SOCIAL SECURITY: WHAT CHANGES ARE NECESSARY?

HEARING

BEFORE THE

SPECIAL COMMITTEE ON AGING UNITED STATES SENATE

NINETY-SIXTH CONGRESS

SECOND SESSION

PART 1—WASHINGTON, D.C.

NOVEMBER 21, 1980

Printed for the use of the Special Committee on Aging

U.S. GOVERNMENT PRINTING OFFICE

70-797 O WASHINGTON : 1981

SPECIAL COMMITTEE ON AGING

LAWTON CHILES, Florida, *Chairman*

FRANK CHURCH, Idaho
JOHN GLENN, Ohio
JOHN MELCHER, Montana
DAVID PRYOR, Arkansas
BILL BRADLEY, New Jersey
QUENTIN N. BURDICK, North Dakota

PETE V. DOMENICI, New Mexico
CHARLES H. PERCY, Illinois
JOHN HEINZ, Pennsylvania
NANCY LANDON KASSEBAUM, Kansas
WILLIAM S. COHEN, Maine

E. BENTLEY LIPSCOMB, *Staff Director*
JOHN A. EDIE, *Chief Counsel*
DAVID A. RUST, *Minority Staff Director*

CONTENTS

	Page
Opening statement by Senator Lawton Chiles, chairman	1

CHRONOLOGICAL LIST OF WITNESSES

Ball, Robert M., Washington, D.C., senior scholar, Institute of Medicine, National Academy of Sciences, and former Commissioner of Social Security	18
Boskin, Michael J., Ph. D., professor of economics, Stanford University, Palo Alto, Calif., and director, social insurance program, National Bureau of Economic Research—presented by Henry Aaron	36
Aaron, Henry, Washington, D.C., senior fellow, Brookings Institution, former Chairman of the 1979 Advisory Council on Social Security	44

APPENDIX

Letter and enclosure from Peter Loeb, executive director, Disability Advocates, Boston, Mass., to Senator Lawton Chiles, dated November 20, 1980	71

SOCIAL SECURITY: WHAT CHANGES ARE NECESSARY?

FRIDAY, NOVEMBER 21, 1980

U.S. SENATE,
SPECIAL COMMITTEE ON AGING,
Washington, D.C.

The committee met, pursuant to notice, at 10:10 a.m., in room 5110, Dirksen Senate Office Building, Hon. Lawton Chiles, chairman, presiding.

Present: Senators Chiles, Melcher, Pryor, Domenici, and Heinz.

Also present: E. Bentley Lipscomb, staff director; John A. Edie, chief counsel; David A. Rust, minority staff director; Deborah K. Kilmer, legislative liaison; Eileen M. Winkelman and Betty M. Stagg, minority professional staff members; Marjorie J. Finney, correspondent; Fred Becker, intern; and Eileen Bradner, assistant clerk.

OPENING STATEMENT BY SENATOR LAWTON CHILES, CHAIRMAN

Senator CHILES. Good morning. Welcome to our first hearing on "Social Security: What Changes Are Necessary?"

Our main purpose today is to review some of the most urgent problems of social security and to examine some of the main solutions now being offered.

We are indeed fortunate to have with us two very distinguished experts: Robert M. Ball, former Commissioner of Social Security; and Henry Aaron, senior fellow at the Brookings Institution and Chairman of the 1979 Advisory Council on Social Security. We regret that our third witness, Michael Boskin, will not be with us today due to illness. Mr. Ball and Mr. Aaron, I greatly appreciate your willingness to be with us this morning and we look forward with great interest to your testimony.

In some respects, the hearings we begin today could not come at a better time. Front page news articles this week have brought a flurry of interest in the proposals that may be made to the next administration affecting social security. I am truly hopeful that our efforts here today and in December will help the Congress and the American people gain some insight and understanding about the changes that may be necessary for social security.

I am sure it will come as no surprise to you that in my home State of Florida I am again and again asked to make sure that the financing of social security is sound. I know that my colleagues on the committee, and in fact every Member of Congress, hear the same concern—that the working people who are paying into the system are wondering if there is going to be anything there when they get ready to retire.

This problem of financial stability comes in two forms: short term and long term. It will require new law to resolve both, and the general consensus of opinion is—there is no time to waste. Congress must face the short-term question as soon as possible, and that a strategy for the long-term solution should not be delayed.

The immediate cash flow problems facing the Old Age Survivor's Trust Fund—OASI—will, I am sure, be the central social security issue to be resolved by the next Congress.

But I think it will be a mistake for Congress to look only at the short-term immediate problem and to ignore the more serious long-term crisis that may await us in the next century.

Today social security clearly has a serious funding problem. What will the magnitude of that problem be 30 years from now when the baby boom generation begins to reach age 65?

Our committee would be careless in its duty if we did not point out at the beginning of these hearings certain major demographic predictions.

First, the number and percentage of persons over age 65 will grow dramatically. Today there are 25 million older Americans representing 11 percent of the population. In 50 years or less, we will have 50 million elderly or 62 percent of the population.

Second, workers are retiring earlier. The work force participation rate for men over 65 has dropped from roughly 40 percent in 1950 to 20 percent today.

Third, those who do reach 65 are living longer. Life expectancy at 65 today is almost 3 years longer than it was in 1940 when social security began.

In short, we face a trend today where a growing number of older persons are retiring earlier and living longer. The implications for a program the size of social security should be pretty obvious.

At our request, the President's Commission on Pension Policy was kind enough to prepare a background paper for our hearings which summarizes many of these important trends. I would like to thank the Commission publicly very much for their assistance, and, without objection, I will insert their paper in the record.

[The paper referred to above follows:]

DEMOGRAPHIC AND RETIREMENT TRENDS IMPLICATIONS FOR PENSION PROGRAMS*

At the beginning of the 20th century, 4 percent of the U.S. population was 65 and over. Today, this group has grown to 11 percent of the population and in the next fifty years this proportion could double to 22 percent. Table 1 shows the historical data as well as projected data under (1) high, (2) medium and (3) low fertility assumptions.**

Table 1

Persons 65 and Over
Incidence in the Population
1900-2030

	Number	Percent	Projection Series 1	Projection Series 2	Projection Series 3
1900...	3,099	4.1			
1930...	6,705	5.4			
1960...	16,675	9.2			
1977...	23,431	10.8			
1990...	29,824		11.7	12.2	12.6
2000...	31,822		11.3	12.2	12.9
2010...	34,837		11.1	12.7	13.9
2020...	45,102		12.7	15.5	17.8
2030...	55,024		14.0	18.3	22.1

Source: U.S. Bureau of the Census. Current Population Reports, Series P-23, No. 59 and Series P-25, No. 704. All Three Census Series, I, II, & III, are identical for the number of people 65 and over for the projections.

The people 65 and over will increase relatively slowly both in absolute numbers and as a percent of the total population between now and the turn of the century. However, as is shown in table I, between 2000 and 2030 the increase will be more rapid as the post-war baby boom cohort retires.

*Prepared by Elizabeth L. Meier, Staff Member of the President's Commission on Pension Policy. Much of the material in this paper is drawn from two working papers of the Commission: Demographic Shifts and Projections: the Implications for Pension Systems by Barbara Boyle Torrey and Varieties of Retirement Ages by Elizabeth L. Meier and Cynthia C. Dittmar.

**Respectively, 2.7, 2.1, and 1.7 children per woman.

The post-World War II baby boom produced a demographic tidal wave which has already had an enormous impact on the society. When this cohort entered elementary schools they produced overcrowded conditions until new facilities could be built. When they passed out of the schools they left a surfeit of teachers and a surplus of rooms. Labor markets and housing markets have also felt the impact of the large demands made by the baby boom. Retirement programs will be the last major social institution to feel the full effects of this unique generation when the first of the baby boom reaches 62 in 2009.

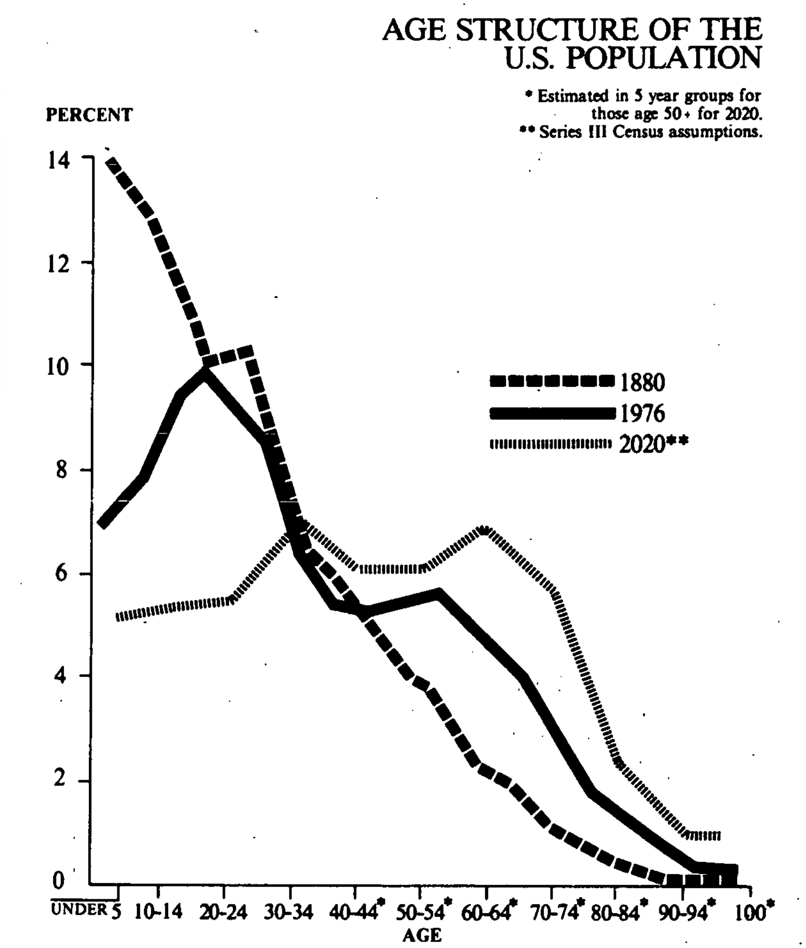
Today, the baby boom generation is a part of the labor force which contributes to resources for the aged, particularly through their taxes for social security. But the generations behind the baby boom are much smaller. Therefore, when the baby boom retires the ratio of the number of retired to the number in the labor force could double if population trends continue.

Chart I shows how the age structure of the population could shift by the year 2020 under low fertility assumptions. Compared to the past and present, there is a noticeable redistribution toward the upper ages should the more conservative long-range fertility assumptions prove to be current.

Chart II illustrates one reason why low fertility rates are being projected. In 1940, the marriage rate peaked at 12.1 per 1,000 population. Since then the rate has varied between 8.6 and 11.0 and since 1975 has stabilized at approximately 10 per 1,000. Today there are half as many divorces as there are marriages per 1,000 population. The rate of divorces reached 5.1 per 1,000 population by 1978 which is 46 percent higher than it was in 1970. To the extent that marriages encourage having children and divorces discourage the creation of children, continuation of this trend would mean continuation of a low fertility rate.

Mortality. Another factor that affects the age structure of the population is life expectancy or rate of mortality. Mortality dropped sharply in the U.S. during the first half of the 20th century. Average life expectancy rose from about 47 years in 1900 to almost 60 years in 1930—due largely to improved public health measures, such as improved sanitation. By 1950, life expectancy at birth was 68 years and reached almost 73 by 1976.

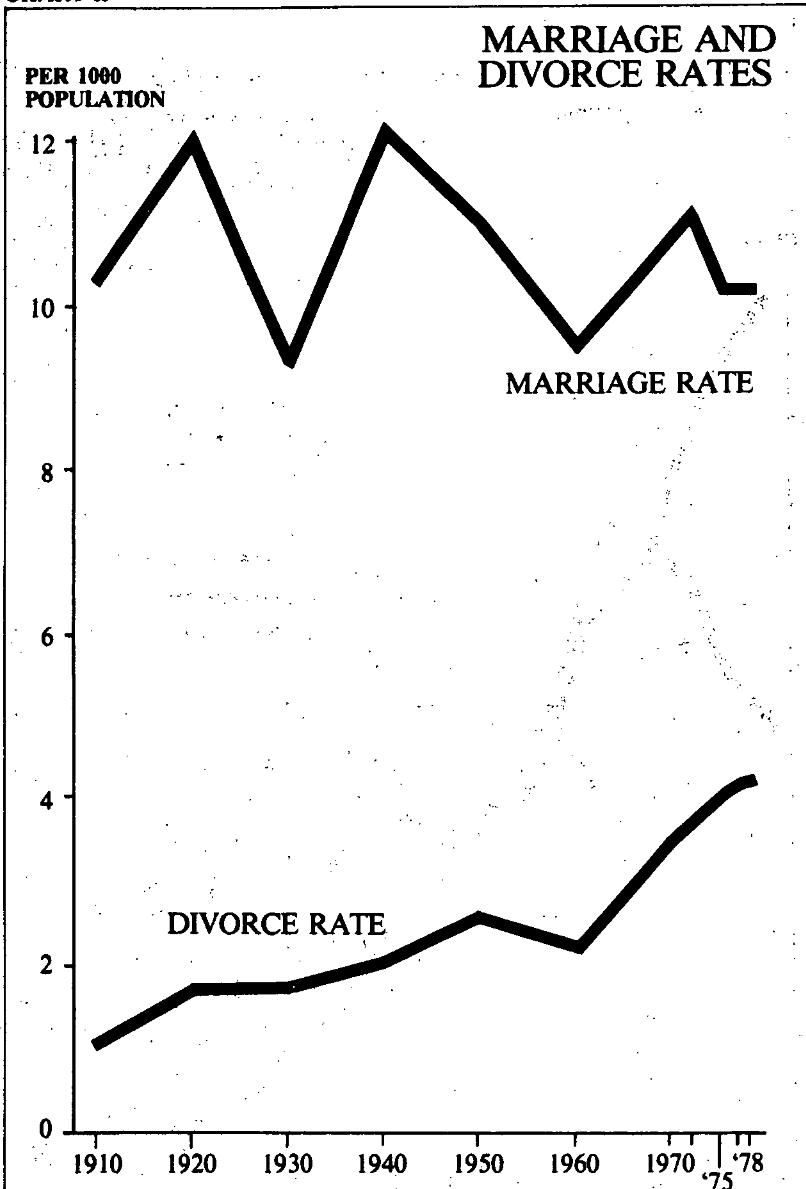
CHART I



Source: U.S. Bureau of the Census.

PRESIDENT'S COMMISSION ON PENSION POLICY

CHART II



Source: U.S. National Center for Health Statistics, Vital Statistics of the United States.

Not only are more people living to retirement ages, but they also have a longer period of retirement. Today people are living, on the average, almost 3 years longer after age 65 than they did in 1940 when life expectancy at age 65 was 12.0 years for men and 13.6 years for women. Social Security Administration figures show that in 1975 life expectancy at age 65 increased to 13.6 years for men and 17.7 years for women and is projected to increase to 15.1 years for men and 19.7 years for women by the year 2025. In this projection, the current imbalance of women over men in the upper age groups is expected to continue.

The latter estimates may be conservative as more disease controlling technologies are utilized. A recent article, for example, suggests that the ideal average life span could reach 85 years with the aid of health research strategies to improve the quality of life over the next decades.*

Labor Force Participation. Table 2 and Chart III provide data on older worker labor force trends over almost three decades. The trend has been for more males who are 60 and over to leave the labor force. Although age 62 early retirement under social security was provided for males in 1961 (females in 1956), the decade of the seventies has seen the largest drop, indicating an acceleration of the early retirement trend. In 1979, only 62 percent of men 60-64 were in the labor force compared to 75 percent in 1970 and 78 percent in 1960. The proportion of women ages 60-64 has also dropped in the seventies although the labor force participation rate is still above the 1960 and 1950 rates. The rate for older women in general had been increasing but the 1970s have seen a leveling off of this trend.

For the population 65 and over, only a fifth of the males and 8 pecent of the females were in the labor force by 1979. About 30 percent of the males and 15 percent of the females 65-69 were working or looking for work compared to 15 percent and 5 percent for those aged 70 and over. Slightly over 3 million persons 65 and over were still in the labor force and of these 1.2 million were 70 and over.

*James F. Fries, "Aging, Natural Death, and the Compression of Morbidity," The New England Journal of Medicine, July 17, 1980.

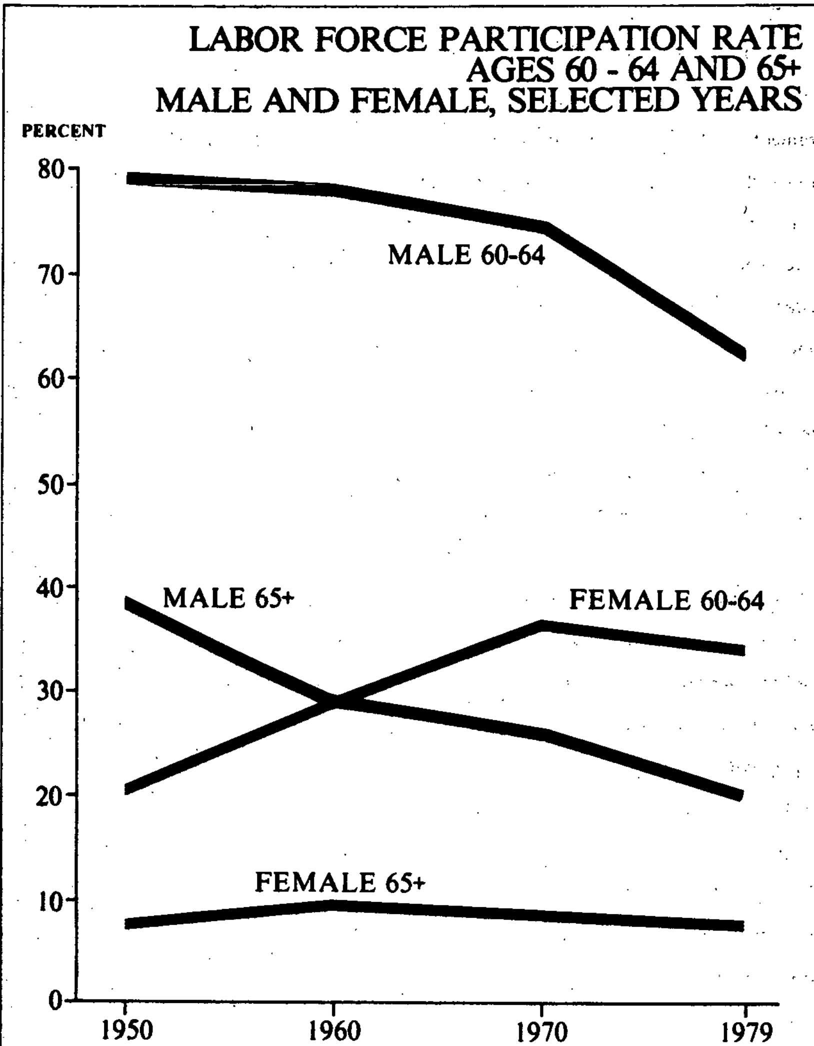
Table 2

Older Worker Labor Force Participation Rates
by Sex and Race
1950, 1960, 1970, 1978, 1979

	Male 1950	Male 1960	Male 1970	Male 1978	Male 1979	Female 1950	Female 1960	Female 1970	Female 1978	Female 1979
Total										
55-64	83.0	82.6	83.0	73.5	73.0	23.2	34.6	43.0	41.4	41.9
55-59	86.7	87.7	89.5	82.9	82.2	25.9	39.7	49.0	48.6	48.7
60-64	79.4	77.8	75.0	62.0	61.8	20.5	29.5	36.1	33.1	33.9
65+	39.0	29.4	26.8	20.5	20.0	7.3	10.0	9.1	8.4	8.3
White										
55-64	83.3	83.4	83.3	73.9	73.6	22.6	34.0	42.6	41.2	41.6
55-59	87.0	88.5	90.1	83.6	83.1	25.2	39.1	48.5	48.5	48.5
60-64	79.7	78.4	75.2	62.2	62.3	20.0	29.0	35.8	32.7	33.6
65+	39.0	29.5	26.7	20.4	20.1	7.2	9.9	9.5	8.1	8.1
Black & Other										
55-64	79.4	74.6	79.2	69.1	66.9	31.2	39.5	47.1	43.6	44.3
55-59	82.9	80.6	83.5	76.5	74.6	34.9	44.8	53.4	49.4	50.5
60-64	76.0	68.7	73.6	59.4	57.1	27.6	34.2	39.0	36.4	36.4
65+	40.0	28.0	27.4	21.3	19.6	9.8	12.2	12.2	10.7	10.6

Source: U.S. Bureau of the Census. Census of Population 1960; Detailed Characteristics. Employment and Earnings. U.S. Departmetn of Labor, January, 1971, January 1979, January 1980.

CHART III



Source: Elizabeth L. Meier. *Employment of Older Workers: Disincentives and Incentives.* Working Paper, President's Commission on Pension Policy, 1980, Table I.

Social Security Early Retirement. The trend for lessened labor force participation before age 65 is also reflected in the number and proportion of early social security retirements. Table 3 shows that 61 percent of all retired workers receiving benefits had retired early, 55 percent of the males and 68 percent of the females.

However, the number of early retirees appears to be at least leveling off as shown by year-to-year data. The number of reduced social security benefit awards as a proportion of all awards was 64 percent in 1979 compared to 66 percent in 1978 and 67 percent in 1977. For men and women in 1979, the figures were 59 percent and 71 percent respectively. 1977 may have marked the high point and a start of a gradual trend toward fewer early retirements.

Retirement Age Expectations. Chart IV has the results of a household survey in which working adults were asked at which age they expect to quit working full time.

The Commission survey found that 47.5 percent expected to retire at age 62 or before. Age 65 was the one most popular age with 42 percent opting for this age. Only about 9 percent expected to continue working past 65. Thus, the results of this survey do not appear to predict a lessening of the popularity of early retirement or a great desire to work past age 65, at least on a full time basis.

