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A STARTING POINT FOR REFORM: IDENTIFYING THE GOALS OF SOCIAL SECURITY

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BEFORE THE

SPECIAL COMMITTEE ON AGING
UNITED STATES SENATE

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A STARTING POINT FOR REFORM: IDENTIFYING THE GOALS OF SOCIAL SECURITY

TUESDAY, FEBRUARY 10, 1998

U.S. SENATE,
SPECIAL COMMITTEE ON AGING,
Washington, DC.

The committee met, pursuant to notice, at 10:05 a.m., in room SD–628, Dirksen Senate Office Building, Hon. Charles Grassley, (chairman of the committee), presiding.

Present: Senators Grassley, Burns, Santorum, Reid, and Reed.

OPENING STATEMENT OF SENATOR CHARLES GRASSLEY, CHAIRMAN

The CHAIRMAN. I call this first hearing of the Special Committee on Aging for the year 1998 to order. To open it up, I think I should first of all explain to all of you in the audience who have come to this very important hearing particularly to our witnesses, that there will probably be sparse attendance at the hearing this morning because there are three other committee meetings going on. There are two others that I should be at that I am not going to be at, one of them a very important hearing, a discussion of taxes as it relates to education credits. But I am going to conduct the meeting and hopefully people can come and go.

But I particularly want to make a point for Senator Breaux. He has a lot of the same committee assignments I have, plus another important one on Commerce, and he is always faithful at being at these hearings and he is going to have to be at these others, as well. But if he comes into this meeting I am going to break into whatever we are doing and accommodate Senator Breaux so that he can make an opening statement, if he is able to, and leave.

I want to say also I just talked about conflicts from committees. At 11:00 or thereabouts we will probably have to shut down for a short period of time to have a vote on the Senate floor, a cloture vote, which I hope won't take any more time than just my running over there and casting a vote and coming back, and that is in the neighborhood of usually 6 or 7 minutes.

[The prepared statements of Senators Breaux and Enzi follow:]

PREPARED STATEMENT OF SENATOR JOHN BREAUX

I am delighted to be here today, and I thank our distinguished panelists for joining us. I am glad our committee is at the point of taking a serious long-term look at what I think is the greatest issue facing our country with the exception of Medicare reform—the future stability of Social Security. I firmly believe that long-term entitlement reform is certainly a legacy that this President and Congress should leave behind. Moreover, I am pleased to work with Senator Grassley as the Aging Committee takes a leading role in this historic debate.

The urgent need for reform is clear. The 1997 Trustees Report for Social Security set forth solvency predictions, which the trustees themselves described as "sobering." This report described the aging of the baby boom generation as "requiring substantial changes and sacrifices by some or all Americans."

As we look toward options for reform, Republicans and Democrats alike need to accept certain fundamental truths. The changing face of America has produced the ingredients of a potential crisis—smaller families, fewer workers, higher benefits, and longer life spans. While we can all be proud that both Social Security and Medicare have dramatically increased the quality of life for the elderly, the truth is simply that we live in times that hardly resemble 1935 when FDE signed Social Security into law. The public retirement program was forged in an era of economic hardship when no one could envision today's complex demographics.

The current financial problems facing Social Security are not new, and we certainly do not need to spend months debating how to simply restore solvency. This debate is not just about financial reform. If we only want to balance the books we can rely on the same traditional fixes we've used in the past with Social Security and Medicare. I believe, however, we owe it to the next generation to do much more. Future generations should feel confident that Social Security will not only be there for them, but that it is also a worthy investment.

Already, several policy options are on the table. However, this hearing gives us an opportunity to step back and look at the more fundamental and underlying decisions our country must make. What do we want our public retirement system to look like in the 21st Century? What values, principles, and goals should guide us as we look towards reforming Social Security?

These are questions that must be answered before true reform can begin, and I look forward to the input from our witness today.

Prepared Statement of Senator Michael B. Enzi

Thank you, Mr. Chairman. I appreciate your holding this hearing to discuss the goals of our nation's Social Security program. We are all aware of the value of the Social Security program in helping our nation's senior citizens achieve a secure retirement. It is important, therefore, that changes are enacted to ensure that the program is available in the future to those who currently support it with their payroll taxes. This hearing will be extremely helpful as we debate the future role of Social Security in our society.

Our nation's demographics are to blame for the projected insolvency of Social Security in 2029. When the Baby Boomers begin to retire, the program will be forced to rely on the payroll taxes of a smaller pool of workers to finance retirement benefits of a growing segment of our population. It is well known that the current system is unsustainable. Therefore, it is inevitable that reforms will be necessary to save Social Security. Since the program is so important, it is vital that all proposals, from modest tinkering to the current system to large-scale overhauling, are evaluated in a careful, rational manner. This issue should not be subject to the demagoguery that persistently plagues any effort to save Medicare which incidently is scheduled to go broke long before Social Security.

I believe that it is important that we take action to save Social Security as soon as possible. In fact, I am proud to be a cosponsor of two pieces of legislation that I believe will help preserve our nation's Social Security program. I was an original cosponsor of the "Strengthening Social Security Act of 1997," which was introduced by my colleague Senator Gregg. This bill would provide for the refund of one percent of the current employee Social Security payroll tax to be placed into personal investment accounts. Individual employees could choose—like in an IRA—whether to invest these accounts via a menu of options similar to the Federal employees' Thrift Savings Plan. The change would be instituted in a manner that enables the youngest workers to plan for this modification of the Social Security system while seniors currently over 55 would not have their benefits affected at all. This modest reform will give people a choice on how to invest their money for their retirement needs, without fundamentally altering the Social Security program.

In addition, I cosponsored another bill offered by Senator Gregg that would require the Commissioner of the Social Security Administration to submit specific legislative recommendations that are deemed necessary to ensure the long-term solvency of the program. This will put the Administration on the record as to what legislation they would endorse for saving Social Security. The President has unfortunately been silent on the subject of Social Security reform, except for his vague demand that any budget surplus be set aside for Social Security until a reform plan is developed. We need the participation of the executive branch of our Federal Government now as we work to develop a reform plan to save Social Security, and this bill will guarantee it.

Once again, I thank the Chairman for holding this hearing. I am aware that there are many different viewpoints involved in the debate over Social Security. I appreciate our panelists taking the time to share their thoughts and views of the objectives of the Social Security program. If we all work together in a constructive manner, I am confident that we will be able to restore long-term solvency to the Social Security program in a way that is fair and equitable to all retirees, both current and future.

The CHAIRMAN. I want to call the hearing to order now. I thank everybody who participated in the preparation for this, member and committee staff as well as the staff of the people who are testifying and also, those of you who are in attendance because of your interest in this subject.

We will be hearing important testimony on how to confront an issue of great concern. This is the financial problem of the Social Security system, a very sound system today, a sound system for the near future, but what do we do about making it a very sound system for Baby Boomers and beyond?

This is one program that calls out for reform. In order to save Social Security for the future, we must act, and the sooner we act, the better. And the reason for that is that if we act now, 10, 15 years ahead of time, it is not going to hurt anyone. If we act 10 years from now a lot of people are going to be hurt.

Without Social Security, many retirees simply could not survive because Social Security provides the vast majority of resources to people in retirement.

When President Clinton recently called out for action on the need to reform the Social Security program, I was very, very encouraged and still am encouraged, particularly following up, as he has, with his speech at Georgetown University yesterday because everybody in this audience knows, right or wrong, Social Security, as well as Medicare, are two of the most politically sensitive issues that all political leaders must deal with. If anything is ever to be accomplished in the way of reform, it must be bipartisan.

The President has taken a necessary first step to accomplish this. The President's move to open a public dialog and put a timetable in place is action embraced by all of us in Congress who already have been talking about the crucial need to reform Social Security.

But we here in Congress also understand that tackling a problem as large and as sensitive as Social Security requires presidential leadership. So on behalf of my colleagues, I say to President Clinton, welcome to the debate.

Before I discuss the focus of today's hearing I would like to address the issue of the projected Federal budget deficit. Of course, there is no surplus yet, but from all the talk, you would think that the money is burning holes in everybody's pocket.

Since the President made his pledge to save Social Security first, we have been trying to unravel exactly what those words mean. They do not mean that the President proposed a transfer of Social Security revenue into some account walled off from Treasury—not at all. What do those words mean in the short term? I think they mean that we should not spend any budget surplus until we have enacted a program to restore the long-term viability of Social Security. In practical terms, not spending the surplus will reduce the Federal debt.

We must make full use of the window of opportunity made possible by the budget surplus, but reform of the Social Security program will present a special challenge. And quoting from the Post, which addresses President Clinton's speech yesterday, I quote from the President, "Do not have a tax cut. Do not have a spending program that deals with that surplus." I welcome that statement because it mirrors some things that I have said, that we have an opportunity as far as the surplus is concerned if Congress just does nothing. In other words, if we don't pass any laws dealing with this windfall, we do good. We automatically pay down the national debt. Congress doesn't have to act. That puts the government in a very good position to meet our obligations to Social Security.

I suppose I could be accused of one-upmanship to the President at this point if I would suggest that, as the President has said, don't mess with the surplus. The President has suggested additional revenue, a good deal of it, from the tobacco settlement if there is such a settlement, as an example. And I would suggest to the President that if we are going to be entirely credible, and I am not accusing him of not being credible—he is very credible on everything he has said to this point—but with additional revenue coming in, we can really strengthen the Social Security system by making sure that that doesn't go to a lot of new programs. That money could also go to shore up Social Security.

The Social Security program is now 62 years old and may be starting to show its age. The program that was created in the 1930s looks very different. The country it was designed to serve looks far different than it did in 1936. We have more two-earner families and we have many more people covered by private pensions.

But the greatest change society is undergoing is the dramatic shift in the number of people who are over the age of 65. We could say to Otto von Bismarck 110 years later that people do live beyond the age of 65 and they are going to retire sometime and draw out of Social Security.

In 1940, 8 percent of the United States was 65 or over. That is 57 years ago. By the year 2030, that number is going to increase from 8 percent to 20 percent. Life expectancy for a man who reached age 65 in 1940 was 12 years. By 2000 it is projected to be 15.5 years. For women, life expectancy at age 65 was 13 years. By 2000 it will almost be two full decades, 19 years. Just think what life expectancy rate we may achieve in the future as we continue to reap the benefits of medical technology.

Changing those demographic proportions has made reform of the program inevitable. Consideration and study of a variety of programs to reform Social Security is now under way. Some proposals assume no major restructuring of the Social Security program. However, other proposals go beyond restoring financial balance.

Dramatic changes to the program have been proposed, which try to meet other objectives that are new to the Social Security equation. For instance, providing a reasonable rate of return on contributions is a relatively new objective. Unfavorable returns for future generations mean that Social Security is not a good investment when looked at strictly from the retirement perspective.

For some, reform of Social Security is about how to continue providing individuals with an adequate income when their working years have ended because of their old age. But for others, the debate over Social Security will be much wider in scope.

So the purpose of this hearing is to sort out the objectives that different groups want to achieve through Social Security reform. There have been many different road maps for reform laid out before us but a map does not do any good if we don't know where we want to go. In order to evaluate the various reform proposals, we need to come to a consensus on the role Social Security should play in our lives.

We have asked witnesses with diverse viewpoints to come here. We have our Commissioner of Social Security with us. The Commissioner will present the first testimony by a Social Security Administration official on the issue of reform of the Social Security program since the President has started his strong initiative.

We will also hear from former Congressman Tim Penny; an officer of the AARP, Joseph Perkins; and Fidel Vargas, a member of the 1994–95 Advisory Council on Social Security. These witnesses will provide us with their view on what the mission of Social Security should be in the next century.

Finally, Jane Ross of the GAO will be here. She will describe some of the conflicts that arise in trying to achieve the objectives that other witnesses will discuss.

With the President's call for national public forums, Social Security reform has been put on hold for one more year. One of the first priorities in this discussion will be to reach some understanding of the objectives Americans want this reform to achieve.

Let me repeat something. Unless we come to some agreement on what Social Security will do, reform will not succeed. I hope this hearing will push open the lines of communication so that we can reach where we are headed.

I now want to call upon our two colleagues who have come, to make their opening statement. We usually call in the order of their coming, so that is Senator Reed of Nevada—I mean Rhode Island—and then Senator Reid of Nevada.

Senator REID. We are interchangeable. It doesn't matter.

STATEMENT OF SENATOR JACK REED

Senator REED. Thank you, Mr. Chairman. I want to commend you for holding this hearing and addressing this very crucial issue.

Social Security has represented a fundamental intergenerational commitment in our society for more than 60 years but it is facing a huge demographic shift which is causing fewer people to work to support more people who have reached the age of 65 to retire. We have to confront this issue very straightforward. It is not an easy issue but it is an unavoidable issue because the population will continue to age and we will see the Social Security system under increased pressure.

I think it is important to have a dialog about these issues, not only here in this committee but also throughout the country and I am encouraged that such a dialog is beginning to take place, not only to arrive at a solution but also to legitimize in the minds and the hearts of the American people what this solution should be.

So I am encouraged today that we are beginning that dialog and I want to again commend you and look forward to our continued deliberations on this issue, and I thank the Chairman.

The CHAIRMAN. Thank you and I want to thank both of you for your participation because there is so much conflict this morning. So I appreciate very much your being here.

Senator Reid of Nevada.

Senator REID. Mr. Chairman, one of the first things I would note is people are always wondering what the difference is between Democratic and Republicans. I, this morning, have figured out one difference. When we were in charge we all had pads on our chairs so we were as tall as the Chairman. Now we are kind of in a hole, aren't we, Jack?

Senator REED. No, I sit tall, Harry.

The CHAIRMAN. I suggest to you there is a screw underneath your chair. I will screw it up next time so that you are on the same level I am because you truly are on the same level I am.

Senator REID. You are not suggesting I have a screw loose?

The CHAIRMAN. No, you do not have. I can say categorically you do not have.

Senator REED. We hope you don't screw it up, Mr. Chairman.

STATEMENT OF SENATOR HARRY REID

Senator REID. Thank you, Mr. Chairman. Mr. Chairman, I an pleased that the first hearing of the second session of this 105tl Congress is dedicated to Social Security.

I welcome the new Commissioner here. We appreciate the worl that you have done and that you have to do, which is even mor important.

Social Security is a program that is often referred to as the mos successful social program in the history of the world. I acknowledg that and I believe that to be the case. This is a program that pro tects almost 32 million seniors and 12 million individuals unde the age of 65 from conditions of poverty and a program that bene fits the elderly and allows them to live their latter years with dig nity, a program that pays benefits to a covered worker's spouse children and their survivors.

Today we will examine the objective of the Social Security program in the context of overall retirement. I hope we do so with a clear understanding that Social Security is a social insurance package. It provides income replacement after retirement, death or disability of worker.

Because it is a universal social insurance program, we are able to offer coverage to many. If such a successful government program were not available, coverage would be out of the reach of many, many Americans.

It has been stated that without a clear understanding of what we as a nation want from Social Security, it will be difficult to examine reform proposals. This is just as the Chairman said. It doesn't do any good to have a map if you don't know where you are headed. I think that's an important part of this discussion. Let's try to find out where we are going before we develop a map.

There is little doubt in my mind regarding the purpose of Social Security. It exists to provide a floor of protection to American workers and their families to replace income lost due to retirement, death or disability. It has been extremely effective in fulfilling this mandate.

I have supported the notion that effective retirement planning be based on three legs, a three-legged stool it's been referred to: one provided by Social Security, one by employer-sponsored plans and one established as a result of private savings. All three are essential elements of a strong retirement financial plan.

We, as policymakers, need to do all we can to ensure the American people understand this concept and the vital importance of one leg of this stool. What concerns me recently is what appears to be a philosophical shift in the country in favor of shifting the onus of responsibility for the sturdiness of the stool solely to the shoulders of the individual. Instead of having a balanced stool, it would be just one leg.

As we shift to defined contribution from defined benefit pension plans; consistently emphasize the need for individuals to engage in private saving efforts; and now hear so much discussion to privatize or partially privatize Social Security; many in and out of government appear to be encouraging us to step away from our role in ensuring a strong Social Security retirement program.

The contribution provided by Social Security to ensure its leg of the three-legged stool is sturdy must be protected and should remain a firm commitment of this government to honor its pledge to the American worker and their families.

I was happy to hear in the State of the Union message the much talked about expected surpluses would be set aside to ensure the viability of the Social Security Trust Fund. The great debate about tax cuts today or Social Security for tomorrow comes down very succinctly to a question of paying now or paying later.

There are some who would rather pay the tax-paying public now by offering an immediate tax cut. This sounds very attractive. Who wouldn't want an immediate break today without concern for the impact on the future?

I believe it is more important though, Mr. Chairman, to first honor the debt already owed, honoring our Social Security benefit for the future, before we offer a dividend today that will bankrupt the future. To do anything less is fiscally irresponsible.

I have tried to do this before by offering amendments to exempt the Social Security Trust Fund from inclusion in calculations for a balanced budget, and I will continue this argument in the foreseeable future because it is the right thing to do.

One must honor past commitments before incurring new ones. This is nothing more than sound financial management.

Regarding the future of the Social Security program, we will need to make changes to address the demographic shifts that are occurring. It is not fair however to change the ending of the play in the final act. Once we honor the commitments we have made, then we can and must talk reform to assure the system is designed to carry us into the next century. My hope is that we will respect the Social Security insurance component of the program and insist that it remain a universal program, providing a benefit to all workers and their families.

Today's beneficiaries, as well as those of tomorrow and beyond, are counting on its availability when their day comes.

We have a very successful program that requires some change to address the realities in the years ahead. We have time because we are acting now to make careful, hopefully thoughtful and incremental changes. We are fortunate that the Social Security program today enjoys a surplus but we must ensure that this surplus is protected for its intended purpose. That purpose, quite simply, is to honor the government's commitment to the stool that I have talked about, the leg of the stool for the individual's retirement security.

As policymakers we should also continue to address which programs promote the other two legs, as well. That is employee pensions and personal savings. Some work is done in this area but much more needs to be done.

When President Roosevelt signed the Social Security Act in 1935 he said, "We can never ensure 100 percent of the population against 100 percent of the hazards and vicissitudes of life, but we have tried to frame a law which will give some measure of protection to the average citizen and to his family against the loss of a job and against a poverty-ridden old age."

So as we discuss today what our national objective for this nation's Social Security program should be, I hope we will remember the words of President Roosevelt expressed 63 years ago. The role government has played through Social Security in insuring that our elderly have a meaningful quality of life in their senior years cannot be denied. Protecting workers and their families from loss of income due to death or disability has been vital to the stability of our society.

As we discuss reform to ensure the long-term solvency of Social Security, let us be careful before jumping to embrace proposals that shift all burden to the individual. While these proposals might look attractive while the markets are high, let us not forget that a market that is up today could be down tomorrow. If we forget the past and only focus on the immediate financial gain, I worry that we will set our nation up to repeat the very history that led President Roosevelt to create the Social Security program in the first place.

The CHAIRMAN. Thank you, Senator Reid.

Senator Santorum and then Senator Burns.

STATEMENT OF SENATOR RICK SANTORUM

Senator SANTORUM. Thank you, Mr. Chairman. Mr. Chairman, first I just want to congratulate you and thank you for holding this hearing and for lining up such an impressive list of people to testify. Unfortunately, I won't be able to stay very long but I do want to congratulate you for this, focussing the attention of the American public on an issue which I think is one of the most important facing not the elderly, although this is the Aging Committee, but I think more so, Social Security right now impacts, at least in a psychologically real way, young people in this country.

I have the opportunity to go around and talk to young people a lot. I have been to over 100 high schools since I was elected to the

U.S. Senate and I talk to young people and there is one question I always ask. Actually, it is two questions.

I ask the question how many people believe in UFOs and then I ask, how many people believe that their Social Security will be there when they get to be retirement age. Usually by a two- or three-to-one margin more people believe in UFOs than they believe Social Security will be there when they retire.

In fact, the few people that do raise their hand are laughed at by their fellow students because they understand the dynamic that is at work, which is they are paying a lot of money into a system that is not going to be generationally fair to them, as it has been to previous generations; that as a result of the demographics, not just the Baby Boom generation but probably as important, if not more important, the fact that people are living substantially longer, that it is going to have fewer and fewer people paying for more people on retirement; and that the system will be very costly to them and the benefits are, at best, uncertain.

If we continue with this head-in-the-sand approach, in fact, if we just sort of tweak the system believing everything will be okay, we will be left with a system that will continue to be unfair generationally. Even if we fix it so that there is money there, it will be much more costly and the return on the contribution that people have made into the system will not be fair to future generations, even if we "fix it" so it is financially secure.

That is not the way this system should work. It should work so, in fact, people have an opportunity to get a reasonable rate of return on the taxes or investment or insurance that they are paying, whatever you want to call it. The only way to accomplish that I know of is to transition Social Security.

I know this is on camera so we have it for the record here. In this respect I agree with the President of the United States, and I don't say that very often so I thought I would get that on the record. I agree with the President of the United States that we should use the surplus to transition Social Security. We should not use it to prop up a system that is unfair for future generations of America. We should transition it so young people can have some hope that the tremendous amount of money that they are paying into the system is going to somehow make its way back into their pockets when they need it, when they turn retirement age. And obviously the way to do that is through a private savings component of the system.

I believe Social Security needs to be maintained in some form. It is a social insurance program, but just that—an insurance program, not a transfer payment program that is a pay-as-you-go system. That is not a fair generational program.

There are lots of things that we can do. The most important, I believe, is to hold people in the system harmless and those approaching retirement harmless. But we have to create new opportunities for young people in this country and if we don't do that then we are really looking at the younger people in this country and the future generations and saying, "Frankly, we don't care much about you; we just care about satisfying the very powerful interest groups that happen to populate the halls of the U.S. Congress."

