples retiring in the future, the value of benefits will approach 1 million dollars.

Conclusion

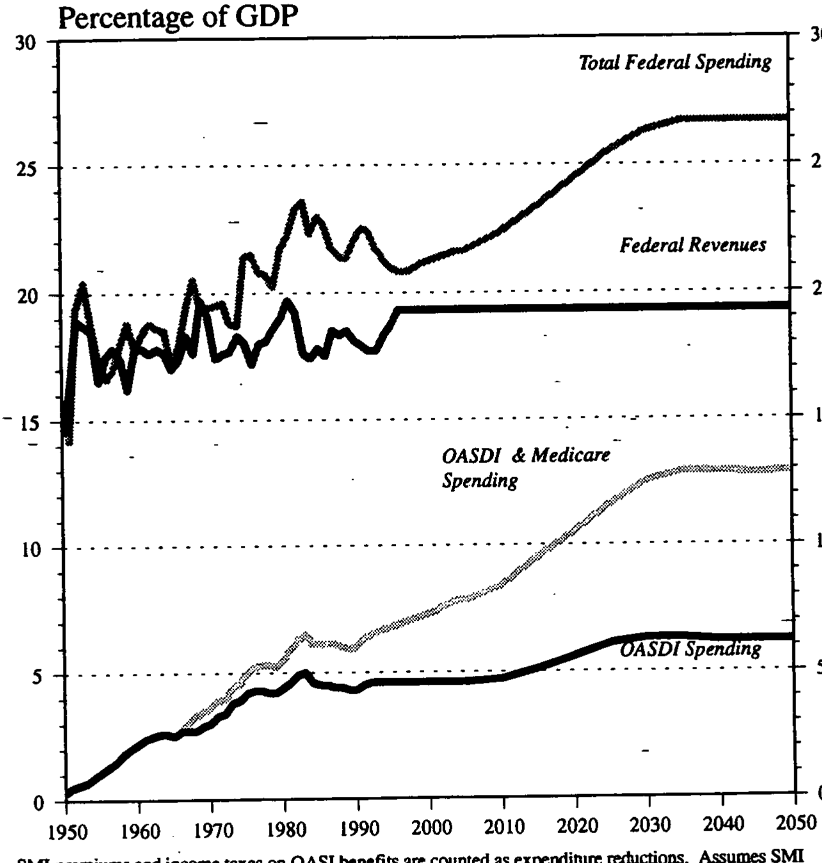
I have suggested that a framework for reform should give considerable attention to historical context, principles, process, and use of comprehensive measures. While a good framework will not provide any final answers, it will help focus attention on the main issues at hand and help keep poorly designed options off the table. In the end, however, we must remember that the requirement for Social Security reform should be viewed positively as an opportunity. It is a vital step in defining our journey in the 21st century and making the very best use of the valuable financial and invaluable human resources of this nation.

FIGURE 1:CHANGE IN THE COMPOSITION OF THE FEDERAL BUDGET, 1950-2002



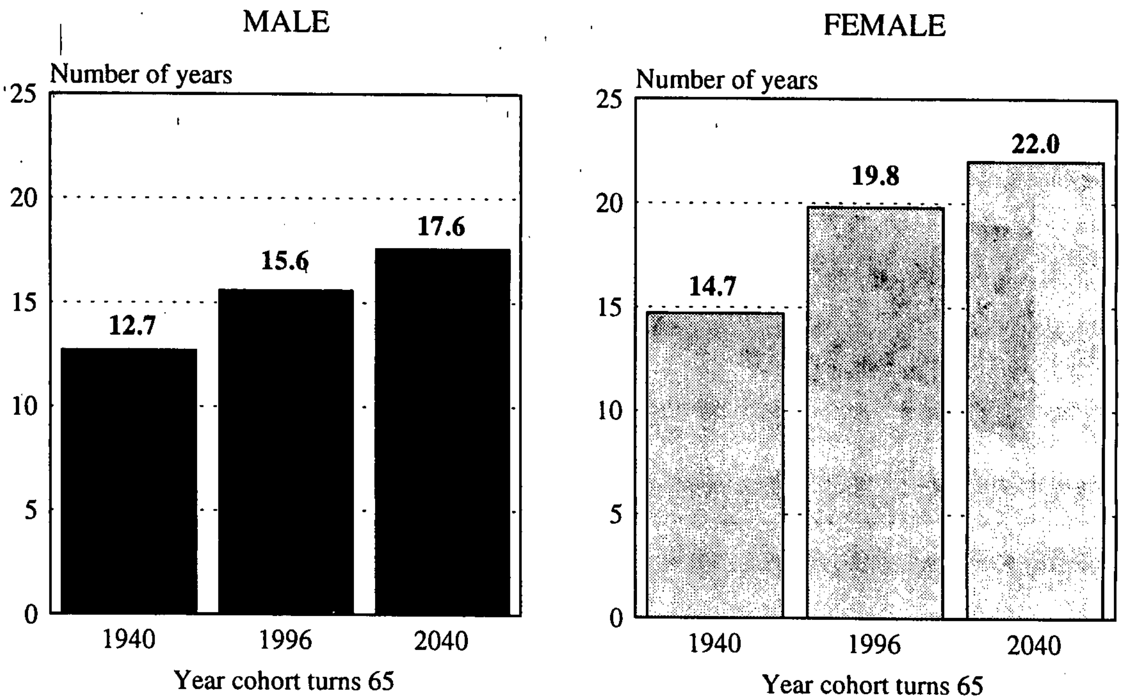
Source: C. Eugene Steuerle and Gordon Mermin, THE URBAN INSTITUTE. Calculations based on data from the President's budget proposal in the *Budget of the United States Government Fiscal Year 1998*, OMB (1997).

FIGURE 2:FUTURE GROWTH IN SOCIAL SECURITY AND MEDICARE MEANS HIGHER TAXES, LARGER DEFICITS,OR LOWER SPENDING ON EVERYTHING ELSE



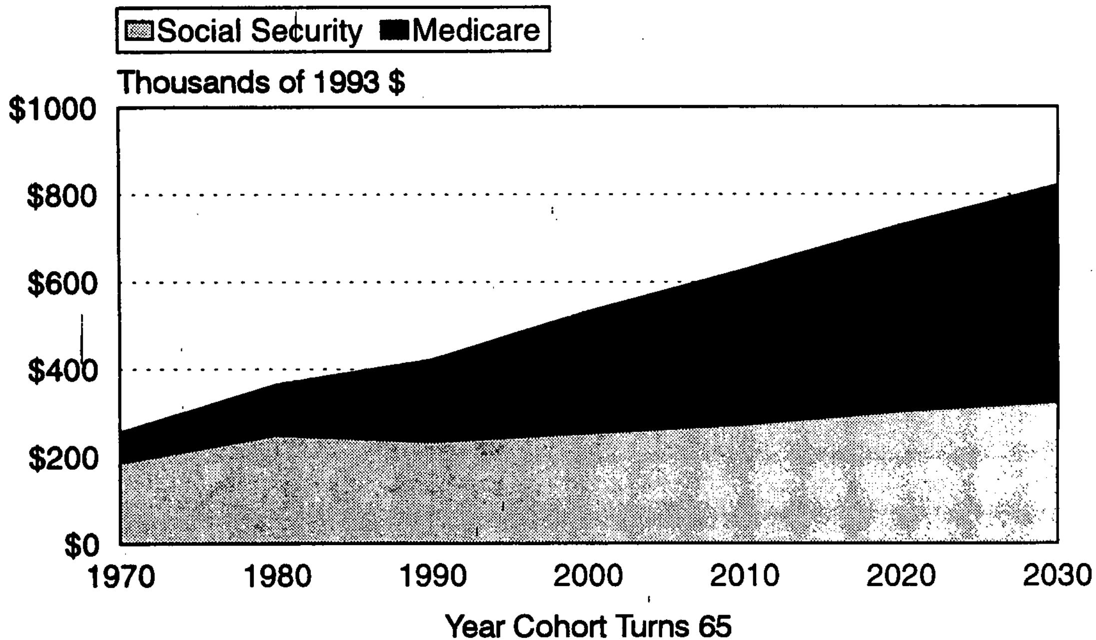
SMI premiums and income taxes on OASI benefits are counted as expenditure reductions. Assumes SMI premiums remain at 25% of program costs indefinitely and spending - besides OASDI and Medicare - and taxes remain constant as percent of GDP after 1996.
Source: C. Eugene Steuerle and Gordon Mermin, THE URBAN INSTITUTE. Based on data from the Office of Management and Budget (1996) and the Board of Trustees of the OASDHI Trust Funds (1995).

Figure 3: Life Expectancy At Age 65



Source: Data and projections from the U.S. Social Security Administration, Office of the Actuary, 1992, Life Tables for the United States Social Security Area 1900-2080: Actuarial Study No. 107, Washington, D.C.: U.S. Government Printing Office.

Figure 4: Growth in Lifetime Social Security and Medicare Benefits for Average-Wage One-Earner Couples



Data are discounted to present value at age 65 using a 2% real interest rate. Assumes survival to age 65 and retirement at the OASI normal retirement age. Projections based on intermediate assumptions of the 1993 Social Security Board of Trustees reports.

Source: C. Eugene Steuerle and Jon Bakija, Retooling Social Security (Washington, DC: Urban Institute Press, 1994).

The CHAIRMAN. Helen.

STATEMENT OF HELEN BOOSALIS, BOARD CHAIR, AMERICAN ASSOCIATION OF RETIRED PERSONS

Ms. BOOSALIS. Thank you, Mr. Chairman and Senators Kerrey and Hagel.

I am Helen Boosalis, chair of AARP's Board of Directors. We do appreciate your invitation to share our views regarding options to restore Social Security's long-term financial health. I also appreciated all your comments this morning and your concern, Senators.

As you would expect, AARP and its members have a considerable stake in the Social Security solvency debate. The majority of AARP's members receive Social Security and know how important these benefits are. As the parents and grandparents of today's workers, they—we want a viable program that will serve tomorrow's beneficiaries as well.

Social Security is our most successful and popular Federal program. Despite Social Security's popularity, many workers worry about the ability of the program to pay benefits in the future.

Their anxiety largely reflects widespread misinformation about the program and its financing as well as a general mistrust of any government-administered program. These fears are misplaced.

As the Social Security trustees reported in April, the program can pay full benefits on time until 2029 without any change in current law. Beyond that even, Social Security can continue to pay benefits, as you heard; at about three-fourths of promised benefits.

We know that some incremental modifications can and must be made to bring the system into long-term actuarial balance. In the past solvency has been restored by additional revenue or benefits changes or a combination of the two.

The sooner such changes are made, the less painful they will be for workers and beneficiaries. Also, early changes would mean that working Americans will have more time to adapt their retirement planning.

AARP believes changes can and should be made that do not fundamentally alter the current system or undermine the principles that led to Social Security's success and enormous popularity. We too in AARP have adopted principles that will guide us as we evaluate solvency options.

AARP believes that we must consider the needs of all generations in crafting a solution. One option that has received considerable attention is that of substituting individual retirement accounts for part of Social Security's benefit promise.

Although individual accounts could encourage greater individual control, it results in greater risks. Social Security is designed with a fundamentally different objective of income security provided throughout a worker's life.

Changing this goal could have an adverse effect on the income security of many workers and their families.

Social Security includes many benefits that are often overlooked, including lifetime inflation protection and dependent survivor and disability benefits. These benefits are too costly for most workers to purchase in the private market.

Low earners would fare particularly badly under individual accounts, because Social Security's weighted benefit formula now results in their receiving a greater portion of their pre-retirement earnings than do higher earners. These workers will have less to invest and are more likely to have limited investment experience. Having less, they tend to invest conservatively and are likely to pay proportionately higher administrative fees.

Also, diverting money from the current system to individual accounts will require one generation of workers to face a double burden. They must finance the benefits of those currently receiving or about to receive Social Security as well as pay for their own retirement.

Social Security has been the base of retirement income for the majority of retirees for over 60 years. In fact, almost two out of three beneficiaries count on Social Security for at least half their income. But Social Security is only one part of the retirement income framework.

Clearly, while Social Security must be made more secure, greater attention must be focused on the other two legs of the retirement income stool. Pensions and savings have not lived up to their potential. Indeed, pensions and savings are the parts of the retirement income framework where individual risk and responsibility already exists.

The fact is, however, that only two out of five retirees now receive any pension income, and amounts saved for retirement have been far less than needed. Given the current shift to individual accounts in the pension system, the secure, defined benefit promise in Social Security takes on greater importance. Indeed, if pension coverage continues to stagnate at under 50 percent of the work force and savings rates continue at current low levels, Social Security will continue to carry an even greater burden for retirement income than was ever intended. The importance of Social Security to both current and future retirees cannot be underestimated.

Senators Grassley, Hagel, and Kerrey, I want to assure you that AARP stands ready to work with all of you on a bipartisan basis with the Congress and with the Administration to enact solvency legislation that maintains the benefit promise for current and future generations. Thank you.

The CHAIRMAN. Thank you. I appreciate your offer to help as well.

Ms. BOOSALIS. We will be glad to.

[The prepared statement of Ms. Boosalis follows:]

AARP

Bringing lifetimes of experience and leadership to serve all generations.

STATEMENT

BY THE

AMERICAN ASSOCIATION OF RETIRED PERSONS

BEFORE THE

SPECIAL COMMITTEE ON AGING

OF THE

UNITED STATES SENATE

ON

SOCIAL SECURITY SOLVENCY

August 26, 1997

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AARP appreciates the opportunity to present its views regarding options to restore the long-term solvency of the Social Security system. Americans of all ages have a stake in the future financial strength of this critical family program. We hope today's hearing will further a national dialogue on options for assuring Social Security's long-term financial health and also help allay fears that the program is in imminent fiscal danger.

This April, the Social Security trustees reaffirmed that the program is not in, or near, crisis but does have a long-term problem. In order to help find solutions, it is important for the American people and their elected officials to engage in an inclusive national dialogue about how Social Security works and the many options to restore the program's long-term financial stability. An early discussion of the options will allow workers and beneficiaries adequate time to voice their preferences and concerns. And, if changes are enacted in the near future, they will be less painful than those made later. Early action also would provide workers with adequate notice and the opportunity to plan accordingly.

I. PUBLIC OPINION

Public opinion polls consistently demonstrate that Americans of all ages strongly support Social Security and believe society should honor the long-term commitment that Social Security be there for people when they retire. Nevertheless, many people, particularly younger workers, lack confidence in the program's long-term viability. This lack of confidence has many sources: a lack of confidence in all institutions, particularly government; a widespread perception that the Social Security trust funds have been "raided"; and a pervasive belief that benefit levels are too low -- a view held particularly by the "Boomers."[1] Finally, the lack of confidence reflects the widely held idea that the program will not have the resources to finance the Boomers' retirement.

Despite a lack of confidence in Social Security, most Americans (88 percent of all individuals according to DYG, Inc.) still want to know that Social Security will be there for them "just in case" they need it. In order to ensure that benefits will be there, the public will need to become

[1] These findings are based on over ten years of analyses of public attitudes done for the Association by DYG, Inc.

more engaged in the solvency debate. A discussion of solvency options will not be fruitful, however, unless the public's understanding of Social Security improves. Millions of Americans, convinced that the trust funds have been stolen, are unaware that even after 2029 the system can honor all but about 25 percent of the benefits currently promised, i.e., if Congress does nothing to change Social Security.

The American people not only need better information about Social Security, but they also require time to work through some of the policy tradeoffs that are a necessary part of the national debate. Right now, the public opposes most solvency options in isolation and is particularly resistant to options that require much "pain." Fortunately, there is sufficient time to engage in a meaningful dialogue that can lead to greater public support for enactment of an acceptable solvency package.