Dependency Ratios. The baby boom generation is currently in the under age 35 portion of the labor force. After the turn of the century, the forefront of this large cohort will be reaching age 65 in 2012 and thereafter will cause a shift upward in the aged population. Chart I illustrates what could happen in 2020. The expected financial burden of pay-as-you-go retirement programs for this future aged population on the working population can be illustrated through dependency ratios which are the number of dependents as a percent of workers.

Table 3

Social Security Retired Worker Beneficiaries With Reduction for Early Retirement

by Sex, Selected Years 1956-79

	Total		Men		Women	
Year (December)	Number	Percent of Worker Beneficiaries	Number	Percent of Worker Beneficiaries	Number	Percent of Worker Beneficiaries
1956*					115,029	10.2
1961	1,456,264	16.3	273,460	4.7		
1965	3,519,198	31.7	1,435,912	21.0	2,083,286	48.7
1970	6,066,880	45.4	2,758,060	35.9	3,308,820	58.5
1975	9,368,692	56.5	4,465,217	48.7	4,903,475	66.0
1979	11,591,117	61.1	5,585,510	54.8	6,005,607	68.4

Source: Social Security Administration. Social Security Bulletin. June 1980, Table Q-5.

*Women were given an early retirement option in 1956; men in 1961.

CHART IV

AGE AT WHICH RESPONDENT EXPECTS TO QUIT WORKING FULL TIME

AGE	TOTAL %
LESS THAN 55 YEARS	14.0
55	7.3
56	.2
57	.5
58	.6
59	.3
60	9.9
61	.4
62	14.3
63	1.0
64	.5
65	41.9
66	.2
67	.2
68	.5
69	.1
70	5.1
71	.1
72	.2
73	.1
78	-
75 AND OVER	2.4

Source: President's Commission on Pension Policy, 1979 Household Survey

There are several different ratios to measure the dependency of the non-working to the working population. The size of the age 65 and over, or assumed retired population, compared to the assumed working population gives an approximate measure of the aged dependency; the number of children and aged combined compared with the work force gives a measure of what is generally called total dependency in the society. The total dependency ratio, however, omits the disabled who are an important component of the dependent population. Estimates have also usually ignored the effects of early retirement, that is, retirement before age 65. Table 4 details past and projected aged and total dependency ratios under series II and III fertility assumptions.

Table 4

Potential Dependent Population as a Percent Of the Potential Working Population

	Aged Dependency (Population 65 Yrs & Over As a % of Population 18 to 64 years)		Total Dependency (Population 65 Yrs & Over & 0-17 As a % of Population 18-64)	
	Actual		Actual	
1930.....	9.1		67.8	
1940.....	10.9		59.7	
1950.....	13.4		64.4	
1960.....	16.8		81.6	
1970.....	17.5		78.0	
	Series II	Series III	Series II	Series III
Projections				
1980.....	18.4	18.4	64.3	63.2
1990.....	20.0	20.0	63.5	58.7
2000.....	19.9	20.2	53.2	56.5
2010.....	20.2	21.2	59.4	52.8
2020.....	26.0	28.6	67.2	60.5
2030.....	31.8	37.6	73.8	70.3
2040.....	30.6	39.0	71.8	71.5

Source: Bureau of Census, Current Population Reports, Series P-25, No. 704, July 1977.

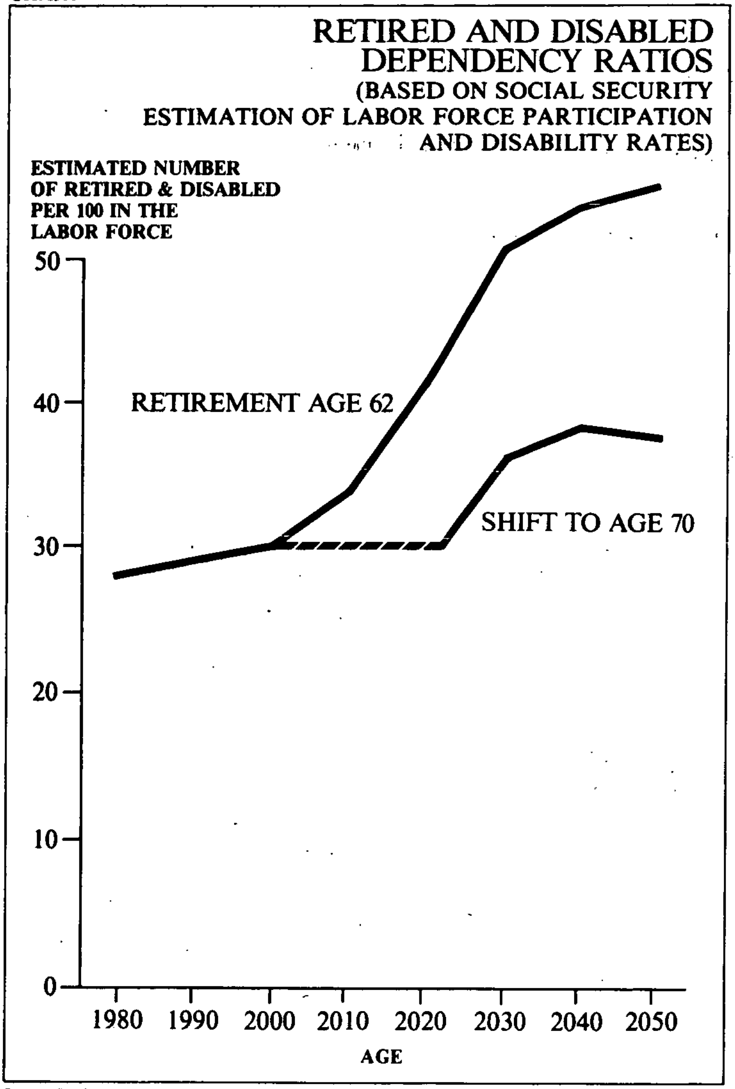
The aged dependency ratio increases slightly until the turn of the century, but then increases much more quickly as the baby boom retires under both Series II and Series III. But when children dependents are added to the aged, the ratios are changed considerably. When both the young and the old are counted as dependents, the net effect of the shifts of both of their populations tends to be small. As the aged increase, the young decline. And under the present assumptions the high level of total dependency in the 1960s and 1970s will not be reached again in the foreseeable future.

As has been indicated, the ratios in table 4 do not take into account the disabled and assume age 65 retirement for all. Chart V* estimates retired and disabled dependency ratios first with everyone retiring at age 62 and then shifting to age 70 (under series III fertility assumptions). The disabled population was estimated using social security disabled rates for people under the retirement age. Chart V shows that the increase in the dependency ratio when the baby boom generation retires would be alleviated but not eliminated by increasing retirement age to 70.

Implications. Both the trend toward early retirement and the long-term outlook for an increase in the aged population, particularly after the turn of the century, are a matter of concern for retirement programs. Retirement costs of pay-as-you-go systems like social security are affected by the dependency ratio of the retired to the working population since the taxes of those working pays for the retirement benefits. The "real" aged dependency ratio based on those actually working and not working under and over 64 is affected by early retirement. It is also affected by the incidence of disability retirement. The "assumed" age dependency ratio assumes work force participation by those under 65.

* Prepared by Shelley Lapkoff of the Commission staff.

CHART V



Source: President's Commission on Pension Policy

The tendency over time for old-age dependency ratios to increase is assured by underlying demographic trends, particularly by the baby boom bulge and the smaller cohorts following. Continuation of the early retirement trend to the end of the century and beyond could also increase the real dependency ratio and retirement costs for pay-as-you-go systems. Increasing the retirement age could reduce dependency ratios but its affect would be limited by an increase in disability dependency.

Senator CHILES. Social security now has 35 million recipients and an annual payout in excess of $147 billion. Obviously, any proposed changes to this system are going to stir intense interest.

As part of our effort to improve the understanding of the important issues, the committee, with the help of the Congressional Research Service, has recently published a summary of the major reports and national surveys that have focused on social security over the past several months. These reports and surveys have been widely publicized in the media but to my knowledge they have not been summarized in one document before. We are hopeful that this information paper will be a useful contribution to people who are trying to get this information.

Rather than say more at this point, I would prefer to save time for the question and answer period because I am certain there will be a great deal of interest in what you all have to say today.

Senator John Glenn, a member of our committee, cannot be with us today because of a prior commitment. He has submitted a statement for the record, and without objection, it will be inserted at this point.

[The statement of Senator Glenn follows:]

STATEMENT OF SENATOR JOHN GLENN

Mr. Chairman, I am pleased that the Senate Special Committee on Aging is holding this series of hearings on social security financing issues and proposed changes in the social security system.

Almost daily, I hear from senior citizens who are distressed by reports that the social security system is running out of money, and they fear that their retirement income will be cut. Also, workers who are paying higher and higher social security taxes question whether they will receive promised benefits when they reach retirement age.

Since its beginning, the social security system has been successful, and we must assure workers who are paying into the system and the elderly and disabled who are dependent on social security benefits of its continued solvency. Changes are needed in the social security system because of the effects of our current economic situation on social security revenues, and in the longer term because people are living longer and the ratio of workers to retirees will decrease when the post-war "baby boom" reaches retirement age beginning in 2010.

I look forward to hearing from today's witnesses and those who are scheduled for our future hearings. Your testimony and discussion with us will be valuable in bringing into focus the major short-term and long-term social security issues requiring congressional attention.

We know that action is needed to avoid the deficit in the social security trust funds anticipated in late 1981 or 1982, as well as to avoid future short-term deficits that cause so much concern among the American people. Also, now is the time to determine what future changes are needed in the social security system so that workers will be aware of these changes and will have an opportunity to prepare for them.

Many of the issues being discussed are controversial—whether to use general revenues to partially finance social security, raising the age of entitlement to benefits from 65 to 68, changing the method of calculating benefits, the tax treatment of social security benefits, universal coverage, and others. Our hearings will provide a comprehensive discussion of these important issues, and should provide valuable information for upcoming congressional deliberations on how to improve the social security system.

Senator CHILES. Mr. Ball, we are going to let you lead off with your statement at this time.

STATEMENT OF ROBERT M. BALL, WASHINGTON, D.C., SENIOR SCHOLAR, INSTITUTE OF MEDICINE, NATIONAL ACADEMY OF SCIENCES, AND FORMER COMMISSIONER OF SOCIAL SECURITY

Mr. BALL. My statement is rather long and I would like to have it included in the record, and I will summarize it.

Senator CHILES. Your statement will be included in the record[1] in full and we appreciate your summarizing that for us.

Mr. BALL. Mr. Chairman, I know that this committee is interested in a great variety of problems that affect the elderly population but I would like to begin by emphasizing that the universal need of the retired elderly—the major factor that determines the quality of life in retirement is a dependable, adequate, continuing income paid as a matter of right and protected against increases in the cost of living. For most of the elderly, social security, the cornerstone of our income security program, is the most important single factor in their well-being.

Now there has been considerable discussion about what the goal of retirement income should be, but I believe there is fairly wide consensus that if we could achieve it, the desirable goal would be to have a level of living roughly comparable to that earned while working. That does not mean that the size of the social security benefit or any combination of retirement income has to be as much as the wages that were earned, because in retirement, for most people, there is less in the way of expenses and lower taxes. It has been estimated that from two-thirds to four-fifths of previous earnings would maintain about the same level of living in retirement as previous earnings.

We have in this country, contrary to what is sometimes said, a retirement income policy that has been a firm policy of our society. It is composed of four tiers. The four tiers consist first, of a social security system, wage-related contributory, nonmeans tested, and almost universal in its coverage. Second, supplementary pensions based upon occupation, either private pensions or career government pensions. To look at those two tiers, just for a second, social security in itself probably needs to be adequate for those who have average and below average earnings because usually such workers do not have a supplementary occupational pension. Supplementary pensions are usually important only to above average earners.

Then in addition to these two systems, we have individual voluntary saving. This is quite a different thing from private pensions, which are sometimes lumped together with individual voluntary savings. Our private pension system, to a considerable extent, is the result of deliberate Government policy. It is an institution now subsidized to the extent of something over $16 billion in terms of forgone taxes. The individual worker has very little to say about the nature of those plans; they flow from the kind of job that he happens to find himself in, and he cannot choose higher wages instead even if he wants to. Individual voluntary savings are however, just

[1] See page 25.

what the term says and are entirely up to the individual. Largely they have resulted for elderly people so far in a very impressive degree of homeownership among retired couples. Nearly 80 percent of elderly couples do own their own homes and nearly 80 percent of them own them free and clear. However, for most elderly people there is not enough accumulation of liquid assets so that the earnings on those assets contribute significantly as a regular recurring part of their retirement income.

Then finally as a fourth tier we have underlying the whole, the supplemental security income program. This is now a national program although most States supplement it. This program prevents the aged, blind, and disabled from falling below minimum standards set by the Federal Government and in most cases the higher level set by the States.

Mr. Chairman, I take up quite a bit of space in my prepared statement to discuss the nature of social security and its important role in this four-tier system, but I think it would probably be a better use of the committee's time if I turned immediately to the problems of financing. I would be very happy in the questioning to go back into the part of the statement that deals with the questions of the importance of social security and its nature.

Financing is the overwhelming central issue in social security to face the Congress in the near-term future, as you have so rightly stated. It is proper to divide the issue into two parts, the short-term financing issue, which is primarily an economic issue, and the question of long-term financing which is influenced primarily by demographics. The short-term financing problem is that the old age and survivors part of social security—not disability and not hospital insurance but the old age and survivors part—will very likely face a cash flow problem as early as 1982 and possibly in late 1981—unless the law is changed to provide more financing for that part of the program.

The Congress passed and the President signed into law on October 9 a stopgap measure temporarily reallocating the rates between disability insurance and old age and survivors insurance, but, in all probability, that will have secured the situation only through 1981, so that, at the very least and looking at the old age and survivors insurance part separately, the Congress will need to take some further action next year.

Now this can either be quite minimal action, or the Congress and the administration can take the opportunity to do something much more fundamental and make changes in the basic method of financing social security. I believe this would be preferable. It would be much more reassuring to people than steps that would see us only through the near term future.

So far the Carter administration has proposed a relatively modest change. The administration has proposed to help the old age and survivors insurance system by allowing borrowing among the Old Age and Survivors Trust Fund, the Disability Insurance Trust Fund—which is an entirely separate fund—and the Hospital Fund which is also entirely separate. Under relatively optimistic assumptions, that change alone might see the system through the next 50 years and leave us only with the possibility of a long-term problem after that.

On the other hand, under somewhat more pessimistic assumptions this interfund borrowing alone runs into a cash flow problem in the 1984–85 period. That is, the accumulation of a contingency fund is not quite sufficient, without further action of the Congress, to pay benefits before the 1985 rate increase really takes hold. So it seems to me, as a minimal approach, the Congress would want in addition to interfund borrowing to take into account the possibility that there would need to be some advance from general revenue in the 1984–85 period.

As I suggested, my own view is that it would be preferable next year to make more fundamental changes in social security financing so that we could be sure that the cash benefit program would have an adequate contingency reserve on into the next century and without having to raise social security tax rates beyond those that will take place in 1981.

Those would be my two objectives, because as you suggested, Mr. Chairman, in your opening statement, it is very disturbing to beneficiaries and contributors alike to keep running into these short-term crises because of an insufficient margin in the short-term rates, and it is disturbing to contributors to keep facing a series of rate increases in the future.

So what I would propose specifically is that in 1981 the rate for cash benefits, the OASI, and the disability insurance programs combined, be set at 6 percent of earnings, rather than the 5.35 percent scheduled in present law, and that, at the same time, hospital insurance under medicare be financed in 1981 and from then on by a combination of employer-employee contributions matched by an amount from general revenues that would be the equivalent of the combined employer-employee contributions.

Now the way that works out in 1981 is as follows: Under present law, the overall social security rate will go to 6.65. That means if you put 6 percent in the cash program, of course, you would have 0.65 from employers, 0.65 from employees and then a matching amount from general fund revenue that would be equivalent of the combined employer-employee rate or 1.30. That is the same amount of financing for hospital insurance as under present law, but of course much more going to the cash benefit program—6 percent compared to 5.35 percent.

Now the idea of supporting half of hospital insurance out of general revenue is not original with me; it was provided for in a bill introduced by Congressman Barber Conable, the ranking Republican on the Ways and Means Committee. I believe it would have widespread support, including support from labor organizations and from all the major senior citizens groups. The National Commission on Social Security, which will be reporting shortly, will also be proposing this sort of financing for hospital insurance.

There just has not been nearly the opposition to the introduction of general revenues into the hospital insurance part of social security as there has been to general revenue in the wage-related cash benefit program. It is very likely that this difference in attitude stems from the fact that cash benefits are wage-related and it seems very logical, therefore, to have the support of that system also wage-related, a percentage of earnings, whereas the hospital insurance is a package of benefits which is the same amount for everyone. Thus the reasoning which supports reliance on contributions related to wages for the wage-related program does not apply to the same degree to medicare.

Also part B of medicare is supported in very considerable part now by general revenue. About 70 percent of supplementary medical insurance, which provides primarily for physicians' costs, comes from general revenue, and although part A, the hospital insurance part, is almost entirely supported by earmarked deductions from workers' earnings and by taxes on employers' payrolls, if you look at the two parts of medicare together, about 20 percent of the total cost is met from general revenues. So for these reasons, there does not seem to have been and is not now throughout the Congress the degree of concern about the introduction of some general revenue financing into medicare that still exists in connection with the cash benefit program.

Although I have described my preferred plan, there are, of course, others that would be satisfactory. There is first of all the administration proposal for interfund borrowing, and if you add to this the authority to borrow also from the general fund—perhaps on a short-term basis for 1984–85—the system would probably be able to stick with the contribution schedule in present law for the next 50 years.

It would also be possible in 1981 to follow generally the outlines of the plan that I have suggested but arrive more gradually one-half support of hospital insurance from general revenue. I was proposing that in 1981 you start supporting half of hospital insurance out of general revenue but you could start more gradually. For example, it would be possible to draw on the reserves in hospital insurance and not have any general revenue contribution in 1981 and yet make the shift to 6 percent for cash benefits. One could take a position anywhere in between zero and one-half—25-percent financing of hospital insurance from general revenue, for example, in 1981, and then gradually move up to one-half.

Another approach which would have the same financial results as the one I proposed, would be to increase the deductions from workers' earnings and taxes on employees' payrolls in the near future by 0.65 percent, each.

In summary, on short-term financing I prefer what I have suggested to the other proposals by reason of the fact that the other proposals would require increases in the contribution rates and would continue complete reliance on the social security tax for full support of all three parts of the program. I would prefer to introduce more progressive revenue sources into at least the medicare part of social security. Moreover, only the last alternative—the near-term increase in the contribution rates—would build the contingency funds up as fast as my proposal.

Mr. Chairman, I would like now to turn to the long-term financing issue. By long-term financing, I mean financing 25 years or more down the road. Social security in this country has been looked at traditionally over a 75-year period. Long range might mean 5, 10, 15 years in many countries and to many people here, but when we talk about long-term financing of the American social security system, we are talking about the next century. Here I would like to make a sharp distinction between what we really know about what will happen in the next century that has an influence on social security costs, and cost assumptions that are much more speculative. I think it is important to distinguish between the two.

What we know is that there will be a very large increase in the absolute number of the elderly. There is no doubt about this. People who will be over 65 between now and 2045 have already been born and give or take a few million—the variation is caused by the mortality rate assumptions used—it is quite possible to get a reasonably accurate picture of the increase in the absolute number of the aged over the next 15, 25, and even 65 years from today.

What is much less certain is the size of the contributing population, and, of course, what is really important to social security financing is the ratio of the people who are paying in to the people who are taking out there. Now, we are dealing with much less certain factors in estimating the size of the group who will be paying in. The size of this group is affected by the future fertility rate, the immigration rate, and, among other things, labor force participation rates of women and older people. Under circumstances where we may well be faced with a labor shortage in the next century, will employers be interested in holding onto workers who are 66, 67, and 68 rather than has been true in the past encouraging most of them leave because they had the possibility of picking up plenty of younger workers?

So I want to emphasize as my first point about the long range that although we can predict a tremendous increase in the number of elderly, we do not know what the size of the work force will be.

The second point I would like to emphasize is that the very assumptions that result in an increase in the size of the elderly population relative to the population ordinarily thought of as a working age—say 20 to 64—also result in there being many fewer children. If we are concerned about the fundamental economic fact of how many people will be at work as compared to the people who have to be supported by those at work, either children under age 20, say, or those over 65—if we put these two groups together—we get very different results than if we look only at a comparison of the group over 65 and those 20 to 64.

As a matter of fact, this total dependency ratio, as it is called, those under 20 and over 65 compared to the group from 20 through 65, declines considerably between now and the early part of the next century and then grows some. But even at the high point, we don't quite get back to the number of dependents per worker that we had in 1970. The picture of each worker in the future carrying on his back a great increase in the number of dependents is not correct.

What is correct is that the composition of the dependent group changes. There will be many more old people and many fewer children. Now, I am not suggesting that, therefore, social security has no problem. About 80 percent of social security costs go for benefits to older people, and it is also possible that, on the average, older people may cost more to support than younger people. It is not necessarily easy, either, to shift financial resources now used to support children over to support for elderly people, but I, nevertheless, think it is important to keep in mind that, in fundamental economic terms, the ratio of dependents to those of working age is not going to increase as compared to, say, 1970 or 1975.

Now, two other quick points on the long range—without taking the time to develop them very much—is that, one, even if one assumes that costs as a percentage of payroll are going to rise because of low fertility rates, low labor force participation rates, increase in the incidence of disability, and so forth, it is also important, I believe, to keep in mind that real income levels will also increase.

The productivity increases that are suggested in the intermediate estimates of the last trustees' report are 1¾ percent a year, a difference in the long run between a 4-percent price increase and a 5¾-percent wage increase. This produces by 2025 approximately a doubling of the real wage level after social security taxes. Thus, as we think about the situation where there may be a relative increase in beneficiaries compared to workers and, perhaps, therefore, the need for a higher social security contribution rate, it seems to me important to realize that such a higher rate will be easier to bear because of the very much higher level of living that will prevail when such contribution increases may be needed. I don't think the argument is whether we are going to have productivity increases later on, the argument is how big they will be. The burden of the social security contribution relative to what people are earning and their level of living will be smaller in the next century than it is today.