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Santorum.
Senator Burns.

STATEMENT OF SENATOR CONRAD BURNS

Senator BURNS. Thank you, Mr. Chairman, for holding these hearings. I think it is very important.

The American people are telling us that we should reform Social Security and I, too, agree with the President in what he had to say the other day. Now, how we do that, we may differ.

But I want to associate myself with Senator Santorum because I speak to a lot of young people, too, that have a lot of cynicism about the program and the amount of money that they will put in it and how much money will be returned to them when they retire.

Social Security didn't really enter my thinking until last January 25. It is more on the front burner now because I turned that age. You wonder where we can put our money to ensure that not only do the people who administer the programs but also the people that have to pay the money in get a fair return on their investment; plus the fact that we know there are those in our society that have problems saving money to take care of their retirement and we must be aware and cognizant of their needs, also.

So how we marry that and how we deal with that will have to be done in a very sane, quiet debate, rather than getting carried off on emotions or subjects that can be demagogued very easily by either side of the debate.

So I appreciate the Chairman for confronting this, having this hearing. We will be very interested in hearing what the Administration has to say. I think the ultimate responsibility is going to fall on the shoulders of this Congress if we are to have a system that protects the integrity of the system but also returns to the taxpayers and the people who invest in Social Security their due.

Thank you very much, Mr. Chairman.

[Prepared statement of Senator Burns follows along with prepared statements of Senators Jeffords, Craig, and Hagel:]

PREPARED STATEMENT OF SENATOR CONRAD BURNS

Thank you, Chairman Grassley. I want to thank you for holding this important hearing this morning.

We have a real problem on the horizon as the number of Social Security recipients increases relative to the number of workers. We know exactly what will happen: payroll taxes will increase from the current 12 percent to over 17 percent in 2030, according to estimates I've seen. Taxes at this level will bring a whole host of new problems for workers and employers alike, and would take a serious toll on our GDP and standard of living.

I think most Americans realize Social Security will need some substantial changes in the next few years. This is certainly the case among younger Americans, many of whom are pessimistic about ever receiving a Social Security check. So if we are near a consensus that structural changes need to be made, the burning questions become where do we want to go?

Today's workers are much more sophisticated about retirement savings than their parents were. National savings rates are still considered too low, but with the rise of private pension plans such as 401(k) plans, more workers than ever are actively saving for retirement. I think we need to look at giving workers freedom and opportunity to invest in new savings vehicles as part of Social Security, while maintaining a safety net. A double tiered system with an investment tier could result in greater benefits at level or reduced costs.

There are many questions about where we should go, not to mention how to get there. I look forward to hearing the advice of some of the experts this morning.

PREPARED STATEMENT OF SENATOR JAMES M. JEFFORDS

Yesterday, the Clinton Administration proposed holding regional conferences on the future of Social Security. I look on this hearing before the Special Committee on Aging as the legislative equivalent of a national town meeting on Social Security. With the broad spectrum of opinion on the subject represented here today, we can make a good beginning on setting forth the parameters of the problem.

As Jane Ross of the GAO will testify, we must balance income adequacy and individual equity; we must allocate risks and responsibilities to taxpayers; we must choose among various benefit reductions and revenue increases; we must decide between pay-as-you-go or advance funding; and we must decide how much to save and invest in the nation's productive capacity. And we must make explicit the underlying assumptions that each proposed plan makes so that they can all be scrutinized in the plain light of day.

As Ms. Ross will testify, one such reform proposal to increase the role of individual savings would change the overall mix of different types of retirement income and, with it, the relative emphasis on adequacy and income equity of our current mix.

This change in the mix will impact on other programs that form the social safety net for seniors. So what we do with Social Security must dovetail with our other legislative efforts—such as ERISA, IRS reform and Medicare—to address the problem from its four corners.

For example, recently five other members of the Senate Finance Committee and I sent a letter to the Commissioner of the IRS warning him that the IRS must treat with greater flexibility businesses that voluntarily attempt to correct errors in their pensions. It is crucial that businesses do not face disincentives to running their pensions in the best way that they can, and feel able to correct errors when they are found. The alternative would dissuade employer sponsored pension benefit plans altogether—which would itself adversely effect Social Security by increasing its workload.

We must look at proposals to provide beneficiaries with options to invest wage taxes in mechanisms other than government bonds. But, while we're looking at them, we must bear in mind that, since its inception, most of the actuarial assumptions about Social Security have been proven wrong.

I thank Senators Grassley and Breaux for organizing this hearing and I believe that it will be the first in a series of salutary efforts to define a sound strategy for Social Security reform.

PREPARED STATEMENT OF SENATOR LARRY CRAIG

Mr. Chairman, thank you for holding this very important hearing on the future of our Social Security System. This hearing today really begins the debate in earnest, and I am privileged to be able to participate. I commend the Chairman and the Ranking Member for gathering such a broad-based and experienced panel of witnesses. I'm especially happy to see my former House colleague and friend, Tim Penny, on the panel. Many times when we served together in the House, we worked for fiscal responsibility and balancing the budget and it is my pleasure to welcome him here today. I look forward to listening to all our witnesses today.

It is clear that the Social Security system we have in place today needs to be fixed. According to the intermediate estimates of the Social Security actuaries, starting in 2012, payroll tax revenues will be insufficient to cover outgo from the funds. Total income is expected to fall short of outgo beginning in 2019, and the funds are due to be exhausted in 2029. These statistics become reality in the not-so-distant future. We need to firmly address the problems within the system, as well as create a consensus on what the goals of the program should be. We need to do this now.

During this debate, however, it is important that we keep in mind that whatever reforms we make are aimed at protecting our seniors now and in the future. No one is talking about cutting benefits for our seniors, and I hope no organization tries to block needed reform by frightening older Americans. Never again should those of us who want to save problems like Social Security and Medicare have to fight against political demagoguery.

We have established that we do need to address the problems facing Social Security for the longer term. At the same time, we are looking at how the Balanced Budget Act will affect the Social Security trust fund and vice versa. In the past, Congress has sometimes waited to act until a problem became a crisis. That is why we must keep in mind that we also should address the future of Medicare, which is a more immediate need. Medicare part A will be completely insolvent by the year 2010. The Medicare trust fund will be in crisis years before the Social Security trust fund. We need to remember that for the total security of seniors, we will have to address both Medicare and Social Security.

Social Security worked just fine for many years, given the demographics and the demographic projections of the 1940's and 1950's, but the world has changed since then. People are living longer, and the numbers of workers relative to the number of retirees is steadily declining. Changes in society and demographics have essentially turned the old Social Security system into a pyramid scheme.

The right reforms ultimately mean that we continue to protect the economic security of our seniors and protect the next generation of workers from a ruinous tax burden. Generally speaking, Social Security needs to be changed from exclusively a system of transfer payments into a true system of savings over which today's workers and tomorrow's retirees have some control.

In the State of the Union, the President talked about dedicating budget surpluses to protecting Social Security. That will happen automatically, as long as we do indeed run budget surpluses. The danger to Social Security is in the new spending on bigger government that the President is proposing. We should especially be wary of new entitlement programs, because they have a consistent history of costing much more than originally projected. There is room in future budgets for both a surplus and some additional tax relief for overburdened Americans. There is not room for the time bomb of major new entitlement spending.

I look forward to the discussions here today. I think it is very important that we hold this hearing so that we may educate ourselves and the public about the Social Security crisis that will affect all Americans.

PREPARED STATEMENT OF SENATOR HAGEL

Thank you, Mr. Chairman. I would like to thank you for calling this important hearing of the Senate Special Committee on Aging.

We all want exactly the same thing—to keep the Social Security system strong and secure. This program has been important for each generation of Americans since the 1930s and we must ensure that Social Security remains solid and dependable 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 a key part of this process.

Social Security is the single largest program in the Federal Government. In 1998, the Congressional Budget Office estimates that the Social Security trust funds will pay out $381 billion in benefits—almost one-fourth of total Federal outlays. But this issue is not just about numbers—it's about people. 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 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 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 retiree drawing from it.

Today, that ratio is about 3–to–1. By 2030 there will be only two active workers for each retiree. By 2012, Social Security will be taken 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 bankrupt by 2029.

We can't let that happen to Social Security. 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 will be big payroll tax increases, big benefit cuts, or both. That is unacceptable.

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 their retirement 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 need to move to an investment-based approach to Social Security. Individuals should be able to invest a portion of their payroll taxes in private securities held in personal retirement accounts. A majority of the 1996 Social Security Advisory

Council supported transitioning into investment-based personal accounts. Other countries have adopted or are considering adopting similar reforms, including the United Kingdom, Australia, Sweden, Italy and Chile. Personal retirement accounts would harness the power of private markets and compound interest, giving individuals an increased sense of ownership of their retirement savings. They would also reduce future demands on the Social Security trust funds, increase national savings and promote economic growth and personal wealth.

We have time to do what is right for Social Security and for our people. We must use that time to craft thoughtful, lasting solutions before a crisis is upon us. We must keep an open mind and study all of the options.

Above all, this issue must be taken out of politics. If we work together with honesty and courage, 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.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

Commissioner Apfel is the head of the Social Security Administration. We in the Senate know him because he was a close associate as a member of the office of Senator Bill Bradley and he worked on the issue of social policy for Senator Bradley and Senator Bradley was a very important member of the Finance Committee that I serve on.

Also Commissioner Apfel served as associate director for human resources at the Office of Management and Budget. He also served as assistant secretary for management and budget at the U.S. Department of Health and Human Services.

We have asked each one of our witnesses to stay within seven minutes. If that is too short of a time for some of you, just figure out how short it is and please inform me ahead of time. But if we can, that will give us an opportunity to have a good round of questions.

Commissioner Apfel.

STATEMENT OF KENNETH APFEL, COMMISSIONER, SOCIAL SECURITY ADMINISTRATION

Mr. APFEL. Thank you, Mr. Chairman and members of the committee for inviting me to appear before you today. It is an honor to appear before the Aging Committee. I spent many years sitting on the back row, in an earlier life many years ago, and I know the importance of this committee to the American public.

I believe no issue is more important to the American people than ensuring Social Security's future. And for that reason I am especially pleased that this is the topic of my first congressional hearing as commissioner of Social Security.

Yesterday morning at Georgetown University, President Clinton stated that "Social Security has been there for America's parents in the 20th century and I'm determined that we will have that kind of security for the American people in the 21st century."

As we move to address the challenges facing Social Security in the future, we must remember what Social Security has meant and what it means to America. In its more than 60-year history, Social Security has become the most successful domestic government program in our nation's history and our most significant anti-poverty program. Only one in nine older Americans have incomes below the poverty line today and about 40 percent are kept out of poverty by their monthly Social Security benefit.

While most people think of Social Security as a retirement program, it is also much more than that. It is America's family protection program. About one out of every three Social Security beneficiaries is not a retiree. They are workers or families who receive income protection in the event of a wage-earner's death or disability. This protection can be invaluable, especially for young families that have not been able to protect themselves against the risk of the worker's death or disability with private insurance.

But many younger workers are wary that the retirement benefits of the program will not be there for them in the future. Today the trust fund reserves are building rapidly. However, they are projected to become exhausted by 2029. At that time revenues will be sufficient to pay only about 75 percent of benefits due. The underlying reason for the shortfall, as the Chairman has pointed out, is that America's demographics are changing. People are living longer, and this is good news. In 1945 the average life expectancy for a 65-year-old was about 14 years. Today it is 18 and rising.

But it isn't just the number of years people are living; it is the number of people living them. There will be nearly twice as many older Americans in 2030 as there are today.

While these demographic changes raise serious, long-range solvency issues, Social Security is not a program in crisis and if we act wisely, we can prevent a crisis from ever occurring.

President Clinton has said that the time to act is now. The budget has been balanced, the economy is strong and our fiscal discipline provides us with the opportunity to ensure economic security for future generations of retirees. During President Clinton's State of the Union address he proposed that decisions on spending the budget surpluses be deferred until we address the program's long-range solvency. He said that we must save Social Security first. In doing so, the President made clear that he intends to work with Congress in a bipartisan manner to preserve the program.

Toward this end, the President is calling for a national dialog on how we can best achieve this goal. Yesterday at Georgetown University he announced that the first in a series of four nonpartisan forums will take place on April 7 in Kansas City. Activities are under way with the Concord Coalition, with the AARP and with the Pew Charitable Trusts.

The President has also said that the national call to action must spread to every corner of the country. He has asked members of Congress to hold forums in their districts and he has invited other organizations to play a role.

An accurate understanding of the facts about Social Security is needed as the foundation for this public discussion. The Social Security Administration will be focusing its efforts on educating the public about Social Security so that Americans are in the best possible position to talk about the program's future.

What do I believe Americans should understand about their Social Security program? I want all Americans to understand the economic facts about Social Security. The trust funds now take in more than is paid out and large reserves are being accumulated, but they will be exhausted in 2029 if no changes are made to the program. An understanding of the economics is a very important precondition.

I want all Americans to understand what Social Security has meant to older Americans. Social Security provides them with a solid measure of economic security, even if they outlive the actuarial tables and their savings.

I also want all Americans to understand that Social Security is much more than a retirement program. I want younger people to know that not only will Social Security be there for them in the future, with changes, but it is there for them now through disability and survivors protection.

I want all Americans to know that Social Security was never intended to provide for all of a worker's retirement income needs, as Senator Reid pointed out, when Roosevelt signed it. Pensions and personal savings have always been and should always be a part of a sound financial retirement plan.

I want everyone to understand that, as I noted earlier, changing demographics are driving the need for change.

Finally, I want all Americans to understand one important fact: there is no free lunch. As attractive as any option for change may be, there are trade-offs that must be accepted if we choose it. The advantages and disadvantages of each will have to be examined and discussed in the year ahead.

With these facts, people will be able to make informed choices about the Social Security program of tomorrow.

As they consider change I hope they will ask themselves some hard questions. Will changes to the program preserve and protect important Social Security accomplishments? Will Social Security continue to be a benefit that people can count on? Will the elderly, the disabled and survivors of workers be protected from financial hardship? Will the program be universal, efficient, fair, and maintained as a public trust?

In conclusion, let me say that I strongly support the President's initiatives to begin to restore Social Security to long-term fiscal health. What is needed now is a full and an open public debate. Part of the Social Security Administration's role in this process will be to continue the process of educating the public about Social Security: how it works, what has it achieved and the nature of the long-range actuarial problem. The public discussion must take place not only in think-tanks and congressional hearing rooms but in family living rooms all across America.

This Administration and this Congress have demonstrated that they are capable of coming together in a bipartisan way to fashion solutions important to this nation. I look forward to closely working together with the members of this committee and the Congress in that spirit on this very important endeavor.

[The prepared statement of Mr. Apfel follows:]

PREPARED STATEMENT OF KENNETH S. APFEL

Mr. Chairman and Members of the Committee: Thank you for inviting me here today. I am especially pleased that the topic of my first congressional hearing as Commissioner of Social Security is to discuss how we begin to strengthen Social Security for the 21st century, because I can think of no issue more important than ensuring the program's future.

President Clinton's message on Social Security in his State of the Union message is clear: "Save Social Security first". One of our most important goals today is making sure Social Security is financially sound. I strongly believe that we can meet that goal, and today I would like to discuss how we can begin to take steps to accomplish it.

Importance of Social Security

It would be almost impossible to overestimate the importance of Social Security in American lives. Only 1 in 9 elderly people have income below the poverty line today, compared to 1 in 3 in 1959. About 40 percent of beneficiaries age 65 and older—and more than 15 million beneficiaries overall—are kept out of poverty by their monthly Social Security benefits.

Social Security is the most successful antipoverty program we have. It is the major source of income for 66 percent of beneficiaries age 65 and older, and it contributes 90 percent or more of income for about 33 percent. Poverty protection is reinforced by Social Security providing benefits which are inflation adjusted through an annual cost of living adjustment known as a COLA.

Much of the current debate concerning the future of the Social Security program has centered exclusively on the retirement program. But this narrow perspective on the program ignores the vitally important insurance benefits that the program provides in the event of the death or disability of a worker. For instance, almost 1 in 6 of today's 20-year-olds will die before retirement, and 3 in 10 will become disabled. Over 30 percent of our Nation's Social Security beneficiaries are receiving disability and survivors benefits, and those programs make up over 30 percent of the benefits Social Security pays.

This protection can be extremely valuable, especially for young families that have not been able to protect themselves against the risk of the worker's death or disability with insurance policies. The average benefit paid today to a disabled worker with a spouse and children is about $1,200 per month. For a family in which the worker dies, leaving a widow with two children, the average monthly survivor benefit is about $1,500.

Serious problems must be addressed

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. 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 Old-Age and Survivors Insurance (OASI) and Disability Insurance (DI) Trust Funds are projected to become exhausted in 2029, at which time revenues will be sufficient to pay about 75 percent of benefits due.

The underlying reason for the shortfall is that the demographics of America are changing. First, people are living longer, and fertility is declining. Today, the average life expectancy for an individual reaching age 65 is 18 years; back in 1945, the average 65-year-old was expected to live an additional 14 years. The number of people over age 65 is climbing. We expect that the population of elderly—currently 35 million—will nearly double between now and 2030.

Not only is the population of retired workers increasing, but it is increasing faster relative to the number of workers contributing to Social Security. Today, there are 3.3 covered workers for each retiree, but by 2030 there will be only about 2 covered workers per retiree. That ratio generally holds for far in the future.

While these demographic changes raise serious long-range solvency issues, Social Security is not a program in crisis. The projected shortfall in the system, while serious, will not happen for almost three decades, by which time the program will be almost 100 years old.

Nevertheless, President Clinton has wisely said that the time to act is now—the budget has been balanced, the economy is strong, and our fiscal discipline provides us with the opportunity to ensure economic security for future generations of retirees. In fact, I believe that under the President's leadership, we have the opportunity to avoid a crisis, and early action in approaching the solvency problem is the safest course. If we wait ten or twenty years to make changes, the changes will need to be more drastic, and the opportunity for individuals to plan for their retirement needs will have been lost. The American people deserve early action to be able to plan for changes. The earlier we can determine the changes that must be made to the current program, the better off we will be.

When it comes to a program as important as Social Security, there are no such things as "minor" changes. Any change is going to impact on the lives of most Americans, and as such deserves serious consideration. However, the history of the program is one of evolution and change. As the program has evolved over the past decades, through the additions of the disability and Medicare programs and the changes of the 1977 and 1983 Amendments, so must it now evolve again.

Process for reaching consensus for change

During President Clinton's State of the Union address, the President voiced his strong commitment to strengthening Social Security for generations to come. He has proposed that the Federal budget surpluses be reserved pending Social Security reform. In doing so, President Clinton has made it clear that he intends to work with Congress in a bipartisan effort to preserve the program.

Toward this end, the President is calling for a national dialog this year on how we can best achieve this goal. The President has called on the American Association of Retired Persons and the Concord Coalition to hold jointly three or four regional nonpartisan forums throughout the country on Social Security. The President, Vice President, and members of the Cabinet will participate in these forums.

At the end of the year, the President will convene a conference on Social Security at the White House, followed by bipartisan negotiations with congressional leadership on how to best achieve Social Security reform. This bipartisan, national debate can achieve, as the President has said, "a landmark for our generation—a Social Security system that is strong on the 21st century."

We need to be able to meet the challenges of the demographic changes I have just discussed and be sure that Social Security will be there for younger workers, just as it was for their grandparents and parents.

As we begin this dialog, we need to reflect on what features have led to Social Security's success. The dialog will most certainly be about how to address the challenges facing Social Security in the future, but it will also be about how we preserve and protect the accomplishments of the program that has served this nation so well for over 60 years.

First of all, Social Security is dependable. Social Security has been there each and every month. Millions of Americans count on the arrival of their Social Security benefit. Today, more than 90 percent of the elderly in this country receive Social Security. Americans of all ages must be able to count on Social Security in the future. We have an obligation to provide a dependable source of income that Americans can use to plan their financial future with confidence.

In addition, Social Security is efficient. Less than one penny of every dollar collected is used for administering the Social Security program. It is a program that is portable and it is a program that provides benefits that are indexed to inflation.

Social Security is also the greatest anti-poverty program ever created. Without Social Security, nearly 50 percent of today's elderly would be living in poverty. Social Security doesn't make people rich, but it gives Americans rightly deserved financial independence. This financial protection, however, is not just for the elderly. Social Security also protects working families through disability and survivors insurance.

Social Security ensures that all workers receive an equitable benefit through a progressive benefit formula. It is a program that is universal and fair. Proportionally larger benefits are provided to lower income workers who will need it most.

Finally, Social Security is a public trust. Social Security spreads the risk associated with disability, premature death, and old age among the entire working population and provides a guaranteed benefit that is adequate and fair.

As we begin this dialog, we would do well to question whether changes to the program preserve and protect these important accomplishments: whether Social Security continues to be a benefit people can count on; whether the elderly, disabled, and survivors of workers are protected from financial hardship; whether the program is efficient; whether the program is universal and fair; and whether the program is maintained as a basic public trust. The dialog about how we ensure the solvency of Social Security in the 21st century will need to include these critically important questions.

Public participation critical

As President Clinton has said, we must inform Americans about Social Security and the issues confronting it. The President's proposal to conduct regional forums to raise public awareness of the problems facing Social Security acknowledges an important truth: the broad-based participation of the American public is critical to achieving a resolution of the long-term solvency issue. An accurate understanding of the facts is needed as the foundation for public discussion. We have been focusing our efforts on educating the public about the Social Security programs to put them in the best possible position to be able to enter into public debate about options for the future of Social Security.

What do I believe Americans should understand about our Social Security program? What is it about this program that reduced to essentials makes it of such important to the American electorate?