II. STATUS OF SOCIAL SECURITY TRUST FUNDS

Social Security is the nation's most closely monitored federal program and the only one that projects future income and costs over 75 years. In April 1997, the trustees reported that Social Security will be able to pay full benefits on time until 2029 -- the same as in last year's forecast. The combined Old Age and Survivors Insurance (OASI) and the Disability Insurance (DI) trust funds (OASDI) will take in more tax revenue annually than is needed to pay benefits until 2011. From 2012 through 2018, revenue to the trust funds plus interest earnings will exceed expected benefit payments. Starting in 2019, annual outgo will exceed annual income, and the trust funds' reserves will be gradually drawn down until they are exhausted in 2029. Even in 2029, without any change in current law, incoming revenue will cover about 75 percent of the benefits currently promised. (See Chart 1)

The annual trustees' report serves as an early warning system of impending problems. Throughout the program's history, changes have been enacted to improve solvency; many were adopted with considerably less lead time than we have now. The major factors contributing to the projected shortfall have been apparent for some time. One of the largest is demographics. We know that the retirement of the roughly 77 million people born between 1946 and 1964, the

Boomer generation, will be costly. However, our nation has adapted to the Boomers as they moved through life's other life landmarks -- when they entered school, college, the work place, and the home-buying market. Reasonable accommodations were made then, and adjustments can be made to Social Security and other retirement systems to deal with the Boomers' retirement and that of the generations to follow.

III. REPORT OF THE 1994-1996 SOCIAL SECURITY ADVISORY COUNCIL

A 13 member advisory council was appointed in 1994 to recommend a solution to Social Security's long-term problem. The Council, which delivered its report this January, did not reach consensus on a single approach for restoring long-term solvency. However, it did agree on key principles and features of the current system that should be retained, such as maintaining full cost-of-living adjustments (COLAs) and rejecting means-testing. It did recommend some modest changes to the program that considerably reduce the projected shortfall.

The Council also emphasized the importance of early action to restore long-term solvency. Generally, long-term solvency can be restored by increasing revenue, reducing benefits, or some combination of the two. The last reform package, the Social Security Amendments of 1983, included revenue and benefit changes and sacrifices were asked of all who participate in the program: workers, employers, and beneficiaries. AARP believes the 1983 approach of shared sacrifice and balanced changes within the program should serve as a model for the future.

A. Principles That Should Be Maintained

The Council highlighted numerous principles of the Social Security program that should be retained. In 1995, AARP adopted a set of principles which we believe should be reflected in any solvency plan (see appendix for the complete list). AARP and the Council agree on the following principles:

- **Social Security should be self-financed;**
- **Social Security should be compulsory;**

- **Social Security benefits should bear a reasonable relationship to contributions, plus interest;**
- **"Conventional" means testing should be rejected; and**
- **Social Security should continue to protect low income retirees by paying benefits that keep them from relying on means tested benefits.**

The above principles have been largely responsible for the enormous support Social Security enjoys among Americans of all ages. The Social Security benefit blends the concepts of "individual equity" (a reasonable relationship between contributions and benefits) and "social adequacy" (providing an income floor). To preserve the concept of equity, benefits are computed using an individual's work history and payroll tax contributions. To provide adequacy, however, the formula is weighted so lower-wage workers receive a benefit that replaces a higher percentage of their pre-retirement wages than for average or higher earners. This weighting provides lower income workers and their families with a benefit that helps protect them from destitution when a wage earner leaves the workforce and provides a measure of dignity and independence. The progressive benefit formula is critical to lower-wage workers since they generally do not accumulate sufficient financial resources, such as a private pension or savings, to help replace wages lost when they retire or become disabled.

If Social Security benefits were conditioned solely upon need, i.e., means tested, public support would drop precipitously. And, if benefits were denied to high-income workers, they would be far less willing to support and participate in the program. Since the Social Security formula represents an implicit income transfer from higher earners to lower earners, Social Security's progressive benefit structure would not be possible in its current form if high earners opted out of the system.

The Council also endorsed, and AARP supports, the following principle:

- **The goal of universal coverage should be achieved.**

In order to attain universal coverage, the Council recommends extending mandatory coverage to newly hired state and local workers. Although Social Security covers about 96 percent of the workforce, some state and local employees remain outside the program. Mandatory coverage for all newly hired state and local workers would better serve both the excluded employees and the financial health of the Social Security trust funds.

Universal coverage is desirable in a social insurance program to ensure public cohesiveness. It also makes sense because Social Security provides excellent protections. For many Americans, Social Security is the only source of survivor, dependent and disability benefits, and it is their only income source that is adjusted annually for inflation. Additionally, Social Security's progressive benefit formula means lower-income workers often receive higher benefits under Social Security than under public plans.

Equity considerations also suggest that universal coverage is preferable. Some state and local employees who have also worked in Social Security-covered employment or who marry a covered employee gain a Social Security benefit with fewer contributions than other beneficiaries. Although their benefits are smaller, their overall return on the payroll taxes paid is greater. AARP believes all workers should be covered; states and localities wishing to supplement Social Security coverage should be encouraged to do so, similar to private employer pension plans.

B. Important Benefit Features to Retain or Improve

The Council concurred on numerous features of the current benefit structure that should be maintained or improved. AARP believes that one of the most important is:

➪ **Social Security should continue to provide full cost-of-living adjustments (COLAs).**

The Council affirmed that full cost-of-living adjustments are one of Social Security's most important contributions to the income security of retirees. Today, Social Security remains the dominant income source for 3 of 5 beneficiaries and virtually the only source of income for 1 in

4 beneficiaries. Given this widespread reliance on Social Security, any reduction in COLAs would mean that millions of beneficiaries would face economic hardship. Annual COLAs are the only means that most older Americans have to keep up with the rising costs of goods and services. In fact, most of the reduction in the poverty rate for those age 65 and over in the early 1970s was due to the large ad hoc increases in Social Security that occurred prior to automatic cost-of-living adjustments. And, since then, the poverty rate for the elderly has stabilized because annual COLAs have prevented the more than one in five older Americans -- mostly older single women -- who hover within 125 percent of the poverty line from falling further behind economically.

COLAs are not intended, nor do they function, as a benefit increase. COLAs help ensure that beneficiaries, particularly the oldest ones, will not outlive their resources. In an ironic twist, proposals to permanently reduce COLAs mean that as beneficiaries age, the real value of their benefits would decline. In effect, beneficiaries would be paid higher real benefits at age 65 than at age 80 although their other income has likely declined and their health care costs will have risen sharply.

Some advocate reducing COLAs by legislatively changing the Consumer Price Index (CPI), which is used to adjust benefits, or by providing partial COLAs. Those who want to reduce COLAs by changing the CPI contend the index overstates inflation. It is not clear to what extent this may be true. The Bureau of Labor Statistics (BLS) determines the CPI, revises the CPI market basket every ten years, and makes technical adjustments to the index on an on-going, as-needed basis. AARP believes that the experts at BLS, not Congress, should continue to make adjustments to the current index.

Others suggest limiting COLAs for beneficiaries whose Social Security benefit or Primary Insurance Amount exceeds a specified threshold. Affected beneficiaries (all those above the cut-off point) would receive a flat dollar amount of no more than the COLA provided to a beneficiary at the threshold. A "capped" COLA is a form of means testing the basic benefit package. But, Social Security is a social insurance program that provides lifetime protection for workers and their families as an earned benefit, rather than a benefit contingent upon income. Those who advocate means testing, in any form, ignore the insidious message it sends to workers: if you do well, if you work hard, if you save, you are penalized. A "capped" COLA also incorrectly assumes Social Security benefits are an indicator of comparative wealth. Some individuals have low benefits because they spent only a brief period working in Social Security-covered employment and the rest of their career in non-covered employment. Many of them may be eligible for other types of pensions (typically public employee pensions and/or military benefits) or may have accumulated additional financial resources for their retirement. Yet, other beneficiaries with larger Social Security benefits may have no other income sources. To more accurately assess wealth would require beneficiaries to give a full accounting of their income and assets, which if feasible, is administratively complex and inconsistent with the concept of an earned benefit. In addition, a portion of the COLA is recaptured through the tax system for beneficiaries who pay taxes on their Social Security benefits. Finally, AARP rejects a capped COLA because it could lead to further reductions in this critical part of the Social Security benefit if the initial threshold is unindexed or actually lowered.

The Advisory Council also stated that we should:

➪ **Increase benefits for widow/ers.**

Council members recognized that widow/ers benefits are critical to the income security of millions of single beneficiaries. They proposed to finance the improved widow/ers benefits by a reduction in spousal benefits. Clearly, the loss of a spouse increases the probability of poverty in old age, particularly for women. This proposal would reallocate benefits throughout the expected lifetimes of both spouses by lowering joint benefits and raising survivor benefits an equivalent amount. This change may be worthwhile, but it deserves to viewed in the larger context of the relative needs of married couples and survivors for retirement income. Any changes should be based on findings that better adjust Social Security benefits to the actual needs of its beneficiaries.

C. Increasing Social Security's Rate Of Return

The Council members agreed that the rate of return on Social Security investments should be increased, but they differed on how to achieve an increased rate of return and who should benefit from any improvement. These differences produced the three plans that divided the Council.

The Maintenance of Benefits plan (MB), or the Ball Plan, includes five modifications to the program that restore about two thirds of the shortfall. Ball proponents believe that in order to eliminate the remainder, serious consideration should be given to investing up to 40 percent of the trust funds' assets directly in common stocks indexed to the broad market. Since the investments are being made on behalf of the trust funds, any increased returns would be credited to the trust funds collectively. Individual benefits would not be directly affected by changes in the market.

The Individual Accounts (IA) plan, or Gramlich plan, creates individual accounts alongside a pared back Social Security system. Workers would invest an additional 1.6 percent of wages -- that is, in addition to their current payroll tax contributions -- in individual accounts held by the government. Investment choices would be made by individuals but options limited to a "menu" of those selected by the trustees. The return on these individual accounts is intended to augment the reduced basic Social Security benefit.

The Personal Security Accounts (PSA), or Schieber/Weaver plan, creates larger individual accounts designed to replace a significant portion of the Social Security benefit. Workers age 54 and under would direct 5 percentage points of the current payroll taxes into these accounts, which would be individually managed and invested in financial instruments of the individual's choice. The investment yield would be added to a basic flat Social Security benefit, which is roughly equivalent to two-thirds of the poverty line in 1996, or $410 per month. In order to finance the transition to this new system, payroll taxes would be increased by 1.52 percent and over $1.9 trillion in new borrowing would be needed.

The IA and PSA plans require individuals to make investment decisions and bear the risks associated with their investment choices. The larger the portion of Social Security's defined benefit that these accounts replace, the greater the risk to individuals, and the greater the change to our nation's current retirement income structure.

1. Three Legged Stool

Retirement income has been compared to a three legged stool, with Social Security, pensions and private savings representing the three legs. (The Advisory Council describes retirement income as a tiered structure and adds a fourth level: means tested programs). This diversity is a source of strength that provides beneficiaries with an array of protections through the balanced distribution of risk among Social Security, employer based pensions and individual savings.

Social Security serves as the base of retirement income to be supplemented by the other two legs. In practice, for many retirees, the other two legs are weak or nonexistent. Currently over 3 in 5 older Americans count on Social Security for at least 50 percent of their total income, and 16 percent have no other income. This trend is not likely to change significantly for the next generation of retirees.

Social Security is a social insurance program with compulsory and near-universal participation. It was never intended to be a personal investment plan. In a social insurance program, workers pool their resources in a government-sponsored program to "buy" protection that they might not otherwise have purchased (or afforded) on their own or received from their employer. As social insurance, the program is shaped by societal decisions about who should receive benefits and the amount of those benefits relative to a worker's contributions. Since Social Security's progressive benefit formula deliberately blends the concepts of equity and adequacy, the program should not be evaluated solely with regard to one purpose -- the level of return on one's investment.

Pensions are the second leg of the income stool. Pensions are retirement benefits earned in voluntary, employer-sponsored plans. Only half of all workers today are covered by a pension plan. Highly compensated individuals are more likely to be covered by such plans and accrue higher benefits. However, private sector pension plans are undergoing a shift in design that places greater responsibility and risk on the employee. At a time when pension plans are becoming more individual-account oriented, it is even more important to maintain Social Security's social insurance design and defined benefit promise.

Savings, the third leg, are individually held assets and investments. Like pensions, higher earners are most likely to accumulate savings and in far greater amounts. Many households have no retirement savings or use those that they do accumulate for non-retirement purposes. It seems therefore probable that many future retirees will have inadequate savings to meet their income needs.

2. The Risks of Individual Accounts

Individual investment accounts are touted not only as a mechanism to improve Social Security's solvency but also as a way to improve individuals' rates of return and to increase national savings. AARP agrees with the need for increased national savings, but we believe that this outcome should be achieved in a way that does not interfere with the goal of a secure retirement income, particularly for low wage workers and their families. Moreover, as the Congressional Budget Office (CBO) concluded in 1994, individual accounts funded through existing payroll taxes are unlikely to increase national savings.

Worker controlled accounts should not be substituted for Social Security benefits because they would shift to the individual a larger portion of the nation's commitment to assure a foundation of retirement, disability, and survivor income for workers and their families. Individual accounts would gradually transform Social Security from a universal defined benefit plan to a non-guaranteed, defined contribution or individual savings plan. Social Security's design as a secure base of retirement income -- to be supplemented by pensions and private savings -- would become less predictable and not be guaranteed. Indeed, the distinction between Social Security and the other legs of the retirement stool would be blurred, and the differing purposes each leg serves could be jeopardized.

The shift to individual accounts poses special risks for low wage earners. First, if individuals receive back a portion or all of their current contributions, less revenue would be available to finance the progressive benefit formula that helps low wage workers. Furthermore, since low earners would be investing relatively small amounts, they would be less able to adequately diversify their holdings to shield against risk and would face proportionately larger administrative costs and higher fees that would, in turn, lower the return on their investments.

Some of the touted financial advantages of individual accounts are dubious. The rates of return are often overstated by many proponents of privatization. Stated annual rates of return represent an average, and few, if any, actually receive the "average." In fact, many receive less. Also, proponents overlook the possibility of poor investments, failed financial institutions, and failed businesses. Ultimately, investment success requires considerable knowledge of investment options and strategies, a properly diversified portfolio, and a willingness and the resources to bear some risk.

On the other hand, people who invest conservatively -- many are lower wage earners -- will see more modest returns that are unlikely to outpace the current rate of return to the trust funds. Yet, encouraging workers to invest in riskier ventures only invites hardship for those whose investments do not do well -- hardships that might have to be offset through other government programs. And, unless early withdrawals and borrowing from these accounts are prohibited, workers may not wait until they retire before tapping into these accounts, thus diminishing the base of their retirement income security. In fact, the recently adopted tax legislation, which expanded the non-retirement uses of Individual Retirement Account funds, continues a trend to allow greater pre-retirement access to retirement accounts.

Moreover, there is no guarantee that historical patterns of return on assets will continue in the future. (In fact, historical patterns represent average annual returns, which do not apply to everyone.) And, many of those with dramatic paper gains today may not realize them tomorrow when large public and private retirement programs will be selling off assets in order to finance their commitments to the retirement of the Boomers. This simultaneous unloading could drive down the price of a worker's holdings. Also, the significant administrative costs of millions of individual accounts will reduce returns.

In addition, moving from the current system to a partially privatized one poses large transitional problems. If benefit levels for those now in and those near beneficiary status are protected, then workers will have to pay to finance two benefits: those of current recipients <u>and</u> their own. Current beneficiaries and those nearing retirement face added risks. The deterioration in the trust funds resulting from the draw-down to finance individual accounts is likely to generate pressure to cut benefits for current retirees and those nearing retirement. Yet, for those nearing retirement the opportunity to offset any lost income with individual investments is limited. Similarly, younger workers who become disabled or die shortly after individual accounts are inaugurated may face lower benefits for themselves and their families. They may not have accumulated enough in their individual accounts to provide benefits that are the same as they would receive under current law.