Then, finally, to put the social security cost question into some perspective, if you take the middle range estimates of the trustees, then on a pay-as-you-go basis, you would reach the point in the last 25 years of the 75 years over which the estimates are made where workers and employers would have to contribute, in that far off time, about 8 percent of earnings as compared to the 6 percent which would be adequate for the next 50 years. Now 8 percent of earnings is not overwhelming. German workers today are paying 8 percent for these same types of protection and German employers are matching this rate. In addition, the German Government pays nearly a fifth of the total cost of the system.

If you look at the burden of the present social security system in terms of a percentage of gross national product—a better measure of what society can afford—next year social security will constitute a little over 5 percent of GNP. That drops by the year 2003 to 4.3 percent under the assumptions of the trustees' report, and then peaks at about 6.36 percent in 2030, again not a very scary figure, and then the percentage falls under these estimates to 5.82 in 2055.

Mr. Chairman, my summary point is that I do not believe it is wise to take steps now to cut back on social security protection on the notion that we are somehow going to be faced in the next century with an overwhelming burden because of the operation of the present social security system. I think there is good reason to believe that, if anything, the burden will be easier to bear than it is today.

So for that reason I am opposed to the various proposals that have been made for cuts in social security protection. I am not one of those who says you can never make any changes in social security that reduces protection. I have supported several moves in the Congress that have resulted in some reduced protection but I do not think that we need to cut back because of a demographic situation estimated to occur way down the road. I do not think promised social security protection is too generous.

The proposals to cut back come in several forms. There are the specific benefit cuts—cut out the minimum benefit, cut out the student benefits, various kinds of specific benefit cuts. Another way of cutting back is to shift from the computation of benefits under present law which keeps up to date with wages and therefore the level of living of current workers over to keeping up only with price increases. This has the result over time of very substantially reducing the role of social security. It reduces the replacement rate—the proportion of recent earnings replaced by social security benefits from 42 percent today for the worker alone who earns average wages to about a 30-percent replacement rate around 2010 and to about 25 percent later on.

Senator HEINZ. May I make sure that I understand what you are saying?

Mr. BALL. Yes, sir.

Senator HEINZ. Mr. Ball, do you mean to shift the basis on which benefits are paid, or in which taxes are collected?

Mr. BALL. The basis on which benefits are computed prior to the time that the beneficiary draws the benefit. Under present law, as a result of the 1977 amendments, the way benefits are computed is that, automatically as the average wage levels in the country rise, the worker's wage record is indexed so as to bring it up to date. The benefit formula is also indexed to wages. We have in place, therefore, a system which will pay roughly the same proportion of earnings at the time a worker retires in the future that is payable today to workers who retire today. Thus, today, the program keeps up to date with the level of living.

Now one proposal is to change the benefit computation so as to keep benefits up to date only with price increases. This has the result of reducing social security benefits as a proportion of future wages because, unlike the recent past, wages, in the long run will undoubtedly rise faster than prices. I am speaking only of the computation of benefits. Automatic increases, once benefits are awarded, are now tied to prices, not wages.

Another proposal that also has the result of cutting back on social security protection is to pay full-rate benefits at a later age. The specific form of proposal that has gotten the greatest currency is to eliminate the right to receive reduced benefits at age 62 as under present law, and instead, make reduced retirement benefits available at age 65, and then pay full benefits at 68 instead of 65. In other words people would get a 20-percent reduced benefit at 65 instead of 62 and then a full-rate benefit at 68 instead of at 65. Now this proposal is really nothing but a benefit cut and one's attitude toward the proposal is likely to be determined by whether one thinks it is necessary or desirable to cut social security benefits. I don't think they are too high; I don't think what has been promised is too much.

A somewhat more subtle proposal for shrinking social security is to drop the weighted-benefit formula in social security or the spouses benefit, or in some proposals both, and make the social security benefit the same percentage of past earnings regardless of the wage level and without regard to the number of dependents. In all probably, under this proposal, the higher paid workers would get about as much as they do today, but for the great bulk of people covered under social security, protection under the contributory social security system would be significantly reduced. Consequently, more and more people would have to turn to the general revenue supported supplemental security income program based upon a means test.

Mr. Chairman, in summary and conclusion, I believe that there is really no reason to expect that in the long run the economic burden of supporting the present social security law will be greater than it is today. I think there is reason to expect that it will be less.

First, it is not at all clear whether, and to what extent, there will actually be an increase in the ratio of those drawing benefits to those paying in although I must say I think there will be some increase.

Second, in terms of the basic economic situation in the future, there will not be more dependents per worker than there were, say, in 1970—there will be more older people but fewer children.

Third, it can be expected that the real wage level will be much larger in the long-range future than it is today—perhaps about twice as high by 2025.

Finally, under present law, social security benefits as a percentage of gross national product—using the assumptions in the middle-range estimates of the latest trustees' report—show a considerable drop between now and the early part of the next century and a relatively small increase thereafter—in the range of 5.05 next year, 4.30 shortly after the turn of the century, 6.36 in 2030, and 5.82 in 2055.

All in all, I believe that the social security system that emerged from the 1977 amendments is a good one. Social security, as shown by the latest polls, continues to be immensely popular. The one weak spot shown by the polls is a lack of public confidence in the system's financing. The changes I have suggested would meet this problem while retaining the present relationship among social security, private pensions, private savings, and supplemental security income—the four-tier system that we have in place.

Certainly there are minor changes to be made that would improve the system and, over the long run, I believe that modifications will need to be made that improve protection for both homemakers and women who work for market wages but that will be expensive to do. So I would suggest for now concentrating on adequate financing for what the present system provides. I see no need to cut back in benefit protection, and I must say I suspect this is not a good time to propose further improvements.

Thank you, Mr. Chairman.

Senator CHILES. Thank you, Mr. Ball. Your prepared statement will be entered into the record at this point.

[The prepared statement of Mr. Ball follows:]

PREPARED STATEMENT OF ROBERT M. BALL

Mr. Chairman and members of the committee, my name is Robert Ball and I am now a senior scholar at the Institute of Medicine of the National Academy of Sciences. From April 1962 until March 1973 I was Commissioner of Social Security and prior to that served for approximately 20 years in various positions in the Social Security Administration and its predecessor organization, the Social Security Board. I am testifying today as an individual and my opinions do not necessarily represent those of any organization with which I am associated. Although I was a member of the most recent Advisory Council on Social Security and agree generally with most of the recommendations of that Council, I am testifying today solely as an individual and not as a representative of the Council.

The elderly have many important needs. They should have the right to work in paid employment if they can and want to and the opportunity for voluntary service if they are retired. The 15 to 20 percent of the elderly who are unable to perform the tasks of daily living need the help of family and friends and the support of social services. The 5 percent of all the elderly who are within this group who need institutional care, by and large, need a better quality of care, the opportunity for rehabilitation, and the protection of their savings and those of their relatives against the overwhelming costs of long-term care in nursing homes.

Everyone needs the opportunity for recreation and social contact, but this is especially difficult for many of the elderly who are no longer able to drive cars. Medicare, our national health insurance program for the elderly and the disabled, while in most respects a very successful program, needs improvement. The universal need of the retired elderly, however—the central factor in determining the quality of life in retirement—is a dependable, adequate, continuing income paid as a matter of right and protected against increases in the cost of living. For most of the elderly, social security—the cornerstone of our income security programs—is the most important single factor in their well-being.

THE GOAL FOR RETIREMENT INCOME

The goal for retirement income should be to provide in retirement a level of living roughly comparable to that earned while working. Because, on the average, taxes and other expenses in retirement are less than those while working, this goal can be achieved for those in good health with a retirement income of roughly two-thirds to four-fifths of work income.

To achieve the goal, we need to work toward: (1) An improved social security system, adequate in itself for regular workers earning less than average wages (for most of these workers sizable private pension supplementation is not feasible); (2) supplementary private pensions which together with social security are adequate for those with above average earnings; (3) additional individual voluntary savings; (4) improvements in the Federal welfare system of supplementary security income so that it will, at least, keep all elderly, disabled, or blind people from falling below the federally established poverty level.

The foundation of this four-tier retirement income system is social security. Although the other parts of the four-tiered system—private pensions, individual savings, and the means-tested supplemental security income program—are important supplements, social security is the base. Just about everyone is protected by social security, whereas only a third of the elderly and somewhat less than half of current workers—usually those with above average earnings—have supplementary private pension coverage. Social security protection follows the worker from job to job, it is inflation-proof and tax free. With its protection against loss of income not only because of retirement in old age but also because of total disability or the death of an earner in the family, social security is the most important insurance protection that most people have.

THE NATURE OF SOCIAL SECURITY

What is this social security system? The details of the program are so complicated, and the rules and regulations so numerous, that we are apt to forget that the basic idea of social security is very simple. All there is to it is that while people work and are earning, they contribute a part of those earnings to social security, with their contributions matched by the employer and with the self-employed, too, paying in while they work. When earnings stop or are greatly reduced because of retirement or because one is too disabled to work, or because a family has suffered an income loss when a wage earner dies, then benefits are paid by the system to partly make up for these lost earnings. The cash benefit part of social security is "income insurance"—protection against the loss of income, just as other insurance protects against the loss of a house through fire, or the loss of an automobile in case of an accident. It is a huge group insurance and retirement program based on a compact between the contributing worker and Government, which promises to pay benefits under defined conditions in return for earmarked social security taxes.

The program today provides monthly benefits to 35 million people—one out of every seven Americans. Another 115 million Americans are building protection through payments into the program. Social security is entirely self-financed by the contributions of these covered workers and their employers and the self-employed.

There is not only a legal right to the defined benefits—a denied claimant can go go to a Federal court for redress in the event of improper denial—but the right to protection is an earned right, earned by the work and contributions of those who benefit from the system. Social security is a program not just for the poor, but a base on which everyone can build his own retirement protection. The benefits reflect the beneficiaries' previous levels of living and thus serve in some measure as a reward for diligence. The benefits are payable without the scrutiny of individual means and needs and so permit supplementation by anything the recipient has been able to save. Because they are payable as an earned right, the benefits accord with the self-respect of people accustomed to providing for themselves.

Social security is America's most successful program of social reform. Built on the conservative principle of self-help, with the protection growing out of past work, it has, nevertheless, created a revolution, transforming life for millions of people from poverty and insecurity to relative economic well-being.

In 1935, when the Social Security Act was passed, less than 15 percent of the jobs in the United States were covered by any sort of retirement system, and only a tiny proportion of those over 65 were drawing retirement benefits. Many people ended their lives in a now almost forgotten institution, the "county poorhouse." This year nearly 95 percent of the people reaching age 65 will be eligible for social security payments and most of those who are not will be eligible for retirement pay from some other government system such as railroad retirement, Federal civil service, or a State or local plan.

Not only are social security benefits tax free and inflation-proof once they are awarded, but prior to retirement the protection is kept up to date with rising wages. Thus when a worker now in his early 40's retires at 65 after regularly earning the average wage, his benefit will be about $15,000 a year. The $15,000 reflects not only increases in prices but also the increase in the level of living arising from productivity increases. The $15,000 figure is based on the assumptions in the 1980 report of the Trustees of the social security system that over the long run, prices will rise at an average level of 4 percent a year and wages at 5¾ percent a year. Because of the automatic provisions now in the law, if wages rise less than has been assumed, social security benefits will be lower, and, if they rise more, benefits will be higher. The benefits payable at the time of retirement, disability, or death are thus kept up to date with the level of living of current workers. Once benefits begin to be paid, they are kept up to date automatically with the increases in the cost of living.

Now certainly there are changes to be made in our social security system. I, among others, have proposed certain improvements in benefit protection and changes in the method of financing, but the point to be stressed is that the system works just as it is, and it works well. Thirty-five million beneficiaries—one in seven Americans—get a check every month, on time, and in the right amount, and those who are working today are counting on getting their social security benefits when they in turn become eligible. What we need to do is assure the sound financing of the system.

FINANCING SOCIAL SECURITY

Short-term financing

The well-known—but, in my opinion, exaggerated—short-term financing problems of the old-age and survivors' insurance part of social security (the disability insurance program and the hospital insurance part of medicare are not in difficulty) have been seized on by some as a reason for cutting back on overall social security protection. I do not believe this is necessary or desirable. Social security benefits are not too high, and social security protection is not too generous. There are several quite feasible approaches to meeting the short-term financing problems in the OASI part of the system which fully protect promised benefits. Let me first discuss these proposals and then separately consider the cries of alarm that have been raised about social security financing in the distant future. (The most recent Trustees' reports show the cash benefit part of social security to be underfinanced in the last 25-year period of the 75 years over which the estimates are made.)

It is clear that some congressional action will be needed next year to avoid a short-term financing problem in the old-age and survivors' insurance part of social security in spite of the social security tax increase scheduled for 1981. The reallocation of rates between old-age and survivors' insurance and disability insurance signed into law on October 9, 1980, was intended as a stopgap measure and is probably sufficient only through the calendar year 1981. The action required can be quite minimal or we can take the occasion to make rather fundamental changes in financing.

The Carter administration has proposed merely borrowing among the three social security funds—the old-age and survivors' insurance fund, the disability insurance fund, and the hospital insurance fund—as a way of meeting the short-term problem in old-age and survivors' insurance between the end of 1981 and the point at which the presently scheduled 1985 contribution rate increases take hold. If the economy improves rapidly and substantially, this provision alone might well make the present financing of the cash benefit program sufficient for the next 50 years and financing of the hospital insurance program under medicare sufficient at least into the 1990's. Under quite pessimistic economic assumptions, however, this plan would be inadequate in the 1984–85 period. Under these circumstances, OASI would need some additional source of income—perhaps some advance from the general fund—for a short time just before the scheduled 1985 rate increase becomes fully effective.

My own view is that it would be preferable next year to make more fundamental changes in social security financing so that we could be sure that the cash benefit program would have an adequate contingency reserve on into the next century and without having to raise social security tax rates beyond those which will take place in 1981. It is very disturbing to beneficiaries and contributors alike to keep running into these short-term crises because of an insufficient margin in the short-term rates. And it is disturbing to contributors to keep facing a series of rate increases. What I would propose is that in 1981 the rate for cash benefits, OASI and DI combined, be set at 6 percent of earnings rather than the 5.35 presently scheduled. At the same time, hospital insurance under medicare would be financed in 1981 by a combination of an 0.65 percent contribution rate for the employee, an 0.65 percent for the employer and with a matching amount from general revenue equivalent to the combined employer-employee rate, or 1.30 percent of covered payrolls. Legislation next year could make this change retroactive to the beginning of the year since the overall social security tax rate would remain at 6.65 percent of earnings as provided by present law.

The idea of financing half of hospital insurance under medicare out of general revenues is not original with me, but was provided for by a bill introduced by Congressman Barber Conable, the ranking Republican on the Ways and Means Committee. I believe it would have widespread support, including support from labor organizations and senior citizens' groups. The National Commission on Social Security—established by the 1977 amendments to the Social Security Act and which will soon be reporting to the Congress—will also be proposing this sort of financing for hospital insurance.

There has not been nearly as much opposition to the introduction of some general revenue financing into hospital insurance as there has been to introducing general revenue financing into the cash benefit program. Perhaps because part B of medicare already has the major part of its cost covered by general revenue financing, and perhaps also because the benefits in both parts of medicare are not geared to past earnings as they are in the cash benefit program, there has for some time been less reluctance to move away from total reliance on an earnings or payroll tax in the medicare program as compared with the cash benefit part of social security.

At the present time, the hospital insurance part of medicare (part A) is financed almost entirely from a tax on employers' payrolls and deductions from workers' earnings, as in the case of cash benefits under social security. The exceptions are minor: contributions from general revenues, for example, to pay for noncontributory credits for military service, and for hospital insurance benefits paid to people uninsured under social security at the time the hospital insurance program began. On the contrary, about 70 percent of the costs of supplementary medical insurance (part B) under medicare, which reimburses for the cost of physicians' services, is paid from general revenues, and the rest of the cost is met from premiums paid currently by those insured under the program. If both parts A and B of medicare are looked at together, about 20 percent of the revenues for medicare come from general taxes.

The plan I propose would require a general revenue contribution to hospital insurance for fiscal year 1981 of about $11.4 billion, and for calendar year 1981, $15.1 billion. The proposal provides for the same amount of financing for hospital insurance in 1981 as that presently scheduled.

The amounts from general revenues would, of course, increase somewhat in future years as the deductions from workers' earnings and the tax on employers' payrolls increased in the future to meet the costs of the hospital insurance program. It is to be noted that the present schedule calls for an increase in hospital insurance contribution rates of 0.05 in 1985, and 0.10 in 1986.

By shifting half the cost of financing hospital insurance to general revenues it is possible to increase the amount going to the cash benefit program from social security taxes without—for a very considerable period of time—raising the overall social security tax rate beyond the rate going into effect next year. The 6-percent rate proposed for the cash benefit program is to be compared with the present schedule for cash benefits of 5.35 for 1981, 5.40 for 1982–84, 5.70 for 1985–89, and 6.20 from 1990 and thereafter. The scheduled 1990 rate of 6.20 is estimated to produce very large excesses of income over outgo for at least 15 years or so after 1990, and the proposed 6-percent rate, starting in 1981, would finance the cash benefit program from 1981 well into the next century without the need for any rate increases beyond the 6 percent effective in 1981. The 6-percent rate would also rather quickly build contingency reserves back up to reasonable levels.

Although what I have described is my preferred plan, there are, of course, others that would be satisfactory:

(1) It would be possible in 1981 to follow the outlines generally of the plan I have described, but to make the general revenue contribution to hospital insurance less in the near future than I have proposed. Instead of $11.4 billion for fiscal year 1981, and $15.1 billion for calendar year 1981, it would be possible to put the plan in effect gradually. Any general revenue contribution in 1981 could be avoided by using the accumulated funds in the hospital insurance trust fund, a plan that would not be entirely unreasonable if accompanied by a commitment to provide one-half the cost of the system from general revenues in later years. Various in between positions could be taken, for example, reducing the trust fund to 25 percent of the next year's outgo which would require a general revenue contribution of $3 to $4 billion for calendar year 1981, or, for example, setting the fund at 50 percent of the next year's outgo which would require a general revenue contribution of $11 to $12 billion for calendar year 1981. Later on, under this proposal, the general revenue amounts would gradually be increased to equal the combined contributions of employers and employees.

(2) As stated at the beginning, the very minimal change of interfund borrowing proposed by the Carter administration might well get the cash benefit program through the next 50 years (and the hospital insurance program into the 1990's) under the contribution schedules provided by present law. If necessary, this approach could be supplemented by some advances from general revenue during the 1984–85 period should they be needed.

(3) Another approach would be to provide for interfund borrowing as proposed by the Administration but also, at the same time, move the 1985 scheduled increase in the contribution rate for cash benefits to 1984.

(4) A plan which would have the same financial result as the one I propose, but which would not depend on any general revenue financing for hospital insurance, would be to provide for a direct increase of 0.65 percent in the cash benefit rate in the near future. Such an increase would, of course, take the place of the various scheduled increases for the cash benefit program in present law.

The point is that there is no need to turn to cutting benefit protection to meet the short-term financing problem in the OASI part of social security; there are any number of satisfactory solutions to finance the benefit protection promised by present law. I prefer what I have proposed because as compared to proposals (1), (2), and (3), it builds a contingency reserve that would help meet any future problems caused by economic fluctuations, and, as compared with proposal (4) would not require an increase in overall social security taxes, but rather shift part of the burden of social security support to more progressive general revenue sources.

Long-term financing

Mr. Chairman, I have so far addressed the issue of how to finance social security over the next 25 years or so and have not yet addressed the implications for social security costs of the changing demographic composition of the Nation in the next century.

70-797 O - 81 - 5

In discussing these implications it seems to me of the first importance that we be clear in distinguishing between those matters we can be quite certain about and those matters which are more speculative. The broad outline of the growth in the absolute number of the elderly population over the next 50 years is quite certain—nearly a 600,000-a-year increase, on the average, in those over 65 for about 15 years in the future, then a considerable slowing down in the rate of increase for 10, followed by a huge increase, averaging well over 1 million a year, for the following 25 years, and then a more or less leveling off for many years after 2030. The people who will become 65 between now and 2045 have already been born, and the application of expected mortality rates (which include a substantial allowance for improved mortality) to the existing population produces the results described. In other words, give or take a few million, the number of people over 65 will rise from 26 million today to 35 million by 1995, rise relatively slowly for the next 10 years, and then be followed by a huge increase in just a 25-year period from about 37 million in 2005 to 65 million in 2030, with the number over 65 leveling off after that.

It is a fact that for approximately the next 15 years large numbers of people will be reaching age 65 because birth rates were relatively high in the period from 1915 to 1930. It is also a fact that the number over 65 will not increase as much for the 10 years after 1995 because of the low birth rates during the great depression. And it is a fact that the baby-boom generation of post World War II starts to reach 65 in the early part of the next century.

Much less certain is the widely held belief that shortly after the turn of the century, just at the time the number of elderly starts to increase so rapidly, the growth in the 20- to 64-year-old population—ordinarily thought of as the working age population—will come to a virtual halt and remain stable for many years. It is the possibility of the relative growth in the number of retirees compared to those at work that causes concern about long-range financing of social security. Between now and about 2005 there continues to be a major growth in the 20- to 64-year-old group—again a near certainty—so that the ratio of those over 65 to this younger age group changes relatively little during this period. Thus there is no significant demographic problem for social security for the next 25 years at least. The proportion taking out and the proportion paying in will probably change very little.

In the longer run, however, there could be substantial increases in the cost of social security cash benefits if we continue to have low birth rates, a continuation of immigration rates at the present legal level, a substantial increase in the rate of disability, and a work force that retires even earlier than today. These are the assumptions made by the Trustees, and on strictly a pay-as-you-go basis (no reserves) these assumptions produce a need for a contribution rate from 2025 on of about 8 percent of earnings as compared to 6 percent or less for the rest of this century. If this turns out to be the case, however, it is of great importance to recognize that the very assumptions which produce an increasing ratio of older people to those at work also result in a declining ratio of children to those at work. If instead of the ratio of those over 65 to those 20 through 64, we take what has been called a total dependency ratio, the ratio of those over 65 plus those under 30 to the group 20 through 65, we get a much difference picture than if we look only at the elderly. It just isn't true that reasonable demographic assumptions about the early part of the next century show a larger number of dependents for each worker. Instead what they show is a shift in the composition of dependency group—fewer children, more elderly.