I want all Americans to understand the economic facts about Social Security. Presently, the Social Security Trust Fund takes in more money than it spends, creating reserves to the Trust Fund. These reserves were designed to help pay for the future growth in the benefit rolls in the early part of the next century. Beginning in 2019, the Trust Fund will start declining and will be exhausted by 2029, if no changes are made to the current program. Even after the Trust Fund is exhausted, however, annual revenues will still be able to pay three-quarters of current-law benefits.

I want all Americans to understand what Social Security has meant to older Americans. The plight of older Americans used to be a national disgrace. Now, Social Security provides them with a solid measure of economic security even if they outlive the actuarial tables . . . and their savings. It also provides many of them, and their children, the advantages that only living independently can offer.

I want all Americans to know that Social Security is more than a retirement program. I want younger people to know that not only will Social Security be there for them in the future, but it is there for them now. How many people know that 1 out of every 3 Social Security beneficiaries is not a retiree but a disabled worker, or a member of his or her family, or a survivor of a worker who has died? They need to know that.

I want all Americans to know that Social Security was never intended to provide for all of a worker's retirement income needs. Pensions and personal savings have always been and should always be part of a sound financial retirement plan.

I want all Americans to understand that the changing demographics of the country are the primary driver of the need for change. There is an unalterable dynamic at work: by 2030, there will be nearly twice as many older Americans as there are today, putting great strains on our retirement system.

Finally, I want all Americans to understand one important fact: there is no free lunch. As attractive as any option for change might be, there are tradeoffs that must be accepted if we choose it. These are complex issues. The advantages and disadvantages of each will have to be examined and discussed.

Let me remind you again that the purpose of public education is to enable members of our society to participate in an earnest and informed dialog about this most important issue. We need to hear from Americans on this issue. Their views are clearly important because Social Security is their program.

Conclusion

I strongly support the President's initiatives to begin to restore the Social Security program to long-term fiscal health. What is needed now is a full and open public debate. I would like to emphasize, however, that as we begin to seriously address these issues, we must continue to preserve fiscal discipline and not increase the Federal deficit. For the sake of our children and future generations, we must not jeopardize the progress we have made in balancing the budget.

Part of SSA's role in this process will be to continue the process of educating the public about Social Security: how it works, what it has achieved, and the nature of the long-range actuarial problem. The public discussion must occur not just in congressional hearing rooms but in the living rooms and kitchens throughout the country.

This Administration and Congress have demonstrated that they are capable of coming together in a bipartisan way to fashion solutions important to this nation, and I look forward to working closely with the members of this Committee in that spirit on this important endeavor.

The CHAIRMAN. Thank you very much. Would staff keep the time for five minutes for each member?

Senator REID. Mr. Chairman?

The CHAIRMAN. Yes.

Senator REID. As you have indicated, there are a lot of things going on. If I could just take 30 seconds to acknowledge that I wanted to come to hear my colleague, former colleague Tim Penny testify. Tim and I came to the House together. He was the financial conscience of the House of Representatives until he retired. I am sorry I am unable to listen to his testimony. I have it here. I am going to read his testimony and I would like to be excused.

The CHAIRMAN. Thank you very much.

Mr. Apfel, I know that the President is going to use the public hearings that he has. By the way, I have called on the President to have more than the four that he has suggested, with the idea obviously he can't attend 50 if he were to hold one in every state, but there might be other people in the Administration that would be able to fill in for him because it is very important to get people thinking about this, not only from the national television that the President gets but also to be thinking about it on an on-going basis.

I know he is going to wait until he gets some evidence in and what people's views are but I am going to ask you, as much as there has been some thought within the Administration, to flesh out some of the things that the President might be thinking about or people in the Administration might be thinking about because we want to get as many ideas out on the table as we can.

It would be indifferent of me to avoid asking you about the President's statements regarding Social Security and the budget surplus. Last week's hearing on the budget, and I am a member of the Budget Committee, seemed to have clarified that the President is not proposing any legislative or mechanical change in how payroll tax revenue is treated. Taxes will go to the Treasury and be credited to the trust funds as investments in nonmarketable securities. In effect, President Clinton is saying do not spend the surplus; he is not saying that we must save the surplus literally.

The prospect of a surplus does raise a possibility that we could look seriously at using any surplus to advance-fund some of the benefits for future generations. Advance funding was something that was specifically rejected by the authors of the Social Security Act in 1935.

Secretary Rubin mentioned that the Administration is looking at ways to use the surplus to extend solvency 8 to 15 years. That would imply that the Administration is looking at a different investment policy for trust funds or advance funding for some benefits.

First question: do you think that it is time to take a second look at prefunding some of the benefits that people are counting on receiving? Additionally, could you describe for us some of the options, if they are being considered, that the Administration is reviewing which would extend the solvency of Social Security?

Mr. APFEL. Thank you, Mr. Chairman. First, I want to reiterate that the President's proposal, as you described, was to reserve those surpluses pending Social Security reform. Specifically, it was to not spend the surpluses right now.

I should also point out that the surpluses are projected to start in 1999 and we would expect in 1999 that we would have a solution on Social Security before that first surplus is actually on the books.

The issue that you raise is whether the surpluses in the future should be used for some form of advance funding.

The CHAIRMAN. Is that part of the thinking of the White House at the present time?

Mr. APFEL. There are a number of ways that the surplus could potentially be used for Social Security. The Administration is very early in this process in terms of establishing proposals and wants this national debate to go forward during this year. But, hypothetically, there is a whole range of different alternatives that again, I am not here to endorse, from, as you pointed out, buying down the debt, to providing the surpluses to the trust funds, to some form of change in investment policy for investing in equities.

There is a range of different alternatives, including the possibility of individual accounts.

The CHAIRMAN. Would they all be on the table?

Mr. APFEL. The Administration, as I said, is early in the process on this and wants to have this debate during this year. It has not made a judgment on any one of those alternatives at this point in time, but wants to explore them all in the course of the year, with the Congress.

The CHAIRMAN. Does that mean they would all be on the table?

Mr. APFEL. They are all for discussion, absolutely.

The CHAIRMAN. When I first took over as Chairman of the Aging Committee last year I stated that whatever path reform takes to fix Social Security, one of our first priorities should be to ensure that younger Baby Boomers and their children be able to count on the same level of economic protection that their parents enjoyed.

Last week, in the speech before the National Academy of Social Insurance, you indicated that how we do that is one of the biggest questions that we have to answer. Medicare faces severe problems in the very, very near term. Further, the budget will be feeling the impact of Social Security problems by the year 2012. That is the first year of negative cash flow of Social Security funds.

How realistic is it to expect that government programs can continue to provide the kind of economic protection that they have in the past? Don't we have to start looking at other alternative ways to ensure income is adequate in retirement to close the gap in the way that the government may no longer be able to do?

Mr. APFEL. It is true, Senator, that if we look out 20 and 30 years from now, the funding shortfall is significant in terms of Social Security. The dollars coming into the Social Security Trust Fund would roughly be available to pay only about 75 cents on the dollar in terms of benefits.

There is a wide range of options that are going to have to be talked about this year. Will the same full level of benefits be provided to future generations in terms of the floor of protection, the foundation of protection, as is currently provided?

The answer, Mr. Chairman, already is no. The increase in the retirement age, which was enacted in 1983, will have the effect of lowering benefits somewhat for future generations compared to the current generation of retirees. So there has already been a change that is being phased in, starting in 2003, over the next 25 years, that will have the effect of somewhat reducing benefits.

Can we develop mechanisms to assure that the foundation of support provides the full levels of support that we now have? That is really one of the open questions. That gets into the questions of possibly advance funding, as you have pointed out, changing investment mechanisms and other things that we are going to talk about.

Clearly it is going to be very hard to do so in the future 20 and 30 years out, given the financial constraints that we have.

The CHAIRMAN. I am going to go to Senator Reed. I think that I draw the conclusion from what you have said in answer to my two questions that the Administration is really looking at a lot of options. They are encouraging participation in these public hearings. These public hearings are going to play a big role in what they come up with as a plan at the end of that process.

Mr. APFEL. Well, Mr. Chairman, that is what this year is all about. We are very early in this process. These public forums are very important.

I would also add, sir, that you mentioned that there are four that the President has indicated he and the Vice President will be going to. I will be going to a lot more than that. There will be many, many forums around this country. I will be appearing in Louisiana with Senator Breaux at an Aging Committee hearing to talk about this same issue next Tuesday. I would assume I will be in Iowa. I probably will be in Texas soon thereafter. I am going to be in Denver. The list goes on.

There will be many forums for senior level officials. We need to have this debate not just here in Washington and inside think-tanks. We have to move it out into communities and into families. That is really a very important priority for me personally. I think it is a precondition for action next year.

Now, the issue will be at the end of the year how to move forward on a bipartisan process to develop a plan. That depends a lot on what happens over the course of this year and the bipartisan discussions that take place between now and then.

The CHAIRMAN. Thank you.

Senator Reed.

Senator REED. Thank you, Mr. Chairman.

Thank you, Mr. Apfel. As we consider the issue of Social Security, it is important, I think, to recognize two significant points.

First of all, the majority of the recipients, the current beneficiaries, depend on Social Security for the largest share of their income. In fact, I am told that one in four beneficiaries depend on Social Security for at least 90 percent of their income. So this is an extraordinarily vital program to so many people.

Also, it is not just important to seniors but there are hundreds of thousands of families around the country that depend on it for protection in the case of retirement or disability or death, and these are points that are critical.

Another aspect that is important is to recognize that the reliance, this reliance on Social Security is, in many respects, a reflection of the weakness in our private pension system. I am wondering, as we consider the issue of Social Security reform, how do we also integrate or develop responses to the issue of our private pension system with respect to the future of Social Security? You might want to comment.

Mr. APFEL. As you pointed out in your opening remarks, the three legs of the stool in terms of——

Senator REED. That was the other Reid, the older guy.

Mr. APFEL. We have actually talked about this before so I know it is an important issue to you, too, sir. You point out a very, very important point, that Social Security was never intended to be the full retirement benefit for older Americans.

Two-thirds of older Americans rely on Social Security for more than half of their income, so it is clearly a centrally important platform and foundation for support, but trying to live on just Social

Security alone is not easy, even though a majority of Americans rely on it very significantly.

We have to be able to strengthen both the savings and the pension legs, as well. The President has a series of proposals to try to expand pensions, particularly for small businesses, to be able to expand 401(k)s and other alternatives.

I think the whole discussion of Social Security reform can't take place in a vacuum. All three legs of the stool need to be strengthened as we move forward in terms of Social Security reform and, really, economic security for all Americans. So I share your concerns.

The Labor Department is involved in a very major public education campaign about pensions. We are, in terms of the Social Security Administration's PEBES form, providing information to the public about what the Social Security benefit can be. We have got to strengthen all the legs of the stool.

Senator REED. Mr. Apfel, could you comment on or reiterate really the President's process for considering the Social Security reform, how it is going to be accomplished?

Mr. APFEL. Yes, sir. First and foremost is to reserve the surpluses pending action on Social Security reform. Two is the major public debate over the course of the next year, involving on a nonpartisan basis, the American public and Congress, in a series of forums around the country.

Three, in December the President will hold a White House Conference of all the affected parties to bring everyone together to talk about what has happened over the course of this year.

Then four, starting next January would be opening up discussions with the Congressional leadership on a bipartisan basis, on how best to fix the Social Security system and ensure it will be there for future generations.

That is the plan. I think we are off to a very good start.

Senator REED. Could you comment on the impact of the proposals in general that are being made on certain discrete populations, minority populations specifically; for example, African-Americans?

Mr. APFEL. Yes, Senator. There were recent articles that African-Americans receive lower rates of return from Social Security than whites. There was a study that came out that documented that.

There were a number of errors in that study and I would ask for the record if I could include an analysis that the Social Security Administration Office of the Actuary has conducted comparing rates of return for African-Americans and whites.

The CHAIRMAN. That can be included if it is not too voluminous.

Mr. APFEL. It is 750 pages—five pages.

The CHAIRMAN. What we will do, we will make reference to it and it will be on file.

Mr. APFEL. It is about a five-pager, sir.

The CHAIRMAN. Okay. No problem.

[The information referred to follows:]

February 4, 1998

MEMORANDUM

From: Steve Goss, Deputy Chief Actuary
Social Security Administration

Subject: Problems with "Social Security's Rate of Return", A Report of the Heritage Center for Data Analysis

The analysis by William M. Beach and Gareth G. Davis of the Heritage Foundation attempts to provide an answer to the question "What can Americans expect in future Social Security retirement benefits?" The paper suggests that expected rates of return will decrease substantially in the future and that African Americans do now and will in the future have substantially lower expected rates of return than for the general population. However, the conclusions are highly misleading due to two major errors in methodology, plus a number of incorrect or inappropriate assumptions.

Due to these errors, rates of return for the general population in this study are at substantial variance with those produced for the 1994-6 Advisory Council on Social Security (See Appendix 2 of Volume 1 of the report, pages 219-22). For example, for single men (all races combined) born in 1970 with average earnings, real rates of return are estimated at only 0.47 percent by Heritage, compared with 1.28 percent in the Advisory Council Report.

More importantly, the methods utilized by the authors bias expected rates of return downward to a far greater degree for African Americans than for the general population. This study thus erroneously indicates differences in rates of return by race that are greatly exaggerated. In fact, results from more careful research reflecting actual work histories for workers by race indicate that the non-white population actually enjoys the same or better expected rates of return from Social Security than for the white population. (See Duggan, et. al., "The Returns Paid to Early Social Security Cohorts," *Contemporary Policy Issues*, (October), pp. 1-13.)

Error in Method of Computing Expectation

Expected values indicate the average of all possible outcomes for individuals at a point in time with an uncertain future. Instead, the Heritage study erroneously analyzes a single outcome where an individual is assumed to know how long he or she will live. For persons at each age 22 through 66 in 1997, the authors estimated the remaining life expectancy, i.e., the average number of years of life remaining after 1997. Individuals at each age were then assumed to live for precisely the number of years indicated by this average life expectancy. This approach consistently overestimates the expected number of years of work and consistently underestimates the expected number of years after reaching retirement age. As a result, it grossly underestimates the expected rates of return from Social Security retirement benefits. Moreover, the extent of this bias is greater for workers with lower life expectancy, in particular for African Americans. The error is also greater for younger workers who are far from retirement age in 1997.

To illustrate this error, consider the expected years of work and retirement under the Heritage method in comparison with the true expected years for white and black men based on the 1992 United States Life Tables. Life expectancy at age 20 was 54.3 years for white men and 47.2 years for black men. Assuming both planned to work until retirement at age 65, the Heritage approach would assume 45 work years for each, and 9.3 retirement years for white men but only 2.2 years of retirement for black men.

However, the true expected number of work years for both black and white men must be less than 45, because some will die before reaching age 65. In fact the true expected number of work years (reflecting deaths before 65) is 42.2 years for white men and 39.1 years for black men. Computing, for 20-year-old men the expected number of retirement years after 65 requires both the probability of surviving to 65 and the life expectancy at 65 for those who do survive. For white men age 20, 78.1 percent would expect to survive to 65 at which point they would average an additional 15.5 years of life after 65. Thus, the expected years of life for a 20-year-old white male after reaching 65 would be 12.1 years (= 15.5 X .781). For black men age 20, 60.3 percent would be expected to survive to 65 at which point they would average an additional 13.5 years of life. Their expected retirement years would thus be 8.1 (= 13.5 X .603).

Expected Work and Retirement Years for 20-Year-Old Males in 1997

	Work Years		Retirement Years	
	White Men	Black Men	White Men	Black Men
Heritage Erroneous Method	45	45	9.3	2.2
True Expectation	42.2	39.1	12.1	8.1

Clearly, computed rates of return for retirement benefits using true expectation will be much higher for all men, and, moreover, the difference between rates of return for black and white men will be dramatically smaller, than if the erroneous Heritage method is used. While this is the largest and most fundamental error in the Heritage analysis, a number of additional errors further bias the results.

Error in Not Reflecting Relationship Between Mortality and Income

The authors acknowledge the fact that life expectancy is highly correlated with income, and that their estimates do not reflect this fact. Estimates made by the Office of the Chief Actuary, Social Security Administration indicate that for the general population, about 20 percent of the difference in rates of return between low- and high-income workers is removed by properly reflecting mortality differences by income. However, this correlation would be far more important in comparing rates of return between African Americans and the general population.

The authors note that rates of return would be lower for low-income and higher for high-income workers if adjusted appropriately for mortality at the indicated income level. Average-income workers would presumably have mortality at about the level of the average population, and thus be unaffected by the adjustment. While this is all true for the general population, the African American rates of return would be increased much more for high-income workers, would also increase for average-income workers, and would decline much less for low-income workers. This is true because average income for African Americans is substantially lower than for the general population at this time.

For example, African Americans with earnings equal to the general-population average have much higher-than-average earnings within the African American population. As a result, they must be assumed to have much better mortality than the average for all African Americans. Thus, with proper adjustment of mortality by income level, race differentials in life expectancy would diminish greatly, for individuals at the same income level.

Without appropriate adjustment of mortality by income, race-differentials in rates of return are highly misleading. This is the reason that the Office of the Chief Actuary, Social Security Administration has not as yet developed race-specific money's worth ratios or rates of return.

Additional Errors

The authors of the Heritage study exclude disability benefits and taxes from the analysis, even though the Disability Insurance program represents nearly 15 percent of the Social Security. While including disability would not substantially change the expected rate of return for the general population, it would considerably narrow the rates of return for African Americans versus the general population. This follows from the fact that disability benefits are significantly more likely for African Americans than for the population as a whole.

Because Social Security provides survivor benefits when a worker dies before retirement age, and Heritage omits these benefits, the authors also deducted from taxes a premium intended to cover these benefits. The premium appears to exclude those survivor benefits for a spouse that are payable after the youngest child reaches age 16, i.e., widow(er)s benefits that are payable from age 60 to the end of life. Premiums are also likely to be too low if Heritage used premiums for commercially-available life insurance. Life insurance is sold largely to healthy, higher-income persons who can afford the premium and can qualify as insurable. Including lower-income and uninsurable individuals would boost the premium substantially. Making these changes would increase rates of return from Social Security.

The authors raised tax rates for Social Security starting 2015 by enough to cover future benefit costs, ignoring the fact that the Trust Fund balance projected for that time, 300 percent of annual benefits, would continue to grow as a percent of annual benefits under these conditions. In order to produce a pay-as-you-go financed Social Security program, tax rates would not need to be raised until around 2025, and by less than the authors assumed. The early, too-large increase in tax rates results in rates of return that are estimated to be too low for Social Security.

The authors included a "high-income" worker with earnings at 300 percent of the average wage. In fact, the maximum level of earnings that is taxable and creditable for Social Security benefits is now and will be in the future 240 percent of the average wage (less than 240 percent in years before 1978). It is not clear whether the authors included taxes above this maximum taxable level. If they did, then rates of return for Social Security are estimated to be too low for high-income workers.

February 11, 1998

Social Security Administration Fact Sheet

The overall rates of return for African Americans compare favorably to those of Whites.

Mortality

- The average black male currently aged 65 can expect to live to about 78 compared to about age 80 for white men. For females, the comparable figures are age 82 for blacks and age 84 for whites.

- African Americans are more likely to die prematurely and their families receive survivor benefits than are white workers. (About 23% of awards to young survivors in 1995 went to African Americans even though this group comprises only 12% of the general U.S. population.)

- The African American community experiences higher than average infant and juvenile mortality rates. In order to compare rate of return for Social Security life expectancy at the time of entry to the workforce the age 20 is a better number for assessment rather than birth.

- The average African American male currently aged 20 can expect to live to approximately 67 years of age. For females, the comparable figure is approximately 76 years of age.

Disability

- African Americans are more likely to receive disability benefits than white workers.

  - In 1995, 18% of disabled workers awarded benefits were African Americans, compared to their 12% representation in the population.

  - This difference is most acute at younger ages. In 1995, 21 percent of workers awarded disability benefits between ages 30-39 were African American; for awards at ages 60 and over, the percentage drops to 14.6 percent.

- Note that in 1995 white disabled workers were awarded disability benefits averaging $714 a month while African American were awarded disability benefits averaging $623. In part this is a reflection of income differentials.

Progressivity and income

- The progressive structure of the Social Security system replaces a higher percentage of prior wages for lower and average earners than it does for higher earners.

  - Earnings vary significantly by race with white men and women earning higher incomes than black men and women. In 1995 on average white men earned \$11,000 more than black men (\$34,276 versus \$23,876 respectively) and white women earned \$2,000 more than black women (\$19,647 compared to \$17,485).

Mr. APFEL. The reality is that African-Americans do just about the same as whites in Social Security benefits. Social Security is race-neutral. African-Americans do have a somewhat lower life expectancy but African-Americans, as one would expect with a lower life expectancy, have higher incidence of survivors benefits, and of disability benefits. In addition, African-Americans have somewhat lower incomes and, given the progressive benefit structure, receive a proportionately higher level of benefits.

So I would like to include that study in the record.

Senator REED. Thank you.

There is lots of talk about Generation X and the belief in Social Security. In fact, I was struck listening to my colleague from Pennsylvania with this disparity between believing in UFOs and believing in the Social Security system. Maybe it is a function of the fact that instead of the X-Files if we had SSA Files, where you had two sexy Social Security auditors going out unraveling the mystery of Social Security, maybe they would believe in it just as much as UFOs.

But nevertheless——

Mr. APFEL. You are describing our new initiative. [Laughter.]

Senator REED. I'm a fount of wonderful ideas.

Nevertheless, why should young people in their 20s or 30s have a sense that we are going to essentially do the right thing and provide Social Security for their future?