For all of these reasons, AARP believes Social Security should not be replaced with individually controlled accounts. While individual accounts have a legitimate role to play in overall retirement income security, these accounts are best left -- and should be encouraged -- for the two private legs of the 3-legged stool. Given the shift to individual accounts in the private pension system, the secure defined benefit promise in Social Security takes on greater importance. Indeed, if pension coverage continues to stagnate at under 50 percent of the workforce and savings rates continue at current low levels, Social Security could, in the future, be responsible for an even greater portion of retirement income security. If greater individual control over investment decision-making is the desired goal, then public policy could encourage greater savings in existing vehicles (e.g. IRAs, 401(k) plans, etc.) that already provide for individual control. We do not have to undermine Social Security to achieve that goal.

3. Rates of Return

The Advisory Council's solvency proposals are also designed to improve the "money's worth return" for future generations. Money's worth is one way of assessing the program's fairness across generations. "Fairness," however, does not necessarily mean every generation or every individual within a generation will have exactly the same rate of return. Given the variability in birth cohort size, life expectancy, changes in the economy, and Social Security's evolving nature, fairness will always be a relative measure.

Money's worth analyses often underestimate the value of Social Security by excluding disability and, in some cases, survivor and dependent benefits. Yet, Social Security is the only long-term disability insurance for 3 out of 4 workers, and its life insurance features provide income protection for 98 percent of the children in this country. According to the Social Security Administration, the Social Security survivor benefit is equivalent to a $295,000 life insurance policy for the spouse and two children of a deceased worker with an average earning history, and the disability protection is equivalent to $203,000 for that worker and his/her family. Moreover, Social Security provides disability and survivor benefit coverage for workers with pre-existing conditions, whereas in the private market they are often excluded. When these critical factors are taken into account, the full lifetime value of Social Security becomes even more apparent.

Another caveat regarding money's worth analyses is that most workers' situations change over the course of a lifetime. Few workers have close to average earnings throughout their lives, and some workers may be single for only part of their lives. Moreover, many workers have periods of unemployment or reduced earnings. Social Security protects these workers by providing "dropout years." (The Social Security benefit formula assumes a forty-year work history, but calculates the worker's benefit on the thirty-five highest earning years, thus allowing five "drop-out" years.) Many of the money's worth studies do not allow for these variations.

IV. OTHER OPTIONS FOR CHANGE

1. Raising the Normal Retirement Age

The 1983 Social Security Amendments included a phased-in increase in the age of eligibility for collecting full benefits (the Normal Retirement Age) from age 65 to age 67, beginning with those born after 1937 and becoming fully effective for people born after 1959. In order to improve Social Security's long-term solvency, some propose further changing the age for collecting full benefits. These proposals range from accelerating the twelve-year hiatus in the current timetable, as recommended by many on the Advisory Council, to raising the full retirement age to 70 years old.

Proponents of increasing the retirement age point out that increased longevity means future beneficiaries will live longer and collect Social Security for a longer period of time. If people live longer, proponents argue, they could reasonably be asked to work longer and postpone receiving benefits in order to improve Social Security's long-term solvency. While many policy experts support raising the retirement age, the public soundly rejects the idea. Many polls show that Boomers and the following generation, the Baby Busters, intend to stop working before age 62. Their anticipated retirement ages reflect the reality of the current labor market in which the retirement age has now dropped to about age 62. The polls also strongly suggest that most workers are unaware of the existing increase in the age of eligibility for unreduced benefits.

Current trends affecting older workers suggest that raising the retirement age could exacerbate existing problems in the labor market. Many willing older workers are unable to find employment, and some older workers have physically demanding jobs or health conditions that make continued work difficult. Despite the elimination of mandatory retirement in 1986, age discrimination remains a significant factor in today's work place. Studies show that older workers continue to have the longest spells of involuntary unemployment, and many employers remain reluctant to hire older workers. Also, many employers have policies in place to move out their older workers, such as early retirement incentives, that younger workers tend to support. In short, age bias, health problems and limited job opportunities for older workers could mean that an increase in the Normal Retirement Age will result in lower benefits, not additional work.

AARP believes that any increase in the Normal Retirement Age should be accompanied by policies promoting expanded job opportunities for older workers and incentives that encourage older workers to extend their working careers. We are pleased that the Advisory Council agreed on the need for improved work incentives for older workers. These incentives would encourage older workers to remain in the workforce and also provide overall benefits to our economy.

2. Changing Number Of Years In Benefit Calculation

The majority of Council members support increasing the indexing period for computing benefits from the current 35 years to 38 years. This change would result in an average benefit reduction of 3 percent. While this may be a preferable alternative to any increase in the retirement age, it particularly disadvantages women who spend more years out of the labor force caring for family members. In evaluating this and other options, it will be critical to assess the compounding effects of multiple options on particular groups, such as older women.

3. Raise Early Eligibility Age (EEA)

Some not only want to increase the age for collecting full benefits, but also to raise the age -- currently 62 -- for first collecting benefits. AARP believes we should maintain an early eligibility age because of the conditions in the labor market discussed above, and because many individuals are unable to work past age 62 due to ill health or physically demanding jobs. Without these protections, many older Americans would face serious economic hardship while they wait to collect benefits as well as throughout retirement. If we did raise the early retirement age, disability benefits should be expanded to protect those physically unable to work longer.

4. Increase the Taxation of Benefits

The taxation of Social Security benefits was introduced in the Social Security Amendments of 1983. Single taxpayers with modified adjusted gross incomes (MAGI) over $25,000 (adding in tax exempt interest and half of their Social Security benefits to their adjusted gross income) and joint filers with MAGIs in excess of $32,000 were to be taxed on the lesser of half of their benefits or half the amount by which their MAGI exceeds these thresholds. The maximum percentage of benefits subject to federal income taxation was set at 50 percent of benefits because employees contribute half of the Social Security payroll taxes and employers contribute the other half. Since the provision was enacted to help restore Social Security's long-term solvency, the revenue has been credited to the Social Security trust funds.

The 1983 thresholds deliberately were not indexed in order to provide Social Security with increasing revenue in the future when the number of beneficiaries will rise dramatically and the ratio of workers to retirees will decline. Initially, about eight percent of beneficiaries were taxed on up to 50 percent of their Social Security; today, almost one in four beneficiaries are affected. Without any change in current law, by the turn of the century almost one in three beneficiaries will be taxed on their Social Security.

Effective taxable year 1994, single beneficiaries with MAGIs over $34,000 and couples with MAGIs above $44,000 are taxed on up to 85 percent of their benefits. The revenue from taxing the additional 35 percent, unlike the revenue from taxing 50 percent of benefits, is credited to the Medicare Hospital Insurance (HI) Trust Fund.

The rationale for taxing up to 85 percent of benefits was to more closely conform the tax treatment of Social Security benefits to the taxation principles that apply to private pensions. However, <u>Social Security is fundamentally different from a private pension</u>. Social Security is a mandatory, almost universal social insurance program established by the government to provide income protection to workers and their families if the wage earner retires, becomes disabled, or dies. Given Social Security's unique features, it is not necessary to have parallel treatment to private pensions.

Members of the Advisory Council and others support increasing the amount of Social Security that is taxed in order to help restore long-term solvency. Options range from lowering the 1993 thresholds for taxing 85 percent of benefits (e.g. to levels that apply for the 50 percent rate) to fully taxing Social Security for all beneficiaries with taxable income. AARP recognizes that the additional taxation of benefits (assuming the receipts are deposited in the OASDI trust funds) could improve Social Security's long-term health, but we remain concerned that any further increases will result in an unanticipated heavy tax burden for many already retired middle and moderate income beneficiaries. Also, fully taxing benefits could bring millions of older Americans who currently do not pay any income taxes back onto the tax rolls. Since moderate income beneficiaries rely heavily on Social Security, the increased tax burden would be significant, and many of those affected would be unable to recoup lost income. Also, since the current thresholds are not indexed, additional taxation of Social Security will already gradually occur over time.

5. Payroll Taxes

Historically, payroll taxes have been increased as part of legislation to improve long-term solvency. Although the payroll tax is considered regressive by some, many low-income workers are eligible for the Earned Income Tax Credit (EITC), which offsets some of the initial payroll tax contributions. In addition, Social Security's progressive benefit formula provides low earners with a larger portion of their pre-retirement earnings than average and high earners. Despite criticisms of the payroll tax, most workers consider it fairer than the income tax because they believe few can avoid paying the tax and because they know it is used to pay Social Security benefits. (Seventy-one percent consider it a fairer tax than the income according to DYG, Inc.) Any payroll tax increase, however, should not be a first choice and should be limited in order to protect the standard of living of younger working families.

6. Benefit Changes

Some policymakers suggest modifying the "bend points" in the Social Security benefit formula, particularly for average and higher earners. Significant reductions in benefits for average and high earners could undermine support for the program, particularly among highly compensated workers, but proposals to modify the Social Security benefit formula for high earners should be distinguished from means testing benefits -- which the Association opposes -- since workers would continue to receive benefits under a modified formula.

Significant changes in any aspect of the benefit formula would affect today's workers once they retire, while increasing payroll taxes affects them while they are in the workforce. AARP believes today's workers should be given the opportunity to voice their views about the timing and desirability of any additional financial sacrifices they will bear.

V. CONCLUSION

Americans of all ages need to be better informed about the Social Security system so they can participate in the debate about its impact on their future. The program has been, and should continue to be, an important part of our nation's commitment to ensuring that workers who retire, die, or become disabled, and the families and the survivors of those workers will be protected from "the hazards and vicissitudes of life." Fortunately, Social Security has over $550 billion in its trust funds, so we have time to conduct a national dialogue that will lead toward consensus.

AARP is encouraging this dialogue in our publications and in conversations with our members and other interested people of all ages. The Advisory Council proposed three solvency packages, and there are many other options that have been suggested. AARP believes these proposals and others that will emerge should be part of the public debate. It is important to recognize that while some options may have little support in isolation, modest changes that are incorporated into a broad solvency package may be acceptable to most Americans.

We agree with the Advisory Council that solvency packages should spread the responsibility for bringing the system into balance among all who are part of the system. As we continue our dialogue with our members, one-third of whom are still in the work force, and most of whom have children and grandchildren about whom they are concerned, we will be mindful of our principles and the need to preserve Social Security for future generations. Maintaining Social Security's long-term solvency and improving the overall retirement income of future generations is vital to our nation's economic well-being. The Association looks forward to working on a bipartisan basis with our nation's elected officials to achieve a solution to Social Security's long-term problems that maintains the program's guiding social insurance principles, achieves solvency in a fair manner and ensures an adequate benefit for all.

The CHAIRMAN. Go ahead.

STATEMENT OF SYLVESTER J. SCHIEBER, Ph.D., VICE PRESIDENT, WATSON WYATT WORLDWIDE

Dr. SCHIEBER. Mr. Chairman, Senator Hagel, Senator Kerrey, thank you for the opportunity to address this committee and this audience today about this very important issue.

I am one of several members of the recently concluded Social Security Advisory Council that proposed significant changes to the current structure of Social Security. Under our proposal workers would contribute a portion of their payroll tax to something we call personal security accounts or PSAs. The PSA would be an individual account very much like an individual retirement account, an IRA or 401(k) plan, that many workers in our society and our labor force already use. It would be different than those accounts in that participation in the program would be mandatory, and distributions could not take place, would not take place until people were eligible for retirement.

Our group believed that the projected financial shortfalls in the Social Security system are very serious and are only one symptom of the problems that are currently facing the system. In addition to the financial problems, several of us believe that the growing perception that Social Security is not fair to many workers, especially younger workers, is something that needs to be addressed in any reform.

Furthermore, we believe that the growing lack of faith in the system will dramatically erode its support as we move into the next century. Finally, we believe that the natural inclination to delay addressing this public policy issue, prior to its reaching its crisis, will exacerbate the system's other problems. We certainly urge that we begin to address this issue seriously and soon.

Under the option that my colleagues and I supported, the personal security accounts would be financed by channeling a portion of a worker's share of the payroll tax that now goes to Social Security into their own PSA. The amount would equal 5 percent of covered payroll. This is approximately half of the tax that now is used to finance retirement benefits under Social Security. The PSAs would be subject to some restrictions, but they would be under the sole direction of the workers themselves.

The young survivors and disability programs would be left intact and would continue to be financed through Social Security by the share of the payroll tax that now finances those benefits. We would not eliminate those benefits; we would not eliminate the way they are provided.

Under our proposal the part of the payroll taxes not rebated to workers would continue to fund retirement benefits through Social Security. The current benefit structure would remain in place for individuals already retired, so anybody now retired would continue to get their benefits, and for those who are close to retirement.

Ultimately the total benefits paid to retirees would come from two separate tiers of the system. The first tier would be the basic benefit provided through Social Security, and in the modified system in the future, this would be a flat benefit. All workers would get the same level of benefits.

These kinds of systems are relatively common throughout the world. In the system that we conceived, in 1996 dollars this flat benefit would be around $410 a month. It would grow over time by the rate of growth and wages.

Benefits, once they started to be paid, would be indexed by the Consumer Price Index just as they are today. The remaining part of the benefits that would be paid to individuals would be financed through these personal security accounts.

Under our proposal the implementation date for transition to the new plan would be January 1, 1998. Workers age 55 or older on that date would continue to be covered under the existing system. People close to retirement would stay under the current system. They would pay their full payroll tax into Social Security. They would get their full benefit from Social Security.

Individuals between 25 and 55 would receive part of their benefit based on their years of participation in the current system and part of it based on their years in the modified system. Individuals younger than 25 would be fully covered under the modified system.

Under the PSA proposal Social Security would be transferred from a system that is largely funded on a pay-as-you-go basis to one that is significantly funded.

Let us get to the wealth issue that Senator Kerrey was raising a while ago. A problem created by this shift, though, is the previously accrued but unfunded liabilities would continue to mature during the transition period at the same time future benefits are being prefunded. We are not proposing to renege on benefits people have already paid for.

Financing the transition on a pay-as-you-go basis with a payroll tax would mean a relatively limited number of workers would have to pay off the prior debt—the debt that Helen was talking about a minute ago—while prefunding their own PSAs. We think there is some inequity in that.

For reasons of intergenerational fairness, we propose that the transition costs not be imposed on a single generation of workers. Our proposal would require that some of the statutory, unfunded obligations of Social Security be converted into more formal government debt over a portion of the transition period.

The magnitude of this formal debt will undoubtedly be an important consideration in evaluating the merits of our proposal. Based on the actuaries' intermediate assumptions—work that Steve Goss and his staff did for us—the converted debt would peak somewhere around 2040, 2045 at around $1.2 trillion in present value terms.

While the thought of taking on an added $1.2 trillion in Federal debt today is daunting, especially since we went through the turmoil in the last several years of getting to what we are calling a balanced budget, we need to think about it in the context of overall government financing. Under this proposal we would reduce the present value of existing Social Security obligations by about $5 trillion and eliminate unfunded obligations by nearly $3 trillion.

At the end of the transition period, the earmarked tax would completely pay off the transition debt. Such a restructuring of this program and its obligations is not only wise, it would ultimately be a bargain for future taxpayers.

The explicit debt that our transition financing calls for would be created in order to spread the transition costs across a broader set of generations than if we attempted to pay it off as it comes due. The borrowing could be thought of as taking out a mortgage to help pay off a significant portion of the unfunded, statutory obligations that we have accrued over the last 60 or 65 years. It would take about 70 years to work through the transition.