Today we have about 75 people either over 65 or under 20 for every 100 in the age group 20 through 64. Over the next 25 or 30 years this proportion drops steadily until it reaches a low point of 68 per 100 around 2010. In other words, up to that year there are actually fewer dependents per worker than we have now, and it takes until about 2020 to get back to where we are today. Even at the high point in the total dependency ratio in 2035, we get a ratio of only 86 per 100, as compared to 90 in 1970, and 95 in 1965. In the future people will need to shift some of the resources that were once spent to raise children to building the kind of world they want for themselves and others in retirement.

In spite of the relative stability of the total dependency ratio, there would be increased costs for the social security system, considered as a closed system, under the Trustees' assumptions. This is true because about 80 percent of the cost of social security is for the elderly. Under the central set of assumptions used by the Trustees, some 50 years from now only 2 covered workers per beneficiary will be paying into the system as compared with 3.2 today. As stated earlier, this depends on assumptions that include fertility rates not rising above the rate necessary to replace the population, continuation of the trend to earlier and earlier retirement, immigration held to the present legal limit of 400,000 a year and an increase in the incidence of total disability to a level substantially higher in the future than it is today. These assumptions can be defended but they can also be questioned. The result of these assumptions is that, while the present cash benefit program, kept up-to date with wages and prices, can be financed well into the next century for a 6-percent contribution rate or less, in the longer run, on a strictly pay-as-you-go basis, a self-financed system would require about an 8-percent contribution rate because of the shift in the ratio of beneficiareis to contributors.

Now an 8-percent contribution rate is not an overwhelming burden. German workers already pay that rate for old-age, survivors' and disability insurance protection and, in addition, the general revenues of the German Government pay for 19 percent of the cost of the system. But an 8-percent rate for the U.S. system is in sharp contrast to what would be required under a different and, I would think, perhaps as reasonable a set of long-range assumptions. No matter what assumptions are made about fertility rates, immigration, retirement age, etc., it does not make startling differences in the estimated cost of the social security system for the next 25 years. In the near term, financing problems, if any, arise from the lack of an adequate contingency reserve to see the system through major economic fluctuations. The important factors in the short run are the depth and length of recession periods, the level of unemployment and inflation, the relation of price increases to wage increases—that is, economic factors. But in the next century, predicted costs vary widely depending on demographic and other factors not primarily economic.

A set of assumptions developed by the actuaries which are more optimistic than the central set shows that the social security contribution rate for cash benefits might not need to rise above about 6.5 percent for the next 75 years. The most pessimistic set of assumptions, on the other hand, shows the need for a much higher rate than called for by the intermediate estimates. What is crucial, of course, is how many people are paying in, compared to how many people are taking out.

My main point is that we don't know very much about what will happen on this crucial factor some 25 to 50 years from now. We can be quite certain about the large increase in the absolute numbers of the elderly, but we really don't know very much about future fertility rates, the extent to which women in the future will work in the paid labor force rather than as homemakers, the extent to which under conditions of fewer new entrants to the labor force employers will offer inducements to workers to stay on at their jobs longer than they do today, what our immigration policy will be, and all the other factors which will affect the ratio pf "payers-in" to "takers-out." We just don't know whether social security costs measured as a percentage of payrolls will significantly increase in the next century or not.

In any event, it can be expected that over the long run productivity increases translated into higher levels of living will make any increase in contribution rates that might be necessary easier to bear. The argument is not over whether in the long run there will be productivity increases, but over how high they will be. Even modest increases of 1¾ percent a year, on the average—for example, the Trustees' assumptions of a 4-percent annual price increase and a 5¾ percent wage increase over the long run (a much lower percentage increase in productivity than the historical average of 2 to 2.5 percent up until recently)—translate into a level of real wages by about 2025, after social security taxes, that is about twice what we have today. As a percentage of GNP, social security cash benefits, according to the intermediate estimates of the Board of Trustees, gradually drops from 5.05 next year to 4.30 by 2003, and then rises to a peak of 6.36 in 2030, falling again to 5.82 in 2055. It seems to me quite wrong to consider making reductions in social security protection now based on the notion that in the distant future the costs of the present social security law will somehow become much more difficult to support. This is just not the case.

I am, therefore, completely opposed to the various proposals now being discussed that would shrink the future role of social security. They are of several kinds:

(1) Specific benefit cuts such as a reduction in the cost-of-living adjustment, elimination of the lump-sum payment, the minimum benefit, etc.

(2) A shift to price indexing instead of wage indexing in computing benefits at the time they are to be received. This proposal has the effect of significantly reducing, in the long run, the proportion of recent earnings replaced by the social

security benefit. As an example, let me take the proposal made in 1976 by a consultant panel on social security to the Congressional Research Service. This panel proposed that benefits for future retirees be indexed more or less to prices although it did not go all the way in this regard. But even so, under the panel's approach, benefits as a percentage of wages in the year before retirement for the average earner retiring at 65 dropped from about 42 percent today to 30 percent by 2010 and to 25 percent by 2050.

(3) The proposal that the age at which full social security benefits are paid be raised from 65 to some later age such as 68. This proposal is simply another way of cutting benefits. Benefits would still be payable at 65, they would just be 20 percent less than they are today and one would have to wait until 68 to get the amounts now promised at 65. This significantly reduces the value of the protection that young workers are now paying for. More fundamentally, there would be many people who could not get jobs or keep jobs after 65 who would be forced to take the lower benefit even if the job market were more favorable to the average older person than it is today.

(4) A somewhat more subtle proposal for shrinking the role of social security is to drop the weighted benefit formula in the system or the spouse's benefit (some proposals would do both) and to pay all workers a single percentage of past average earnings. The percentage paid would probably leave higher paid workers about where they are today under the social security system, but the lower paid, without a weighted benefit formula or dependents' benefits, would in large numbers be forced to turn for supplementation to supplemental security income, with its tests of income and assets, its penalty on savings, and the undependability and humiliation of welfare programs in general.

The most recent polls that I have seen show clearly that social security is a popular program, that the majority of people do not favor cuts in benefits, and that, if necessary, they are willing to pay higher social security taxes to support the level of protection now provided. People just do not react to social security taxes as they do to other taxes since social security taxes are earmarked for specific protection, and they do not react to social security benefits as they do to other Government expenditures because they see the benefit resulting from a compact between the Government and the contributor.

A financing plan for the full 75 years over which the estimates are made

I think it would be a good idea, as the last Advisory Council on Social Security suggested, to have a social security tax rate put in the law that would fully finance the cash benefit program according to the official estimates of the Board of Trustees over the entire 75-year period for which the long-range estimates are customarily made. But we ought to realize that such a rate is just an illustration of what might happen under one set of assumptions about what the world will be like in the distant future.

The Council called for a single step increase early in the next century based on the theory that it is the absence of a schedule which fully finances the cash program over the 75-year period that causes journalists and editorial writers to emphasize that social security does not have enough financing to cover all costs in the long run. The facts that under the present assumptions the deficit is not estimated to occur for 50 years and that estimating costs some 50 years from now is an impossible business are frequently lost on the reader; the story just comes out that social security is underfinanced. For the cash benefit program, a contribution rate of 6 percent into the next century and a rate of 7 to 7.5 percent from then on would meet the costs as now estimated by the central set of assumptions over the whole 75-year period. (A rate of 7 to 7.5 percent is sufficient for this purpose rather than the ultimate pay-as-you-go rate of 8 percent previously referred to because the 7 to 7.5 percent is the average rate needed over a period of many years and also includes interest earnings on a sizable fund.)

I believe this is worth doing even though it is true, of course, that as one approaches the effective date for the higher rate it would need to be modified. First of all, if present estimates were exactly correct, it would undoubtedly still be desirable to stretch out the increases in terms of a current cost financing formula, just as we have in the past, rather than have such an abrupt rise in rates and a big jump in trust fund accumulations. Second, it would become clear as one nears the turn of the century that the actual long-range costs of the program would be somewhat different than are presently estimated, either higher or lower.

My main point, though, is that we cannot possibly know what social security costs will be some 50 to 75 years from now. This point, I think, is well illustrated by the fact that in the late 1930's and early 1940's the same sort of dire predictions that we are now hearing were projected to occur in the year 1980. The National Resources Committee of the Federal Government in "The Problems of Changing Population" predicted in May 1938, in an estimate that gained wide currency, that by 1980 from 13 to 17 percent of the total population would be over age 65. Actually the figure is about 11 percent today and the dire predictions then made about the "burden of the elderly" and all the other changes that arise from such a huge increase in the percentage of the elderly have, of course, not occurred. It seems to me that the part of wisdom is to move very slowly indeed in making current program changes based on a picture of how things are going to be some 50 years or more from today.

CONCLUSION

In summary, there is no reason to expect that in the long run the economic burden of supporting the present social security law will be greater than it is today: (1) It is not at all clear whether, and to what extent, there will actually be an increase in the ratio of those drawing benefits to those paying in. (2) In terms of the basic economic situation in the future, there will not be more dependents per worker than there were, say, in 1970—there will be more older people but fewer children. (3) It can be expected that the real wage level will be much larger in the long-range future than it is today—perhaps about twice as high by 2025 after social security taxes—so that any increase required in social security contributions would be much easier for workers in the future to bear. (4) Finally, under present law, social security benefits as a percentage of gross national project (using the assumptions in the middle-range estimates of the latest Trustees' report) show a considerable drop between now and the early part of the next century and a relatively small increase thereafter—in the range of 5.05 next year, 4.30 shortly after the turn of the century, 6.36 in 2030, and 5.82 in 2055.

All in all, I believe that the social security system that emerged from the 1977 amendments is a good one. Social security, as shown by the latest polls, continues to be immensely popular. The one weak spot shown by the polls is a lack of public confidence in the system's financing. The changes I have suggested would meet this problem while retaining the present relationship among social security, private pensions, private savings, and Supplemental Security Income. Certainly there are minor changes to make that would improve the system, and, over the long run, I believe that modifications will need to be made that improve protection for both homemakers and women who work for market wages. But I would suggest concentrating now on adequate financing for what the system presently provides. I see no need to cut back in benefit protection, and I suspect this is not a good time to propose further improvements.

Senator CHILES. Our plan was to listen to our panel and then to have us question. We do have a number of our colleagues who are here now.

Senator Heinz, do you have an opening statement?

Senator HEINZ. Mr. Chairman, I do but so that we might proceed I ask unanimous consent that it be placed at the appropriate point in the record.

Senator CHILES. Fine. We will place your statement in the record.

Senator MELCHER. I make a similar request, Mr. Chairman.

Senator PRYOR. I have a statement I would also like to have placed in the record, Mr. Chairman.

Senator CHILES. All right. All of your statements will be inserted into the record at this point.

[The statements of Senators Heinz, Melcher, and Pryor follow:]

STATEMENT OF SENATOR JOHN HEINZ

Mr. Chairman, Senator Domenici, I want to commend you for calling these extremely important hearings to examine the issue of the future of our social security system—an issue that will be of critical importance to the well-being of generations of Americans.

In my trips around Pennsylvania and the country, I have been asked again and again by senior citizens and young workers alike about the future of our retirement system.

The concerns they express are real, and they want real answers. They are concerned about the level and adequacy of benefit payments.

They are worried about what they have heard and read about the future capability of the social security system to pay any benefits at all.

Young workers, those applying into the system today, are troubled by the increased taxes needed to maintain the system. And they want to be reassured that they, too, can reap the benefits in their later years.

As we know, the answers to these difficult questions vary as do all the proposals to maintain and stabilize the social security system. But there are several facts that any solution to these problems must address:

—First, in terms of size and, impact, the social security system is by far the most important retirement income program. In fiscal year 1979, for example, social security payments amounted to $101 billion and were received by 35 million people.

—Second, the number of people 65 years and older will dramatically increase in the years ahead, and our retirement system will have to support more people for a much longer time. Today, the percentage of the population over 65 is 11 percent. By 2035, projections put that figure at 22 percent, 55 years from now.

—Women represent—and will continue to represent—a much larger proportion of the very old than men. The system currently fails to meet many of the needs of these economically and frequently medically dependent women.

There are other critical facts about our Nation's retirement system we must take into account:

—The social security system was enacted in 1935 with two distinct goals: (1) To replace a certain portion of individual income lost at retirement; and (2) To provide a minimum level of support and security for the aged and other eligible groups. The system has gone a long way toward meeting those twin goals of equity and adequacy.

—Between 1959 and 1997, the number of elderly persons officially counted as poor dropped from 5.5 million to 3.2 million—a decrease of nearly 20 percent.

It is our great responsibility to continue to meet the commitments of equity and adequacy—the same commitments that have benefited millions of retired persons since 1935.

Our first priority in meeting that goal must be—to maintain the fiscal integrity of the social security system.

Our second priority must be—to solve the current problem of inequitable benefit payments.

And, we will have to improve the system's responsiveness to the growing number of retirees and their dependents without breaking the financial back of the employed population.

Those are the difficult tasks we face in the months ahead.

I look forward to working with each one of you—Mr. Ball, Mr. Boskin, and Mr. Aaron. I am interested in your insights and your recommendations for solving the problems facing our retirement program.

Statement of Senator John Melcher

Mr. Chairman, social security is so important to our senior citizens it is hard to imagine what their lives would be like without it.

Looking backward, in 1934, the year before social security was enacted, my State of Montana was one of 28 States with an Old Age Pension Act. But only 2,780 people were receiving such pensions and the average monthly payment was just $5.32.

As important as the program is to most all of us, there are some warning flags up. Earlier this year, Peter D. Hart Research Associates released the results of their survey of the Nation's attitude toward social security. Two of the survey's findings underscore the acute problem Congress faces as it begins to consider changes to strengthen and stabilize the social security system.

For one thing, 61 percent of the people surveyed who have not yet retired, expressed little confidence that there will be sufficient funds in social security to pay their retirement benefits. On the other hand, the vast majority of people—something like three-quarters of those surveyed—expressed basic support for the program. Despite the views of one of this year's Presidential candidates, only 19 percent of those in the survey said they would pull out of social security if they had the chance.

So, what we have here is an overwhelming number of Americans supporting the system at the same time that a like number are seriously worried about its future. Congress should keep those sentiments clearly in focus.

There is little doubt social security has financial problems right now. The annual Social Security Trustees Report makes it clear that, under current conditions, the old age and survivors insurance trust fund will have cash flow problems by the end of 1981. But I believe these problems are manageable. This hearing or any congressional hearing on social security would make a grave mistake if we gave the impression that a meltdown is imminent and that it is unavoidable. Our responsibility must be to highlight the problems and seek the best opinions on options to correct them. We must make it clear that what we have here is not a runaway problem. Instead, social security is an overheated system burdened by inflation, fluctuating unemployment, a declining birth rate, and—and this is very important—the addition of programs it was not meant to carry.

Unlike the program signed into law in 1935, today's social security package also involves a disability program and medicare. Both are fine and necessary programs, but should not be funded by the social security payroll tax. Under present law, one-third of the 6.67 percent tax rate (2.125 percent) set for 1981 will to the trust funds for disability and medicare. That's too much and too great a strain on the payroll tax. Without those two add-ons to the social security program, the taxes for employers and employees would be about 4½ percent. That is more reasonable and the reduction would be a great stimulant for business and industry, both small and large, and a most welcome tax relief for wage earners.

I am a cosponsor of S. 2804, which would reduce the portion of the payroll tax that supports medicare and fund the difference from General Treasury dollars. These are steps in the right direction and I plan to consider carefully the proposals we will hear today on what other responsible steps might be taken to safeguard social security.

Statement of Senator David Pryor

I am pleased to be here today, Mr. Chairman, as the Special Committee on Aging begins the first in a series of hearings designed to examine the future of the program upon which our Nation's elderly rely most heavily for their retirement income.

It is clear, Mr. Chairman, that the concern being expressed throughout the Nation about the future of social security is well founded. Perhaps never before in the history of the public retirement income system have we been confronted with so major a challenge as faces us now. Certainly never before have such staggering projections been made about the social security system:

—Until recent congressional action, the old age survivors insurance trust fund was projected to go into deficit by 1981.

—Despite that action, the Office of Management and Budget has projected that by 1983 the old age survivors insurance (OASI) trust fund will again be in deficit.

—By early in the next century, the worker to retiree ratio will increase from 3¼ to 1 to a 2 to 1 ratio.

Increasing levels of unemployment with accompanying decreases in contributions to the OASI trust fund and the inequitable treatment of women under the current system are also areas of chief concern which must be addressed in the very near future.

I am pleased that in recent years Congress has worked toward abolishing mandatory retirement, leaving the individual free to continue in the work force if he so desires. This allows for increased worker productivity and benefits us with the experience and know-how of one of our most prized resources, our senior citizens.

The abolishment of retirement at age 65 is of benefit to the worker because it allows him to stay in the work force, rather than go on retirement income which is slowly eaten up by inflation.

Another serious concern of mine is the earnings limitation which is currently placed on those who would like to continue working. I believe that a balance between the desire to continue to work and the collection of social security benefits can and should be established.

Mr. Chairman, these are only a few of the dilemmas that face us in the beginning of the 97th Congress. While we have never before been faced with the possibility of such major changes to the social security system, we have never been given so many options, either.

We must be wary, though, that neither the Congress nor the administration take a broad ax to a program that may require only the most delicate of surgery. We must guard the process so that we achieve a program that is not only financially possible, but also one that is of greatest benefit to the retired of this Nation.

I want to commend you, Mr. Chairman, and the staff of the Special Committee on Aging, for scheduling such timely and informative hearings. I am sure that all of us will gain very much from the views presented to us today, and in ensuing hearings. Thank you.

Senator CHILES. All right. Henry Aaron is the name that we also hear in baseball some, so I would say to our present distinguished Henry Aaron, we will now have you pinch-hit for Mr. Boskin, who cannot be here. So if you would highlight his statement for us, I think it would be very helpful.

STATEMENT OF MICHAEL J. BOSKIN, PH. D., PROFESSOR OF ECONOMICS, STANFORD UNIVERSITY, PALO ALTO, CALIF., AND DIRECTOR, SOCIAL INSURANCE PROGRAM, NATIONAL BUREAU OF ECONOMIC RESEARCH—PRESENTED BY HENRY AARON

Mr. AARON. I will try to do so. Batting after Bob Ball is like coming up to bat after Babe Ruth. I have been impressed over the years with the reasonableness and the good judgment, both from a policy standpoint and a political standpoint, that he has consistently shown, although we disagree on a few matters.

I would like to start off by saying that I fully endorse his emphasis on the basic soundness of the four tiers of retirement income protection as he sketched it, and it seems to me that while we want to strengthen them and improve their strength, we should be very careful of substantially altering instruction.

Now switching hats and wearing for a moment that of Professor Boskin, he has submitted a statement for the record.

Senator CHILES. Without objection, his statement in full will be be included in the record.[1] He made every effort to be here and we are very sorry that he could not be here today. He is professor of economics at Stanford University and director of the social insurance research program, National Bureau of Economic Research.

Mr. AARON. I have spoken to Mr. Boskin on the phone in order to get some clarification on a number of points and to flesh out some details. The gist of Professor Boskin's position is that the social security system is a highly popular system and a highly successful one, but that it faces very serious financial problems in the short run and the long run flowing from the potential retirement of the postwar baby boom generation.

The potential increase in payroll taxes is very large—early in the 21st century as much as 8 percentage points for both retirement and medicare benefits. Professor Boskin emphasizes that it may be considerably

---

[1] See page 39.

higher because there is a possibility of medical breakthroughs that could significantly decrease mortality and thereby significantly increase the cost of social security.

The first main section of his testimony addresses social security's long-run financial problems. Social security serves two distinct functions: One is to replace income loss at retirement and the second is to provide minimum income support for low-income aged persons. The second of these is a kind of welfare role, the first is an attempt to provide a kind of social insurance. Both of these objectives are important and both should be continued. Each enjoys wide public support. The problem, however, is that we are attempting to deal with two very distinct problems in a single system and thereby prevented by doing as good a job as we might do on either.

The result of the present benefit formula is that at present retirees receive rates of return substantially in excess of any that are payable on private investments. But that situation will change and as one moves into the next century, people will face the situation where, had they retained the funds they pay in social security taxes and invested them on their own, they could have earned a substantially higher rate of return than is available from social security. The rate of return mentioned is 3 to 4 percent which has been the average real rate of return over the past half century.

Given the pay-as-you-go nature of the present system, we face a fundamental dilemma. If we decide to shift to a fully funded system or to some other method to deal with the long-run problem, then the population working at the time that decision is made will have to pay twice, once to finance their own retirement and once to take care of current retirees.

In brief summary, social security, as a forced saving program, has been a mixed success; the benefits are tied only loosely to past earnings, and a variety of changes in the economy make the implicit return lower than could be obtained on alternative investments; but there is evidence that some of the elderly would undersave in its absence and therefore a forced saving program of some sort is required.

The second goal of social security, that of achieving minimum income support for the elderly, has also met with mixed, but greater, success. Social security benefits account for about one-third of the money income of elderly individuals and families and many individuals would be destitute without social security.

Each of the purposes of social security should be continued in a major Government program. However, progress toward improving the cost effectiveness and target effectiveness of the benefit payments is seriously impeded by attempting to combine both goals in a single program. For that reason it would be desirable and not difficult to split social security into two programs—into an earned entitlement program, and a transfer payment program, instead of mixing them together in the social security program. Professor Boskin proposes separate but parallel programs.

An earned entitlement program should be based on an actuarily fair computation of lifetime benefits paid in plus interest. In other words, benefits would be proportional for each worker. In such a forced savings program it does not make very much sense for different groups in the population to be treated differently. Everyone should receive the same rate of return and that refers not only to workers at different earning levels but to workers in different marital status. For that reason, Professor Boskin proposes a gradual deferred and phased elimination of benefits for spouses and surviving spouses. This insurance-type system would be funded out of payroll taxes.

The second system would provide transfer payments along the lines of the SSI program.