Mr. APFEL. Well, Senator, we have to. As I said in my opening comments, Social Security is the most important program in this nation's history. We owe it to the American public for future generations and current generations, to assure that we have a strong and vital program in the future.

Two, when I speak to young Americans I say, will Social Security be there? The answer is absolutely yes, but changes have to be made. That is really what this year and next year is about, is to try to figure out what is necessary to move the system forward into the future.

Another question I address, as I said in my opening remarks, is is Social Security going to be there for me 20, or 30, or 40 years from now? For a 25-year-old or a 30-year-old, Social Security is there for you now in terms of survivor benefits and disability benefits that are very important to the fabric of our country.

Basically about 15 percent of all 20-year-olds will die before age 65, many leaving families behind. There is more than about a one-in-four chance of a 20-year-old becoming disabled before the age of 65.

I know this from personal experience. When my wife was a young girl, her father died, leaving her and her three sisters and her mother with a Social Security check. It is an important variable that people need to understand.

So the intergenerational nature of Social Security is critical. Understanding that Social Security is an intergenerational program in financing terms is important but it is also true in terms of benefits: it is there for young people, as well as old.

Senator REED. Thank you very much.

Thank you, Mr. Chairman.

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The CHAIRMAN. I need to have you out at my town meetings because I have young people ask me will Social Security be available for them and I go into a long answer, down the road 30 or 40 years, how it will be. But I think you have just reminded us of a very important answer.

Three percent of the young people who are asking us that question could make use of Social Security disability very soon. Then there is another percentage where, if they were to die, married and they died, then there would be a survivor who would benefit from it. What is that percentage?

Mr. APFEL. About a 15 percent probability at age 20 that one would die before age 65.

The CHAIRMAN. Okay, so they would get benefits of survivors. Also, 3 percent become disabled. Is that what you said?

Mr. APFEL. No. About 26 percent of all 20-year-olds have a probability of going on the disability rolls before age 65. It's sizable. About 30 percent of all benefits paid out right now, one in three benefits roughly are for Social Security survivors or disability benefits.

The CHAIRMAN. If I could ask you a couple of short questions, and then if you had another question?

Senator REED. I don't, Mr. Chairman.

The CHAIRMAN. Okay. Some members of Congress have recommended that a national committee on Social Security be established to devise a solution to the Social Security problem. The President meanwhile has this ambitious agenda that we all thank him for, for having these public hearings and to arrive at a legislative solution in 1999.

Would the Administration see the commission idea, which was used very successfully in 1983 and 1984, a bipartisan commission much like the Greenspan Commission, but in a sense it was a Reagan-Tip O'Neil Commission, to bail out Social Security—would he see a commission as a way of arriving at a solution?

Mr. APFEL. Well, we haven't proposed that, Mr. Chairman, as the solution. We have proposed the alternative of moving forward with the public debate, the White House Conference and then the bipartisan discussions. We don't at all rule out such an option.

If members were interested—I know that the Speaker has indicated some interest in a commission—we would not necessarily rule it out because we want a public debate. It could potentially help the public debate. All we would ask is that, if there is such a proposal, that the Commission comes to conclusion by the end of the year so it can be built into the bipartisan process that we need to have at the end of the year.

The CHAIRMAN. Then my last question would be from your testimony. You referred to a number of features that we have just now discussed that we should try to retain, even if we reform Social Security as a retirement system.

One of the assurances that has been provided in the past is an equitable benefit. I know that you are aware of the research which shows that the time it takes for people to get back the contributions that they have paid is increasing. For example, people who retired in 1980 would only have to receive benefits 2.8 years to get back both what the employer and employee paid in. By the year

2025 it would take 26.2 years to do that. Do you believe that Americans would consider that equitable?

Mr. APFEL. This is the whole issue of rates of return. Clearly rates of return have been lowered over time. When Social Security was first established back in the 1930s it was established not as an advance-funded system for some very good reasons. We had over half of all older Americans living in very desperate conditions. It was really one of the national disgraces of this country.

We set up the system originally as a pay-as-you-go system. That meant very, very high rates of return in the beginning years. Now that we have matured as a social insurance system, those rates of return are considerably lower, as you point out.

I think that the issue of rates of return is an important issue that needs to be part of this debate. I think that also the assurance of the foundation of protection is another important variable that needs to be thought through and considered in this process, as well.

So, is what you have articulated an important issue that needs to be thought through as part of this debate? I think absolutely it should be. There are others, because Social Security is a multiple program that serves multiple needs and, therefore, needs, as you have pointed out and as this hearing will, multiple objectives and multiple goals.

The CHAIRMAN. Yes. Well, I look forward to working with you in the future months of this year as you hold your hearings and as this committee will play a role in this debate, as well, both from the hearings here as well as each individual members' interest outside of the formal hearings. Thank you for being a part of the first Senate discussion of the President's proposals. We thank you very much.

Mr. APFEL. It is an honor to be here, sir.

The CHAIRMAN. I am going to dismiss Commissioner Apfel now and then call our next panel. We have four witnesses.

First we are going to hear from Congressman Tim Penny. Congressman Penny served the State of Minnesota for 12 years and had a very good reputation of leadership in the areas of budget deficits and entitlement spending. He is involved in public policy through his work at the Minnesota Humphrey Institute Policy Forum. Also he is a board member of the Concord Coalition and the Committee for Responsible Federal Budget. Today, though, he is appearing before us through his work at the CATO Institute.

Congressman Penny will be followed by Joseph Perkins, president-elect of the American Association of Retired Persons. Mr. Perkins retired in 1994 from Polaroid Corporation, where he served as corporate retirement manager. He was also recently appointed as public representative on the Advisory Committee for the Pension Benefit Guaranty Corporation. Mr. Perkins has a broad base of experience in issues affecting the elderly through his position on the board of the Alzheimer's Association and as a counselor for the Andrus Gerontology Center at the University of Southern California.

Next we will hear from Fidel Vargas. Mr. Vargas was a member of the 1994–1995 Advisory Council on Social Security. He has already acquired experience as an elected public servant when he was mayor of Baldwin Park, CA from years 1992 through 1997. He is currently attending Harvard Business School.

Also we have our final witness, Jane Ross, director of Income Security at the General Accounting Office. She will discuss some of the interactions and trade-offs that arise with the goals our previous witnesses have identified.

Prior to her work at the General Accounting Office, Miss Ross worked at the Social Security Administration as deputy associate commissioner for policy. She has written extensively on Social Security issues and holds a Ph.D. in economics from American University.

Now, I would also like to note before our panel begins, and, by the way, I think the first buzzer has gone off and it might be better if I would go vote and come back before you start your testimony. It should take about seven minutes.

But before I go I would like to note that on panel two we have the happy coincidence in that two of our witnesses are associated with groups that the President of the United States has selected to organize the presidential forums. This would be the AARP, Mr. Perkins, and Tim Penny, who is a fellow at CATO, but also because the President has asked the Concord Coalition to be involved with those hearings.

I might also note that Congressman Penny is going to play a role for Concord in organizing the forums I have been told. You may want to explain that, Congressman Penny. Anyway, this is an opportunity for us to hear some of your ideas ahead of time.

Is it okay with you if I would just adjourn for a minute? I will hurry over and hurry back. Thank you very much. [Recess.]

The CHAIRMAN. I thank everybody for being patient while we voted. There is also some indication there might be another vote shortly but I am not going to stay over there and wait because sometimes it does not happen. It might be inconvenient but at least I want to use the valuable time we have.

Would you please start, Congressman Penny?

STATEMENT OF HON. TIM PENNY, FISCAL FELLOW, CATO INSTITUTE, FORMER REPRESENTATIVE IN CONGRESS FROM THE STATE OF MINNESOTA

Mr. PENNY. Well, thank you, Mr. Chairman. This hearing and others to follow will be vitally important. Changes in the Social Security system need to be exhaustively debated. The intellectual groundwork must be laid in order to transition to a new system that offers future retirees a sense of security comparable to that experienced by current retirees.

Allow me to specifically acknowledge the work of the CATO Institute in this regard. I am an advisor to their Social Security privatization project and I can say without reservation that CATO has been a preeminent leader in researching and articulating both the problems with the current system and possible alternatives which will enhance the well-being of tomorrow's retirees.

Mr. Chairman, in your letter of invitation you asked that we offer observations on the principles that should govern our approach to Social Security reform, so I offer for you today seven principles that I think ought to govern your work and the work of others in Congress as you move forward.

First of all, do it now. President Clinton is to be applauded for committing the nation to a thorough debate about the future of Social Security. I am excited about the several public education forums recently announced by the White House. Social Security reform must come sooner rather than later. Social Security's financing problems are coming much sooner than is commonly believed. The key date is not 2029, the date of actuarial insolvency, but actually 2012, the date at which Social Security begins running an operating deficit.

The looming financial problems in the system are a consequence of the nature of the program. Under a pay-as-you-go structure, future benefits depend on a workforce much larger than the retired population, either that or significantly higher taxes on those workers who enter the system later. Obviously faced with a doubling of our retirement population by the year 2040, policymakers must begin reforms now so that we have time for a gradual transition to a financially sensible alternative.

Second, reform must absolutely be pursued on a bipartisan basis. In his State of the Union message and again yesterday at Georgetown, President Clinton properly invited all legislators, Democrat and Republican, to participate in those regional conferences. He also correctly suggested that a bipartisan dialog among congressional leaders must begin shortly after the next election, if not before. The framework of a national discussion followed by concerted legislative effort is exactly the right formula.

In particular, I would recommend to the White House and to this committee legislation that is currently being drafted by Representatives Stenholm and Kolbe, who co-chair the Congressional Pension Reform Caucus. They want to create a supercommittee, a bicameral, bipartisan committee that would develop and recommend changes to the Social Security system. I think creating such a group would set the stage for quick action on this issue in the next session.

Third, the government should not invest the Social Security funds but we should rather move toward a system of personal retirement accounts, and I will elaborate on that later in my testimony. On this point let me simply state that allowing the Federal Government to become the nation's largest stockholder would undoubtedly create political problems and major problems for our economy.

Fourth, I believe that we should avoid further increases in the payroll tax. Over the past 60 years the payroll tax has been increased on 13 occasions and the amount of income subject to the tax or the earnings base has been increased 26 times. We now have a combined payroll tax of 15.3 percent on $65,400 of income. Changes in the payroll tax prior to 1977 were typically necessitated because of increases in benefit levels. But since 1977, we have increased payroll taxes while, on occasion, cutting benefit levels in one way or another, so it is becoming very much a losing proposition.

Further, the payroll tax is a regressive tax. The increase required to keep Social Security solvent would fall hardest on those least able to afford it. Today over 70 percent of American workers pay more in payroll taxes than income taxes. I trust no more needs to be said about the inadvisability of resorting to additional payroll tax hikes to sustain the system.

Fifth, I believe the new system should encourage greater savings and thereby spur economic growth. The current system, many economists believe, actually deters the individual's propensity to save by giving them the illusion that Social Security is a substitute for their own personal responsibility to prepare for retirement. We may talk a lot about a three-legged stool but in the recent past, more and more Americans have begun to rely on Social Security and little else for retirement, and we cannot allow that perception to persist.

Sixth, any changes in the system should strengthen people's confidence in their retirement security. Today many young people do not expect that Social Security will provide them with adequate or indeed any benefits. A poll conducted by the Democratic Leadership Council found that among those aged 25 to 50, roughly 74 percent expressed not very much or no confidence in the current Social Security system.

I have come to believe that the best way to enhance confidence in the system is to give future workers more control over their investment. As the father of four young children, I want very much for my children to have a better system than Social Security as currently structured. I would like to see more of that payroll tax directed under their control in a personally directed investment account, and I would like to see that change accomplished, as much as possible, as soon as possible.

A reformed system should allow people to be confident that they will get back their money's worth on the amounts that they set aside during their working years. Likewise, it should give the working poor in this country and women in this country a chance to create economic wealth for themselves and their heirs.

The RAND Corporation concluded that Social Security as currently structured transfers wealth from the poor to the rich, from black to white and from men to women. Working women today are particularly penalized, not only because they, on average, earn much less but because there is a disparity between what is received by women who do not work and those who do work.

A wife is automatically entitled to 50 percent of her husband's benefit whether or not she works. If she works and pays Social Security taxes, she does not receive any extra benefits until she passes that 50 percent threshold. Again, allowing more personal control over the investment will provide a better return for these women.

Of the poorest in America, 20 percent of them receive 81 percent of their income from Social Security. Again, better returns on a personally directed investment account will not only give them a better benefit level upon their retirement but will also provide for them an asset that they can transfer to their heirs.

The bottom line is changing from the current structure to a structure that involves more control over investments is a change that will, in my judgment, restore the confidence of America's workers in this retirement system. For future workers it will increase their rate of return and give them greater confidence in the system.

In yesterday's speech, President Clinton referenced an economics lesson or a political lesson that he learned during his freshman year at Georgetown. He called it the theory of future preference, whereby America, as a society, has almost always put its preference on policies that do better for the future. That really ought to be where we come down on this Social Security debate. What kind of system can we create for the next generation of workers that will be better than the system as it currently exists?

My final point, and I see the time has run out, is that we need a new system that does maintain an appropriate social safety net. Workers should be protected in case of disability and minor children and surviving spouses should be provided for in the event of a worker's death, and a basic minimum benefit should be guaranteed in any event. The current system does provide those protections and a reformed system must maintain that same commitment.

With those as my seven principles of reform, I would conclude my remarks at this point but stand ready to answer any questions you might pose. Thank you, Mr. Chairman.

[The prepared statement of Mr. Penny follows:]

PREPARED STATEMENT OF TIMOTHY J. PENNY

Social Security is a hugely popular government program, and rightly so. It has provided financial independence to generations of retirees. It has lifted millions of elderly Americans out of poverty. It has developed into more than a safety net, as was originally intended. It has become a significant source of retirement income for Americans, providing approximately one-half of all retirement income in the United States to the elderly.

Yet, a growing number of younger Americans have begun to doubt the ability of the Social Security system to deliver for them. They have come to understand that the system is not an individualized retirement plan (which their parents and grandparents generations mistakenly believed the system to be), but rather the system is designed as an intergenerational transfer payment. This growing awareness has helped to move Social Security reform onto the political agenda.

This hearing, and others to follow, are vitally important. Changes in the Social Security system need to be exhaustively debated. The intellectual groundwork must be laid in order to transition to a system that offers future retirees the same sense of security experienced by current retirees. Allow me to acknowledge the work of the Cato Institute in this regard. As an advisor to their project on Social Security Privatization, I can say without reservation that Cato has been a preeminent leader in researching and articulating both the problems with the current system and possible alternatives which will enhance the well-being of tomorrow's retirees.

Mr. Chairman, in your letter of invitation, you asked that I offer my observations on the principles that should govern our approach to reforming the Social Security system. I offer seven principles for your consideration.

First, do it now. President Clinton is to be applauded for committing the nation to a thorough debate about the future of Social Security. I am excited about the several public education forums recently announced by the White House. The President's personal attention and leadership is vital to the success of any effort to modify this program. And, there is no waste to time!

Social Security reform must come sooner rather than later. Social Security's financing problem is coming much sooner than commonly believed. The key date is not 2029, the date of actuarial insolvency, but 2012, the date at which Social Security begins running an operating deficit. That is the date at which the Federal Government will have to find the revenue to redeem the bonds (and interest) in the Social Security Trust Fund. Where will that money come from?

There is already a $9 trillion unfunded liability in the Social Security system. Talk of trust balances is misleading. Trust fund surpluses are no more than a bookkeeping exercise. As noted earlier, projections are that annual payroll tax revenues will be insufficient to pay annual Social Security benefits beginning as early as the year 2012. Beyond that date, the system will be in deficit.

The looming financial problems in the system are a consequence of the nature of the program. Under a pay-as-you-go structure, future benefits depend on a work force much larger than the retired population (or significantly higher taxes on workers who enter the system later). Until now we have studied the system through a highly favorable worker to retiree ratio and through periodic increases in the tax rate and the earnings base. Today's ratio of nearly four workers to each retiree will decline to only two workers for each retiree once the babyboom generation is fully retired.

Faced with a doubling in our retirement population by the year 2040, policymakers must begin reforms in the system now as to allow a gradual transition to a financially sensible alternative.

Second, reform must be pursued in bipartisan fashion. In his State of the Union message, Clinton properly invited all legislators, Democrat and Republican, to participate in the regional conferences that the White House will sponsor. He was also correct to suggest a bipartisan dialog with Congressional leaders to begin shortly after the next election. The framework of a national discussion followed by concerted legislative effort is exactly the right formula. I would recommend to the White House, and to this committee, legislation currently being drafted by Representatives Stenholm and Kolbe (co-chairs of the Congressional Pension Reform Caucus) to create a "supercommittee". This bicameral and bipartisan supercommittee would develop and recommend changes in the Social Security system. Creating such a group would set the stage for quick attention to this issue at the start of the next legislative session.

Third, the Government should not invest Social Security funds but should move toward a system of Personal Retirement Accounts, which I'll elaborate on later in my testimony. Many have suggested that the government invest the Social Security surplus in real assets such as stocks, rather than government bonds as is currently done. As former Social Security Commissioner Robert Ball asks, "Why should the trust fund earn just one-third as much as common stocks?" However, allowing the Federal Government to become the nation's largest stockholder would undoubtedly create political problems and major problems for the United States economy.

Fourth, we should avoid raising payroll taxes. In 1937, when first instituted, the Old Age and Survivors Insurance tax was levied at a two percent rate on only the first $3,500 of income (one percent paid by the employer, one percent as a payroll deduction). Over the past 60 years, the payroll tax has been increased on thirteen occasions. The amount of income subject to the tax, or earnings base, has been increased twenty-six times.

Further, the payroll tax is a highly regressive tax. The increase required to keep Social Security solvent—at least 50 percent would fall hardest on those least able to afford it. Today, over 70 percent of American workers pay more in payroll taxes than in income taxes. I trust more need not be said about the inadvisability of resorting to additional payroll tax hikes to sustain the system.

Fifth, the system should encourage greater savings and thereby spur economic growth. The current system, many economists believe, actually deters individual's propensity to save by giving them the illusion that Social Security is a substitute for their own personal responsibility to prepare for retirement. A survey conducted by the research group Public Agenda bears out this point. The survey found that: fully 30 percent of those aged 51 to 61 have saved less than $10,000; just 29 percent of these pre-retirees have saved more than $100,000; nearly 40 percent of those aged 33 to 50 have saved less than $10,000; and, a mere 16 percent of these babyboomers have saved more than $100,000.

A reformed system should be structured so as to increase net national savings rather than to substitute for private savings. It should also encourage the Federal Government to end its dis-saving policies.

Ideally, the new system should increase individual's personal (sense of) responsibility for achieving retirement security. The current system, if anything, diminishes the sense of individual responsibility for retirement preparation. A reformed system should encourage people to do more than the required minimum.

Sixth, any changes in the system should strengthen people's confidence in retirement security. Today, many young people do not expect that Social Security will provide them with adequate, or indeed any, benefits. And many middle-aged people wonder whether they can rely on the system, on their workplace pensions, or their own savings. A reformed system should give people a sense of confidence that, provided they make a reasonable effort, they will have an adequate retirement income. A poll conducted for the Democratic Leadership Council found that among those aged 25 to 50 roughly 74 percent expressed "not very much or no" confidence in the current Social Security system. The best way to enhance confidence would be to give future retirees more control over their investment.

Accordingly, in the future the system should offer a better return on people's investment/contribution than the current system. Even today, single men with above average incomes cannot receive back in benefits the equivalent of amounts they pay in FICA taxes during their working years. This will be increasingly true for many groups in the future. A reformed system should allow people to be confident that they will get back their money's worth on the amounts they set aside during their working years. Likewise, it should give the working poor in this country and women, who receive less in wages than men, a chance to create economic wealth for themselves and their heirs.

Under a new Social Security system, we could allow young workers the choice of diverting their Social Security taxes to individually-owned privately invested accounts, similar to IRA's or 401(k) plans, transforming Social Security into a mandatory defined contribution savings program. Accounts should be managed by the private sector and workers should have as much freedom to choose their investment as possible, consistent with regulations to minimize risk and speculation.

The current Social Security system penalizes working women. Social Security provides a subsidy to non-working spouses, but does so by penalizing working women. A wife is automatically entitled to 50 percent of her husband's benefits, whether or not she works. If she works, and pays Social Security taxes, she does not receive any extra benefits until she passes that 50 percent threshold. Under a system that encouraged real savings, a working woman would receive benefits based on every dollar she contributes.

The poorest 20 percent of seniors receive 81 percent of their income from Social Security. Because a privately invested Social Security system would earn higher returns and pay higher benefits, it would lift many of those seniors out of poverty.

The current Social Security system is unfair to the poor and minorities. Despite Social Security's progressive benefit formula, the program actually penalizes the poor and the ethnic minorities. The amount of benefits a person receives over a lifetime depends on how long the person lives. Because the poor generally have shorter life expectancies than the wealthy, they receive back less than in life-time benefits. The same is true for African-Americans. The life expectancy of an African-American man is only 65 years and 6 months. As a result he will pay Social Security taxes his whole life and receive almost no benefits. The RAND Corporation concluded that Social Security transfers wealth from poor to rich, black to white, and men to women. In a private system, those who die early could pass their accumulated benefits on to their heirs. (Note: some argue that disability and survivors benefits restore Social Security's progressivity, but there are not empirical studies to support this idea.)

In this regard, any Social Security reform should allow the poor to accumulate real wealth. Middle and upper-income workers already have private investment opportunities. Allowing poor workers to divert the payroll taxes to individually-owned, privately invested accounts will allow them to accumulate real wealth and have an opportunity for ownership in America. Such a program would operate as a national ESOP plan, turning every worker into a stockholder.

