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SEVENTH IN A SERIES OF SUBCOMMITTEE HEARINGS ON PROTECTING AND STRENGTHENING SOCIAL SECURITY

HEARING

BEFORE THE

SUBCOMMITTEE ON SOCIAL SECURITY

OF THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

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SEVENTH IN A SERIES OF SUBCOMMITTEE HEARINGS ON PROTECTING AND STRENGTHENING SOCIAL SECURITY

TUESDAY, JUNE 21, 2005

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON SOCIAL SECURITY,
Washington, DC.

The Subcommittee met, pursuant to notice, at 10:02 a.m., in room B–318, Rayburn House Office Building, Hon. Jim McCrery (Chairman of the Subcommittee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON SOCIAL SECURITY

FOR IMMEDIATE RELEASE
June 21, 2005
No. SS–7

CONTACT: (202) 225–9263

McCrery Announces Seventh in a Series of Subcommittee Hearings on Protecting and Strengthening Social Security

Congressman Jim McCrery (R–LA), Chairman, Subcommittee on Social Security of the Committee on Ways and Means, today announced that the Subcommittee will hold the seventh in a series of Subcommittee hearings on protecting and strengthening Social Security to hear the views of Members of the House. **The hearing will take place on Tuesday, June 21, 2005, in room B–318 Rayburn House Office Building, beginning at 10:00 a.m. or immediately following the conclusion of the full Committee hearing.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Subcommittee and for inclusion in the printed record of the hearing.

BACKGROUND:

The Trustees of the Social Security system consider both demographic and economic factors to project the future condition of the Social Security Trust Funds. The demographic factors, covered in a previous Subcommittee hearing, are the primary reason why the system is facing insolvency. However, economic factors, while subject to greater variability than demographic factors, are important, too.

Four important economic variables required to project Social Security's finances are the rate of real earnings growth, the real interest rate, the inflation rate, and the unemployment rate. In particular, the earnings growth and inflation rates have direct effects on various automatic benefit and tax base adjustments in the program. As a result, it is important to examine the interrelationship between Social Security and the economy as we look for ways to strengthen Social Security's financing.

While these and other economic variables help to determine Social Security spending and revenues under current law, it is also important to consider the larger impact of the Social Security program on the Nation's economy. According to the Social Security Trustees, the program's costs are growing faster than the economy and the tax base that supports it. Some economists have suggested that the current system is inefficient because it induces workers to save less andretire early and that strengthening Social Security could have positive economic effects.

One way to strengthen Social Security and potentially enhance national savings and economic growth is to pre-fund benefits. The past two Administrations, as well as the 1994–1996 Social Security Advisory Council and the 2001 President's Commission to Strengthen Social Security, proposed partially pre-funding Social Security through either personal accounts or the collective investment of theSocial Security Trust Funds.

In announcing the hearing, Chairman McCrery stated, "Many people think of Social Security in terms of how it affects their personal retirement income and their

take-home paychecks. However, Social Security also affects the economy, and vice versa. As we examine ways to strengthen Social Security, we must consider both the individual and the broader consequences of options under discussion."

FOCUS OF THE HEARING:

The Subcommittee will examine how economic assumptions are used to project the future condition of the Social Security system and determine Social Security benefits, along with the merits of, and options to, achieve pre-funded benefits.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, *http://waysandmeans.house.gov*, select "*109th Congress*" from the menu entitled, "*Hearing Archives*" (*http://waysandmeans.house.gov/Hearings.asp?congress=17*). Select the hearing for which you would like to submit, and click on the link entitled, "*Click here to provide a submission for the record.*" Once you have followed the online instructions, completing all informational forms and clicking "submit" on the final page, an email will be sent to the address which you supply confirming your interest in providing a submission for the record. You ***MUST REPLY*** to the email and ***ATTACH*** your submission as a Word or WordPerfect document, in compliance with the formatting requirements listed below, by close of business Tuesday, July 5, 2005. **Finally**, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225–1721.

FORMATTING REQUIREMENTS:

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All submissions and supplementary materials must be provided in Word or WordPerfect format and MUST NOT exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. All submissions must include a list of all clients, persons, and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone and fax numbers of each witness.

Note: All Committee advisories and news releases are available on the World Wide Web at *http://waysandmeans.house.gov*.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman MCCRERY. The hearing will come to order. Good afternoon, everyone. Welcome. This is our seventh Subcommittee on Social Security hearing on protecting and strengthening Social Security. Before we start this morning, I would like to take just a moment to acknowledge the work of our former Subcommittee Chairman, Congressman Jake Pickle. Jake died this past weekend. As you all know, he served a long time in the House, about 31 years. He was a lifelong Texan, a World War II naval combat veteran, a fiscal conservative. He worked tirelessly in the early eighties toward finding a bipartisan solution to the Social Security solvency crisis of that day. So, I think it is fitting that we pause for a second and remember Jake Pickle this morning as we try to follow a path toward a solution to the Social Security problems that confront us today and in the near future. Social Security, of course, occupies a special place among government programs because it has a profound impact not only on an individual person's finances, one's personal economy, but also on our National economy. Today we will examine the larger macroeconomic issues associated with Social Security.

One such issue involves the economic variables used to estimate Social Security's finances. The variables include the rate of real earnings growth, the real interest rate, employment, and the inflation rate. The real earnings growth rate affects growth of initial benefits payable to individuals as well as the tax base supporting the program. The interest rate affects the balance of the Social Security Trust Funds. The employment rate affects current revenue and future benefit obligations for the program. The inflation rate determines adjustments to benefits after they begin.

From an economic and an individual perspective, a key question we face is how best to finance Social Security benefits, whether to stick with the current pay-as-you-go financing structure under which today's workers' payroll taxes support today's retirees, or whether we begin to save real assets to help pay benefits in the future—also known as prefunding Social Security. Through voluntary prefunded personal accounts, we would have the opportunity to not only strengthen Social Security, but encourage savings, which could in turn greatly expand the pool of capital available for investment, leading to more economic growth and jobs. I welcome our very distinguished panel this morning, and I look forward to hearing your views and responses to our inquiries. Now, I would ask my colleague Sandy Levin, the Ranking Member of the Subcommittee, if he would like to make some opening remarks.

Mr. LEVIN. Thank you very much, and it is most appropriate that you started off our hearing today to remember Jake. He was a wonderful and, in his own way, colorful character. If he were with us today, I am sure he would have a story or two to enlighten our hearing. He had an intense dedication to the Social Security system, and I was relatively new when he—very new when he was in full bloom in 1983. He stayed that way throughout his years here. So, Jake, as we delve further into this, we remember you well and we miss you. In announcing today's hearing, our Chairman suggested that one way to strengthen Social Security is to prefund, as you put it, benefits, and that doing so could enhance national savings and economic growth. This is an important discussion. I

am glad we are having it, and we very much welcome this very distinguished group of experts.

This is not, however, a new discussion. In 1983, we made the decision to shift from a pure pay-as-you-go Social Security system to one that was partially prefunded. As a result, we currently have over $1.7 trillion in the Social Security Trust Fund. This year alone, Social Security will earn $169 billion more than is needed to pay this year's benefits. Although those surpluses invested in U.S. Treasury bonds are enough to secure Social Security's future for many years, some of their economic benefit has been muted because Congress often borrowed Social Security surpluses to pay for other priorities rather than using them to increase national savings by paying down the national debt. For example, President Bush's current budget and the budget resolution passed by the House and Senate majorities proposed to spend every dime of this year's surplus to finance other priorities, including over $100 billion in tax cuts. As we demonstrated in the late nineties, when President Clinton led us in saving the surplus for Social Security and we built up a $5.6 trillion projected budget surplus, fiscal discipline can have real economic advantages as well as ease the pain of keeping future obligations. Unfortunately, the current Administration squandered the surplus in Social Security funds on a massive tax cut aimed at the very wealthy, undoing progress we had made toward prefunding Social Security's obligations.

So, as we discuss prefunding today, we should keep in mind that privatization and prefunding are two different things. A guaranteed benefit pension system can be prefunded, as all State pension systems and private pensions in the United States are, and a privatized system can be essentially unfunded, as under President Bush's Social Security privatization plan, by borrowing all the money for future accounts and passing on the cost to future generations. I hope our witnesses can help us better understand the real costs and benefits of prefunding, and the various ways it can be achieved. Social Security's guaranteed benefits, whether prefunded or pay-as-you-go, are critical to millions of current and future retirees and families. I would just add, if anyone has any doubt about that, they should read the articles in the New York Times, especially the one on Sunday. It would be particularly disingenuous for those who made decisions to move off a fiscally responsible path to use their own poor policy choices to justify privatizing Social Security and putting guaranteed benefits at risk for millions of Americans. So, we look forward to your testimony. Thank you, Mr. Chairman.

Chairman MCCRERY. Thank you, Mr. Levin. This morning's rather large panel is quite a distinguished one. We have with us this morning Dr. Douglas Holtz-Eakin, who is the Director of the Congressional Budget Office (CBO); Dr. June O'Neill, formerly of the CBO and currently Wollman Distinguished Professor in Economics at the Zicklin School, Baruch College, New York; Stephen J. Entin, President and Executive Director, Institute for Research on the Economics of Taxation; William W. Beach, Director, Center for Data Analysis, The Heritage Foundation; Lee Price, Research Director, Economic Policy Institute; Dr. Andrew Samwick, Professor of Economics and Director of the Nelson A. Rockefeller Cen-

ter, Dartmouth College in New Hampshire; Dr. Jason Furman, Senior Fellow, Center on Budget and Policy Priorities and Visiting Scholar of New York University; and William G. Shipman, Chairman, CarriageOaks Partners, Manchester-by-the-Sea, Massachusetts, and Co-Chairman of The Cato Institute's project on Social Security Choice. Welcome, all of you. Thank you very much for joining us this morning. Dr. Holtz-Eakin, we are going to begin with you, if you would. All of your written testimony will be included in the record in their entirety. If you could try to summarize that in about 5 minutes, we would appreciate it. Thank you.

STATEMENT OF DOUGLAS HOLTZ-EAKIN, PH.D., DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. HOLTZ-EAKIN. Thank you, Mr. Chairman, Mr. Levin, and Members of the Committee. The CBO is pleased to be here today. The written testimony that we have submitted has four basic points. Point number one is to summarize the financial outlook for Social Security under current law and identify the financing problems. This is not news and I will leave that to written testimony. The second point is to document the role of economic performance in contributing to and solving the financing problem, the particular contribution of wage rates, interest rates, and the like. Point number three is to reverse the direction and look at the role of fixing the Social Security and larger budgetary issues that face the United States in providing better economic performance. Then the testimony closes with a bit of a discussion about the virtues of moving sooner, as opposed to later, in addressing these pressing financing problems.

Let me take those in order. The first is the role of economic performance in the Social Security finances. As the Chairman mentioned at the outset, there are some key variables which are used for projecting the outlook for Social Security under either current law, or in a reform program. They are the earnings growth, interest rates, inflation, and the mix of unemployment and employment for any given labor force.

Earnings growth is by far the most important. Earnings growth is driven by productivity advances in the United States. Earnings will rise with productivity and take a mix of taxable earnings and untaxed compensation. Those rises in earnings will increase both taxes received by the system, and also benefits due in the system. The rise in productivity that drives earnings will come from two sources. One is the continuous progress of innovation in the United States, which is captured in the economist's term "total factor productivity." The second is the additional productivity that comes with the accumulation of wealth and capital resources, the provision of workers with greater amounts and higher quality factories, machines, and the like, which raise productivity, and thus earnings. There is a timing difference. Increases in productivity and earnings first are reflected in taxes, and then later show up as higher benefits from the higher earnings. In any event, it is unlikely, given the historic pace of productivity growth and the likely variation around that historic pace, that we can grow our way out of the Social Security financing problem. The figure that we brought as a display in this regard shows, at the top, the outlays

under current law for Social Security. These are scheduled benefits as a fraction of GDP. The bottom dark line is scheduled receipts as a fraction of GDP in the system, and the light blue shaded area shows the variation in productivity that would be about 80 percent likely under historic growth rates of productivity. So, there is an 80 percent chance, given what we know, that productivity will lie somewhere in that band and produce outlays somewhere in that band.

As you can see, while it is the case that higher productivity growth could ameliorate the Social Security financing problem, it is extremely improbable that it will by itself be a solution to the mismatch between scheduled benefits, at the top, and revenues, at the bottom. That is the most central economic variable affecting the future of Social Security as it is currently constructed. The second key variable is real interest rates. While they don't affect this picture of the current annual benefits or the current annual receipts, they do affect system financial measures such as trust fund exhaustion. To the extent that interest rates are higher, bonds in the trust fund accumulate greater interest, and the trust fund lasts longer. A rough rule of thumb is that in our projections raising real interest rates by 1 percentage point would allow the trust fund to last a little under a decade-and-a-half longer, a little under 15 years. Going the other direction, if interest rates were lower by a full percentage point, trust funds would be exhausted about that much sooner.

The second thing that interest rates are important for are measures of actuarial balance. Interest rates are used to discount the future back to the present. To the extent that interest rates are higher, future deficits count less in those computations compared to current surpluses, and the actuarial balance does not look as bad. The reverse is also true. To the extent that interest rates are lower, future deficits will count more heavily and the actuarial balance will move in the other direction. I will leave to Members and the staff the comments we have written on the inflation and unemployment rates in our projections. They are less central to either measured or actual performance of the system in the future.

The second aspect is to look at achieving better performance and fixing the budgetary problems facing the United States. Not just Social Security, but fixing the larger demands in Medicare and Medicaid would improve the future economic performance of the United States. There, the key issue is that by saving more in the present as a nation, we can accumulate greater national wealth, produce greater national income, and enlarge the pie available to fund all of the private-sector and public-sector demands. We did some illustrative calculations that raising the national saving rate by 2 percentage points might raise the capital stock by 15 percent by 2050, raise GDP per person by 4 percent over that period. Even simply saving the current Social Security surplus, genuinely saving it as national saving increases, could raise GDP per capita by 1.5 percent over the next 50 years. That prefunding could take place in the government, it could take place in the private sector, and the central issue is a design one which allows any resources devoted to prefunding not be offset by government or private sector actions.

Then finally, the testimony closes with a short discussion that is intended to illustrate the benefits of moving sooner as opposed to later. One can think of current-law Social Security as a wait-and-reform strategy. In our projections, when the trust funds exhaust in 2052, benefits are at that point mechanistically cut by about 22 percent. That is a wait-and-reform strategy of a rather meat-cleaver fashion. One could imagine moving sooner. This display shows, simply for illustration, the difference between benefits received over the lifetime of beneficiaries. If one waits and reforms, that is the dark line that shows those cohorts born in 1950–1959 getting fully scheduled benefits but later cohorts getting much less. Or with the light blue lines, imagining a 10 percent across-the-board cut in benefits now, which would share the burden, providing less for the older cohorts but allowing younger cohorts, those who are 15 and younger at the moment, to receive greater benefits over the life of their participation in the program. We are pleased to have the chance to both submit the written testimony, and to be here, and we look forward to your questions.

[The prepared statement of Dr. Holtz-Eakin follows:]

Statement of Douglas Holtz-Eakin, Ph.D., Director, Congressional Budget Office

Mr. Chairman, Congressman Levin, and Members of the Subcommittee, I appreciate the opportunity to appear before you today to discuss Social Security and the economic factors that influence its financial outlook.

As you know, Social Security is the single largest Federal program. In 2004, the Social Security system received $569 billion in tax revenue and paid out $493 billion in benefits. The program provided benefits to more than 47 million people—about two-thirds of them retired workers and the rest disabled workers, survivors of deceased workers, workers' spouses, and minor children.

Although today the program takes in more revenue than it spends, that situation will not continue once large numbers of baby boomers begin claiming retirement benefits. In coming years, the Social Security system will face mounting financial pressures as its outlays start to grow much faster than its revenue. The Congressional Budget Office (CBO) projects that scheduled Social Security outlays (those implied by the current benefit formula) will rise from 4.3 percent of gross domestic product (GDP) in 2004 to 6.4 percent in 2050.[1] Revenue, however, is scheduled to average less than 5.0 percent of GDP.

The aging of the population will place similar pressures on the government's two big health care programs, Medicare and Medicaid. Without changes in spending or revenue policies, Federal debt could begin to grow at an unsustainable pace. Faster economic growth would help reduce some of that budgetary imbalance, but it is highly unlikely that economic growth alone could solve the problem. Conversely, slower growth would exacerbate the situation. Prefunding future retirement obligations by increasing national saving could noticeably reduce the burdens that an aging population would impose on future workers, and taking action sooner rather than later could lessen some of the uncertainties that future retirees face.

The Financial Outlook for Social Security

The next decade will see the beginning of a significant, long-lasting shift in the age profile of the U.S. population. Over the next 50 years, the number of people ages 65 and older will more than double, while the number of adults under age 65 will grow by less than 20 percent. That shift reflects demographic trends that have been evident for years and that are expected to continue, such as the aging of the baby-boom generation, increases in life spans, and a relatively low fertility rate.

Those trends imply that the number of workers per Social Security beneficiary will decline significantly, from 3.3 in 2004 to 2.0 in 2050. Because Social Security depends on revenue from current workers to finance benefits, that demographic shift will have a profound impact on the system's finances.

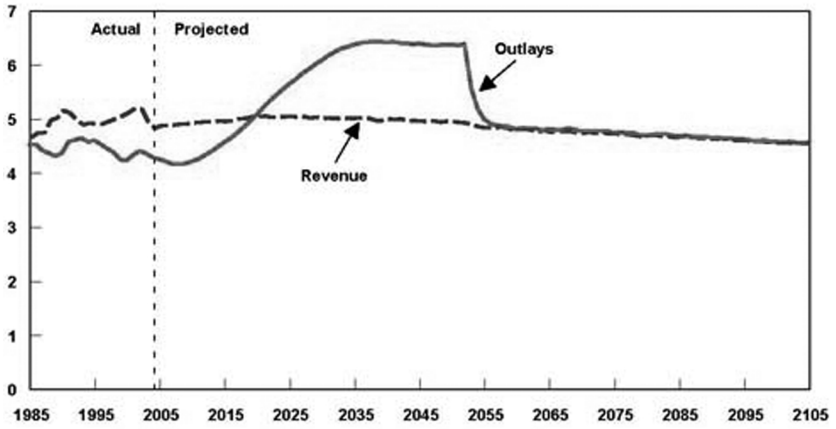
[1] See Congressional Budget Office, Updated Long-Term Projections for Social Security (March 2005).

Social Security's Finances

In 2009, the Social Security surplus—the amount by which the program's dedicated revenue in a year exceeds the benefits paid in that year—will start to diminish. In 2020, that surplus will disappear, and outlays for benefits will begin to surpass the system's annual revenue (see Figure 1). To pay full benefits, the Social Security system will eventually have to rely on interest on the government bonds held in its trust funds—and ultimately, on the redemption of those bonds. In the absence of other changes, bonds can continue to be redeemed until the trust funds are exhausted, which will occur in 2052, CBO projects. But where will the Treasury find the money to pay for the bonds? Will policymakers cut back other spending in the budget? Will they raise taxes? Or will they borrow more?

Figure 1. Social Security Revenue and Outlays Under Current Law

(Percentage of GDP)



Source: Congressional Budget Office.

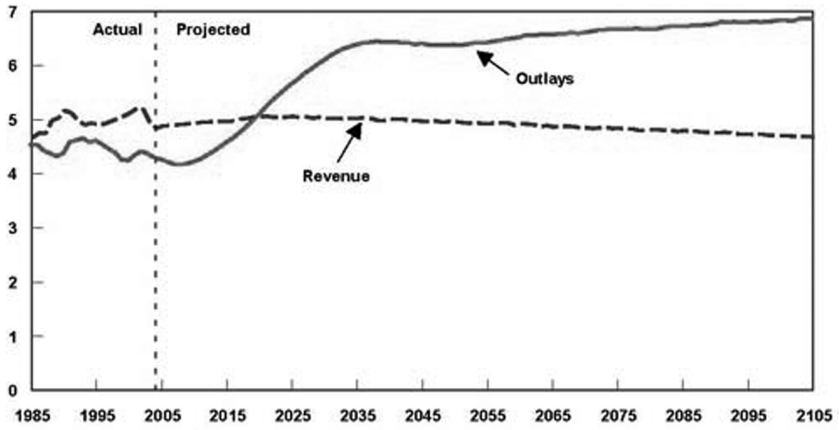
Note: The projections in this figure employ the Social Security trustees' 2004 intermediate demographic assumptions and CBO's January 2005 economic assumptions. Revenue includes payroll taxes and income taxes on benefits but not interest credited to the Social Security trust funds; outlays include trust-fund-financed Social Security benefits and administrative costs. Under current law, outlays will begin to exceed revenue in 2020; starting in 2053, the program will no longer be able to pay the full amount of scheduled benefits.

Once the trust funds are exhausted, the Social Security Administration will no longer have the legal authority to pay full benefits. As a result, it will have to reduce payments to beneficiaries to match the amount of revenue coming into the system each year. Although the exact size of that reduction is uncertain, CBO estimates that benefits will have to be cut—both for current recipients and for new beneficiaries—by about 22 percent to match the system's available revenue.

The key message from those numbers is that with benefits reduced annually to equal revenue, as they will be under current law when the trust funds run out, some form of the Social Security program can be sustained forever. Of course, many people would not consider a sudden 22 percent cut in benefits to be desirable policy. In addition, the budgetary demands of bridging the gap between spending and revenue in the years before that cut could prove onerous. But Social Security is sustainable from a narrow programmatic perspective. What is not sustainable is continuing to provide the present level of scheduled benefits given the system's present financing (see Figure 2).

Figure 2. Social Security Revenue and Outlays with Scheduled Benefits Extended

(Percentage of GDP)



Source: Congressional Budget Office.

Note: The projections in this figure employ the Social Security trustees' 2004 intermediate demographic assumptions and CBO's January 2005 economic assumptions. Revenue includes payroll taxes and income taxes on benefits but not interest credited to the Social Security trust funds; outlays include Social Security benefits and administrative costs. In this outlay projection, currently scheduled benefits are assumed to be paid in full after 2052 using funds from outside the Social Security system.

Implications for the Budget and the Economy

CBO's projections offer some guidance about the potential impact of those developments on the budget. Under CBO's assumptions, the Social Security surplus (excluding interest on bonds in the trust funds) will reach about $100 billion in 2007. By 2025, however, the surplus will have turned into a deficit of roughly $100 billion (in 2005 dollars). That $200 billion swing will represent a significant challenge for the budget as a whole, especially in light of the current budget deficit.

The demand on the budget from Social Security will take place at the same time as—but is projected to be eclipsed by—the demand from Medicare and Medicaid. Currently, outlays for Social Security benefits are slightly more than 4 percent of GDP, as is Federal spending on Medicare and Medicaid combined. But whereas Social Security outlays are projected to grow to 6.4 percent of GDP by 2050, spending on the two health programs could reach a total of 20 percent of GDP if current trends in health care costs continue.

Without changes in policy, therefore, Federal spending is likely to increase sharply in coming decades. Unless taxes rise well above their historical levels, the gap between spending and revenue will widen, expanding the amount of Federal borrowing. The resulting increase in government debt could seriously harm the economy. It could crowd out private capital formation, and although its impact on capital accumulation could be muted by borrowing from abroad, foreign borrowing is no panacea. The debt owed to foreigners would still have to be serviced. In the end, Federal debt would reduce the disposable income of U.S. residents and erode future living standards.

Effects of Economic Assumptions

Projections of the future financial status of Social Security depend on a number of demographic and economic assumptions. In its projections, CBO uses the demographic assumptions of the Social Security trustees and its own economic assumptions. CBO's economic assumptions for the next 10 years are described in *The Budg-*

et and Economic Outlook (January 2005); the assumptions for later years are consistent with those used in the 10th year of the projection.

Assumptions about four economic factors affect the finances of the Social Security system: the growth of earnings, the interest rate used to compute the interest credited to the trust funds, employment, and inflation. Of those four, earnings growth has the largest impact on Social Security's outlays and revenue. The interest rate affects Social Security's finances because it determines the amount of interest paid to the trust funds, but that interest is an intragovernmental transfer and has no effect on the total budget. The other factors have important implications for overall economic performance, but they do not affect Social Security's finances significantly.

Earnings Growth

Real (after-inflation) earnings growth—and its main underlying determinant, productivity growth—is the key economic determinant of Social Security's finances as well as of the performance of the economy in general. Social Security benefits are based on earnings during a person's working years. Workers with higher lifetime earnings receive higher benefits, as do their dependents and survivors. The benefit formula is also structured to ensure that as average earnings grow, benefits for new recipients grow at approximately the same rate. As long as the system pays scheduled benefits, Social Security benefits will replace the same portion of earnings for future generations as they do for today's beneficiaries (for workers who claim benefits at the normal retirement age). However, the purchasing power of those benefits will be greater than that of benefits paid today.

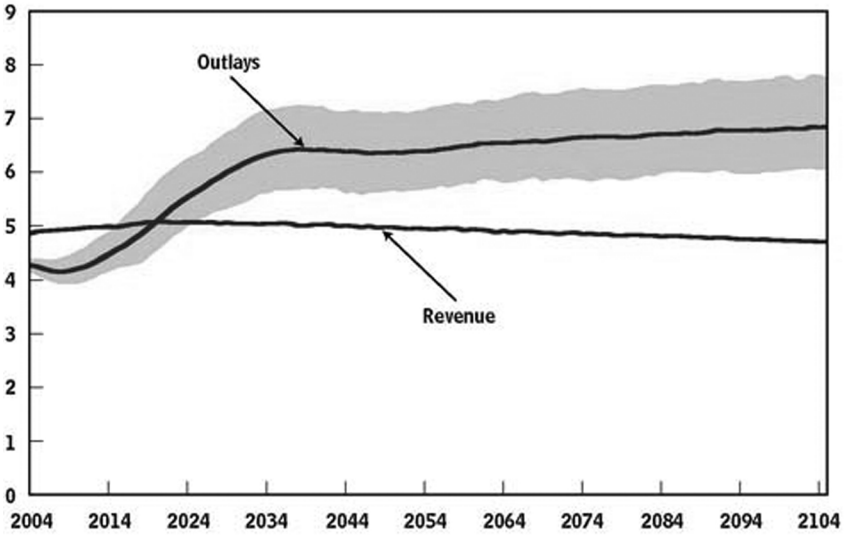
Although initial Social Security benefits are indexed to earnings, higher-than-expected earnings growth would improve Social Security's financial position. Higher real earnings immediately result in higher payroll tax revenue, but outlays do not increase until the workers with higher earnings claim benefits, which can be years or even decades later. The benefits paid to current recipients are indexed to prices, not earnings, so overall outlays do not increase in lockstep with real earnings.

In the long run, workers' compensation grows with productivity. Productivity growth in turn stems from two factors: increases in the amount of capital per worker and, more important, technological advances that raise the amount of goods and services that can be produced with a given level of capital and labor—so-called total factor productivity (TFP). Workers do not receive all of their compensation in the form of earnings; some is received in nontaxable forms, such as health benefits. CBO assumes that the increasing share of compensation received as nontaxable benefits will slow the annual growth rate of taxable earnings by 0.1 percent. For its part, TFP is assumed to increase at an average annual rate of 1.25 percent over the long term. With the growth in nontaxable compensation and other technical factors that affect earnings accounted for, that assumption implies that earnings will grow by about 1.2 percent annually.

Uncertainty about earnings growth results in uncertainty about the size of future Social Security shortfalls—but there is little, if any, uncertainty that shortfalls will exist. On the basis of analysis of historical variation in TFP, CBO has projected the range of probable outcomes for Social Security outlays that lies between the 10th and 90th percentiles for TFP (see Figure 3). By definition, there is a 10 percent chance that TFP will be above the 90th percentile and a 10 percent chance that it will be below the 10th percentile. CBO projects that the gap between Social Security spending and revenue will equal 1.39 percent of GDP in 2050. The 10th percentile projection for that year is a deficit of 2.1 percent of GDP, and the 90th percentile projection is a deficit of 0.7 percent of GDP. Moreover, even the 99th percentile projection (which implies only a 1 percent chance that TFP will be so high) shows the Social Security system running a deficit of 0.3 percent of GDP.

Figure 3. Social Security Revenue and the Potential Range of Scheduled Outlays with Uncertainty About Productivity

(Percentage of GDP)



Source: Congressional Budget Office.

Notes: The dark lines in this figure indicate CBO's projections of expected revenue and outlays based on the Social Security trustees' 2004 intermediate demographic assumptions and CBO's January 2005 economic assumptions. In those projections, annual Social Security outlays (for benefits and administrative costs) exceed revenue (from payroll taxes and income taxes on benefits but not interest credited to the Social Security trust funds) starting in 2020. Currently scheduled benefits are assumed to be paid in full after 2052 using funds from outside the Social Security system.

The shaded area indicates the 80 percent range of uncertainty for projected outlays, assuming that total factor productivity varies as it has in the past. (The 80 percent range of uncertainty means that there is a 10 percent chance that actual values will be above that range, a 10 percent chance that they will be below it, and an 80 percent chance that they will fall within it. The uncertainty range is based on a distribution of 500 simulations.)

Interest Rate

The real interest rate has no direct effect on annual Social Security revenue and outlays. However, it does affect trust fund measures and summarized measures, such as the 75-year summarized balance (the difference between the present values of projected revenue and outlays over 75 years).

The interest rate used to calculate the interest credited to the trust funds is equal to an average of the rates on privately held Treasury bonds.[2] A higher rate results in a later trust fund exhaustion date. CBO assumes that the real interest rate will be 3.3 percent. If that rate was 1 percentage point higher (4.3 percent), the exhaustion date would be extended from 2052 to 2066. A rate of 2.3 percent would accelerate the exhaustion date to 2045.

[2] Specifically, the interest rate on new special obligations equals the average market yield on all outstanding, marketable U.S. obligations that are due or callable more than four years in the future. See Jeffrey L. Kunkel, Social Security Trust Fund Investment Policies and Practices, Actuarial Note 142 (Social Security Administration, Office of the Chief Actuary, January 1999).

In the computation of summary financial measures, future outlays and revenue are discounted using the real interest rate. A higher discount rate would weight past and current surpluses more heavily and would give less weight to future shortfalls. With a higher real interest rate, the summarized balance would show an improvement.

From the perspective of the total budget, the interest rate is important because it determines the amount of interest that the Federal Government will owe to members of the private sector and foreign governments that hold Treasury securities.

Employment

Higher levels of employment increase total earnings and thus revenue from Social Security payroll taxes. They also lead to higher Social Security benefits in the future. On net, however, higher employment levels improve Social Security's financial position because the higher revenue precedes payment of the associated benefits, often by many years.

The percentage of the population working is determined by two factors: the labor force participation rate, which measures the portion of people working or seeking work, and the unemployment rate, which measures the share of people in the labor force who are unemployed. Over the long term, reasonable variation in either factor is not likely to have a large impact on the financial outlook for Social Security. In its most recent long-term Social Security projections, CBO assumed an average unemployment rate of 5.2 percent. If the average rate turned out to be 6.2 percent, the Social Security deficit in 2050 would be 1.38 percent of GDP rather than the projected 1.39 percent. The effects of reasonable variation in labor force participation are of the same magnitude.

Inflation

In general, the economy benefits from low and stable inflation. However, in a mechanical sense, high inflation actually improves Social Security's finances. Assuming that real earnings growth is constant, higher inflation will immediately result in higher earnings and higher payroll tax revenue. But Social Security benefits will not be adjusted for inflation until the following year.[3] Of course, higher inflation can also have broader negative effects on the economy that may worsen Social Security's finances.

In its most recent long-term Social Security projections, CBO assumed an average inflation rate of 2.2 percent. If the average rate turned out to be 3.2 percent, the Social Security deficit in 2050 would be 1.29 percent of GDP instead of 1.39 percent, as projected.

Consistency of Projections

A concern that arises among some analysts is the consistency of economic projections, including CBO's, that envision much slower growth of GDP than was experienced over the past 50 years and projections of earnings growth that are at the same pace as historical experience. The projections of lower GDP growth stem from projections of slower labor force growth. CBO does not anticipate that the fertility rates experienced during the baby boom will recur. Moreover, since 1950, the labor force participation rate of women has risen from 40 percent of the rate for men to 80 percent, an increase that is numerically impossible to repeat. However, the continued rise in productivity will be reflected in growing earnings per worker, and the flexible adjustment of a market economy will ensure sustained high rates of employment.

Prefunding Future Obligations and Economic Growth

Any strategy to prepare the United States for an aging population must deal with a key fact: the goods and services that retirees will consume in the future will have to be produced by the U.S. economy or imported from abroad at that time. From that perspective, what matters is not the financial structure of the Social Security program but the capacity of the economy and the distribution of economic output. Various options for changing Social Security will have different effects on the economy and on the division of resources between the elderly and other people. To the extent that those options boost the future size of the economy by increasing the nation's accumulation of assets, they will make it easier to support a larger portion of the population in retirement.

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[3] The annual cost-of-living adjustment that applies to payments beginning in January is determined by the increase in the consumer price index for urban wage earners and clerical workers (CPI–W) from the third quarter of two years before to the third quarter of the previous year. For example, the adjustment made to payments in January 2005 was determined by the increase in the CPI–W from the third quarter of 2003 to the third quarter of 2004.

Just as individuals prepare for their retirement by saving in advance, a nation can prepare for an aging population by prefunding its future obligations. That goal can be accomplished by increasing national saving, which is the combined saving of the private sector and the government. A rise in national saving increases the pool of funds available for investment at home and abroad, thus adding to the stock of productive capital and providing resources to purchase assets from other countries. As investment in businesses' structures and equipment increases, workers become more productive, real wages rise, and the United States is able to produce more goods and services. Moreover, the income from additional foreign assets supplements the income produced domestically.

Prefunding could have a noticeable effect on the future production of goods and services. In 2004, net national saving amounted to only 2.2 percent of net national product (though it averaged 6.1 percent from 1980 to 2000), and CBO projects that it will average 3.9 percent between 2005 and 2015.[4] If net national saving was permanently increased by 2 percentage points of net national product, the nation's capital stock would be 15 percent larger in 2050, CBO estimates. With more capital, workers would earn higher wages, and real GDP per capita would rise by 4.3 percent. Even a more modest goal of simply saving Social Security's noninterest surplus instead of spending it could raise real GDP per capita by 1.5 percent in 2050.[5]

In principle, prefunding could be carried out by either the private sector, the government, or both. Households could prefund their future retirement by saving more; the government could prefund its future obligations by reducing the budget deficit. However, not all policies intended to increase private or government saving are equally effective in raising total national saving. For example, higher income tax rates might increase government saving but might also serve to reduce private saving. Similarly, tax incentives to stimulate private saving might involve revenue losses to the government, which reduce the amount of government saving. Conversely, curbing the growth of entitlement benefits might raise both government saving and private saving, as beneficiaries saved more to offset the reduced benefits. For example, indexing initial Social Security benefits to prices instead of to wages, as the President's Commission to Strengthen Social Security proposed as part of its Plan 2, would raise both private and government saving initially and could boost the capital stock by between 4½ percent and 6½ percent in 2050, CBO estimates. In the end, what matters for the growth of the capital stock and the economy is the combined impact of a policy change on government saving and private saving—not the effect on either one alone.

In practice, could the government actually maintain the potential budget surpluses that would be generated from a tax increase or spending cut? That question has provoked a great deal of controversy, particularly in the context of Social Security's cash flow surplus. From a technical standpoint, the question is impossible to answer because it is impossible to know how other policies would have been changed if the Social Security surplus did not exist. The ultimate question of whether a surplus in the Social Security program causes policymakers to spend more on other programs—or tax less—is thus not one that is easy to answer.