In a phone conversation, Professor Boskin indicated he would favor an SSI program that provided benefits at least equal to the social security poverty thresholds, and that in certain specified circumstances provided benefits before the age of 65. Furthermore, he felt there was some case for relaxing the treatment under disability insurance for those just before age 65, so that there would be a cushion for those not able to find productive employment.

The second fundamental reform which Professor Boskin believes is absolutely crucial is to gradually raise the age at which benefits under social security may be collected. He points out that we continue to view age 65 as a normal retirement age, but with each succeeding cohort it is ever more true that the majority of people would claim their social security benefits before age 65. Moreover, there is a fair amount of evidence that early retirement is encouraged by the social security system. At the same time that retirement at an early age is becoming a widespread phenomenon, increasing dramatically since 1960, the increase in life expectancy has been about 3 years for women and 1½ years for men.

Combined with earlier retirement, we have seen a lengthening of the typical retirement period of approximately a third which places greater stress not only on social security but on private savings, intrafamily support across generations, and on private pensions.

Much has changed since we adopted the retirement in current law. The labor force has gradually shifted out of physically demanding and dangerous jobs; the increased life expectancy and improved health of the elderly have been well documented; workers are entering the labor force later; and the long-term financial integrity of social security is in doubt. For all of these reasons and others, Professor Boskin favors a gradual phasing in of an increased retirement age at which people could collect full social security benefits from the current 65 years of age to 68 years of age and he would do so 1 year per decade for each of the next three decades, and complete the transition in 2010, just about when the baby boom becomes a retirement boom.

Professor Boskin goes on in the remainder of his statements to emphasize that the standard cost estimates, the intermediate cost estimates prepared by the actuaries, may turn out to be much too low either if productivity does not return to projected levels or if life expectancy increases more than anticipated. I would like to come back to that in my own comments because I think that is one of his points that needs some clarification.

In brief summary, the long-term financial status of the social security system is precarious. If we wait and attempt to provide the benefits currently being planned under the social security system, we face the most massive tax increase in the history of the United States, one that is sure to test the fabric of our society, jolt our economy, and wrench our political system. A more sensible course of action would be to gradually raise the age at which full social security benefits may be collected and combine this with a separation of social security's two goals into a twin program, each of which could be made fairer and most cost effective in meeting its target.

The concluding pages of Professor Boskin's statement concern a number of other reforms. He discusses switching from wage to price indexing. Those of you who have his written statement will note that he refers to the indexing of earning histories. That is a misstatement of the position that he takes. He is referring to indexing of the benefit formula. If your eyes begin to glaze over a discussion of the alternative issues involved in indexing those two matters, I cannot blame you but the effects of these two changes in indexing are drastically different.

Changing the indexing of earning histories is not a proposal to the best of my knowledge that anybody is seriously entertaining at the present time.

In addition, Professor Boskin proposes that part of all of social security benefits should be taxed and he has made clear that he supports treating social security the same as we treat private pensions. That is a somewhat more strenuous version of a recommendation which the Advisory Council on Social Security made and which both of us witnesses this morning endorse.

I will not go through the remainder of the statement which will be included in the record according to your instructions, Mr. Chairman. On behalf of Mr. Boskin, I know he wishes he could have been here to take your questions. You may have some questions on which I could provide some information when the time comes but I cannot speak for his proposals as I am sure he could do.

Let me turn to my own statement.

Senator Chiles. All right, but before you do, I will insert Mr. Boskin's statement into the record.

[The statement of Michael J. Boskin follows:]

Statement of Michael J. Boskin

1. Introduction

The social security system—perhaps the most popular, and in many ways the most successful, Government income security program in the United States—is in serious trouble today. Although it is the major source of retirement income for millions of Americans, and an important source for millions more, it also imposes the largest part of the tax burden for many American families. While there are substantial short-term problems affecting the funding of social security over the next several years, these problems pale before the pending long-term financial crisis facing social security. Put simply, when the post-World War II baby boom generation retires early in the next century, the ratio of retirees to workers in our society will increase from 1 retiree for every 3¼ workers to 1 retiree for every 2 workers. Combined with other economic factors, this creates a long-term funding deficit in the social security system (including medicare) of hundreds of billions of dollars. The chief actuary of the social security system estimated in 1978 that early in the next century, social security tax rates would have to rise by almost 8 percentage points as a fraction of payroll above and beyond the 15 percentage points they are scheduled to reach later in this century. Such an abrupt increase in taxes, if we maintain the current benefit promises implied by current legislation, would lead not only to a severe disruption of our economy, but to an unprecedented polarization of our society between those paying the taxes to finance such benefits and those receiving them.

I believe this would be a crisis of unmitigated proportions. But it need not occur. Sensible advance planning, and concomitant fiscal action, can do much to mitigate unnecessary increases in taxes, rationalize and render more cost effective future benefits, and do much to strengthen the long-run fiscal integrity of the social security system. I believe that a combination of two crucial policy reforms will help solve a wide variety of social security's problems: Its long-term funding crisis; its apparent inequities; and some of its potentially adverse effects on the overall economy. This can be done in an environment which guarantees that social security will continue to play a vital element in our income security system for the elderly.

2. TOWARD SOLVING SOCIAL SECURITY'S LONG-RUN FINANCIAL PROBLEMS

The old-age component of social security is intended to achieve two major goals: To replace income lost at retirement, and to provide minimum income support for the aged. The second of these, sometimes called the transfer or welfare goal of the system, aims at providing some socially adequate level of support; the first is an attempt to provide social insurance against the vagaries of macroeconomic fluctuation, imperfections in private insurance markets, and imperfect foresight regarding future income, inflation, life expectancy, health, and the like. These conditions may lead many citizens to undersave for retirement, forcing them on the public as general charges via welfare or other government transfer payment programs. Each of these goals enjoys wide public support, but in attempting to meet both with a single program, the social security system is not doing the best job possible in achieving each.

Various studies have shown that as a result of poor planning or unanticipated events, a large proportion of the elderly might find themselves destitute in the absence of the social security system. What sort of return can each generation expect from this implicit forced saving program? Since tax contributions by current workers are used to pay benefits to current retirees, with an implicit promise that the next generation of workers will pay taxes to finance retirement years of the current generation of workers, the pay-as-you-go nature of the system prevents the development of a real trust fund and the formation of real capital. If the social security tax rate remains constant, as the base upon which taxes are levied grows (because of increases in the working population or in real per capita income due to technological change), retirees will obviously receive much more than they paid in taxes when they were working. The ratio between the total benefits received and the total taxes paid, discounted to the present, can be regarded as an implicit rate of return on social security taxes. The tax base will grow at a rate that is the sum of the growth rates of the population and of real wages—about 3 to 4 percent on the average over the last half century. However, the annual rate of return earned on investments in private capital has apparently substantially exceeded this return. This has led several critics of social security to argue that social security is a bad deal for the young. Given the pay-as-you-go nature of the system, we are in a fundamental dilemma—if we decide to shift to a fully funded system, or to some other method of financing the retirement benefits of the elderly, the population working at that time will have to pay twice—once to finance their own retirement and once to take care of the current retirees.

In brief summary, social security as a forced saving program has been a mixed success; the benefits are tied only loosely to past earnings, and a variety of changes in the economy make the implicit return lower than could be obtained on alternative investments; but there is evidence that some of the elderly would undersave in its absence, and therefore a forced saving program of some sort is required.

The second goal of social security, that of achieving minimum income support for the elderly, has also met with mixed, but greater, success. Social security benefits account for about one-third of the money income of elderly individuals and families. Many social security recipients would be destitute without social security. It is not true, however, that the total income of the elderly, as a group, or as individuals, has increased by amounts equal to total, or per capita, social security benefits payments. This is because social security does not take place in a vacuum but occurs in a broader context of private intrafamily and intergenerational transfer payments and may merely substitute for some other income sources (for example, continued earnings, private intrafamily transfers of income, and greater private saving for retirement).

Therefore, each of these purposes of social security should be continued in a major Government program. However, progress toward improving the cost effectiveness and target effectiveness of the benefit payments is seriously impeded by attempting to combine both goals into a single program. One may decompose any individual's or family's social security benefit payment into two components: Contributions paid in by the worker and his or her employer, plus interest, on the one hand, and transfer payments from current workers on the other. Current retirees receive back approximately five times on the average what they paid in plus interest. This fraction will diminish through time, and by the time we have examined the expected future financial situation for young workers, they can expect to receive back less than they have paid in plus any reasonable rate of interest. It would not be a difficult matter to split social security's program in two—into an earned entitlement program and a transfer payment program. We already have substantial elements of both mixed together in our current social security system. I would propose separate, but parallel, programs.

First, an earned entitlement program should be based on an actuarily fair computation of lifetime benefits paid in plus interest. In such a forced savings program, it does not make very much sense for different groups in the population to be treated differently. Everyone ought to receive the same rate of return on their total lifetime contributions. This would eliminate all of the problems of inequity based on calculations of different groups in the population receiving different returns in their contributions, for example, working women versus nonworking women; men versus women; etc. This program should be funded out of payroll taxes.

Second, a transfer payment program should be created, along the lines of SSI, but taking all of the current and expected future transfer payments across generations out of the current social security program. This transfer payment program should be based exclusively on income adequacy criteria, should be income tested, and should be the sole program for which various claims for benefits aside from an actuarily fair return on the earned entitlements program, should be arbitrated and discussed by the general polity. Among concerns with the current program, for example, are that retired wealthy people may receive substantially more in social security benefits than persons who "need" the funds much more; persons with relatively short covered earnings histories who have paid in substantially less than those with lower wages who paid in over a much longer period, may receive greater benefits, etc. All such inequities would be removed by the dual program proposed here. Everyone would get their actuarily fair return on their earned entitlements based on contributions over their lifetime; and everyone would be treated along general income transfer rules and criteria in the social adequacy, or income transfer program. I would gradually shift such benefits to general revenues.

In a forthcoming paper, I have estimated the aggregate amount of taxes, benefits, and transfers under a variety of alternative scenarios with respect to productivity, inflation, and retirement patterns. I would like to make two points concerning these intergenerational transfers. First, their aggregate amount is enormous. For persons not currently retired, for the base case assumptions generally used by the Social Security Administration concerning inflation and productivity growth, total transfers to persons not yet retired will amount to almost two trillion discounted 1977 dollars. These transfers obviously are a substantial component of the benefits paid to current retirees who paid much lower tax rates on a much lower tax base during their working lives than current workers are paying. My estimate is that people over 65 have transfers as a percentage of total benefits of almost 87 percent; the corresponding figures for younger workers projected into the future declines to 39 percent for 45 to 54 year olds, becomes negative to persons under the age of 35, and a very large negative number for persons under 25. Hence, we really are talking about a major structural change in social security which would substantially strengthen the earned entitlement function and provide a much fairer and much more open means of adjudicating claims for income adequacy in the transfer payment component of the system.

The second fundamental reform which is absolutely crucial is to gradually raise the age at which benefits under social security may be collected. We continue to view 65 as a "normal" retirement age. In fact, more people collect their first social security check at age 62 than at age 65. The labor force participation rate of men over the age of 65 has fallen from about one-half in 1948 to only one-fifth today; a similar, although not quite so severe, decline has occurred for men age 55 to 64. This explosion in earlier retirement has been partly caused by a variety of features of the social security system.[1] A number of studies, including several of my own, have documented this fact. At the same time that retirement at an earlier age is becoming a widespread phenomena, the life expectancy of the elderly

[1] Discussed in more detail below.

has been increasing dramatically since 1960. This increase in life expectancy has been about 3 years for women and 1½ years for men. Combined with earlier retirement, we have seen a lengthening of the typical retirement period of approximately 30 to 35 percent. This obviously places greater stress on not only social security but private saving and intrafamily intergenerational support patterns in order to provide any given level of income annually for a much longer period of time during retirement.

But much has changed since we adopted such retirement ages. The labor force has gradually shifted out of physically demanding and dangerous jobs (e.g. out of agriculture and heavy industry into light industry and services); the increased life expectancy and improved health of the elderly have been well documented; workers are entering the labor force later; and the long-term financial integrity of social security is in doubt. For all of these reasons, and others, I strongly favor a gradual phasing-in of an increased retirement age at which people could collect full social security benefits from the current 65 years of age to 68 years of age. I would do so 1 year per decade for each of the next three decades. To give some idea of how important the length of the retirement period is to the long-term financial status of social security, and hence its ability to provide any given level of annual resources to the elderly at given tax rates, I have simulated the impact of the proposal to gradually raise retirement age. Such a proposal would not only reduce total benefit pay-outs by some 600 billion discounted 1977 dollars (out of a total of $4 trillion), but would leave social security with a very modest surplus under the base case assumptions (a point I will return to in a moment).

The long-term deficit of the social security system, as noted above, would require enormous tax increases early in the next century to meet current benefit plans, or a substantial reduction in benefits. I believe that an intelligent combination of reducing benefits by paying them for a slightly shorter retirement period, decreasing markedly the necessary tax rate increases, and restructuring the benefits along the lines of the dual program mentioned above in order to help contain benefit costs and provide fair income adequacy, will remove any long-term fiscal problem facing social security. I believe it is extremely important to point out how sensitive the long-term fiscal problems of social security are to modest changes in the length of the retirement period, changes in the rate of productivity growth in our economy, and a variety of other factors. The two factors I wish to focus on are the length of the retirement period and productivity growth. An intermediate set of assumptions of the SSA usually use an annual productivity growth rate of 1.5 percent. While our recent productivity growth has been substantially below that, indeed has been negative in the very recent past, I do not think such a growth rate is unobtainable with a substantial improvement in our monetary and fiscal policies, reduction in our inflation, and restoration of private incentives to save, invest, and generate new research and technology. But, I do want to point out that for each one-half of 1 percent that productivity growth falls short of the projected 1.5 percent, total tax collections under social security would decrease by about 500 billion discounted 1977 dollars, whereas total benefit payments would decrease by only about $400 billion. That is, for each one-half of 1 percent decline in productivity growth below the 1.5 percent base case estimate, the deficit will increase by $100 billion or so in present value terms; and for each one-half of 1 percent of productivity growth above and beyond the 1.5 percent intermediate estimate, the deficit will decline by a similar amount.

Even more striking, for each year decline in the length of the retirement period over which social security benefits are paid, the deficit will decline by about $250 billion. This occurs mostly because benefits decline, being paid over a smaller numbers of years at the same annual rate, but also slightly because tax revenues will increase a modest amount due to the increased working life.

In brief summary, the long-term financial status of the social security system is precarious. If we wait and attempt to provide the benefits currently being planned under the social security system, we face the most massive tax increase in the history of the United States, one that is sure to test the fabric of our society, jolt our economy, and wrench our political system. A more sensible course of action would be to gradually raise the age at which full social security benefits may be collected, and combine this with a separation of social security's two goals into a twin program, each of which could be made fairer and more cost effective in meeting its target.

3. FURTHER CONSIDERATIONS

The program described above would do much to increase the equity, efficiency and financial solvency of the social security system. It is focused primarily on gradually restoring financial solvency and separating the genuine welfare goals of social security from its earned entitlements function. By separately targeting these in a two-tier program, a much greater target effectiveness can be achieved. But there are several more intermediate, piecemeal proposals, which can move us in the proper direction. I would like to address each of the major ones very briefly.

(a) Switch from wage to price indexing of earning histories

Under current law, an individual's wage history used to compute his or her primary insurance amount at retirement, is indexed by nominal wage increases. While for the last 2 years, nominal wage increases on average have fallen short of nominal price increases, in general the reverse is true. As a rough approximation, wages increase more rapidly than prices by the rate of productivity growth. Therefore, the current wage indexing scheme leads to substantial increases in future benefits. These increases are only justified conceptually if one takes a completely relativist position about the well-being of the elderly. That is, they lead to rising replacement rates based on any measure of constant purchasing power; to constant replacement rates relative to ever-growing nominal wages. Switching from wage indexing to price indexing of earning histories is likely to result in a saving of several hundred billion dollars over the next several decades. While there will probably be some years in which price increases exceed wage increases, there are few among us who believe that there will be no productivity growth in the future. Therefore, substantial consideration should be given to shifting to price rather than wage indexing of earning histories.

(b) Taxing all or part of social security benefits

As noted above, under current law many of the elderly receive a very substantial income transfer from the tax-paying population and a nontrivial fraction of them are by fairly well-to-do. They receive these benefits far in excess of what they paid in plus interest once they stop earning beyond the earnings-tested amount regardless of their other income or assets. Since social security benefits are not taxed currently under the personal income tax, taxing them would create a situation where low-income recipients would pay no tax—given the exemptions, deductions, etc., in the income tax, moderate income elderly people would pay a very modest tax given the low progressive tax rates that they would face, and wealthy individuals would pay high tax rates, and hence would have their benefits reduced substantially because under the progressive income tax they would face higher tax rates. I would propose partial taxation of social security benefits as an interim step while the dual program outlined in the section above was gradually phased in. The proportion of the benefits taxed obviously would be the key to how much revenue could be saved. But the amounts can be substantial if we go anywhere from half to full taxation of benefits.

(c) Other reforms

Many other reforms merit consideration on either equity, efficiency or financial solvency grounds. On equity grounds there is much to be said for abolishing the earnings test (while either taxing benefits or moving to the dual system described above), making the delayed retirement credit more actuarially sound, and a variety of other such changes. The point is, there are an enormous number of special incentives in the current social security law which encourage people to retire earlier, and hence start to collect benefits at a much earlier age than typical retirees did many years ago. This occurs despite the fact that the life expectancy of these people is dramatically greater than those who retired several decades ago.

4. CONCLUSION

In brief summary, social security—perhaps our most popular and certainly our most important social program—faces serious future problems. We cannot wait indefinitely to begin to deal with them, or we will disrupt the financial planning of individuals as they approach retirement and of their firms as they attempt to rationalize pension programs. Indeed, if we wait until the baby boom generation retires before we begin to deal with the tremendous long-term deficit in social security, we will see the greatest tax revolt and age warfare in the history of the United States. This can and should be avoided by sensible, moderate reforms which restructure social security to take account of the vastly different economic, demographic, and social circumstances that exist today, relative to decades ago when social security was adopted, grew, and admirably filled important social and economic needs. We cannot sit passively by and expect future taxpayers to pay 23 to 25 percent of their payroll in social security taxes before they pay a dime of Federal or State income tax. In my opinion that simply will not occur. We therefore need some intelligent combination of careful restructuring of benefits and taxes to prevent the necessity for such enormous tax increases and the tremendous disincentives and dislocations that they would create and improve equity and efficiency in both the cost and target effectiveness senses of the terms. Sensible possibilities are being discussed as never before. The time for action is rapidly approaching. We owe our future elderly retirees and taxpayers no less.

Senator CHILES. Please proceed, Mr. Aaron.

STATEMENT OF HENRY AARON, WASHINGTON, D.C., SENIOR FELLOW, BROOKINGS INSTITUTION, FORMER CHAIRMAN OF THE 1979 ADVISORY COUNCIL ON SOCIAL SECURITY

Mr. AARON. I am now speaking as Henry Aaron.

Senator CHILES. Henry Aaron is now at the plate in his own name.

Mr. AARON. I have submitted a full statement from which I shall excerpt, but I hope that the full statement can be included in the record.[1]

The points of view that were expressed by Mr. Ball and in Professor Boskin's statement are very different and the proposals that are advanced are quite diverse. What I would like to do is to try to sketch a point of view that I think in most respects parallels that of Mr. Ball but nevertheless reaches the conclusion that some of the proposals that Professor Boskin endorses do deserve serious consideration and support.

I divide my comments into three parts. The first discusses the proposal advanced not only by Professor Boskin but by other economists to move to a two-tier benefit structure, to separate out the welfare function into kind of negative income tax for aged and to create a parallel insurance system providing benefits proportional to earnings running next to it. The second and third parts of my statement discuss the two financing problems, the shortrun problem that is critical but not serious and the longrun problem that is serious but not critical.

The two-tier system would neatly and cleanly assign the provision of insurance-like replacement of earnings to one system and welfare-like provision of aid to the needy to the other.

As an economist I am trained to like neatness—most of the prominent supporters of this proposal are economists and I once liked the two-tier plan, too, but I now think it would be bad policy.

The first reason is that, it is well documented, that many people legally entitled to income tested benefits do not claim them because they are shamed by the aura of public charity that surrounds such programs, and because application for income-tested benefits is perceived to be time-consuming and burdensome. Even for those who claim such benefits, the stigma and inconvenience attached to them constitute a real cost. Because the takeup of income-tested programs is incomplete in actual operation, they are not capable of reaching all of

[1] See page 49.

those who are made legally eligible for benefits. Thus, the two-tier program is not capable of achieving the objective that Professor Boskin would like to have it achieve; that is, having a kind of welfare-type income for the needs of all the aged poor. The facts are that many of the aged poor go without income rather than apply for SSI.

In addition, income-tested programs are costly to administer. Administration of supplemental security income costs about 10 percent of the amount paid out in benefits. Administration of social security costs about 2 percent of the amount paid out in benefits. I think we ought to be very careful about instituting a changed program that may raise the deadweight loss of administrative costs by very large amounts.

So the basic configuration of social security benefits, it seems to me, makes sense. Nevertheless, it does provide disproportionate benefits to some. For example, the current formula treats workers who have spent only a few years in covered employment as if they had earned low wages all of their lives and, accordingly, awards them relatively large benefits. The Advisory Council recommended, and both Bob Ball and I support the recommendation, that we change the benefit structure and not ask the social security system to subsidize such workers.

Senator CHILES. So you strike the minimum benefit?

Mr. AARON. The minimum benefit is a separate issue. What I am referring to now is the provision under which a worker who has spent only a few years in covered employment and may have had relatively high earnings is treated, because of the long averaging period, as if he had low lifetime earnings. The result is that that worker receives the disproportionately large benefit that we intend for the long-term low-wage workers.

What we recommended was changing the benefit formula so that such workers would not be unduly rewarded but we also supported long service credits to protect workers who have spent a long time with low wages under the social security system. The reason I emphasize this particular provision although it is not directly germane to the activities this morning perhaps is that it is a good example of how you can deal with the problem contained in the present system without undermining the basic structure under which we do provide extra benefits for low-wage workers, and thereby enable the mass of the low-income aged to escape the need to go through a welfare system. It seems to me that is a valuable feature of the present social security system.