The bottom line? Any reform must increase the rate of return for future workers. Social Security taxes are already so high relative to benefits that most young workers will receive a low or even negative return on their investment—less back in benefits than they pay in taxes. Most commonly discussed Social Security reforms, raising taxes or cutting benefits, would make that problem worse. While some benefit cuts may be necessary in the future—such as raising the retirement age or changing the CPI formula—those cuts should only be undertaken in the context of an overall reform that increases the rate of return for young workers.

Finally, a reformed system must maintain a safety net. The system should have safeguards to prevent elderly people from falling into poverty or from outliving adequate benefits. Workers should be protected in case of disability and minor children and surviving spouses should be provided for in the event of the worker's death. The current system provides those protections and a reformed system must also address these concerns.

The government should continue to guarantee a safety net in the form of a minimum benefit to all Americans. This benefit should be financed out of General Revenues or some portion of payroll taxes.

Thank you for this opportunity to address the principles of Social Security reform. I stand ready to answer any questions the committee might pose.

The Chairman. Thank you very much. Very concise. Mr. Perkins.

STATEMENT OF JOSEPH PERKINS, PRESIDENT-ELECT, AMERICAN ASSOCIATION OF RETIRED PERSONS

Mr. PERKINS. Thank you, Senator Grassley.

Social Security, we feel, must remain the foundation of lifetime income security, which must be supplemented by individual savings and pensions and retirement. Social Security is the defined benefit that was intended as the base of income security. Many older Americans depend on these benefits for at least 90 percent of their income. This reliance reflects gaps in our private pension system, and the inability of many wage-earners to accumulate and preserve significant savings.

Social Security faces a long-term challenge, but it is not in crisis. The trust funds have sufficient assets and revenue to continue paying full benefits on time for another 32 years and continue to finance about 75 percent of benefits beyond that time.

We need to find a reasonable solution to strengthen Social Security and the changes should come sooner rather than later. AARP is pleased that the President and congressional leaders have called for a dialog to help instruct us on the best packages of changes for Social Security's future. Today's hearing can help further that dialog.

Our testimony details the features we believe are essential to Social Security. A key element is universal participation. Universal participation helps ensure that all Americans will receive a benefit in retirement and income protection against unforeseen events. We must continue disability and survivor benefits to ensure a lifetime of income protection for workers and their families against risks they did not anticipate at the beginning of their working life. As Commissioner Apfel very aptly said, one in three current beneficiaries are not retired workers at all.

Another key feature is Social Security's progressive benefit formula. Blending the concepts of adequacy and equity, the formula provides low-earners with a larger share of their preretirement earnings than higher earners. This weighting protects low-income workers against the poverty they could face if they lack adequate pensions or savings.

Social Security also should continue providing benefits to all who qualify. If benefits were based on need, public support would drop precipitously and the program's progressive benefit formula would be undermined, since high-earners would be less willing to participate in a program that denied them benefits.

In addition, savers would be penalized for their thriftiness and far-sightedness. We certainly wouldn't want to do that.

Social Security should also continue to provide automatic cost-of-living adjustments, (COLAs). COLAs help all beneficiaries, particularly older single women, keep pace with rising prices, even if they lack other resources. If COLAs were eliminated or permanently reduced, the real value of Social Security would decline as beneficiaries become older.

Social Security's goals must also be viewed within the broader text of overall income protection. The three-legged stool, which everyone talks about, can improve economic security by distributing financial risks and responsibility among the government, Social Security, the employer pensions, and individuals and their personal savings.

Social Security is the strongest of these three legs. Pension coverage has stagnated and only half of all workers are covered by any pension plan. Over the past 15 years there has been a dramatic increase in individual account plans, such as 401(k)s, in which the responsibility to save as well as the risks of poor investment performance rests with the employee.

Given this on-going shift in private pensions, it becomes even more important to maintain Social Security's shared risk design and defined benefit promise.

In addition, many households have little or no retirement savings, and those with savings all too often need to or choose to spend them for nonretirement purposes.

We should look for improvements in all three legs. AARP believes we should build upon the opportunities for individual responsibility and control that already exist in the pension and savings legs, areas more appropriate for individual risk and responsibility. The Social Security leg, however, should continue its role as the guaranteed base of income.

To ensure a viable Social Security system, Americans of all ages must become better informed about Social Security and participate in the debate about its place in their future.

AARP looks forward to participating in a bipartisan way with our nation's elected officials to achieve a solution that maintains the program's guiding social insurance principles, ensures benefit adequacy and achieves solvency in a fair and timely manner. I will be ready to answer any questions and I thank you for inviting us to be here, Senator.

[The prepared statement of Mr. Perkins follows:]

PREPARED STATEMENT OF JOE PERKINS

AARP appreciates the opportunity to present its views regarding the goals for our Social Security system. Americans of all ages have a stake in ensuring that this critical family income protection program continues as the stable base on which beneficiaries can build a secure financial future with the addition of individual savings and pensions.

For over 60 years, Social Security has been the base of our nation's family income protection system. The program faces a long-term challenge, but not a crisis. Today, Social Security has a reserve exceeding $600 billion, which is invested in government securities. Since the program will continue taking in more revenue than will be needed to pay benefits and administer the program for many years to come, it will continue to accumulate substantial assets. According to Social Security Administration (SSA) actuaries, the program will have sufficient assets and revenue to continue paying full benefits on time for another 32 years. Although its assets are projected to be depleted in 2029, Social Security's incoming revenue can continue to finance 75 percent of the benefits promised under current law well beyond 2029.

In order to help find a reasonable solution to restore long-term financial stability, the American people and their elected officials should first engage in an inclusive national dialog about how Social Security operates, its goals, the many options to achieve long-term solvency, and the impact of these options on their families' future. This dialog can help identify the essential features of a financially-strengthened Social Security program that can continue providing income protection to all beneficiaries, now and in the future.

AARP commends this committee for furthering the dialog regarding Social Security's future. We hope this hearing underscores the need for a comprehensive discussion that helps lay the foundation for a reasonable solution to Social Security's long-term challenge.

I. SOCIAL SECURITY: AN EVOLVING PROGRAM

Social Security was conceived during the Great Depression when millions of working Americans faced an uncertain economic future and millions of older Americans faced an impoverished retirement, or no retirement at all. Social Security was designed to protect against "the hazards and vicissitudes" that workers might face if they had sole responsibility for their financial security in retirement. It is a near universal, defined benefit program that serves as the income base, to which workers can add an employer-provided pension, and their personal savings. Social Security was not intended to be the sole retirement income source, yet today, one in four beneficiaries depend on it for at least 90 percent of their income. This reliance, which is projected to continue in the future, reflects weaknesses in our private pension system and the inability of many individuals to accumulate and preserve significant savings while in the paid labor force. It is critical that we address these areas as well.

Since its inception, Social Security has weathered financing problems and adapted benefits to reflect changing economic and demographic conditions. The system will face its most serious demographic test when the 75 million Boomer generation retires. In 2008, the first Boomers will be eligible for Social Security, and the system should be financially prepared. Adjustments ought to be in place to ensure the continued payment of reasonable benefits to succeeding generations. A timely adjustment before the Boomers retire can and should be made. In fact, other institutions, such as the public school system, responded to the impact of this generation. While the schools had to accommodate the Boomers with little advance notice, Social Security has had a considerably longer lead time to prepare for the Boomers' retirement. We should begin considering changes to Social Security now so this nation's most successful and popular Federal program can accommodate this generation and those who follow them.

II. PRINCIPLES THAT SHOULD BE MAINTAINED

Some of the enduring elements of a Social Security system already have been identified by the Social Security Advisory Council. In 1995, AARP adopted a set of principles that we believe should be reflected in any solvency plan. (They are attached)

AARP and the Social Security Advisory Council agree on the following goals:

Social Security should be self-financed with contributions from workers and employers

The Social Security system is financed through an earmarked revenue source, payroll taxes, that is credited to the Social Security trust funds. Payroll tax contributions by employees and employers give both a stake in the program's future. Since Social Security's financing source is distinct and its operations are separate from the rest of the government, the system can be carefully monitored. This scrutiny helps ensure adequately financed benefits and a timely warning of potential problems. Earmarked funding means Social Security does not take away general government revenues needed for other programs, and it prevents Social Security dollars from being used directly for non-Social Security purposes. Moreover, most Americans consider the payroll tax fairer than the income tax.

Social Security should be compulsory and universal participation achieved

Universal participation is essential in a social insurance program. Under social insurance, workers pool their resources in a government-sponsored insurance plan to protect them against unforeseen circumstances, which as individuals they otherwise might not have purchased, afforded, or received from their employer. Although some people might have sufficient financial resources to purchase the benefits—including survivor, dependent, disability, and retirement protection—a pooling arrangement means all contributors can receive a more secure base of financial protection throughout their lives and far fewer people will face impoverishment.

Universal participation enlarges the pool of money from which to finance benefits, and, therefore, provide more complete protection. For many working Americans, Social Security is the only source of survivor, dependent, and disability benefits. For most beneficiaries, it is the only source they have which is adjusted annually for inflation. By requiring universal participation, the program can distribute benefits progressively, and low-income workers are provided a more adequate level of financial security. Universal participation also protects those whom private insurers might exclude from their plans. For example, insurers might be reluctant to underwrite a disability benefit for someone with a pre-existing medical condition or a life insurance policy for someone whose older relatives are long-living.

Universal participation is desirable for other reasons as well. It ensures that workers will have continuous protection even if they change jobs. It keeps administrative costs low by eliminating fees traditionally associated with private insurers. Universal participation ensures a sense of community and public purpose and a consistency from one generation to the next. Everyone contributes, everyone receives benefits, and everyone bears a measure of responsibility for their retirement. Since everyone contributes while working, future retirees need not endure the financial uncertainty and hardship earlier generations faced. Because their past contributions as workers qualify them for Social Security, current and future beneficiaries will not have to depend on the financial fortunes of their younger relatives or the empathy of society.

Social Security benefits should bear a direct relationship to contributions; Social Security should continue to protect low-wage earners by paying benefits that keep them from relying on means-tested benefits; and Social Security benefits should be provided regardless of income.

These three principles have been largely responsible for the enormous and consistent support Social Security enjoys among Americans of all ages. The Social Security benefit formula blends the concepts of "individual equity" (a direct relationship between contributions and benefits) and "social adequacy" (providing an income floor to all who qualify for benefits). To preserve the concept of equity, benefits reflect an individual's work history and payroll tax contributions. Thus, average and higher earners will receive a higher benefit because they contributed more. 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 high-wage earners. This weighting helps protect lower-income workers and their families from destitution when a wage earner leaves the workforce, and provides all beneficiaries with a measure of dignity and independence. The progressive benefit formula is critical because lower-wage workers generally do not accumulate sufficient financial resources, such as a private pension or savings, that help replace their lost wages. In a sense, the blending of adequacy and equity acknowledges that Social Security is not designed as an investment program, but rather as basic income insurance against economic hardship and unforeseen events. If equity were the only consideration, the highest contributors would receive a larger benefit and those with smaller overall contributions would have less adequate income protection.

Social Security benefits are based on contributions made over a working life and are provided to all who qualify. If benefits were conditioned solely upon need, i.e., means tested, public support would drop precipitously. If there is any doubt about this, one need only compare the level of public support for programs that serve those with low incomes to the support for universal programs like Social Security. Denying benefits to high-income workers would make them far less willing to participate in the program. The Social Security benefit formula, which represents an implicit income transfer from high to low earners, would be undermined if high earners opted out of a system that might deny them benefits. Moreover, a means testing sends the wrong signal about savings. By curtailing benefits when they retire, savers, in effect, are penalized for their thriftiness and farsightedness.

III. BENEFITS THAT SHOULD BE PROTECTED

Social Security includes an array of benefits and income protections that should be maintained in a future solvency package. These include

Social Security benefits for the spouses and children of retired and deceased workers; and Social Security benefits for disabled workers and their families

The availability of these benefits further demonstrates that Social Security has a broader purpose beyond that of an individual investment. By extending financial protection to the families of retired and deceased workers and to disabled workers and their families, the program protects a broad spectrum of society against risks that cannot be anticipated, particularly at the beginning of a working life. Spousal benefits make a considerable difference in the economic well being of widows, young and old, and for divorced spouses, who otherwise might find themselves in or close to poverty. While the percentage of married women workers is higher now than when the program began, women's wages tend to be lower than their male counterparts. Consequently, many women will receive a retirement benefit that blends their own benefit with one earned for them by their spouse.

Disability benefits were added to Social Security in the 1950s. Younger workers tend to overlook and undervalue these disability and survivor benefits (equivalent to life insurance). 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 about $300,000 in life insurance for the spouse and two children of a deceased worker with an average earnings history, and disability protection equivalent to a policy worth over $200,000. If survivor and disability benefits were based solely on a worker's contributions, young workers and/or their families might not receive extended benefits because they would have "used up" their contributions.

Social Security benefits are adjusted annually for inflation once they begin

Among the provisions which the Social Security Advisory Council reaffirmed is automatic cost-of-living adjustments (COLAs). COLAs are critical to most beneficiaries' income security. These adjustments provide beneficiaries with an income source that helps keep pace with rising prices even if they have insufficient additional resources. Today, Social Security is the dominant income source for 3 of 5 beneficiaries and virtually the only income source for 1 in 4 beneficiaries, most of them single older women. Given this widespread reliance on Social Security, any reduction in COLAs would mean that millions of beneficiaries would face economic hardship. In fact, most of the dramatic 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 preceded automatic cost-of-living adjustments. Since then the poverty rate for the elderly has stabilized because annual COLAs have prevented the more than 1 in 5 older Americans—mostly older single women—who are below 125 percent of the poverty line from falling further behind economically.

COLAs help ensure that beneficiaries, particularly the oldest ones, will not outline their resources. If COLAs were eliminated or permanently reduced, the real value of Social Security would decline as beneficiaries become older. In effect, beneficiaries would be poorer at age 80 than at age 65. This is particularly true given that their other income and assets have likely declined and their health care costs have risen sharply.

IV. OTHER CONSIDERATIONS

A. Overall retirement income

While it is important to consider specific Social Security goals, decisions about the program should be viewed within the broader context of overall income security in retirement. Retirement income often has been compared to a three-legged stool comprising Social Security, pensions and private savings. Multiple retirement income sources can improve economic security by distributing financial risk among the government (Social Security), the employer (pensions), and the individual (savings). Today, Social Security is the strongest of the three legs. A majority of current beneficiaries depend on Social Security for the largest share of their income, and 1 in 4 have little or no other income.

Pensions are retirement benefits earned in employer-sponsored plans. Today, only half of all workers are covered by any type of pension plan. Highly compensated individuals are more likely to be covered by or participate in pension plans and generally accrue higher benefits. Some pension plans ("defined benefit"), like Social Security, promise a specific benefit level based on earnings and time in the labor force. The benefits provided by other types of pensions ("defined contribution") reflect the value of the worker's account when he/she retires. Over the past 15 years, there has been a dramatic increase in individual account plans, such as 401(k)s, in which the responsibility to save, as well as the risk of poor investment performance, rest with the employee. Given this ongoing shift in the private sector, it becomes even more important to maintain Social Security's shared risk design and defined benefit promise.

Savings represent individually held assets and investments. High earners are most likely to accumulate savings and in far greater amounts than low-wage workers. Many households, however, have little or no retirement savings, and those with savings all too often need to choose to expend them for non-retirement purposes. Currently, three quarters of all lump-sum payouts are not rolled over into another retirement vehicle. Given the low level of individual savings, it seems probable that many future retirees will have inadequate savings to meet their income needs.

Since pensions and savings continue to be modest or non-existent for many households, Social Security is likely to continue as a dominant income source. In order to ensure retirement income adequacy, policy makers will have to improve all three legs. As legislators consider options for all three legs, they should acknowledge the different role each leg plays. Future policy should build upon the opportunities for individual responsibility and control that already exist in the pension and savings legs—areas more appropriate for individual risk and responsibility. The Social Security leg, however, should continue its role as the guaranteed base of income.

B. Work force participation

The shape of the Social Security program influences the labor market and older workers' labor force participation rates. It is legitimate to question whether Social Security should be neutral with regard to decisions about continued participation in the labor force or whether it should affect the decision. Currently a worker can collect reduced benefits at age 62, the Early Eligibility Age. These benefits are actuarially reduced to reflect receipt prior to the Normal Retirement Age. The age at which workers apply for Social Security has dropped by about three years since the 1960s. For some workers, access to Social Security at age 62 enables them to voluntarily leave the labor force and spend a longer period of time in retirement. Others do not retire voluntarily but leave because of ill health, a physically demanding job, or unemployment. Some ostensibly retire voluntarily but do so in the face of possible employment termination. As policy makers consider an increase in the Normal Retirement Age and/or the Early Eligibility Age, they should determine whether the labor market will generate sufficient jobs for older workers who are able to work, and whether there are adequate income protections within or outside of Social Security for those who become disabled or unemployed before attaining the age of eligibility for Social Security.

C. Employers

Decisions about Social Security will affect employers costs independent of a change in their share of the payroll tax. If older workers delay retirement in response to an increase in the age for initial or full Social Security benefits, employers could incur added pension and employee benefit costs. For example, employers who provide "bridge payments" to workers who take early retirement until they become eligible for Social Security might have added costs. If Social Security benefits are scaled back, employers, many of whom "integrate" their pensions with Social Security, might well face added pension costs. Indeed, some workers might pressure employers to improve their pension benefits because a smaller Social Security benefit diminishes their overall retirement income.

V. CONCLUSION

Americans of all ages should become better informed about the Social Security system so they can participate in the debate about its place in their future. The program has been, and should continue to be, an important part of our nation's commitment to providing income protection for workers and their families against the financial difficulties many otherwise would endure as a result of retirement, death or disability.

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. Fortunately, the over $600 billion now in the Social Security trust funds will increase dramatically over the next decade. Thus, we have time to conduct a meaningful national dialog that will lead toward informed judgment and consensus about the best way to strengthen the program for the long term.

The Association looks forward to participating on a bipartisan basis with our nation's elected officials to achieve a solution to Social Security's long-term problems. This solution should maintain the program's guiding social insurance principles, ensure benefit adequacy, and achieve solvency in a fair and timely manner. Social Security must continue its role as the foundation of lifetime income security for tomorrow's beneficiaries.

PRINCIPLES FOR SOCIAL SECURITY REFORM

Any Social Security solvency package must:

1. maintain the earned-right nature of the benefit (beneficiaries earn the right to a benefit by working a minimum of 10 years in Social Security covered employment);
2. maintain the link between a worker's pay and time in the labor force and that worker's benefit;
3. maintain a progressive benefit formula that provides a higher replacement rate for low-income earners;
4. provide a benefit to all who have contributed to the system and meet the qualifications for a benefit (no means-testing i.e. no conditioning of eligibility on individual income or assets);

5. maintain the self-financed nature of the system;
6. require contributions from both employers and employees;
7. require participation from all workers—this means newly hired state and local workers; this would not be retroactive (provide an opportunity for those workers still in non-covered employment to participate as self-employed Social Security-covered workers for the remainder of their lives in non-covered employment);
8. continue full and automatic adjustments of benefits for changes in the cost of living;
9. continue to provide disability protection;
10. continue to provide protection for families of workers through dependent and survivor benefits;
11. maintain early retirement benefits that, while reduced, are the actuarial equivalent of the amount received at full retirement age.

AARP believes all who participate in the system (beneficiaries, employers, and employees) should share the sacrifice that will be required to achieve long-term solvency.

The CHAIRMAN. Mr. Vargas and Miss Ross, give me 7 minutes to go vote. I will have to call a recess, but I will hurry. [Recess.]

The CHAIRMAN. I would take this opportunity to reconvene the hearing and to thank everybody for being patient and now go to Mr. Vargas.

STATEMENT OF FIDEL VARGAS, MEMBER, 1994–1995 ADVISORY COUNCIL ON SOCIAL SECURITY

Mr. VARGAS. Good morning, Senator Grassley. I am honored to be here today to share my perspective on Social Security as you attempt to define the goals of the Social Security system going forward.

I have been invited to share my thoughts as a younger contributor to Social Security and as a member of a minority population. Before I begin, however, I would like to state that as a former mayor and former member of the Advisory Council on Social Security, I am acutely aware of the politically charged nature of this issue.

I personally struggled to balance the concerns of competing interests groups throughout my tenure on the Advisory Council. I know that this is a difficult issue and I commend you for your efforts to address it responsibly. My true hope is that partisan politics can be put aside in order to build a strengthened Social Security system.

No matter where you stand on the issue of reform, it is evident that action is required in the short term to address real long-term problems. There were no voices on the Advisory Council supporting the status quo. Our only differences were found in the specifics of each proposal and the philosophical foundations on which those proposals are based.

Since the purpose of this hearing is to identify what the core goals of Social Security should be, I would like to focus my comments on what I, as a young American, believe should be the goals for Social Security. In addition to being young, my thoughts on this issue are also shaped by my status as a member of a minority population, the Hispanic community, and as a father of three young boys.

As I look back at my experience on the Advisory Council on Social Security, I am reminded of a practice that I would follow in preparation for our meetings. Prior to flying back to Washington I would visit our local senior citizens center to speak with my constituents about Social Security. They each had their own opinions about what should be done regarding the future of the system, but few of them, although I would like to say more than I expected, offered to sacrifice their present benefits for future generations. They contributed to the system when they worked and they expected, and I believe rightly so, that everything they put into the system would be gotten back.

Next I would speak to some of my peers. As I listened to the many twentysomethings, what I heard was what most polls were telling us on the Advisory Council and what we have already heard today. My friends said that they were not counting on the Social Security system to be there when they retired. And, as we heard already, more young Americans believe in the existence of UFOs than the future of Social Security benefits.