A 70-year mortgage might seem like a very long one, but if an individual worker can take out a 30-year mortgage to buy a house, then it may not be so unreasonable for our country to take out a 70-year mortgage, especially in light of the benefits of ultimately doing so.

There was a consensus among the council members that the assets backing the largest of our retirement program, Social Security, should at least partially be invested in the capital base of our economy. There was very strong disagreement, however, on how this investment should be accomplished.

In the council's other two proposals, the Federal Government would become the largest manager of private capital in our economy. Under one proposal it would buy up over a trillion dollars' worth of stock in a 15-year period in today's dollars. In the other proposal it would buy up much more than that.

Those council members who supported the personal security account proposal did not believe that the central government management of such large pools of private assets was desirable. We did not believe that the public policymakers could resist the use of these monies for other purposes than the security of Social Security benefits.

Our concerns were heightened during our deliberations by advocacy on the part of the Labor Department that we should be socially investing pension funds accumulated to cover private retirement benefits or the Administration's use of Federal pension monies to avoid debt limit ceilings during the budget debates in early 1996.

We believe that there are a number of advantages to modifying the current Social Security system along the lines of the PSA model. It would secure the pay-as-you-go benefits for those currently receiving them. It would create substantial wealth. It would increasingly back the retirement security of workers and give many workers some wealth to pass on to future generations.

It has the potential to generate benefit levels that are higher for many people than current Social Security benefit levels would be. This would be especially true for younger workers.

Finally, it would provide clearly superior value for many workers participating in the plan relative to the current system. Given the burden that the baby boomers' retirement will place on future workers, we believed that we needed to do everything possible to ensure that they enjoy a fair rate of return on their retirement savings, and we think this would help.

We also felt we needed to do something to restore the general public's faith in the current system, and we thought having people hold some portion of their retirement security in a personal account would help to do that.

Finally, I would like to close by taking a minute and talking about the composition of the group that supported this proposal. Some have characterized this as a radical group.

There were five of us on the council that supported the option. Three of us were women; two of us men. We had three of the five women on the council. We had the youngest member of the council, the 27-year-old elected Democratic official from out in California. We had the second oldest member of the council, a 70-year-old woman. We had two Republicans. We had two Democrats. We had one Independent.

We were the most broadly diversified group on the council. This was not a group that came to the Council's deliberations with a strong ideological bent. This was a very open-minded, very diverse group. We sought out a proposal that we thought would be fair to current retirees, to current workers, and to future participants in this program.

Thank you very much.

[The prepared statement of Dr. Schieber follows:]

The Need for Social Security Reform and the Creation of Personal Security Accounts as a Means of Securing Future Generations' Retirement Security

by

Sylvester J. Schieber, Ph.D.
Vice President
Watson Wyatt Worldwide

Testimony before the
Senate Aging Committee
Subcommittee on Social Security and Family Policy

August 26, 1997

The views in this statement are those of the author and do not necessarily reflect the views of Watson Wyatt Worldwide or any of its other associates.

Introduction

Mr. Chairman, and members of the Committee, I am one member of a group on the 1994-1996 Social Security Advisory Council that proposed significant changes to the current structure of Social Security. Under our proposal, in the future each worker would contribute a portion of his or her payroll taxes to a Personal Security Account (PSA). The PSA would be an individual account like an individual retirement account or a 401(k) account that many workers in our society already utilize in order to help assure their retirement income security.

The reasons that we suggested such significant changes relate to our perceptions of the problems that have arisen under the current system and because we believe that the solutions proposed by other Council members will not be achievable. There was a consensus among Council members that a portion of the Social Security trust funds should be invested in the capital base of our economy. A number of us believe that such investment will only be meaningful in a macroeconomic context if we can increase the level of national savings at the same time that we diversify the investments of the system. We believe that only two of the proposals would create such increases in national savings. We believe that the pools of savings that would be created under these options would grow to be so large that it would be impractical and undesirable to have them invested in the private capital markets through the auspices of a centrally managed fund. We believe that only the reform proposal known as the Personal Security Account (PSA) option can accomplish the goals laid out here.

The Nature and Scope of the Social Security Financing Problem

This year Social Security will collect approximately $60 billion more in revenues than its expenses for the Old Age and Survivors Insurance and the Disability Insurance (OASDI) programs. Trust fund balances in the programs currently exceed $550 billion. Social Security's current funding flows and trust fund balances might encourage us to be tranquil about the down-stream prospects. But its actuaries and trustees have been telling us for some time that the program is significantly underfunded for future generations of retirees. The most recent Trustees Report suggested that the payroll tax would have to be about 2.23 percentage points higher than it is today to provide promised benefits over the next 75 years.[1]

If the current actuarial imbalance is to be made up through a tax increase, it would represent an 18 percent increase relative to current law in the program's cost over the next 75 years. Such an increase in the tax that has become the largest federal tax for many workers is no trivial matter. If it were imposed this year, it would amount to $72 billion and it would grow at the compound rate of average wage growth in the future. In addition, the 2.23 percent figure assumes that we could have raised the payroll tax rate 2.23 percentage points early in 1997 and "banked" the added accumulation, or cut benefits by a comparable amount. There are three problems with such an assumption.

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[1] ***The 1997 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*** (Washington, DC: US Government Printing Office, April 1997), p. 24.

First, Social Security's 2.23 percentage point actuarial deficit understates the financing imbalance because it does not consider the deteriorating funding status of the program at the end of the 75-year projection period. To deal with the 75-year calculation period problem, Social Security's actuaries estimate that we would have had to raise the payroll tax 2.5 percentage points in 1995. The required tax increase would be even greater now.

Second, the 1983 Amendments to the Social Security Act were intended to partially prefund the baby boomers' retirement benefits by having the trust funds accumulate substantially larger balances than they have held historically. But over the period since the passage of those Amendments, the government ran substantial deficits in other accounts and effectively used the accumulating Social Security trust funds to mask the effects of these deficit operations on the larger economy. This experience raises questions about the government's ability to convert added payroll tax collections into national savings—i.e., it is unlikely that we can really accumulate a substantial pool of financial wealth through a government mechanism.

Finally, policymakers have not been willing to raise taxes by the 2.23 percentage points, or the more realistic 2.5 points needed in 1995, or to cut benefits immediately by a corresponding amount. By the time we get around to dealing with Social Security's financing problems, the 2.23 percent or 2.5 percent funding gap will be much larger than it is currently. If we wait until the baby boomers are retired to deal with this problem, the actuarial imbalance will be double its current level.

Not only have the Social Security actuaries warned us repeatedly of Social Security's financing imbalance, their estimates of the magnitude of the imbalance has consistently worsened over the last 15 years as reflected in Table 1. The table shows that since 1983 the projected accumulation in the trust funds has diminished significantly in virtually every subsequent valuation of the program. The actuarial underfunding of the program, stated as a percentage of covered payroll over the 75-year projection period, has worsened in almost every projection year since 1983. The year the trust fund is projected to be depleted has gone from 2063 under the 1983 projections to 2029 under the projections developed earlier this year. Finally, the projected underfunding of the program has grown by more than $3 trillion dollars since 1983. We have been told repeatedly that this program is significantly underfunded downstream, and each subsequent valuation tells us that the underfunding is worse than that revealed in the last valuation.

Public policymakers must change Social Security's course in order to assure the retirement security of most of today's workers. It is important that Congress deal with Social Security's financing imbalance soon because the program's underfunded status damages the public's perception about the long-term viability of the program. Some people dismiss reports that the majority of workers under age 50 believe they will not get full benefits now provided by Social Security when they retire as an example of the public cynicism that pervades our society today. While most people do not understand the arcane nuances of Social Security financing, many of them do catch the news reports telling of the annual release of the Trustees Report. The headlines generated this year by the annual Trustees Report indicated that Social Security would run out of money in 2029—that is, within the normal life expectancy of virtually all workers under age 50 today. Is it cynicism to believe that our

Table 1

Projected Maximum OASDI Trust Fund Accumulations in Current Dollars, Projected 75-Year Actuarial Balance as a Percentage of Covered Payroll, and Estimated Year Trust Funds Will Be Depleted by Year of Actuarial Estimate and Present Values of 75-Year Surpluses of OASDI Funds Relative to Obligations

Year of Estimate	Projected Maximum Trust Fund Balance ($ billions)	Actuarial Balance as Percent of Payroll	Year Trust Fund Projected to Be Depleted	Present Value of Tax Income plus Current Fund minus Obligations ($ billions)
1983	$ 20,750	0.02	2063	$ 148.3
1984	18,393	-0.06	2059	37.4
1985	11,955	-0.41	2049	-268.8
1986	12,739	-0.44	2051	-342.6
1987	12,411	-0.62	2051	-377.6
1988	11,838	-0.58	2048	-664.0
1989	11,930	-0.70	2046	-849.5
1990	9,233	-0.91	2045	-1,242.7
1991	8,020	-1.08	2041	-1,185.1
1992	5,535	-1.46	2036	-1,772.6
1993	4,923	-1.46	2036	-1,863.7
1994	2,976	-2.13	2029	-2,841.9
1995	3,275	-2.17	2030	-2,832.7
1996	2,829	-2.19	2029	-3,094.2
1997	2,834	-2.23	2029	

Sources: ***1983 to 1997 Annual Reports of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*** (Washington, DC: Social Security Administration) and the Office of the Actuary, Social Security Administration.

benefits will be reduced when the program's own trustees report that Social Security will run out of money in our lifetimes? More likely, it is simply common sense that leads many people to conclude they cannot expect to receive what Social Security is currently promising them.

Balancing Social Security within the Context of Government's Total Operations

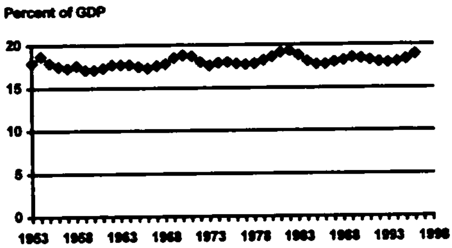
In 1997, total expenditures under the OASDI programs will be an estimated 4.66 percent of our gross domestic product (GDP). By 2030, the OASDI claim on the economy is expected to rise to 6.57 percent of GDP and by 2035 to 6.64 percent. In other words, over the next 30 to 35 years, we expect Social Security's claim on the economy to grow by about 2 percentage points. Some analysts would have us believe that such a shift in national resources to this vital retirement program can be achieved without significant difficulty. One of the problems that we face in rebalancing Social Security is that it is only one of several governmental programs that will be affected by the aging of our society. The combination of these programs, including Social Security, Medicare, Medicaid, and other federal retirement programs, will place a tremendous strain on the government's fiscal operations.

Figure 1 shows three-year averages of the total receipts of the federal government as a percentage of GDP starting with Fiscal Year 1951 through Fiscal Year 1996. Three-year averages are used rather than actual annual data to smooth the effects of economic cycles on tax revenues. Over the 45-year period from the end of the Korean War, total federal tax receipts have varied from a low of 17.1 percent of GDP to a high of 19.3 percent, roughly a 2 percentage point variation in the federal government's claim on taxpayers. Looking at actual year-to-year numbers, the maximum claim in any year was 19.7 percent of GDP.

While there is no natural limit to government's claim on the economy, there are clearly political forces that have narrowly limited the amount US taxpayers have rendered to it over virtually all of the last half century. If total government revenue claims on the economy are

Figure 1

Three-Year Averages of Total Federal Receipts as a Percentage of GDP



Source: *Historical Tables: Budget of the United States Government, Fiscal Year 1998*, pp. 21-22.

narrowly limited and Social Security is scheduled to make a bigger claim than currently, then some other government expenditures must shrink. It is here that projected expansions in Social Security's economic claims would seem to be particularly constrained.

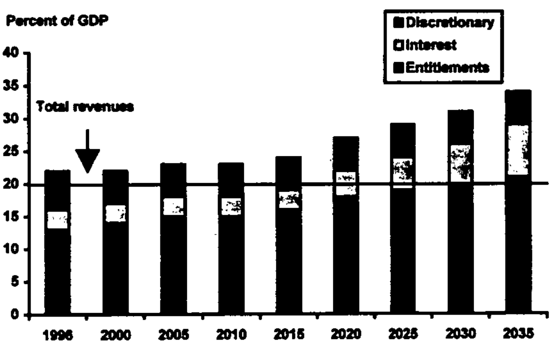
Earlier this year the Congressional Budget Office (CBO) published an analysis of the aging of the population in the United States and the implications of current laws on potential federal expenditures in light of the seeming budget constraint that the government faces. The CBO projections are based on their own independent modeling of the various programs. In the CBO's analysis, discretionary spending was assumed to grow at the rate of growth in the overall economy after 2007. The CBO's projections focused on federal entitlement programs and the implications of aging on these programs and on overall government expenditures.[2]

[2] Entitlement programs include Social Security, Medicare, other federal retirement programs, Medicaid, and federal welfare and food stamp programs.

By 2030, federal entitlement programs are projected to make a claim on the economy that is the equivalent to or larger than the level of revenue claims the government has made on taxpayers over each of the last 45 years. We are beyond the era when reductions in federal defense programs, our space program, or any other federal initiatives can finance the projected growth of entitlement programs. Indeed, the bottom line from Figure 2 is that unless taxpayers are willing to cede more of their resources to the federal government than they have been in

Figure 2

Projected Federal Outlays and Revenues under Present Law



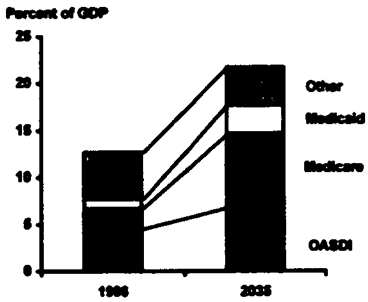
Source: Congressional Budget Office, *Long-Term Budgetary Pressures and Policy Options* (Washington, DC: The Congress of the United States, March 1997), Executive Summary, Table 2.

the past, entitlement expenditures must be severely constrained if we have any hope of eliminating federal deficit financing over the long-term.

Figure 3 shows the projected increases in the claims on the economy by various federal entitlement programs between 1996 and 2030. The graphic shows the projected increasing claim of Social Security as discussed earlier. The projected relative growth in Medicare claims is expected to far outstrip that of OASDI. Some analysts conclude from this picture that we should really focus our energies for managing entitlement growth on federal medical programs

Figure 3

Current and Projected Levels of Entitlement Program Operations as a Percent of GDP



Source: Congressional Budget Office, ***Long-Term Budgetary Pressures and Policy Options*** (Washington, DC: The Congress of the United States, March 1997), Executive Summary, Table 2.

in general and Medicare in particular. They claim that if we can restrain the rapid growth in the health care programs, we can sustain projected growth in the cash retirement programs.[3]

While constraining federal health programs for the elderly may be desirable, it will be more difficult to do so than constraining the cash programs for retirees for four reasons. First, the elderly simply use more health care services than younger ones. Second, the percentage of our population over age 65 is expected to grow by as much in 20 years between 2010 and 2030 as it had in the prior 80 years. Third, excessive medical price inflation is likely to continue pushing up the cost of medical care.[4] Fourth, the continued technological development in the health sector and increasingly intensive treatment of patients will continue to drive up costs in the future.[5]

These four factors are all compounding factors that will drive up the cost of Medicare claims even in the face of program reforms. Current projections suggest that under present law Medicare's claim on the economy will grow from 2.5 percent of GDP today to 7.5 percent

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[3] Henry Aaron, "Is a Crisis Really Coming? (Social Security and...)," ***Newsweek*** (December 9, 1996).