I would like to turn now to the issue of the rate of return calculations that Professor Boskin and many others have raised. One ought to recognize that a corollary of the generous treatment of low-income or low-wage workers within a closed system is that some workers are going to get higher rates of return than others do. I believe that the calculations of the rates of return that will be earned by workers at different points in time and at different earnings levels are instructive. They point to the fact that all classes of beneficiaries up to the present, and for many years into the future, have benefit entitlements worth more—often many times more—than the taxes they have paid in, even after all proper adjustments have been made for inflation. They make clear that at some point in the future, some classes of workers—notably workers who have high incomes and those who remain single—will receive benefits on which the rate of return is rather low.

In interpreting these findings, it is important to keep in mind that they assume that alternative investments with an assured rate of return of 2 or 3 percent per year in addition to inflation are readily available to all. I would ask each of you to think of your own investment portfolios. Have you earned 2 or 3 percent in addition to inflation on your investments lately? Most people haven't. Many have lost money, even in such secure investments as gilt-edged bonds afteı adjustments for inflation.

It is important to note that people pay large amounts each year, for example, in the form of fire and health insurance, to escape the risk of financial loss that the aged and the rest of us have had to face throughout the seventies, and which we are going to continue to face as long as inflation remains a serious problem. So the value of the protection that social security affords against inflation, the reduction in financial risk for the aged and the disabled, is not built into any of the calculations of the rate of return to social security. If the value of such protection were better recognized, many who fear that social security is a bad buy would realize that it is a very, very good buy, indeed.

I would like to turn now to the first of the financial problems, the one that is critical but not serious. The immediate financial predicament of the social security system is well known and it is getting better known every day. A combination of high unemployment and the fact that prices are rising faster than wages is causing the growth of social security benefits to outstrip that of social security revenues. That is the source of the current financial problem, it was not anticipated when the social security amendments were enacted in 1947.

Because a failure to bring the system into balance would soon bring benefit payments to a halt, the problem is critical. Because so many solutions are at hand and no one doubts congressional determination to see that current beneficiaries receive their benefits, the problem is not serious.

In the next page or so of my testimony I review three proposals for dealing with the short-run problem that I believe are not good ideas. One of these is to reduce the cost-of-living adjustment contained in the present law. My feeling is that that solution, like the French law prohibiting both rich and poor from sleeping under bridges that was memorialized by Zola because it fell with lofty indifference on the rich and poor alike, is unfair because it falls with equal weight on rich and poor alike. It would be desirable perhaps after a phase-in period to include a portion of social security benefits in taxable income and to return those revenues to the social security trust funds. This change would reduce benefits in effect, for the minority of recipients who can best affort a cut.

A second proposal for finding a quick fix is to introduce universal coverage of social security. I think universal coverage is a splendid idea whose time has not only come but is long overdue but it is too important and too delicate to involve it in shortrun financing, and there are questions that are going to have to be resolved rather quickly.

I also think that an increase in payroll rates with no other change but allowing for interfund borrowing would not be a desirable step.

We would be asking the American public to allow us to put our hands in their pockets once again on the promise that things would be all right and that the system would be financially sound for the next, however many, years. But we did that in 1977 and it seems more basic steps are called for.

The best approach, it seems to me, is the one that was put forward by the Advisory Council. Mr. Ball has presented a modified version this morning. In my testimony I describe a proposal somewhat more far-reaching than his.

The best approach to the shortrun financing problem that I know of is the one put forward by the Advisory Council on Social Security. Because time has passed and facts have changed since thar report was submitted, the specific number in the Council's plan have to be altered, but the basic approach is sound. Brought up to date, that plan would increase the payroll tax allocated to OASDI in 1981 from 10.7 to 12 percent; it would repeal the medicare payroll tax, scheduled to be 2.6 percent in 1981. The net tax reduction would be 1.3 percent or about $17 billion. Such a tax reduction would be an appropriate personal component of a 1981 tax reduction bill that should also include incentives to business to promote investment and innovation. Under this plan, medicare would be paid from an earmarked portion of the income tax and a portion of the corporation income tax designated as coming from the corporation income tax.

I would like to turn to the last problem, the serious but not critical problem. It is well known that the number of covered workers per OASDI beneficiary will fall from 2.9 in the year 2005, to 1.4 in 2035, and 1.2 in 2055. This demographic trend will increase the cost of social security dramatically. It is less well known that between now and 2005, as unemployment drops and growth in productivity resumes, there will be only a small increase in the number of beneficiaries per worker and that the cost of each social security benefits is expected to drop slightly as a percent of payroll from 10.87 percent to payroll this year, to 10.48 percent in 2005.

As the cost of social security rises starting in 2005, logic assures us that we have three choices: We can raise payroll taxes; we can cut benefits below those in current law; or we can find other sources of revenue.

Present law calls for sizable increases in payroll taxes beyond those we are now paying. These revenues are projected to be sufficient to pay currently legislated benefits until about 2035, but not thereafter.

So we face a problem and it is a serious one, I think, but it is not an imminent one. I think feeling that we must make final decisions for the year 2035 would be rather as if we had expected Calvin Coolidge to make binding policy for America of the eighties.

Nevertheless, it is time now to think about what we intend to do about the demographically induced rise in the cost of currently legislated benefits that awaits us. While it is important to recognize, as Mr. Ball urges us to do, that forecasts of the distant future are notoriously unreliable, particularly those that rest to a considerable degree on projections of birth rates, it is equally important to make sure that we have on the books a system built to handle the various contingencies that the future holds for us.

I would like to point out also that we don't really know how many retirees there are going to be, and the reason we don't, is that there is very considerable uncertainty that attaches to those estimates based on the possible variability in mortality rates. The difference in mortality assumptions used by the Social Security Administration on its high- and its low-cost estimates could cause social security benefits to be as much as to vary by as much as one-third over the long pull, not just by a small amount.

Now it is true that the birth-rate assumptions are also very important, in fact even more important than the mortality assumptions, but it is a mistake to think that we really do know how many aged there are going to be. That fact might suggest that we have no idea what is going to be happening in the future and therefore there is no need to take action at the present time. But I think we really do need to have on the books a system that is able to handle various contingencies precisely, because we are not able to forecast well the future that lies before us. Our present system is not as well adapted to that end as it might be.

The first step that I would urge is that Congress reexamine the way in which it has chosen to index the benefit formula for the computation of the initial benefits entitlements. The method now on the books guarantees that workers with a given level of real earnings will receive higher earnings if they retire in the future than they will if they retire today. Now this is a different way of looking at the characteristics of the benefit but I think it is just as valid as the one which Mr. Ball suggested. To illustrate, a worker with average indexed monthly earnings of $1,000 will receive $433 if he retires today plus 50 percent for a spouse. If he retires in 1995, he will get $471; in 2025, $570; and in 2045, $670.

There are arguments on behalf of that kind of a benefit formula, but I would like to suggest an alternative formula and then argue why I think it would be a good idea. It is one that I looked at when I was working at HEW. Under that formula, the current method of adjusting initial benefit entitlements would be retained for the next 15 years; in other words, up to the eve of the demographic wave that will be washing over us early in the 21st century. Beginning in 1995, however, the benefit formula would be adjusted for prices, not for wages.

The crucial aspect of this plan is that by itself it would erase the longrun deficit of the social security system; it would obviate the need for any tax increases beyond those contained in current law and such other measures that we think may be necessary to do by the short-run problem.

Enactment of such a plan would leave to future Congresses the decision about whether to increase real benefits. Now I want to make clear that I think further increases in benefits are and would be justified. I am not endorsing, and to the best of my knowledge, no supporter of price indexing, endorses 20 or 25 percent replacement rates that are often maintained to flow from price indexing. Indeed, moving to price indexing on a deferred basis 15 years hence would be vastly more generous than the social security benefit formula that we lived with quite successfully until 1972 which provided no automatic adjustment whatsoever for prices or for wages. Instead, it left to successive Congresses the decision about how much and when to increase benefits and how to distribute them among various classes of beneficiaries.

It seems to me that it is bad government for this generation, financially blessed by a relatively small population of aged persons, to tie the hands of the next generation by leaving in place a set of benefits that will necessitate ever higher taxes. I intend to support higher benefits for some beneficiaries now, and I hope to be able to do so after 1995. But unless we are prepared now to shoulder the costs of the larger aged population by drastically increasing taxes, accumulating very large trust funds, and channeling additional resources into capital formation, we sacrifice our right to place the future generation in a position where it must pay ever higher benefits and dramatically higher taxes or renege on commitments to those about to retire.

Let me comment at this point on the use of the total dependency ratio that Mr. Ball made during his remarks. The numbers are absolutely right. If you add together the number of kids and the number of expected retirees, the increase in dependency is not very high. But I would point to another aspect of his statement. He pointed out that we expect retirees to have incomes of two-thirds to four-fifths those of active workers. We don't expect children to have resources of two-thirds to four-fifths of the average earnings of the adult population. Children cost much less than retired adults.

The total dependency ratio seriously misstates the increase in the burden that the aged will constitute for the next generation. If you want to add together children and old folks, a child costs only a fraction as much as does an older person in terms of the financial costs that will be borne by the active population at that time.

Now I want to stress that the step I just described would be sufficient by itself to put the social security system in long-term actuarial balance. Together with the short-term measures either along the lines that I described or along the lines what Mr. Ball described in his testimony, we would have a system which was financially sound, even in the face of rather pessimistic economic events in the coming years, and we would not have precommitted the subsequent generation to a level of benefits that will entail substantially higher taxes.

I want to stress again that I shall support those higher taxes to pay the more generous benefits but it seems to me that that is a decision that we are not in a position to make for the future, any more than Calvin Coolidge would have been in a position to make decisions for us today.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Aaron follows:]

PREPARED STATEMENT OF HENRY AARON

Mr. Chairman, my name is Henry Aaron. I am a senior fellow at the Brookings Institution and professor of economics at the University of Maryland. I was Chairman of the Advisory Council on Social Security, and before that served as Assistant Secretary for Planning and Evaluation in the Department of Health, Education, and Welfare. I have studied and written on the social security system for more than 15 years.

You have just been privileged to receive two thoughtful, but utterly divergent, analyses of the future prospects of social security, you have just heard two coherent, but different sets of recommendations for action. I shall try to sketch a point of view that supports the basic structure of social security as it exists and acknowledges the serious financial problems that social security faces; I shall then present a program for action, consistent with the present structure, that will solve those problems.

My testimony is divided into three parts. In the first, I shall examine whether the United States should adopt the two-tier benefit structure proposed by Professor Boskin. I shall argue that it should not, but should instead modify the current benefit formula. I shall argue that the United States faces two largely distinct social security financing problems

—A short-run problem that is critical, but not serious; and

—A long-run problem that is serious, but not critical.

In the second part of my testimony, I shall urge a solution to the short-run problem that closely resembles the program advanced by Mr. Ball and previously recommended by the Advisory Council on Social Security. In the third part, I shall suggest a solution to the long-run problem that includes some of the steps urged by Professor Boskin.

HOW SHOULD WE CHANGE SOCIAL SECURITY BENEFITS

Several academic students of social security have urged that social security be divided into two systems, one of which would pay benefits strictly proportional to previous earnings as a matter of right, and one of which would provide income-tested benefits on demonstration of need. This two-tier system would replace the current, weighted-benefit formula under which workers with low-average covered earnings receive benefits larger in relation to those earnings than do workers with high-average covered earnings. The two-tier system would neatly and cleanly assign the provision of an insurance-like replacement of earnings to one system and a welfare-like provision of aid to the needy to the other.

As an economist, I am trained to like neatness—most of the prominent supporters of this proposal are economists—and I once liked the two-tier plan too. But, I now think it would be bad policy.

First, it is well documented that many people legally entitled to income-tested benefits do not claim them. They do not claim them because they are shamed by the aura of public charity that surrounds such programs and because application for income-tested benefits is perceived to be time-consuming and burdensome. Even for those who claim such benefits, the stigma and inconvenience attached to them constitute a real cost. Because the takeup of income-tested programs is incomplete in actual operation, they are not capable of reaching all of those who are made legally eligible for benefits. Thus, the two-tier program is not capable of achieving the objective that Professor Boskin would like to have it achieve.

In addition, income-tested programs are costly to administer. Administration of supplemental security income costs about 10 percent of the amount paid out in benefits. Administration of social security costs about 3 percent of the amount paid out in benefits. The difference is attributable in part to the expense of processing applications and periodically verifying income—and it does not even include the costs borne by applicants that do not appear on the budget. If some of the benefits of the redistributive features of social security accrue to people whom we think are treated overgenerously, we should change the law to assure that benefits go where we think they should go—and I shall have a specific suggestion along those lines—but we should be careful about instituting a changed program that may raise the deadweight loss of administrative costs by large amounts.

While the basic configuration of the social security benefit structure makes sense, some of its details do not and should be changed. For example, the current formula treats workers who have spent only a few years in covered employment as if they had earned low wages all of the lives and, accordingly, awards them relatively large benefits. The last Advisory Council concluded that the system should not be asked to subsidize such workers. Some are retirees from uncovered employment who had substantial earnings during most of their lives; others are people who for one reason or another did not need to work most of their lives. The Advisory Council proposed that social security benefits of such workers be substantially reduced. Those short-term workers who are poor should have recourse, along with other low-income aged, to an expanded SSI program that would guarantee the aged and disabled income at the official poverty level. I should point out that the Advisory Council also recommended that benefits of lifetime low-wage workers be maintained or even increased by credits for long service in covered employment. This is an illustration of how the misdirection of benefits, intended to excuse most of the low-income aged from a means test, can be corrected and money saved without imposing a means test on all.

A number of other changes in the benefit structure should be made, some of which will add to costs, some of which will reduce them. But none, in my opinion, should end the tradition of entitling low-income retirees to benefits relatively more generous than those provided to high-income retirees.

One should recognize that if some people are treated more generously than others within a closed system, some will receive higher rates of return than do others. I believe that the calculations of the rates of return that will be earned by workers at different points in time and at different earnings levels are instructive. They point to the fact that all classes of beneficiaries up to the present and for many years into the future have benefit entitlements worth more—often many times more—than the taxes they have paid in, even after all proper adjustments have been made for inflation. They make clear that at some point in the future, some classes of workers—notably workers who have high incomes and those who remain single—will receive benefits on which the rate of return is rather low.

In interpreting these findings, it is important to keep in mind that they assume that alternative investments with an assured rate of return of 2 or 3 percent per year in addition to inflation are readily available to all. Investors in stocks, bonds, and savings accounts and holders of private pensions, know from painful experience during the 1970's that such assured rates of return simply are not available. They know that social security is the only "investment" that is fully protected against inflation. No other asset is so protected. It is important to note that people pay large amounts each year, for example, in the form of fire and health insurance, to escape similar risks. They know full well that the expected value of the payments they stand to receive is much below the value of the premiums they are paying, but they buy the insurance to escape the risk of loss, and they do so willingly. The value of the protection that social security affords against inflation, the reduction in financial risk for the aged and the disabled, is not built into any of the calculations of the rate of return to social security. If the value of such protection were better understood, many who fear that social security is a bad buy would realize that it is a very good buy, indeed.

Even if the value of protection against inflation were recognized, however, some social security beneficiaries could still be shown to be paying more in taxes than the value of the benefits they can expect to receive. The last Advisory Council proposed that benefits for high-wage workers be increased to improve their protection. But the fact that some workers get lower rates of return than others is inescapable and should not be denied. Those payments are made in order to support the relatively generous benefits provided to retirees with low-wage histories. If we find the low rates of return unacceptable, then we can either use some other source of revenue to pay them, the relatively generous benefits low-wage workers will receive, or we can renege on those benefits. I have urged above that we should not renege on those benefits and that they should be provided within the social security system. I do not find the payroll tax burden on high-wage workers to be excessive, but if others do, I would urge them to find an acceptable method to infuse general revenues into the system so that tax rates can be reduced.

"CRITICAL, BUT NOT SERIOUS"—THE SHORTRUN FINANCING PROBLEM

The immediate financial predicament of the social security system is well known. A combination of high unemployment and the fact that prices are rising faster than wages is causing the growth of social security benefits to outstrip that of social security revenues. At statutory tax rates and under the most recent economic assumptions, the retirement and survivors trust fund will run dry some time in 1982. Even if the reserves of the disability and health insurance trust funds were pooled with those of the retirement and survivors insurance system, the funds would be exhausted some time in late 1984 or early 1985.

Because a failure to bring the system into balance would soon bring benefit payments to a halt, the problem is critical. Because so many solutions are at hand and no one doubts congressional determination to see that current beneficiaries receive their benefits, the problem is not serious.

Many of the proposed solutions to the short-run problem have important drawbacks, however. For example, Congress could bring the system into balance by reducing the cost-of-living adjustment in OASDI benefits by 2 percentage points per year and reallocating some additional revenues among the trust funds. This solution, like the French law memorialized by Zola, prohibiting people from sleeping under bridges, would fall with lofty indifference on the rich and poor alike. I question whether the low-income aged should be asked to share in the consequences of mistaken economic policies and the economic losses imposed on us by OPEC. If we wish to reduce benefits, the simplest and fairest way to do so would be to include a portion of benefits in taxable income. If half of benefits were so included, no beneficiary dependent solely on social security benefits would be liable for one penny of taxes; and if the funds were returned to the social security trust funds, the financial difficulties of the system would be solved. However, I recognize that this proposal is widely unpopular—partly as Mr. Ball suggests because it is not well understood—and that we should therefore consider other solutions.

Small increases in payroll taxes would solve the short-run financial problem if revenues were reallocated among the trust funds. But the public is not likely to take kindly to yet another payroll tax increase enacted without reforms that would provide some assurance that Congress will not discover yet another unanticipated shortfall 2 or 3 years hence.

Extending social security coverage to all workers or even just to Federal employees would go a long way toward solving the financial problem in the short run because revenues from newly covered workers would begin to flow in faster than benefit obligations would increase. But the universal coverage issue is too important and too delicate to be treated as a quick financial fix. Universal coverage is desirable and should be enacted soon, but it should be done so that Federal and State employee compensation and pension schemes can be adjusted.

The best approach to the short-run financing problem that I know of is the one put forward by the Advisory Council on Social Security. Because time has passed and facts have changed since that report was submitted, the specific numbers in the Council's plan have to be altered, but the basic approach is sound. Brought up to date, that plan would increase the payroll tax allocated to OASDI in 1981 from 10.7 to 12 percent; it would repeal the medicare payroll tax, scheduled to be 2.6 percent in 1981. The net tax reduction would be 1.3 percent or about $17 billion. Such a tax reduction would be an appropriate personal component of a 1981 tax reduction bill that should also include incentives to business to promote investment and innovation. Under this plan, medicare would be paid from an earmarked portion of the income tax and a portion of the corporation income tax designated as coming from the corporation income tax.

The advantages of this system are several:

—It would reduce payroll taxes on business, thus lowering unit labor costs, increases in which are widely thought to contribute to inflation.

—It would terminate use of the payroll tax to finance health benefits which are unrelated to earnings, a modification that has received the support of the last two advisory councils—the one appointed by President Ford and the one appointed by President Carter.

—It would infuse general revenues into the social security system in a way that preserves fiscal discipline and the earned right principle.

—It would provide sufficient revenues to pay OASDI benefits without further tax increases for about 25 years.

—It would have the same effect on the budget deficit as any other tax cut and would produce numerous benefits within the social security system.

I believe that this proposal merits the bipartisan support from Congress that it received within the Advisory Council.

"SERIOUS, BUT NOT CRITICAL"—THE LONGRUN FINANCING PROBLEM

It is well known that the number of covered workers per OASDI beneficiary will fall from 2.9 in the year 2005, to 1.4 in 2035, and 1.2 in 2055. This demographic trend will increase the cost of social security dramatically. It is less well known that between now and 2005, as unemployment drops and growth in productivity resumes, there will be only a small increase in the number of beneficiaries per worker and that the cost of cash social security benefits is expected to drop slightly as a percent of payroll, from 10.87 percent of payroll this year to 10.48 percent in 2005.

As the cost of social security rises starting in 2005, logic assures us that we have three choices: we can raise payroll taxes; we can cut benefits below those in current law; or we can find other sources of revenues.

Present law calls for sizable increases in payroll taxes beyond those we are now paying. These revenues are projected to be sufficient to pay currently legislated benefits until about 2035, but not thereafter.

So we face a problem, and it is a serious one. But it is not an imminent one. Feeling that we must make final decisions for the year 2035, would be rather as if we had expected Calvin Coolidge to make binding policy for America of the 1980's.

Nevertheless, it is time now to think about what we intend to do about the demographically induced rise in the cost of currently legislated benefits that awaits us. While it is important to recognize, as Mr. Ball urges us to do, that forecasts of the distant future are notoriously unreliable, particularly those that rest to a considerable degree on projections of birth rates, it is equally important to make sure that we have on the books a system built to handle the various contingencies that the future holds for us. Our present system is not as well adapted to that end as it might be.

First, I would urge Congress to reexamine the way in which it has chosen to index the benefit formula for the computation of initial benefit entitlements. The method now on the books guarantees that workers with a given level of real earnings will receive higher earnings if they retire in the future than they will if they retire today. For example, a worker with average indexed monthly earnings of $1,000 will receive $433 if he retired today. A worker who retires in 1995 with the same earnings will receive $471. One who retires in 2025 will receive $570, and one who retires in 2045 will receive $670.

There is some justification for paying workers with given real earnings ever higher benefits. Such workers will occupy progressively lower rungs on the economic ladder as growth of productivity boosts real incomes. Our system pays relatively higher benefits to workers low on the economic ladder than it pays to workers with high earnings. However, in view of the projected increases in the cost of social security, I do not think that we should commit ourselves for the indefinite future to do more than adjust benefits'to assure that workers with given real earnings receive constant benefits fully adjusted for inflation.

While Assistant Secretary at the Department of Health, Education, and Welfare, I explored the consequences of a plan under which initial entitlements would be adjusted only for prices.[1] This plan would assure that all persons reaching retirement age between now and 1995 would receive the same benefits they would receive under current law. Beginning in 1995, however, the benefit formula would be adjusted only for prices.