While expectations remained low, no one seemed to mind that 12.4 percent of their paycheck was going to fund current retirees. Like me, my peers view this as part of the program. In other words, there was nothing they could do to change the situation, so why be upset? Besides, the money was going to our grandparents or our friends' grandparents and helping them live a more comfortable life.

Finally, I would talk to my wife. We would discuss our future and the future of our children. Having been blessed with many great opportunities in life, we believed that our future, both immediate and long-term, would be secure. Having just completed my first semester at Harvard Business School, I am hopeful that I will be able to secure a good job after graduation so that I will be able to pay back all those Federal loans and plan for our retirement.

In terms of our children, we were not as certain about their future prospects. In fact, we came to realize that their future was directly linked to the decisions that would be made on programs such as Social Security. Ultimately it will be our children and their children who will be responsible for bearing the burden of the choices we make today. Should we move away from a pay-as-you-go system? Should we establish a trigger tax 45 years into the future? The answers to these questions and other questions will determine my children's future.

Throughout the entire process I tried to balance the interest and concerns of seniors, Baby Boomers, Generation X'ers and my children's generation. This was not an easy task. However, after careful consideration and after putting extra weight on the concerns of my children and future generations, I came to rest on three basic principles or goals that I would urge you to consider as you develop your proposals.

Honoring current obligations. First, retired Americans or those approaching retirement should receive what they have been promised. No proposal presented by the Advisory Council ignored those obligations. In terms of specifics, there was broad agreement on issues relating to taxation of benefits, as well as the adjustment of the retirement age.

Maintenance of the safety net or minimum benefit for low wage earners. Second, the Social Security system should provide a basic floor of protection for all full-career workers which is fully cost-of-living-adjusted for people in retirement and keeps pace with earnings growth prior to retirement.

In addition, the system should intentionally, as it does now, redistribute benefits towards low-wage workers. This is especially relevant for minority communities. Due to structural issues that are beyond the focus of this discussion, a large percentage of the African-American and Hispanic workforce is comprised of low-wage workers. Any proposal that would significantly reduce the minimum benefit should be viewed negatively.

Move towards some form of advance funded system. Third, as outlined by the personal security account proponents within the Advisory Council on Social Security, the benefits of a PSA-type plan exceed those offered by the current system for a number of reasons. An advance-funded system would replace a system of unfunded benefit promises that shifts the cost of benefits for the elderly to workers in future generations with a fully funded system in which each generation saves for its own retirement.

Create a direct link between the tax contribution workers make and the benefits to which they are ultimately entitled, eliminating much of the complexity of the current system. Such a system would also replace a system whose solvency is highly sensitive to demographic developments with a system that essentially runs on automatic pilot. Personal accounts vary in value with changes in investment choices and performance but remain fully funded at all times.

It would also allow individual workers and families to be directly involved in the investment decisions that will vitally influence their future wealth and income. And it would give workers real ownership claims over the contributions and the proceeds of their accounts, thus substantially reducing the political uncertainty surrounding the size and cost of future benefits.

In conclusion, I believe this committee, the Congress and the President have an opportunity to make fundamental changes that can solve our Social Security problem once and for all. While the political and financial costs are substantial, the cost of delaying action could be even greater still. Thank you.

The CHAIRMAN. Thank you, Mr. Vargas.

Ms. Ross.

STATEMENT OF JANE ROSS, DIRECTOR FOR INCOME SECURITY, U.S. GENERAL ACCOUNTING OFFICE

Ms. ROSS. Thank you, Senator Grassley. Thank you for inviting me to speak about the Social Security program and the difficult choices that restoring its long-term solvency will require.

Several witnesses have talked about the crucial importance of Social Security to the nation's retirement income system. They have also talked about actions to financially strengthen Social Security.

The CHAIRMAN. I think the microphone may be close enough but can you turn it? Yes, like that.

Ms. ROSS. In my written testimony I discuss five fundamental choices that the Social Security reforms will reflect. This morning I want to concentrate on three of these choices. They are balancing income adequacy and individual equity, determining who bears the risks and responsibilities in various proposals, and deciding how much Social Security should be involved in saving and investing in the nation's productive capacity. I have also been asked by your staff to discuss where the other witnesses have come out on these choices.

First with regard to income adequacy and individual equity, helping to ensure adequate retirement income is a fundamental goal of Social Security. While Social Security was never intended to guarantee an adequate income, it provides an income base on which to build.

Virtually all the reform proposals pay some attention to income adequacy. However, they place a different emphasis on it, as compared with the goal of individual equity, which means seeking to ensure that benefits bear some relationship to contributions.

The current Social Security benefit formula focusses on adequacy by redistributing income from high earners to low earners to provide relatively more benefits in proportion to wages to low earners. In addition, Social Security helps ensure adequate income by providing benefits for dependent and surviving spouses and children. Also, it automatically ensures that the purchasing power of benefits keeps pace with inflation.

Proposals that would increase the extent to which workers save for their own retirement would reduce income redistribution because contributions to individual accounts would no longer be available to be shifted to benefit lower earners.

Still, proponents of individual accounts assert that virtually all retirees would be at least as well off as they are now and that such reforms, at the same time, would improve individual equity. Citing historical investment returns, they argue that rates of returns that workers could earn on their individual retirement savings would be much higher than the returns they implicitly earn under the current system and that their retirement incomes would be higher as a result.

However, income adequacy under such reforms would depend on how workers invest their savings and whether they actually earn the higher returns.

The testimonies we have heard this morning all mentioned both income adequacy and individual equity in one way or another. However, they also demonstrate clearly the different emphasis that can be placed on these two goals.

Commissioner Apfel and Mr. Perkins from the AARP emphasize strong support for achieving income adequacy through program features such as redistribution from higher to lower earners. They also emphasize the importance of survivor and disability benefits as a source of adequacy.

Mr. Penny from the CATO Institute, while endorsing a safety net to assure some minimum level of income, gives high priority to changes that offer a better return on people's contributions. Mr. Vargas also speaks about individual equity in terms of giving workers real ownership claims over the proceeds of their accounts.

To oversimplify a great deal, we see two quite different visions of Social Security here with regard to the relative importance of adequacy and equity.

Moving on to who bears the risk and responsibility in various proposals, the balance between income adequacy and individual equity also influences how risk and responsibility are borne by individuals and the government.

Workers face individually based risks, such as how long they are able to work, how long they will live and whether they will be survived by a spouse or dependent children. They also face some collective risks, such as the performance of the economy and the extent of inflation.

Under the current Social Security system, the society as a whole largely takes responsibility for these risks as they relate to retirement income. This tends to minimize the risk to individuals, but in the process lowers the rate of return they implicitly earn on their retirement contributions.

The commissioner spoke about Social Security spreading the risks associated with disability, premature death, and old age among the entire working population and Mr. Perkins talked about supporting the broad sharing of this risk of income loss.

Under reform proposals that increase the role of individual savings, virtually all the risk and responsibility is placed on individuals while, at the same time, they are also given greater control of the management of their assets.

Mr. Penny suggests that a reform system should increase an individual's personal sense of responsibility for achieving retirement security and Mr. Vargas favors allowing workers to be directly involved in the investment decisions that will influence their future wealth and income.

Finally, let me talk a little bit about saving and investing for productivity growth. Some people believe that Social Security reforms should help address the fundamental economic issues that underlie Social Security's financing problems. Although people are living longer and healthier lives, they have also been retiring earlier and having smaller families. Unless these patterns change, relatively fewer workers will be producing goods and services for a society with relatively more retirees.

Economic growth could help ease the strains of providing for a larger elderly population by producing more goods and services for consumption. Increased investment in physical and human capital should generally increase productivity and economic growth, but investment depends on national saving.

Recognizing these economic fundamentals, proponents of increasing the role of individual retirement savings usually observe that advance funding through individual accounts would increase savings. However, it is also true that Social Security reforms could increase national saving within the current program structure. So advance funding could increase saving and it could be applied to government-controlled trust funds, as well as to individual accounts.

Mr. Penny discussed the importance of economic growth and argues that one principle on which a reform system should be based is to increase national savings and thereby spur economic growth. However, there are others who believe that issues of national saving and economic growth, while incredibly important, should be a part of a broader economic discussion. They don't think it is appropriate to tightly link issues of economic growth to Social Security reform.

So to conclude, restoring Social Security's long-term solvency presents complex and important choices or trade-offs. The preceding testimonies give you some idea of how differently the system may turn out as a result of choices in several areas. These choices include how reform will balance income adequacy and individual equity, how risks are shared as a community or assumed by individuals, and how much the nation saves and invests its capacity to produce goods and services.

We need to think carefully about these choices. In the end, whatever reforms are adopted, they will reflect these fundamental choices, either implicitly or explicitly.

Mr. Chairman, I would be happy to answer your questions.

[The prepared statement of Ms. Ross follows:]

United States General Accounting Office

GAO

Testimony

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SOCIAL SECURITY

Restoring Long-Term Solvency Will Require Difficult Choices

Statement of Jane L. Ross, Director
Income Security Issues
Health, Education, and Human Services Division

GAO/T-HEHS-98-95

Mr. Chairman and Members of the Committee:

Thank you for inviting me to speak about the goals of the Social Security program and the difficult choices that restoring its long-term solvency will require. Social Security is the foundation of the nation's retirement income system. It provides 42 percent of all the income of the elderly, which is twice as much as any other single source. However, because of dramatic demographic changes, Social Security now faces a serious long-term financing shortfall.

Today, I would like to discuss five fundamental choices that Social Security reforms will reflect: (1) balancing income adequacy and individual equity, (2) determining who bears risks and responsibilities, (3) choosing among various benefit reductions and revenue increases, (4) using pay-as-you-go or advance funding, and (5) deciding how much to save and invest in the nation's productive capacity. My testimony is based on work we have done over the past few years.[1]

BACKGROUND

When Social Security was enacted in 1935, the nation was in the midst of the Great Depression. About half of the elderly depended on others for their livelihood, and roughly one-sixth received public charity. Many had lost their savings. Social Security was created to help ensure that the elderly would have adequate retirement incomes and would not have to depend on welfare. It would provide benefits that workers had earned because of their contributions and those of their employers.

When Social Security started paying benefits, it responded to an immediate need to bolster the income of the elderly. The Social Security benefits that early beneficiaries received significantly exceeded their contributions, but even the very first beneficiaries had made some contributions.[2] Initially, funding Social Security benefits required relatively low payroll taxes because very few of the elderly had earned benefits under the new system. Increases in payroll taxes were always anticipated to keep up with the benefit payments as the system matured and more retirees received benefits. Virtually from the beginning, Social Security was financed on this type of pay-as-you-go basis. With

[1]See the list of related GAO products at the end of this statement.

[2]While early beneficiaries made relatively small contributions within the Social Security system, as a group they contributed substantial amounts outside the system to the retirement incomes of their parents' generation, which did not qualify for Social Security benefits. Such contributions included not only income support that some provided to their own parents but also taxes and charitable contributions that paid for other [illegible] support.

any single year's revenues collected primarily to fund that year's benefits. The Congress had rejected the idea of advance funding for the program, or collecting enough revenues to cover future benefit rights as workers accrued them. Many expressed concern that if the federal government amassed huge reserve funds, it would find a way to spend them.

Over the years, both the size and scope of the program have changed, and periodic adjustments have been necessary. In 1939, coverage was extended to dependents and survivors. In the 1950s, state and local governments were given the option of covering their employees. The Disability Insurance program was added in 1956. Beginning in 1975, benefits were automatically tied to the Consumer Price Index to ensure that the purchasing power of benefits was not eroded by inflation. These benefit expansions led to higher payroll tax rates in addition to the increases stemming from the maturing of the system. Moreover, the long-term solvency of the program has been reassessed annually. Changes in demographic and economic projections have required benefit and revenue adjustments to maintain solvency, such as the amendments enacted in 1977 and 1983.

Profound demographic trends are now contributing to Social Security's long-term financing shortfall. As a share of the total U.S. population, the elderly population grew from 7 percent in 1940 to 13 percent in 1996; this share is expected to increase further to 20 percent by 2050. As it ages, the baby-boom generation will increase the size of the elderly population. However, other demographic trends are at least as important. Life expectancy has increased continually since the 1930s, and further improvements are expected. Moreover, the fertility rate has declined from 3.6 children per woman in 1960 to around 2 children per woman today and is expected to level off at about 1.9 by 2020. Combined, increasing life expectancy and falling fertility rates mean that fewer workers will be contributing to Social Security for each aged, disabled, dependent, or surviving beneficiary. While 3.3 workers support each Social Security beneficiary today, only 2 workers are expected to be supporting each beneficiary by 2030.

As a result of these demographic trends, Social Security revenues are expected to be about 14 percent less than expenditures over the next 75-year period, and demographic trends suggest that this imbalance will grow over time. By 2030, the Social Security trust funds are projected to be depleted. From then on, Social Security revenues are expected to be sufficient to pay only about 70 to 75 percent of currently promised benefits, given currently scheduled tax rates and the Social Security Administration's (SSA) intermediate assumptions about demographic and economic trends.[3] In 2031, the last members of the baby-boom generation will reach age 67, when they will be eligible for full retirement benefits under current law.

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[3]Some demographers project even more dramatic growth in the elderly population than Social Security actuaries do. In particular, the 1994-96 Social Security Advisory Council's Technical Panel on Assumptions and Methods noted that Social Security's mortality assumptions reflect a lower rate of mortality improvements than may be warranted

Restoring Social Security's long-term solvency will require some combination of increased revenues and reduced expenditures. A variety of options are available within the current structure of the program, such as raising the retirement age, reducing inflation adjustments, increasing payroll tax rates, and investing trust fund reserves in higher-yielding securities.

However, some proposals would go beyond restoring long-term solvency and would fundamentally alter the program structure by setting up individual retirement savings accounts and requiring workers to contribute to them. Retirement income from these accounts would usually replace a portion of Social Security benefits. Some proposals would attempt to produce a net gain in retirement income. The combination of mandated savings deposits and revised Social Security taxes would be greater than current Social Security taxes, in most cases.

RELATIVE EMPHASIS BETWEEN INCOME ADEQUACY AND INDIVIDUAL EQUITY

Helping ensure adequate retirement income has been a fundamental goal of Social Security. While Social Security was never intended to guarantee an adequate income, it provides an income base upon which to build. Virtually all reform proposals also pay some attention to "income adequacy," but some place a different emphasis on it relative to the goal of "individual equity," which seeks to ensure that benefits bear some relationship to contributions. Some proponents of reform believe that increasing the role of individual retirement savings could improve individual equity without diminishing income adequacy.

The current Social Security program seeks to ensure adequate retirement income in various ways. First, it makes participation mandatory, which guards against the possibility that some people would not otherwise save enough to have even a minimal retirement income. Reform proposals also generally make participation mandatory.

Second, the current Social Security benefit formula redistributes income from high earners to low earners to help keep low earners out of poverty. It accomplishes this by replacing a larger share of lifetime earnings for low earners and a smaller share for high earners.[4] In addition, Social Security helps ensure adequate income by providing benefits for dependent and surviving spouses and children who may not have the work history required to earn adequate benefits. Also, it automatically ensures that the purchasing

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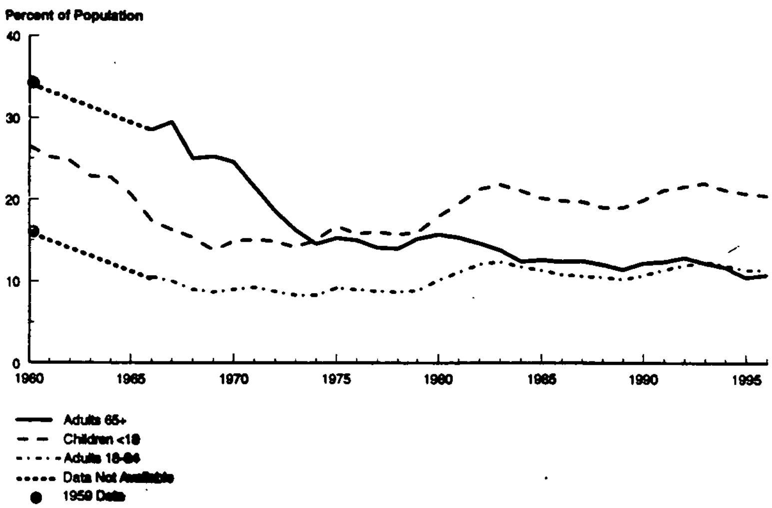
[4]Specifically, the primary insurance amount (PIA) is the full monthly benefit payable to retired workers at age 65 or to disabled workers when first entitled. For those entitled to benefits in 1997, the PIA equalled (1) 90 percent of the first $455 of average indexed monthly earnings (AIME) plus (2) 32 percent of the next $2,286 of AIME plus (3) 15 percent of AIME over $2,741. The bend points in this formula (dollar amounts of AIME defining each bracket) are indexed to increases in average national earnings.

power of benefits keeps pace with inflation, unlike most employer pension plans or individually purchased annuities.

While the Social Security benefit formula seeks to ensure adequacy by redistributing income, it also promotes some degree of individual equity by ensuring that benefits are at least somewhat higher for workers with higher lifetime earnings.

In helping ensure adequate retirement income, Social Security has contributed to reducing poverty among the elderly. (See fig. 1.) Since 1959, poverty rates for the elderly have dropped by two-thirds, from 35 percent to less than 11 percent in 1996. While they were higher than rates for children and for working-age adults (aged 18 to 64), they are now lower than for either group. For more than half the elderly, income other than Social Security was less than the poverty threshold in 1994.

Figure 1: The Decline in Poverty Rates for the Elderly

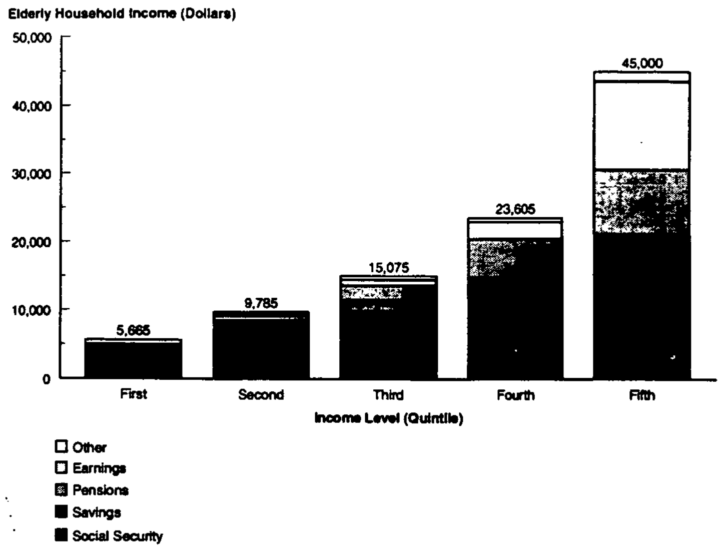


Note: Estimates for adults 65+ and adults 18-64 are not available for 1960-65.

Source: U.S. Bureau of the Census.

While Social Security provides a strong foundation for retirement income, it is only a foundation. In 1994, it provided an average of roughly $9,200 to all elderly households. Median Social Security benefits have historically been very close to the poverty threshold. Elderly households with below-average income rely heavily on Social Security, which provided 80 percent of income for 40 percent of elderly households in 1994. (See fig. 2.) One in seven elderly Americans has no income other than Social Security. Pockets of poverty remain. Women, minorities, and persons aged 75 and older are much more likely to be poor than other elderly persons. For example, compared with 11 percent for all elderly persons (aged 65 and older) in 1996, poverty rates were 23 percent for all elderly women living alone, roughly 25 percent for elderly blacks and Hispanics, and 31 percent for black women older than 75. Unmarried women make up more than 70 percent of poor elderly households, although they account for only 45 percent of all elderly households.

Figure 2: The Reliance of Lower-Income Elderly Households on Social Security



Note: Data are for 1994. Median incomes for each quintile are GAO estimates. Social Security income for the highest fifth may be lower than for the previous fifth because, among other possible reasons, some elderly workers or their spouses may not yet be collecting benefits.

Source: GAO analysis of data from Susan Grad, Income of the Population 55 and Older, 1994 (Washington, D.C.: SSA, Office of Research and Statistics, 1996).

Proposals that would increase the extent to which workers save for their own retirement would reduce income redistribution because any contributions to individual accounts that would otherwise go to Social Security would not be available for redistribution. Still, proponents of individual accounts assert that virtually all retirees would be at least as well off as they are now and that such reforms would improve individual equity. Citing historical investment returns, they argue that the rates of return that workers could earn on their individual retirement savings would be much higher than the returns they implicitly earn under the current system and that their retirement incomes could be higher as a result. Nevertheless, earning such higher returns would require investing in riskier assets such as stocks. Income adequacy under such reforms would depend on how workers invest their savings and whether they actually earn higher returns. It would also depend on what degree of Social Security coverage and its income redistribution would remain after reform.

In addition to examining the effects of reform proposals on all retirees generally, attention should be paid to how they affect specific subpopulations, especially those that are most vulnerable to poverty, including women, widows, minorities, and the very old. Reform proposals vary considerably in their effects on such subpopulations. For example, since men and women typically have different earnings histories, life expectancies, and investment behaviors, reforms could exacerbate differences in benefits that already exist. An individual savings approach that permits little redistribution would on average generate smaller savings balances at retirement for women, who tend to have lower earnings from both employment and investments, and these smaller balances would need to last longer because women have longer life expectancies.[5]

WHO BEARS RISK AND RESPONSIBILITY?