[4] Medical price increases in the consumer price index (CPI) in comparison to overall growth in the CPI have moderated recently, but the ratio of the compound growth in the Medical CPI to the total CPI has been larger from the beginning of this decade through the end of 1996 than it was over each of the prior three decades. The record from the last 40 years does not support the conclusion that the recent slowdown in medical price inflation will persist.

[5] For a full discussion of the projected growth in health care costs related to the aging of the population, see Roland D. McDevitt and Sylvester J. Schieber, ***From Baby Boom to Elder Boom, Providing Health Care for an Aging Population*** (Washington, DC: Watson Wyatt Worldwide, 1996).

by 2030. A major problem that policymakers will have in dealing with the Medicare dilemma is that limiting eligibility does not provide the same leveraging opportunity that it does with Social Security. For Medicare, raising the age of eligibility would largely exclude the part of the eligible population that uses the least medical care because even among the elderly, older people use more health care than younger ones. To the extent that some people would be excluded on the basis of an increase in eligibility ages, the most unhealthy among them would still qualify for Medicare benefits because their health status would qualify them as disabled beneficiaries. For those in the lowest income categories, limiting Medicare eligibility would merely transfer them more completely to Medicaid coverage.

The point of this lengthy discussion is that the potential rededication of 2 percent of GDP to rebalance OASDI might be tenable if that were the only imbalance that the government were facing. But it is not. As we look for policy options to deal with Social Security, we have to consider rebalancing it in the larger context of the total federal government's claim on the economy and within the context of other entitlements that must be financed out of total government revenues.

Social Security Reform Options

Social Security is financed largely by the earmarked payroll tax, and promised benefits are defined in current law. The problem of insufficient revenues to meet the promised benefit stream can be addressed in a number of ways. One would be to simply raise the payroll tax by the necessary amount to meet benefit promises. There is very little support for this option even among the staunchest supporters of the current system.[6] An alternative way to rebalance the system would be to reduce benefits by a sufficient amount to live within the current payroll tax rates. The Social Security Advisory Council actually considered a proposal along these lines, but no one on the Council was willing to support the proposal because of the resulting low levels of benefits that would be provided by the program and because of the relatively low rates of return that future generations of workers would receive under this approach to reform.[7]

Given the reluctance to address the shortfalls explicitly through straightforward tax increases or benefit reductions, a number of Advisory Council members opted to impose a set of implicit charges on workers and beneficiaries to cover the actuarial shortfalls under the auspices of the "Maintenance of Benefits" (MB) option. The majority of the Council members opposed the MB option largely because it proposed levying payroll taxes on our grandchildren that we were not willing to pay ourselves and because of the proposal to invest Social Security trust funds in private capital markets.

The latter proposal would make the federal government by far the largest owner of private capital in our economy. Such a policy might result in politically motivated investment

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[6] For example, the members of the 1994-1996 Social Security Advisory Council who advocated maintaining the current system and benefit structure to the maximum extent possible argued that any increase in the payroll tax should be largely devoted to supporting the Medicare program. See Robert M. Ball, et al., "Social Security for the 21st Century: A Strategy to Maintain Benefits and Strengthen America's Family Protection Plan," in ***Report of the 1994-1996 Advisory Council on Social Security***, Volume 1, Findings and Recommendations, p. 64.

[7] Transcript of the Public Meeting of the Social Security Advisory Council, December 14, 1995 (Social Security Administration).

of such capital for reasons other than the economic interests of the program's participants. Even as Advisory Council's debate was unfolding, Secretary of Labor Robert Reich was advocating that some of the assets in employer-based pensions should be used for "economically-targeted investment" purposes. At the height of the debate within the Advisory Council over this proposal, the Clinton Administration actually tapped federal workers' pension funds to avoid debt ceiling limits that were being exceeded during the budget battle with Congressional Republicans early in 1996. Concerns about the political use of retirement funds held by the federal government is not a pipe dream; it has already been a reality. An OASDI trust fund holding more than a trillion dollars worth of equities in today's dollars would be much more tempting for such uses than the relatively small existing federal retirement funds that hold only a few billion dollars today. There are many cases from all across this land, from California to Kansas to New York to Florida, where the investment of assets in public retirement plans at the state and local levels has been influenced or dictated by political rather than economic considerations. Around the world, there are also cases from Singapore to Sweden where the assets in partially funded national retirement systems have been used for social investing purposes. While the advocates of Social Security becoming our economy's largest private investor dream up ways to insulate the investing from political directives, there is no way that a current Congressional limitation in this regard could preclude future Congresses from undoing it.

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In addition to the problems of politicizing investment decisions, the MB proposal would also raise conflict of interest questions as the government reconciled its role as a fiduciary responsible for protecting the economic value of its portfolio while at the same time fulfilling its responsibility as a regulator of businesses in the interest of public welfare. Finally, it would raise issues of corporate governance. The advocates of this proposal suggest that the government would not vote its shareholder interests in proxy voting matters. Such a policy would change the relative balance of other stockholders on proxy votes and would be contrary to the government's own position on employer-based retirement program fiduciaries voting their ownership position for shares in their pension programs.

Those Council members opposed to the MB proposal, 7 out of the total 13 members on the Council, proposed substantial reform of the current structure of Social Security as the means to salvage the system. They recommended that part of the solution include some funding of benefits through personal accounts. Two members developed an "Individual Account" (IA) proposal where the personal accounts would be financed by an added employee contribution of 1.6 percent of covered payroll with the accounts being held and managed by the Social Security Administration. Although workers would be given some discretion in directing where the individual account funds would be invested under this proposal, the other five members of the Council felt that it was inappropriate to have Social Security managing the funds for the same set of reasons that they opposed the MB proposal.

These latter five members of the Council, including me, felt that the accounts should be financed by the workers' share of the payroll tax contributions now going to finance retirement benefits through Social Security—namely 5 percent of covered payroll. Under our proposal, workers would have considerable discretion in investing their retirement assets held in the form of PSAs just as they do in the investment of individual retirement accounts and 401(k) assets.[8] The PSA proposal raises a transitional financing issue because current benefits are largely financed by current payroll tax revenues. If workers are allowed to keep their portion of the payroll tax that finances retirement benefits, added revenues would be required to meet current benefit commitments.

To address concerns about intergenerational fairness, we proposed that the transition not be financed purely on a pay-as-you-go basis. We proposed levying a flat 1.52 percent payroll tax over roughly 70 years with transitional borrowing when the transitional payroll tax supplement is insufficient to meet pay-as-you-go costs. Under this transition proposal, the burden on any single worker would not increase more than 12.3 percent (i.e., 1.52 percent payroll tax supplement divided by the base rate of 12.4 percent) in any given year. This compares with the pay-as-you-go transition where some workers would incur payroll tax increases of as much as 28.2 percent (i.e., 3.5 percent supplement divided by 12.4 percent). Spreading the transition costs over a larger number of cohorts of participants would make the

[8] For a complete description of this proposal and its financing and benefits implications, see Sylvester J. Schieber and John B. Shoven, "Social Security Reform Options and Their Implications for Future Retirees, Federal Fiscal Operations, and National Savings," a paper prepared for a public policy forum, "Tax Policy for the 21st Century," sponsored by the American Council for Capital Formation, Washington, DC, December 1996. Copies available from the author on request.

transition less onerous for those caught at the early part of the transition. Of course, it increases the cost for those at the end of the transition, but the workers adversely affected have the most to gain from the proposal under consideration.

Under the PSA proposal, the transitional federal borrowing would reach about 2 percent of GDP in 2007 and then gradually decline to zero around 2030 or so. The transitional borrowing would add to formal government debt. The added debt would peak at around 20 percent of GDP by 2020 and decline after that. At its peak, the present value of the added government debt would be equal to about $1.1 trillion. In the context of today's dollars, the borrowing would peak at $2.4 trillion. The added debt would be completely paid off by 2070 under the transition program.

Critics of the PSA proposal argue that the transitional costs are simply too great to be borne by workers and by the government. Their arguments seek to obfuscate the actual obligations that are implied by the current operations of Social Security and to confuse people about the financial transactions that would be involved in the various reform approaches. They argue that lower- and average-wage workers cannot afford to pay the extra cost of transitioning out of the current system. They argue that a government striving to balance its budget cannot afford to take on the transitional debt that would be involved in the PSA proposal. Both arguments are misleading.

The confusion over the creation of "federal debt" under the PSA transition proposal arises because the government does its accounting purely on a cash basis. Under cash accounting the only governmental debt that is recognized in a given year is the difference in cash receipts and expenditures for the year. As such debt arises, the holders of the debt are issued government bonds. These bonds represent a claim on future revenue streams of the government and, as such, they represent obligations that will have to be met by future taxpayers. The cash accounting that recognizes the government's formal debt, however, only recognizes part of the true operations under federal financing and expenditure programs. It does not recognize the unfunded obligations that arise under various federal programs such as Social Security. For example, looking back to Table 1, the unfunded obligations in the OASDI programs have risen from zero at the end of 1984 to more than $3 trillion at the end of 1996. Just as in the case of formal federal debt, these obligations also represent a claim on future revenue streams of the government and, as such, they also represent obligations that will have to be met by future taxpayers. The only difference between them and the formal debt is that one is accounted for and the other is not when we calculate the annual budget flows and balances. Some analysts claim that there is a difference in the two forms of obligations because Congress can restructure Social Security, thus wiping out the statutory obligations under the program. While that is technically true, current benefit promises cannot be met without imposing added taxes on future workers. If policymakers are not willing to impose such costs on future taxpayers they are left only with the option of reneging on current benefit promises. The latter is just as much a cost as raising taxes, the only difference being on the group on which the cost of rebalancing the system is imposed.

When the total economic costs of the various proposals developed by the Social Security Advisory Council are considered, the proposed borrowing in the PSA plan can be seen in an appropriate perspective. Table 2 shows the estimated present value of the 75-year total federal obligations under the three proposals put forward by Council members. The PSA plan, including the full cost of transition financing cuts the obligations to future taxpayers by significantly more than either of the other proposals. The formal debt that would be created under the PSA would arise because of a restructuring of total federal obligations in a way that would ultimately reduce those obligations.

Table 2

Present Value of OASDI's 75-Year Obligations under Alternative Policy Options

	Obligations	Change from current law	Percent Change
	(dollar amount in billions)		
Present law	$ 21,345	———	———
PSA flat benefit plus transition tax	16,487	4,858	22.8
OASDI benefit under IA proposal	18,867	2,478	11.6
MB proposal	21,177	228	1.1

Source: Derived from tables prepared by the Social Security Administration, Office of the Actuary for 1994-1996 Social Security Council.

Table 2 is quite clear that either the PSA or IA proposals would significantly reduce the "entitlement" obligations of the federal government through reformation of Social Security. While some people believe that would be inadvisable policy, they have failed to address the issues raised by the projected growth in federal entitlement claims on the economy that were discussed earlier. The only way we can keep Social Security, Medicare, and other federally sponsored retirement programs from making a larger claim on the economy than historical levels of total government funding is by constraining them. In that regard, the MB proposal and others like it are a total failure. It is likely that we can only accomplish the kinds of reductions in costs necessary to maintain Social Security's future viability by significantly restructuring it to meet the needs of workers and retirees in the 21st century.

Shifting from a Defined Benefit to a Partial Defined Contribution Regime

The individual account approaches included in the IA and PSA plans would change the defined benefit nature of Social Security. Once again, some people see this as an undesirable change to the existing system. They raise the specter of individual financial risk and argue that exposing workers to such risk would be bad public policy. What they fail to address in their arguments is that the current system is fraught with risks that are not accounted for in their analysis. The implications of these risks are clear when the last two major policy adjustments to the Social Security Act are considered.

During the early 1970s the Social Security system faced a severe short-term financing crisis because of rapid growth in new retirees' benefit levels. The 1977 Amendments addressed this problem by reducing by about 25 percent the benefits of workers who would become eligible to retire five years after the implementation date of the Amendments. Despite the severe benefit reductions they imposed, the 1977 Amendments failed to completely address the short-term financing problem and by the early 1980s the program faced trust fund insolvency. In addition, by the early 1980s there was growing awareness of the long-term financing problems facing the program. The 1983 Amendments were meant to address both of these by further curtailing benefits. While the 1983 Amendments supposedly "fixed" Social Security's financing problems for at least the next 80 years, here we are again less than 15 years later worrying about the system's underfunding. In a little over a decade, Social Security will begin to run a cash flow deficit, and it is projected to be facing insolvency before the youngest members of the baby boom generation are eligible to receive full benefits.

The risks that we face under the current system are that benefits are going to be cut significantly or that the taxes on workers are going to be increased significantly. Implicitly, if not explicitly, one or the other has to happen because the system is 20 percent out of actuarial balance today and is projected to be much further out of balance in the future. A colleague and I have recently explored the range of risks that workers would face under various approaches to Social Security reform.[9] Our analysis considered the substantial variability in the way people invest across the earnings spectrum that must be taken into account in evaluating reform proposals that include some element of personal accounts. In addition, we considered the implications of administrative costs under such reform proposals. Finally, our analysis took account of the historical volatility in financial market returns that would likely lead to some considerable dispersion of benefits within and across cohorts.

Our simulations of various policy options suggests that there are virtually none, including personal account options, that are likely to provide currently promised Social

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[9] For a full discussion of the simulation approach used in developing the figure and the results of simulations for lower- and higher-wage workers, see Gordon P. Goodfellow and Sylvester J. Schieber, "Social Security Reform: Implications of Individual Accounts on the Distribution of Benefits," Pension Research Council Working Paper (Philadelphia: The Wharton School, University of Pennsylvania, May 1997.

Security benefits to the baby boomers without substantially higher contribution rates than we are now incurring. Our projections suggest that some baby boomers are likely to see reduced benefit levels relative to current law promises, and that these are likely to be largest for the middle cohorts of the baby boomers. In the long term, though, our projections suggest that Social Security reforms including some level of personal account funding would lead to improved benefit levels for significant segments of future retiree populations. We duly note that our analysis did not take into consideration any of the potential macroeconomic effects that might occur if a personal account reform option was adopted that contributed to higher levels of national saving. Other policy analysts have suggested that such effects would be positive and significant.[10] We are confident that higher savings rates would contribute to general improvements in worker and retiree welfare over time.

Critics of the PSA proposal argue that it would be costly if not impossible to administer. In this regard, the experience of the employer-based 401(k) system is instructive. Although this system is completely voluntary, it has experienced explosive growth since it was first made available to workers in the early 1980s. The system went from virtually nothing to accounting for more than half the total contributions going into private employer-sponsored retirement programs in 1993. Under current law, these programs allow young and old workers alike to contribute from a few dollars a week or up to nearly $200 per week into them.

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[10] For example see Barry Bosworth and Gary Burtless, "Privatizing Social Security: The Troubling Tradeoffs," Brookings Policy Brief (March 1997), No. 14, and Martin Feldstein and Andrew Samwick, "The Economics of Prefunding Social Security and Medicare Benefits," (Cambridge, Massachusetts, National Bureau of Economic Research, Inc., August 1997).

In the aggregate, workers pour more than $1 billion per week into private 401(k) plans. Most workers are free to direct the investment of their own retirement savings in these plans, and they do so on a fully accounted basis that costs much less than the 1 percent per year that was used in our analysis of the implications of various policy options discussed above.

Critics also argue that the PSA plan is flawed because it does not require the annuitization of the benefit at retirement. While the PSA proposal did not call for forced annuitization, it did not preclude it either. Indeed, its authors suggested that it might make sense to require retirees to show that they had a lifetime annuity income that would equal 1.5 times the poverty line, or some other similar multiple of the poverty level income before they could liquidate their PSA accumulation at retirement. At some level of income that protects taxpayers from having injudicious consumers demanding welfare support, however, it is not the government's business how private consumers choose to distribute their lifetime savings. In addition, our analysis of the implications of various Social Security reform approaches included an analysis of the cost of workers with personal accounts buying personal annuities. The results of that analysis suggest that purchase of annuities does not have a significant adverse effect on the PSA proposal relative to other reform options.