The crucial aspect of this plan is that by itself it would erase the long-run deficit of the social security system; it would obviate the need for any tax increases beyond those contained in current law (and beyond any additional steps that may be taken to deal with the short-run financing problems).

Enactment of such a plan would leave to future Congresses the decision about whether to increase real benefits. I want to make clear that I think further increases in benefits are and would be justified. There are some places where I think benefits are now insufficient (for example, for the long-term, low-wage workers I mentioned earlier), and as incomes rise after 1995 contemporary standards would require still others. But it is bad government, in my opinion, for this generation financially blessed by a relatively small population of aged persons to tie the hands of the next generation, by leaving in place a set of benefits that will necessitate ever higher taxes. I intend to support higher benefits for some beneficiaries now, and I hope to be able to do so after 1995. But unless we are prepared now to shoulder the costs of the larger aged population by drastically increasing taxes, accumulating very large trust funds, and channeling additional resources into capital formation, we sacrifice our right to place the future generation in a position where it must pay ever higher benefits and dramatically higher taxes or renege on commitments to those about to retire.

If this step is taken, no further legislation would be necessary to put the social security in long-term actuarial balance. If it is not taken, then other steps to reduce the precommitted cost of social security to the next generation should be considered. Even if it is taken, Congress should consider a gradual increase in the age at which unreduced social security benefits are paid. Gradual improvements in life expectancy and a growing sense that the aged should play a more prominent and active role in economic and social life than they now play argue

[1] This plan was considered by the Advisory Council and received the support of former CEA Chairman Gardner Ackley, the three business representatives and me; but it was rejected by the other eight members of the Council, including the three labor representatives, Mr. Ball, and the public members, other than me.

for such a change. However, there are strong arguments against such a step as well—the fear that jobs will not be available for older workers, the fact that an increasingly affluent population can afford increased leisure, and that revealed preference of workers in many occupations is to retire earlier than they used to do.

After considering these arguments, a narrow majority of the 1979 Advisory Council recommended that Congress consider an increase in the normal retirement age from 65 to 68 beginning about the year 2000, and spread gradually over the next 18 years. Even such a gradual increase in the retirement age is sufficient to remove about half of the long-run deficit in the social security system. The Advisory Council appointed in 1975 by President Ford made a similar recommendation.

Any increase in the age at which unreduced benefits are paid must be enacted many years before it goes into effect to give affected persons time to adjust their personal plans. For that reason, it is necessary for Congress to act soon if the option is to be retained of acting before the retirement boom to increase the age at which unreduced benefits are paid. If, as the year 2000 approaches, Congress concludes that the age at which unreduced benefits are paid should not rise, it could delay or cancel the increase without imposing hardship. But if it defers action on the ground that it can act when the problem in imminent, opponents will argue fairly that action must be deferred so that people about to retire are not disadvantaged. In short, we should act now to keep our options open.

Senator CHILES. Thank you very much, Mr. Aaron.

I would like to ask you both a question about the short-term problem. Mr. Aaron, you said in your statement that economists are trained to like neatness. I certainly can believe that. Politicians, I think, are trained to like economists who can predict with accuracy. Quite frankly, some of us are a little puzzled and I will tell you why.

In 1977, when we amended the Social Security Act, we were told the money was running out. We raised the payroll tax and the base and we were told that that would solve the financial problem for decades to come, and we are here today with the same problem.

In 1979, the social security trustees' report said the long-term financial health of the OASDI system is in good shape, surpluses are predicted in each of the next 30 years. In 1980, the trustees' report said combined OASDI funds will be exhausted by 1984. Now, today, we are being told that OASDI may run out by the end of next year even though we have adjusted the rate and raised the taxes.

Why are we back again at the drawing board? What is going on? Are we like Harry Truman who said he was going to get himself a one-armed economist so they could not say on the one hand it was something but on the other hand the problem may be something else? Are we going to be back here after we deal with this problem in the next 2 or 3 years?

Mr. AARON. Your chagrin and disappointment at being misled is well justified. I think there are two reasons why the predictions went awry; one of them was unforeseeable by economists, the other perhaps was not and we missed it. The one that was unforeseeable was that OPEC was going to put its hand in our pockets again for a very sizable increase in the price of oil, larger than the one that occurred in 1974 that sent us into recession. That increase precipitated price increases greater than wage increases. Maybe such contingencies should have been built into the system, but it was not. The other cause of current financial problems was that productivity just has not grown; in fact, it has gone down some in recent years. As a result, wages have grown much less rapidly than prices. Both of those factors cause financial grief to the social security system.

Your concern about being put in the position of having to come back and fix the system again a few years hence is also sound and legitimate and I think it argues strongly for the kind of financing arrangement that Mr. Ball and I sketch in our testimony. Under both of those arrangements,the funds going into the OASDI system would be sufficient to weather even very severe economic conditions, severe recession and high unemployment, rapid inflation. I think the system that we describe would call for a buildup of trust funds under reasonable, more likely economic assumptions.

Senator CHILES. Mr. Ball, do you want to comment on that?

Mr. BALL. I think Mr. Aaron has described accurately the reason for the errors in the projections made in 1977. I fully support the idea of a 6-percent rate for cash benefits to get a contingency fund built up to a level that would handle this sort of problem in the future.

I might add, Mr. Chairman, that if it were possible to attain the full advisory council proposal of an entirely new method of handling hospitalization under medicare through an earmarked part of the income tax as Mr. Aaron suggests, I would be very much pleased. It is not that I disagree with that objective. It is more that since the rates are going to go up next year to 6.65, it seems to me more feasible to finance only half of the hospital insurance program from general revenue. It works out quite neatly to have a 6-percent rate for cash and 0.65 for employer and employees and a matching amount from general revenue. Actually I proposed to the advisory council what Mr. Aaron is suggesting; I am not against it in theory.

Senator CHILES. Thank you, Mr. Ball.

Mr. Aaron, I have a question about the long term. You seem to feel the long-term financing issue is serious but not critical. Mr. Boskin thinks that it is serious and critical, and in fact he says we are looking at a time bomb and that unless we move quickly we are in for a tax revolt and taxes of unmitigated proportion, I think his statement says.

Mr. Ball, you don't seem to think it is that serious, at least not serious enough to make any drastic change to the benefits.

Mr. BALL. That is correct.

Senator CHILES. Again, you cannot all be right, and our problem is how do we select who is right and who is wrong when we are attempting to deal with the system here. There obviously are different opinions about what the long-term future has in store and about the number of "payers in" and the number of "takers out." Can you show us where you differ and where you agree so we can try to get a better picture of where we stand?

Mr. BALL. I think one place where Mr. Aaron and I disagree is a policy point more than it is a difference about predicting the shape of the future.

Senator CHILES. Bring Mr. Boskin's statement in, too, if you would.

Mr. BALL. I think Mr. Boskin is just wrong. I don't want to attack him in his absence and I don't expect Mr. Aaron to be able to defend him, so that is a little more difficult. But if I understand Mr. Aaron, he is saying that given the uncertainties of the future and the possibility of major cost increases growing out of the demographics that we need to move now to cut back on protection by moving toward price indexing. However, he expects actually that the price indexing would not prevail in the future. Price indexing would be the automatic part, and then the Congress, he believes, would probably, on an ad hoc basis, move in to keep the system either fully up to date with wages or partly up to date. I feel, on the contrary, that the present method of automatic indexing to wages and the level of living is very important to the protection of the system.

All of this discussion of whether younger workers are disaffected and whether they get their money's worth and what they can look forward to would be greatly influenced by a change to a system which, as you looked at the law, guaranteed only keeping up to date with prices whereas under present law it is, as Mr. Aaron said, a very good bargain, at all ages.

Mr. Aaron can correct me if he thinks I have sketched his position wrong, but let me state my views on that same point. My feeling about keeping wage indexing for 15 years and then shifting over to price indexing after that is a little complicated to say, but I am afraid the proposal is somewhat deceptive—not deliberately so, I don't mean that—but you do make the system look inexpensive by going to price indexing in 15 years and if, in fact, the Congress on an ad hoc basis, kept the system up to date with wages, the full cost of proposed changes is never shown.

The proposal appears to eliminate the long-range deficit shown by the estimates and yet, in fact, as Mr. Aaron suggests you probably would come in from time to time with ad hoc increases, as was true before the 1972 amendments, to keep benefits up to date with wages rather than prices. Yet every time you do that or make any benefit improvement, it looks as if you are doing something inexpensive because according to the law the benefit changes are increased only according to prices when in fact the intention is to do more than that. So not only from the point of view that is more natural to me, which is that I think we ought to reassure people that we have a basic system that is constant in its replacement rate, but also from the standpoint of fiscal responsibility and from a conservative standpoint I believe wage indexing is better. I know a former colleague of mine, an actuary, strongly supports wage indexing mostly on the grounds I have just described—to avoid costing out a system based on price indexing but knowing that the system will actually be more expensive than it appears. So I think that is one difference that we have.

Senator CHILES. Mr. Aaron.

Mr. AARON. Let me turn first to the question of whether or not we face a crisis. My own view is that Professor Boskin's rhetoric is a little strong. The main source of his position is that he thinks there are probably underestimates in the projected long-run cost of the system embodied in the intermediate cost assumptions of the social security actuaries. I disagree with him. My basic starting point is that that is the best set of estimates that we have, that we should make policy on the basis that that is the most likely single outcome, but we should recognize that it is an uncertain prediction, that costs may well be higher or lower. I don't have any strong beliefs that they will be higher as I think Professor Boskin does.

Another reason that Professor Boskin stresses the crisis nature of our problems is that when he speaks of payroll taxes, he includes not only OASDI but HI as well. Health insurance projections are not now made beyond 25 years. Health prices are growing faster than other prices. If you let compound interest become what Baron Rothchild said it is, the eighth wonder of the world, one can get some very large numbers for health insurance out there.

Again, I think it is a mistake to just let compound run free. When I was in college, my math professor had been a member of one of two committees to project population in the State of California and of Los Angeles County. Working independently, they concluded that by 1980 the population of Los Angeles County would exceed that of the State of California. The problem is if you let compound interest run free, you can get some kind of silly results.

The reason I support the proposal I advanced is that I am very concerned about our inability to forecast the future; and I don't mean in an economic sense, I mean in an institutional sense. Think of what has happened in the last 30 or 40 years in the United States. A whole system of private pensions has grown up so that now about half of the retirees have some pension benefit but frequently not very good private pension benefit.

A whole system of health insurance has grown up. The whole status of women has changed so that we now face an important problem to change the way in which one- and two-member families are treated under social security. I don't think we can forecast what this world is going to look like 25 years hence and I think it is very important for us to have fiscal flexibility to reallocate benefits or to provide more generous benefits to certain types of beneficiaries who are not now so generously treated.

If one has a fully wage indexed system, the only way that one can allocate more benefits in one area is by building cost increasing changes on top of an already increasing cost system. The fact of the matter is that when you want to make structural changes, it is very hard to take benefits away from somebody in order to give them to somebody else. So it seems to me that it is important to have our system structured in such a way that we can reallocate benefits in response to events that are unforeseeable at the present time without inflating the cost of the system. I am afraid that if we remain with a strictly wage index system we are going to be very much locked into a system that structurally may not match the needs of our country as it moves into the new century.

Senator CHILES. Thank you.

Senator Pryor.

Senator PRYOR. One area, Mr. Chairman, Mr. Aaron, and Mr. Ball, which has only been briefly mentioned this morning is that of the earnings limitation which is placed on retired individuals who wish to continue in the work force. I have long been opposed to this practice because I believe that in every way possible we should encourage the individual to remain in the work force. I know that there are many arguments against my beliefs on this issue, and I would like to hear your opinions on it.

Mr. BALL. He says it is my turn.

I wish I had a turn on something else. The most controversial and unpopular provision in the whole social security system, I think, is this so-called retirement test or earnings test, and over the years, more bills have been introduced on this subject than almost any other.

My own view, Senator Pryor, is that the present test strikes a fairly reasonable balance between two conflicting objectives. You can't have them both. One objective is to retain the benefits of the social security system largely for people who have had to suffer a reduction in earnings because of total retirement or partial retirement. If you pay everybody who continues to work full time when they hit a given age, like 65, or in some proposals, 62, it costs at 65 about $2 billion a year; if you abolish the test at any age, $6 or $7 billion.

Let me hasten to add if you take everything into account, there are offsetting savings in additional income taxes paid and that sort of thing, but for social security purposes, it is about $2 billion a year at 65 and most of that money goes to those who continue working as they did before 65. Mostly it goes to people who work at 66 or 67 as they may have worked at 55. They just keep on with their jobs or they are professional people—lawyers, physicians—and they continue to work. That is one objective of the test, trying to conserve the funds of the system for people who have suffered a loss of earnings.

The other objective is the one you were stressing, and that is the highly desirable objective, in my view, of not discouraging people from continued employment. There is no doubt but that the existence of any kind of a retirement or earnings test, to some extent, does discourage people from continued employment.

You can't attain both objectives completely. The present provision does try to straddle the objectives and hit a balance. As you know, this year the first $5,000 of earnings, if you are 65 or more does not count against you, and then benefits are reduced $1 for each $2 earned above that, so that for most people there is a gain from continued employment, when you count both earning and social security. So the test leaves some incentive to work; not as much, of course, as if you abolished the test but there is an incentive feature left, and at the same time the test goes part way in preserving the benefits for what I think are the main purpose of the program, partly making up for earnings that are lost on full or partial retirement.

Now this provision has come very close to being completely abolished. The House voted to abolish it in 1977, and in the Senate, it was a very close question. It was liberalized in major ways by the Senate provision that prevailed in conference so that after 1981, the test will not apply after age 70.

At present it does not apply after age 72, also the amount of exemption is larger. The test has been continually liberalized in various ways and may well be again.

Senator PRYOR. I guess that I have just always considered that the contributions made by these working retirees in taxes and social security contribution would offset the trust fund loss. I certainly am not an expert at this, especially as compared to you two gentlemen. I do know, though, that each time I have the opportunity to visit with senior citizens, or retirees, or even prospective retirees, that this is something that is very much on their minds. This is very important to our elderly—they view it as a penalty or a removal of their freedom of choice. It can almost be viewed as a sort of stigma that is attached once an individual reaches a certain age—he is no longer free to produce to the degree that he would like because once he reaches a certain stage, he is penalized. The effect is probably even more debilitating psychologically than financially. I realize that there are two differing views on this subject, but I just want you to know that there are many, including myself, who subscribe to the other viewpoint.

Mr. BALL. Senator Pryor, if it were possible to design a test, and I have thought about this, that required a person to retire from his major job and then you were talking only about incentives to have a second career or to work part time, and so on, I think that would be fine. The problem is that the retirement test, the earnings test, applies equally to people who continue at full-time work and don't really retire. Nobody has been able to figure out how you test retirement without affecting those who work part time after leaving their regular employment. The people who have retired from their regular job now feel that the test is a restriction on their doing some work after retiring. If we could make that distinction, which I don't know how to do, then I think it would be more popular.

Mr. AARON. The reason I deferred it to Bob was I recognized this was a hard and sensitive question, and I knew he could say it better than I could. I think he said it very well.

There is only one other point, and it is a point that may or may not carry weight, depending on one's point of view. Because of the characteristics of the retirement test, it turns out that the primary beneficiaries would be those who are earning so much that they now receive no benefit.

The several billion dollars that it would cost to repeal the retirement test would go largely to the aged with the highest incomes and the greatest total resources. I think you need to consider, in thinking about this proposal, whether the particular distribution of benefits that would result from the repeal of the retirement test is one you find appealing or not.

Senator PRYOR. Mr. Chairman, I think that is all the questions I have at this time.

Senator CHILES. Senator Domenici.

Senator DOMENICI. Mr. Chairman, first I apologize for being late. I don't know if you are interested in the superfund issue, but that is where I was this morning. We may have reached a compromise, so perhaps my hour was well spent. I wish I could have been here.

Could we make my statement a part of the record?

Senator CHILES. It will be a part of the record.

[The statement of Senator Domenici follows:]

STATEMENT OF SENATOR PETE V. DOMENICI

I would add that I certainly share Senator Chiles' concern about the urgency of the need for Social Security reform. Social security outlays in 1981 will account for 25 percent of all Federal expenditures. In 1980, social security was expected to pay out approximately $147 billion in Federal benefits to approximately 35 million recipients. If we are going to balance the budget and reduce Federal spending to acceptable levels, we will obviously have to look at this program. Furthermore, we are now told that the social security system, all three trust funds, could be facing a cash flow deficit by the end of 1983.

In the 1977 Amendments to the Social Security Act, we enacted the largest peacetime tax increase ever. Now, only 3 years later, we face again a critical financing problem. High rates of inflation, low productivity growth, decline in real wages, and higher unemployment have combined to undermine our seemingly sound solutions. We were told earlier in this session of the Congress that the old-age and survivors trust fund would dip to unacceptable lows by 1981. So we realigned the tax rates—the portions of the payroll tax that go into each fund—moving money from the disability insurance fund to the old-age and survivors insurance fund. That move was designed only to buy some time. Apparently, it did not buy enough.

It now appears that depending on economic conditions, we could be facing a severe cash deficit in social security even if all three trust funds are combined. The alternatives, put simply, are to increase revenues, reduce outlays, or both. Within these alternatives are an infinite number of approaches—all with complex repercussions.

Our responsibility as members of the Senate Special Committee on Aging and for many of us on the Budget, Appropriations, and Finance Committees, is to carefully evaluate proposals, set priorities and choose the most responsible solution. As a member of the Senate Committee on Aging and the Budget Committee, I am concerned about the financial soundness of the social security system from both the fiscal and social perspective. I know its importance to the economic well-being of millions of older Americans. At the beginning of 1979, 93 percent of Americans aged 65 and over were receiving social security. For almost a third of the elderly, it is practically their only source of income.

In the short range, we must deal with this immediate crisis, but in doing so, we must consider the impact of our choices on the long-range picutre. The older population is expected to double in the next 50 years. By the year 2030, there may be only two workers for every beneficiary as compared to a ratio of over three workers per retiree today and 11 to 1 when social security was started. Even under intermediate economic conditions, this could result in a combined tax rate exceeding 30 percent in the year 2030. Younger people are extremely generous and caring about the older generation and have contributed willingly to their financial support. But those supporting such a pay-as-you-go system may be increasingly unable to bear such a burden without a better return on their own investment.

When we return for the 97th Congress, the debate will begin with fervor. The program is complex and solutions do not come easily. For that reason, I feel it is extremely important that the Members of Congress and the public be as well-informed as possible. I hope that the Committee on Aging, through these hearings can play a valuable role in crystalizing the differences between competing viewpoints and making sound recommendations designed to strengthen social security. I know that our witnesses today hold strong views on the future of social security and the need for reform. We look forward to their testimony to lay the framework for our future deliberations and the remaining hearings in December of this year.

Senator DOMENICI. As you know, I have a new job next year——

Senator PRYOR. We know that.

Senator DOMENICI [continuing]. Of chairing the Budget Committee.

Senator CHILES. You let me know that every day.

Senator DOMENICI. Lawton now bows when he comes into the office.

We must look at the indexing of American social programs sooner or later. In briefing myself on it, I was amazed to find that as recently as the last year that President Kennedy was President, there was not a single American entitlement program that was indexed. Now that does not say much but a phenomenon has occurred since then which is having a great effect on the budget, and that is that almost every entitlement is now being indexed.

Senator CHILES. What was the inflation rate?

Senator DOMENICI. Well, it was under 4 percent, I believe. I am not arguing that we ought to stop it; I am just saying that we have to have a talk about it and I don't think we can escape talking about it in the social security field. I wonder if either of you would talk with us about whether the present inflator, the CPI, ought to be looked at in terms of its real relevance. Does it add to the checks an amount that is the best indicator of inflation? Does the CPI do that as well as or better than some other measure?

Mr. AARON. I guess I better speak to that as an economist. I have worried a bit about the Consumer Price Index and whether it adequately represents the impact of inflation on the aged. I think the conclusion that most economists have reached is that the CPI in the past couple of years has been a defective index for everyone. It has been defective because of the way in which housing is handled. The BLS has looked at a variety of alternatives for changing the CPI, and some would be improvement.

The aged do buy a somewhat different bundle of goods from the nonaged. An argument can therefore be made for having a separate aged person's Consumer Price Index. I think that would be a mistake, not because it is undesirable to have an index well tailored for the aged but because I don't think you could stop there. You would soon be bothered with requests for separate indexes under this program and that program and the burden would become excessive. So I would urge that we look at the Consumer Price Index as a measure of the cost of consumption for all of us and make such corrections as we think are necessary but that we not go in the direction of having a separate index for the aged.

Senator DOMENICI. Are you now saying that we should consider keeping the CPI measure, but adjusting how it is arrived at, and also that we cannot do that only for social security beneficiaries?

Mr. AARON. That is exactly right. We periodically change the weights that are used in order to keep it up to date. We recently began to publish two Consumer Price Indexes rather than just one. That was a change. So it is not unheard of to change the weights.

Mr. BALL. Senator, I agree generally with what Mr. Aaron has said. When I was Commissioner of Social Security, we looked at the question of a separate index for the elderly with the Bureau of Labor Statistics and came to the conclusion that the differences would be relatively small. I have no objection, however, for a direction to the Labor Department to look again at this question of a separate index, bearing in mind that social security alone is not just for the elderly. It is also for the disabled, and 5 million children receive benefits. All that has to be taken into account, and it is quite possible that the difference between the regular CPI and a separate index may not be worth it.

The other point which I think is inherent is this discussion is that I don't think you can tell ahead of time which way a revised index might go, up or down. You can predict what a particular revision might do next year, but over time it might either compensate people who have automatic indexing more than the present CPI or less than the present because there are many pluses and minuses to be considered. I would just urge that any consideration of a revision not be gone into with the objective of designing a cost-of-living index that would be lower than the present CPI, but rather that it be done objectively to make sure we get as accurate a measurement of cost-of-living increases as possible.

Senator DOMENICI. I wholeheartedly agree. It just happens that in the kind of inflation that we are having, interest rates carry enormous weight in the present formula. I would hope that we could get some adjustment so that the beneficiaries would not necessarily suffer a reduction over a period of time because the index might go down a little bit for a couple of years and then it might be up over the present level, depending upon the makeup. Really, almost everyone says the

CPI is not terribly relevant in these particular years, and that interest rates are the prime ingredient, throwing it out of focus. Is that not a true statement?