The balance between income adequacy and individual equity also influences how much risk and responsibility are borne by individuals and the government. Workers face a variety of risks regarding their retirement income security. These include individually based risks, such as how long they will be able to work, how long they will live, whether they will be survived by a spouse or other dependents, how much they will earn and save over their lifetimes, and how much they will earn on retirement savings. Workers also face some collective risks, such as the performance of the economy and the extent of inflation. Different types of retirement income embody different ways of assigning responsibility for these risks.

Social Security was based on a social insurance model in which the society as a whole through the government largely takes responsibility for all these risks to help ensure adequate income. This tends to minimize risks to the individuals and in the process lowers the rate of return they implicitly earn on their retirement contributions. Social Security provides a benefit that provides income to workers who become disabled and to workers who reach retirement, for as long as they live, and for their spouse and dependents. The government takes responsibility for collecting and managing the revenues needed to pay benefits. By redistributing income, Social Security helps protect workers against low retirement income that stems from low lifetime earnings.

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[5]See Social Security Reform: Implications for Women's Retirement Income (GAO/HEHS-98-42, Dec. 31, 1997).

Social Security pays a pension benefit that is determined by a formula that takes lifetime earnings into account. This type of pension is called a defined benefit pension. Many employer pensions are also defined benefit pensions. These pensions help smooth out variations in benefit amounts that can arise from year to year because of economic fluctuations. Defined benefit pension providers assume investment risks and some of the economic risks and take responsibility for investing and managing pension funds and ensuring that contributions are adequate to fund promised benefits. In contrast, defined contribution pensions, such as 401(k) accounts, base retirement income solely on the amount of contributions made and interest earned. Such pensions resemble individual savings.

Retirement savings by individuals place virtually all the risk and responsibility on individuals but give them greater freedom and control over their income. Under reform proposals that increase the role of individual savings, the government role would primarily be to make sure that workers contribute to their retirement accounts and to regulate the management of those accounts. Workers would be responsible for choosing how to invest their savings and would assume the investment and economic risks. Some proposals would allow workers to invest only in a limited number of "indexed" investment funds, which like some mutual funds are managed so they mirror the performance of market indexes like the Standard and Poor 500. Some proposals would require workers to buy an annuity at retirement, while others would place few restrictions on how workers use their funds in retirement.

Social Security places relatively greater emphasis on adequacy and less on individual equity by providing a way for all members of society to share all the risks. An individual retirement savings approach places relatively less emphasis on adequacy and more on individual equity by making retirement income depend more directly on each person's contributions and management of the funds. Reform proposals that would increase the role of individual savings would change the overall mix of different types of retirement income and with it the relative emphasis on adequacy and individual equity embodied by that mix.

In addition to changing the relative roles of Social Security and individual savings, such Social Security reform could indirectly affect other sources of retirement income and related public policies. For example, raising Social Security's retirement age or cutting its benefit amounts could affect employer pensions. Some employers pay supplements to their pensions until retirees start to receive Social Security income, or they set their pension benefits relative to Social Security's. Employers might terminate their pension plans rather than pay increased costs. Reforms would also interact with other income support programs such as Social Security's Disability Insurance or the Supplemental Security Income public assistance program. For example, raising the retirement age could lead more older workers to apply for Social Security's disability benefits because those benefits would be greater than retirement benefits, if they qualify.

REDUCING BENEFITS OR INCREASING REVENUES?

No matter what shape Social Security reform takes, restoring long-term solvency will require some combination of benefit reductions and revenue increases. Within the current program structure, examples of possible benefit reductions include modifying the benefit formula, raising the retirement age, and reducing cost-of-living adjustments. Revenue increases might take the form of increases in the payroll tax rate, expanding coverage to include the relatively few workers who are still not covered under Social Security, or allowing the trust funds to be invested in potentially higher-yielding securities such as stocks.[6] Reforms that increase the role of individual retirement savings would also involve Social Security benefit reductions or revenue increases, which might take slightly different forms. For example, such reforms might include Social Security benefit reductions to offset any contributions that are diverted from the current program or permitting workers to invest their retirement savings in stocks.

The choice among various benefit reductions and revenue increases will affect the balance between income adequacy and individual equity. Benefit reductions could pose the risk of diminishing adequacy, especially for specific subpopulations. Both benefit reductions and tax increases that have been proposed could diminish individual equity by reducing the implicit rates of return the workers earn on their contributions to the system. In contrast, increasing revenues by investing retirement funds in the stock market could improve rates of return.

The choice among various benefit reductions and revenue increases–for example, raising the retirement age–will ultimately determine not just how much income retirees will have but also how long they will be expected to continue working and how long their retirements will be. Reforms will determine how much consumption workers will give up during their working years to provide for more consumption during retirement.

PAY-AS-YOU-GO OR ADVANCE FUNDING?

Reform proposals have also raised the issue of increasing the degree to which the nation sets aside funds to pay for future Social Security benefits. Advance funding could reduce payroll tax rates in the long term and improve intergenerational equity but would involve significant transition costs. As noted earlier, Social Security is largely financed on a pay-as-you-go basis. In a pure pay-as-you-go arrangement, virtually all revenues come from payroll taxes since trust funds are kept to a relatively small contingency reserve that

[6]About 4 percent of the work force remains uncovered, which mostly includes some state and local government employees and federal employees hired before 1984.

earns relatively little interest compared with the interest that a fully funded system would earn.[7]

In contrast, defined benefit employer pensions are generally fully advance funded. As workers accrue future pension benefit rights, employers make pension fund contributions that are projected to cover them. The pension funds accumulate substantial assets that contribute a large share of national saving. The investment earnings on these funds contribute considerable revenues and reduce the size of pension fund contributions that would otherwise be required to pay pension benefits.

Defined contribution pensions and individual retirement savings are fully funded by definition, and investment earnings on these retirement accounts also help provide retirement income. Similarly, Social Security reform proposals that increase the role of individual retirement savings would generally increase advance funding.

Advance funding is possible in the public sector simply by collecting more revenue than is necessary to pay current benefits. However, advance funding in the public sector raises issues that prompted the Congress to reject advance funding in designing Social Security. A fully funded Social Security program would have trust funds worth trillions of dollars. If the trust funds were invested in private securities, some people would be concerned about the influence that government could have on the private sector. If these funds were invested only in federal government securities, as is required under current law, taxpayers would eventually pay both interest and principal to the trust funds and ultimately cover the full cost of Social Security benefits. Moreover, the effect of advance funding in the public sector fundamentally depends on whether the government as a whole is increasing national saving, as discussed further below.

If Social Security reforms increase the balances in privately held retirement funds, interest on those funds could eventually help finance retirement income and reduce the system's reliance on Social Security payroll contributions, which in turn would improve individual equity. At the same time, the relatively larger generation of current workers could finance some of their future benefits now rather than leaving a relatively smaller

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[7]Social Security is now temporarily deviating from pure pay-as-you-go financing by building up substantial trust fund reserves. It is collecting more in revenues than it pays in benefits each year partly because the baby-boom generation makes the size of the work force larger relative to the beneficiary population. In 2012, shortly after the baby boom starts to retire, the benefit payments are expected to exceed revenues, and the trust fund reserves and the interest they earn will help pay the baby boom's retirement benefits. For more detail about this temporary trust fund buildup and how it interacts with the federal budget, see Social Security Reform: Demographic Trends Underlie Long-Term Financing Shortage (GAO/T-HEHS-98-43, Nov. 20, 1997).

future generation of workers with the entire financing responsibility. In effect, advance funding shifts responsibility for retirement income from the children of one generation of retirees to that retiree generation itself.

However, larger payroll contributions would be required in the short term to build up those fund balances. Social Security would still need revenues to pay benefits that retirees and current workers have already been promised. The contributions needed to fund both current and future retirement liabilities would clearly be higher than those currently collected.

Thus, increasing advance funding in any form involves substantial transition costs as workers are expected to cover some portion of both the existing unfunded liability and the liability for their own future benefits. Reform proposals handle this transition in a variety of ways, and the transition costs can be spread out across one or several generations. The nature of specific reform proposals will determine the pace at which advance funding is increased. For example, one proposal would increase payroll taxes by 1.52 percent for 72 years to fund the transition and would involve borrowing $2 trillion from the public during the first 40 years of the transition to help cover the unfunded liability.

SAVING AND INVESTING FOR PRODUCTIVITY GROWTH

Ideally, Social Security reforms would help address the fundamental economic implications of the demographic trends that underlie Social Security's financing problems. Although people are living longer and healthier lives, they have also been retiring earlier and have been having smaller families. Unless these patterns change, relatively fewer workers will be producing goods and services for a society with relatively more retirees. Economic growth, and more specifically growth in labor productivity, could help ease the strains of providing for a larger elderly population. Increased investment in physical and human capital should generally increase productivity and economic growth, but investment depends on national saving, which has been at historically low levels.

Recognizing these economic fundamentals, proponents of increasing the role of individual retirement savings generally observe that a pay-as-you-go financing structure does little to help national saving, and they argue that the advance funding through individual accounts would increase saving. However, reforms would not produce notable increases in national saving to the extent that workers reduce their other saving in the belief that their new accounts can take its place.

Social Security reforms might also increase national saving within the current program structure. Advance funding would increase saving, and it could be applied to government-controlled trust funds as well as to individual accounts. Any additional Social Security savings in the federal budget could add to national saving but only if not offset by deficits in the rest of the federal budget. More broadly, overall federal budget surpluses or deficits affect national saving since they represent saving or dissaving by the government.

To the extent that reforms attempt to increase national saving, they will vary by how much emphasis they place on doing so through individual or government saving. That emphasis will reflect not only judgments about which is likely to be more effective but also values regarding the responsibilities of individuals and governments and attitudes toward the national debt. While these points will be much debated, few dispute the need to be aware of the effect of increasing national saving, although it may be hard to achieve.

OBSERVATIONS

In some form and to varying degrees, every generation of children has supported its parents' generation in old age. In economic terms, those who do work ultimately produce the goods and services consumed by those who do not. The Social Security system and, more broadly, the nation's retirement income policies, whatever shape they take, ultimately determine how and to what extent the nation supports the well-being of the elderly.

Restoring Social Security's long-term solvency presents complex and important choices. These choices include how reforms will balance income adequacy and individual equity; how risks are shared as a community or assumed by individuals; how reforms assign roles and responsibilities among government, employers, and individuals; whether retirements will start earlier or later and how large retirement incomes will be; and how much the nation saves and invests in its capacity to produce goods and services. Whatever reforms are adopted will reflect these fundamental choices implicitly, if not explicitly.

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This concludes my testimony. I would be happy to answer any questions.

RELATED GAO PRODUCTS

Social Security Reform: Implications for Women's Retirement Income (GAO/HEHS-98-42, Dec. 31, 1997).

Social Security Reform: Demographic Trends Underlie Long-Term Financing Shortage (GAO/T-HEHS-98-43, Nov. 20, 1997).

Budget Issues: Analysis of Long-Term Fiscal Outlook (GAO/AIMD/OCE-98-19, Oct. 22, 1997).

401(k) Pension Plans: Loan Provisions Enhance Participation But May Affect Retirement Income Security for Some (GAO/HEHS-98-5, Oct. 1, 1997).

Retirement Income: Implications of Demographic Trends for Social Security and Pension Reform (GAO/HEHS-97-81, July 11, 1997).

Social Security Reform: Implications for the Financial Well-Being of Women (GAO/T-HEHS-97-112, Apr. 10, 1997).

401(k) Pension Plans: Many Take Advantage of Opportunity to Ensure Adequate Retirement Income (GAO/HEHS-96-176, Aug. 2, 1996).

Social Security: Issues Involving Benefit Equity for Working Women (GAO/HEHS-96-55, Apr. 10, 1996).

Federal Pensions: Thrift Savings Plan Has Key Role in Retirement Benefits (GAO/HEHS-96-1, Oct. 19, 1995).

Social Security Retirement Accounts (GAO/HEHS-94-226R, Aug. 12, 1994).

Social Security: Analysis of a Proposal to Privatize Trust Fund Reserves (GAO/HRD-91-22, Dec. 12, 1990).

Social Security: The Trust Fund Reserve Accumulation, the Economy, and the Federal Budget (GAO/HRD-89-44, Jan. 19, 1989).

(207030)

The CHAIRMAN. Thank you. Every one of you has had a very unique perspective to offer and I appreciate it very much. I would hope that this would be a forerunner to the national dialog that the President is promoting in the sense that I think you have laid out very well what most of the alternatives and problems are, and each of you have different ideas to deal with them.

My first question would go to any or all panelists. The change that will most impact the Social Security program is the increasing life expectancy rates for our citizens. The eligibility age, of course, was 65 and still is, since 1935. That age, I have been told, was what the German social security system set and we just kind of adopted it.

Now, however, retirement patterns are changing very dramatically. Social Security may or may not be responsible for that. Many people retire at age 62. In contrast, our younger workers, like Mr. Vargas, I presume, will have to wait until he's 67 for full retirement because that is based on the law that we changed in 1983.

I would like to hear from all of you about whether we should accept the fact that people want to spend more time in retirement if, that is a fact, or should we encourage people to continue to work or whether the marketplace makes that decision, but that we eliminate disincentives for productive work, as it relates to Social Security.

Any and all of you, I hope you all have something to contribute to that because it is very central.

Ms. ROSS. Perhaps I could provide a little bit of information about it, the usual GAO-type contribution.

In the future, as the Baby Boom population is moving into retirement, the group behind it is relatively smaller. That means that there will be relatively fewer workers in the traditional working age groups. Economics would suggest that fewer workers will command higher wages as you try and entice more people into the workforce.

So it may be that the economy will induce older people to stay in the workforce longer because the wages will be higher.

Second, there is evidence at this point that over the last 10 years there has not just been an increase in longevity but there also has been an improvement in the health of older people. So it is possible that individuals not only are living longer but are also more capable of working well into older age.

In addition to those two pieces of information, I would like to add one other issue changing the normal retirement age, that is, the age for full benefits. If you simply move the normal retirement age up from 67 to an older age, you still are allowing people to elect to retire as early as age 62 with reduced benefits.

Some people have proposed eliminating the early retirement age or moving it up, as well, so that you would have a set of people from 62 to something—64, 65—who wouldn't receive any retirement benefit at all.

If that should happen, I think one needs to think about how you might make changes in the disability program, whether there is something else that might need to be done.

Mr. PERKINS. Basically, and it is relative to your final remarks, Ms. Ross, there are concerns that we have with the increase in age.

Age is one of the elements that very definitely, sitting around the table, should be discussed. But right now the age 62 benefit is a dignified benefit, providing about 80 percent of the full benefit to the many who do retire at age 62.

At age 67, and I recall that the benefit is reduced about 7 percent a year, it is going to be only about a 67 percent benefit. There is a question of whether that is dignified. And if the upper age is increased beyond age 67 it would certainly reduce the benefit even more.

We haven't been able to find continuing work for older workers to the extent that we would like. That is an issue. We have to have ways of making sure that jobs are available and that employers are willing to hire those older employees.

I have been a proponent of older workers staying in the workplace forever. Anecdotally, I come from one of the few companies, Polaroid, that never had a mandatory retirement policy and we had employees staying on well into their '70s and very productive. But it is a fact that the retirement age has been dropping, such that it is actually about age 62 now.

So all those concerns are there. I very definitely want to express them as part of the debate.

The CHAIRMAN. Congressman Penny.

Mr. PENNY. I think Ms. Ross offered a perspective that is very helpful to this particular question and I want to follow on Mr. Perkins' remark about the retirement age and the lack of decent jobs for people who are in their late 60s.

Ms. Ross mentioned that this is not a static situation. The economy changes. The demographics of the workforce change. And if we, in fact, have a follow-on generation that is much smaller, job opportunities for people to stay in the workforce longer will almost certainly materialize.

So we could be facing a totally different economy with different types of job opportunities at different age levels in the future and we shouldn't pass policy based on what we are experiencing today, but rather have policies that are flexible about where we may be in years ahead.

Obviously when Social Security was first enacted we created a 65-year-old retirement age on the expectation that most people would not live to that age. So talk about perspective. There is that historical perspective, as well, and we have not adjusted, other than the 1983 changes, that Social Security age in the years since then.

In 1987 my first legislative initiative in the arena of Social Security reform was to propose an increase in the retirement age beyond 67 as a way of phasing it up as the Baby Boom generation moved into their retirement years.

I am still comfortable with making that change in our public system as one of many options that we may need to consider to keep the system solvent as current workers move through the system.

But for the longer term, I really think that this is an issue that resolves itself under an approach where we have personally directed investments because under that approach, you are building that fund; you are also aware of the growth in that fund. You are going to have a much stronger incentive to add to and build that fund to an even larger level. And in some ways you are going to determine your own retirement age based on how soon you get to that retirement goal.

So in terms of public programs, yes, we may need to keep the option of raising the retirement age on the table as a way of reducing the cost to the current system and making it fiscally solvent. But for the longer term, if we phase in a system in which more and more of that payroll tax is allowed to be directed by the individual worker, you, in a sense, are creating a system where they define their own retirement age based on when they reach their retirement goals.

The CHAIRMAN. Mr. Vargas, do you want to respond to the question.

Mr. VARGAS. First of all, I am planning hopefully to work well beyond 67 when I reach that age.

My main concern, adding onto what Congressman Penny said, my concern really is for not so much the choice but the need for many Americans today to continue to work beyond that age. That is a whole other issue to speak of. I know that my father, for example, might have to make that decision not because he wants to but because he has to.

So I think that in moving towards a reform of Social Security and talking about how we can improve savings for Americans in the future, I think that will go a long way towards helping us address that very issue.

The CHAIRMAN. Thank you. I will move on to another point that has been touched on but I want to kind of center on it for a minute with some discussion from any or all of you. That is the principle that Social Security is founded on, that society as a whole accept responsibility of providing retirement income security so that each individual has less risk.

Of course, some individuals take a lot of responsibility and save for their retirement and do what they can to enhance any pension that they get from the employer.

In some of the testimony we have heard today it is clear that there is a view that reform should put more responsibility on individuals to prepare for retirement. Could each of you discuss how would a more individualized approach threaten the social cohesiveness of the Social Security system, if you think it is threatened?

Mr. PERKINS. I wouldn't mind starting on that one, Senator. You have to go back to the three-legged stool. When it was first devised, the only leg which required individual saving, where the individual took on the risk, was basically the third leg. Social Security was one leg, and the employer leg was basically, at that point in time, considered to be a defined benefit plan.

Now, with more and more employer plans becoming defined contribution, where the risk and responsibility is shifted to the individual, and with individual savings already being that way, there is a concern about having the third leg, the basic leg, the base leg, the one that is supposed to be the strongest, becoming the same way.

There has always been a need for individual savings. AARP has expressed that over the years and has been a proponent of individual savings for years, over and above what there is for Social Security.

To me, we very definitely are concerned with maintaining a benefit system that protects low income workers to the extent that the current system's income transfer does. For instance, the regressiveness of the payroll tax is ameliorated by the progressive benefit formula and the earned income tax credit to an extent.

And just anecdotally again, I had a brother-in-law whose taxes I did. He was a Mason. He was a grandparent, bringing up grandchildren. It was the earned income tax credit, over and above no income taxes at all, that really paid back the Social Security tax that he was spending in those years that he was bringing his grandchildren up.

So to me, that base and that strength of the Social Security system, where there is an income transfer, is part of the progressivity and is something that we certainly want to maintain. And very definitely, we have always said that savings, over and above that, is important and we definitely want to encourage that as much as we can.

The CHAIRMAN. Congressman Penny.

Mr. PENNY. Social Security was first intended to be a safety net. While we have given lip service to this three-legged stool for the past 60 years, we haven't really done much to encourage the second and third leg of that stool.

As a consequence, we have generations of retirees who went into retirement ill prepared in the sense that they expected more from the Social Security system than it could deliver. Consequently, throughout the years of the Social Security system, we have repeatedly increased the benefit levels. Prior to instituting the cost-of-living adjustment, we had bidding wars between politicians on Capitol Hill and between Capitol Hill and the White House as to who could offer the most generous increases. All of that subsequently led to more payroll tax hikes because we got ahead of ourselves and couldn't afford the benefit increases that we promised.

But the point I am making is we really have done a lot over the years to perpetuate the impression that the Social Security system is your retirement program and we haven't done enough to stress the other legs of the stool.

I think that getting back to the original intent of Social Security is exactly what we ought to do. We ought to make it clear that this system is there to provide a safety net and a floor so that all retirees, regardless of income, regardless of how they have planned in other ways, has at least some support that we provide as a society to make sure that in their retirement years they have some retirement income through the Social Security system.

But I think that turning more of this payroll tax over to the control of the individual worker has many salutary benefits. First of all, even Commissioner Ball has acknowledged that you get three times the return on investment over the course of time through private investments than you would get by putting that money into the Social Security system.

In addition to that, it becomes your own asset, which is transferable if you die young, as many of our low-wage workers and minority workers unfortunately do.

Beyond that, it becomes a system in which you watch the money grow, which then provides that psychological incentive to add to that fund and build that fund even larger. It becomes, in addition to whatever tax breaks we might pass, tax breaks targeted toward encouraging savings, it becomes another way to encourage added contributions to a savings plan.

So I think that all of this is to be taken together and that we need to be thinking about ways we can strengthen the other legs of the stool. Certainly maintain Social Security as the safety net that it was meant to be, a safety net that includes a financial floor that you cannot fall below. But allow more control over a larger share of that payroll tax because that control and that investment will begin to encourage attention to the other legs of the stool, attention which I think has been lacking over the last number of decades, and we cannot afford to ignore those other legs of the stool any longer.

The CHAIRMAN. Do either one of you want to respond?

Ms. ROSS. I would like to go back and reinforce a point or two that I made earlier in my testimony. It has to do with trade-offs or choices.

The current Social Security system has some important features of shared risk and of social adequacy. Proponents of the individual plans talk about higher rates of return and on individual responsibility for the risks.