Finally, critics of Social Security reform proposals that include a personal account element argue that Congress would be unlikely to force workers to keep the money in the accounts until they reach retirement. They suggest that our political leaders could not withstand the pressure to allow workers to tap retirement savings in cases of personal and financial hardship. The fact is that a wide range of countries around the world have adopted Social Security reforms of the sort recommended under the PSA proposal. Such reforms have swept across Latin America. A much larger, fully funded individual account program is being phased in currently in Australia. A similar approach is used in Singapore and is being considered by a number of other Asian countries including China. Sweden, the mother of all social welfare states, is moving toward a system very similar to the one recommended by the authors of the IA proposal. The UK has allowed workers to "contract out" of the second tier of their national retirement program for some years, essentially allowing voluntary PSAs in their national retirement system. The UK is beginning to discuss moving further down this path in the direction that Australia has gone. A wide range of other countries around the world are carrying on similar deliberations.[11] If our political system or our national policymakers are so politically incontinent that they cannot do what a wide range of countries around the world have been able to achieve, we may have a much larger problem to resolve than figuring out how to secure the retirement benefits of today's workers at a cost that future workers will be able to bear.

The father of the US Social Security system, Franklin D. Roosevelt, felt strongly that a significant portion of the system's promises should be funded. When he discovered that the original proposal submitted to Congress by his Committee on Economic Security did not

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[11] For a more in-depth discussion of what is going on in the international arena see Sylvester J. Schieber and John B. Shoven, "Social Security Reform: Around the World in 80 Ways," ***The American Economic Review*** (May 1996), vol. 86, no. 2, pp. 373-377.

provide for such funding, he made them revise the legislative package to include it. While his proposed funding was included in the original Social Security Act, the levels of funding that FDR had insisted upon for his beloved Social Security program were never achieved, largely for two reasons. The first was Congressional worries that the accumulated funds would be used to buy up significant shares of private capital. The second was that it was always easier for Congress to delay tax increases that would have led to the trust fund build-up that FDR envisaged than to bear the pain of imposing the taxes, or it was more politically expedient to to use excess tax revenues to raise benefits than to allow the trust fund to accumulate. FDR was right, a healthy fund would be good for the economy as well as the economic security of the participants in the program. What more than 60 years of experience has told us, however, is that we can only achieve FDR's vision by significantly reforming the current system.

The CHAIRMAN. I compliment each of you for staying within your allocated time. We appreciate it very much.

Also, I would remind the audience that you have your cards. If you would just hold up your hands, our staff will pick up your card and bring them up here. I already have two questions.

But I am going to ask Senator Hagel to take about 5 or 6 minutes for questions of the panel, and then Senator Kerrey to take up 5 or 6 minutes of the panel. Then if we get questions from the audience, we will take some of those. But I also want to make sure that Senator Kerrey and Senator Hagel have an opportunity to bring out questions they want to. So I want to limit you to your 5 minutes.

Senator HAGEL.

Senator HAGEL. Senator Grassley, thank you. I, again, want to thank the panel for an excellent presentation.

Dr. Steuerle, allow me to begin with you. In your testimony you mentioned that reform was inevitable. You mentioned that we should focus on long-term structural reform.

Well, your colleague, Dr. Schieber, has laid down a rather specific long-term structural proposal. What do you think about it?

Dr. STEUERLE. At this point I am not fully satisfied with any of the options that are out on the table; that is, I am not ready to grab on to any one or the other.

Let me state what I think is positive about his proposal and what I think is negative. I liked certain aspects of his proposal—in fact, some things that he did not even talk about—and the way that it neatly structures what is the redistributive aspect of Social Security.

Social Security does redistribute toward the poor, and this proposal separates that from the rate-of-return portion. It is cleaner. You can see it.

The current system keeps a lot of that very hidden. It does this by pulling together some aspects of what is called a double-decker system; the first deck being a kind of minimum benefit, and the second deck being a rate of return on contributions. The current system promises both of these, while it leaves it vague how it is achieved. Because the current system leaves it vague, it does a lot of things I mentioned only peripherally in my proposal.

I think it creates very great discrimination to second earners in families who often get absolutely nothing for their contributions to the system. Indeed, in families with two earners, they often get fewer benefits than a one-earner family who has contributed no more to the system. Fixing things like that that I think are very nice about the proposal.

Where I think that the proposal falls apart is that the advocates were determined to take 5 percentage points out of the Social Security tax rate so they could claim that they privatized half of the Social Security system. To get there, then, they had to come through the back door and do all sorts of things.

They had to have a transition tax, a huge tax. They debated whether they would have a value added tax, or Social Security tax on top of the current one to finance some sort of 75-year transition. I do not think the Congress enacts taxes for only 75 years. I think that is a little silly. The proposal borrows $2 trillion directly. It tries to replace Social Security's unfunded liability, but it literally goes out on the market and would borrow $2 trillion. I think that would create havoc with the financial markets.

Finally, this first tier of benefits in this system, this $410 a month that Syl mentioned, to me, is inadequate for low income people. So I think there is a lot of work that needs to be done on this plan.

As I say, the dilemma was caused partly because they wanted to be able to claim that they were going to privatize so much of the system, but there are so many people retiring relative to the size of work force that it becomes very hard to solve the problems of the system just purely by putting some money in the financial markets.

You will soon have only two people working for every one person that is retired. I do not care how you set up the system. You have huge costs to society.

I think that one of the things that we have to address is one of the issues that I think the privatization debate hides, although I do not think Mr. Schieber hides it—is we are taking so many of our productive, really middle-aged people now and taking them out of the work force. To overcome that problem of by trying to put money in private accounts is just not going work.

I am sorry, that the privatization debate has shifted focus from the extent we retire so many productive people so early from our society.

Senator HAGEL. I suspect Dr. Schieber is going to want an opportunity to respond. Before I ask Dr. Schieber to do that, would you develop your theory? Going back to what you said about long-term structural reform, what kind of long-term structural reform are you advocating?

Dr. STEUERLE. I think there are a variety of things I would do. One is I would push very hard on the retirement age. The younger new elderly, especially of my generation, are going to have nearly 20 years of life expectancy. We do not need to be supported by younger people, who are going to be much smaller in supply, for that many years.

So I would push fairly hard on the retirement age, bumping it up 2 or 3 years, and then indexing it so that the longer we live, we do not get more and more years of retirement support.

Senator KERREY. You mean the eligibility age?

Dr. STEUERLE. That is right; eligibility age.

Senator HAGEL. Going beyond 67 to what?

Dr. STEUERLE. Index it over time so that if we live one more year, then we have to work one more year as opposed to automatically giving us more years of retirement.

If we decide as a society we want retirement for 20, 22, or 25 years as opposed to what we do now, we can decide that, but let us decide that on a discretionary basis. Let us not box you in as a Congress to have it automatically and then to constantly be cutting back on the benefits.

I would also pare the growth rate in annual benefits, especially for higher-income retirees—I just think we have to do that this moves toward the type of flat benefit structure that Syl has.

I would strongly consider one type of individual account or another—one perhaps like the panels that Senator Gramlich, the chair of the council has put forward, or Senator Kerrey has put forward—I would consider modestly trying to add on this type of account. But given that it is a risky account, I would not make the system dependent upon those monies. That is, if there is a stock market crash like Japan has had, which is very probable at some point, or heaven forbid something like the Depression, we still need to have that minimum benefit adequate; that the risky part of the account should not be something we are dependent upon.

I would do a lot of things about second earners who, I think, are discriminated against. I would bump up minimum benefits because I think the very old, especially a lot of widows and few widowers, get inadequate benefits from the system. So there are areas where I would even increase the cost to the system.

Finally, one of the complicated matters is that I would not deal with Social Security in abstraction from Medicare, Medicare is coming along with such force and has such cost on the system, you cannot do a lot on Social Security if Medicare is going to come along and raise tax rates like mad.

Senator HAGEL. Do you generally agree with the proposition that Senator Kerrey has talked about—I think Dr. Schieber agrees—with the creation of wealth being a long-term objective here for everyone? Do you agree with that proposition?

Dr. STEUERLE. I agree with that proposition. The only amendment I would put to it is that I think we are primarily wasting our human resources and not just our physical capital resources.

We can save so much and build so many more steel mills, but it is really individuals working in society that are the backbone, the wealth of society. I would put a special emphasis on that as well while trying to convert Social Security a little bit more toward a system that does not encourage consumption as much as it does.

Senator HAGEL. Dr. Steuerle, thank you.

Dr. SCHIEBER.

Dr. SCHIEBER. Gene made several points. One is that we were somehow hidebound by 5 percent as a magical number. I do not think we were necessarily hidebound at 5 percent as the magical amount that should be put into personal accounts,

We did come to the conclusion that more funding and more saving was better than less, and 5 percent is better than 1.6 percent or 2 percent. So we pushed the model to try and get as much saving as we could because of the wealth considerations that we have been talking about.

Gene mentions that one of his primary goals here is to raise retirement age. If you look at our proposal, the flat benefit would accelerate the rate of increase in retirement age under—relative to current law. We would start raising the rate of 2 months a year after the turn of century until it got to age 67, and then beyond that it would be increased by the rate of longevity. So in terms of the flat benefits, I think we have accomplished what Gene said is one of his goals.

We would completely change the dynamics on retirement through the personal account. If you think about a person who is eligible for an annuity—Let us say you get $10,000 a year from an annuity, and the day you are eligible to receive it, you make a decision whether or not you are going to take that annuity or you are going to continue to work and not take it.

Let us say you have a life expectancy of 17 years on the date you are eligible and let us assume that you do not take it for 1 year to begin receiving the annuity. The way the current system works, for all practical purposes, you lose one-seventeenth of your annuity for each year you do not take it.

Under our personal security account, by not retiring and not starting to draw that down, you maintain your wealth. So we have completely changed the dynamics of the retirement incentives that are in the current system or we would if we adopt the kind of system that we are talking about.

In terms of changing the path of the rate of growth and benefits, they would be changed significantly also because the base that is now fully indexed, fully guaranteed by the government is smaller than it is under current law. You would be riding the value of your assets throughout your retirement to a greater extent than you are currently.

The issue of the Stock Market Crash, 1929. If we have a complete crash in our stock market, we are going to have more than the capital side of our economy that is going to be affected.

There are two factors of production in this economy that largely account for the output we have. One of them is capital, and the other is labor. If we are going to somehow depress the value of capital so significantly, as we did in 1929, it is undoubtedly likely we are also going to have a very significant effect on the labor market.

If you go back and look at history, that, in fact, happened. That is where those high unemployment rates experienced during the depression came from.

If we have a sustained period of that type of economy, we are not going to be able to deliver on the current promised benefits that are being financed by a tax on labor. There is no free ride from an economy that completely collapses.

So the thing we have to do is we have to structure a benefit, a program that will allow us to effectively take advantage of this wealth concept, that the Senators have been talking about here, as well as take account of the need to provide a floor of protection. That is what we were really trying to do.

As for dealing with the issue of Social Security in the abstract, I make two comments. One is: At the advisory council we were limited to looking at the Social Security Program. That was our charter.

The other thing, if you look at my testimony, my prepared testimony, I have gone on at length about why you cannot look at Social Security in the abstract, and it is because of the other issues that are on the table that you need to do something of greater magnitude in the Social Security area than you would if these other problems did not exist.

Senator HAGEL. Thank you.

The CHAIRMAN. Senator Kerrey.

Senator KERREY. Thank you, Mr. Chairman.

First of all, is it correct to say that none of you, as you look at Social Security, believe Social Security is in crisis? This is not a program that is in short-term or——

Dr. SCHIEBER. Even in short term.

Senator KERREY [continued.] even in mid-term crisis?

Ms. BOOSALIS. I agree.

Senator KERREY. Second, let me ask Mr. Goss, as you calculate the future of Social Security, you do not—do you, in your actuarial analysis, presume a depression-like turndown in the economy in the next 75 years?

Mr. GOSS. No. We explicitly presume that there will not, over the next 75 years, be anything really that is equivalent to the Great Depression or a major world war.

Senator KERREY. Let us just take the Great Depression as approximately a 10-year collapse of the U.S. economy with unemployment rates close to 30 percent. Let us assume you put into your actuarial tables that from the year 2005 to the year 2015 we were going to be in a depression. Would you answer the question then, "Yes. Social Security is in short- or medium-term crisis itself?" Do you take the point that I am making?

Helen, I think, in her very good testimony, indicated that AARP is willing to participate in reform for the long term, but they are concerned that a personal investment or a savings plan has to do with a potential risk, and one of the risks that very often is mentioned is a downturn in the economy that could occur.

I take it as a good sign, in fact, that many of the people are concerned about it. They experienced the Depression. Indeed, what is so paradoxical about it is the people who experienced the Depression have much higher rates of savings than people who did not experience the Depression. The baby boomers are saving at a much lower percentage rate as a consequence of not having had this experience.

It is fair to say, is it not, that this downturn in the economy, this depression, would not only result in a depreciation of the value of a savings account, but it would dramatically decrease the revenue that is coming into Social Security and produce the crisis in Social Security that we now do not have?

Mr. GOSS. That is an absolutely correct statement. In fact, as I mentioned earlier, one of the sets of assumptions the trustees put forth, the alternative three high-cost assumptions, while not incorporating specifically a depression, it does have substantially less economic growth in a number of other variables that would be less positive than the intermediate assumptions. The data at which the trust funds would be exhausted would not be 2029 but 2018 under the scenario.

I think, as Syl mentioned earlier, that not only the current system but, as you have also mentioned, Senator Kerrey, the proposals such as Syl's would also be very dramatically affected under these. This is really the reason why I think under the current system there is the so-called contingency reserve fund targeted to be on the order of 100 to 150 percent of annual outgo, which by most estimates would be enough to carry the program for five to perhaps 10 years of negative experiences.

Senator KERREY. But none of the options in the trustee's report includes anything that approaches the fears that are very often attached to allowing some of the Social Security program to become a savings program. None of those prognostications are included in the actuarial analysis over the next 75 years.

Mr. GOSS. It is hard to say, especially because when you mention the possibility of beginning with the year 2005 having a negative experience of something like the Great Depression, the high-cost alternative three presumptions, assume they begin in the very next year, in 1997, 1998, that we would have substantially worse experiences bolster in the economy. In the demographics we have a much lower fertility rate and a much faster growth in life expectancy. Because that would begin immediately in 1997, I think the cumulative effect through something like 2015 would probably be at least as great as one would—might expect from the Great Depression.

Senator KERREY. Well, the cumulative effect would be as great as the Great Depression?

Mr. GOSS. We would have to go back and do some calculations on this, but I think the cumulative effect through about the year 2015 might well be close to what you would expect if we had a relatively robust economy through 2005 and then for the 10-year period 2005 through 2015 had something that was akin to the kind of growth rates we had under——

Dr. SCHIEBER. What is your unemployment rate, Steve? The unemployment rates you are using are nowhere near what the unemployment rates that persisted during the Depression. The size of your labor force has got to be a major factor.

Senator KERREY. You guys can recalculate that. I just wanted to point out that even with the intermediate assumption you are using, there is no economic calculation that there is going to be, over that period of time, a significant period comparable to the Depression or other such moment.

Gene, you made a point that—you did not have much time to do it; none of us do. I think it is important to give you an opportunity to restate it.

There is an apparent fixed percent of the GDP that has been collected by the Federal Government and used for expenditures, but what is dramatically changing is the mix of those expenditures as well.

Is it true that the Federal Government collects somewhere around 19 percent of GDP and is sort of forecast to collect that amount for the foreseeable future, but that the mix of expenditures inside of the total amount that has been—has changed and continues to change dramatically?