Some analysts point to the reduction in Federal debt in the late 1990s as evidence that the government could save if it tried; others argue that the experience of the past few years shows the enormous difficulty of maintaining budget surpluses over an extended period, even despite efforts to put Social Security surpluses in a "lock box." Indeed, many proponents of personal savings accounts argue that diverting the Social Security surpluses to personal accounts could create a more effective "lock box." In their view, such accounts would raise total national savings and effectively prefund future retirement obligations by making it more difficult for policymakers to spend resources.

The effectiveness of accounts in increasing national savings, however, would depend on how the accounts were financed and on the rules governing both accumulations in and withdrawals from them. For example, if it was too easy to take money from an account before retirement, participants might not accumulate as much as they would under a more restrictive arrangement. Administrative costs could also reduce the amount of net savings created by the accounts. Furthermore, some individuals might respond to personal accounts by reducing other private saving. Indeed, experience with 401(k) plans suggests that although low-income people increased their saving in response to tax incentives that favor such plans, most high-income people responded by shifting their assets from other accounts into their

[4] Net national saving is national saving minus depreciation of the capital stock. Net national product is gross national product minus depreciation.

[5] That calculation assumes that private savers would respond to the change in government saving as they have in the past.

401(k) plan rather than by increasing their total saving. Combining a tax incentive for saving with lower future Social Security benefits, however, could limit the risk that people would reduce other saving dollar for dollar, because those who did could have less income in retirement.

Some analysts have also suggested that private accounts might strengthen marginal incentives to work because people would see the link between their contributions to the accounts and their eventual retirement benefits more clearly than they do under the current system. That effect might not have a large impact on the labor supply, however. Although perceptions of improved marginal incentives would tend to boost the labor supply, perceptions of higher—and possibly more certain—retirement income would tend to reduce it (because people would not have to work as much to reach a given standard of living). The net effect on the labor supply would depend on the balance between those two factors and might not be large.

Making Changes Now or Later: Economic and Budgetary Effects

Uncertainty is an economic cost in its most fundamental form, and in the current context, there is uncertainty about the future of Social Security: what the program will look like and who will be affected by changes to it. The sooner that uncertainty is resolved or reduced, the better served will be current and future beneficiaries, who must make various decisions about their retirement. Phasing in changes to Social Security allows for gradual accommodation, giving people time to modify their expectations and to adjust their work and saving behavior. For example, younger workers who learned that they would receive lower-than-anticipated retirement benefits would have many years to respond. They could work or save a little more each year. If the same benefit cuts were announced as those workers neared retirement, however, workers might be forced to make dramatic changes and still might not have time to accumulate sufficient savings.

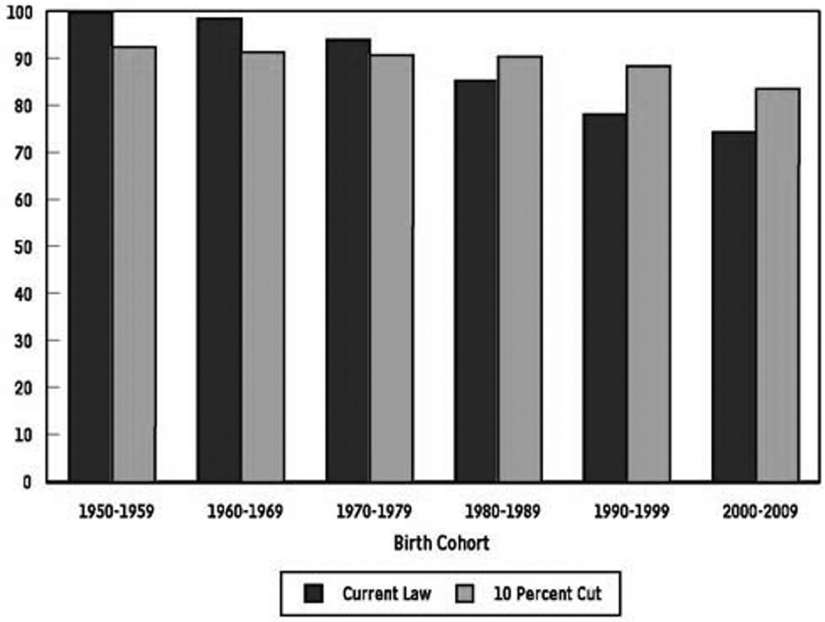
One way to gauge the advantage of acting earlier is to examine potential changes to the current pay-as-you-go Social Security system. As noted above, CBO projects that the Social Security trust funds will become exhausted in 2052 under current law. After that, the Social Security Administration will lack the authority to pay benefits in excess of the system's annual revenue, meaning that outlays will have to be reduced immediately by 22 percent to match that revenue, CBO estimates. Put another way, current law constitutes a "wait and change" strategy. Until 2052, beneficiaries would continue to receive scheduled benefits; however, those benefits would have to be cut by 22 percent in 2053, and larger reductions would be needed in later years.

Alternatively, policymakers could reduce the benefits paid to earlier cohorts so that the benefits paid to later cohorts would not have to be cut as much. To illustrate that point, CBO examined a hypothetical policy that would reduce all new Social Security benefit awards by 10 percent (relative to those currently scheduled) beginning with people retiring or becoming disabled in 2012.

In general, lifetime benefits for current workers (those born before 1980) would be lower under this policy than if no changes were made to the program (see Figure 4). However, assuming other government finances were held constant, such a change would allow greater benefits to be paid to later generations than under current law. The reduced benefits paid to earlier generations would result in government savings, probably in the form of lower debt, that could be used to pay higher benefits to later generations.

Figure 4. Lifetime Social Security Benefits Under Current Law and with a 10 Percent Benefit Cut Beginning in 2012

(Percentage of scheduled benefits)

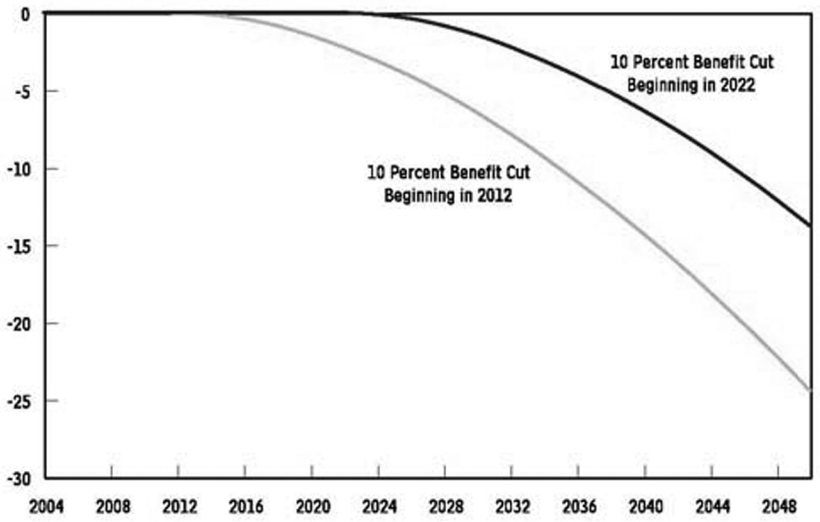


Source: Congressional Budget Office.

Such a policy could also substantially slow the growth of Federal debt held by the public over coming decades. Compared with current law, a 10 percent cut in new benefit awards starting in 2012 could reduce Federal debt by 25 percent of GDP by 2050 (see Figure 5). That debt reduction could also bring economic benefits from more private saving, faster capital accumulation, and higher economic growth. Enacting the same policy 10 years later would also reduce Federal debt, but the effects would be smaller.

Figure 5. Change in Federal Debt Held by the Public from a 10 Percent Cut in Social Security Benefits

(Percentage of GDP)



Source: Congressional Budget Office.

The mechanistic approach of CBO's example is not intended as a recommendation or a comprehensive gauge of options. More-realistic proposals would include multiple provisions (such as tax increases, benefit reductions, or both) and would most likely be instituted gradually. This example is merely a convenient means of demonstrating the implications of earlier changes versus later ones.

Such policy changes entail a variety of trade-offs about how to allocate the burden of bringing Social Security into long-term balance. One trade-off involves making decisions about the value of consumption today relative to the value of consumption tomorrow. The more that consumption is delayed, the more that resources are available for capital investment, which can boost economic growth. Another set of trade-offs involves balancing fairness across income classes and generational cohorts. In some respects, those trade-offs cannot be neatly separated into decisions about income groups and generations, since the prospect of rising wages is likely to make future generations more affluent than current generations, on average.

Whatever the policy—benefit reductions, tax increases, transfers of resources from other Federal programs, or a combination of those approaches—earlier action would distribute the burdens of the change over more generations. For both workers and beneficiaries, gradual changes are generally preferable to precipitous and disruptive actions, such as sudden, large reductions in benefits or sudden, large increases in taxes. Moreover, if changes were announced in advance and phased in gradually, workers and beneficiaries would have more time to prepare and to appropriately adjust their decisions about work and saving.

Chairman MCCRERY. Thank you. Dr. O'Neill?

STATEMENT OF JUNE O'NEILL, PH.D., WOLLMAN PROFESSOR OF ECONOMICS, BARUCH COLLEGE, CITY UNIVERSITY OF NEW YORK, NEW YORK

Ms. O'NEILL. Mr. Chairman, Members of the Subcommittee, I appreciate the opportunity to appear before you today. For many years we have known that some time in the future the Social Security benefits currently scheduled would not be fully funded by scheduled tax increases. Yet the point in time when the system will run deficits always seemed far in the future, a distant period when Baby Boomers become retirees. We are now rapidly approaching that period. Social Security has grown to become the largest program in the national budget. Yet, despite its size, Social Security has seen surpluses, not deficits, for the past two decades, a fact that may have lulled some people into thinking: What's the problem? The emergence of surpluses, however, is partly the result of a favorable but temporary demographic episode, and partly the result of legislation that raised taxes. The baby bust generation of the thirties has been reaching retirement age over the past decade, a trend that slowed the growth in retirees. At the same time, the Baby Boomers were still enlarging the size of the work force, and therefore of taxpayers. Also, on the revenue side, legislation enacted in 1983 increased Social Security taxes by an amount that produced surpluses for many years.

The quandary faced by the Greenspan Commission that recommended the 1983 legislation is endemic to the problem of funding a pay-as-you-go system. Social Security is required to balance costs and revenues over a 75-year fiscal horizon. Benefits are scheduled, and automatically indexed, but legislating the taxes to fund these benefits depends on long-run projections based on aspects of the economy that cannot be known with any certainty. If tax revenues to pay for the benefits are set too low, the system will run deficits. If taxes are set too high, there will be surpluses. The Greenspan Commission erred on the side of surpluses, which turned out to be surpluses for the first 30 years but, after that, deficits for the long run. The commission may have believed that the surpluses would be saved to help fund the subsequent retirement of the Baby Boomers. Instead, the surpluses have been used routinely to fund other programs and have helped to mask deficits on the non-Social Security side of the budget.

The period of Social Security surpluses is now expected to come to an end sometime between 2015 and 2020 as more and more Baby Boomers are added to the beneficiary population; at that point, annual deficits will replace surpluses. Expressed as a percentage of GDP, the Social Security shortfall, or gap, is estimated to increase rapidly, reaching 1.5 percent of GDP in 2035, and growing after that. How will we meet this shortfall? Some hold to the belief that we will not face a financing problem for four decades from now. That belief is based on the accounting practices of the Social Security system that treat the balances in the so-called "trust fund" as though they were actually available to fund the revenue shortfall. The Social Security Trust Fund does not hold assets purchased in private markets that can be sold to pay benefits. The balances in the trust fund are bookkeeping entries showing the ac-

cumulated surpluses borrowed by the Treasury from the Social Security system, plus interest.

In other words, the trust fund holds promises. The only way to make good on those promises is to increase general revenues or increase the publicly held debt. This will obviously entail a growing fiscal burden starting in another 10 to 15 years, when Social Security begins running deficits. Thus, our actual problem will begin at least two decades before the projected date of legal trust fund insolvency. Current projections of the trustees indicate that the trust fund balances will be exhausted about 2041—the CBO has it a decade later—at which point Social Security would be declared legally insolvent. The one practical effect of legal insolvency is that, by law, benefits must be held to the level of Social Security revenues once the balances of trust fund promises are depleted. Current estimates indicate that insolvency would trigger a precipitous reduction in benefits of 26 percent in 2041. Those are trustee estimates; CBO has a later-date insolvency, and somewhat lower initial decline in benefits. If Congress at that time chose to change the law and legislate higher taxes to close the gap, a payroll tax increase of 34 percent would be required, an increase in the combined payroll tax from about 13 percent to about 18 percent.

One lesson to be learned from the financial history of Social Security is that we would not be in this fix if we had a prefunded system. If the Baby Boomers had started out making contributions into their own individually held accounts, their savings would have been invested in assets that eventually provide retirement income. Social Security, which is funded as a pay-as-you-go basis, shares many of the same problems faced by the defined benefit plans of the troubled airline and auto workers pensions. Benefits are promised, but the funding that will be needed to pay for them is not necessarily there when the time comes.

The trust fund has no mechanism for prefunding benefits, nor would it be feasible or desirable for the Federal Government to purchase and hold assets from private markets. The only way for the Federal Government to prefund benefits is through individual accounts, in which each worker's contribution would go directly into an investment that cannot be directed to pay for other government programs but would grow in value over time and eventually contribute to the worker's own retirement income. For reasons such as these, prefunded, defined contribution plans have become the dominant type of pension plan in the private sector and the proportion of workers participating in defined benefit plans has sharply declined.

Several concerns have been raised about the substitution of prefunded individual accounts for a portion of traditional Social Security benefits. Some argue that because workers cannot be certain of the ultimate value of the private accounts, they are better off with the safe benefit promised under our current system. Benefits under the current program are not risk-free. Today's young workers cannot be sure what the level of taxes and benefits will be over the next 40 years. The state of the economy and the world situation, as well as the political inclinations of the public and of future lawmakers, are uncertain, yet are bound to affect the future benefits that can actually be paid. Risk is present in private market in-

vestments, but can be minimized by well-known techniques of diversification. Moreover, based on past history, the average return to private investment securities can be expected likely to exceed the return that Social Security benefits will bring relative to tax payments made.

Another concern is the transition cost that arises when a portion of taxes is diverted to private accounts and additional funds from either general revenues or government-issued debt must be obtained to fund the benefits of existing retirees. However, these transition costs are not a dead-weight loss. When the workers who have contributed to individual accounts retire, no tax payments will be needed to pay for the portion of their benefits that was prefunded. The transition costs may be viewed as an economic investment that will lower government costs in the future and will benefit saving and encourage economic growth.

In my view, there are two significant changes that should be made. One is to begin a transition to at least a partially prefunded system. With prefunding we can look forward to a period when a significant portion of Social Security benefits will not be subject to unfavorable demography and constant political crises. Workers would gain by receiving a higher return on their savings in a more flexible form. Society would gain from increased economic growth. The second change needed is to contain the costs of the pay-as-you-go portion of the system while maintaining an adequate safety net. Under our current wage indexed system, benefits are automatically set to replace about 40 percent of the average retiree's earnings no matter how high the earnings get of all future retirees. In 40 years, the average worker at retirement is expected to receive a benefit that is 50 percent higher than that of the retiring worker today. A plan such as progressive indexing would reduce the growth of benefits awarded to the average retiring worker while enhancing the benefits of low-wage earners.

The provision of benefits at the high levels currently scheduled goes far beyond Social Security's original mission of poverty prevention. In signing the original law, President Roosevelt said, "We can never ensure 100 percent of the population against 100 percent of the hazards and vicissitudes of life. We have tried to frame a law which will give some measure of protection to the average citizen and to his family against the loss of a job and against a poverty-ridden old age." At this point in time, doing nothing is not a sensible option. It ultimately would result in a sudden sharp decline in benefits when the program reaches legal insolvency. Major changes in retirement plans must be made enough in advance so that workers have time to adjust their work plans and savings. The time for planning and for reform is now. Thank you.

[The prepared statement of Dr. O'Neill follows:]

Statement of June O'Neil, Ph.D., Wollman Distinguished Professor of Economics, Baruch College, City University of New York, New York

Mr. Chairman and Members of the Subcommittee:

I appreciate the opportunity to appear before you today to discuss problems concerning the Social Security system. For many years projections of the long-term financial status of Social Security have indicated that the benefits scheduled under current law cannot be fully funded by scheduled tax revenues. Yet the point in time when the system will run deficits always seemed far in the future—a distant period when baby boomers become retirees. We are now rapidly approaching that period.

I will give a brief overview of the projected financial status of the program under current law and then comment on the economic issues raised by a mandatory retirement saving plan that is financed on a pay-as-you-go basis, under which the benefits of current retirees are funded by the taxes of current workers. Issues related to the financial status of Social Security and its "trust fund" frequently get the most attention. But fundamental questions need to be addressed concerning the economic costs of maintaining Social Security in its current form.

Projected Financial Status

Social Security currently is the largest program in the Federal budget. This year the program is estimated to spend $515 billion dollars, an amount that exceeds defense expenditures and accounts for 23% of total Federal outlays. In another five years Social Security will begin to grow more rapidly as the oldest wave of baby boomers starts retiring. By 2015, social security is projected to be 70% larger than it is today, accounting for 26% of the budget. Combined with Medicare, the two programs are expected to consume almost half the Federal budget in 2015. (Medicare is growing faster than Social Security and it is estimated that in 2015 will be about 85% as large as Social Security and eventually will overtake it.)

Despite its size, Social Security has not incurred funding problems for the past two decades. Although Social Security expenditures have been large, tax revenues from the payroll tax and from taxes paid on social security benefits have been even larger, generating substantial annual social security surpluses. The surpluses are partly the result of favourable economic conditions and favourable demography and partly the result of legislated tax increases. Regarding demography, the baby bust generation of the thirties has been reaching retirement age over the past decade while the baby boomers were still enlarging the size of the work force. In addition, increases in tax rates and coverage legislated in 1983 set in motion a flow of revenues that either accidentally or by design, produced surpluses for many years. Presumably the Greenspan Commission that recommended the bailout package—-Social Security was at that time close to default—believed that any surpluses would be saved to help fund the subsequent retirement of the baby boomers. But the surpluses have been used to fund other programs. At present the annual Social Security surplus is approaching $100 billion. It has significantly helped to mask the deficit in the non-Social Security side of the budget for most of the past two decades.

Figure 1 shows the past record and current projections of scheduled benefit payments and tax revenues from 1990 to 2080, based on the Trustees 2005 projections. The long period of Social Security surpluses is now expected to come to an end around 2015 as more and more waves of baby boomers are added to the beneficiary population. Between 2015 and 2020 the Social Security surplus fades and turns to deficits. If no changes in the program are legislated, the overall Federal budget will experience considerable strain from the added burden of funding the growing Social Security shortfall.

Expressed as a percentage of GDP, the small Social Security surplus of 0.2% in 2015 is estimated to turn into a shortfall or gap between scheduled benefit payments and tax revenues of 0.4% in 2020 (Figure 2). The gap then climbs quickly to 1.5% of GDP in 2035 and increases more slowly after that, reaching 1.9% of GDP in 2080.

How will we meet this shortfall? Some hold to the belief that we will not face a financing problem for more than three decades from now. But that belief is based on the accounting practices of the Social Security system that treat the balances in the so called "trust fund" as though they were actually available to fund the revenue shortfall. Unfortunately, the Social Security trust fund does not, and could not hold assets purchased in private markets that can be sold to pay benefits. The balances in the trust fund are bookkeeping entries showing the accumulated surpluses borrowed by the Treasury from the Social Security system plus the interest that would have been earned on those balances from investing in various Treasury securities. In other words, the trust fund holds promises. But the only way to make good on those promises is to raise general revenues or increase the publicly held debt. This will obviously entail a heavy fiscal burden starting in another 10 to 15 years, when social security begins running deficits. Thus our actual fiscal problem will start at least two decades before the projected date of legal trust fund insolvency.

Eventually the trust fund balances are projected to be exhausted, at which point Social Security would be declared legally insolvent. The Social Security trustees currently estimate that insolvency will occur around 2041, a date that undoubtedly will be altered many times. The one practical effect of insolvency on the program is that by law, benefits must be held to the level of social security revenues, once the balances of trust fund promises are depleted. If the law remains unchanged, that would mean a precipitous reduction in benefits of 26% in 2041 and 32% in 2079 (Figure

3). It should be noted that a change in the law that closed the gap between benefit costs and revenues in 2040 with a payroll tax increase would require a 34 percent increase (an increase in the combined payroll tax from 13.3% to 17.8%). The size of that tax increase would have to continue growing after 2040 to keep pace with increasing costs.

Basic Economic Issues

One major conclusion suggested by the pessimistic Social Security outlook is that we would not be in this fix if we had a pre-funded system. If the baby boomers had started out makingcontributions into an individually held account, their savings would have been invested in assets that eventually provide retirement income. But Social Security, which in many ways is similar to the troubled airline and autoworkers' defined benefit pension programs, is funded on a pay-as-you-go basis. The trust fund has no mechanism for pre-funding benefits. Nor would it be feasible or desirable for the Federal Government to purchase and hold assets from private markets. The only way for the Federal Government to pre-fund benefits is through individual accounts in which each worker's contribution goes directly into an investment that cannot be directed to pay other government programs, but would grow in value over time and eventually contribute to the worker's own retirement income. For reasons such as these, pre-funded, defined-contribution plans have become the dominant type of pension plan in the private sector as the proportion of workers participating in defined-benefit plans has dropped sharply.

Several concerns have been raised about the substitution of pre-funded individual accounts for a portion of traditional Social Security benefits. Some argue that because workers cannot be certain of the ultimate value of their private accounts they are better off with the "safe" benefit promised under our current system. But benefits under the current program are not risk-free. Today's young workers cannot be sure what the level of taxes and benefits will be over the next 40 years. The state of the economy and the world situation as well as the political inclinations of the public and of future lawmakers are uncertain, and are bound to affect future benefits. Risk is present in private market investments, but can be minimized by well-known techniques of diversification. Moreover, based on past history, the average return to investment expected, even with conservative strategies, is likely to exceed the return that Social Security benefits bring relative to the tax payments made.

Another concern involves the transition costs that arise when a portion of taxes is diverted to private accounts and additional funds from either general revenues or government issued debt must be obtained to fund the benefits of existing retirees. However, these transition costs are not a deadweight loss. When the workers who have contributed to individual accounts retire, no tax payments will be needed to pay for the portion of their benefits that was pre-funded. The transition costs should be viewed as an investment that will lower government costs in the future and will benefit saving and encourage economic growth.

Decisions We Must Make

In my view there are two significant changes that need to be made. One is to begin a transition to at least a partially pre-funded system. The die is cast for the financing problems of the near term. But with pre-funding we can look forward to a period when Federal retirement benefits will not be subject to unfavourable demography and constant political crises. Workers would gain by receiving a higher return on their savings and in a more flexible form. Society would gain from increased economic growth.

The second change needed is to contain the costs of the pay-as-you-go portion of the system program while maintaining an adequate safety net. Under our current wage-indexed system, benefits are automatically set to replace about 40 percent of the average retirees earnings, no matter how high the earnings get of our future retirees. For example, the earnings level and benefit award of the average worker retiring in 40 years is expected to be 50 percent higher than that of the retiring worker today. A plan such as progressive indexing would reduce the growth of benefits awarded the average retiring worker while enhancing the benefits of low wage earners.

Providing benefits at the high levels currently scheduled goes far beyond Social Security's original mission of poverty prevention. In signing the original law, President Roosevelt said: "We can never insure one hundred percent of the population against one hundred percent of the hazards and vicissitudes of life, but we have tried to frame a law which will give some measure of protection to the average citizen and to his family against the loss of a job and against poverty-ridden old age."

At this point in time, doing nothing is not a sensible option. In fact, it ultimately would result in a sudden sharp decline in benefits when the program reaches legal

insolvency. Major changes in retirement plans must be made enough in advance so that workers have time to adjust their work plans and savings.

Figure 1: Scheduled OASDI Cost and Revenue As a Percentage of GDP

(2005 Trustees Report)

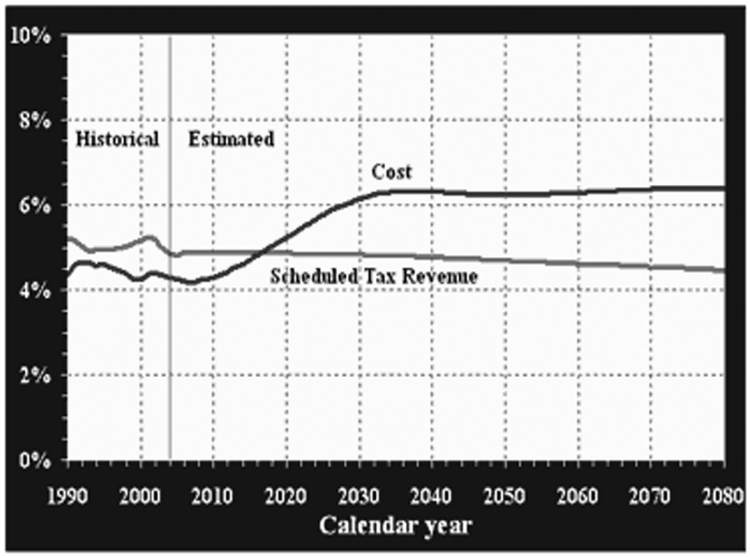
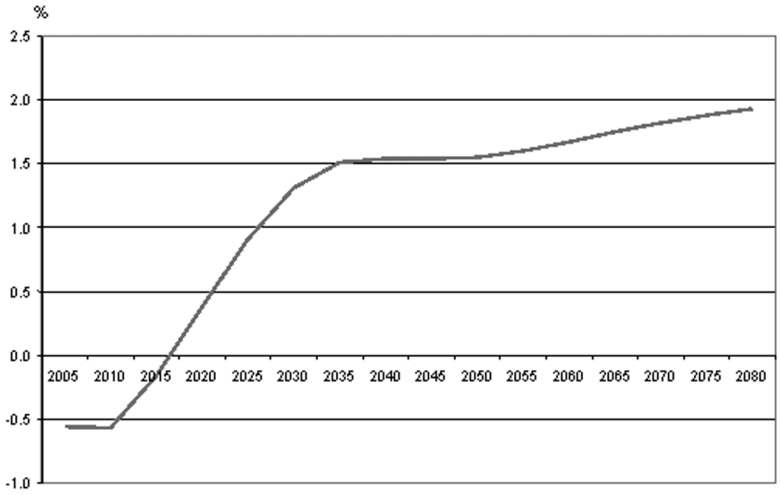


Figure 2: Social Security Gap (Scheduled Benefit Costs—Tax Revenue)

As a Percentage of GDP (2005–2080)

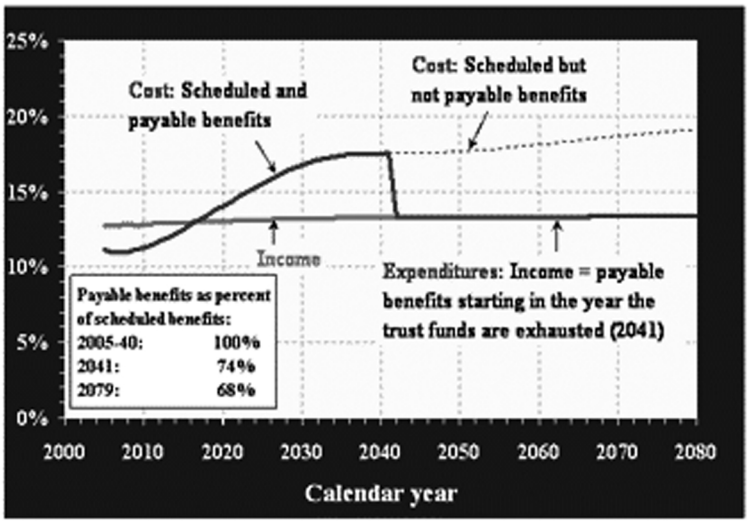


Source: 2005 Trustees Report.

Figure 3: OASDI Income and Cost Rates Under Intermediate Assumptions

(2005 Trustees Report)

(As a percentage of taxable payroll)



Chairman MCCRERY. Thank you, Dr. O'Neill. Mr. Entin?

STATEMENT OF STEPHEN J. ENTIN, PRESIDENT AND EXECUTIVE DIRECTOR, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

Mr. ENTIN. Thank you, Mr. Chairman, Members of the Subcommittee. I thank you for the opportunity to testify on the issue of Social Security reform. If your only concern is about the national budget and keeping the Old-Age and Survivors Insurance (OASI) program solvent for a few more years with minimal political fallout, then Congress must either raise taxes or cut benefit growth in some manner, as in 1977 and 1983. Those efforts did not improve the economy; they did not help your constituents on a permanent basis. We need to take into account not only how the economy affects Social Security, but how Social Security affects the economy, and how proposed solutions might impact your constituents and the economic performance of the Nation.

I would suggest that if you want to deal with the economic situation as well as the technical budget situation within Social Security, then your best bet would be to treat Social Security as an insurance program and a safety net, and strengthen those aspects of the system, but to spin off the retirement feature. Social Security is not real saving. Let younger workers put some of their tax money into real saving vehicles that offer a much higher rate of return and that, unlike Social Security, make the economy grow. I would also like to ask you, quite literally, why are we making a Federal case out of retirement saving? The government's interest in this is to keep people out of poverty in their old-age and to prevent them from needing public assistance. If this is the case, the mandated saving should only extend to achieving the socially acceptable minimal level of retirement saving. Any Federal retirement system should let people stop adding to the government-mandated accounts when they are big enough to provide whatever basic level of lifetime income Congress deems appropriate.

Mae West once said, "Too much of a good thing is wonderful." She wasn't talking retirement saving or Federal intervention in personal finances. Carve-outs should be large enough and accounts should earn enough to allow people to replace all of their Social Security retirement benefits. They should not be so large as to displace private pensions or Individual Retirement Accounts (IRAs). You don't have to do the whole thing. Some of the plans that have been offered are too small. They involve small carve-outs, low-yielding assets, and low-yielding retirement annuities. The personal accounts would offer only part of the Social Security retirement benefit, leaving a residual burden on the OASI system and future Congresses. The President's Panel Plan Two and the Graham Plan would have that drawback. Some plans are too big. They match the relatively high benefits and replacement levels promised low-income workers, but they overshoot for middle-and upper-income workers. The Ryan-Sununu Plan has an average carve-out of 6.4 percent; it could, if invested in stocks, yield replacement rates of 80 to 100 percent of pre-retirement income. You don't need to go that far. Perhaps something on the order of a 4-percent carve-out tilted a bit toward the low-income, a bit less toward the upper-in-

come, would do the job and would still induce most people to use the personal accounts.

Should you trim the benefit growth? Well, if you don't have personal accounts and just patch up Social Security, you are going to have to do that anyway. If you make the carve-outs and the private plans big enough to attract everyone into them, then it would in theory not be necessary to trim the promised benefits since nobody would be claiming them. If you don't trim the promised benefits, they get very high, as Dr. O'Neill has mentioned and as the chart I have reproduced from the trustee's Report in the back of my testimony shows. So, if you fail to trim the benefits it makes it harder for the new personal accounts to better the Social Security promises, and fewer people would switch into them. Wage indexing of the benefit formula and the projected 128-percent increase in real wages by 2080 would send benefits for some couples very, very high. An upper-income married couple could be getting over $109,000 a year from Social Security in today's money. We can't afford that, and the payroll tax hike that would be necessary to provide such a benefit would be outrageous. There are many ways to trim benefits. I have mentioned some in my testimony.

The economic outcome depends on how you do it. Do not cap the carve-out; you won't be giving any labor incentives to people above the limited amount of money covered by the amount of payroll tax diversion. The President's Panel Two Plan and the Graham Plan effectively omit labor incentives for people above $25,000 and $32,500. The Ryan-Sununu Plan extends its carve-out all the way up to $90,000 and has more labor force incentives. You mustn't neglect the labor force impact because the saving in investment impact is not so certain. The latter would depend on what you do with the money and how you handle the financing. The labor force effects of lowering the payroll tax are very well-known. As I mentioned, how you fund the transition is going to affect the economic outcome. Trimming government spending would free real resources and money to help the private sector expand and Gross National Product (GNP) would be about 2 to 3 percent higher over time. Borrowing would not do that. Raising other taxes, especially on capital at the margin, could cause GNP to fall by about 8 percent by the time the Baby Boomers is done retiring.

Don't assume that simply establishing personal accounts and prefunding will boost growth in tax revenues by increasing national savings and investment. Some of the saving would displace other saving. Businesses that borrow the saving might be fully invested in the United States, and expand abroad. If you couple the Social Security reform with better tax treatment of capital formation, you could ensure that the saving would occur, that it would not be borrowed back by the government if you trim government spending, that it would be invested in the United States, and then you might end up with GNP about 6 or 7 percent higher; over twice the gain from just having the personal accounts alone. Social Security reform and tax reform go hand in glove. Thank you.

[The prepared statement of Mr. Entin follows:]

Statement of Stephen J. Entin, President and Executive Director, Institute for Research on the Economics of Taxation

Congress has been asked to deal with the projected outyear deficits in the Social Security Old Age and Survivors Insurance program (OASI), and to help future generations better meet their retirement needs. It would be wise to take action now, while policy changes would have time to work, rather than wait until a crisis forces less benign choices on a future Congress. Before taking action, however, the Subcommittee needs to be clear about several things. What are the problems that you are trying to address? What policy options are available and what do they do? How can they be matched to the objectives?

What are the problems that you are trying to address?

Is your objective merely to deal with Congressional concerns about the Federal budget consequences of the OASI deficits? Is it merely to keep OASI solvent, more or less in its current form, for some period of time after the retirement of the baby boom generation, with minimal political fall-out? If these are the goals, Congress must either raise taxes dedicated to OASI, raise other taxes, trim OASI benefits, or trim other spending. There are an infinite number of ways to do this. Some combination of changes must be selected. In 1983, a compromise was agreed to under the cover of the Greenspan Commission. It merely bought time. It did not solve the System's long run problems, and paid no attention to the proposal's effects on the economy and the well-being of the population.

Are there additional objectives this time around? Should the solution enhance the retirement income of future generations? Should it improve the functioning of the economy? Should it give people more freedom and responsibility for their own welfare? Should it provide a permanent fix, throughout the 75 year planning period and beyond, rather than a temporary one as with the 1977 and 1983 Amendments? If so, you must address the solvency and budget issues in certain ways and not others, and go beyond solvency to address these other issues. In doing so, be very careful how you design your program to make it effective, affordable, and devoid of unintended consequences.

The interests of the public go beyond the narrow concerns of the Congress in these matters. Over the years, this Subcommittee has tried to study and address these more fundamental interests. Members of both parties have offered thoughtful and effective proposals. The Subcommittee's recent attention to the problem is most encouraging.

Hybrid nature of Social Security: a sound safety net, a shaky retirement system

Social Security combines a social safety net program and a retirement income program. The social safety net includes insurance features, such as disability and survivors' benefits, and income transfers to low income earners. The original purpose of Social Security was to prevent poverty among the elderly, a stark problem in Depression-era America.

To attract political support for what was then a revolutionary national welfare arrangement, President Roosevelt and Congress extended retirement benefits to most workers, not just to the needy. The immature system, with many workers and few retirees, could offer middle and upper income workers a good return on their contributions to gain support for the safety net system. The retirement benefits were to be only one leg of a three-legged retirement income program, however. The other two legs were pensions and private saving.