Mr. BALL. Well, I am really not expert enough to know whether there is general agreement on that, but I certainly appreciate your point of view. Let's examine this objectively and let's determine what is the best possible measure and if the present one should be revised, then let the chips fall where they may. We want the best measure of cost-of-living increases that are applicable to a variety of situations, including social security benefits.

Senator DOMENICI. To follow up on the previous question on income earning limitations, do we have any indication that the great fear and trepidation that seniors have that they will lose some of their social security invites the nonreporting of substantial income?

Mr. BALL. I have concern about that, Senator. I think particularly in self-employment and perhaps small business there is an opportunity for nonreporting. My guess is that it does not occur very often in a large industry. It takes a conspiracy between the worker and the employer to avoid the report, but in self-employment, particularly, I think there is that possibility and danger.

Senator DOMENICI. Well, I have no better analysis than you. I just know that many of my friends tell me that in certain fields there is a request very frequently that payment be made in cash. I am not being accusatory. It just seems to me that when you hear it everywhere that you have that going on, that there is a fear on the part of many persons that if they tell anything, they are going to lose some of their social security. So they tell nobody. You don't think that would change your answer to the Senator's question?

Mr. BALL. Not sufficiently, Senator. It is certainly a point on Senator Pryor's side and has to be taken into account. I think that frequently the nonreportiug of wages which does exist is partly motivated not only by the earnings test but the question of reporting for income tax purposes as well. In household employment, for example, where there is much discussion of household workers asking employers not to report social security for them, it may be partly due to the earnings test for those eligible for social security, but I think it is also the question of whether such workers are concerned about the income tax, too.

Senator DOMENICI. Mr. Aaron, just one last question. Do I understand that if we were to adopt your recommendation of changing the benefit formula to price indexing in 1995, it would not be necessary to raise the social security age of eligibility? Are you saying one without the other would be sufficient?

Mr. AARON. From a financial standpoint, the one would be sufficient. If that were done, I think I would still support the consideration of an increase in the age at which unreduced benefits are paid, partly for the reasons that Senator Pryor has sketched in his statement of the desire of the aged increasingly to remain part of the economic mainstream.

The Advisory Council, on a very close vote, have urged the Congress to take a look at a plan under which the age at which unreduced benefits are paid would increase gradually from 65 to 68 beginning in the year 2000 with an 18-year transition. We did not support ending early retirement at age 62 on an actuarially reduced basis, but one would have to consider, it seems to me, the desirability of such early retirement and perhaps the desirability of expanded disability or income tested program for those under age 64 or 65.

So on straight social policy grounds, I think we ought to take a very careful look at the retirement age question and put on the books now a gradual increase beginning about then. The reason I say that is not because I am dead sure that in the end we are going to want to have the retirement age go up. But you know perfectly well that in the year 1995, if you were sitting in the same chair and somebody came and proposed that the retirement age be increased in the year 2000, you would find it very hard to tell a 60-year-old that he cannot claim an unreduced benefit in 5 years. You would have to defer action. So I think we have to act now to keep options open.

Senator DOMENICI. Thank you.

Mr. BALL. To raise the age at which full social security benefits are payable because there may be greater opportunity for older people to work in the future and because we want more older people to work seems to me oversimplified. There will obviously be many people, whatever the job situation is, who will not be able to get jobs and hold jobs at 65. For them, this is just a proposal to cut benefits, to pay them 20-percent less than under present law and I am not fully persuaded, therefore, by the idea that for many people the situation will have changed by the year 2000 so that age 68 will be comparable to what 65 used to be.

Senator DOMENICI. It seems to me that you are arguing for some kind of an option, for example, building in some additional incentives for a person to continue working.

Senator CHILES. That I think is a very good question. You know, while we are talking about making changes to the system, what do we do? I think we have to face the fact that a lot of things have changed since someone selected 65 and that decision was made, you know, long before any of us were in the decisionmaking process and an awful lot of things have changed since that time.

When there was a great thrust in this country toward shorter work-weeks, shorter hours, reducing retirement age—we added reduced benefits at age 62. That was a very popular thing and a lot of people were talking about 60, you know. Why not reduce this down to 60? Why not reduce the full retirement down?

Now it looks like the trend has really changed on that. One, the people are living longer. We have raised the retirement age and the thrust is to do away with it entirely. Inflation is such a fact of life now. It didn't used to be that people needed to work but that they desired to work in many instances. While recognizing that we don't want to force everybody to work, how do we build some incentives in to encourage later retirement?

Mr. BALL. Mr. Chairman, could I first just remind the committee that the present law is quite flexible. First of all, if you are totally disabled, you receive benefits prior to 62.

Senator CHILES. Sure.

Mr. BALL. At 62, you can receive reduced benefits. The amount grades up to 65, and, then as a result of the 1977 amendments, there will be a 3-percent increment for every year you work after 65 up to 70. If you retire at 70 instead of 62, you have a 35-percent larger benefit.

Now I think, in preference to an outright repeal of the earnings or retirement test, one possibility would be to increase that 3-percent increment after 65. If you did it on an actuarial basis, it would cost as much as to get rid of the retirement test, but you might hit somewhere in between. My memory is it would become something like 8 percent a year if it were strictly on an actuarial basis, but even if you went that far, you would avoid paying people a retirement benefit while still working full time and regularly. Instead you would say, "Yes we urge you to keep working and when you do retire you will get more money because you continue to work." The system would save some money if instead of 8 percent you picked a figure in between 3 and 8 percent.

Mr. AARON. I agree, Mr. Ball, that there is no guarantee that jobs would be as available for 68-year-olds as they are today for 65-year-olds. I think that is a serious problem and it does deserve the committee's and economists' attention to create such opportunities. If it turns out those opportunities were not there, then I think it would be a mistake to allow the higher retirement age to go into effect.

My point is a different one. If you are to have the option of a higher retirement age, you must, it seems to me, give workers very, very lengthy notice. It is not too soon to tell a 45-year-old that he is going to face a higher retirement age than he previously thought.

Mr. BALL. Henry, with younger workers already worried about the relationship of what they pay in to the value of their benefits, it seems to me the change you propose would be quite disturbing to the 45-year-old worker.

Senator CHILES. Except, Mr. Ball, if they thought you had done something that made it more likely that they were going to receive something. Right now, they don't think they are going to get anything and they are afraid. I think it is almost as if I said, here is the pill and you are going to have to take the pill, and the pill is, you know, that there may be some increased age. But if they thought that medicine was going to cure the patient, I think that it might almost give them some security because they don't believe what we are saying now. When I try to tell them, you have the full faith and credit of the United States behind your receiving something——

Senator DOMENICI. So what else is new?

Senator CHILES. That is right. I don't see any change in expression on their face, it is still that same kind of "What are you doing to us?" I think if you had something that made them feel you had changed the system, and make it sound, I think it might make them feel better.

Mr. BALL. As you know, I think you can fully finance the present system without a reduction in the age at which full benefits are paid or going to price indexing. I don't want to repeat what I said earlier, Mr. Chairman.

Senator CHILES. Yes.

Senator PRYOR. For the benefit of our witnesses and to make the record complete, I would like to mention a very fine hearing [1] which was held by this committee earlier this year at which the chief executive officers of four major American corporations testified—I believe the corporations were Xerox, Polaroid, Atlantic Richfield, and Bankers

[1] See "Work After 65: Options for the 80's," part 2, May 13, 1980.

Life. I was amazed to see what exciting things were being done in the area of retirement planning. I think one of the most effective options some of these corporations make available to their employees is that of a retirement rehearsal, which helps the employee in deciding whether or not he really wants to retire.

I know that, in my own case, many times I think that all I need is to get away for a month or so and I would come back a whole new person. Yet I only have to get away for about 3 days and I get anxious to get back—I wasn't ready to get away for a whole month.

I think that oftentimes this same thing happens to someone who is approaching retirement. The individual thinks that he's ready to retire and go off and sit on a beach somewhere. After only a short time, he may realize that that was not what he really wanted or was ready to do; and yet it's too late. The decision has already been made.

I just wanted to mention that hearing because I considered some of the new practices of these corporations to be very exciting and innovative—and of great value to their retiring employees.

Mr. BALL. I am glad you mentioned it because I had not heard of the hearing; I will look it up.

I think you are absolutely right that what we want is choice—flexibility and informed choice—so that people know what they can count on ahead of time. I like the fact that there is available a range of protection, from disability prior to age 62 to increased benefits up to age 70. I would hate to force everybody into the mold of retiring at a particular time. I think there is some misunderstanding on this. People keep referring to the retirement age under social security as if social security required people to retire. Of course, it does not. It is a short hand way of speaking, but I think some of the public does think that somehow they ought to retire at 65 because, under social security, that is the first age at which you get full benefits. That is wrong.

I want people who are capable of it and want to, to continue to work longer. No matter what else happens in the next century, there are going to be a lot more older people and everybody will be better off if more older people contribute to the production of current goods and services than if older people all retire early. So I am very sympathetic to the objective of more older people working. I want to do what I can to promote that.

Senator CHILES. Both of you supported the proposal to tax social security income, and you both confess that today. I was not going to bring that up unless you confessed but I want to ask you why you think this situation received such a tremendous negative response and what your feeling is about that.

I just want to put a plug in that we will be holding three hearings in December. On December 2, we are going to hear from Robert Myers, former Chief Actuary at the Social Security Administration; and Martin Duffy from Data Resources, Inc.; and Thomas Woodruff of the President's Commission on Pension Policy, who will be talking about CPI indexing, wage versus price indexing; impact of inflation on the elderly; and the Commission's interim recommendations.

December 3, we are going to hear from a panel of our national organizations. We will hear from the National Retired Teachers Association and the American Association of Retired Persons, the National Council of Senior Citizens, the National Council on Aging, the National Association of Retired Federal Employees, the National Caucus on the Black Aged, and the National Association of Spanish Speaking Elderly.

Then, on December 4, we are going to hear from a panel of national pollsters consisting of Humphrey Taylor, of Louis Harris & Associates; Geoffrey Garin, of Peter D. Hart Research Associates, and D. Garth Taylor, of the National Opinion Research Center. We will hear also from William Driver, the Commissioner of the Social Security Administration.

I just wanted to plug those hearings and give you all a chance to determine why we got this storm on the proposition of taxing social security.

Mr. BALL. I should have know better, Senator Chiles, because way back in the Kennedy-Johnson administration when Stan Surry was Assistant Secretary of the Treasury for tax policy we tried to get action on to such a proposal, and we got the same reaction. I think the basic reason is that for those who are affected, which is by no means all the elderly—a bare majority would continue to be unaffected by such a change as proposed by the Advisory Council because they have low enough incomes that even if you tax half the benefits, their tax exemptions results in their still not having to pay an income tax—but for those who are affected, it is the same thing as a cut in social security benefits and they, understandably, don't like that. That is the main reason. I think also there is some misunderstanding.

Senator CHILES. I wondered about that.

Mr. BALL. If you say it fast and you say, "Tax social security benefits" rather than say it slowly and say, "Let the progressive income tax work its will," it sounds like an excise tax on social security. I think a lot of people who would not have been affected at all, because they had such low incomes, but thought the proposal was to tax their social security money.

Senator CHILES. Most of the people we heard from in my office were people that would not have been affected.

Mr. AARON. I had the same experience.

Senator CHILES. But they were terrorized by it and many of them felt that it cut off half of their social security benefits.

Mr. BALL. It is clear that it is not going anywhere and we probably should not have raised it in the first place. I think it is logical and good tax policy, but I see no hope of it being accepted.

Senator CHILES. I should say that this question causes problems just by asking it, and I will pose it again if I can figure out how to do so judiciously. I know that immediately the aging groups came out as a body and came down very strong. I think how the issue was phrased had an awful lot to do with the way that opinions just firmed up and the issue became such an evil.

Mr. AARON. Could I comment?

Senator CHILES. Henry, what you suggested, if the money went back into the system itself, would there be any way of having a different result?

Mr. AARON. Well, I think returning the revenues to the fund would make clear that one is talking about distribution of benefits, not a reduction. That is where the debate ought to take place. I would also point out that we had a specific way of doing it which was to include half of social security benefits and taxable income. There is a multitude of possible ways.

A few years ago, I think many people would have reacted with disbelief that we might tax part of unemployment insurance, yet it happened. Similar devices are available if you wish to confront this issue. I would think the idea of returning revenues to the trust fund in any event would reduce opposition.

Mr. BALL. Reduce the eligibility.

I would like to do what Mr. Aaron suggests, too. I think returning it to the trust fund would not overcome the objection by any means, but it is a desirable result if one were going to do it. I think it is important to remind the committee that the proposal for including one-half of the social security benefit for income tax purposes is still a lot more liberal than the treatment the tax code gives contributory private pensions or other public pensions. Under these systems, as soon as you have recovered in benefits the amount you yourself have paid in, then the entire pension is taxable, including interest that has been earned on the workers' contributions. Most private pensions are taxable as soon as you start to get them because most are not contributory.

We used the rough approach of suggesting that half be taxable because the worker has already paid taxes on his own contributions. The part derived from the employer contribution is the part that ought to be taxed. One of the supplementary statements in the Advisory Council report pointed out correctly that if you followed the private pension approach, then for a long time in the future, about 85 percent of social security benefits would be included in gross income.

Mr. AARON. That is a minimum; for most people it would be more.

Senator CHILES. My staff said we received a letter saying any Senator who would tax social security would bite little babies.

Mr. BALL. I have heard comments like that.

Senator CHILES. You raised a point, Mr. Aaron, when you were talking about Mr. Boskin's proposal in the two-tier system that I think has concerned us all. It certainly has concerned me and Mr. Boskin is seeing what happened to social security and inflation. In 1970, when I came to the Senate, before we had, you know, all of the indexes, some of the increases that we made—10 and 20 percent—were very necessary at a point when we were going through some critical times. Inflation had just really begun to hit. But it also bothered me that we were giving that raise to all the recipients and that some were desperately in need, but some really were not in need and had not paid in so much to the system to start with. They had other assets. So I think the idea of a two-tier system immediately has some appeal because we worry that we are not able to provide for some real needs.

We still don't provide glasses and dentures and other things under medicare. Continually, I am running into desperate old people who say they need these things. We are not providing those kinds of benefits. At the same time, we know that there is a percentage of people, 20 to 30 percent of the recipients, that do not need the social security as a basic underpinning of their existence. Every time we give a cost-of-living adjustment, we do it not based on what people earned or paid in, but really based on the fact that we have just got to try to have these other people keep up. That is the constant question.

How do we best approach this dilemma? There are two reasons for my concern: (1) so we will have more dollars to pay those that desperately need it, and (2) so that we will not be charging that young worker so much that he loses all confidence and all faith.

Mr. AARON. The position I tried to argue is that the pursuit of preciseness is going to entail some very real costs. There are classes of workers who are receiving benefits greater than, after careful consideration, we would like them to receive. Where we can identify those classes I think we ought to do something about it. It seems to me if you deal with two such problems, however, the misdirection of benefits would be relatively minor.

One is the class of short-term workers that I described earlier. A combination of the revised benefit formula as it affects short-term workers and universal coverage will solve that problem completely.

The second is the treatment of the family. If you deal with both of those problems, you will find that the benefit formula really looks remarkably good. There are very few people who have earned very little during their lives who turn out to be wealthy old folks—a few, but not very many.

The price of dealing with those few cases would be imposing means tests on millions of people and administrative costs of very considerable magnitude in order to measure income periodically as you would have to do in a large SSI system. There might be some benefits in improved targeting, but the costs would be greater.

Senator CHILES. Along that line, we talked about the prohibition on outside earnings and you mentioned this would affect primarily those in the higher income bracket—that is where most of the money would go. Don't we have a situation today that lends itself very much to, generally speaking, favoring the more well to do? The way we classify earnings is if you earned from rent or stocks or bonds, that is not earned income as such. So we have many people that are over 65 who are wealthy who have their funds coming in on the basis of investments as opposd to the lower income person that has to be a wage-earner and does not own the stocks or have rents. Yet, the one with the stocks or rents, all of that passes through, and there is no limitation.

Mr. BALL. Mr. Chairman, Henry responded partly on this before. Before coming directly to your point, if I could say something more generally related to your previous question and then come to this——

Senator CHILES. Yes.

Mr. BALL. I think one of the greatest strengths of social security is that it is not a program just for low-income people; it is the base on which everyone builds his protection. All the private pension systems in this country—for high-paid people, for the lower paid and for whatever level of earnings—are built on the concept that the pension recipients will also get a social security benefit. If you moved in any way to try to target the program more for low-income people by income-testing social security, it would interfere, it seems to me, with incentives for building on top, either through private pensions or individual savings.

I would like to ask you to think very carefully about the strengths of a program which allows people to add to whatever they get in social security what they can save on their own or whatever private pensions they are covered for even though you might end up with some people relatively well off getting social security. Social security is designed as a system not only for low-income people, but for everyone, and that is its real strength; it is not a weakness, in my opinion.

Now the idea of including in the earnings test or retirement test income from dividends, interest, and so on, is a part of the same discussion. The test is now designed to determine who has lost income by reason of retiring, either partly or wholly. If you also include in that test earnings on investments that you would have before you retire and you have after you retire, it seems to me you are introducing a test of means and are shifting from trying to determine whether people have suffered a loss from retirement to determining who has low income. This is a welfare principle rather than a social insurance principle and that is what my objection is to, including dividends, interest, and rent in that kind of test. I would rather go Senator Pryor's route than that.

Senator CHILES. We want to thank you both very much for your appearance here and, Mr. Aaron, you for pinch-hitting for Mr. Boskin. I think your testimony is very helpful to us.

Mr. AARON. Professor Boskin bats right hand, I bat left.

Senator CHILES. Thank you very much.

We will recess our hearings.

Senator DOMENICI. Mr. Chairman, in announcing the schedule for the future hearings we did not have an opportunity to tell you that all of the Republican Senators have to be in caucus on December 2. If it is possible, therefore, to make some adjustments, we would hope you would. I hope you would understand that we are required to organize under the rules and there is no exception.

Senator PRYOR. We had better be nice to him, Mr. Chairman.

Senator CHILES. Yes.

Senator DOMENICI. Of course, we will have staff here, and we will have the benefit of the testimony in any event.

Senator CHILES. Thank you very much. We will see what we can do. The committee stands recessed.

[Whereupon, at 12:35 p.m., the committee recessed.]

APPENDIX

LETTER AND ENCLOSURE FROM PETER LOEB, EXECUTIVE DIRECTOR, DISABILITY ADVOCATES, BOSTON, MASS., TO SENATOR LAWTON CHILES, DATED NOVEMBER 20, 1980

DEAR SENATOR CHILES: Enclosed pleased find testimony regarding the refinancing of social security which is being considered by the committee of which you are chairman.

We are advocates for persons with disabilities—and disabled although NOT on social security—and in general in touch with the disability movement in this country. Our function has been to follow legislation.

We hope our contribution is of some assistance to you and your committee.

Do not hesitate to contact us should there be any questions.

Warmest regards,

PETER LOEB.

Enclosure.

STATEMENT OF PETER LOEB, DISABILITY ADVOCATES

We represent persons with disabilities in this Nation and are intimately concerned about our elderly citizens. It is an honor to be able to testify in support of the elderly and express our hopes that the needs of the elderly be adequately met through the social security system.

At this time the disabled and the elderly are being pitted against one another for funds. We earnestly hope that all lawmakers irregardless of party affiliation will perceive the social security system not as a system only for one group but as a system which represents an essential bond between those who have and those who have not in our society, a bond that is not based on charity or volunteerism.

Over the past weeks we have spoken with many in Washington concerning social security for persons with disabilities. We have been told that social security for retirees is the vital part of the program. As to where cuts are to be made we have no precise information. Some studies indicate that there will be "massive cuts."

There have been bills introduced in the House of Representatives which, in our opinion jeopardize the economic viability of disability benefits and the medical benefits available only through social security for many people.

We wonder how many of you realize the concrete implications of these programs?

We are sure that you have heard "scare stories" and information about fraud and waste. We do not think that similar stories about the IRS would lead you to eliminate, reduce or jeopardize the "rotten apples." Several measures of the 96th Congress seek to refinance social security by eliminating medicare taxes (H.R. 1549), to provide for the funding of medicare from general revenues (H.R. 2430), to reduce social security taxes removing medicare (H.R. 5742), to transfer disability insurance benefits and medicare to general revenue (H.R. 968), to reduce social security taxes (H.R. 2429), to transfer disability insurance and medicare to general revenue (H.R. 2847).

This session of Congress will soon end but the basic impulses of the legislation mentioned will reappear in the 97th Congress.

We hope that lawmakers understand the message you are sending us. Many of us are uncertain as to whether or not we can survive with basic life-sustaining services. In some cases a few hours of assistance from a personal care attendent and the skills of an independent living program enables persons with disabilities to function within the community and to work.

We have heard the phrase "work-related." We also hope that those who because of disability are unable to work will not be discounted in your decisions. All of you may become disabled. Someone has said that a person is only temporarily able-bodied. We do not wish one's essential worth to be determined by the number of years one has been in the work force. You will understand that many of us will never be worthy as there are no possibilities to "compete" on this basis with those who have been in the labor force for many years—who have "earned" their social security.

Many of us simply do not live very long at all.

More important we do not feel that we should be judged on this basis.

We hope that lawmakers increase their contact and understanding of the lives of persons with disabilities. We hope you perceive the medical assistance or other assistance not simply as a lump of money—but as a real concrete factor which permits many of us to contribute to the promise of this Nation in a fuller way.

We urge you to consider social security refinancing on a bipartisan basis and contact us should there be concerns with which we can assist.

We look forward to returning again to lend our support to you and to the elderly of this Nation in our common struggle for human dignity.

We have been encouraged by the contacts we have had from Members on a bipartisan basis and from the support which we have received for the views we have shared.

I might add that we are realists and knowledgeable in government and its processes.

On this and similar concerns we look for the cooperation of the Senate Special Committee on Aging and its members.

Thank you.

O