Dr. STEUERLE. That is exactly correct, Senator. In fact, the percentages have been relatively constant almost since the end of the Korean War, roughly 19 percent of GDP. There have been other big changes. Social Security taxes have gone up; corporate taxes have gone up, but the total tax collections have been relatively constant.

But the one clear trend has been that expenditures on retirement and health and to a little lesser extent, disability have been absorbing larger and larger shares of the budget. Instead of 10 percent at the end of the Korean War, it is about 50 percent now.

If you did nothing and you just kept the laws as currently scheduled, they could absorb all revenues, which means either you have a huge deficit or you do not spend anything on anything else.

In that sense, this is one reason why it is important to start thinking about solutions today rather than waiting a year or two. Despite what you have done this year in the Budget Agreement, the percent of revenues, the percent of expenditures that are going to be spent on retirement and health are going to go up.

That inevitably means that the percent of expenditures on, let us say, programs for the young and for the middle-age has to go down. The decision of whether that trend should continue forever, it seems to me, is not something that should be made automatically. You have to look up to the discretion of Congress each year how to decide how to allocate tenures to our greatest needs of society.

Senator KERREY. For me, I will be eligible, under normal retirement age, for Social Security in 12 years. I have no objection to the current level trends that provide the current level of benefits. In fact, I will not have any objection to the current level of taxation needed to provide benefits 12 years from now.

But 15 to 20 years from now, not only am I going to have some difficulty with the level of taxation needed to sustain the benefits that I will be eligible for, but I am going to be very uncomfortable with the underinvesting in education, underinvesting in transportation and a whole host of other things as a consequence of the demands that I have put on the system.

One of the ways that I think it is easier to express the problem is that this really is a problem where baby boomers have to decide. It is really not a problem for current beneficiaries. It is a problem for baby boomers.

The question for us is: What kind of a country do we want our children to live in? What kind of demands are we going to place upon the system relative to the demands that they are going to be able to place upon the system?

What I find myself saying is that when I retire I am going to have four or five times the demands on the system than my parents had when they were retired versus what they were investing in me through education, through the interstate highway, through research, through all sorts of other things that were going on. I find that unacceptable. At the same time I understand that it takes time to plan.

I think we need to—If the baby boomers are to solve the problem, we need to be identifying the changes that need to be made so we have time to plan on those changes. But I think one of the ways we have to look at this thing is: Are we willing to accept the demands that we are going to be placing on this system 12 to 30 years from now?

Dr. STEUERLE. I could not agree more, Senator. I am about the same age.

The question for us is: Do we allow our benefits to be reduced slightly, or do we raise taxes and reduce expenditures that would be made on our children? That is really the major issue that we are facing.

Ms. BOOSALIS. Well, Senator, I absolutely agree, and we are not the same age. [Laughter.]

Senator KERREY. In spirit we are.

Ms. BOOSALIS. In spirit. OK.

I think you are absolutely right, and that is why I really congratulate you three senators for beginning this kind of dialog. It is a dialog that needs to be taken all over the country so that people understand—and not just the baby boomers; because they are going to be more affected. But it needs to be a dialog that speaks to what the value of Social Security is, what is to be expected in the future and how much people are willing to pay to achieve what they want.

But you have got to know what they want in order to even plan what your legislative program is going to be. The more of this national dialog that goes on, the better off, I think, we will all be.

The CHAIRMAN. When I read a question, I am not going to give the name of the person that submitted it, because I do not know whether you want privacy or not. So I will just ask the question.

This might be something for you, Helen, because you spoke about supplemental savings and Social Security. Would not it be beneficial to encourage individual savings plans, less taxation of 401(k)s, higher interest rates on savings accounts to ease dependence on Social Security; thus, returning the program to its original supplemental status?

Ms. BOOSALIS. We certainly do encourage it, and that is what we talked about, encouraging individual savings. That is what we are suggesting.

I said in my comments, changes would need to be made in the pension programs that now exist. Changes would need to be made to encourage more employers to have more pensions for their employees.

We at AARP are working through our media, through our Modern Maturity Magazine, through our AARP Bulletin, through national legislative council meetings with people all over the country to try and develop that kind of interest and to push people and legislators into that kind of activity.

The CHAIRMAN. Here is a person who says that they have friends who evidently have not needed Social Security. I am paraphrasing that. They have tried to return the money to the Social Security Administration but have been told that they cannot return the monies. Why not? Would not this at least solve part of the problem, meaning more money for people who did not need it?

Dr. SCHIEBER. Anyone who wants to send money back to the Treasury of the United States has got every right to do so. If someone precludes you from doing that, you ought to contact your Senator. I am sure he can help you. Make sure that what you send back to the Treasury gets duly deposited and probably duly deposited wherever you want it.

The CHAIRMAN. Has Congress thought about giving tax incentives to people who want to create their own retirement? I think we probably discussed different ways.

Do either one of my colleagues want to comment on what we are doing to encourage savings and pension plans? I think we have had some good legislation. Last August we had the small business——

Senator KERREY. Yes in this year's Balanced Budget Act we have made it easier for people to establish individual retirement accounts.

There are two hard things about savings. One is to really generate wealth the variable most important is the length of time you save. If you start saving when you are 55 and you are planning on using it when you are 65, you have got 10 years. That does not give you enough time to take advantage of compounding interest rates.

You are better off trying to establish a program that enables you to save over a 65-year period of time. Then compounding interest rates allow a doubling of seven or eight times over the period of your lifetime.

To do that one of the things we need to start looking at is answering the question: Do you want Social Security to be in addition to a generator of income, the promise of a defined benefit, but would you like it to generate wealth as well? One of the things I modestly suggest is if you took a tenth of a point of payroll tax and opened a $1,000 account for every baby that is born in America, that is 4 million live births a year; that is $4 million a year.

It would throw Steve's actuarial tables off slightly to do that, but just slightly; not radical alteration. A thousand dollars over a 65-year period of time, even if you put it in the S & P 500's or bucket invest it, for God's sake—just buy Burkshire Hathaway or whatever you can buy for $1,000. Invest it safely. Put it in the safest possible investment that even Steve Goss says is not going to be altered radically over the 75-year period it is going to be invested, that individual generates substantial wealth; nearly a quarter of a million dollars saved at average rates over a 65-year period.

Again, if you look in Nebraska, 98 percent of our citizens die with estates under $600,000. It would not be difficult at all for us to change the law to enable families to save relatively small amounts of money over a long period of time.

One of the problems we have with people saving today, the median family in Nebraska, a family of four, earns $35,000 a year. We take out $2700 in income tax. There was a time when the income tax was larger than payroll today. We take $4300 in FICA and payroll taxes. The payroll tax is higher today; almost twice as high as income tax. One of the reasons that families are struggling to save money is after they pay their taxes, especially their payroll taxes, they do not have much left over to get the job done.

In addition to things Congress has done to help families save money, one of the things I would recommend we do, if we sort of do it in a dispassionate, calm fashion, is to look at the power of compounding interest rates and ask ourselves: When do we want to start that savings? I think it inevitably leads to the conclusion that the moment that child is born in this country, we want them to start saving money. We want them to start acquiring the wealth they are going to need when they reach retirement age.

The CHAIRMAN. I will ask another question, and then I will call on Senator Hagel and you to ask the panel another question, if you want to, each.

This is something that I think has been alluded to, but these IOUs within the Social Security Trust Fund, I think, needs some clarification. So I am quoting. "Social Security accumulated funds have been used as a source of revenue for spending other than Social Security with IOUs placed in the trust funds. How much has been used this way? Is this not the reason for the current shortfall; at least a large part of it? If these IOUs were covered with cash, would the shortage not be solved?"

Our expert panel will handle that. You have more credibility than we do on this issue. [Laughter.]

Ms. BOOSALIS. Where is the shortfall?

The CHAIRMAN. I am going to let you respond. I do not know whether it is "he" or "she," but——

Ms. BOOSALIS. I think there is a misunderstanding.

The CHAIRMAN. Then I want you to explain it, because I think you might have more credibility than we do.

Ms. BOOSALIS. The money is credited to the trust funds but is used by the general fund, as I understand it, the money that is specifically allocated for Social Security should not be touched.

Dr. SCHIEBER. When I pay my payroll taxes—actually, my employer collects it and sends it to the Treasury Department—the Treasury Department receives the money. They either use the money to pay benefits, or if there is some left over—this year there will be somewhere around $55 billion, $60 billion left over—what they do is by law, invest in government bonds. Some people call government bonds IOUs. They are long-term government bonds. They pay a rate of return that is comparable to the rate of return that long-term government bonds you or I might buy.

It is a promise by the Federal Government that it is going to pay interest, and it does pay its interest, and it is going to redeem them when they are presented back to the Treasury Department. When Social Security officials bring the bonds back and redeem them at the Treasury Department, the Treasury Department gives Social Security money to pay benefits.

You can argue that we should be investing somewhere else than in government bonds because government bonds do not pay a high enough rate of return, but nobody has stolen this money. It is audited on a regular basis, and it is a remarkably efficient operation.

Nobody has complained that the people are not honest or efficient in terms of their administering it. Nobody has stolen the money. Believe me, I have looked. [Laughter.]

The CHAIRMAN. Senator Hagel for a question.

Senator HAGEL. Thank you.

Helen, let me pick up on a little of your testimony and see if I can understand a little bit where AARP is for the future of Social Security. If I am paraphrasing this correctly, my understanding is that, as you say in your testimony, workers consider it, you believe, a fairer tax than the income tax, the payroll tax. You go on to say that any payroll tax increase should not be a first choice and should be limited.

However, my question is this: Then what do you believe we should do about the future? Because you know the numbers, that we are going to essentially run out of resources, and you know all the other dynamics involved there. If you do not support privatizing in some way a PSA, age increase eligibility, cutting benefits, all those other benefits, what is your suggestion?

Ms. BOOSALIS. We are not saying that we do not support any or all of those things. We are saying: Have a national dialog to discuss that with the general public. That is what we are saying.

We are open to looking at whatever is put together in a reform package that would work together that does not violate, to a great extent, our principles, and many of those things you are talking about we could work with. We want to see a total package. That is why we do not want to quantify at this time what our position will be.

There are a number of ways that you can address where we are going.

Senator HAGEL. But the fact is some of these things are going to have to be done, and right now AARP does not take a position on any of these. But I think it is pretty clear that we are going to have to prioritize our resources, and, in fact, we are not going to have enough money; we are not going to have enough workers. The facts here are that we are going to have to probably alter considerably our future.

Ms. BOOSALIS. Well, we are principally interested in seeing how any package you put together spreads the sacrifice among all the participants, the beneficiaries, the workers as well.

All three should be part of the sacrifice. It should not all be loaded on the beneficiaries, all on the employers. It should be spread fairly well. The sacrifice should be generally spread.

Senator HAGEL. Thank you.

Doctor, if I can go back to some of your testimony that you did not get to, which I read last night, you referenced a number of countries who are taking the initiative on restructuring their Social Security systems, and some have been quite successful, as we know. Obviously, we cannot take the Chilian Social Security system and overlay that on ours. There are a lot of differences.

I would be very interested if you could, for our audience, develop a little bit of what you were referring to in your testimony.

Dr. SCHIEBER. I think if you pay attention to the discussion here and the news that has covered it, the media's coverage of these issues, one of the countries we talk about all the time is Chile. They privatized their Social Security system in some regards in the early 1980's and gave people individual accounts, and they have gotten very high rates of return in that economy.

Some people point to that as a model. I do not think it is a very good model for a variety of reasons. It was a much less developed country. They did not have financial markets. They had a political dictatorship, which makes things a little bit easier when you want to change social policies than when you have the form of government that we have.

But there have been other rather dynamic and developed economies that have changed their system. Australia, a country that many of us can relate to, changed their system a number of years ago. They now have a mandatory personal savings, and it is financed through employers. But the people that implemented this were savvy enough to know that if you are going to mandate that employers contribute to an account on behalf of an individual that is part of the labor cost, they allowed employers to either freeze wages while this was being implemented and in some cases actually reduce wages. So the workers are really paying for it.

They have modified it. Ultimately the total contributions to individual accounts would be 13 percent of pay a year to finance workers' retirement benefits.

The U.K. has allowed for some personal saving as an opt-out option for their Social Security system for quite a number of years.

Even countries on the continent in Europe. Sweden is working on a proposal where individuals would save, I believe, 1.8 percent of pay in an individual account. You do not exactly think of Sweden as being some stark, conservative, individualistic driven country.

These kinds of reforms are going on literally all over the world. One of the concerns I have is we were one of the last developed countries actually to implement the Social Security program we have. My hunch is we may be one of the last ones to reform it also.

We ought to look around at what else is going on elsewhere in the world. I think there is a lot more to learn.

Senator KERREY. I would just like to ask Mr. Goss to talk about—You said there is no crisis going on right now, but I had breakfast this morning with my brother and his little baby boy that he just adopted here a little while ago.

In the year 2019 that boy will be 20 something getting out of college or in the work force for a couple of years. Significantly my brother will be 3 or 4 years into Social Security. He started his family a bit late, so he will be a beneficiary by that time.

Now, as I see it, there are a couple things that that child will face. No. 1, the amount of money that will be allocated at the Federal level for defense, the environment, education, transportation, NASA, all the rest of it will be about 15 percent of the budget. Today it is about 34 percent of the budget.

So we are going to have a lot less. He is going to have a lot less; that young adult is going to have a lot less than young adults today do, so that piece gets squeezed down.

Do we not face a crisis in 2019 of cash-flow? Particularly if you presume, as I do, that the 1983 reforms would not pass in Congress today. We had an increase in eligibility age in 1938; an increase in tax in 1983, a substantial increase in tax in 1983; a 2-year increase in eligibility age.

We passed on doing it again this year because of a variety of things. Do we not have a cash-flow problem in 2019? That is the year that we drop below both with interest and payroll tax income, and we have got to come up with the cash somehow to write these checks.

Is it accurate that in 2019 we are going to have a cash-flow problem that we will notice pretty substantially?

Mr. GOSS. Senator Kerrey, a lot of people, when they refer to this timing, refer to an even earlier date of 2012 when the total amount of taxes coming into the system will no longer be sufficient to pay the benefits. We refer to that as a crisis point.

I guess I would suggest I believe it was 1994 or 1995 when the hospital insurance program reached that same state. I do not mean to make light of this issue.

Senator KERREY. It will not be like 1983 where we either change the law or we did not have the money to write checks. I am not suggesting that.

Mr. GOSS. Absolutely.

Senator KERREY. It will not be that kind of crisis. In order to come up with—As I understand it, 2 or 3 years beyond it, it will be 50 or so billion dollars below what is needed. We have got to come up with the greenbacks. We have got to convert bonds, do we not, in order to pay the bills? We have to come up with the resources to that.

Mr. GOSS. That is absolutely right. The Treasury of the United States will have to come up with that money. That process will actually be fairly gradual.

Senator KERREY. Describe the transaction in terms, as I was trying to do earlier, with the baby boomers. I have a 22-year-old whose baby is a year old today, and a father who will be 68, 69 years old, and that baby is going to be facing all kinds of situations.

As a citizen concerned about the Social Security payment to his mom and dad, what kinds of citizen choices will he have to make?

Mr. GOSS. The answer to that, Senator, is if there were no change to Social Security in the interim, which we are all quite confident will not be the case, and we were to play out what happens in the intermediate assumptions as we approach 2012 and 2019——

Senator KERREY. I would disagree with you, by the way. I think there is no momentum for change. I think the likelihood is they will do it exactly the way we have always done: Wait for the crisis, and then act.

Senator HAGEL. Bob Kerrey is giving a lot of leadership here. He is having garage sales, by the way.