Today, the system is mature. A full complement of retirees is drawing benefits, and the recipients are living longer than ever before. The birth rate is down, and there are fewer workers per retiree. Today, the Social Security system remains an effective anti-poverty program and safety net. As a retirement program, however, it is now a bad deal, and getting worse. Today, the carrot for younger workers to support the safety net is to allow them to buy their way out of the retirement system, rather than to remain in it, and to put some of their tax money into real saving vehicles that offer a much higher rate of return.

Social Security is a pay-as-you-go tax-transfer system, in both its safety net and retirement features. Income is payment for production. When a transfer system shifts income from taxpayers to beneficiaries, it is effectively taking output from those who produced it and giving it to others. A real retirement system, by contrast, involves real saving. It is funded, not pay-as-you-go. People devote some of their current earnings to saving. They consume less than they produce, and support capital formation, boosting productive capacity. The capital adds to future output, and when the savers retire, they are still producing goods and services via the capital they own. Their income is not a transfer from others, it is payment for additional output

they are currently making happen. Substituting Social Security benefits for real saving has depressed capital formation (or made it more dependent on foreign saving), and has retarded productivity, wages, and GDP for decades. If done correctly, switching back to a system of real saving would boost capital formation and Americans' ownership of capital. It would boost productivity and wages too.

Role of government in retirement saving decisions today

Why are we making a federal case out of retirement saving? What reason is there for the Federal Government to concern itself with the saving and retirement decisions of individuals? The usual justification is a concern over moral hazard. Society will not stand by and let people suffer extreme poverty in old age. But society does not want people to take advantage of that fact, and does not want to pay for people who could have taken care of themselves. Thus, the government feels it has a right to force people to save when young to avoid needing assistance when old, and perhaps to make them buy an annuity so they won't fritter away the money or outlive it when they retire. This is a rather paternalistic attitude, piling one intervention (mandated saving) on top of another (the safety net). If this is the case for Federal involvement, the mandate should only extend to achieving the socially acceptable minimum level of retirement income. The government should not require people to do more, nor should it coopt other forms of saving.

How much saving should we mandate?

Mae West once said, "Too much of a good thing is wonderful." But she wasn't talking about retirement saving, or federal intervention in personal finances.

The program should let people stop adding to the government mandated accounts when they are big enough to provide whatever basic level of lifetime income the Congress chooses to set. Once an account holder is able to buy a minimum required annuity, or can fund a staged payout over his or her remaining life expectancy, that should be enough. The plan should then allow people to use the payroll tax diversion for anything they wish, i.e. an unfettered tax cut. (This feature is in the Chilean plan.) The plan should not make people contribute up to a specified retirement age no matter how large the accounts get.

Most plans only require individuals to annuitize a basic level of benefits, and leave them free to allocate the rest of their assets as they like, and that is good. But there is no public purpose served by forcing people to accumulate excessive funds in the government program in the first place. Let people use pensions, IRAs, and other saving plans for such purposes. Do not nationalize the retirement savings industry. Give people their freedom once they have met their mandated retirement needs.

How big a carve-out is needed? Should it be invested in high- or low-yielding assets?

Carve-outs should be large enough, and accounts should earn enough, to allow people to replace all their Social Security benefits. They should not be so large as to make transition financing unnecessarily difficult or to displace private pensions or IRAs.

Some plans are too small. Some plans recommend small carve-outs to minimize the apparent transition cost to the Federal budget. Some would make available low-yield investment options consisting mainly of government or corporate bonds. Such plans may be convenient for budget makers, and may satisfy people with a profound distrust of financial markets, but they do a disservice to the people.

Locking people into low-yielding assets as they work and save, and into low-yielding retirement annuities, would guarantee them a heavy saving burden when young and a low income when old. Their personal accounts might then deliver less than currently promised benefits, or even the reduced benefits that a trimmed down OASI system might offer. Their personal accounts would offset only a part of their Social Security benefit, leaving a residual burden on the OASI system. For example, the relatively small carve-outs and the contribution caps in the President's Panel plan 2 and the Graham plan, and presumed investment guidance, could keep the accounts from matching current benefit levels for many people. The carve-out should be large enough, and the investment options should be high-enough yielding, to generate a fund at retirement that can replace fully whatever retirement benefit would be available by remaining in Social Security. If Congress decides to trim the growth of future Social Security benefits for those who choose to remain dependent on the Social Security system, a lower carve-out would be needed to make the personal accounts more attractive than Social Security benefits.

Some plans are too big. Some plans propose large carve-outs to match the benefits and replacement rates given to low income workers, who receive higher replacement rates than higher earners under OASI. For example, the Ryan/Sununu plan

has an average carve-out of 6.4%, and, in a blended stock-bond fund, could match low income benefits currently promised. Another plan would let people put all 12.4% of the OASDI tax aside, including the Disability Insurance portion. Such carve-outs would over-shoot benefits and replacement rates currently promised to average and higher income workers, and far over-shoot what Social Security can pay at current tax rates, unless people could stop contributing to them once enough saving to generate a socially mandated basic retirement income floor was attained. (See tables 2, 3, and 4, below. Multiply the carve-out rates in the various plans by the potential replacement rates each percent of income saved could generate, and compare the results to what Social Security is promising.)

Furthermore, the accounts are assumed to be invested in fairly conservative blended funds before retirement, and low-yielding bonds afterwards. Such large carve-outs, if invested more in stocks, and in balanced annuities, would yield much larger retirement benefits. Replacement rates could reach 80 percent to 100 percent of pre-retirement income, and could coopt pensions, IRAs, and other private saving arrangements. We should not be proposing to take over the bulk of retirement saving in the revised Federal program. Too large a carve-out would also increase the transitional borrowing requirement or the amount of spending restraint needed to avoid the borrowing.

Just right? An average four percentage point carve-out, designed to be higher for low income workers, and lower for high income workers, should be more than sufficient to induce most people to use personal accounts, especially if benefit growth is trimmed to avoid payroll tax increases, and if stock investments are encouraged. (See Table 4, Alternative plan.)

Should promised benefit growth be trimmed?

If Congress makes the carve-outs and the resulting personal accounts so big that they will exceed everyone's promised Social Security benefits, and everyone will opt for them in lieu of benefits, it does not matter whether the regular benefits are trimmed or not. However, failure to trim benefit growth would make it harder for the personal accounts to beat what Social Security is promising, and less likely that people will switch. Bigger carve-outs would be needed, with a bigger explicit transition cost for the federal budget. That is something of an illusion, since we are shedding a corresponding Social Security promise (cutting the current unfunded obligation by $10.5 trillion at a cost of $2 trillion to $4 trillion). Still, it is less costly to trim the program back to what current taxes can now pay for. Furthermore, trimming benefits would reduce government intervention in the saving decision. Smaller benefits would mean that more people would get all their system-related income from individual accounts instead of SSA.

The attached table VI.F10 from the Social Security 2005 OASDI Trustees Report shows the projected growth in real retirement benefits under current law. These numbers are after inflation. Wage indexing of the benefit formula, coupled with a projected increase of 128% in real wages by 2080, will send real benefits soaring in line with wage growth. Add fifty percent for married couples getting a spousal benefit, and double the numbers for two worker couples each earning at the illustrative levels. Upper income couples could be getting over $109,000 a year, in today's dollars. To meet these benefits, the payroll tax would have to rise by six percentage points, a major blow to low income workers. Surely, some trimming of benefit growth could be done without injuring future cohorts.

If we are to trim benefits, how shoujld we do it?

Price versus wage indexing. The 1972 Social Security Act Amendments included an automatic mechanism that over-adjusted benefits for inflation, and replacement rates soared. Prior to the 1976 election and the 1977 Amendments, a panel headed by actuary William C. Hsiao addressed the error. Unions, SSA, and HEW recommended wage indexing worker's earnings histories and the "bend points" of a new benefit formula, keeping benefits growing with wages over time. The Hsiao panel and OMB recommended using a price index for those elements to keep the system solvent over time. The resulting benefits would still have risen in real terms, just not as fast as with wage indexing. (See the Report of the Consultant Panel on Social Security to the Congressional Research Service, Prepared for the Use of the Committee on Finance of the U.S. Senate and the Committee on Ways and Means of the U.S. House of Representatives, 94th Congress, 2nd session, August, 1976.) In an election year, President Ford opted for the more generous wage indexing. He lost the election anyway.

This old form of price indexing the benefit formula differs from the current proposals for price indexing benefits in the President's Panel plan 2 and the Graham plan. The new proposals would hold benefit growth to the rate of inflation, starting

in 2009. (It would keep wage indexing earnings and bend points, but lower the replacement factors in each bend point to offset inflation.) Cohort over cohort, future average wage workers would get the same real benefit as today's average wage worker; future low wage workers would get the same real benefit as today's low wage worker, and so on across all earnings levels.

A progressive price indexing plan has been suggested by Professor Robert Pozen. Benefits for the bottom 30% of the earnings distribution would be calculated as under current wage indexing. Benefits for the highest earners would be limited to price increases (as in this new form of price indexing). Benefits for workers between the 30th percentile and the top would be gradually scaled from the wage-indexed level to the price indexed level.

In 1994, Ways and Means Chairman Dan Rostenkowski and Social Security Subcommittee Chairman J. J. Pickle introduced measures to eliminate projected Social Security deficits. The Rostenkowski bill (H.R. 4245) slowed benefit growth for workers with average income and above by adding an additional bend point with a 10% replacement factor, and holding the growth of the top two bend points to a percent below wage growth for 50 years. The results roughly resemble the Pozen plan. The Pickle bill (H.R. 4275) gradually raised the normal retirement age to 70, which is another way to trim benefit growth. Other proposals would "index" normal retirement age to rising life expectancy.

To annuitize or not to annuitize, another key question

Too much of an annuity is a bad deal for retirees. One cannot leave an ordinary annuity to one's heirs; payments die with the recipient. Annuities can be designed to cover more than one beneficiary, or to guarantee a minimum return if the annuitant dies early, but such arrangements are expensive and complex. People should have alternatives, such as a paced withdrawal in line with life expectancy. If Congress insists on annuities, once a minimal anti-poverty annuity is purchased, a person should be free to use the rest of the account's assets as he or she wishes. But then, why make people accumulate that excess in the government sponsored plan in the first place?

Economic benefits demand careful design

Do not cap the carve-out. The most certain economic benefit from diverting a portion of the payroll tax to personal accounts will come from the added incentive to work and hire. For that to occur, however, the incentive must exist "at the margin," i.e., extend to the next dollar one might earn by working longer or harder. To that end, the carve-out must not be capped. The President's Panel plan and the Graham plan only reduce the effective payroll tax rate at the margin on incomes up to $25,000 and $32,500, and give no incentive to people with higher incomes. The Ryan-Sununu plan reduces the tax rate and extends the work incentives all the way up to the maximum covered wage of $90,000.

How the transition is funded will affect the economic outcome

Trimming government spending growth would free real resources to expand the private sector of the economy, funded by increased private saving. Borrowing would not free real resources, and would take back much of the saving in the personal accounts to pay for government operations. It would leave the economy slightly worse off over time. Raising other taxes, especially on capital, at the margin, would weaken the economy and reduce investment, employment and wages. For a more extensive discussion, see my testimony to the House Budget Committee Social Security Task Force, May 18, 1999. The attached Chart 1, adapted from that testimony, shows the impact of the various financing options on GNP.

To maximize gains in a global market, combine with tax reform

One cannot assume that simply establishing personal accounts will boost growth and tax revenues by increasing national saving and investment. Some of the saving will displace other saving that people are already doing. Some of the saving may be borrowed by the government. Some of the saving will back out some of the saving flowing in from abroad, or will flow abroad. Businesses that borrow the saving may be fully invested in the United States under current tax and regulatory regimes, and may expand abroad instead.

To ensure that the personal accounts increase U.S. saving, investment, wages, employment, and output, Congress should: trim spending instead of borrowing to fund the transition; accord the accounts the same tax incentives given to pensions and IRAs; improve the tax treatment of investment by moving toward expensing of investment outlays and by extending the relief from the double taxation of corporate income provided by the 15% tax rates on capital gains and dividends. In short, Social Security reform and fundamental tax reform work hand in glove. Each rein-

forces the other. Chart 2, adapted from my Task Force testimony, shows the impact of adopting expensing as well as personal accounts. The resulting increase in GNP is substantially larger than without adding that feature.

Some tables to guide the design of a proposal

Table 1 lists historical rates of return on various assets that could be included in investment options for personal accounts. Compare these to the 2% return in OASI, which is the sum of population growth and productivity/real wage growth. Table 2 presents mixes of assets that would result in various rates of return. It also shows how much retirement income could be replaced, for each percent of income saved while working over a 45 year period, if invested in these mixed funds. Table 3, top section, shows the replacement rates that Social Security is promising to people at various levels of income, and how much it can actually deliver at current tax rates. The bottom section shows how much of a carve-out would be needed to match the Social Security replacement rates in personal accounts, at the various rates of return. Table 4 shows the carve-outs contained in various Congressional proposals.

Table 1: Average Annualized Returns on Assets, 1926–2004 (Ibbotson Associates)

	Nominal	Real
Large company stocks	10.4%	7.2%
Small company stocks	12.7%	9.4%
Long term corp. bonds	5.9%	2.8%
Long term govt. bonds	5.4%	2.3%
Intermediate term govt. bonds	5.4%	2.3%
U.S. Treasury bills	3.7%	0.7%
Inflation	3.0%	n.a.

Table 2: Returns on various portfolios of assets, and replacement rates for each % of income saved

Portfolio mix: Percent Stocks and Percent Bonds*	0/100	40/60	60/40	75/25	95/5
Approximate real return during accumulation	2.5%	4.5%	5.5%	6.5%	7.5%
Payout as % of pre-retirement income (replacement rate), annuity in bonds (real return of 2.5%), for each % of income saved*	4.0%	6.5%	8.6%	11.3%	15.0%
Payout as % of pre-retirement income (replacement rate), annuity in mixed portfolio (real return of 4.5%), for each percent of income saved*	4.8%	7.8%	10.3%	13.5%	18.0%

*Stocks roughly 2:1 large company: small company; Bonds roughly 2:3 corporate: government. Assumes income rise 1.1% a year in real terms. Assumes 20 years average lifespan in retirement.

Table 3: Social Security replacement rates for retirees with various earnings histories, as promised under current law and as funded under current tax rates

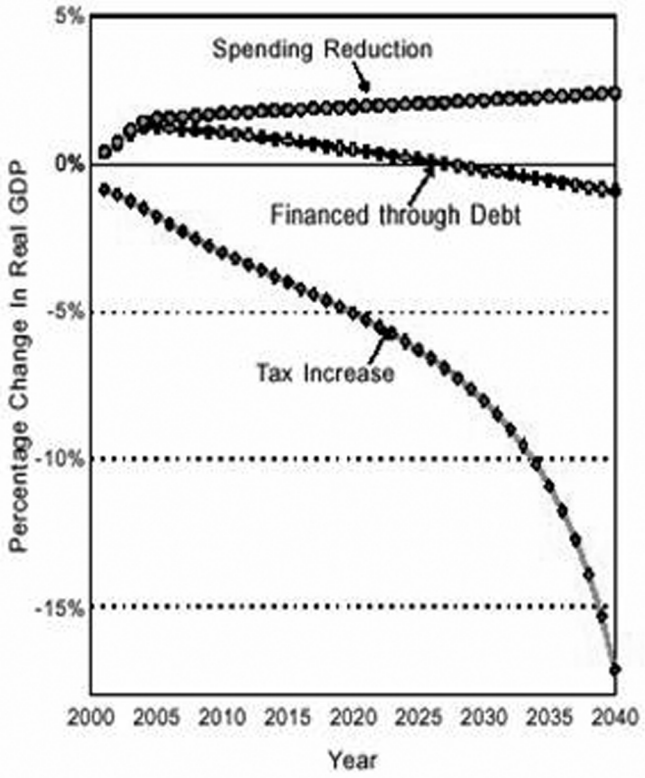
Income categories, 2005:		low wage* ($15,820)	average wage* ($35,157)	high wage* ($56,251)	max. wage* ($90,000)
Promised replacement rate:		55%	41%	34%	27%
Funded replacement rate:		38%	28%	23%	18%
Percent of income (required carve-out) that must be saved in working years in various portfolios to equal Social Security's promised/funded replacement rates (above). Top line assumes an annuity with a 2.5% real return (all bonds) and bottom line assumes an annuity with a 4.5% real return (60/40 stocks/bonds)*					
0/100	2.5%	13.9%/9.6%	10.3%/7.1%	8.6%/5.8%	6.8%/4.5%
stocks/bonds	4.5%	11.6%/8.0%	8.6%/5.9%	7.1%/4.8%	5.7%/3.8%
40/60	2.5%	8.4%/5.8%	6.3%/4.3%	5.2%/3.5%	4.1%/2.8%
stocks/bonds	4.5%	7.0%/4.8%	5.2%/3.6%	4.3%/2.9%	3.4%/2.3%
60/40	2.5%	6.4%/4.4%	4.8%/3.3%	4.0%/2.7%	3.2%/2.1%
stocks/bonds	4.5%	5.4%/3.7%	4.0%/2.7%	3.3%/2.2% 2.6%/1.8%	
75/25	2.5%	4.9%/3.4%	3.6%/2.5%	3.0%/2.0%	2.4%/1.6%
stocks/bonds	4.5%	4.1%/2.8%	3.0%/2.1%	2.5%/1.7%	2.0%/1.3%
95/5	2.5%	3.7%/2.5%	2.7%/1.9%	2.3%/1.5%	1.8%/1.2%
stocks/bonds	4.5%	3.1%/2.1%	2.3%/1.6%	1.9%/1.3%	1.5%/1.0%

*Uniform low wage earner at 45% of average wage; high wage earner at 160% of average; maximum earner at covered wage cap. Figures for 2005, Social Security OASDI Trustees Report.

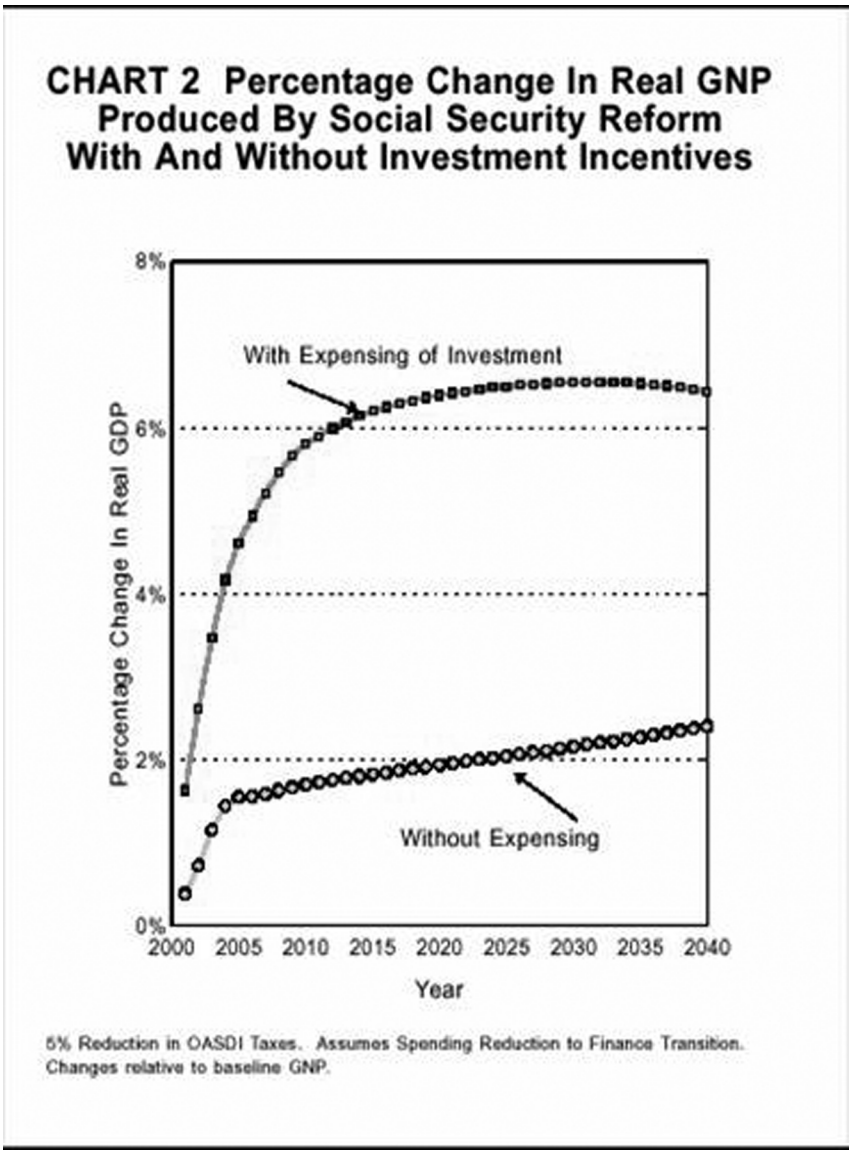
Table 4: Carve-out Rates Under Various Reform Plans

Income categories, 2004:	low wage	ave. wage	high wage	max. wage
Social Security Panel Plan 2: 4% of wages up to $1,000 contribution (covers 1st $25,000 of wages)	4.0%	2.8%	1.8%	1.1%
Graham: 4% of wages up to $1,300 contrib. (covers 1st $32,500 of wages)	4.0%	3.7%	2.3%	1.4%
Ryan/Sununu: 10% of 1st $10,000 of wages, 5% of remainder up to max. wage	8.2%	6.4%	5.9%	5.6%
Alternative: 10% of 1st $10,000 of wages, 2% of remainder up to max. wage	7.1%	4.3%	3.4%	2.9%

CHART 1 Percentage Change In Real GNP Produced By Social Security Reform Under Various Transition Funding Options



5% Reduction in OASDI Taxes.
Changes relative to baseline GDP.



Chairman MCCRERY. Thank you, Mr. Entin. Mr. Beach?

STATEMENT OF WILLIAM W. BEACH, DIRECTOR, CENTER FOR DATA ANALYSIS, THE HERITAGE FOUNDATION

Mr. BEACH. Thank you very much, Mr. Chairman. My name is William Beach, with The Heritage Foundation. Mr. Levin, Members of the Subcommittee, it is a pleasure to be with you this morning. I am going to continue to be a footnote to Steve Entin and talk

about taxes. My testimony today focuses on how raising taxes to pay for Social Security's expected financial shortfalls would likely affect major economic indicators. That is, what does the mainstream economic theory tell us about the likely effects on the general economy if Congress increases dedicated revenue flows to finance projected shortfalls between Social Security's income and its outlays? Research conducted by myself and my colleagues at The Heritage Foundation's Center for Data Analysis (CDA), shows that either raising tax rates or increasing the taxable income amounts comes with an economic price. Of course, so does the President's plan, but the economic costs are considerably different.

Social Security's trustees estimate that increasing the payroll tax rate by 1.9 percentage points to 14.3, roughly, percent, in total might be sufficient to make Social Security's Old-Age, Survivors and Disability Insurance (OASDI) programs solvent over the 75-year test period. This is the sort of small change that many opponents of reform, that is of structural reform, paint as a reasonable solution to Social Security's developing crisis. Using a mainstream model of the U.S. economy, Mr. Chairman, we at the Center for Data Analysis simulated the economic effects of a 1.9 percent point increase of the payroll tax on the general economy. It should come as no surprise to this Committee that a tax increase of this magnitude would increase the cost of labor in the economy and therefore have an impact on jobs. The CDA study found that a 1.9 percentage point increase in the payroll tax would reduce potential employment by roughly 277,000 jobs per year, on average, over the next 10 years, relative to the baseline—a baseline that we adopted from the CBO. There are spillover effects on economic growth as well. Increasing the payroll tax would reduce U.S. GDP, a broad measure of economic activity, by roughly $35 billion per year, on average, over the next 10 years.

Overall, raising the payroll tax would have a major impact on U.S. households. On average, every American would have roughly $302 less in disposable income per year for each of the next 10 years, amounting to over $1,200 less for a family of four. Raising the payroll tax rate is only one variant of the revenue-enhancement approaches to reform. Other proponents of tax increases argue that the amount of wages subject to the tax should be increased. This increase is what is called the maximum taxable income amount. It would in fact increase revenues, but again, come at an economic cost. The cost of eliminating the cap—let's just take that, for example—would, among other things, result in a very large increase, perhaps the largest tax increase in U.S. history, subjecting millions of Americans to a massive hike in overall payroll tax rates and, I fear, a very significant increase in the capital taxes. Among its effects, this would be a very large increase in taxes, as I have said—roughly $607 billion over 5 years, and $1.4 trillion over our 10-year period in our model.

It would, oddly enough, fail to save Social Security from bankruptcy. Social Security would start paying out more in benefits than it collects in 2025, only eight years later than under the current system. Attached to my written testimony is a graphic to that effect. It would increase the top effective Federal marginal tax rate on labor income to over 50 percent, its highest level since the sev-

enties. It would reduce the take-home pay of 9.8 million workers by an average of $4,200 in the first year alone after the cap is removed. It would weaken the U.S. economy by reducing the number of job opportunities and personal savings significantly. In fact, in fiscal year 2015 in our model, in the number of job opportunities lost would exceed 965,000 jobs. Personal savings, adjusted for inflation, would decline by $55 billion.

Opponents of real or structural Social Security reform are right in the sense that we can make small changes to the system—there is certainly that. They are, in a sense, misleading because they are not talking about the economic consequences of those small changes, particularly on the tax side. The changes may indeed be small, or seemingly small, but the numbers involved are, in the last analysis, enormous. Raising the payroll tax or the maximum taxable income limit enough to fully fund Social Security would put a damper on savings, jobs, and economic growth, to the great detriment of working Americans. Raising taxes enough to take Social Security's cash flow problems off the table would require even more sacrifice. I am happy to answer questions.

[The prepared statement of Mr. Beach follows:]

Statement of William W. Beach, Director, Center for Data Analysis, The Heritage Foundation

The salutary news from Capitol Hill this summer is the steady movement toward reforming Social Security's Old-Age Program. Despite news stories and public opinion polls, many Members of Congress in both parties have pushed forward with serious debate over Social Security financial future and analysis of ways to make that future more secure. Everyone who cares about Social Security's retirement programs applauds that effort.

Indeed, it appears likely that the principal bill writing committees of the House and Senate may complete work on reform legislation over the next few months. Given that increasing probability, it is important now to consider the ramifications of reform plans on a host of factors, not the least of which is U.S. economic activity.

My testimony today focuses on how raising taxes to pay for Social Security's expected financial shortfalls would likely affect major economic indicators. That is, what does mainstream economic theory tell us are the likely effects on the general economy if Congress increases dedicated revenue flows to finance projected shortfalls between Social Security's income and its outlays?

Why start with the question rather than with one focusing on the economic effects of using higher taxes to fund the transition costs to an improved Social Security retirement program? Clearly, Congress will need many answers to this question. However, I believe it should first ponder an often heard "reform" to the current system that its advocates claim would avoid any necessity for embracing Personal Retirement Accounts: raise taxes to fill in the financing shortfalls either by increasing the payroll tax rate or raising the maximum taxable income amount.

Research conducted by me and my colleagues at Heritage's Center for Data Analysis indicate that either approach to revenue enhancement comes with an economic price. Of course, so does the President's plan. The economic costs, however, are significantly different.

President Bush proposes to solve the problem of Social Security's unfunded liabilities by enacting a reform plan that includes personal retirement accounts (PRAs). Proponents of PRAs argue that this sort of reform would increase national savings, bolster employment, and improve economic growth, all while closing Social Security's funding gap. Opponents of the President's approach argue that Social Security's funding problems do not demand wholesale reform and that Social Security's shortfall is only a "challenge" that can be addressed by making small changes to the current program.

One such change that has been proposed would be to raise payroll taxes enough to render Social Security solvent. Opponents of real reform are right that raising payroll taxes could close a portion of Social Security's funding gap, but they are wrong in saying that doing so would require only a small change. Raising payroll taxes would make Social Security a worse deal for millions of working Americans,

harm the economy, and cost thousands of jobs, and still would not fix Social Security.

Social Security faces an unfunded liability of $3.7 trillion in today's dollars over the next 75 years. This number represents the amount that the system, despite having promised the money to America's workers, will be unable to pay. Short of major reforms, raising taxes or cutting benefits are the only ways to close this funding gap.

Right now, workers pay a 6.2 percent tax on their wages up to $90,000 to fund Social Security. Employers pay an additional 6.2 percent tax. This division in the payroll tax is artificial, however, as employers regard their part of the payroll tax as an expense of hiring, just like wages and other benefits: In other words, it is money that the employer is willing to spend on his workers. Though workers see only a 6.2 percent deduction on their pay stubs for Social Security, they really pay the whole 12.4 percent tax in terms of foregone wages.

Social Security's Trustees estimate that increasing the payroll tax by 1.89 percentage points, to 14.29 percent in total, would be sufficient to make Social Security's Old Age, Survivors, and Disability programs solvent.[1] This is the sort of "small change" that opponents of reform paint as a reasonable solution to Social Security's developing crisis.

The average worker might disagree. If payroll taxes were increased by 1.89 percentage points, a worker earning $35,000 would forego an additional $662 in pay every year. Raising payroll taxes by 1.89 percentage points would cost this worker, on average:

- As much as he spends on gasoline over three months;
- As much as he spends in two and a half months on clothing;
- As much as he spends in one month on food for consumption at home; or
- As much as he spends in two months on food outside of the home.[2]

In other words, this "small change" in the payroll tax would have a major impact on most workers' household budgets.

Using the Global Insight U.S. Macroeconomic Model, economists at The Heritage Foundation's Center for Data Analysis simulated a 1.89 percentage point increase in the payroll tax.[3]

It should be no surprise that a tax increase of this magnitude would increase the cost of labor in the economy and thereby have an impact on jobs. The CDA study found that a 1.89 percentage point increase in the payroll tax would reduce potential employment by 277,000 jobs per year, on average, over the next 10 years relative to the baseline.

There are spillover effects on economic growth as well. Increasing the payroll tax would reduce U.S. gross domestic product (GDP), a broad measure of economic activity, by $34.6 billion per year, on average, over the next 10 years.

Overall, raising the payroll tax would have a major impact on U.S. households. On average, every American would have $302 less in disposable income per year for each of the next 10 years, amounting to over $1,200 per year for a family of four. Personal savings would also decline in the aggregate by $46.9 billion per year, on average, over the next 10 years. Ironically, this decline in savings would make worse the very problem that Social Security is intended to fix—workers retiring with insufficient savings.

Raising the payroll tax rate is only one variant of the revenue enhancement approach to reform. Other proponents of tax increases argue that the amount of wages subject to the tax should be increased. This increase in what is called the maximum taxable income would, indeed, increase revenues.

However, the amount of the increase falls far short of expectations. Using SSA's own projections, Heritage analysts found that eliminating the cap would generate only enough revenue to delay the date of the system's insolvency by eight years,

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[1] The Trustees base this estimate on a 75-year time horizon.

[2] Data taken from U.S. Department of Labor, Bureau of Labor Statistics, Consumer Expenditure Survey.

[3] These estimates are preliminary and subject to change. CDA used the Global Insight, Inc., U.S. Macroeconomic Model to conduct this analysis. The methodologies, assumptions, conclusions, and opinions in this report are entirely the work of Heritage Foundation analysts. They have not been endorsed by and do not necessarily reflect the views of the owners of the model. This analysis was conducted by Tracy Foertsch and Rea Hederman of the Center for Data Analysis.

from 2017 to 2025. Under the current law, by 2041, the OASI program would receive only enough revenue to pay 74 cents on every dollar in promised benefits.[4]

Yet the cost of eliminating the cap would be substantial. It would result in the largest tax increase in the history of the United States,[5] subjecting millions of American families to a massive hike in their payroll taxes and further reducing the already dismal rate of return to Social Security.[6] It would also negatively affect America's economic prospects, slowing U.S. output growth and eliminating hundreds of thousands of employment opportunities.

Specifically, eliminating the cap on taxable wages would:

- Result in the largest tax increase in U.S. history, raising $607 billion (in nominal dollars) over five years and just over $1.4 trillion over 10 years.[7]
- Fail to save Social Security from bankruptcy. Social Security would start paying out more in benefits than it collects in taxes in 2025, only eight years later than under the current system. (See Chart 1.)
- Increase the top effective federal marginal tax rate on labor income to over 50 percent, its highest level since the 1970s.
- Reduce the take-home pay of 9.8 million workers by an average of $4,206 in the first year alone after the cap is removed.
- Weaken the U.S. economy by reducing the number of job opportunities and personal savings.

By fiscal year (FY) 2015, the number of job opportunities lost would exceed 965,000, and personal savings (adjusted for inflation) would decline by more than $55 billion.

But the problem is even more fundamental: Social Security's very structure is such that even all this sacrifice would not be enough to save it. Currently, the system is in a cash-flow surplus, which means that it takes in every year more money in taxes than it pays out. But these extra funds don't really accumulate. Instead, the government spends them and issues the Social Security Trust Fund special bonds, which are really just IOUs to pay back the money at a later date.

According to Social Security's Trustees, the system is set to have a negative cash flow beginning in 2017. To pay out promised benefits, it will have to cash in the government's IOUs, and the money to pay them will have to come from somewhere—either higher general revenue taxes (e.g., income taxes), lower government spending, or, ironically, more government debt. Because of the way the Trust Fund operates, raising payroll taxes would only delay the date when Social Security's cash flow goes negative. Future tax increases or benefit cuts would still be on the table.

Opponents of real Social Security reform are right, but also deeply misleading, when they say that the current system can be saved by making only small changes: The changes may indeed be small, but the numbers involved are enormous. Raising the payroll tax or the maximum taxable income limit enough to fully fund Social Security would put a damper on savings, jobs, and economic growth to the great detriment of working Americans. And raising taxes enough to take Social Security's cash-flow problem off the table would require even more sacrifice.

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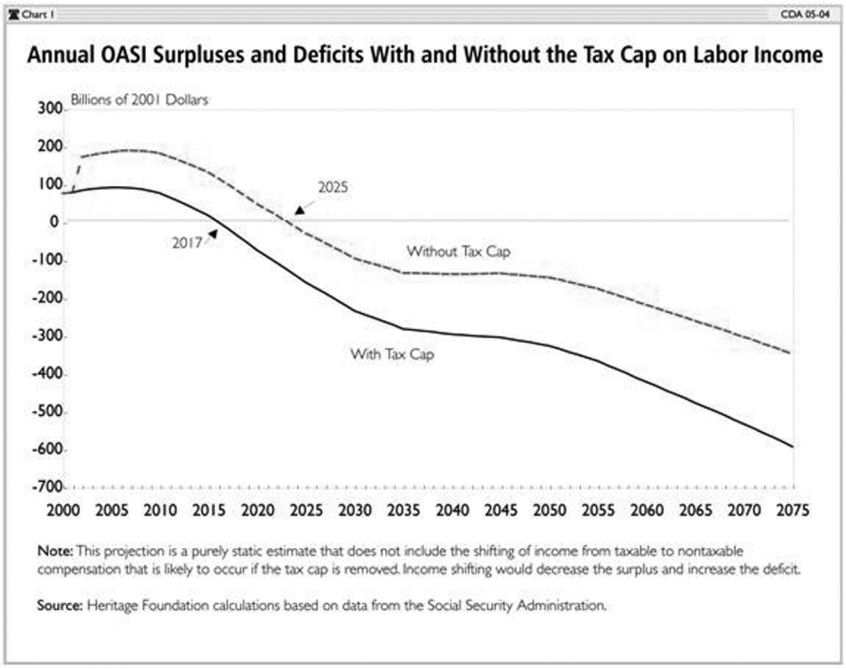
[4] Social Security Administration, *The 2005 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*, March 23, 2005, p. 8, at *www.socialsecurity.gov/OACT/TR/TR05/tr05.pdf* (April 11, 2005).