What I think is important to keep in mind is that it is difficult and maybe even impossible to maximize both equity and adequacy goals simultaneously. This is a matter of choices that policymakers will have to make. If we want to have more individualized responsibility and higher rates of return, you will probably reduce the redistribution and shared risk, and vice versa.

So my point is to reiterate that there are trade-offs here. You can't have all you want from both sides of the ledger.

Mr. VARGAS. I would just stress on that point in terms of choices, in the plan that we put forward, the two-tiered system, we proposed essentially two things. One is for the existence of a safety net, of something that people would not be able to go beyond when they retired so that they could retire with dignity and, at the same time, giving individuals, younger generations, new entrants to the Social Security system, the ability to manage their own future and have a say in how their money is being invested.

But, at the same time, we also recognize that there is a cost to that. I think that whatever is decided, I think those costs need to be considered. And it was very out in the open and we recognize that those costs are very expensive in terms of the transition costs to a two-tiered system.

So, in the end, I think that you might not be able to have it all but if you choose to try to have it all, there are costs associated with that and it all depends on what sort of philosophical position you are willing to take in terms of the future of the system and where you would like it to be.

The CHAIRMAN. I suppose I could ask any of you but since Ms. Ross represents a government agency and given that is her expertise I was just wondering if, as you have heard, these witnesses, and you have probably heard a lot of other people that aren't even here today, describe ideas on the direction reform should take.

Have you heard any areas of consensus that you think we can build on? I ask you to start that discussion. Others, even though you represent specific points of view, if you feel that ideas you have presented are common enough with other organizations as a base of consensus that we can build on, I would like to hear that, as well.

Ms. ROSS. I think I hear some areas of consensus that are really pretty fundamental. That is most people who talk about the Social Security system talk about its inherent importance in the American society. So there seems to be broad agreement that this retirement income system is something that we want to provide for perpetuity.

The second thing is most people seem to be of the belief that we need to start thinking about changing it soon. Some people think it is more of a crisis than others but most people are in favor of beginning the process of resolution quite soon.

What is interesting beyond that, I think, and is important to keep in mind is that after that, you see people's own values and belief systems have a lot of bearing on the kind of system they want to propose.

So again I just would reiterate what I had said earlier. We have a whole series of choices which really are reflecting values about the relative importance of various things, and that is what is causing the difference among proposals. But with this overall agreement on the importance of the system, it seems to me that the discussion this year ought to be quite fruitful on this values issue.

The CHAIRMAN. I would encourage any other panelists, although I don't want to call on a specific person.

Mr. PERKINS. Very definitely, AARP has been wanting a dialog to consensus-build for quite a number of years. We have been very concerned about a lot of the misinformation about the system—it's being in bankruptcy right now, for example.

We look forward very much to the forums that are being discussed. I understand the first one is in Kansas City in April and we will be part of that. We think that they should be bipartisan. We think that they should be impartial. Congressional leaders should participate in them. And also the intergenerational aspect is very important. We certainly want that input.

So we welcome that and to us, that dialog is going to help build a consensus and we look forward to participating in an impartial way.

Mr. PENNY. I can say virtually every organization I am aware of on all sides of this debate are in agreement with the first two principles that I outlined, which is to do it now, get this debate moving forward, and to do it in a bipartisan fashion. Obviously something this important cannot be pursued on a party line vote.

There is growing interest in giving individuals more control over their investments for all of the positive benefits that I have described, particular interest, of course, among younger voters in having that sort of control over their retirement income.

But I think in my generation, the Baby Boom generation, we are very much willing to pay some transition costs to do something better for our children. This is exactly the right time for us to be a part of this debate because we can be more self-sacrificing at this stage in our lives, when we are still 15 and 20 years away from retirement, than we might be when we are just on the verge of retirement. So now is the time for us to be part of the debate about making the system better for our children and following generations.

I can also say that many, many groups, obviously business groups, self-employed groups but many, many worker groups are very interested in seeing us hold the line on payroll taxes. Beyond that, we have strong consensus among just a whole range of fiscal and monetary policy groups about the need to establish new policies regarding our entitlement programs that eliminate government dissavings and provide stronger incentives for both government savings and for private savings.

Mr. VARGAS. One area that I see in terms of agreement is the fact that there is no, at the existing time, no intergenerational conflict that exists between young people and seniors, for example. I think that just as Congressman Penny stated, for Baby Boomers, we are willing to listen and to do our part in order to fix the system going forward.

I think it is very interesting that we talk about the fact that young people believe in the existence of UFOs more than they believe in the existence of the future of Social Security and, at the same time, aren't out marching in the streets saying, "We want our money back."

I think we recognize the responsibility that we have to fund current retirees but, at the same time, I think we are looking for fairness in the debate. We want to make sure that our interests going forward in the future and the interests of our children and their children are considered, as well, and I don't think there is any debate or disagreement on that with anybody on that particular issue.

So I think it is a perfect opportunity to enter into that discussion and to consider what transition costs or what costs we might have to bear, as young people, in order to make sure that the system in the future is fair and is sustainable.

The CHAIRMAN. I think I will end my questioning. There might be some questions that members who couldn't be here would submit for answers in writing. If they do that I would appreciate it if maybe in a period of 15 days we could have those responses. Also some questions that I didn't get to ask maybe would be submitted.

But let me say that this last response that you gave is very pleasing to me. I suppose my view is based on some confidence that this national conversation can bring us to a consensus, now that the President is involved. I am not so sure that without his highlighting it, even though each of you represent very important organizations that can bring about this discussion, I think it takes that sort of leadership to accomplish it.

So I am somewhat more encouraged and particularly for those of you that are in a position like Mr. Perkins, representing an organization of, I think, 36 million people. Congressman Penny, you are involved with organizations that are quoted in the paper every day, as well. Then Mr. Vargas, having served on the commission as an individual, is in a very good position.

Anyway, it does give me confidence that you say that we need to move ahead and sooner is better than later.

The frustration to me comes from another point of view, like within the last 2 or 3 years. I don't know how many of even my own constituents who were somewhat mad at Congress, mad at Washington, would say to me, "Just leave my Medicare alone. Just leave it alone." And they just didn't trust Washington. They didn't want anybody messing around with it.

You know, it is kind of a rude awakening but I did get their attention. "Do you know what will happen if we just leave it alone? It won't exist after the year 2001." Now, of course, there are some changes made. I can say to that person, "Do you know that if we just leave it alone, it won't exist after the year 2008?"

That is the other side. I think with your involvement, with the President's involvement, with Congress and those of us that are on the Aging Committee and other committees of jurisdiction helping it along, maybe we can get that consensus.

But you have been a very important part of the process with this first Capitol Hill discussion of the necessity for doing this, at least the first opportunity since the President has highlighted it, so I thank you very much for your participation and look for continued dialog with each of you and your organizations on this subject.

Thank you very much and I adjourn the meeting.

[Whereupon, at 12:33 p.m., the committee was adjourned.]

APPENDIX

THE HERITAGE FOUNDATION

To: Senator Charles Grassley, Chairman of the Senate Special Committee on Aging.
From: William W. Beach and Gareth G. Davis, Center for data Analysis, The Heritage Foundation.
Re: Response to the Social Security Administration analysis of Heritage Paper "Social Security Administration's Rate of Return," presented to the Senate Special Committee on Aging on February 10, 1998.

This memorandum responds to a memorandum entitled "Problems with "Social Security's Rate of Return", A Report of the Heritage Center for Data Analysis," by Mr. Steve Goss, Deputy Chief Actuary of the Social Security Administration. Mr. Goss' comments were submitted for the record by Mr. Kenneth Apfel, (Commissioner of the Social Security Administration), during hearing before the U.S. Senate Special Committee on Aging entitled "A Starting Point for Reform: Identifying the Goals of Social Security," which were held on February 10th, 1998. We request that this memorandum be included in the record of the above hearings.

It should be noted that we have welcomed the opportunity to discuss our methodology in a public forum with Mr. Goss (or with other analysts from the Social Security Administration). Unfortunately the Social Security Administration have chosen to decline two invitations to appear with us in a public forum, during which a number of the questions raised by Mr. Goss might have been resolved.[1]

While we welcome constructive criticism of our paper, the comments made by Mr. Goss appear to be based on a number of mis-interpretations and mis-characterizations of our methodology and assumptions.

NOTES ON COMMENTS SUBMITTED BY MR. STEVE GOSS

Mr. Goss' memorandum contains ten arguments or assertions that require a response. Mr. Goss' comments are noted in italics, and our comments follow.

1\. . . *the Heritage study erroneously analyzes a single outcome where an individual is assumed to know how long he or she will live. . . . This approach consistently overestimates the expected number of years of work and consistently underestimates the expected number of years after reaching retirement age. As a result, it grossly underestimates the expected rates of return from Social Security retirement benefits*

We note below in responses to other arguments made by Mr. Goss that Social Security has employed a similar methodology to examine, as we did, rates of return for typical cases. We also describe other work that relies upon this estimating technique and achieves results close to those presented in our paper. All of that to one side, however, the criticism that he raises reflects a significant difference in perspective between Heritage and the Office of the Actuary.

Mr. Goss and his colleagues are focused on the actuarial risks to a stream of future benefits payments (the liabilities of the trust funds) and the tax payments of various classes of future beneficiaries. They analyze the same type of problem that actuaries for insurance companies and pension plans routinely examine: how many of the insured members of these classes of claimants survive to receive their benefits and will the insurance and pension funds be able to pay out benefits required by the formulae in the insurance or pension contracts. For his purposes, he computes the percentage of claimants who will survive to the retirement age and then takes the expected lifespan of that class of survivors to determine the benefits draw on

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[1] Hearings before the Senate Budget Committee Task Force on Social Security on January 21, 1998, and a Social Security Rate of Return Forum hosted by Senator Lieberman (D–CT) and Senator Gregg (R–NH) on February 12, 1998.

the trust funds. The "rate of return" for Mr. Goss is then calculated on the class of surviving former workers across that class's probable period of retirement.

We ask a different question: what can an individual, not a class of individuals, expect from Social Security. A twenty-year-old worker must make some assumptions about the number of years he or she will work and about the likely age at which he or she will die. To answer the latter question, when will I die, this worker can look at a life table that gives the average life expectancy for an individual that is similar in terms of age, race, income, health, and so forth. To answer the former question, how long will I work, such a worker can assume 45 years or until age 65. Naturally an individual investing in a pension plan can assume a longer or shorter lifespan than the average for their age group. Likewise, an individual can assume that he or she will work more or fewer than 45 years. The point is that people will set up age and work parameters for a pension plan that are different from the parameters that an actuary will examine for purposes of determining the viability of a defined benefits program.

The Heritage study calculates rates of return on Social Security and alternative investment strategies from the perspective of clearly defined individual cases at various ages. Our case study approach shows what an individual can expect from Social Security's retirement program given the reasonable assumptions that people at various ages make about their likely lifespan and work years. It also calculates the "opportunity costs" they face by not being able to invest the payroll taxes in reasonably safe private retirement plans, It is worth noting that our extensive methodological appendix describes in detail each of the assumptions we made in constructing these case studies and the substantial degree to which we relied on government data and the assumptions of the Trustees for the Old-Age and Survivors Trust Fund in arriving at our results.

While differences do exist between these two approaches to rates of return on Social Security payroll taxes, we believe our "explicit rate-or-return" calculations are more consistent with decisions made by individuals on supplemental retirement investments than is the method employed by Mr. Goss in assessing the actuarial risk to the trust funds.

2. *For example, for single male (all races combined) born in 1970 with average earnings, real rates of return are estimated at only 0.47 percent by Heritage, compared with 1.28 percent in the Advisory Council Report (page 1)*

The methodology and assumptions used by the Social Security Administration in estimating Social Security's rates of return were not made public, so we were unable to assess the validity or comparability of their estimates.

In any case, the figure of 1.28 percent for a single average income male born in 1970 also appears to be at the upper-bound of the range of estimates contained in the professional literature. In 1994 Eugene Steurle and John Bakija of the Urban Institute (using a methodology that appears to be identical to that described by Mr. Goss in his memorandum and adopting assumptions which are more optimistic than those justified by more recent Social Security Trustee's reports) found the rate of return of the Social Security Old Age and Survivor's Insurance for single average income males born in 1970 to be 1.07 percent.[2] A 1995 study by Daniel Garrett of Stanford University found that single average income males born in 1925 would receive a rate of return of 0.85 percent.[3]

3. *In fact results from more careful research indicate that the non-white population actually enjoys the same or better expected rates of return from Social Security than for the White Population. (See Duggan et al "The Returns paid to Early Social Security Cohorts," Contemporary Policy Issues, (October), pp. 1–13))*

It may be relevant to note here that the claim made above does not contradict any finding of the Heritage study. The Heritage study suggested that African-Americans (rather than all "non-white" ethnic groups) experienced a lower rate of return for Social Security than the general population. The opposite was the case for Hispanics (and preliminary research suggests that this will also be the case for Asians).

Indeed the work of James Duggan, Robert Gillingham and John Greenlees of the U.S. Treasury Department, which is cited by Mr. Goss, would appear to support this Heritage finding, not contradict it.[4] (See attached chart)

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[2] C. E. Steurle and J. M. Bakija, "Retooling Social Security for the 21st Century," (1994): p. 290.

[3] See Daniel M. Garrett, "The Effects of Differential Mortality Rates on the Progressivity of Social Security," Economic Inquiry, July 1995. All analysts have agreed that the rate of return to Social Security has fallen substantially over the previous 50 years, so it is likely that the rates of return to those born in 1970 lies substantially below that for those born in 1925.

[4] See Chart 1 below.

The implicit claim that the work of Duggan, Gillingham and Greenlees generates results different from that of the Heritage study by virtue of being "more careful" is extremely misleading. The work of Duggan, Gillingham and Greenlees was conducted using earnings history data from the Continuous Work Sample (CWS) dataset maintained by the Social Security Administration. All researchers from outside of the Social Security Administration and the United States Treasury Department are currently denied access to this tax-payer funded data and are forced to rely on the "representative agent/hypothetical worker" methodology adopted by the Heritage Foundation.[5]

4. Criticisms listed under "Error in not Reflecting Relationship between Mortality and Income"

Mr. Goss criticizes the Heritage Foundation Rates of Return for ethnic minorities on the basis that the mortality assumptions that are used in the study are not adjusted for income. Such criticisms undercut the validity of the majority of the rate of return research carried out by the Social Security Administration itself (and by the Office of the Chief Actuary in particular).

Rates of returns estimated by the Social Security Administration Office of the Chief Actuary, (including those completed for the 1994–1996 Social Security Advisory Council) have consistently failed to adjust mortality for income. Because poorer workers have shorter life expectancies, these studies have overestimated the rate of return to low-income workers and under-estimated the rate of return for high-income individuals. This has tended to make the Social Security program appear more progressive than it really is.

Indeed a member of the 1994–1996 Social Security Advisory Council noted recently how Social Security analysts explicitly refused to conduct an analysis in which the mortality assumptions used in estimating the rate of return were adjusted for income:

"As a member of the 1994–1996 Advisory Council on Social Security, I specifically asked, along with some other members of the Council, that Social Security staff undertake an analysis on this very point. They simply would not develop such an analysis."[6]

The Heritage Foundation study, unlike those conducted by many governmental and nongovernmental organizations, explicitly acknowledged the limitations of rate of return calculations conducted in cases where mortality is not adjusted for income. It is also our intention to engage in future research on this topic, and to encourage others to do so. For the Deputy Chief Actuary of the Social Security Administration to engage in selective and self-serving criticism of the work of others is less than helpful in this regard.

5. Thus, with proper adjustment of mortality by income level race differentials in life expectancy would diminish greatly, for individuals at the same income level

The above assertion by Mr. Goss' would appear to be without empirical support. Calculations by Dr. Sylvestor Scheiber[7] (using mortality, income and benefit data produced by the Duggan, Gillingham and Greenlees[8] research) reveal that for those born in 1918, Whites can expect to receive a real rate of return from Social Security that is approximately one percentage point above that experienced by African-Americans with identical incomes. These calculations are shown in Chart 1.

An African-American born in 1918 and earning $10,000 a year can expect to receive only the same rate of return as a White worker earning $22,000 a year. Interestingly, the one percentage point difference in the rate of return experienced by White and Black workers with identical wages born in 1918 is remarkably close in

[5] Indeed while Mr. Goss claims the superiority of studies done using actual work histories, the great majority of the rate of return calculations carried out by the Office of the Chief Actuary of the Social Security Administration (including those carried out for the 1994–1996 Social Security Advisory Council) have been done using the hypothetical worker/representative agent methodology.

[6] Sylvester Schieber, "Rates of Return on Social Security Contributions: Good Deal, Bad Deal, or Do We Even Care?", Testimony before the Senate Budget Committee Task Force on Social Security, January 21, 1998.

[7] Schieber op cit.

[8] James E. Duggan, Robert Gillingham and John S. Greenlees: Progressive Returns to Social Security? An answer from Social Security Records, U.S. Treasury Department, Research Paper No. 9501, November 21, 1995.

magnitude to the difference between the returns experienced by general (i.e. all ethnic groups) and black average-wage workers in the Heritage Foundation study.[9]

In short, Mr. Goss' claim that differences in income for the bulk of differences in mortality between African-Americans and the general population does not seem to be supported by the data. For example in the US Treasury Department study cited earlier in this paper, differences in income levels explain only 35 percent of the difference in mortality between African-American makes and the general male population and 25 percent of the differences in mortality between African-American females and the general female population.[10]

To conclude, we note that our findings are consistent with those produced by Dean Leimer of Social Security's own Division of Economic Research. He reported after an exhaustive survey of the professional literature that "When factors other than race (such as earnings levels) are held constant, there is some evidence that money's worth outcomes for the retirement portion of the Social Security program are less favorable for nonwhites than for whites."[11]

6. *The authors of the Heritage Study exclude Disability benefits and taxes from the analysis, even though the Disability Insurance Program represents nearly 15 percent of the Social Security. While including disability would not substantially change the expected rate of return for the general population, it would considerably narrow the rates of return for African-American versus the general population*

This criticism is irrelevant in that our study explicitly aimed to examine only the Old Age and Survivors' Insurance (OASI) program within Social Security. It is, for example, possible to drastically reform the OASI program while leaving the Disability Insurance program untouched.

In any case, there is no empirical study in existence to support the claim of advocates that including the Disability Insurance program in rate of return calculations will offset the racial differentials embedded within the OASI program.[12] Even if a study of the OASDI program as a whole were to be conducted and led to a narrowing of racial differentials, such a study would itself be vulnerable to a Goss-type critique that it failed to include Health Insurance (HI) (or Medicare). The inclusion of HI, by virtue of the heavy concentration of medical benefits among the very old, is likely to increase racial differentials in rates of return from Social Security.

7. *The premium appears to exclude those survivor's benefits for a spouse that are payable after the youngest child reaches age 16, i.e., widow(er)s benefits that are payable from age 60 to the end of life*

The Heritage does not exclude such survivor's benefits. They are fully accounted for in calculating the rate of return.

8. *Life Insurance is sold largely to healthy, higher-income persons who can afford the premium and can qualify as insurable. Including lower-income and uninsurable individuals would boost the premium substantially*

Mr. Goss appears to be suggesting that the reverse of the adverse selection problem is a common phenomenon in insurance markets, in that the individuals who are least likely to benefit from life insurance are those who are more likely to purchase it. This assertion would contradict the usual defense of universal insurance programs such as Social Security; that universal compulsory insurance is needed because in a free market those with high expected benefits (i.e. low life expectancies) from life insurance would tend to buy greater amounts, driving up the premiums that would have to be paid by other segments of the population.

Also as outlined in the methodology of the paper, the Heritage study did not make any dynamic assumptions. Just as it is assumed that in a private system individuals could continue to purchase life insurance at current rates, the study also assumed that increases in Social Security taxes had no negative economic feedback effects in terms of reduced GDP or higher unemployment. The Social Security Administration makes similar assumptions when it, for example, estimates the tax rate increases which will be necessary to achieve actuarial balance in the trust funds using static methods.

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[9] See Table 1, in W. Beach and G. Davis, Social Security's Rates of Return, Heritage Center for Data Analysis No. CDA98-01, January 15, 1998.

[10] Duggan et al op cit., p. 8.

[11] Dean R. Leimer, "A Guide to Social Security Money's Worth Issues," ORS Working Paper Series Number 67 (April 1995): p. 32.

[12] Schieber op cit., p. 30.

9. *The authors raised tax rates for Social Security starting 2015 by enough to cover future benefit costs, ignoring the fact that the Trust Fund Balance projected for that time, 300 percent of annual benefits, (sic) would continue to grow as a percent of annual benefits under these conditions. In order to produce a pay as you go financed Social Security program, tax rates would not need to be raised until around 2025, and by less than the authors assumed. The early, too-large increase in tax rates results in rates of return that are estimated to be too low for Social Security*

By selecting the option of funding future benefits by tax increases, we are simply adopting the economic logic that the Social Security trust funds, because they are solely made up of Federal debt, are not real assets but are rather promissory notes made by one part of the Federal Government to another. From 2015 onwards current law benefits must ultimately be funded either by increases in the payroll or other Federal taxes, or by cuts in non-Social Security Federal expenditures.

10. *The authors included a "high-income" worker with earnings at 300 percent of the average wage. In fact, the maximum level of earnings that is taxable and creditable for Social Security benefits is now and will be in the future 240 percent of the average wage (less than 240 percent in years before 1978). It is not clear whether the authors included taxes above this maximum taxable level. If they did, then rates of return for Social Security are estimated to be too low for high-income workers*

All taxes and benefits that were calculated in this study were subject to the relevant maximum limits stipulated by law.

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