By the way, I am sorry I did not get by yesterday for your garage sale. [Laughter.]

Mr. GOSS. Partly for your reference, Senator, I hope that will not be the case.

Senator KERREY. You can just use the microphone.

The CHAIRMAN. I hope that dialog of this nature proves you wrong and that we are able to convert the public's opinion into a national consensus a lot sooner before we get to a crisis. I hope. I suppose I am somewhat cynical about it as well, as Senator Kerrey expressed.

Here is a question probably appropriate for Mr. Goss and Mr. Schieber. Most pension plans are defined benefit plans that do not include cost-of-living adjustments. Why does Social Security need a cost-of-living each year, and how much longer would Social Security last if it were eliminated? In other words, how much further out would it extend the bankruptcy date beyond 2029?

Mr. GOSS. Let me just—As far as the cost-of-living adjustment is concerned, I believe this is one thing—just speaking for myself for a moment—that the members of the advisory council, people of a variety of views on Social Security were unanimous on the notion there should be a cost-of-living adjustment.

I think it is pretty widely viewed as one of the great contributions that Social Security does have for the American population, that there is a cost-of-living adjustment. It is one of the, perhaps, shortcomings of the private pension system.

If we were, though, on the other hand, to abandon this aspect of Social Security, it would be a very, very dramatic savings and reduce future costs to the system such that, I believe, the long-range imbalance, long-range deficit would essentially disappear. But I doubt that there is anybody who would advocate that move.

AUDIENCE MEMBER. Why not?

Dr. STEUERLE. Even under current law the very old—the people who, say, are 85, receive benefits that are only 80 percent of the value of what are received by the people that are 65.

There is another index in Social Security which determines that every new generation, every new year of retirees gets slightly higher benefits than people who retired the year before and on and on because of the way the system is designed to grow over time with real growth in the economy.

So even with the cost-of-living adjustment, new retirees get benefits that are 20, 25 percent higher than old retirees. If you take away the cost-of-living adjustment, the new retirees would get benefits that are twice as high as old retirees. That is because through 20 years of inflation, the real level of benefit of these very old would constantly go down. It would be going down 3 or 4 percent or whatever the rate of inflation is every year for 20 to 25 years.

You have a system where the young old, are the people who are the richest, have the most assets, and to some extent are the most capable of working. The very young old would be the big beneficiaries, and the old old would be worse off.

Senator KERREY. I think there is another fundamental answer here, and it gets at the misconception about Social Security. It is not a pension program. It is not a defined benefit program.

If it was a defined benefit program, I doubt that it would have a COLA on it.

Dr. STEUERLE. The one thing Congress did not do, which I think makes the question appropriate, when Congress did adopt a COLA, it did not make an adjustment and say, "Well, let us keep the total cost of the system the same and reduce initial benefits." So we solved this problem of the old old not having enough basically by taking on a COLA and adding it on to the total cost of the system. Because we did not make an adjustment to the whole system, it did add to the cost of the system, if you want to measure it that way.

But I still think you would not want a system where the old old get substantially less benefits than the young old. You might want to ratchet the whole system down.

Dr. SCHIEBER. There were a couple people out here that said, "Why not?" Why did not the advisory council, for example, advocate reductions or eliminations of the COLA? We said that the Labor Department ought to try and get the measurement of the COLA as correct—as correct as they could.

If you think of this phenomenon that Gene has been talking about, all the CPI does, if it is roughly correct, it would keep people's purchasing power roughly constant over their retirement career. If you are going to reduce that arbitrarily, what you do is reduce the total lifetime benefits of people that live a long time in retirement more than you do people who live just a short time in retirement.

If you look at the distribution of people who live a long time in retirement, it tends to be women. It did not make much sense to us to propose or recommend an option that was going to reduce the lifetime benefits of women since so many of them end up in poverty at advanced ages already.

There are a variety of issues that came into play here in our concerns and considerations. We got to exactly the point—or I did, anyway—that Gene did. If we think these benefit levels are too high, we ought to reduce the benefit levels. But we should not use complicated, computational lifetime mechanisms to do it, because it has some real important distributional issues that are not readily apparent to many people.

The CHAIRMAN. This question observes that there are not too many baby boomers here in this room, and with a lot of things we are suffering down the road a long time, the baby boomers would be the ones who would suffer. So the question is: Is boomer apathy a problem, and how does one fight it?

I guess I believe we have got too much apathy in a lot of policy problems in this country, and we overcome that apathy by promoting discussion of those issues.

I am kind of answering the question. Would anybody on the panel or my colleagues have anything to add to that?

Dr. SCHIEBER. One of the amazing things to me—I have done several of these—is they were expecting about 50 people here this morning, I believe, or maybe 100. They spent the first 25 minutes carrying in chairs.

I did one down in Charleston, SC, a couple of weeks ago or a month ago. They were expecting about 50. They ended up with about 250.

I am not sure there is quite as much apathy about this issue around as some of us believe.

AUDIENCE MEMBER. We are baby boomers.

Dr. SCHIEBER. I am sorry?

AUDIENCE MEMBER. We are baby boomers.

Dr. SCHIEBER. I am not sure the baby boomers are as indifferent about this. There is a number of people out here, I would hazard to guess, that may be in the baby boom generation.

AUDIENCE MEMBER. The baby boomers are all at work. [Laughter.]

Ms. BOOSALIS. I wonder if the questioner implies that the baby boomers are more interested in finding a solution to this problem than the beneficiaries, and I do not think that is necessarily true.

I think that we beneficiaries are as interested in finding solutions to the long-term solvency of Social Security as the baby boomers. After all, these are our kids out there and our grandkids out there. Of course we are interested in their future.

The CHAIRMAN. This questioner says: How much money of a personal security account will be lost to financial advisors? In other words, if somebody is paying to get——

Senator KERREY. Let me take that because it is a very—Go ahead.

The CHAIRMAN. Also, what happens if the stock market crashes? I think we have dealt with the last one.

Senator KERREY. The second one, if the stock market crashes, Social Security is in trouble.

The first one we have at the Federal level, as many employers do, programs that allow people to make selections on how they are going to invest their money, and the administrative costs are never a subject of complaint.

If you wanted a statute, you could put the administrative costs at zero. I think it would be kind of foolish to do it, put it at zero, because you typically get something for it. You can organize it so that the administrative cost is not an issue. It is not an issue for Federal employees who are making selections in a variety of investments.

To get to it again, you can jog; you can eat yogurt or whatever else you want to do and watch your diet and get a few extra years, but you do not get those years back that you need to save if you are going to try and take advantage of this compounding interest rate. The longer you wait, the harder it is to generate and accumulate wealth.

You can, in statute or in organization, minimize, if not eliminate, this issue of administrative charges.

Dr. SCHIEBER. This concern about the risks of personal accounts, I believe, carries with it the perception if you have a personal account invested in financial markets that you are subject to certain kinds of risks; whereas, if you stay with the current system, you are not subject to risks.

Now, I think some of you here probably know people that came to be called the notch babies because their benefits were reduced fairly significantly by the 1977 Social Security Amendments. I think some of you probably know people whose benefits either were taxed or somehow were adjusted because of the 1983 amendments, adjusted in a downward direction.

If you look at the current system and its underfunding of 25 to 30 percent by 2030, I would hazard to guess there is a very high probability—I would put a probability of one on it—that we are not going to see that fully made up by tax increases.

There is a lot of risk in these benefits. It is called political risk. So do not think you are talking about one environment where there is risk and another environment where there is not. There is risk in both environments.

The question is how you can diversify that; how you can get on and be fair across all segments of society.

The CHAIRMAN. Senator Hagel asked for a question.

Senator HAGEL. Mr. Goss, you are the real technician among this group, and you have heard many proposals, and you have dealt with this a good part of your life.

Is there any thread of consistency or consensus throughout what you heard over the last 2 years on where we are going and what might be some of the general answers as we restructure Social Security?

Mr. GOSS. I think the one thread of consistency that we saw very much in the advisory council proposals, as well as other proposals that have been put forth by Members of Congress, is the notion of perhaps moving away from the pay-as-you-go financing system that we have for Social Security and moving more towards having some advanced funding; the notion of capturing some of the advantage that Senator Kerrey has described of having advanced funding and getting some of the gains that can be captured.

There has been a lot of discussion about the notion of increasing savings and wealth accumulation in the United States, and I think this is something that is going to have to be studied very, very carefully. As Syl and others have mentioned, it is possible to develop a Social Security system where you would have advanced funding and create more savings within the system but perhaps not have more savings and wealth accumulation within the country as a whole.

I think this is something that has to be studied very much, but in order to assure future generations will continue to have a good rate of return on Social Security, the only solutions we have seen so far would encompass some advanced funding under the system.

Senator HAGEL. Anybody else want to respond to that?

Thank you.

The CHAIRMAN. I think this will be the last question, but I think the premise of the question probably is factually inaccurate, so let me—Help me with this, if you can.

The budget surplus for fiscal years 1999, 2000, 2001 is estimated to be about $300 billion. Then the suggestion is that dancing eyes inside the Beltway are envisioning what to do with all that extra money.

How about using it to protect—to build on the surplus to extend the life of Social Security as a suggestion? We are not projecting those kind of—Go ahead, please.

Dr. STEUERLE. I think I know where the question comes from. There have been some articles in both magazines and newspapers lately that if the economy continues to boom at extraordinary rates, we could see the deficit that we have now turning into a surplus. Then the question arises: Well, what should we do with that surplus, if it arises?

From a fiscal standpoint one of the dangers is there are good times and there are bad times. The economy goes through cycles. If you spend the money that is available in good times, always making sure that a surplus is not there, then in bad times you are always in deficit, which has been our problem for some time.

I also think that the current budget is very misleading. We have talked a lot about the baby boomer population. In terms of demographics, we are really in the eye of the hurricane. We have gone through a large number of years with very large deficits not due to demographics but to spending too much.

We have hit the eye of the hurricane. When the baby boomers retire, we are going to go back into that problem. The projected long-term deficits under current law are still on the order of 6, 7, 8 percent of GDP; far larger than anything we have seen.

The reason the budget is so misleading is that the current influx of individuals into the retired population is actually kind of a baby bust population. That group of people who were born in the Depression and World War II was a relatively small cohort.

So you have this misleading impression about the cost of the system because you are not really putting aside money to pay for the baby boomers and beyond. Meanwhile, you have this relatively small cohort coming into Social Security benefit status.

Being in the eye of the hurricane, trying to spend any possible surplus very quickly could be very dangerous.

The CHAIRMAN. Before I give my closing comments and thank-you, I want to ask Senator Hagel and Senator Kerrey to take a minute apiece to give a summation, if you want to.

Senator KERREY. First of all, as I said, this is a continuation of a dialog, and I think both at the state level and national level such a dialog is important to gain a clear understanding of what Social Security is and what it is not.

One of the things your staff provided me with—I have seen it before, but there are three documents that I would recommend to anyone who has an interest in participating in this dialog. The first one is entitled "Social Security Basic Facts." It tells what the program is and what the program is not. It tells how the benefits are calculated in general terms; what the program pays out; who receives the benefits; who does not receive the benefits.

The second one that I have found, especially at town hall meetings, is important is a thing called "Requests for Earnings and Benefits Estimate Statement." This will allow you to determine what you have paid in and what you are going to get out.

So many people say, "Well, I have paid this in all my life, and I want to get it back out." This thing will tell you whether or not you are getting back out more than you paid in or less than you paid in. It will give you a very specific answer to that question, and I find it to be very useful, again, for those who want to participate in a dialog based upon facts.

The last one is a "Status of Social Security/Medicare Programs." These are the summaries of the annual reports that we referenced earlier.

All three documents I would make available through my office. I am sure both other senators would as well. I think they are very good documents, and they are relatively short and easy to understand. To the end of encouraging a constructive dialog, I would recommend you get them.

I thank, again, both Senator Grassley and Senator Hagel for inviting me here and for putting on this hearing.

The CHAIRMAN. By the way, Senator Hagel and Senator Kerrey have already made those documents available. You can pick them up when you go out the door.

Senator HAGEL.

Senator HAGEL. Mr. Chairman, thank you. I would like to add my thanks to our distinguished panelists, because it is the panelists and those of you who have really lived it and still live it and have responsibilities individually and collectively for helping us all find some answers to this. So I applaud you and look forward to working with you.

I also want to thank my colleagues, Bob Kerrey and Chuck Grassley. They have done an awful lot of work over the years both in the Finance Committee and Senator Kerrey's own individual efforts to lead this effort as well as Chuck Grassley. I think we here in the Midland sometimes overlook the kind of talent and leadership that is right here, and these two gentlemen to my left have done an awful lot of that. So I appreciate their efforts.

Let me make one last comment, Mr. Chairman. One of the facets, I think, that has come to the floor this morning and will continue, and I think we saw evidence of this in the Budget Act and the Tax Bill that we passed, was the continued focus on economic growth incentivizing savings, incentivizing investment. Because whatever program we develop, the nucleus of that is going to have to be the incentivizing of our savings and of our growth and our investment.

And what Bob Kerrey talks about, getting to that wealth, that is the central part of any program and society.

Another point I would make is what we in the Congress are going to have to be doing, and we should not confuse this. It is prioritizing our resources more and more. That does not mean limiting or that does not mean having a smaller pie necessarily. In fact, it should not mean that. It should mean discipline and the prioritization of where we want your money to go, and you are going to have to help us with that.

You heard today some of the facts, real numbers on if we continue to go along the same glide path that we are on now, the kinds of percentages of our tax dollars that will go to retirement and health benefits are there. In fact, in 25 years there will be no money left for education and roads and all the other issues that are very important in this country.

So one last point, and that is: That is why it is important we have dialogs, as Helen talked about, and that is why you are very important to this.

Mr. Chairman, I thank you for the opportunity to be part of this.

The CHAIRMAN. Thank you to my two colleagues for their hospitality of their own and staff, the people of Nebraska. I appreciate the committee being invited to Nebraska and to Omaha. We also thank the College of St. Mary as well for their hospitality, and most importantly, to our expert panel. Those of you that came a long distance to be with us and others that came a shorter distance to be with us, we appreciate very much your sharing your insights on the Social Security program, because I have said so often during this meeting that this type of forum is necessary to advance the debate about how best to approach the challenge of our aging population, and I consider it a challenge.

Some people might refer to this as a problem, but when people live longer, we never looked at that as a problem in American society. If we do, I think we are not as humane as we should be.

Most of all, I want to extend an appreciation to all of you. We have such a large turnout. In fact, the next time this committee meets in Sioux City, I am going to have to find out how you do things in Omaha and get a larger group of people.

Senator HAGEL. We have been trying to explain that to you.

The CHAIRMAN. I know. But I always hear that in terms of football; never in terms of public hearings. [Laughter.]

Mr. Chairman. So I hope the testimony we have heard today will add to everybody's knowledge about the program and the challenge that it faces, and I know that your questions and discussions today will be of great assistance to the work of the Aging Committee as we move ahead raising awareness and working on these solutions.

Finally, I hope that you will be encouraged, all of you in the audience will be encouraged to continue to take part in this discussion. It does not do us any good in the process of representative government to come here and spend 2 hours, if that is all the interest you show. You have to write to Senator Hagel and Senator Grassley and Senator Kerrey in the future and keep up the dialog when you cannot see us face to face.

If the public does not take part in this dialog, it will be impossible to reach a consensus, and we will be unable to proceed, perhaps waiting until the last possible moment to take action, and I want to show that Senator Kerrey is wrong. I think you have reason to feel very right today, but when it is all said and done, I hope we are able to meet this before we reach a crisis point.

Thank you all very much. Meeting adjourned.

[Whereupon, at 12:06 p.m., the committee was adjourned.]

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ISBN 0-16-055986-3

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