[5] Heritage Foundation calculation based on data from Social Security Administration, *The 2004 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*. This projection is a purely static estimate that does not include the shifting of income from taxable to nontaxable compensation that is likely to occur if the tax cap is removed. Income shifting would decrease the amount of revenue available to pay benefits.

[6] See William W. Beach and Gareth E. Davis, "Social Security's Rate of Return," Heritage Foundation *Center for Data Analysis Report* No. CDA98—01, January 15, 1998, at *www.heritage.org/Research/SocialSecurity/CDA98-01.cfm*.

[7] These revenue projections do not account for the negative effects of higher payroll taxes on economic growth and employment. They also do not account for any likely shifting of income from taxable wages and salaries to nontaxable fringe benefits like health insurance. As a result, the amounts of federal payroll taxes ultimately collected are likely to be less.



Chairman MCCRERY. Thank you, Mr. Beach. Mr. Price?

STATEMENT OF LEE PRICE, RESEARCH DIRECTOR, ECONOMIC POLICY INSTITUTE

Mr. PRICE. Thank you, Mr. Chairman and Members of the Subcommittee. I welcome the opportunity to appear before you and talk about this vitally important program and ways to think about addressing its problems. We economists generally agree on the theory, and largely agree to start the debate with the numbers coming out of the Social Security actuaries. We strongly disagree, I'm afraid, on this panel, with key interpretations of the data, and on the value judgments necessary for you to make in reaching policy decisions. So, I am going to spend my short 5 minutes on three major disagreements that I have with what I understand to be positions of several other panelists here and some people on this debate.

One is, I think the general approach of focusing the Federal Government on prefunding is misguided. Number two, I think that the coming burden of having more elderly people is quite manageable. Finally, I think that the costs of private accounts far outweigh the benefits as they have been proposed so far.

Let's talk about prefunding. Here I want to make clear that I am not talking about prefunding within the Social Security account system and creating a system that people think makes sense. We did prefunding in 1983, and we said we would have 37 years, the actuaries said in 1983 we would go into cash deficit in 2020. The

CBO says we are going to go into cash deficit in 2020. That was prefunding, it was planned, there is no crisis there. We need to think about the next 75 years and figure out how to handle that program. I am talking about whether our society today should prefund to prepare for the generation 30 and 40 years from now. On that, I think thrift can be overrated. Our per capita income today is only 55 percent of what it will be in 40 years. Per capita income today in Mississippi is about 55 percent—our lowest per capita State—55 percent of Connecticut. Now, should we tell the people of Mississippi that they need to be thrifty to help the consumption of the people in Connecticut? No. I don't think the logic makes any difference why people today should be sacrificing to raise money for the people who are going to have 80 percent higher income than them 40 years from now.

I think we ought to be focusing on our fiscal policy, on what makes sense for us today, managing our economy well today. We are not doing a good job of that. It should be based on what matters for our generation, not for 30 and 40 years from now, when we will be much richer. So even, though thrift is overrated, so can recent profligacy. We should be focusing on a fiscal policy that keeps our external debt to GDP from rising. They are both rising way out of sight. I have some charts in my report that confirm that. To the extent that we are contributing to national savings, those would be sensible things to focus on. They matter to us today. We should be concerned about today's generation.

Just as a quick aside, I just find that the history of the last 25 years, as some of the panelists here describe it, is just not the way I would read it. We were able to have substantial deterioration of our fiscal situation in the early days without a Social Security surplus. We spent most of from the mid-eighties to the early nineties improving our fiscal situation with the Social Security surplus, and I don't think that the problems we have had in the last 4 years of a rapidly deteriorating fiscal situation. As the CBO charts can show it, when you standardize, take away cyclical effects, we have had a huge 3.5 percent of GDP deterioration in our fiscal situation from policy. Those policies were bad for us today, and they are not—we shouldn't be worried about those so much because of the future, they are not good policy today.

Now, I have passed out some colored charts here, I think people say, well, we're going to have all these old people. I take 6 numbers from the actuary's report, and the ratio of people over 65 to the people 20–64 is going to rise 85 percent in the next 40 years. That sounds terrible when you just look at it in isolation. People don't often talk about, well, we are going to have productivity that is 91 percent as much; we are going to have fewer kids. The most burdensome people using up resources in our economy are the people who are working. They are using up more resources. They are traveling more, buying more cars, doing more—eating at fancier restaurants. The resources that we are using for older people are fairly modest in the economy as a whole. When we look at the total population, which is the right way to think about it, not the blinders on just the elderly, the total population relative to working-age population, that is going to rise 8 percent in the next 40 years. That is entirely manageable with an economy that is going to have

productivity that is 90 percent higher. We can manage this as an economy.

Now, that doesn't say we don't have serious fiscal problems, because you have the combination of a fiscal program in this government that is focusing on health care, primarily on elderly, and so when you combine having more elderly with rising health care costs, that is where the problem is, not in Social Security. We are focusing on entirely the wrong problem. It is not the demographic problem that presents a huge problem for us in the economy. It is health care. It is health care in the private sector for working people, just as much as for older people. We should be addressing health care and thinking about, you know, my wife is a physician. The technology that she is using today is totally different both in diagnosis and treatment from what she was taught 20 years ago. The technology 20 years from now has yet to be invented. We should be talking about how we change technology. Every other industry that has had rapid technological change—and surely medical technology is changing rapidly—has falling costs. We ought to be focusing our resources. We spend $30 billion a year at the National Institutes of Health (NIH) trying to find some guidance, in pages and pages of research guidance for NIH—that we should find ways to improve health but reduce the resources to do it. It is not there. We are improving health, but we are doing it and changing technology to eat up more and more resources.

We ought to be addressing health care costs and the technology 10, 20, and 30 years from now, and not be so focused on demography. We are going to have tremendous prosperity in the future. We can handle a few more old people, 8 percent more population, per working person. We do have to address health care for the private sector, for working people, as well as for the elderly and the budget.

[The prepared statement of Mr. Price follows:]

Statement of Lee Price, Research Director, Economic Policy Institute

Chairman McCrery, Ranking Member Levin, and members of the subcommittee, thank you for this opportunity to appear before you to discuss the economic conditions used to predict the future of Social Security and the merits of pre-funded benefits.

The late Herb Stein, who chaired the Council of Economic Advisers under Presidents Nixon and Ford, wisely recommended that we think in terms of "GDP budgeting." That is, we should not look at the federal budget in isolation, but in terms of how it is shaping the economy as a whole. Too often, our discussion falls into the trap of focusing solely on changes to government inflows and outflows and we fail to consider either the compounding or the dampening responses in the larger economy.

The fiscal challenge presented by Social Security represents a subset of the larger challenge of how our society will provide for more elderly people in the future. The consumption of future retirees will come almost entirely from the output of their working contemporaries. Retirees must finance their consumption through capital income, government transfers, or the generosity of their family and community. As we consider changes to Social Security, we should keep in mind the picture beyond the budget figures: How much pre-funding is realistic? Who stands to gain and who stands to lose? How much consumption should we sacrifice today to increase the consumption of more prosperous Americans in the future?

To prepare for a higher share of elderly people in our population, government policy should not focus on pre-funding but on providing stable macroeconomic conditions to facilitate strong economic growth. That means reducing the federal deficit enough to prevent the debt to GDP ratio from expanding. It also means managing the government's contribution to national saving in a way that keeps our foreign

debt from rising as a share of GDP. We have done a poor job on both fronts in recent years. The federal budget should keep those two debt burdens under control and leave private actors to decide how much saving they want to do for themselves.

After weighing the effects on these broader questions of the proposals by the President and others to change Social Security, I conclude:

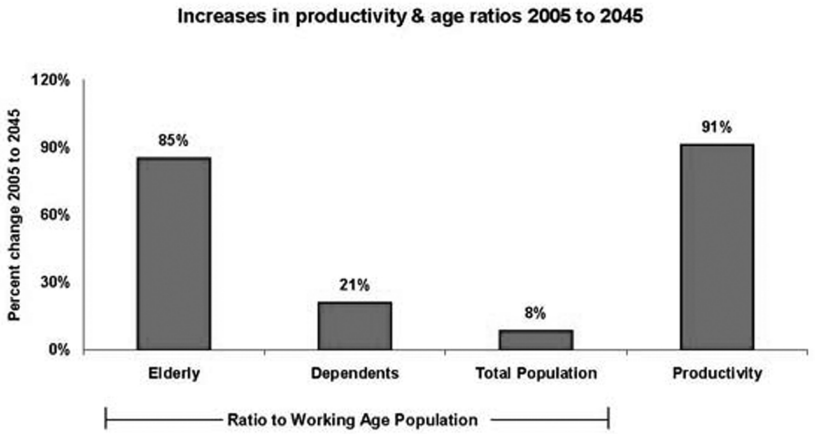
- Our society can manage the increase in the population over 65 relatively easily as an economic matter and with relatively modest difficulty as a fiscal matter because of productivity gains and the benefits of a smaller population under 20.
- Because middle—and low-income Americans rely so heavily on Social Security income, changes to the program should be made cautiously.
- The President's proposal on Social Security does not raise national saving and therefore does not improve the capacity of our economy to handle the coming increase in the population over 65.
- To "pre-fund" the costs of the Baby Boom's retirement, our society would have to produce more than we spend and, like the fabled ants, build up assets here and abroad to ease the transition to a more elderly society. Instead, we are worse than grasshoppers because we are eating up everything we produce and more.
- The federal budget contributed significantly to national saving in 2000 and 2001, but has subtracted from national saving in recent years.
- The President's proposal on Social Security requires substantial new federal borrowing with the goal of having middle-income retirees and survivors rely more on volatile capital income and less on more stable Social Security benefits.
- Were the President's proposal adopted, most Americans should decline the opportunity to create a personal account. Most people would come out losers most of the time because of the volatility of equity prices, interest rates, and inflation, plus the tendency to make bad investment decisions.
- Revenues of the Social Security trust fund are determined by the growth of wages[1] below the cap. The outlook for the trust fund has deteriorated since the early 1980s largely because wage growth has slowed and wages have become more unequal. The recent drop in the share of the population employed has hurt revenues.
- Future growth of trust fund revenues will depend on the growth of employment (for which immigration and the share of the population employed are the wild cards) and the growth of wages under the cap (for which productivity, the wage share of output, and spillover above the cap are important).

Demography presents a manageable economic problem

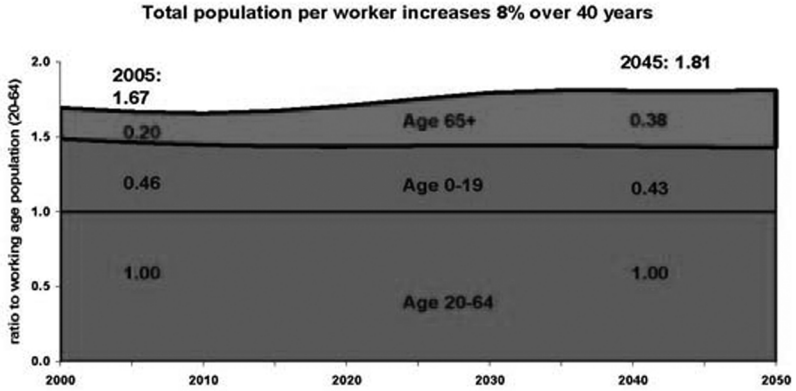
Doomsayers like to emphasize the demographic fact that the population over the age of 65 will soon grow much faster than the working age population. The numbers in this year's Social Security trustees report indicate that the ratio of the population over 65 to the population 20 to 64 will rise by 85% between 2005 and 2045. That extra burden sounds back-breakingly heavy when taken in isolation, but relatively modest when put in the proper context. First, consider the fact that the trustees' intermediate scenario projects productivity gains of 91% over that same period. That means that future workers will have far more income to share with the elderly.

Next, consider the fact that the working age population is not supporting just the elderly. Children are far more numerous than the elderly and their population will fall relative to the working age population. The trustees' intermediate numbers show only a 21% increase in the "dependency ratio," the ratio of the total of children plus the elderly relative to the working age population.

[1] Technically, wage, salary, and self-employment income are all subject to Social Security taxation. For simplicity, this statement often uses the term "wages" as short hand for all those forms of income.



Working age people must support themselves, too. They consume more per person than any other age group and their share of the population is shrinking. The ratio of the total population to the working age population offers the best measure of the economic challenge posed by demography. That measure rises by only 8% over the next 40 years. With productivity gains of 91%, future workers will have ample room to support an additional 8% more people per worker and still enjoy far greater prosperity than we have today.[2]

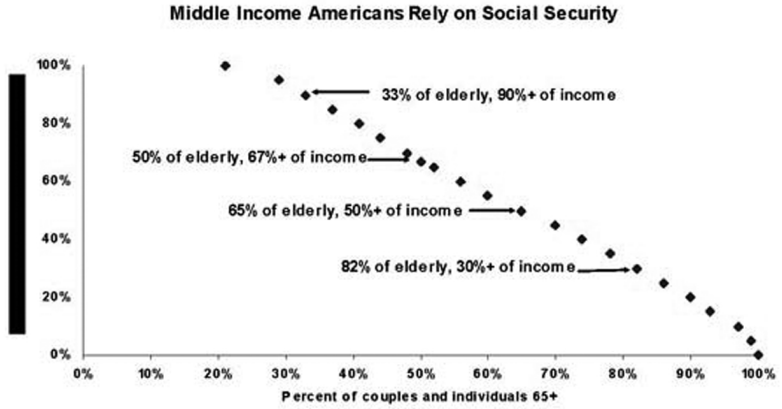


Demography has more pronounced effects on the federal budget than on the wider economy. As currently structured, programs aimed at children and middle-age people should shrink while those for the elderly grow. From that perspective, it is the compounding effect of demography with rising health care costs that presents a serious budget challenge. Assuming that the elderly should continue to obtain decent health, we should be developing policies that slow ballooning health care costs economy wide and not just squeeze on the federal budget part of the balloon. Taking the longer view, we can be confident that the medical technologies of two and three decades from now have not yet been invented. Other industries are raising quality while cutting costs. So can medical care. The Federal Government should use its considerable influence to foster new medical technologies that decrease rather than increase resource use. If we could change the path of medical technologies to make a significant dent in resource use in the future, that would have an enormous effect on future standards of living.

[2] For further analysis, see Spriggs and Price. 2005. "Productivity growth and Social Security's future." EPI Issue Brief No. 208, Washington, D.C.: Economic Policy Institute.

Proceed with caution: Middle-income Americans count on Social Security

Most people who have spent their working lives as middle-income Americans have come to rely on Social Security for their retirement income. One-third of Americans over the age of 64 receive at least 90% of their cash income from Social Security. For another one-third, Social Security supplies between 50% and 90% of income. Note that some of those people receive $20,000 from Social Security and $18,000 from all other sources. Such people would not be in poverty without Social Security, but they would notice a significant cut in benefits. The share of people with over half of their income from federal programs would no doubt be higher if we could also take into account the value of their health benefits.[3]



Source: EPI analysis of CPS data

The privatization plan put forward by the President would substantially cut benefits for middle-income Americans who opt out of a private account. As we explain later, the effective cut is probably even deeper for most of those who opt in to a private account.

Middle-income Americans nearing retirement saw their retirement income prospects improve markedly between 1989 and 2001, but not for the reasons often assumed. The boom in the stock market largely passed them by. Christian Weller and Edward Wolff recently analyzed the Federal Reserve's Surveys of Consumer Finances for trends in sources of wealth for those approaching retirement.[4] For those between the ages of 56 and 64, they found median private pension wealth (including both defined benefit and defined contribution plans) actually declined from $54,000 in 1989 to $48,000 in 2001. Median non-pension financial wealth went from $15,100 to $23,200. Despite increases in home values, increases in mortgage debt caused net home equity to rise only modestly (from $65,700 to $70,000) for the median household.

For the broad swath of middle-income Americans approaching retirement, Social Security accounted for most of their gains in wealth between 1989 and 2001. Weller and Wolff examined the sources of improved wealth for the middle 60% of households (those between the 20th and 80th percentile). This wider group includes some people who benefited modestly more from the stock market boom than those at the median. Yet, they found that, even for this broad group, the gains in estimated Social Security wealth dominated. Social Security wealth rose by $77,600, private pension wealth by $24,100, and all other forms of wealth by $28,500. For this group, the effect of the stock market was dwarfed by the effect of the strong labor market that caused wages to rise and, in turn, raised middle-income Americans' prospective Social Security retirement income.

It is no coincidence that Social Security is the largest program in the federal budget and that so many Americans rely so much on it. While the budget numbers

[3] For further detail, including numbers by state, for women, for minorities, and for persons over 74, see Ettlinger and Chapman. 2005, "Social Security Income and the Elderly." EPI Issue Brief No. 206, Washington, DC.: Economic Policy Institute.

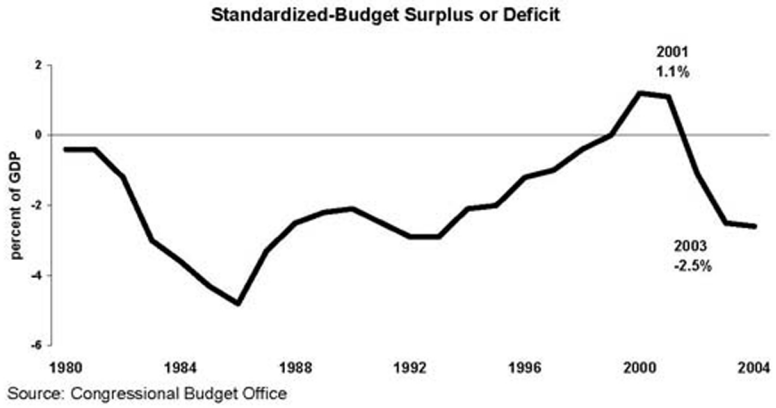
[4] Weller, Christian and Edward Wolff. 2005. "Retirement Income: The crucial role of Social Security." Washington, DC.: Economic Policy Institute..

have alarmed many politicians and economists, we cannot lose sight of what major changes to the program would mean to actual people who rely on it.

Fiscal policy switched from pre-funding to de-funding future consumption

Pre-funding requires sacrifices. Whether in the budget or in the economy as a whole, it entails less consumption today for the sake of more consumption in the future.[5] Rather than sacrifice now to pre-fund part of the consumption of future retirees, we have effectively been *de-funding* future consumption in recent years. The evidence for de-funding is clear, by both the government and the overall economy. The deterioration of our fiscal balance since 2001 reflects decisions favoring current consumption over future consumption. Likewise, the collapse in our current account balance financed by the deterioration of our net international asset position reflects economy-wide decisions to consume more now and less in the future.

The CBO has devised a measure to identify the effects of policy changes by excluding the effects of the business cycle and other transient effects. Fiscal policy is moving in the direction of pre-funding when this measure (the standardized-budget surplus or deficit) is rising and in the direction of de-funding when this measure is falling.



With help from the 1983 Social Security legislation, overall fiscal policy moved in the direction of pre-funding from the mid-1980s through 2001. We have moved in the direction of de-funding since 2001. The CBO estimates that the standardized budget had a balance of −3.0% of GDP in 1983 and hit a low of −4.8% in 1986. The policies that drove the standardized balance down between 1983 and 1986 had largely been adopted at the time of the Social Security agreement. Over the next 15 years, the standardized budget had an average deficit of 1.5% of GDP. While not a surplus the size of the Social Security surplus, that record showed an effort to pre-fund, or at least to stop de-funding future retirement costs.

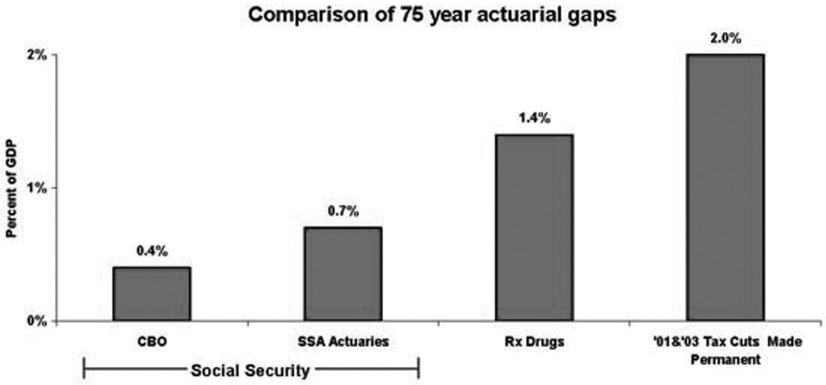
We should put the fiscal decisions since 2001 into the context of today's discussion of pre-funding Social Security. The standardized budget fell from a 1.1% of GDP surplus in 2001 to a 2.6% of GDP deficit in 2004, for a decline of 3.7% of GDP. The entire 75-year shortfall in Social Security has been estimated to be 0.7% of GDP by the SSA actuaries and 0.4% by the CBO. In other words, the fiscal policy changes between 2001 and 2004 worsened our fiscal balance by five to nine times as much as it would take to fully fund Social Security for 75 years.

In relationship to our deficit today and projected into the future, the funding shortfall for Social Security remains modest. If the goal is to address our long-term fiscal issues, we should paying more attention to health care and revenues, but not in the way those issues have been addressed in recent years.[6] Indeed, the enactment

[5] As discussed later, the case for public policy to impose sacrifice today on behalf of more prosperous future generations is problematic.

[6] For further analysis of the relative unimportance of Social Security in our larger fiscal challenges, see Sawicky, Max. 2005. "Big deficit, little deficit: The Bush budget and Social Security." EPI Snapshot May 23, 2005, Washington, DC.: Economic Policy Institute and Sawicky, Max. 2005. "Collision Course: The Bush budget and Social Security." EPI Briefing Paper No. 156, Washington, DC.: Economic Policy Institute.

of permanent tax cuts and under-funded prescription drug benefits stand out as decisions that favor consumption earlier rather than later, and they grow in cost. Over the next 75 years, the tax cuts have been estimated to create a shortfall of 2.0% of GDP. The prescription drug bill added another hole estimated at 1.4% of GDP. Clearly, our government has had other priorities than to pre-fund some of the Baby Boom's retirement.



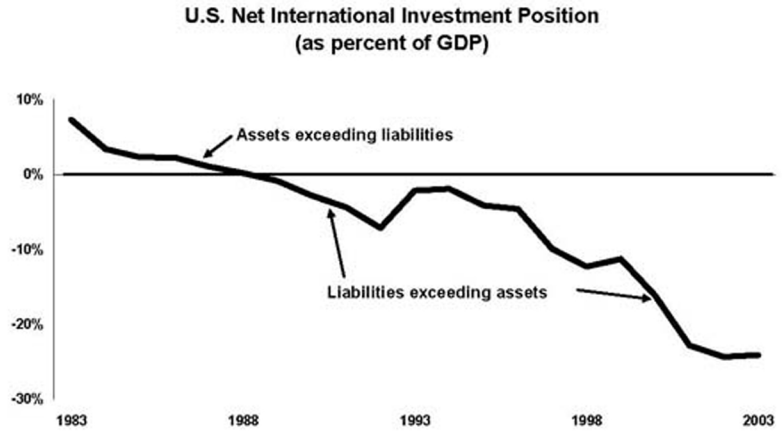
Source: Center on Budget and Policy Priorities

Economy-wide we've been de-funding for some time

Although our fiscal policy was moving in a favorable direction for pre-funding for the decade and a half prior to 2001, the same cannot be said for our nation as a whole. Last Friday, the government reported that we ran a current account deficit of $780 billion at an annual rate in the first quarter, a record 6.4% of GDP. In other words, we are spending 6.4% more than we produce as a nation. In contrast, Japan and Germany justify their large surpluses as appropriate preparation for the fast growth of their retired population.

Some have argued that an increased current account deficit is justified if it finances more investment in the U.S. That argument has both factual and theoretical flaws. As a factual matter, investment has not been particularly strong. Second, even if there were greater investment, it would be raising GDP (output within our

borders) but would not be raising the future income of Americans. To finance our habit of increasing consumption faster than our output and income, we are selling off assets in the U.S. at a rapid rate. Those assets give persons abroad an increasing claim to our future output. The value of foreign-owned assets here now exceeds the value of U.S.-owned assets abroad by $3 trillion, a quarter of our GDP. And we are going into hock abroad at a rapid rate. As we sell off our assets to maintain our trade deficit habit, we mortgage off our future GDP to people abroad.[7]



No pre-funding with private accounts

To my knowledge, no Social Security proposal under debate today provides for any significant pre-funding by reducing current national spending to finance higher benefits in the future.

The President's proposal creates private accounts with borrowing and not spending cuts. As the Administration has conceded, this proposal does not raise saving and therefore has no pre-funding. Because the President's latest budget actually raises the deficit over the next five years, it makes no effort at pre-funding the retirement of the Baby Boom.

Likewise, the proposal to create private accounts to the extent of the current $163 billion Social Security surplus would involve even more borrowing initially than the President's plan. A serious pre-funding plan would have an attainable sacrifice initially and grow over time. The plan to finance private accounts with the Social Security surplus starts out large and dwindles to nothing in a decade.

Pre-funding and fairness

Because the people who pay for pre-funding often differ from the people who benefit, we should carefully consider questions of fairness in proposals for pre-funding. Two fairness questions come to mind. First, what are the implications of changing the pre-funding arrangements of 1983? Second, how much should we sacrifice to future generations who will be far more prosperous than we are today?

Pre-funding played an important part in the 1983 compromise on Social Security. To achieve 75-year actuarial balance with the Baby Boom generation's retirement already looming, the 1983 agreement raised payroll tax revenues above expected benefit payments for the first half of the period to offset a revenue shortfall in the second half. To claim progressive benefits in retirement, the Baby Boom would have to pre-fund the system with regressive taxes. Now, after 22 years of paying regressive payroll taxes to pre-fund the system, Baby Boomers born after 1949 are being told that they must accept benefits cuts because of a newly found crisis: a cash shortfall. In fact, the actuaries projected in 1983 that program costs would first exceed revenues in 2020, the same year that CBO now projects. Despite many claims

[7] The net liability position did not rise in 2003 because of the rise in the dollar against currencies (particularly the Euro) with large U.S. assets abroad. Ultimately, large current accounts translate into deeper net liabilities.

to the contrary, it's hardly a crisis when the date for the end of the cash surplus has been known for 22 years.

Although thrift may always seem virtuous, the economic and moral case for prefunding is debatable. Consider this thought experiment. The Social Security trustees report projects that our per capita income will rise about 80% over the next 40 years. Per capita income in Connecticut exceeds that of Mississippi by about the same percentage today. No one would expect the people of Mississippi to sacrifice today so that the people of Connecticut can consume more today. Does it make any more sense for people today to sacrifice to raise consumption even higher in the future? It's one thing for us to decide to save as individuals, but it's another thing for you as representatives to decide that the nation must cut today's consumption for the sake of higher future consumption.

Most would lose money with the President's private accounts because of big risks

It is unlikely that most people would come out ahead if they chose to set up a private account as proposed by the President. People would be asked to bear substantial risks that they would not face if they opted out of creating a private account. In simulations by Professor Robert Shiller, investors in the President's plan would be expected to lose money 71% of the time. Using historical performance of global market indexes and projections of likely returns in a recent survey of experts by the *Wall Street Journal*, he estimated a median return of 2.6% above inflation, less than the 3.0% charged by the President's plan. (Note that Shiller's calculations do not reflect the decisions of actual people who, as explained below, tend to underperform a balanced portfolio of indexes.)

Some features of the President's proposal—and the attendant risks—have not received the attention that they deserve. Once a person opts to start contributing to a private account, she must do so until benefits are triggered by retirement, death or disability. If a 25-year-old decides to climb on board, they are strapped in to a roller coaster ride and cannot get off before they retire, die, or become disabled.

Consider the multiple ways that the President's plan exposes private account holders to risks of inflation. First, take the fact that people are charged interest at the rate of 3% plus inflation for any Social Security taxes diverted into a private account. Economists and accountants like to subtract inflation in making long-term forecasts because they don't have confidence in forecasting inflation. But the President's plan asks a 25-year-old who puts $1,000 into a private account to take a risk about the inflation charge for the 42 years until he retires. In the long term, stocks and bonds may adjust to higher inflation, but not in the short to medium term. For example, unanticipated inflation in the 1970s was accompanied by a bear market in stocks and a slump in bonds.

Second, there is the risk of inflation after benefits begin. Current Social Security benefits are indexed for inflation, which puts the risk of higher inflation primarily on the government. Recognizing the risks involved, the private market has been reluctant to provide inflation-protected annuities. If they are offered in the future, they will come at a hefty price in terms of reduced annuity payments.

Another risk involved with private accounts comes from the volatility of interest rates. When a person retires, her monthly annuity payment depends on the amount of money used to buy the annuity and the current interest rate. The lower the interest rate at the time of retirement and annuity purchase, the lower the annuity payment until death. A person who traded in a stock portfolio for an annuity in early 2000 would have a much higher annuity than someone who did so in recent years not only because stock prices have declined but because interest rates did, too.

Finally, in deciding whether to create private accounts with Social Security funds, Congress should consider the evidence that most people manage their investments poorly. Because they appear to buy and sell based on trends, they tend to buy high and sell low. This result holds not just for specific stocks but for broad mutual fund categories of the type proposed by the President.

Ironically, those most eager to manage their investments seem to do the most poorly on average. Recent polls suggest that men are more likely to support private accounts than women. But note that recent research has found that men were more active traders and had significantly lower returns on their accounts than women.

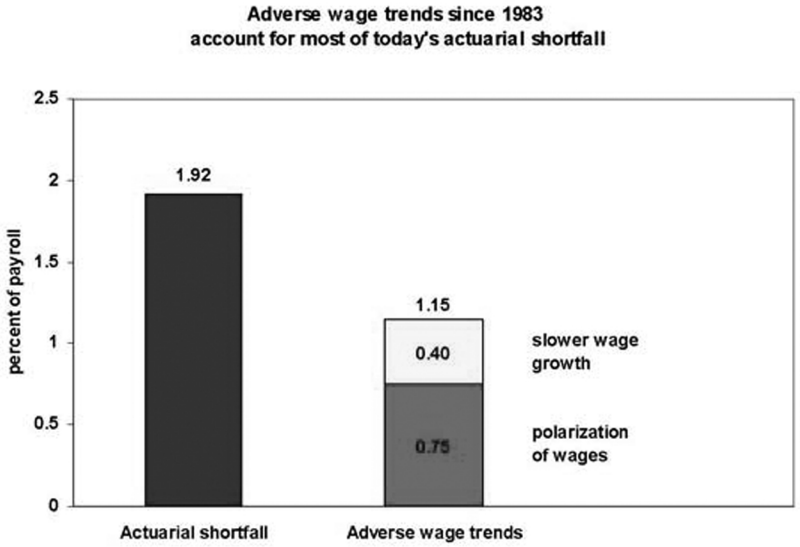
Private accounts have been touted as a "sweetener" to help the public accept sizeable benefit cuts that deepen over time. Given all the risks involved, however, people should assume that opening a private account will reduce their retirement income even further.

Average wage trends have hurt the Social Security trust fund

Two adverse trends in the labor market have had a substantial negative effect on the Social Security trust fund since 1983. The Social Security actuaries have estimated a 75-year shortfall of 1.92% of payroll. The Social Security trustees have lowered their projected growth rate for real wages from 1.5% in 1983 to the current projection of only 1.1%. Slower wage growth causes revenues to fall more than benefits within the 75-year window. SSA actuaries project that real wage growth of 1.5% in the next 75 years would narrow the projected shortfall by 0.40% of payroll—about a fifth of the projected shortfall.

The increased inequality of wage income has contributed even more to the shortfall. The cap on wage and salary income subject to Social Security taxes (now $90,000) has been rising with average annual earnings. Although the share of earners above the cap has remained about 6%, their earnings have risen much faster than average. As a result, the share of wage and salary income not subject to Social Security has risen from 10% to more than 15%. (Recent evidence for 2004 suggests this untaxed share has widened further.) SSA actuaries estimate that covering 90% of wage and salary income over the next 75 years would narrow the shortfall by 0.75% of payroll—two-fifths of the projected shortfall.

We would face a shortfall about 40% as large as they one projected today if, all else equal, real wages were still expected to rise at the rate projected in 1983 and wage and salary income had not become more unequal.[8]

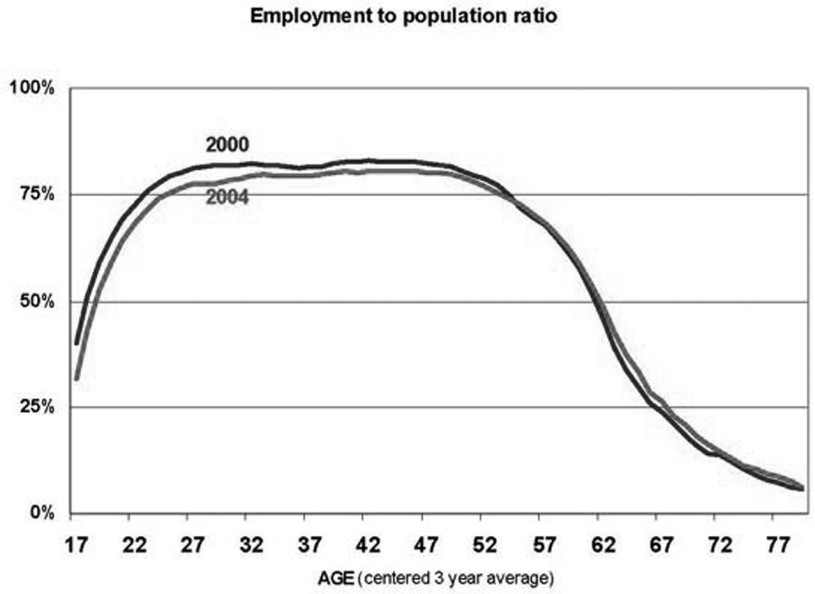


Future health of the trust fund depends on a healthy labor market

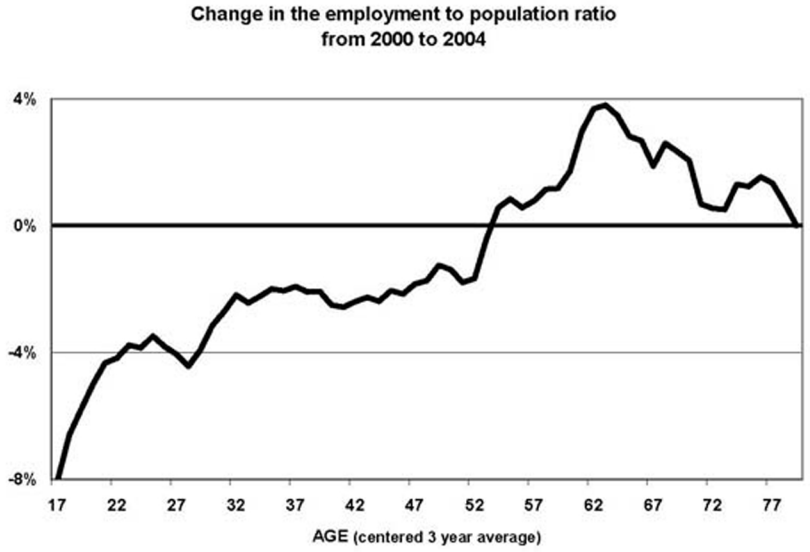
Social Security revenues are a function of how many people are employed and how much of their wage income is subject to Social Security taxes. The number of people employed is a function of the population and the share of the population employed. Immigration appears to present a bigger question mark for future population growth than domestic demography (births and deaths). The trustees projected immigration of 900,000 a year for each of the next 75 years in their intermediate projection and 1.3 million a year in their low-cost projection. With the population of the U.S. and the rest of the world growing and global transportation and communication becoming cheaper, it seems implausible that immigration would remain fixed. If immigration grows at a modest 1% per year from recent levels, it will more than triple the intermediate projection and double the low cost projection within 75 years.

[8] For further analysis, see Bivens, L. Josh. 2005. "Social Security's fixable financing issues: Shortfall in fund is not inevitable." EPI Issue Brief No. 207, Washington, DC.: Economic Policy Institute.

As a matter of logic and recent experience, the employment to population ratio matters more to future employment than the unemployment rate. In recent years, the unemployment rate has gone haywire as an indicator of potential employment. The chart below compares the employment to population ratio for each age level for 2000 and 2004. Note that in both years employment falls sharply well before age 62. This belies the comfortable assumption that people hold a steady job until they start claiming Social Security benefits at age 62.[9]



[9] For further analysis of this point, see Gould, Elise. 2005. "Many already lack a steady job before the Social Security retirement Age." EPI Snapshot June 15, 2005, Washington, DC.: Economic Policy Institute



Note also that the ratio was uniformly lower in 2004 for ages up to the mid-50s and uniformly higher for older ages. The second chart indicates the size of the 2000–2004 change for each age level. The decline was 2% to 4% of the population from the mid-20s to the mid-50s.[10] That represents a decline in employment for more than 3 million prime working age people. If we can restore normal job growth in the range of 300,000 jobs a month instead of the anemic 170,000 jobs of the last six months to a year, it would do wonders for the trust fund coffers. If the employment to population ratio remains depressed, it bodes poorly for the trust fund.

Wage income subject to Social Security taxes is affected by productivity, labor's share on income, the wage share of compensation, and the share of wages below the cap. Fortunately, productivity has improved markedly in the last decade. Labor shared in productivity gains in the 1990s, but its share of the gains since 2001 has been extraordinarily low. Squeezed by a falling labor share of income and rising health benefit costs, wages have grown slowly in recent years. The continued disappointment in wage growth despite strong productivity gains was a major factor accounting for the trustees' decision to advance the projected dates for the trust fund cash flow to turn negative and for the trust fund to be exhausted. On the other hand, if productivity gains of the last decade are sustained and labor's share of those gains reverts to historical norms, then the trustees' projections for taxable wages are too pessimistic.

The share of taxable wage and salary income below the cap represents another key variable. As noted earlier, people making income above the cap have enjoyed faster than average wage and salary gains since 1983. That trend abated somewhat with the downturn in financial markets and technology companies. This year's data on tax revenues and anecdotal information about a revival of bonuses and stock options suggest that the share of income above the cap is rising again.

Unlike other economic variables, the share of wages over the cap can readily be fixed by legislation. The cap does not have to move at the rate of average wages when high income wages are growing faster. The cap could be raised to maintain a fixed share of income above the cap or to restore the 90% coverage of 1983. If the cap is removed altogether, the trust fund would no longer be hurt by greater wage inequality.

Conclusion

Most middle-income Americans have come to rely on Social Security to protect their families in retirement, disability, or early death. In a world of topsy-turvy labor and financial markets, the Social Security system provides a port in the storm.

[10] Separate analysis shows no difference in the decline for men and for women.

Pre-funding the retirement costs of future retirees requires sacrificing current consumption in favor of future consumption. Policy decisions in recent years have turned in the opposite direction. Between 2001 and 2004, policy decisions reduced the federal budget balance by 3.7%, more than five times the annual average shortfall that SSA actuaries project for Social Security. Both the prescription drug legislation and the tax cuts of 2001–2003 have 75-year fiscal effects that are multiple times as large as the Social Security shortfall. As a nation, we are rapidly selling off our assets to persons abroad

The rhetorical argument that private accounts can materially offset the cuts proposed by the President does not bear close scrutiny. Indeed, if Congress enacts the President's plan for private accounts, the private accounts may have few takers because the odds are stacked against the typical investor coming out ahead of the "clawback" interest charge.

Economic variables important to the trust fund include immigration, productivity, the share of the population employed, the share of output received by labor, the share of labor compensation paid as wages, and the share of wages paid below the cap. The trustees were probably too pessimistic on the first two variables, but recent trends on the other variables are worrisome.

Of all the variables with a significant effect on the trust fund, the one most under the control of Congress is the amount of wage income above the cap. Congress should revise the formula for the cap to prevent future erosion. Eliminating the cap altogether would prevent increased wage inequality from eroding trust fund revenue. Otherwise, a return to a normal pattern of gains in both employment and wages would do wonders both for Social Security beneficiaries and for the trust fund.

Chairman MCCRERY. Thank you, Mr. Price. Now, Dr. Samwick.

STATEMENT OF ANDREW W. SAMWICK, PH.D., PROFESSOR OF ECONOMICS, AND DIRECTOR, THE NELSON A. ROCKEFELLER CENTER, DARTMOUTH COLLEGE, HANOVER, NEW HAMPSHIRE

Mr. SAMWICK. Mr. Chairman and Members of the Subcommittee, thank you for the opportunity to testify on the economic factors affecting Social Security's financing and the role of personal accounts in strengthening retirement security. I commend you for holding this series of hearings. I can imagine you must all be exhausted on your seventh out of eight. There is no better place for a bipartisan and comprehensive reform to start than in this Subcommittee. I would like to emphasize the following four points as an overview of my full written testimony.

The first point is that, while it is true that many demographic and economic factors affect Social Security's long-term finances, the most important drivers of the looming shortfalls are demographic—continued improvements in life expectancy and retirement, and fertility rates that remain around two children per woman. I see very little in the economy and society more generally to suggest that this demographic pressure is overstated. The reality of this demographic shift should guide our discussions about how to reform the system, and in particular, I think this demographic pressure should strongly motivate us to consider higher target ages of retirement for non-disabled workers.

Second, among the factors that are both important for Social Security's finances and subject to considerable uncertainty in their projections, the real wage differential is the most critical. While it is true that the ultimate assumption for the real wage differential of about 1.1 percent seems low, particularly relative to the productivity boom that we have experienced over the last decade, when

this number averaged 1.6 percent, any reasonable increase in the assumed rate of real wage growth would still leave a large hole in the system's finances. There really is no alternative to financing the projected retirement income of future beneficiaries other than preparing them to save more as a Nation and work more prior to retirement.

Third, the issue of whether to bring new moneys into the system, and whether to do so in the form of tax increases in the current system or contributions to a new system of personal accounts, is perhaps the most polarizing in the current debate. I can only offer my own perspective. The default outcome if we do nothing today is to wait until the fiscal consequences of running the current system with a retired population of Baby Boomers has become unmanageable. That could happen anytime between 2017, when the current system is first projected to pay out more in benefits than revenues are collected in taxes, and 2041, when the current system is projected to lose its authorization to pay benefits as scheduled without new legislation.

When that day of reckoning occurs, it will likely involve a combination of benefit cuts, tax increases, and delays in the retirement age, as in the 1983 amendments. However, compared to 1983, these changes will have to happen in greater measure and with more immediacy. We will have squandered the opportunity to envision a more modern retirement system that relies less heavily on pay-as-you-go financing. We will have done nothing to prepare a new generation of retirees for their lower retirement incomes. Worst of all, we will impose a tax burden on our children's generation that, with full knowledge of its likely appearance, we will have refused to address today. I wouldn't blame them if they refused to pay, or, in the face of higher taxes, they simply decided to work less.

Fourth, if we do not intend for retirement incomes to fall, and if we are unwilling to move Social Security's target retirement ages higher in the face of these demographic shifts, then the only option left is to increase saving today. There are two reasons why I believe that this additional saving should happen through personal accounts, whether inside or outside the Social Security system, rather than in the trust fund. The first is that in the last two decades the budget policies show quite clearly that the Social Security surpluses do not, as a rule, serve their intended purpose of lessening the burden on future generations. The availability of the Social Security surplus in the unified budget has encouraged the government to run larger deficits in the on-budget account. If new moneys are to be brought into the system, they have to be matched by an outflow to something like personal accounts to avoid this problem. If there is a so-called lock box, it seems that it has 536 keys; but more importantly, it has no lid. The second reason to favor personal accounts is that, if we are serious about restoring solvency to Social Security over the long term, not just postponing the date that the trust fund is exhausted outside the 75-year projection period, then the scale of investments required is simply too large to be managed in anything but a decentralized manner. Some rough calculations suggest that restoring solvency on a permanent basis would require the accumulation of an aggregate portfolio that

would be equivalent to about two-thirds of all mutual funds in existence today.

Mr. Chairman and Members of the Subcommittee, this concludes the overview of my written testimony, and I would be happy to answer any questions that you might have.

[The prepared statement of Dr. Samwick follows:]

Statement of Andrew W. Samwick, Ph.D., Professor of Economics and Director, The Nelson A. Rockefeller Center, Dartmouth College, Hanover, New Hampshire

The Impact of Economic Trends on Social Security's Financing and Retirement Security

Mr. Chairman and Members of the Subcommittee:

Thank you for the opportunity to testify on the economic factors affecting Social Security's financing and the role of personal accounts in strengthening retirement security. I commend you for holding this series of hearings. There is no better place for bipartisan and comprehensive reform to originate than in this committee.

As you have requested, my testimony today will focus on three topics: the economic factors that are used to project the future condition of the Social Security system; the consequences of raising taxes to meet Social Security's obligations, and the advantages of pre-funding future benefits through personal accounts.

I would like to emphasize the following four points:

1) While it is true that many demographic and economic factors affect Social Security's long-term finances, the most important drivers of the looming shortfalls are demographic—continued improvements in life expectancy in retirement (about 4 more years at age 65 over the next 75 years) and fertility rates that are about 2 children per woman. I see very little in the economy and society more generally to suggest that this demographic pressure is overstated in the current projections. The reality of this demographic shift should guide our discussions about how to reform the system. In particular, the shift strongly suggests the need to target higher retirement ages.
2) Among the economic factors that are both important for Social Security's finances and subject to uncertainty in their projection, the real wage differential is the most critical. While it is true that the ultimate assumption for the real wage differential of 1.1 percent seems low, particularly relative to the productivity boom of the last decade when it averaged 1.6 percent, any reasonable increase in that assumed rate of real wage growth would still leave a large hole in the system's finances. There really is no alternative to financing the projected retirement income of future beneficiaries than preparing them to save more as a nation and work more before entering retirement.
3) The issue of whether to bring new monies into the system, and whether to do so in the form of tax increases in the current system or contributions to a new system of personal accounts, is perhaps the most polarizing in the current debate. I can only offer my own perspective. The default outcome if we do nothing today is to wait until the fiscal consequences of running the current system with a retired population of Baby Boomers become unmanageable. That could happen anytime between 2017, when the current system is first projected to pay out more in benefits than the revenues that are collected in taxes, and 2041, when the current system is projected to lose its authorization to pay benefits as scheduled without new legislation to authorize this. When that day of reckoning occurs, it will likely involve a combination of benefit cuts, tax increases, and delays in the retirement age, as in the 1983 amendments. However, unlike 1983, these changes will have to happen in greater measure and with more immediacy. We will have squandered the opportunity to envision a more modern system that relies less heavily on pay-as-you-go financing. We will have done nothing to prepare new retirees for their lower retirement incomes. And, worst of all, we will impose a tax burden on our children's generation that, with full knowledge of its likely appearance, we will have refused to address ourselves today. I wouldn't blame them if they refused to pay, or, if in the face of these higher taxes, they simply decided to work less.
4) If we do not intend for retirement incomes to fall, and if we are unwilling to move Social Security's target retirement ages higher in the face of the demographic shifts, then the only option left is to increase saving today. There are two reasons why I believe that this additional saving should happen through personal accounts, whether inside or outside the Social Security system, rather

than the Trust Fund. The first is that the last two decades of budget policy show quite clearly that the Social Security surpluses do not as a rule serve their intended purpose of lessening the burden on future generations of taxpayers for financing the current generations' retirement benefits. The availability of the Social Security surplus in the unified budget has encouraged the government to run larger deficits in the on-budget account. If new monies are to be brought into the system, they have to be matched by an outflow (to something like personal accounts) to avoid this problem. If there is a "lockbox," it seems that there are 536 keys, but more importantly, no lid. The second reason to favor personal accounts is that, if we are serious about restoring solvency to Social Security over the long term—not just postponing the date of Trust Fund exhaustion outside the 75-year projection period—then the scale of investments required is simply too large to be managed in anything but a decentralized manner. Restoring solvency on a permanent basis would require the accumulation of an aggregate portfolio that would be equivalent to about two thirds of all mutual funds if it existed today.

I would now like to discuss each of these points in more detail. In all of my calculations, I will rely on the projections based on the Intermediate assumptions of the 2005 Social Security Trustees' Report.

The Centrality of Demographic Factors

As the committee has heard in previous hearings, the driving force behind the projected deterioration in Social Security's finances is an increase in the number of beneficiaries relative to the number of workers. Between 2005 and 2080, the number of beneficiaries per hundred workers is projected to rise from 30 to 54, an increase of 80 percent. Over that same period, Social Security's cost rate—the amount of benefits relative to the payroll tax base—is projected to increase from 11.1 percent to 19.1 percent, an increase of about 72 percent.

Given the other assumptions underlying these projections, the demographic shift more than explains the worsening of Social Security's financial picture. Over this 75-year projection period, life expectancy after age 65 is projected to increase by about 4 years. (Note as well that this represents a slowing of the rate of improvement in life expectancy relative to the historical period, suggesting that the actual improvements could be larger.) The fertility rate is projected to be 1.95 children per woman, a rate that would not increase the size of the working age population in the absence of immigration. Even if this assumption turns out to be too low, it would be several decades before a higher fertility rate could meaningfully affect Social Security's annual financial balance.

Regardless of our individual political views or our preferred approaches to Social Security reform, I believe that we can all agree that this unprecedented aging of the population will require a substantial adjustment in the way we conceive of our systems of old-age support.

The Relevance of Economic Factors

There are several assumptions about economic factors that affect the projections of Social Security's long-term solvency. The economic effects come from either of two main channels. First, they can alter the time-value of money, and thus the relative importance of the near-term annual surpluses compared to the longer-term annual deficits. Second, they can alter the size of the payroll tax base relative to the amount of benefits to be paid in a given year. For the purposes of the discussion in this section, I will focus on the projected long-term actuarial deficit as calculated over the 75-year projection period, which was 1.92 percentage points of payroll in the 2005 Trustees Report. Obviously, this is an incomplete measure of solvency, but it is sufficient to illustrate the key points about the role of economic factors. I will focus on longer-term measures of solvency in the next sections.

The intermediate assumptions put the real interest rate at 3 percent. Because the system runs near-term surpluses and longer-term deficits, a higher interest rate would improve the long-term financial outlook for Social Security. However, the effects are fairly small. The sensitivity tests in the Appendix of the Trustees Report show that for each percentage point increase in the real interest rate, the long-term actuarial deficit falls by about 0.7 percent of taxable payroll. Thus, the real interest rate would have to nearly double to close the gap completely. Since the current assumption of 3 percent is only a bit below recent history, we would not expect substantially higher real interest rates than in this baseline. In addition, it would be hard to maintain the "other things equal" assumption in such a scenario, since an exogenous increase of a few percentage points in the real interest rate would dampen economic growth and thus Social Security's finances.

It might seem like the inflation rate would have a large impact on Social Security's long-term finances, particularly given the annual attention given to the size of the cost-of-living adjustments for current beneficiaries (and all of the recent discussion about the possibility of switching from wage—to price-indexing in the current benefit formula). However, higher inflation has only a mildly positive effect on Social Security's projected finances, because the higher COLAs are preceded by higher nominal wages. The effect is not large—the Trustees Report estimates that a 1 percentage point increase in the CPI inflation rate improves the long-term actuarial balance by only 0.21 percent of taxable payroll.

The key economic assumption is the growth in the average annual wage in covered employment relative to the CPI, commonly referred to as the real wage differential. The current projections are based on an ultimate real wage differential of 1.1 percent per year. While this number is consistent with actual experience over the last 45 years, it is about 0.5 percentage point below the average for the past decade. The sensitivity analysis in the Trustees Report shows that raising the real wage differential by this difference would lower the long-term actuarial deficit by about 0.53 percent of taxable payroll. In order for higher real wage growth to close the gap, it would have to average about 2.9 percent per year. To get an idea of how infeasible this is over the long term, the real wage differential averaged 2.9 percent per year over the period from 1996—2000, a period that we now regard to have been a bubble. Nonetheless, an economic policy that focused on capital accumulation—whether privately through enhanced retirement savings vehicles or publicly through a more responsible budget policy—could raise real wages and have the salutary benefit of improving Social Security's financial outlook.

The final economic assumption of interest is the growth of the labor force. As we all know, the growth of the labor force is projected to slow over the coming decades as the large Baby Boom cohort makes its transition from working careers to retirement. There appears to be nothing unreasonable in the way this has been projected in the Trustees Report, but promoting greater labor force participation is one of the few policy levers that we could utilize to help shore up the system's finances. The natural way for this to happen would be lower the overall tax burden on working families (consistent with a responsible budget policy) and to encourage older workers in particular to remain in the labor force. As the committee has already devoted considerable attention to this issue, I can only underscore my agreement with panelists at prior hearings that it makes sense to begin a national conversation about how the target retirement age for most workers should increase in the face of improvements in life expectancy and the impact of demographics on the system's finances.

Consequences of Raising Taxes to Finance Future Benefits

I believe that the question of whether taxes should be raised to finance future benefits is primarily a matter of equity and only secondarily a matter of efficiency. We may feel that larger tax burdens are bad, but we should also feel that larger deficits are surely worse, because they are your children's taxes. If revenues coming into the Social Security system will ultimately have to increase, then the responsible course of action is to increase them now, so that the burden can be spread more equitably across generations.

Consider what happens if we wait to act. In 2005, the Trustees Report tells us that we have unfunded obligations (over the infinite horizon, not just the next 75 years) that are equal to about 90 percent of GDP. Those unfunded obligations could be eliminated by raising the payroll tax by 3.5 percentage points, immediately and forever (and ignoring the likely declines in economic activity associated with this tax increase). If we were to wait until the Trust Fund is projected to be exhausted in 2041, then we would find ourselves (according to my own rough calculations) with unfunded obligations that are about 140 percent of (a much larger) GDP. Tax increases and benefit cuts would have to be commensurately higher, and all of those who retire in the next 35 years would evade any responsibility for sharing in the burden of those tax increases.

As a matter of efficiency, it is worth reiterating points made recently to the Committee in the testimony of Tom Steinmeier and Gene Steuerle that, despite the fact that individuals both pay taxes and earn benefit entitlements as a result of working in covered employment, the link between benefits and taxes is often very weak. There is quite a bit of redistribution in the current system, but surprisingly little of it serves to make the system more progressive, largely due to the spousal benefit rules. In the usual way they are proposed, personal accounts do not redistribute resources as in the current system, and thus contributions to personal accounts should be viewed as less distortionary and less likely to reduce economic activity compared to raising taxes.

The Role of Personal Accounts in Pre-Funding Future Benefits

Once we have decided to make greater saving an element of Social Security reform, there are institutional reasons for channeling that saving to personal accounts rather than the pay-as-you-go system. The first pertains to the way the Federal Government handles the revenues embodied in Social Security surpluses. The second pertains to the scale of investments required if reform is to actually restore solvency to the system on a permanent basis.

The budget process in the Federal Government makes pre-funding through the Trust Fund completely unreliable. Over the past two decades, the government's targeting of the unified budget deficit in its policy making has meant that the presence of the Social Security surplus has facilitated larger deficits in the on-budget account. This practice extends back to the Gramm-Rudman legislation in the 1980s and continues to this day as the Administration sets a budget target of "cutting the deficit in half in 5 years." The "deficit" in question included not just the level of the Social Security surplus but its growth over that period. Absent a budget policy that is truly disciplined—like a balanced budget excluding Social Security over the business cycle—running larger Social Security surpluses will not have the desired effect of alleviating the financial burden on future taxpayers of paying for the current generation's retirement benefits. Requiring the new revenue to immediately flow out to personal accounts would prevent the government from spending it on current projects.

Even if the budgetary institutions could be reformed, a recognition of the scale of new saving that is required argues strongly for investments in personal accounts rather than a Trust Fund. By 2080, the annual deficit in Social Security is projected to grow to 5.75 percent of taxable payroll. Suppose that we wanted to save enough money to accumulate a portfolio so that the investment income from that portfolio would cover this deficit. If we could get a return of 5 percent, after inflation and net of administrative costs, that would require a portfolio equal to 5.75/5 = 1.15 times taxable payroll. If that portfolio existed today, when taxable payroll is $4.73 trillion, it would be about $5.4 trillion. To put that in perspective, it is about two thirds of all mutual funds in the United States today. There is simply no feasible way for that money to be managed in anything but a decentralized manner. Personal accounts provide a mechanism to accommodate the need for widespread ownership and decentralized money management.

Thank you again for the opportunity to testify today. Much of what I have written can be found in further detail on my weblog, http://voxbaby.blogspot.com.

Chairman MCCRERY. Thank you, Dr. Samwick. Dr. Furman?

STATEMENT OF JASON FURMAN, PH.D., SENIOR FELLOW, CENTER ON BUDGET AND POLICY PRIORITIES, AND VISITING SCHOLAR, NEW YORK UNIVERSITY, NEW YORK, NEW YORK

Mr. FURMAN. Mr. Chairman, Mr. Levin, other Members of the Subcommittee, thank you for the invitation to address you today. There are many important issues in the reform of Social Security, some of which I had the opportunity to address at the Full Committee hearing, including the impact on benefits, debt, and the overall economy. Today I want to focus in particular on the issue of prefunding.

In an analogy to help illustrate the choices Congress faces as it crafts reforms to the Social Security system, consider a family with a substantial mortgage on its home and daughter who is going to go to college in 10 years. If the parents want to help pay for the child's education, they have three choices. First, they could prefund their daughter's tuition by reducing their spending, saving more, and paying down their mortgage more quickly. Alternatively, they could save more and use the extra money to invest in an account. Finally, the parents can decide not to prefund and instead plan on reducing their future spending to pay for college when the bills come due. These are three reasonable ways to finance the daugh-

ter's education. Now consider more reckless parents. They take out a second mortgage on their home so they can invest the money they borrowed. That would not be prefunding. This family would not be any better prepared to pay their daughter's tuition. They might have more money set aside, but they would also have much larger mortgage payments. This metaphor is, I hope, instructive as we consider various ways Congress might reform Social Security. I would like to make four specific points that build on the simple insights about Social Security that can be gleaned from this metaphor.

First, partially prefunding Social Security is a sensible goal. If benefits for people at or near retirement are protected, prefunding can only be accomplished by raising Social Security contributions. Prefunding Social Security means making benefit reductions or contribution increases today that would raise net Federal savings. Raising savings should be a fundamental goal of any proposal to reform Social Security. For this reason and others, partially prefunding Social Security as part of an overall strategy to restore solvency is a good idea. President Bush and congressional leaders from both parties have ruled out benefit reductions for people at or near retirement. The Chairman and other Members of this panel have called for more prefunding. The only way you can possibly do that is to increase the contributions people are making to Social Security beyond the 12.4 percent they are making today. I interpreted Dr. Samwick as meaning that when he talked about bringing new moneys into the system. The Committee is interested in prefunding Social Security; this is the only way to do it.

Second, none of the major Social Security reforms under discussion have any significant prefunding. I have reviewed every reform proposal that the Social Security actuaries have scored based on the 2003 and 2004 Social Security trustees' assumptions, and other than two proposals—one by economists Peter Diamond and Peter Orszag and one by former Commissioner Bob Ball, both of which have a modest, relatively small amount of prefunding—none of the other proposals has any real prefunding at all. They do not do anything to benefits before 2012. Even then, the benefit reductions begin gradually and there are no contribution increases. If you look at Figure One and Figure Two in my prepared testimony, they show the benefit changes under two proposals. One of them is the President's sliding scale benefit reductions, and the other is a combination of raising the retirement age and longevity indexing. Both of those do relatively little for solvency in the first decades that they are in effect, and only grow substantially larger much later on. That is not prefunding.

Third, individual accounts by themselves do nothing to prefund Social Security. As I mentioned, increasing Social Security contributions—for instance, raising the total contribution to 15.4 percent and dedicating 3 percentage points of that to individual accounts—would partially prefund Social Security. It is not the accounts that are leading to the prefunding, it is the larger contributions. None of the major recent individual accounts plans that have been scored by the actuaries propose increasing total account contributions. As a result, any assets in the accounts are matched by increases in the government's debt. Like the family that mortgages

its house to put money in a college savings account, this process does nothing to prefund Social Security or increase Federal savings.

One of the leading public finance textbooks, written by Harvey Rosen, the former Chairman of President Bush's Council of Economic Advisors, explains that, "There is no reason to believe that privatization"—and that is the only time I will use that word in this hearing, is in quotes—"by itself would raise Federal savings. At the end of the day, all that takes place is a swap of public and private securities between the trust fund and private markets. No new savings is created."

In short, the primary effect of borrowing to finance individual accounts is no change in national savings. Furthermore, accounts could reduce savings if individuals treat them as net wealth and consequently decrease their savings in 401(k) s and IRAs. This would leave people even less prepared for retirement. Some have argued that accounts could increase savings if the higher deficits associated with them lead to lower government spending and/or higher taxes outside of Social Security. Note that, even in this case the prefunding is a result of other budgetary policies, not the accounts. There is little reason to believe that even this development would occur. The Bush Administration has not claimed that if accounts were passed it would propose additional reductions in Federal programs or higher taxes to offset the increased deficit. In fact, Administration officials emphasize that they do not believe there is any need for such steps because, they contend, the accounts are fiscally neutral over the infinite future.

Finally, and very briefly because I have more than exhausted my time, Social Security is a relatively small part of the long-run deficit, and I urge this Committee to focus on our overall fiscal challenges, which include health care and the level of taxes in light of the tax cuts in the last 5 years. Thank you.

[The prepared statement of Dr. Furman follows:]

Statement of Jason Furman Ph.D.,[1] Non-Resident Senior Fellow, Center on Budget and Policy Priorities & Visiting Scholar, New York University Wagner Graduate School of Public Service, New York, New York

Mr. Chairman and other members of the Committee, thank you for the invitation to address you today regarding an important facet of the Social Security reform debate—prefunding. Social Security is currently running a substantial surplus but in the coming decades the number of workers supporting each retiree will fall and the challenges facing Social Security will grow. Prefunding entails making larger initial reductions in benefits or increases in contributions in order to reduce the magnitude of the changes required in the future. At the same time, prefunding increases national savings, reducing consumption today but expanding the economy and thus consumption possibilities in the future.

An analogy can help illustrate the choices Congress faces as it crafts reforms to the Social Security system. Consider a family with a substantial mortgage on its home and a daughter who will go off to college in a decade. If the parents wants to help support their daughter's education, they have three choices:

- The parents could "prefund" their daughter's education by reducing their spending, saving more, and using the money to pay down their mortgage more quickly.
- Alternatively, the parents could use the additional savings to prefund their daughter's education by investing their new savings in an educational savings account.

[1] The views expressed in this testimony are mine alone.

- Finally, the parents could decide not to prefund their daughter's education and instead plan on reducing their future spending to pay for college when the bills come due.

All three of these are reasonable ways to finance the daughter's education. But one method is not: the family could take out a larger mortgage on their home and invest the borrowed money in an educational savings account. This would not represent prefunding. The family is no more prepared for their daughter to go to college—they have more money set aside for college but they also have larger mortgage payments. And the family might suffer from the dangerous delusion that they have prefunded their daughter's education. They will thus be unprepared for the combined burden of repaying the mortgage and sending their daughter to college.

In my remarks today, I will make five points that build on the simple insights about Social Security that can be gleaned from this metaphor:

- First, fully prefunding Social Security is neither warranted on policy grounds nor feasible.
- Second, partially prefunding Social Security is a sensible goal. But, if benefits for people at or near retirement are protected, prefunding can only be accomplished by raising Social Security contributions.
- Third, none of the major Social Security reform plans under discussion have any significant prefunding. All of the plans protect benefits for people at or near retirement and none contain contribution increases.
- Fourth, individual accounts—by themselves—do not do anything to prefund Social Security.
- Finally, I recommend—as a starting point—prefunding our future fiscal challenges by partially undoing some of the major fiscal errors of the last four and a half years, including the tax cuts and the prescription drug bill.

First, fully prefunding Social Security is neither warranted on policy grounds nor feasible.

Our law requires that private pension plans are fully funded. They must maintain sufficient assets to cover all accrued benefits—even if plan closes down and receives no future contributions. This rule was designed to ensure that companies retain the resources to pay retirees, even if they go bankrupt.

In contrast, Social Security is largely a pay-as-you-go system. The majority of benefit payments in any given year are paid for by revenues collected in that year. If payroll tax contributions ceased today, the Social Security trust fund would only be sufficient to pay benefits for the next three and a half years.

Social Security's pay-as-you-go structure originated in the 1930s. President Franklin Delano Roosevelt and the Congress that created Social Security decided that the elderly, who fought in World War I and bore the brunt the Great Depression, should immediately start receiving benefits. If Social Security had been fully advance funded, no one would have gotten full benefits until the late 1970s—after a lifetime of contributions to the system.

The policy logic that applies to a private company does not apply to Social Security. Unlike a private company, the United States will not cease to exist and the Federal Government can count on continued payroll tax collections into the indefinite future. With adjustments in Social Security benefits and taxes, Social Security can be made sustainably solvent.

Even if one believes that the wrong decision was made in the 1930s and wishes Social Security were fully advance funded, shifting from our current system to an advance funded system is not feasible. Doing so would require either eliminating an entire generation's benefits or doubling an entire generation's payroll taxes. Every significant Social Security reform proposal, whether with or without accounts, largely maintains Social Security's pay-as-you-go structure.

Second, partially prefunding Social Security is a sensible goal. But, if benefits for people at or near retirement are protected, prefunding can only be accomplished by raising Social Security contributions.

Partially prefunding Social Security, as part of an overall reform to restore solvency, is a good idea. America currently enjoys a more fiscally-favorable demographic structure than our country is likely to face ever again in the future. As a result, the Social Security Trustees project that the system will run a surplus through 2017 (on a cash basis) or 2027 (including interest on the trust fund). As the number of workers per retiree diminishes, Social Security will shift into deficit.

Instead of waiting for deficits to emerge, acting sooner to reduce benefits or raise contributions to Social Security would allow for smaller future adjustments. But on the other hand, future generations are likely to be richer and more able to afford

adjustments. Policymakers should weigh these competing considerations. I recommend erring on the side of caution by including at least some prefunding.

Prefunding Social Security means making benefit reductions or contribution increases today that, at a more fundamental level, would raise net national savings. Raising savings should be a fundamental goal of any proposal to reform Social Security. This goal was unanimously accepted by the 1994–96 Advisory Council and endorsed by the President's Commission to Strengthen Social Security.

This goal is particularly important today because in the last three years, net national savings has averaged 1.6 percent of GDP—the lowest level in seventy years. At the same time, investment was financed by an average 4.8 percent of GDP in capital inflows from abroad—the highest level on record. Borrowing at this level is unsustainable; eventually this debt will need to be repaid. Social Security and pension reform can help increase private savings *and* reduce government dissaving (i.e., by reducing budget deficits).

Higher national savings leads to increased investment and/or reduced foreign borrowing. Either way, higher savings is the only way to increase consumption by future generations of the elderly without reducing consumption by future generations of the young.

President George W. Bush and Congressional leaders from both parties have ruled out reducing benefits for people at or near retirement. This is a sound choice because people at or near retirement have already factored their expected benefits into their financial plans and it would be too late for them to make up for reductions by saving more. But, because policymakers have ruled out reducing benefits for people at or near retirement, the only way to meaningfully prefund Social Security is to increase contributions to Social Security.

Policymakers can choose from several ways to raise contributions, including: raising Social Security tax revenues (i.e., raising the ceiling on taxable earnings, applying a smaller "legacy charge" above the ceiling, or raising payroll tax rates); raising other revenues (i.e., dedicating revenues from a reformed estate tax to Social Security); or raising the total contribution to Social Security above the current 12.4 percent FICA rate and dedicating the additional contributions to individual accounts.[2] While all of these steps would partially prefund Social Security, the choice of which provision or combination of provisions to adopt should be guided by several goals: ensuring the source of revenue is progressive, respecting Social Security's role as the core tier of retirement security, maintaining administrative efficiency, and being mindful of the interaction of prefunding with other aspects of the federal budget.

Third, none of the major Social Security reform plans under discussion have any significant prefunding. All of the plans protect benefits for people at or near retirement and do not have any contribution increases.

Few of the major Social Security proposals from recent years have any real prefunding. The proposal by economists Peter Diamond and Peter Orszag and the proposal by former Social Security Commissioner Bob Ball are the only plans scored by the Social Security actuaries that entail even modest prefunding. None of the other proposals increase the total contribution to Social Security. None of the proposals reduce Social Security benefits before about 2012 and even then the reductions in Social Security begin very gradually.

For example, consider the benefit reductions in two leading approaches: the sliding scale benefit reductions (also known as "progressive price indexing") supported by the President and benefit reductions from raising the retirement age and longevity indexing (as proposed by Senator Chuck Hagel). As shown in Figure 1, it takes more than 20 years before either plan reduces Social Security spending by 0.5 percent of payroll, a relatively modest contribution to overall solvency. In contrast, the Diamond-Orszag plan would reduce the Social Security deficit by this amount almost immediately and would continue to grow over time.

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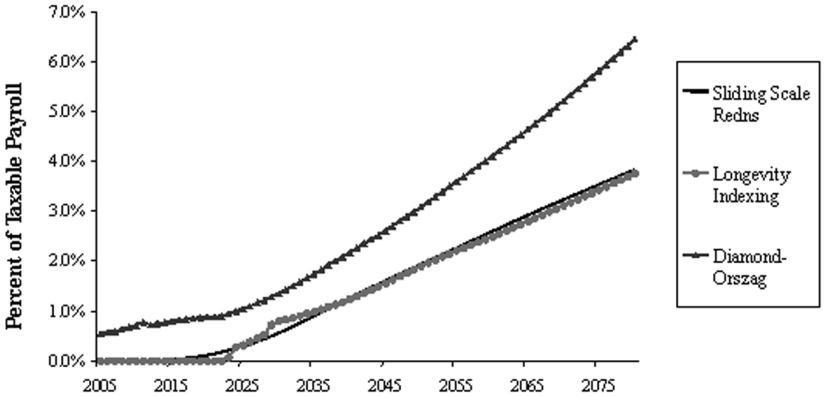
[2] Another variant of this is to establish quasi-mandatory add-on accounts by subsidizing the additional account contributions by those who choose to make the added contributions with even larger benefit reductions than would be necessary to restore solvency for those who choose not to establish accounts. This is the approach taken by Martin Feldstein and Andrew Samwick and proposed by the President's Commission Model 3. Unless the subsidies for the additional account contributions are so large that most people would participate, this approach will not result in significant prefunding.

Figure 1. Reduction in Social Security Cash Flow Deficit*

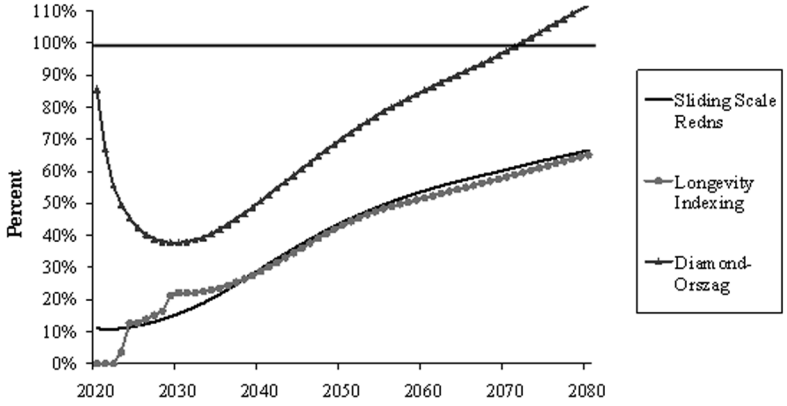


*Increase in the Social Security cash flow surplus before 2017

Note: "Sliding scale redns" indicates the President's proposal. "Longevity indexing" indicates Senator Hagel's plan to raise the retirement age to 68, index benefits for longevity, and modify the early/delayed retirement factors.

Figure 2 shows the percentage of the Social Security cash flow deficit closed by each of the three plans, excluding the individual accounts portions of the plans. Both the President's plan and the longevity indexing plan close only a small fraction of the deficit in the early years, growing to nearly 70 percent of the deficit by 2080. In contrast, the Diamond-Orszag plan closes more than 100 percent of the deficit (or modestly increases the surplus) prior to 2020 (not shown in the Figure) and thus smoothes the process of restoring sustainable solvency.

Figure 2. Percentage of Cash Flow Deficit Eliminated



*Increase in the Social Security cash flow surplus before 2017.

Note: "Sliding scale redns" indicates the President's proposal. "Longevity indexing" indicates Senator Hagel's plan to raise the retirement age to 68, index benefits for longevity, and modify the early/delayed retirement factors.

Fourth, individual accounts—by themselves—do not do anything to prefund Social Security.

Individual accounts, by themselves, do nothing to prefund Social Security. Increasing Social Security contributions—for example raising the total contribution to 15.4 percent and dedicating 3 percentage points of this to an individual account—would partially prefund Social Security. But it is not the accounts but the larger contributions that are leading to the prefunding.

No major recent individual account proposal, however, is proposing to increase total account contributions. In the last few years, every major individual accounts proposal is funded by diverting existing payroll taxes or by borrowing from the general fund. In either case, any assets in the accounts are matched by increases in the government's debt. Like the family that mortgages its house to put money in a college-savings account, this process does nothing to prefund Social Security or increase national savings.

One of the leading public finance textbooks, written by the former Chairman of President Bush's Council of Economic Advisers Harvey Rosen, explains that "privatization" by itself does not raise national savings:

Hence, privatization can help finance future retirees' consumption only to the extent that it allows future output to increase. And the only way it can do this is by increasing saving.

However, there is no reason to believe that privatization by itself would raise national savings—At the end of the day, all that takes place is a swap of public and private securities between the Trust Fund and private markets—no new savings is created.[3] (emphasis added)

In short, the primary effect of borrowing to finance individual accounts is no change in national savings. Furthermore, two secondary effects could be important.

First, the accounts would reduce savings if individuals treat them as net wealth and consequently decrease their savings in 401(k)s and IRAs. The completely rational actor who inhabits economics textbooks should not change his or her savings as a result of the accounts because, in the absence of additional revenue, every dollar contributed to accounts is generally matched by a dollar reduction in present value terms in future Social Security benefits.[4] The accounts do not represent net wealth but are instead are akin to a loan. Workers will still need to save as much of their own money to enjoy a dignified retirement. But, the design of the President's accounts (and the way in which they are often described) could lead many people to overlook the benefit offset associated with the account and to incorrectly assume that the accounts represent new wealth. Such people could feel less need to save in the form of 401(k)s and IRAs.[5] This would not just reduce national savings, it would also leave these people even less prepared for retirement.

Second, in theory the accounts could increase savings if the higher deficits associated with them lead to lower government spending and/or higher taxes outside of Social Security. In this case, the government would not be completely financing the accounts with borrowing and national savings would increase. Note, even in this case, the same level of prefunding could be achieved without the account as long as the President and Congress have the political will to reduce the non-Social Security deficit.

But there is little reason to believe that such developments would occur. The Bush administration has not claimed that if accounts were passed it would propose additional reductions in federal programs or higher taxes to offset the increased deficit. In fact, administration officials emphasize that they do not believe there is any need for such steps because, they contend, the accounts are fiscally neutral over the infinite future. In addition, the Bush administration has not included the short-run deficit impact of the accounts in its budget submissions. It would be imprudent to base a major policy on the hope that future government spending and/or taxes would change as a result.

As a result, debt-financed accounts—including the President's proposal—are likely to reduce national savings permanently. Even with the potentially offsetting effect

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[3] Harvey S. Rosen, *Public Finance,* Seventh Edition, 2005, p. 208. Rosen goes on to explain that "sophisticated schemes" that include additional out-of-pocket contributions could increase savings. Recent carveout account proposals, including the President's proposal, do not have any of the features Rosen identified as potentially leading to higher savings.

[4] This either occurs directly as a result of the benefit offset (as proposed by President Bush) or indirectly as a result of other benefit reductions necessary to make up for the cost of subsidies for individual accounts.

[5] Douglas Elmendorf and Jeffrey Liebman provide evidence suggesting that individuals reduce savings by about 40 percent of the value of individual accounts but only increase savings by 25 percent for future reductions in Social Security benefits (like the benefit offset). As a result, they conclude that "individual accounts are likely to crowd out some other household saving." Douglas W. Elmendorf and Jeffrey B. Liebman, "Social Security Reform and National Saving in an Era of Budget Surpluses," *Brookings Papers on Economic Activity*, 2:2000.

of phased-in benefit reductions, national savings would likely be lower and America as a whole would be poorer for several decades.

Finally, I recommend—as a starting point—prefunding our future fiscal challenges by partially undoing some of the major fiscal errors of the last four and a half years, including the tax cuts and the prescription drug bill.

Social Security is only one part, and a relatively small part, of the long-run deficit. Policymakers should focus on prefunding our overall fiscal challenges by reducing the deficit and thus increasing net national savings.

In the 1990s, policymakers put America in better fiscal shape to meet the future challenges of Social Security, Medicare, and Medicaid. In 2000, President Bill Clinton proposed devoting the entire Social Security surplus to debt reduction and devoting additional portions of the non-Social Security surplus to further debt reduction and Social Security solvency. The Social Security actuaries estimated that paying down the debt and dedicating the savings to Social Security would have extended the life of Social Security by 20 years.[6] It is important to note that these contributions constituted prefunding by increasing the unified budget surplus, reducing the debt held by the public, and raising net national savings. Prefunding does not require equity investment or individual accounts.[7]

In the last five years the surplus has disappeared as a result of several rounds of large tax cuts and spending increases, and, to a lesser degree, adverse shocks. As a result, it is no longer feasible to use debt reduction to substantially prefund Social Security. Nevertheless, there is still substantial scope to close the overall fiscal gap. This is worth doing whether or not the steps are officially scored as extending the solvency of Social Security or not. Ultimately, what matters most is overall fiscal sustainability and, in this regard, the tax cuts passed from 2001 through 2004, if made permanent without causing a large increase in the Alternative Minimum Tax (AMT), would cost more than three times as much as the 75-year Social Security deficit and the prescription drug benefit will cost more than twice as much as the 75-year Social Security deficit.

As a starting point, I recommend repealing a portion of the tax cuts passed from 2001 to 2004 or, at the very least, allowing them to expire in 2010 or offsetting the cost of extending them by broadening the tax base. In addition, I recommend exploring ways to reduce the cost of the prescription drug benefit passed in 2003. This would lay a foundation for more significant deficit reduction, including policies to restore Social Security solvency.

Thank you, I look forward to the Committee's questions.

Chairman MCCRERY. Thank you, Dr. Furman. Mr. Shipman?

STATEMENT OF WILLIAM G. SHIPMAN, CHAIRMAN, CARRIAGEOAKS PARTNERS, LLC, MANCHESTER-BY-THE-SEA, MASSACHUSETTS; CO-CHAIRMAN, THE CATO INSTITUTE'S PROJECT ON SOCIAL SECURITY CHOICE

Mr. SHIPMAN. Chairman McCrery, Ranking Member Levin, and other Members of the Subcommittee, I thank you very much for giving me the opportunity to be here this morning to express my views on Social Security reform. To start off, if I may, I would like to share with you a personal story that I think is central to the debate. It was many years ago when our young teenage son came home very proud. He had his first paycheck. This was a real paycheck, where somebody actually wrote him a check, as opposed to mowing lawns and being paid by neighbors. He opened it up and he said, "Dad, what's "ficka"?" And I said, "I have no idea. I have never heard that term before. Where did you get it?" And he

[6] Stephen C. Goss, "Long-range OASDI Financial Effects of the President's Proposal for Strengthening Social Security—INFORMATION," June 26, 2000.

[7] In addition, the Clinton proposal included another provision to invest part of the trust fund in equities. Even using returns that are not adjusted for risk, the equity investment contributed only 6 years to solvency, much less than the genuine prefunding entailed by the additional debt reduction.

showed me the paycheck and I looked at it and I said, "Oh, that's the Federal Insurance Contributions Act (FICA)."

And "ficka"—FICA—doesn't mean that much to a young teenage boy. He said, "Well, what's that?" And I said, "Well, that's the Federal Insurance Contributions Act." That went directly over his head, and I thought I lost him. He said, "Well, well, what's that?" I said, "Well, that's Social Security." He said, "You know something about that. What does it really mean?" And I said, "Well, do you see what was taken out of your check?" He said yes. I said, "Double that, because you're employer takes the same amount out of your wages and that is sent to the government as long as you work. Then when you get old and retire, the government will send you some money." He pondered that. He said, "Oh, is it a good deal?" And I said, "Frankly, no, it's not." And then the real question: "Do you think I should do it?"

[Laughter.]

And I said to him, "You have no choice." What this lack of choice means is that for about 10 percent of our wage income Americans are not free to be able to spend that on other common and available retirement options. Not having this choice is bad enough. Its costs are compounded by the fact that the 10 percent doesn't really buy very much. An average wage worker today at 45 years of age, retiring in 20 years under scheduled benefits, will receive a benefit roughly equal to about 36 percent of that worker's last year's wage. If that individual were to save half of the amount of the Social Security tax, and just the retirement portion of the Social Security tax, that individual would receive a benefit, based on historical market returns, a benefit roughly double what you would receive from Social Security. Roughly double the benefit at roughly half the price. This may be one reason why Social Security is mandatory. Few people likely would participate if it were voluntary. This should give us some pause. Should our government force its citizens to buy a product they may not want? Or, to put it differently, shouldn't our government encourage competition amongst product providers so that citizens can choose best what meets their needs?

These questions will weigh more heavily as Social Security ages further, because pay-as-you-go systems become less attractive with time. In 1950 in the United States, when there were 16 workers per retiree, the highest Social Security tax any American paid was $90 a year. Today, just for the retirement portion of Social Security, the highest tax is $9,540 a year. Even adjusted for inflation, the tax has gone up by about 2000 percent. You may not have noticed this. Even if you did notice it, you may not have cared so much because it edges up so very slowly that it is unyielding. I kind of think of it as comparable to getting kicked to death by a rabbit. You don't feel it. The last strike is terminal.

As much as this tax has gone up, our friends in Europe would consider us lucky. As you may know Social Security started in Europe, specifically in Germany, in 1889. So, we have something to learn from them. Their payroll is not capped at $90,000, such as ours. Their Social Security tax is on all of their wage income. The payroll tax rate in France today is 51 percent of payroll. In Germany, Italy, and Spain, it is about 38 to 42 percent of payroll. These prohibitive taxes have led to almost zero economic growth in

Western Europe, high unemployment—10 percent in France, over 12 percent now in Germany. There is civil unrest, and they are talking now, as we are, about raising taxes further.

The alternative is a market based system where individuals are free to save and invest in markets highly diversified across asset classes, across national borders, and across time. Much of this from other testimonies that have been given. These systems—and by the way, they are common in the private sector, defined benefit plans, defined contribution plans and the like—these are quite common and they could work extremely well as a national system. In my view, it is almost certain that we will adopt a market based system. In my view, it is almost uncertain as to when we will do it—now, when we have time to prepare, or later, when we don't.

You as Members of Congress hold a hope for America because you have a unique opportunity to provide workers the freedom to choose, to accumulate wealth, to pass it along to their kids if they so choose, and for Americans to no longer be tethered to the government for their retirement. You should grasp this opportunity. Should you do that, all Americans will be forever thankful. Thank you very much.

[The prepared statement of Mr. Shipman follows:]

Statement of William G. Shipman, Chairman, CarriageOaks Partners, LLC, Manchester-by-the-Sea, Massachusetts, and Co-Chairman, The Cato Institute's Project on Social Security Choice

Chairman McCrery, Ranking Member Levin and members of the subcommittee, I thank you for giving me the opportunity to express my views on the reform of our Social Security system. Eleven years ago, on October 4, 1994, I had the opportunity to speak before this same Committee and in my written testimony I offered:

As both a son and a father, I am interested that the elderly are well cared for, and that the young have the opportunity to build sufficient assets so that they, too, can retire in dignity. Social Security, as presently structured, ultimately will achieve neither objective. Although compassionate in its original intent, it is flawed in design.

The system's financial structure is fundamentally unsound. Legislation of 1977 and 1983 attempted to address this by raising taxes and cutting benefits; Social Security was to be on sound financial footing well in to the 21st century. And now, just a few years later, The 1994 Board of Trustees' report suggests that the system will run out of money seven years earlier than it projected just one year ago. Legislative initiatives to reduce benefits further and raise taxes are again on the drawing board. This did not work in 1977 or 1983; it will not work now. Social Security's financial integrity requires an entirely different approach. I offer this testimony in the spirit of the starting point for an alternative: a concept of privatization wherein Americans benefit from the engine of a free economy and free choice. With privatization properly structured, today's elderly will be protected, the young will retire with higher incomes, and our political leaders will have offered, once and for all, a lasting solution for which all voters will be thankful.

Since that testimony our nation has had a vigorous and open discussion. Many new ideas have been offered, ideas not developed prior to 1994. The climate of opinion has changed; more Americans are now aware of the issue, more Americans want the option to save and invest for their own future. We are getting closer to the point where the "rubber meets the road," when you, as Members of Congress, will have to vote. Your decision is more important than perhaps you know.

It has been eleven years since my first testimony on this issue and in many ways, but certainly not all, little has changed politically; we're still talking about raising taxes and reducing benefits. We have wasted precious time.

A Collision Course

Like other nations we face an unprecedented challenge of how to deal with a reality that mankind has never confronted before and one that most people are unaware of. How we and other governments respond will affect each American citizen,

our families, businesses across the land, indeed our very way of life. The reality is not only unprecedented, it is unyielding.

Dr. Karl Otto Pohl, former president of the German central bank, the Bundesbank, stated it this way: "In a relatively short period, we must adapt our domestic institutions, international relationships, and even our individual life plans to a new, and powerful reality."

What he was speaking of, and what confronts each of us here, is the fact that there are two powerful forces on a collision course. The first is the aging of society, the reality that the elderly population is increasing more rapidly then the population as a whole. In America, but even more so in other countries, the elderly rely on Social Security to survive financially. Should Social Security falter, many elderly will be destitute.

The second force is that most Social Security systems, including ours, are, in fact, failing. They are financially unstable, and not sustainable as they are presently structured.

The challenge is to avoid the collision of these two forces. In my view, the risks are high that we will not. But should we prevail by structuring a lasting solution, the rewards will be as unprecedented as the challenge itself.

The Early Years: Social Security's Roots

Social Security was enacted in 1935 during the Great Depression. During the first half of the 1930s real GDP fell by about 25 percent, unemployment jumped to 22 percent and the stock market virtually imploded and fell about 70 percent. Our nation was on her economic knees. President Roosevelt had to do something, something big, but large government programs were anathema to the frontier spirit of our young nation. In order to achieve his goals he needed unprecedented authority. To grasp that authority he went before the nation on March 4, 1933 in his first Inaugural Address and asked for authority ". . . as great as the power that would be given me if we were in fact invaded by a foreign foe." He achieved his goal and ushered in Social Security, the flagship program of the New Deal.

Much like other Social Security programs that preceded ours, the first being Germany's in 1889, benefits paid to the elderly were financed by payroll taxes. In our case, during the Great Depression, people who had jobs were considered the wealthy. It wasn't like today wherein Americans have portfolios of stock and bonds, real estate, defined benefit and contribution plans and the like; you were considered wealthy if you had a job. And needs were so urgent that the "payroll wealth" was taxed. A saving and investment structure would not have worked at that time because it takes time to compound investment returns to accumulate wealth, and time was short.

Today: A Fundamentally Flawed Program

Over the decades, however, this sort of urgent safety net has turned into the rough equivalent of a defined benefit plan. Yet its financial structure has not advanced. The Old-Age and Survivors Insurance part of Social Security, as its finances are presently structured, is inefficient, financially unsound and fundamentally flawed.

Because benefits are paid by taxing payroll, benefits can increase by no more than payroll increases, assuming that the tax rate on payroll is held constant. Over the last four decades or so, payroll has increased by about 1.5 percent per annum in real terms. That is roughly equivalent to saving and investing and receiving a rate of return of 1.5 percent. To put this into perspective, if one were to save $1,000 each year for a 45-year working career and earn 1.5 percent, the saving would accumulate to about $64,000. During the last 79 years a mixed portfolio of 90/10 percent large/small company stocks earned an inflation-adjusted average annual return of 9.7 percent. One thousand dollars invested annually for 45 years earning that return would accumulate to about $650,000. And a conservative portfolio of 60/40 percent stocks and bonds, respectively, would accumulate to about $288,000. These different values give a glimpse of the lost opportunity that our citizens incur by being required to finance their retirement through payroll taxes.

But it is worse. For any particular age group it matters how many workers pay taxes relative to the number of retirees who receive benefits. The change in this ratio is largely determined by the change in national wealth, or GDP per capita. As national wealth rises, life spans also rise. We observe this not only here but across all parts of the globe. When Social Security was enacted life expectancy at birth was 61 years of age; it is now about 78. In the post-war period global life expectancy has increased from 45 to 65 years of age, a greater increase in the last 50 years or so than in the previous 5,000 years. This is all new. We didn't expect it. But now we think it will continue.

Also, as nations become more wealthy birth rates fall. In many countries they have fallen below the population replacement rate of 2.1. The combination of rising life expectancy and falling birth rates causes havoc with pay-as-you-go financed Social Security systems. In the United States there were 16 workers per beneficiary in 1950; today there are about 3.3. It is expected that there will be only two in just 35 years. Therein lies an interesting paradox: as countries become more wealthy their Social Security systems become more poor. The oddity is driven by the causal relationship between increasing wealth—and increasing life expectancy as well as decreasing birth rates—all wrapped around pay-as-you-go financing.

Birth rates have fallen to such low levels in Europe—France-1.9, Germany-1.4, Italy-1.3, Spain-1.3—that "there is now no longer a single country in Europe where people are having enough children to replace themselves when they die."

The Global Political Response: Raise Taxes

The political responses to the changing demographics that squeeze Social Security's finances are frequently the same across the world. Governments and politicians tend to see the problem in the narrowest of lights: merely a solvency issue—too many benefits paid, too few taxes received. This near-sighted analysis is further compounded by the focus on just today's solvency and not tomorrow's.

But from this myopic perspective the options are clear; raise taxes, cut benefits. Of the two, governments tend toward raising taxes first. This makes sense for at least a couple of reasons. There are more workers to tax than there are retirees from whom to cut benefits. Therefore, if the choice were only one or the other, raising taxes inflicts a lesser per capita burden. The second reason is that workers are younger than retirees, therefore, they have more time to adjust to a tax increase than retirees have to adjust to a benefit cut.

The short-sighted strategy of raising taxes has been employed world-wide. In the United States, for example, in 1950 when there were 16 workers per beneficiary, the maximum Social Security tax any American worker paid was $90 a year. At that time the tax rate was 3 percent on only $3,000 of wage income. As the glacial force of demographics slowly and unrelentingly squeezed the system, the $90 tax rose and squeezed the worker. Now, the tax, just for the retirement portion of Social Security, is 10.6 percent of $90,000, or $9,540. After adjusting for inflation over the last 55 years, that tax has increased almost 2,000 percent. In all likelihood, the reason that we stood for this is that the tax rose slowly; the increase was never really noticeable in any one year, but over time it has become more of a burden than the income tax for about three quarters of American workers.

Our friends in Europe, however, would consider us lucky. The payroll tax in France is about 50 percent and in Germany, Italy and Spain it ranges roughly between 38 and 42 percent. It is true that these countries' systems provide more services than ours, but this is not a plus. Europeans are dependent on more of their needs from government programs that are not sustainable.

As many European nations have raised their payroll taxes to prohibitive levels they have choked individual economic freedom and incentive. Economic growth is stagnant, and unemployment rates hover around 10 percent, even 12 percent in Germany. Civil unrest is now more common in Germany and France as governments tell their people that benefits are no longer affordable and will have to be cut, while at the same time they extol the virtues of the welfare state. We are on the same path, but for the moment we trail far behind.

Then, Cut Benefits

At some point, the strategy of raising taxes approaches a political wall. People sense that maybe, just maybe, they could achieve more with their hard-earned wages than they get from Social Security. Politicians sense this and move to the lesser desirable option of cutting benefits. Such blunt language, however, is not commonly uttered. Code is employed: progressive price indexing, longevity indexing, adding a third bend point, reducing bend point factors, increasing the NRA, decreasing the PIA, and it goes on and on. It's all code for cutting benefits.

Fundamental Reform: Retarded by the Claim of Insurance

Eventually, after cutting benefits hits its political wall, the thinking shifts to fundamental reform, saving and investing in wealth-producing assets for all workers. This idea of market-based financing for retirement income is not new, in fact it is old and well established in the private sector, but it is viewed with some disdain from advocates of the status quo. They object to the notion that Social Security should be an investment structure and defend their objection by claiming that it is insurance. This claim had some merit decades ago. Not now. In fact, Social Security's finances are in trouble largely because they are inappropriately based on the insurance model.

Insurance works well when many people are subject to an event that has little chance of happening to any single individual. A good example is homeowners' fire insurance. Many people buy fire insurance to protect their homes and yet few homes burn. Because the number of homes insured is many times the number of homes that burn, the annual insurance premium is very low relative to the replacement cost of one's house. Insurance companies are simply the medium through which individual uncertainty of loss is transferred to, and financed by, the group.

The insurance model does not work well when the group is subject to an event that the entire group experiences. For example, if it were certain that everybody's house would burn down, say, when the owner reached age 65, then insurance companies would have to charge annual premiums the future value of which would be the cost of rebuilding all the houses. This premium would be a large multiple of the premium charged for the uncertain case. Central to the insurance model is that the ratio of the annual premium to the dollar value of what it protects is negatively correlated to the uncertainty of individual loss.

Social Security is frequently heralded as insurance, more precisely social insurance. The 'social' part of the term merely means that the government plays the role of the insurance company. Other than that, it remains the insurance model. When Social Security was enacted in 1935, life expectancy was 61 but benefits weren't payable until age 65. Now benefits are payable at age 62 and life expectancy is 78. The element of uncertainty has kind of flipped upside down. Because of this, the retirement component of Social Security isn't insurance; once born, reaching age 62 and needing retirement income is almost certain. As a result, there is very little risk, or uncertainty, to transfer to the group, resulting in the fact that annual premiums must be enough to accumulate to a sum, including interest, that will finance retirement income.

Under these conditions, social insurance cannot provide such income at a lower cost than saving and investing for retirement. Unfortunately, however, it can and does provide it at a higher cost because it is financed through the payroll tax and is subject to unyielding demographic forces. In a perverse way Social Security's finances and its adherence to the insurance model are caught in a kind of time warp; in the age of the iPod Social Security is a 78 RPM, wind-up phonograph. Unless protected by the power of the state, it can neither compete nor survive.

The State Monopoly Faces Competition

Being protected by the power of the state really means that for 10.6 percent of their wage income American workers are not free to choose among alternatives for their retirement. Bad as that is, the 10.6 percent doesn't buy much relative to reasonable and available alternatives. This is why Social Security is mandatory; few would participate if they had the freedom not to. Competition, as always, is a threat to the status quo. For workers, however, competition is their hope.

Competition would allow all workers to invest part of their payroll tax in capital markets around the world, in professionally managed portfolios that are highly diversified across asset classes, national borders and time. Such an opportunity would allow one to accumulate enough wealth to replace the pay-as-you-go benefit entirely.

For an average wage worker retiring this year at age 65, Social Security's scheduled benefits are projected to replace about 42 percent of his last year's wage. But for workers retiring in the future full benefits won't be paid until age 67. For those future retirees, should they choose to retire at age 65, benefits will replace only 36 percent of their last wage. The worker's cost for these scheduled benefits, which are in excess of what is affordable based on present law, is the 10.6 percent payroll tax.

The Market-Based Alternative

The market-based alternative is significantly more attractive. Over the last 79 years a conservative portfolio of 60/40 percent stocks and bonds, respectively, earned a real return of just a little over 7 percent. Investing just half of the retirement payroll tax, 5.3 percent, each year for 45 years would provide a retirement benefit equal to 97 percent of one's last year's wage. This assumes that there is no interruption in saving each year, that the market return is as stated and falls by 2 percent during the distribution phase, and that life expectancy upon retirement is 20 years. Each of these assumptions can be changed. Work may be interrupted. Markets may do worse or better. Life expectancy may be more or less than 20 years once retired.

To take a conservative path, if the market return were only 5.5 percent and if life expectancy were 30 years at the onset of retirement—about 10 years more than assumed by Social Security—then under these conditions the replacement rate would 39 percent, higher than Social Security's scheduled benefits at age 65 and significantly higher than payable benefits.

Americans Understand the Tradeoffs

Our citizens sense these tradeoffs, risks, uncertainties, and the fundamental differences in providing retirement income from a tax system versus a saving and investment system. This is why, but only part of why, they want the option, the freedom to choose.

If they could acquire this freedom they also would have personal property rights over their accumulated wealth. They have no such rights to Social Security benefits. They also could bequeath some or all of their retirement assets. They cannot under Social Security. They would benefit from the direct relationship between effort, their saving, and reward, their accumulating wealth. They would have the dignity that comes with being personally responsible for their future. They would no longer be tethered to the government. They would no longer be subject to politicians' preferences over when they can retire, how much they can get, how their spouses are treated, how much they're going to pay, and all of the rules and regulations that have evolved to the point of being incomprehensible. They would be free.

It's been eleven years since I had the opportunity to speak before this Committee. Although much of what I am saying today is what I said then, I hope that we are closer to fundamental reform. If we are not, and the two powerful forces that I mentioned above in fact collide, we will edge closer to the wrenching difficulties that Europe is now facing.

You, Congress, are the Hope

But should we grasp the extraordinary opportunity that this challenge offers, we will forever strengthen our nation, our economy, our freedoms, and our ability to finance the many needs that the future will undoubtedly require. It is a matter of will and political leadership in seeing the benefits of greater personal freedom and acting to ensure them. You, as Members of Congress, have the unique opportunity to offer, once and for all, a lasting solution for which all Americans will be forever thankful.

Thank you,

William G. Shipman

Chairman MCCRERY. Thank you, Mr. Shipman. Thank all of you for your excellent testimony this morning. I want to emphasize again something Dr. O'Neill said when she said that in 2042, or in 2052, depending on whose assumptions are correct, beneficiaries would experience an initial decline in benefits. Which implies that after that initial decline, there would be a further decline. Is that correct, Dr. O'Neill?

Ms. O'NEILL. That is correct, according to what we believe is going to happen with the economy.

Chairman MCCRERY. So, whether it is a 22-percent decline or a 27 percent initial decline, the benefits are going to get worse after that. Is that right?

Ms. O'NEILL. Yes, because the gap between revenues and benefits grows.

Chairman MCCRERY. Thank you. Obviously, we have some disagreements about the definition of prefunding and the merits of prefunding. Dr. Furman, I was interested in your comment that the only way to prefund Social Security is to increase Social Security taxes. I assume if we were to increase Social Security taxes and then put those into personal accounts or make a direct government investment in the markets, that that would satisfy your definition of prefunding. Is that right?

Mr. FURMAN. I was giving, I think, a generally accepted definition in the economics profession. You could immediately cut benefits. That has been ruled out, and I think wisely so. Alternatively, I used the word "contributions" because that could come from payroll taxes, raising the cap, a mandatory individual account on top

of the 12.4. I am not saying that I recommend any of those, just giving you that if you want to satisfy the definition——

Chairman MCCRERY. No, I am not calling you an advocate for prefunding. I am trying to get our definitions straight here. Why wouldn't it satisfy your definition of prefunding if we raised, say, personal income taxes and dedicated that to personal accounts in Social Security?

Mr. FURMAN. Oh, no, that would satisfy it. I used the word "contributions" to mean anything that——

Chairman MCCRERY. Broadly speaking. Not contributions——

Mr. FURMAN. At the fundamental economic level, the most important thing is that we are raising savings, which is equivalent to reducing consumption.

Chairman MCCRERY. Right. We could do that either by raising taxes within the Social Security system, you know, raise the cap on income subject to taxes or raise the tax rate itself, or we could satisfy that by raising general taxes and applying them to the Social Security system.

Mr. FURMAN. But again, that wouldn't make the policy good or bad, but that would make it prefunding.

Chairman MCCRERY. Okay, well, that is good. At least we, I think, can agree on that definition of prefunding with respect to funding personal accounts. I don't think it is at issue that—or perhaps some of my colleagues would disagree, maybe some on the panel would disagree—but is it at issue that absent some new source of revenue or some reduction in spending elsewhere to come up with the cash to fund personal accounts, there is no increase in Federal savings? Is that correct? Anybody disagree with that?

Mr. ENTIN. In a static sense, yes, unless the changes you made triggered some additional behavior changes by the public. If you trimmed benefit growth and trimmed the tax rate equally and you, in static terms, got no change in the net budget situation, but if the reduced payroll tax encouraged some additional employment and the people would earn more and save more, you would have a change in Federal saving. So, the mechanisms you choose can have an effect on these static estimates.

Chairman MCCRERY. Sure. I don't want to get into this right now, maybe others will, but Mr. Price's comment that we are not managing the economy very well now. We can certainly agree or disagree on that, but Mr. Shipman—I think it was Mr. Shipman that pointed out that other economies are not doing nearly as well as ours.

Mrs. TUBBS JONES. Mr. Chairman, I am having a hard time hearing you. I don't know if I am the only one, but could you raise your level just a little bit?

Chairman MCCRERY. I will certainly try to do that. Other Nations' economies don't seem to be doing quite as well as ours, so evidently we are doing something right in comparison to those nations that are most similar to us from an economic standpoint in Western Europe and Eastern Europe. So, I think that certainly is something that people could disagree on. That is an example of what Mr. Entin is talking about, making changes in policy that affect other things in our economy which make the economy better. Many of my colleagues in the Minority are disparaging of the tax

cuts that have been made. Most of us, I guess all of us on our side believe that those tax cuts are responsible for, in some part, the difference in economic growth in the United States and those countries in Western Europe, and the difference in the unemployment rate here, which is much better than the unemployment rate in Western Europe.

So, those are things we can discuss. That is a good point Mr. Entin made. I certainly wouldn't discount increases in national saving that are kind of a spinoff of other policies. I am talking about static, direct, what we can identify through the establishment of personal accounts in Social Security. Clearly, if we funded those with some new revenue or by an identified cut in other spending dedicated to the personal accounts, then you would automatically have an increase in national savings.

Dr. Furman.

Mr. FURMAN. Thank you. I am only aware of one study that examines the impact of carve-out accounts on national savings. It was performed by Doug Elmendorf, who is an economist at the Fed, and Jeffrey Liebman, who is an economist at the Kennedy School of government. They found that carve-out accounts financed by debt would, over the long term, reduce national savings and reduce economic output. They found that people would look at the assets in their individual accounts and treat some of that as net wealth, say, oh, I have $100,000 in my account, I don't need to put as much into my IRAs, 401(k), and not realize that that $100,000 they had in the account was matched by $100,000 worth of benefit reductions that were coming 20, 30 years in the future. If people overlook the benefit offset, that is what will happen. That is, as I said, the only study I am aware of, and it finds that the interactions are negative.

Chairman MCCRERY. Yes, Mr. Price?

Mr. PRICE. If I could clarify. I don't want to get into—this is not the place to debate the wisdom of fiscal policy, but simply to point out that as to prefunding, whether we are contributing to more saving today on behalf of future generations, we have gone in the other direction. The policy decisions that we have made have done the opposite of what you had said was the definition of prefunding; we have done the opposite. As a statistical matter, I don't think there can be any question that that is what we have done.

Chairman MCCRERY. I agree.

Mr. PRICE. It may have been the right thing to do to manage the economy. I don't think so; other people think so. The fact is, it was the opposite direction of prefunding.

Chairman MCCRERY. Oh, absolutely. No question about that. Which brings up another question, and that is the 1983 reforms. Some—maybe it was my good friend Sandy Levin, who said in his opening remarks that that was a form of prefunding, when we increased the payroll tax and increased the surplus coming in and we dedicated that surplus to future generations of beneficiaries, that was a way to prefund. I suppose technically it is a way to prefund, and maybe in the macro picture it is a way to prefund, but with respect to the Social Security program itself, as Dr. O'Neill said, it was merely putting promises to pay in the Social Security box. Would any of you like to comment on whether the 1983 reforms,

the increase in the surplus, is prefunding? Is that the kind of prefunding we should do? Dr. Samwick?

Mr. SAMWICK. I would like to draw a distinction between prefunding future benefits and pre-authorizing them. All that the 1983 amendments have done, based on the conduct of our other budget policy, is to pre-authorize those payments. If we, instead, had a fiscal policy which was, say, over the course of a business cycle to balance the on-budget account, then that would be prefunding because it would have engendered no additional government spending outside of Social Security. I think Mr. Price described another scenario, which would be there is no drift in debt-to-GDP ratio, presumably, exclusive of the Social Security Trust Fund. That would make that pre-authorizing of those benefit payments actual prefunding. I don't believe——

Chairman MCCRERY. Had we done that, had we followed a fiscal policy that balanced the operating budget and left aside the surplus—that is what you are suggesting—well, what would we have done with that surplus?

Mr. SAMWICK. Well, you would have bought back existing debt held by the public.

Chairman MCCRERY. Bought back debt. How long would it have taken us if we had started in 1984, when this big surplus began to accumulate, to extinguish all the debt if we had immediately gone to a balanced budget in the operating side of the budget?

Mr. SAMWICK. I don't have the direct answer.

Chairman MCCRERY. It wouldn't have taken very long.

Mr. SAMWICK. Right. In my——

Chairman MCCRERY. In my recollection, it would have taken only a few years to totally extinguish the debt of the United States, the external debt of the United States. So, then what do we do with it?

Mr. SAMWICK. I believe, and my written testimony makes this clear, that if you are to run—if you are to increase contributions to the system, you would like to do so in a decentralized manner of personal accounts for a variety of reasons, not just the availability of suitable credit market instruments for the government to be able to hold.

Chairman MCCRERY. Thank you very much.

Mr. FURMAN. Mr. Chairman, if——

Chairman MCCRERY. I am going to let Mr. Levin have his turn, but maybe he will let you say something. Mr. Levin?

Mr. LEVIN. Thank you for giving me a chance. I will save a minute to do that. I am glad, Mr. Shipman, you are here, because I think your presentation is the most frank discussion of what is behind private accounts. I think everybody should take note of it. That is really what the President's private proposals do. They move toward elimination of what you call tethering of people to a Social Security system, or government system. That is exactly what the President's proposals would do over time, with the clawback and with the change in indexing—and adding annuitization, by the way, which doesn't allow people to pass it on to their heirs. But anyway, your presentation here, Cato has been very direct, and essentially it means the end of our Social Security system over time. That is what you are after. That is what the President is after.

Let me just say—and then we will come back to you if there is time. No one is saying do nothing. That is number one. No one is saying that. Second, I think it is a mistake to read Social Security as an anti-poverty program. It has helped to bring seniors out of poverty, it has reduced the poverty rate from 30 percent at the time of Social Security down to less than 10. It is not only or basically an anti-poverty program. It was structured, originally, and certainly after that to provide a level of retirement benefits so people, as my mother would have put it, could continue to live independently. She wasn't in poverty, she wasn't wealthy, she was allowed to continue to live her own life. So, when we say, we talk about poverty, Social Security and the replacement rate of 39 percent or 40 was an effort to allow people to live in dignity, to live with independence, and not fall back into poverty in many, many cases.

Dr. Furman, let me give you a chance to answer the question, because it raises—and Dr. Samwick. In the Clinton years we projected a deficit that was a form of prefunding, it seems to me. The Chairman asked the question what you do after you pay off the debt. We are a long ways from that today. I think the policies of recent years have shown that fiscal irresponsibility is the opposite of prefunding. Dr. Furman, go ahead. You were going to answer.

Mr. FURMAN. I remember in 2001 one of the problems people in Washington were preoccupied with was paying off the debt too quickly. I think we can all agree that President Bush has decisively solved that economic problem.

[Laughter.]

Mr. FURMAN. But the debate over the 1983 and whether it constituted prefunding or not, in this context, I view as somewhat academic. Which is to say interesting to me, but not very relevant. None of the major Social Security proposals I am aware of—and the Chairman may have one that I am not yet aware of—involve any significant degree of prefunding. So, to debate whether you should prefund through the trust fund or prefund through accounts, when the plan isn't doing any prefunding at all, strikes me as not the most relevant debate to be having. That being said, first of all, the debt is high enough now that we do have substantial scope to prefund the system—but not proposal does that—through debt reduction.

Second of all, the question 1983 and whether it prefunded or not is not, did we raid the Social Security surplus, which we did do and we didn't do in the nineties when President Clinton was President; the question is would the deficit have been even higher if we hadn't had the Social Security reforms in 1983. In that case, the debt would be lower than it otherwise would have been in the absence of those reforms, and we would genuinely have prefunded. That is my reading of the evidence.

Mr. LEVIN. Actually, my time is going to be up, Mr. Chairman. Again, I want to thank you for painting what I think is the basic issue. I think the American public basically disagrees with you. I don't think they think they are tethered to Social Security. It provides, in addition to retirement, disability protection and also survivor benefits, which are hard to purchase in the private market. I think more and more people think they are tethered to their pri-

vate plan. If you ask people who are employed and who are covered by private pension plans, whether they work for United or whatever, I think they feel Social Security is something they worked for, they earned, and is guaranteed. They want it to continue. The problem that President Bush is having is that people understand that inside of his proposals is essentially the essence of what you are proposing, and that is the replacement of Social Security with private accounts. They don't want that.

Mr. SHIPMAN. May I respond?

Mr. LEVIN. You may—you think 50 years from now the decision will be different, but it is not today. Go ahead.

Mr. SHIPMAN. First of all, I believe that you mentioned that my preference is to end this over time. I am speaking only about the retirement portion of Social Security, not disability insurance. Of course disability insurance is part of Social Security, so that——

Mr. LEVIN. And survivors?

Mr. SHIPMAN. Well, that is really—85 percent of survivors are aged widows and widowers, which really come under the retirement portion. Fifteen percent are the tragic cases of children whose parents have died early. Even in a market based system, if those parents die early, from my point of view those children should not be disadvantaged whatsoever because of moving to a market based system. I believe that the amount that is paid is roughly between $3 billion and $5 billion a year to these children, and that should not be interrupted whatsoever even if you were to move to a market based system.

As to whether Americans are tethered or not, as to whether Americans want to continue with Social Security as it is structured now or a market based alternative which we could structure, we will only know the answer to that question if they are given the choice. You may think that they will stay with Social Security. Somebody else may think that they would go to the market based alternative. If you are correct, giving them the option to have a market based alternative will not alter whatsoever the fact that they think that Social Security is a better deal. They will stay with it.

Mr. LEVIN. No, because what it means is massive debt and major benefit cuts for everybody on Social Security. That is what the President——

Mr. SHIPMAN. If they think it is a better deal, they won't move from it.

Mr. LEVIN. I know, but for those who move, it means massive debt for the Nation and major benefit cuts for everybody else. Essentially, what the American people are saying to the President of the United States and to this Congress is that they want to maintain the guaranteed benefit of Social Security. That is what they are saying. Thirty, 40 years from now, you may be right. At this point, I think the American people are saying that you are wrong. Thank you.

Chairman MCCRERY. Mr. Johnson?

Mr. JOHNSON OF TEXAS. Thank you, Mr. Chairman. Mr. Levin, you and I don't agree at all. I mean, you got a couple of people out there that are saying no to everything, and Dr. Furman, his

no-net savings would reduce the input, and the only answer is tax increase. I don't believe that.

Mr. FURMAN. Well, I was thinking if you want to prefund and you don't want to cut benefits for people now, you have to——

Mr. JOHNSON OF TEXAS. I will ask you a question when I get ready to. I believe that Mr. Shipman made a statement some years ago, actually the Board of trustees Report in 1994 suggested the system is going to run out of money, and it didn't work in 1977, it didn't work in 1983, it will not work now. I appreciate that statement because I think that is correct. I think Mr. Shipman is absolutely correct that people need the choice. The choice doesn't include benefits for disability, widows, and orphans. Nobody wants to mess with that. I think those funds are going to be there under any plan that is proposed today. So, I wonder if you would discuss personal accounts with a different vision, maybe, Mr. Shipman.

Mr. SHIPMAN. Yes, thank you, sir. From my perspective, speaking only for myself, all Americans should be free to stay in Social Security as it is structured or move to an alternative, a market based alternative. The efficacy of market based alternatives have been spoken of in extent in this hearing, as well as at others. The way that I would design it would be if you choose to go into the market based alternative, then some portion of your existing FICA tax, the OASI tax, which is 10.6 percent of $90,000 of wage income this year, some portion of that would go into a private account, sent by the employer to Treasury just as it presently is in the FICA tax. Treasury receives the wire transfer and immediately sends it over to a private custodian bank, held in trust for each American that made that choice.

Now, when that amount is reconciled to the individual's name, which takes about a year or so under existing Social Security structure, then each individual would be allowed to put that amount into one of three highly diversified balanced funds—U.S. stocks, U.S. bonds; foreign stocks, foreign bonds; and cash. Very common as structures in defined benefit plans as well as defined contribution plans. One of three funds. One of three funds. After a period of roughly three to 5 years, after the system reaches a steady state, each individual could go down to another level and, through other providers such as mutual funds, registered investment advisors, certified financial planners, and the like, all constrained by the trustees of this system as to what the portfolio would be, they could move down into that level. I refer to this as a retail level. This would be more expensive than the first three balanced funds. I move down to that retail level, let's say go to Fidelity; I could move from Fidelity, to T. Rowe Price, to Vanguard to various other providers, and they would charge me whatever they wished. I don't have to be there because I could move back up into this institutional platform, which would be the three balanced funds.

I testified to the House Budget Committee Social Security Task force, I believe it was called, in 1999 on this structure and shared with the Committee that this had been costed out, including asset management, recordkeeping, custody, an annual statement, 175 to 350 million phone calls per year to a customer service center, 85 percent of which are answered by a computer, 15 percent answered by a customer service representative—very much like a 401(k)

structure. Including all of those costs, assuming just a 2 percentage point savings rate, steady state costs 19 to 34 basis points of assets. That is less than the 401(k) model, that is less than the mutual fund model, and it is very, very cost effective. To Mr. Levin's point, nobody has to do it. It would all be by freedom of choice. Thank you, sir.

Mr. JOHNSON OF TEXAS. Thank you. I might add, Mr. Levin, that all—100 percent—of the young people in our district want that type of voluntary way to put their money into an account.

Mr. LEVIN. Would you yield?

Mr. JOHNSON OF TEXAS. Sure.

Mr. LEVIN. The surveys show the more young people hear about the President's plan, the less they like it. That is what the surveys show. You need to, Mr. Shipman, talk about the impact of diverting those kinds of moneys from Social Security into private accounts on the benefits structure and on the debt of this country. It doesn't come, the diversion isn't cost-free, sir.

Mr. JOHNSON OF TEXAS. No, but it does——

Mr. LEVIN. It is trillions of dollars.

Mr. JOHNSON OF TEXAS. Solvency occurs downstream and you don't have to worry.

Mr. LEVIN. It doesn't touch solvency. It doesn't touch solvency.

Mr. JOHNSON OF TEXAS. Thank you, Mr. Chairman.

Chairman MCCRERY. Actually, it does touch solvency under Mr. Johnson's plan as scored by the Social Security actuaries. Mr. Neal?

Mr. NEAL. Thank you very much, Mr. Chairman. Chairman McCrery mentioned the debate that we have had here over tax cuts, which is in some measure, I think, a reflection of the major differences that we hold about the condition of the Social Security Trust Fund today. Dr. Holtz-Eakin, is it fair to say that in some measure the Social Security Trust Fund surpluses have been used to fund the tax cuts?

Mr. HOLTZ-EAKIN. It is fair to say that the dollars entirely intermingle in the Federal budget and that we have run deficits in recent years, despite the fact that there are Social Security surpluses.

Mr. NEAL. But that is fair to say that the surplus has been used to fund the tax cuts?

Mr. HOLTZ-EAKIN. Not in any dollar-for-dollar matching sense, but on net.

Mr. NEAL. No, no. The general statement, it is accurate, and the other aspects of the budget as well. Given your previous position here, Dr. O'Neill, would you agree with that statement?

Ms. O'NEILL. Well, you can't identify which——

Mr. NEAL. No, you can't identify which dollar, but is it a fair statement to offer?

Ms. O'NEILL. The entire—all of the expenditures——

Mr. NEAL. We have great regard for the role that you have played here, Doctor. One of the things about the positions that you have held here is that you tend to be above the fray. Is that an accurate statement or not, that the tax cuts have been in some measure funded by the Social Security surplus?

Ms. O'NEILL. Well, I—of course it is——

Mr. NEAL. Thank you very much. That is why we have such regard for you folks that hold those positions here, because we do respect you in an academic sense.

Ms. O'NEILL. But I pause——

Mr. NEAL. Let me go to you, Dr. Furman, for a moment here. If we were to establish private accounts, how would we guarantee that they were actually prefunded? Wouldn't we have to fully offset the cost of those accounts by either raising taxes or cutting benefits? I think a moment ago you were headed there?

Mr. FURMAN. Right. My comments today, contrary to Mr. Johnson, I actually didn't view as negative or positive about accounts. I was trying to stick to the topic of prefunding, and not some of the broader issues I have addressed previously. Accounts by themselves don't constitute prefunding. You need to pay for the money that goes into the accounts for prefunding, and you need to pay for that by raising contributions in one way or another.

Mr. NEAL. Is that sustainable?

Mr. FURMAN. It depends on the way in which it is done. I think one would have concerns that some of the prefunding that you think you are getting on paper that way unravels, because people end up saving less in their 401(k)'s and IRAs.

Mr. NEAL. What kind of policy changes would occur, or would lead, if we were to go in the direction of private accounts being retained without prefunding?

Mr. FURMAN. You would need dramatic reductions in future defined Social Security benefits to pay off the debt associated with those accounts. You would not have any up-front increases in national savings to help smooth that transition.

Mr. NEAL. Mr. Price, would you agree with that?

Mr. PRICE. Yes.

Mr. NEAL. You would? Dr. Eakin?

Mr. HOLTZ-EAKIN. I think it is important to recognize that you cannot evaluate the long-run consequences of any of these without a fully specified plan. Just saying "accounts" in isolation really doesn't give you enough information.

Mr. NEAL. What would happen—I mean, the dot-com phenomenon is fresh in all of our minds here for those who would say we would only put these trust fund accounts in certain-to-grow private initiatives. I am certain that if we were sitting here, though, five, six, 7 years ago, the same forces that will be saying these will all be safe investments would have been pressuring this Congress to open up those opportunities for the dot-com industry. What happens to the families that would come here asking their elected officials for ability to access the accounts for purposes other than retirement? Mr. Price, would you like to——

Mr. PRICE. I am sorry, could you repeat the question?

Mr. NEAL. If there were requests from the general public asking for access to those accounts for purposes other than retirement. We have talked about using the IRAs, which I agree with, by the way, for first-time home purchases and things of that magnitude. What do you think would happen?

Mr. PRICE. Well, surely people face big crises in their lives. We have created—you guys have passed laws that allow people to get access to various tax-favored assets for other purposes than retire-

ment. I think that those same kinds of political pressures would apply to these new accounts. Whether you would relent and allow people to do with those, you would know better than I. I think there would be a lot of pressure from people who face medical crises or education finance crises, that they would get access to their—they have been told it is their account, and they think they know better than anybody else when they are 45 or 50 that it should be spent now rather than later.

Mr. NEAL. As we pursue this discussion, it has really healthy, and Mr. McCrery has done a very good job with the panels that have been assembled. Many of us have a fresh memory of the S&L issue and how that played out here, when we allowed people to get into the S&L industry and to do things that they had not been properly chartered, or the issue had not been vetted for. The bill was enormous to the American taxpayer. Do you want to offer your comments on that, Mr. Price?

Mr. PRICE. I would like to comment on that because I think a lot of people have a tendency to exaggerate their ability to make decisions. Some of the most interesting research is that even if you have broad measures, a bond account versus a stock account, that people buy—they read the newspapers that stocks are going up and so they go buy the stocks. Or that stocks are going down and they sell the stocks and buy the bonds. When you look at actual research, when people had access to confidential private accounts, what people were buying and selling, they were doing it—they were buying high and selling low. You look at inflows into mutual funds. They go in at the wrong time. Actual, real people know that they make bad decisions. That these measures, like Robert Schiller shows, the average return using indexes is a median return using historical performance of actual stock markets, and you apply those to—and take what a recent Wall Street Journal Survey projects are going to be the returns, with a median return of 2.6 percent. The President has a clawback charge of 3 percent. That means that 71 percent of the time, people will lose money. That is using an index. That is using steady performance. That is not taking real people, who in real time, evidence clearly shows, make the wrong decisions. They buy high and sell low. They tend to do worse than the averages, because they have confidence.

The evidence is that men are much more active traders than women, they have more confidence. Higher-income people have more confidence than—they do more trading, and they don't do it better. People are not patient to just let things stand. They move into stocks when they have read that they have been going up. They buy high.

Mr. NEAL. Thank you.

Thank you, Mr. Chairman.

Chairman MCCRERY. Thank you, Mr. Neal.

Mr. PRICE. We did the same thing in the S&L situation. We thought that if we just turned the market loose and let people invest, they would make good decisions in housing and whatever else we let them do, and they made a lot of bad decisions.

Chairman MCCRERY. Mr. Shaw?

Mr. SHAW. Mr. Shipman, do you agree with what Mr. Price just said?

Mr. SHIPMAN. No, I don't. And——

Mr. SHAW. Thank you. Dr. O'Neill, I saw you were frustrated at being cut off by Mr. Neal with regard to the answer to his question as to whether the tax cuts that this Congress put in place, or has put in place over the last several years, what effect they have had on the shortfall, the coming shortfall on Social Security. Would you like to expand on that answer?

Ms. O'NEILL. The overall budget deficit—are you referring about the budget deficit that we now face?

Mr. SHAW. Well, he was trying to blame that on the problem with the Social Security. Let me ask you another question. If we had——

Mr. NEAL. Would the gentleman yield?

Mr. SHAW. No, I will not. You didn't yield to her when she was trying to answer your question fully. The question is, would we have put real money, put actual money into the Social Security Trust Fund, or would it have been converted into Treasury bills——

Ms. O'NEILL. But we don't have any way of putting money into the Social Security——

Mr. SHAW. Right.

Ms. O'NEILL. To take money from now and put it into the future in Social Security is the whole problem of a pay-as-you-go system. Various speakers have sort of endorsed the lock-box idea, that if you can, having budget savings, that that will reduce the publicly held debt below what it would have been, and therefore, in the future we will have more money for Social Security. But, that arguement has two problems with it. One is during the days when we did have a large surplus, I think the proof was really shown that it is impossible to have a surplus dangling there and not be touched. The surplus, in part, evaporated because it was there. It meant that after all those years of restraint during much of the nineties, suddenly there was money. It is Members of Congress; it wasn't just the Bush Administration who decided to increase spending of all kinds during that period. It was everybody. It is just difficult to run a surplus. That plus the recession, plus 9/11, contributed to the deficit.

Okay. Suppose we hadn't done that and the surplus—suppose somehow there had been restraint and much of the surplus had been saved. What then? There is no guarantee that if we lowered the debt now that in the future that money would go to Social Security. There is nothing to tie it to Social Security.

Mr. SHAW. That is right.

Ms. O'NEILL. There could be another thing that we would rather spend the money on at the time.

Mr. SHAW. There is no mechanism——

Ms. O'NEILL. There is no direct link.

Mr. SHAW. That is right. There is no mechanism in order to hold money in the Social Security Trust Fund.

Ms. O'NEILL. There is not any lock box.

Mr. SHAW. Now, the years when we had surplus, we paid down the national debt. We did not pay down any of the Treasury bills that were being held by Social Security Trust Fund, did we?

Ms. O'NEILL. Well, on paper there was increasing so-called balances, the promises.

Mr. SHAW. So the Treasury bills actually inside the trust fund continue to grow.

Ms. O'NEILL. They continue to grow, but in terms of——

Mr. SHAW. And they are backed by the full faith and credit of the U.S. government.

Ms. O'NEILL. Yes, but that——

Mr. SHAW. They are not a real economic asset at this particular point if it is a Treasury bill that is owned by the government and held by the government, payable to the government by the government.

Ms. O'NEILL. That is all true, but when the time comes when the funds would actually be needed, there is no guarantee that the economy would be in a position to actually honor those promises, and the law can be changed. It has in the past, and—we do not know what future Congresses and future Presidents are going to do.

Mr. SHAW. This Congress has been very active, and we have seen it in some of the disasters that we have had in the private pension system. United Airlines would be one I know of very well because my brother is a retired United Airlines captain. This was not a fully funded system, and it is going down. This Congress is working on requiring the private sector to fully fund or at least fund up to 80 percent, or some percentage, of the liabilities. That is different—and those funds may have been backed up by the full faith and credit of United Airlines, but certainly they were not funded properly, and we are trying to apply the same standards to the SSA, or at least go in that direction by creating real economic assets. Now, these same bonds, if they were in the name of the people that are in the system of the workers, then those would be real economic assets, wouldn't they?

Ms. O'NEILL. That is their private property, right.

Mr. SHAW. It would really be a very, very strong—make a strong statement as to the full faith and credit of the government payable to the worker. That would be a substantial asset.

Ms. O'NEILL. Which is why I mentioned that the private sector has taken care of this problem by converting to defined contribution plans, which essentially are pre-funded plans. I belong to such a plan, TIAA-CREF. That plan has been highly successful, and I think that most of the participants are very happy with it. It has weathered the storm of the bubble collapse. Enough had already been accumulated. Depending on the share that you had in the stock portion versus the bond portion, everybody experienced some degree of decline. But by now, with the expansion, the rebound for many has more than made up for it.

Mr. SHAW. And in your testimony, you quite correctly testified that some time between 2015 and 2020, there would not be enough cash coming in to honor the benefits in the benefit structure that we have today. Is that not correct?

Ms. O'NEILL. That is correct.

Mr. SHAW. Thank you. Thank you, Mr. Chairman.

Chairman MCCRERY. Mr. Becerra?

Mr. BECERRA. Thank you, Mr. Chairman. Thank you to the panelists for their testimony. Again, an engaging discussion, and we thank you, Mr. Chairman, for the numerous hearings that we have had. Let me ask Dr. Furman a question. This hearing is supposed to focus on the issue of pre-funding, coming up with a system where we prefund the benefits that will be available into the future for those who retire. Yet, if I heard you correctly, what you were saying is that the Bush tax cuts which have benefited mostly America's wealthiest people have amounted to the opposite of prefunding, in fact, a defunding of a system that could be available to help in retirement. Is that an accurate statement?

Mr. FURMAN. That is an accurate statement. They have defunded our overall fiscal situation at a cost that is more than 3 times as much as the 75-year Social Security deficit that so much of the policy discussion has been focused on.

Mr. BECERRA. So, if there is a desire to try to prefund a future retirement system, what we have done through the Bush tax cuts is actually not only made it more difficult to pre-fund, but by a factor of perhaps three or so?

Mr. FURMAN. That is correct.

Mr. BECERRA. Now, did I hear you correctly as well that private accounts, at least those that we know proposed by President Bush, that those themselves, as they have been proposed by President Bush, do not lead to any prefunding as well?

Mr. FURMAN. That is correct. There has been a lot of discussion, and I think it is an important discussion, whether to prefund through accounts or not through accounts. To get to that second stage of the discussion, you need a plan to prefund in the first place, and I have not seen any plans that would do that.

Mr. BECERRA. Mr. Price, I think you are the one that had mentioned that you cannot do prefunding by having the Federal Government borrow money. Is that accurate?

Mr. PRICE. That is accurate.

Mr. BECERRA. As well, okay. Go ahead.

Mr. PRICE. I think the Chairman and everybody on the panel would agree with that.

Mr. BECERRA. Mr. Shipman, I listened with interest to your testimony when you mentioned that the Social Security benefit does not amount to very much for most Americans. I think to myself today there are about 10 percent of America's seniors who are living in poverty. Without Social Security, that number would be about 50 percent. So, I think a lot of seniors, at least that 40 percent that does not live in poverty, probably looks at Social Security and says it does amount to quite a bit.

You mentioned that your alternative to Social Security would be a market based system, if I am quoting correctly, "a market based system where we are free to invest where we want." You also indicated that no one has to do it, no one has to participate, and that there is freedom of choice. Again, that makes me think of what we had prior to the Depression, in the twenties leading up to the Depression. That is what we had—freedom of choice. You could invest wherever you wanted. There was nothing that guaranteed you a set retirement benefit, and we saw what happened as a result of

the Depression. In fact, the result was President Roosevelt coming forward with the Social Security program.

Then I thought to myself, I remember when I was in the State legislature, there was a very similar argument that was made that we should have freedom of choice, you can participate if you wish, and it had nothing to do with retirement. It had to do with motorcyclists on our freeways and whether or not they should wear helmets. Most of the motorcyclists that we had testify before us in Committee would say, "We want the freedom of choice. We want to be able to decide whether we need to wear a helmet or not." The difficulty was we had all the evidence before us, the data that pointed out the number of hospital stays, the amount of costs that were incurred by the traumatic injury to heads and otherwise to motorcyclists, as a result of freeway accidents. The fact that almost none of these individuals had the moneys or the insurance to pay for the costs of their health care, in some cases long-term health care, needed as a result of permanent brain damage, and so forth.

So, the State legislature in California, as I think in most States, had moved forward, has since moved forward with legislation requiring motorcyclist to wear helmets. Under your framework of freedom of choice and you do it if you wish, you are not required to, we probably would still have a lot of motorcyclists in this country riding around on their motorcycles, many of them very good motorcyclists, without helmets. I guess my question would be: While it is great to have freedom of choice, say we were living under your system framework of no Social Security, what would your response be to an Enron employee who yesterday had a 401(k) but today does not?

Mr. SHIPMAN. Enron is a classic case, and——

Mr. BECERRA. What would you say if you had an Enron employee here today sitting before you? How would you respond to them in terms of their retirement benefits under the 401(k) that they had before?

Mr. SHIPMAN. As far as their 401(k) plan, or as far as a market based system for Social Security?

Mr. BECERRA. Well, a 401(k) is a market based plan that is available to those. You are free to choose to participate if you wish, as you have proposed. What would you say to an Enron employee who had a 401(k) plan principally invested in the Enron company itself?

Mr. SHIPMAN. I guess I would say—and I would say to you as well as the rest of the panel—that from my point of view, the freedom of choice is to whether you can go into the market based system or not. Then it ends. Once you are in it, as I mentioned to Mr. Johnson, once you are in it, the trustees stipulate the portfolios, highly diversified across asset classes, borders, and time and so on. In each of these portfolios, there would be literally thousands of securities. One of them will be tomorrow's Enron. There are thousands of them, and the impact upon the portfolio will be to the right of the decimal point.

In a 401(k) plan, it is significantly different because not only are the individuals free to go into the 401(k) plan, in most cases beyond that they are free to invest any way that they want. That is not what I have argued for in the reform of Social Security. Free to go

into the market based system, but not free to invest any way you want after you have made the election to go into the market based system. They are fundamentally different structures.

Mr. BECERRA. I know my time has expired, so I thank you for the response. Mr. Chairman, thank you.

Chairman MCCRERY. Mr. Ryan?

Mr. RYAN. Thank you, Mr. Chairman. I think I followed Mr. Becerra last week, and I have sort of a deja-vu sense. In Wisconsin you do not have to wear a motorcycle helmet, and we are going to defend that right. We make Harley Davidsons there.

[Laughter.]

Mr. RYAN. And bows and arrows. This whole hearing about prefunding, I just want to ask the panel kind of a general question. The younger you are under the current system, the worse you do as a percentage of your payroll, correct? Meaning if you are 70 today, the payroll taxes you experienced are giving you about a 4.5 to 5-percent rate of return based upon those payroll taxes. If you are 40 today, you are getting about a 1-percent rate of return. If you are one today, you are scheduled to get about a negative 1 percent rate of return. Correct? I think everybody——

Mr. FURMAN. Average rate of return in the system going forward is still positive, not negative.

Mr. RYAN. I am not going to take it individually. The average age cohort. So——

Mr. PRICE. Let's just keep in mind that there is no market for many of the products that Social Security provides. You are trying to focus in on the retirement product.

Mr. RYAN. The question was directed specifically as a component of what you pay in and what you get out in the benefit.

Mr. PRICE. Right, and what I am saying is that there is no product that provides people inflation-adjusted benefits until retirement.

Mr. RYAN. Sure, well——

Mr. PRICE. There is no product that——

Mr. RYAN. You could buy a Treasury Inflation-Protected Securities (TIPS) bond that would provide you an inflation-protected instrument against inflation for retirement.

Mr. PRICE. But, the plan so far——

Mr. RYAN. Absolutely.

Mr. PRICE. You talk about—I mean, the problem with——

Mr. RYAN. I do not mean to cut you off, but we only have 5 minutes. So, my next question is—please. My next question is: Since we are talking about prefunding, what is more reliable for a younger worker, say aged 40 and below? The concern I have is, when you talk to anybody in their twenties and their thirties, and half the people in their forties, they almost always tell you, "I don't believe it is going to be there when I retire. I am not counting on Social Security. My investment adviser told me not to count on Social Security for my retirement planning." That is wrong. We do not want that kind of a system. Whether you are Democrat or Republican here, we want to make sure this is a program you can count on when you retire.

So, my question is: What is more reliable for a person to get this certain level of benefits, prefunding by giving an ability for an indi-

vidual to put money in their own account, to grow at a market rate of return, to help finance their benefits, or hoping that Congress will come up with a solution on this pay-as-you-go system given the current problems that we have today? I will just start with you, Mr. Shipman, and go down the row, whoever wants to comment.

Mr. SHIPMAN. I accept the question as being rhetorical. It is clearly safer to save and invest in capital markets and receive the market rate-of-return than it is to pay taxes to the government in a pay-as-you-go system wherein the number of workers relative to retirees has, is, and will be, shrinking.

Mr. RYAN. Mr. Furman, I've got to think you have an answer to that.

Mr. FURMAN. I will try to think of one. First of all, I would not have used the word "prefunding." Prefunding to me, and I think to most of——

Mr. RYAN. Yes, we went through that.

Mr. FURMAN. So I will not repeat that. In terms of the answer to your particular question, if you look at—let's just take the President's proposal as an example.

Mr. RYAN. Okay.

Mr. FURMAN. Under that, you have either a Social Security benefit on the one hand, or a combination of a Social Security benefit and an account on the other hand. In terms of market risk, the one with the account has more market risk than the one without the account, in terms of pure market risk. In terms of political risk, those two retirement systems are, from my perspective, exactly identical. You can still reduce the residual defined benefit under the President's plan or increase it, if you want to. There is also this critical factor of the offset rate, which as he sets it, 3 percent, an arbitrary number, could change it to 2.5, could change it to 3.5. That would dramatically change the value of your account. Finally, you could change the tax treatment of accounts. You could tax them as they accumulate them, tax them upon withdrawal. Any of those——

Mr. RYAN. So, the political——

Mr. FURMAN. The political risk of these two benefits are identical. One of them has more market risk. That means one of them has more overall risk.

Mr. RYAN. Look, I want to get to these other folks, but basically what you are saying is it is impossible for us to tie the future hands of Congress, and they could do anything in the future. Given the fact that we have a $4 trillion 75-year shortfall, $11.1 trillion infinitely rising shortfall, clearly Congress is going to have to do something about this. So, these benefits are right now at risk.

Mr. FURMAN. I feel like we have had this discussion before. They are at the same level of risk. I view that risk as very, very low. Historically, Congress has never made changes in benefits from year to year of the magnitude that Enron stock has fluctuated from year to year.

Mr. RYAN. Anybody else?

Mr. SAMWICK. If you are going to prefund, there are two reasons why you have to do it through personal accounts: one, you want to be able to invest in risky securities, not just riskless bonds; second, there really is no mechanism to make sure that prefunding

actually serves to reduce the tax burden on future generations. That is why it has to be personal accounts.

Mr. PRICE. Personal accounts create tremendous risk for the government. One of the things that is misunderstood about the United plan, most defined benefit plans were in great shape in 2000. The change in the stock market has a big effect. If you had an individual who had all his money in stocks in 2000 and wanted to retire then, and could get the higher interest rate, they could get a great annuity. Three years later, their stock portfolio would have been down. Their interest rate that they can convert to annuity would have been down. They would have had more than—the monthly annuity they could get in 2003 would be cut in half when compared to what they got in 2000. What would be the political response to that if that happened? It is a huge political risk——

Mr. RYAN. Okay, because there are four more hands up, I want to let them go. Mr. Beach?

Mr. BEACH. Well, I would just briefly say, Congressman Ryan, that the creation of the fiscal deficit which we have in Social Security right now—and it is growing—is evidence of the political risk that surrounds the current system. The Congress has not been able to contain its willingness to increase those benefits, and as a consequence, there is now the problem which is before this Committee. I think I would join Mr. Shipman in saying that one of the ways to reduce that risk is embrace a highly diversified personal retirement account system.

Mr. ENTIN. Highly diversified stocks beat bonds over a lifetime of work. Bonds beat the pay-as-you-go potential from the demographic situation. You are going to be better off in that. They have to be diversified. Of course, if you put money into your own account, you have funded it. If the national situation is not funded, that is Congress's fault. You do have to get the government to wean itself from the Social Security revenue if you are going to do that, and it should. As for the annuitization, it is like the savings and loan crisis. Congress passed a bad provision, and people took advantage of it. That was the Congress's fault. If you mandate that people annuitize their account the moment they retire, regardless of the state of the market, somebody could get injured relative to somebody else who did it a year earlier or 2 years later. Let people wait a couple of years and annuitize it in stages. For goodness sakes don't make people annuitize everything, beyond what is necessary for a basic retirement level. Give them the freedom to leave some of the account to their children later.

Ms. O'NEILL. The political risk of private accounts I think would be as close to zero as possible. We do believe in private property in this country and would not abscond the private accounts of individuals. So, the political risk, I think is minimal. On the other hand, the political risk of Social Security can be great because there are too many factors that can affect it that we have no control over now. Given that, the monetary return is obviously better from a market account, even by the most conservative strategy; and, as the other speakers have mentioned, there would likely be control—one could not become a day trader, for example, with your Social Security account. Any prudent plan—I have not really seen any suggested seriously that would allow anybody to invest in any-

thing. Prudent plans would follow the general rule of don't put all your eggs in one basket.

Mr. PRICE. You don't think United diversified its assets?

Mr. RYAN. Dr. Holtz-Eakin?

Ms. O'NEILL. That is not the only——

Mr. RYAN. Please. Typically it is Member to witness instead of witness to witness. Dr. Holtz-Eakin?

Mr. HOLTZ-EAKIN. The systems have different risk and return characteristics. Prefunded plans offer higher rates of return than can any pay-as-you-go system going forward. Risks around those kinds of returns, in a pay-as-you-go system you have got all the risks we talked about in our testimony—productivity, inflation, unemployment, the kinds of things that affect that system. Then you have market risk in individual accounts, and how people manage that is an important issue, the tools that are available for risk management. Finally, both face legislative risk. The system is currently out of balance and will have to be brought into balance at some point, somehow, and to get to a prefunded system we have to somehow get from here to there, and that involves sacrifice by somebody to put the resources away. How that would be done is also unknown. So, there is a competitive set of risks on both sides.

Mr. RYAN. Thank you.

Chairman MCCRERY. Just to follow up real quickly, if we were to make an effort to take as much risk out of personal accounts as possible, Mr. Entin, would it make sense—and be careful how you answer this because this is a suggestion that Dr. Holtz-Eakin gave me some time ago. Would it make sense to require when a person's personal account achieved a level sufficient to an annuity effective on the date of his retirement, which would guarantee him income equal to the poverty rate or poverty plus 10 percent or whatever we want to make it, and then allow him to continue to accumulate in his account without annuitization required at that point?

Mr. ENTIN. I think, in fact, some foreign countries do that to get that added degree of security, but also to get an added degree of freedom, because once you have achieved the basic social objective of preventing yourself from going onto the public dole later in life, you should be free to either add to the account or not add to the account. In Chile, for example, once you have been able to do that and purchase that annuity—and it might take a different form, not necessarily an annuity but some guaranteed set-aside—you can stop contributing. You can take the money out of the system and put it in some other investment, or spend it.

Chairman MCCRERY. So, you would not have any objection to our building in some safeguard like that.

Mr. ENTIN. I would have no objection to building in some sort of safeguard. Why are you going to make people—as some plans do—contribute all the way up until the time they retire, even if their saving has gone way beyond that annuity? You might as well let them out of the system, and let them put their money in some other sort of program at that point. Remember, you have this moral hazard you are trying to guard against, and indeed you may make the protection level more than the poverty level so that independence can be achieved. Beyond some reasonable amount, you don't need to go any further. If you look at the table as to where

benefits are going over time in the Trustees' Report or in my testimony, you might ask yourself: Why do we need to go up to $109,000 a year for an upper-income couple? Let them be free after some reasonable point.

Chairman MCCRERY. I understand. Thank you. Mr. Pomeroy?

Mr. POMEROY. Thank you, Mr. Chairman. You know, there is the story about Strom Thurmond who set all kinds of records for lengthy service in the Senate, and there were some chuckles when he voted for the term limits bill in the Senate. It is like, "Stop me before I run again." I kind of have the same reaction to Members of the majority who presided over the largest swing in our Nation's fiscal standing in the history of the country, largely driven by the 2001 and 2003 tax cuts. Now they are talking about prefunding. It is kind of like, "Stop me before we take some more." I really think that the lock box agreement between the parties represented that brief hour when there was this virtuous competition in terms of who would not spend those dollars the best. Really, it was a wonderful but brief period of time. The notion that we ought to borrow more money to somehow prefund to me defies rationale.

Now, in a visit that the Chairman and I were having with another Member, it helped me understand some of the drive toward this concept, basically saying, look, an unfunded liability is the same as a debt owed by the country. So, if we borrow $2 trillion the first decade, $4 trillion the second decade, and add it to the balance sheet, it is just the same as the unfunded liability for Social Security. Now, I am wondering if the fiscal markets—or is there any recognized treatment in fiscal policy for actually reducing the hard borrowed obligation of the U.S. Government versus an unfunded liability, if those stand an equal treatment at all. Dr. Furman?

Mr. FURMAN. Yes, that is a very good question, and I know of no Nation that has undergone a crisis because its implicit debt was too large. A lot of Nations have undergone crises because their explicit debt was too large, because they had to service that and pay that on an annual basis. There is not a one-for-one economic substitution between explicit debt and implicit debt. Explicit debt is more immediate, more tangible, and implicit debt is less certain and more subject to change and does not carry the same full faith and credit.

Mr. PRICE. There have been researchers looking at the Argentinean experience that claim that added debt for their privatization, and borrowing to do that contributed to their fiscal crisis and their economic problems.

Mr. POMEROY. Dr. Holtz-Eakin, you said a statement that did not surprise me, and I would not think you would have it in one of your scoring models. You indicated that, basically, offsetting risks of the private account theory, markets go up, markets go down, some risk there. On the Social Security side of the equation, you always have political risk. Dr. O'Neill, you have alluded to the political risk of making this system insecure. Basically, the benefits are established in the national code. It is a matter of national law. So, the political risk you are talking about involves Congress strolling over to the House and Senate floor and voting to slash benefits to retirees and having that law signed by the President. That is the

essence of the political risk that Social Security benefits face. Is that correct from an individual recipient's perspective?

Mr. HOLTZ-EAKIN. From an individual recipient's perspective, the question is, will the benefits be changed by law, or will the taxes be changed by law. There are two sides of the equation, and both are up in the air because the current system is unsustainable——

Mr. POMEROY. In seven decades, you have not had that march to the House floor to slash benefits, and I would say that if there is one thing the aging demographic of our country probably makes likely, it is that that it is not a risk that needs to keep people awake in the years ahead. You know, there is something—Mr. Entin, you said a statement that I really like. Government should wean itself off of Social Security revenue. Instead, this fiscal turn that we have had has made us completely dependent upon Social Security revenue. I am wondering if your institute, the——

Mr. ENTIN. The Institute for Research on the Economics of Taxation.

Mr. POMEROY. The Institute for Research on the Economics of Taxation. Did you take a position on the 2001 tax cut?

Mr. ENTIN. Yes.

Mr. POMEROY. Were you for it?

Mr. ENTIN. I was critical of some elements of it. I came down for it. I would have preferred that it be restructured.

Mr. POMEROY. How about the 2003 tax cut?

Mr. ENTIN. Yes.

Mr. POMEROY. I have seen an analysis that while there are many features that may have driven this deficit, the tax cuts were the single biggest component of us being in the fiscal straits that we are, certainly recognizing the economic slowdown, recognizing 9/11, and the costs of the war as all the other contributors, but the tax cut, number one of those causes.Mr. ENTIN. I think the recession was number one, and I think that you are looking at static revenue estimates and taking it out of the economic context. If you let the economy go downhill, you are in trouble. Remember the perfect golden years of harmony in the Congress and the real push for fiscal discipline that occurred between 1930 and 1933? Everyone said, "we have got to balance this budget, we are in a recession," and it turned into a depression. That really threw us in a financial hole. You have to make sure the economy is strong for any of this to work, and if the economy goes south, then the returns in the private accounts will not be so high. Capital formation will be in the tank, wages will not be growing, and payroll tax receipts will slow to a crawl.

Mr. POMEROY. The reference to the pre-Roosevelt period and our Federal Government reminds me of the budget——

Mr. ENTIN. Mr. Roosevelt also raised taxes.

Mr. POMEROY. Committee testimony that blamed the depression on the economic activism of Herbert Hoover. I think that that is an extreme and highly contentious——

Mr. ENTIN. Mr. Hoover recommended balancing the budget in the recession, and Mr. Roosevelt tried by raising taxes to balance the budget in the recession, until he changed later, quite wisely. He started down the wrong road, too. Remember——

Mr. POMEROY. The essence of the question—look, this is interesting——

Mr. ENTIN. In 1983——

Mr. POMEROY. The essence of my question was for someone that just said the government should wean itself off of Social Security revenue, you are with an institute that has supported two tax cuts that have substantially driven the deficit deeper and thereby made our reliance upon Social Security revenue for funding government programs——

Mr. ENTIN. We have also urged a great deal more spending restraint.

Mr. POMEROY. I yield back, Mr. Chairman.

Chairman MCCRERY. Thank you, Mr. Pomeroy. Mr. Brady is next, but just before he begins, I just want to pose a question for you to think about and answer when all of my colleagues have questioned the panel; that is, I think Mr. Pomeroy and Dr. Furman really posed the wrong question when they were talking about debt and the impact of that increased debt, that is, if you use debt to finance personal accounts, there is no market that would accept the proposition that over 75 years it will all even out and actually be better. While that may be true, I don't know that it is exactly relevant. What I think probably is relevant, however, is what level of additional debt would actually impose an economic burden on our society. I think that is the question on which, I suspect, we have different opinions. The weight of the evidence, I believe, is that with what the President has proposed, it would not affect the economy one whit. Mr. Brady?

Mr. FURMAN. Could I briefly respond to that?

Chairman MCCRERY. No. Be thinking about it so that you can respond more than briefly at the appropriate time.

Mr. FURMAN. Thank you.

Chairman MCCRERY. Mr. Brady?

Mr. BRADY. Thanks, Mr. Chairman. Obviously, Members of the panel see different sources for our defecits. I think the economy—the triple hit of the attacks of 9/11, the recession, and the dotcom bust all contributed to the economy in a big way. I think all those press releases we sent out about projects we have delivered back home have contributed greatly to our deficit. Yes, I think the tax cuts have, but to the extent that they have been an economic stimulus have been a price I have been willing to pay. I also think as we look at pre-funding we can look at, rather than raise this "scare our seniors" type approach, we can look at models like the Thrift Savings Plan (TSP), decades old, tens of billions of dollars, averaging 7.5 percent return, Galveston Plan, 24-years-old, interest-bearing accounts only averaging 6.5 percent, Texas Teachers half a century old, averaging now about 10 percent return a year. All models where those participants would not ever choose Social Security and go back to that lower income alternative.

Let me ask this question. Dr. Holtz-Eakin made an inescapable point that preserving Social Security for every generation is going to cost a ton of money, both in the permanent deficit that we face in the future, as well as when we begin to pay back the Social Security Trust Fund, the first year about $16 billion. That is the size of the NASA budget. The second year it doubles, $35 billion. That

is the size of the U.S. Department of Homeland Security. As he testified, it moves very quickly to $100, $200, $300 billion.

It raises the point that to preserve Social Security for every generation, we are going to spend a lot of money. The question I have for you, from an economic impact as we weigh how we are going to do this, whether we fund the pay-as-you-go system or prefund retirement accounts that, like these other models, grow slowly and steadily over the years. Starting, Douglas, with you, if I could, from an economic impact, comparing raising taxes to borrowing money, to reducing spending, from a number one choice as good for the economic impact of those three options, which would you prefer? How would you rank them? I guess that is the question.

Mr. HOLTZ-EAKIN. The core economic question is will we accumulate sufficient assets in the form of capital and technologies and education to have a larger economy in the future. So, you have to give up something now, save for the future. That means you consume less. The next question is the mechanism by which that happens. Do you consume less because you borrow a whole bunch? Do you consume less because of your tax consumption? Those are all secondary features of the core issue, which is how will we grow the U.S. economy so that it will be large enough to pay for these programs in the public sector and the private sector lifestyle that we have come to enjoy.

Mr. BRADY. Doctor?

Ms. O'NEILL. We can't predict very well, and we don't know the exact recipe for stimulating productivity. We know what can have adverse effects on productivity—policies that have disincentives, and Social Security I think is among the programs that have disincentives attached to them, disincentives to save and disincentives to work at certain ages. It is hard to answer the question without introducing your personal beliefs. I don't think it is an exact science that can tell you what strategy is more economically advantageous, by some precise amount, than another. You can point out the elements that you perceive will contribute. To some extent, it is a matter of the way you read the economy. In my view, I think that reducing expenditures would be more stimulating to growth, as would reducing taxes, but certain kinds of taxes, taxes that blunt incentives. Reducing marginal tax rates obviously gives an incentive boost. Raising them gives you disincentives.

The payroll tax can have harmful effects, particularly for low-income workers. I think most economists agree that the payroll tax is paid for—the employer's share is really paid for by the employee in the form of lower earnings. For a low earner, that bumps into the minimum wage for one thing, so that there is nothing to roll it back against, and it leads to unemployment.

Mr. BRADY. Great. Thank you. Mr. Entin?

Mr. ENTIN. We have so many taxes to choose from, and so many spending programs and regulations to choose from. You have to put it in the context of the broader national system. We do know certain things promote investment by lowering the cost of capital, the hurdle rate you have to earn in order to make the investment pay off. You can get that in any corporate finance book. We also know that certain types of taxes certainly affect the asset values of securities, so that would affect the future growth of personal accounts.

You can arrange a change in the fiscal budget, and in the level of Federal spending that would let you make tax changes that would help employment and work incentives, saving incentives, and would cause corporations to want to put more capital in place in the U.S. rather than overseas. You can get a lot of good growth out of doing the right policies. I think economists know what those are. I think the urge to spend a lot right now is blocking such policies, and I think the growth of spending over the last few years has hurt us in our ability to reform the tax system and reform Social Security in a way that will benefit everybody for the next hundred years.

Mr. BEACH. Let me just continue that answer, and add one or two things to it, and also what June and Doug have said. I think the Congress really needs to get a grip on spending. I mean, this is part of the problem. We have not talked about it today. The deficit was either the economy, 9/11, or the tax cuts. It is also enormous spending growth over the last three or 4 years, which in some respects is unprecedented when you have got singularity of party control. The other thing, Congressman, that I know you are concerned about, and I am concerned about, too, is that history may not be a good guide. Implicit debt may become now a major discount against external debt values. We see this happening in Europe where implicit debt for elderly programs is growing rapidly, and I would become concerned with that, despite the relative absence, as Dr. Furman said, of scientific evidence, I think the anecdotal financial evidence is becoming a real factor in the way people see the invest ability in certain economies.

Mr. PRICE. I am very concerned that as a nation we are borrowing, spending 6.5 percent more than we are producing and making. We should not be borrowing that much. We are not going to be able to borrow that much in the indefinite future, and we need to change our fiscal posture, so that when the turn in that comes, we don't squeeze investment too much. So, we should be dealing with the fiscal gap that we have got. That means cutting spending and raising revenues. We all have candidates for cutting spending. I am not going to defend every spending program that is out there, but I think it is also the case that we do not have such an ideal tax system that we could not raise more revenue and still have as good economic performance. We have got to be able to find ways to raise more revenue that does not hurt our economic performance. We have a lousy tax system right now, and we can raise more revenue and do it in a way that does not hurt growth that much. I think we have got to watch spending, but we also have to be realistic that that is not going to be enough politically if we are going to allow enough financing in the private market to support the investment we need.

Mr. BRADY. I am going as long as the Chairman will let me go.

Mr. SAMWICK. I would simply say that a larger program involves more distortion to the economy via the revenue that is raised and the spending decisions that are made. Some of that distortion is absolutely essential if you believe that the cornerstone purpose of this program is to reduce elderly poverty. The demographic shift means there is not enough money to achieve all of the objectives that Social Security may have achieved in the past with-

out reducing somebody's consumption of something at some time. Since consumption is going to have to go down, we ought to start that process sooner rather than later to smooth those reductions.

Mr. FURMAN. I just wanted to clear up one misunderstanding. I am not saying that implicit debt does not matter. It does matter, and it would be better to have less of it than more of it, all things equal. As a pure hypothetical, let's say right now we have 20 units of explicit debt, 80 of implicit debt, so we have a total of 100. Don't worry about what the units are. What carve out accounts do is they take some of that implicit debt and turn it into explicit debt. Let's say it makes it 50/50. What I was saying is that composition, having the same amount of debt, more of it in explicit form, leads to more of a danger of a financial crisis. At the very best, it is neutral and we are fine, it does not hurt us, it does not help us. At worst, it hurts us really badly. You average those two together, and it is not such a good idea.

Mr. SHIPMAN. In the ranking—reducing spending, raising taxes, cutting benefits—number one in my view is reducing spending, absolutely. As far as raising taxes or cutting benefits—I am speaking about payroll taxes and cutting payroll benefits—we have gone over the last 55 years, we have increased the payroll tax by 2000 percent, roughly, inflation-adjusted. We are sitting here again talking about how we keep this system going. Raising taxes will not solve the problem. Reducing benefits, by the way——

Mr. BRADY. Thank you. Mr. Chairman, Ms. Tubbs Jones has said that my extra time could come out of hers, so there is no problem.

[Laughter.]

Chairman MCCRERY. I am sure. Mrs. Tubbs Jones, feel free to take your time and all the rest of Mr. Brady's.

Ms. TUBBS JONES. In your dreams.

[Laughter.]

Good afternoon, panel. Thank you, Mr. Chairman. We will work out a relationship here. What I think it ought to be is that I get as much time as you got in order to make my inquiry in a bipartisan conduct of this wonderful hearing we are having here. Let me start with Mr. Beach. Mr. Beach, I think I heard you say something to the effect that we need to reduce our spending.

Mr. BEACH. Yes, ma'am.

Ms. TUBBS JONES. From my perspective, the only time this Administration really talks about reduction of spending is when we are outside the expenditures of dollars for Iraq and Afghanistan, and we are talking about domestic spending that is a particular concern to people who are the have-nots, like on Social Security, on Medicare prescription drug benefits, on a health care benefit for America, even on No Child Left Behind. Would you agree with me on that, sir?

Mr. BEACH. The Administration is full of spending ideas and has given you lots of opportunities to spend additional money, and you have taken those and you have added to them as well.

Ms. TUBBS JONES. Wait a minute. Go back to my question. There is no talk about a limit on spending when we talk about the war in Afghanistan or the war in Iraq.

Mr. BEACH. I am not an expert on the war. I understand you have to spend money to win them.

Ms. TUBBS JONES. You do understand deficit spending and restraint on spending, and you never heard a discussion about restraint on spending with regard to Iraq or Afghanistan, have you, Mr. Beach. Come on, be nice and say yes or no. That is the truth.

Mr. BEACH. Well, yes, I——

Ms. TUBBS JONES. You may not be an expert on war, but you are supposed to be an expert on spending money.

Mr. BEACH. Congresswoman, I do believe I heard a debate on the spending in Iraq, yes.

Ms. TUBBS JONES. Okay. Thanks, Mr. Beach.

Mr. BEACH. You are welcome.

Ms. TUBBS JONES. At least you got close to a yes or no answer. Mr. Price, let me ask you this: When there is a discussion about how young people want to have a private account in this "ownership society," do you ever hear them talk about the fact that Social Security is the best deal for young people if they should become disabled or die?

Mr. PRICE. Very rarely. The fact is that a 20-year-old has a 3 in 10 chance in their lifetime of claiming some disability insurance. It is a big program. One in 10 of those or 1 of those 3 will die and have survivor benefits, and another, 2 in 10, 1 of whom was disabled, 2 in 10 are going to get survivor benefits for their families. The insurance piece of this program is vitally important.

Ms. TUBBS JONES. Have you ever heard a dollar figure for the cost of a young person being able to purchase a policy that is as clear and broad as either the disability or survivor benefit policy?

Mr. PRICE. I have not. I would love to see a measure, if you were to buy in the private market, of what it would cost for somebody to get the disability insurance, get the survivor insurance, get the inflation insurance, and the retirement part. I think it would come out to a good buy.

Ms. TUBBS JONES. I have heard in the private market in some of the reports that I have read that it ranges between $323,000 to $400,000 for a young person to to go out into the market and purchase the coverage that the disability or survivor benefits provide.

Mr. PRICE. No. That is the sort of face value of the insurance policy.

Ms. TUBBS JONES. Right.

Mr. PRICE. When I buy $300,000 worth of life insurance, I pay $1,500 a year. I am not paying $300,000.

Ms. TUBBS JONES. Face value, you are correct.

Mr. PRICE. Right, but the face value of the life insurance and the face value of the disability insurance are on the order of $300,000 to $400,000.

Ms. TUBBS JONES. In some of the prior questions, Mr. Price, there was a whole discussion—I have lost that thought. How did I do that?—about private accounts and other benefits—no, it was about prefunding, and you got cut off in your response about prefunding. I wonder do you want to continue any response that you had given previously. If not, it is okay. I am going to go to Dr. Furman and see if he.

Mr. PRICE. I apologize. I was cut off, but I have forgotten.

Ms. TUBBS JONES. Okay. Dr. Furman, you can use up the rest of my time.

Mr. FURMAN. I will even give some back to make up.

Ms. TUBBS JONES. No, they owe us time. I got cut off. Go ahead.

Mr. FURMAN. I guess I would summarize what I have said. A lot of it is if you are interested in prefunding, I would be more than happy to work with you, but——

Ms. TUBBS JONES. Oh, I know what the question was, Dr. Furman——

Mr. FURMAN. Have to figure out ways to get additional contributions.

Ms. TUBBS JONES. Excuse me. My father—and I say this in every hearing. My father, my sister, my brother-in-law, and my niece are all United Airlines employees. The question was with regard to United Airlines and the problems that they are facing, and I want to get a response. Actually, Dr. Price, I think that is where we were. Either of you can.

Mr. FURMAN. I think it is an important reminder that we have a three-legged stool for retirement. One is Social Security, which has no market risk associated with it; one is private pensions; and one is your personal savings. We need to be focused on strengthening all three of those legs, not chopping one off and using it to replace another leg.

Ms. TUBBS JONES. Do you remember what you wanted to say about United Airlines, Mr. Price? If you do not, it is okay. I will get you on another occasion. Ladies and gentlemen, Mr. Chairman, I am returning the time I did not get on these questions back to you, and I thank you for the opportunity.

Chairman MCCRERY. Yes, ma'am, thank you very much. Mr. Hulshof?

Mr. HULSHOF. Mr. Chairman, thank you. Let me start by saying how much I appreciate the evenhanded manner that you have conducted this hearing, especially as we have heard some interesting questions, some speeches, and other things, and just how much I appreciate that you do not get ruffled, because when you come on the tail end of this and you have heard the questions, the advantage is you have heard all of the testimony that you provided. One of the disadvantages is that I feel compelled to respond to some of those things that have been raised. Mr. Pomeroy talked about the use of excess payroll taxes in our national budget, as if that were a recent phenomenon. I think, Dr. Holtz-Eakin, correct me if I am wrong, but I think even going back perhaps to the late sixties through 1998, excess payroll taxes were, in fact, used to help finance the national budget. Mr. Levin, you had made a comment that no one says to do nothing. I think I wrote that quote down. Yet, I respectfully disagree because other than your colleague, Mr. Wexler, Mr. Boyd, I hear little in the way of constructive dialog as far as what to do.

Dr. Furman, I agree with you that your presence here as the subject matter of this hearing was on prefunding, and yet you seemed eager to offer gratuitous criticism of fiscal policy, and specifically that President Bush is primarily responsible for our current fiscal situation. So, let me probe that bias of yours. I was

tempted to let it slide, but do you acknowledge that our country experienced a recession?

Mr. FURMAN. The recession has almost nothing to do with the deficit.

Mr. HULSHOF. That is not my question. Dr. Furman, here is how this works. Let me ask you a question.

Mr. FURMAN. Yes.

Mr. HULSHOF. If I do not—if you do not understand my question, I will rephrase it. Do you acknowledge that our country experienced a recession?

Mr. FURMAN. Yes.

Mr. HULSHOF. Now, I take it from your expanded answer that you disagree with Mr. Entin that the recession is the number one cause for our fiscal situation.

Mr. FURMAN. In fiscal year 2004 and fiscal year 2005, it is not a major cause of our fiscal situation.

Mr. HULSHOF. Let me ask, do you agree with many mainstream or most—I hate to characterize it as "most," but many mainstream economists that the economic slowdown began in the last quarter of the year 2000?

Mr. FURMAN. The official recession began in March 2001.

Mr. HULSHOF. That the economic slowdown began, commenced in the last quarter of the year 2000. Agree or disagree?

Mr. FURMAN. There are a variety of measures of the economy on a month-to-month basis. I have not studied them all. I am sure some of them show that and some of them show other——

Mr. HULSHOF. So, you agree or disagree?

Mr. FURMAN. Recession began March 2001.

Mr. HULSHOF. Agree or disagree?

Mr. FURMAN. I agree that the recession began in March 2001.

Mr. HULSHOF. I think as—you know, this is somewhat rhetorical, because you have to admit that the direct attacks on September the 11th had some direct and indirect economic consequences, did they not?

Mr. FURMAN. They certainly did.

Mr. HULSHOF. And as Ms. Tubbs Jones pointed out, Federal expenditures for conflicts in Iraq and Afghanistan, those are real dollars, whether we agree or disagree with the policy, the fact is Federal expenditures have gone into those military conflicts, have they not?

Mr. FURMAN. That is correct.

Mr. HULSHOF. Now, I do want to, on a lighter note—because it is interesting, Mr. Chairman, in the remaining time I have, we each try to come up with an analogy of what prefunding is, and I like, Dr. Furman, your analogy of a family with a substantial mortgage on its home and a daughter who is going off to college in a decade, because that is basically my family's situation, and then the choices that we have. We have also heard—and for those newcomers to the room, we have also heard about being kicked to death by a rabbit. I invite you to watch the replay of this, if you are wondering about this rabbit possessing murderous intent. Mr. Shipman, you say that regarding prefunding—and this is from your testimony—that in the age of the iPod, Social Security is a 78 RPM wind-up phonograph. Would you like to elaborate just a bit, briefly?

Mr. SHIPMAN. Yes, the purpose of that was to say that things have changed from when Social Security started, really as a reaction to the Great Depression. The OASI part has really morphed into a defined benefit plan, essentially. Its finances have not advanced. It is still a pay-as-you-go system. It is archaic in trying to pay for relatively certain future liabilities through a tax transfer system as opposed to saving and investing for those relatively certain future liabilities.

Mr. HULSHOF. To conclude, again, a crude analogy. If I own, Mr. Chairman, a 1935 antique car that can do the speed limit, I would like to pass it to my kids. It sprang an oil leak, and I have noticed that I have had to add a quart of oil almost from—it used to be every month and then every week, now it is almost daily. It seems that I now have a choice of whether to continue to just pour oil into this car, or to actually drop the engine and overhaul it. Of course, I know that that is going to entail some cost to do that. Again, that is my crude analogy of this issue, but I certainly applaud you for having yet again another stellar hearing. Thanks.

Chairman MCCRERY. Thank you, Mr. Hulshof. Mr. Thompson, welcome to our Subcommittee. We are glad to have you, and if you would like to pose any questions to the panel, you may do so.

Mr. THOMPSON. Well, Mr. Chairman, thank you very much for having the hearing and for allowing me to sit in. Mr. Levin, thank you very much for inviting me. I, too, came at the tail end and have found interesting some of the analogies and some of the comments that were made. I am particularly concerned from a fiscal perspective, and I suspect that all of you share all or part of that concern. A lot of the discussion prompted, I think, by Mr. Brady when he asked his question—that is where I came in—about cutting programs, cutting spending versus increasing taxes, it just seems to me that at some point—and I do not want to suggest that this has not been an honest hearing, but we have to have an honest debate on what the American people want in regard to those services and how it is we are going to pay for those services. The idea that we can just somehow cut, I think people need to know what that means. You know, just the $427 billion deficit this year, you could cut the Environmental Protection Agency, Health Services, Housing and Urban Development, Commerce, Education, and a whole bunch of other programs, and not even get to the deficit number of $426 billion. That does not even include the $160 billion that was borrowed from Social Security.

So, I think that discussion has to take place, but I think it has to be a transparent, honest discussion. I think the whole issue of borrowing money and the debt has to be part of it. You could go a long way to prefund this program just by diverting the billion dollars a day that we spend in paying the interest on our National debt. We could use that to front-load this prefunding. I guess that brings me to my first question. When David Walker was before our full Committee, he had an interesting chart that he put up on the board that showed that by the year 2040, the Federal Government would be taking in just a small amount of revenue more than what we would paying out in the interest only on our National debt. Now, if we borrow to prefund Social Security or we borrow to privatize Social Security, it seems to me that we are going to grow

that national debt. We could actually trigger a scenario that, by 2040, our interest is actually as much of, or more than what we are taking in just to pay that interest. I would be interested to know what this panel thinks the impact of that would be on our overall economy. Just briefly, if you could just—whoever would like to take it.

Mr. HOLTZ-EAKIN. Well, I think, Mr. Thompson, that the debt profile that you have characterized is the outcome of current law mandatory programs which will——

Mr. THOMPSON. I understand. My question is if the Walker scenario comes to fruition or, even worse, if we continue to borrow and it becomes worse, as was explained, what impact is that going to have on our National economy.

Mr. HOLTZ-EAKIN. It will have, initially a corrosive, and ultimately a contractionary effect if left unattended.

Mr. THOMPSON. Does everybody—when we are talking about debt-financed accounts, this is obviously in today's situation going to lead to more foreign borrowing. When you have Japan and China and the Organization of Petroleum Exporting Countries Nation's leading the way in regard to foreign lending to us, I think we are at $2 trillion now in the amount of money that we owe other countries.

Mr. PRICE. Three.

Mr. THOMPSON. Pardon me?

Mr. PRICE. We will find out next week it is three.

Mr. THOMPSON. Three trillion?

Mr. PRICE. Yes.

Mr. THOMPSON. I am going to lose even more sleep than I was planning on. Just since January of last year, about $500 billion in foreign debt, and as this continues to grow. I think that puts our priorities in conflict—I don't care what side of the aisle you are on—what we want to see this government doing and what we want to see happen for our country. I would like to know—Dr. Price, we will start with you—what do you see as the pitfalls of us continuing to grow not only our National debt but our national foreign debt?

Mr. PRICE. Well, this is a big open question. We had a foreign exchange crisis and went off the gold standard in 1971 when we were going from a trade surplus to a trade deficit. Then, you know, in the mid-eighties when the dollar turned and people were worried about the dollar being too high, we had a current account deficit of 2.5 percent of GDP. The international financial markets have become more generous, particularly the central banks of Asia. So, we now have a 6.5 percent of GDP borrowing, and we have yet to see a real turn that I think we need to have.

So, the big open question is how long, how generous are the central banks of Asia going to be? Otherwise, what is going to happen to private markets? Because at some point, if private markets turn against—and it can be Americans. I mean, the big decline of the Mexican peso, or the British pound, or the U.S. dollar in the past has been as much by people inside moving their currency out, as people outside. We could have a run on the dollar by Americans that the Asian central banks cannot keep up with, and that would

cause serious problems for our interest-sensitive industries, like housing, autos, and others.

Mr. THOMPSON. Can we differentiate between a Social Security strong dollar and a national strong dollar? Can you have one and not the other?

Mr. PRICE. No.

Mr. THOMPSON. Thank you.

Thanks, Mr. Chairman.

Chairman MCCRERY. Mr. Thompson, thank you for coming, and I agree with you that we ought to have an honest debate about any number of decisions we must make as policymakers here in the Congress. In the pursuit of that, I would like to clarify some of the numbers you used in your question. First of all, the $426 billion figure, was that last year's deficit, Dr. Holtz-Eakin?

Mr. HOLTZ-EAKIN. You are talking about 2004? The current year, 2005, our current estimate is a ball park $350 billion.

Mr. THOMPSON. $350 billion.

Mr. HOLTZ-EAKIN. For the fiscal year ending September 30th.

Chairman MCCRERY. Okay. Mr. Thompson also said—that does not count the $160 billion we borrowed last year, maybe this year, from Social Security. In fact, have we borrowed from Social Security and spent $160 billion either last year or this year?

Mr. HOLTZ-EAKIN. The primary surplus in Social Security is much smaller. I have failed to remember this number twice in front of you, and I will never show up again without knowing it.

Chairman MCCRERY. Sixty-nine billion.

Mr. HOLTZ-EAKIN. Thank you.

[Laughter.]

Chairman MCCRERY. That is the correct, honest number that we used from the Social Security Trust Fund. That was the cash surplus. The interest that was credited to the trust fund, of course, we could not spend that. It is on paper. It is interest. So, I would like for us to be honest in this debate and use good numbers when we are trying to paint the picture that we would like everyone to see and operate from.

Mr. THOMPSON. Mr. Chairman, could you yield for a moment?

Chairman MCCRERY. Sure.

Mr. THOMPSON. If the number $427 billion or the numbers that you just gave us, $419 billion, the issue is those are real dollars. I think.

Chairman MCCRERY. Those are real dollars, Mr. Thompson, but to exaggerate those in the pursuit of your ends I don't think serves the public or the debate well, and I was just trying to make it clear that the correct numbers are much different from those you cited. Now, I agree with the point you were trying to make very much, and that is the point of these hearings, and that is the point of those of us, including the President, who want to reform Social Security. Then we would like—some of us would like to move on to Medicare, and yes, Mr. Price, health care, because you are right, that is the biggest looming problem from a fiscal standpoint, and perhaps from a quality-of-life standpoint. And, fortunately or unfortunately, the government plays a huge role in health care through Medicare and Medicaid, and other policies, including tax policy. So, yes, I would like very much for us to move on from Social Security,

which is much easier to fix, and to generate some savings from current policy in the out-years, and then address these more difficult and eventually bigger problems like Medicare, Medicaid, and health care. With that, thank you all very much for your testimony. It was all excellent, and we look forward to continuing to consult you as we move through this discussion. The hearing is adjourned.

[Whereupon, at 12:50 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

Statement of Dolores Guinn, Horshoe Bay, Texas

In reference to the Social Security reform hearings, I feel strongly that the committee should consider all aspects of this issue. The cornerstone of the proposed reform is to let the future generations set aside their own savings and/or pension funds. This is a disturbing proposal and I ask that each of you be honest. I, for one, can remember what was happening in my life during the age of twenty to forty. I spent many hours wondering if I could survive to the next payday, being a single Mom with three daughters. Do you think, for one moment, that I even considered a savings account.

Surely, intelligent people that you are, you have studied the living conditions of those at the lower end of the spectrum who cannot even afford a car for transportation or medical treatment at the hospital. Have you given any consideration to them? Have you looked ahead to see what will be the results if we leave every American in charge of their own pension? Perhaps if you did, you would see that there will be a lot of elderly people out on the street. You know, and I know, that they will not be able to survive with the reduced Social Security payment that will be in place at that time.

More importantly, what plans do you have if some catastrophic decline in the stock market should occur? What alternative plan do you have if over half of the American population is ready to retire and their account is empty? I believe that the easiest way to reform Social Security is set it aside, untouchable and unmolested by the government,as it was originally planned. The other thing is to take the cap for Social Security off of the wealthy. There is nothing wrong with having **all** Americans pay on **all** that they earn.

We can surely see that fairness in the system has been at the heart of all of Americans discontent. Remember the beginning of the American Revolution? Americans were unhappy over taxation. Taxation without representation. Unfairness in the system!

The Social Security plan, drawn up by Franklin.D. Roosevelt, was good and has helped so many people, probably some of your own relatives. It needs to be returned to its roots and tweaked with the earnings cap issue, but please do not destroy this program. I remind you, that you are making decisions that will affect future generations and the shame and blame for its failure will be upon your head.

Thank you for allowing me to be heard on this issue.

Statement of Thomas S. Marino, La Habra, California

I wish to provide my personal support of HR 147, "Social Security Fairness Act". When I retire in 2008, at the age of 65, I will be affected by the present Government Pension Offset (GPO) and the Windfall Elimination Provision (WEP).

I am employed by the County of Orange in California, with many years of government service behind me. I did, however, manage to earn my forty Social Security credits during the years before government service. This included fours years of military service to my country during my Marine Corps enlistment.

I earned my right to collect the *full* benefits of Social Security, irregardless of the fact that I chose a career in government service. I feel that government service workers, as well as teachers have a right to receive full *earned* benefits from their government pension plans and Social Security if they contributed to the systems.

I work for a County agency that provides aid to needy persons. I am personally aware of individuals who also receive Federal Social Security benefits who have *never* paid into this system. I don't understand how it can be considered fair or ethical for these persons to receive benefits when our government will deny me from receiving the full measure of the benefits I earned because I contributed to a government pension plan.

I personally urge the members of Congress to support passage of HR 147.

Statement of Bob Moore, Lawton, Oklahoma

Reform Social Security and Personal Income Tax

First item is federal income tax on interest earned on bank accounts. Why have income tax laws for 300 million people when the Federal Government should have the financial institutions (appr. 10,000) pay a monthly tax being a percentage of the total dollars paid as interest to clients. No tax due from the citizens, the bank pays the tax, SIMPLE.

Same is true with stock dividends, have the corporations pay the government a percentage of the dollar amount paid to the stockholders. No tax due from the citizens, the corporations pay the tax, SIMPLE. 10% is a good rate.

a. Second item is a 40–40 Tax on Gasoline:
b. eliminate the.9 cent;
c. this tax shall not be amended for forty (40) years;
d. a total tax of forty (40) cents a gallon tax according to the following:
e. twenty (20) cents shall go to the Federal Government and
f. twenty (20) cents shall go to the originating State government
g. gasoline tax to ONLY go toward roads and bridges.
h. Third item is Truthful Tax Reform—Federal Tax Payroll Program.

"TOTALLY" Eliminate the Personal Income Tax "TOTALLY".

1. Fact: FICA tax is over 15% of the employees' paycheck. Federal Courts have ruled the FICA is a tax not a retirement fund. The Federal Government needs to be honest and declare that FICA tax goes to the general fund to pay for government spending programs. Re-name FICA tax to Federal Tax Payroll Program.
2. Government taxes should be on commission, just like all private businesses and private business' employees. The government spending can only grow if more people make more money.
3. Payroll deduction is the most efficient way to collect taxes. The Federal Tax Payroll Program will be the only federal tax that wage-earning Americans will pay. Never a personal income tax form to file with the IRS.
4. Keep the system simple, one rate for all taxpayers. Ten (10%) Percent is good enough for GOD, then Ten (10%) Percent should be good enough for the government. However the Federal Government is not as efficient as GOD so lets put the maximum rate at twenty (20%) percent.
5. The Federal Tax Payroll Program shall be 20% "Maximum" of which Ten (10%) Percent to be withheld from the wage-earners' pay to be matched by Ten (10%) Percent from the Employer. Rate shall not be raised ever.
6. Earmark how the money shall be allocated, such as:

- 1% to DOD for National Defense;
- 4% to Citizens Retirement Fund, a 401K type program—private social security fund for each person;
- 15% to Social Security and other spending programs.
- A total of 20% of the wage-earners' salary to go to the Federal Government.

This type of system would result in no forms, no worry and a much smaller I.R.S. No tax forms to file each year. No tax credits to be given or taken away by the Federal Government. No increase or decrease in the tax rate.

This would get the Federal Government out of micro-managing the daily life of the taxpayers. It is called FREEDOM!

Social Security; at this point, the government should just pay everyone the same amount each month once the person has reached age 62 or 65. We are a rich Country and we do not want our Senior Citizens living below the poverty level so just increase the monthly check for all senior citizens. If Congress was really serious about eliminate the national debt, Congress would cut the spending program.

An advantage given by the government to one person means an unfair dis-advantage to all other Americans. Our Founding Fathers believed that small government and less taxes means more freedom.

The Oklahoma Taxpayer, Editorial by Bob Moore

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