SOCIAL SECURITY: THE LONG–TERM BUDGET IMPLICATIONS

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SOCIAL SECURITY: THE LONG–TERM BUDGET IMPLICATIONS

WEDNESDAY, JUNE 19, 2002

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to call, at 10:25 a.m. in room 210, Cannon House Office Building, Hon. Jim Nussle (chairman of the committee) presiding.

Members present: Representatives Nussle, Gutknecht, Toomey, Hastings, Brown, Crenshaw, Spratt, Bentsen, Price, Moran, and Hooley.

Chairman NUSSLE. Good morning, and welcome. We have a number of guests joining us as well. We are pleased to have you with us today for our committee's hearing on Social Security and the budget implications of long-term sustainability.

First of all, I would like to compliment Mr. Spratt for his suggestion, last year now, that we hold this hearing. We have obviously had many things to touch on and focus on since he made that suggestion after the budget went through last year. Certainly, September changed everyone's focus and there were many immediate necessary issues that we had to deal with.

That may be a good segue or threshold for this hearing today. The necessary and the immediate and the emergency and the things that focus our attention on a minute-to-minute, day-to-day, election year to election year basis, oftentimes are the only things that occupy Congress' attention.

Today, I am pleased to focus the committee's attention on Social Security. Social Security is our Nation's most successful anti-poverty program. It benefits more than 44 million Americans and its preservation is a responsibility that neither I nor any of my colleagues take lightly.

Members may recall that this hearing was originally scheduled for last September 13; then, of course, 2 days before the hearing our world changed. As a result of terrorist attacks, we significantly altered our perceptions about our own personal security. Still I know that today our colleagues—and myself for that matter—are determined not to let the events of that very important and fateful day derail our obligation to ensure that retirement security is available not only for this generation, but future generations.

Although the Budget Committee has no specific legislative jurisdiction over Social Security itself and the program—or, for that matter, any changes to the program—we must deal with the consequences of any reform plan or any plan to change or alter or deal with Social Security as well as—maybe more importantly—the consequences of failing to act. It is absolutely critical that Budget Committee members and the general public understand the budget implications of Social Security's long-term sustainability before proceeding to a debate on potential solutions.

We have today a host of high caliber witnesses who have given us a number of good ideas in the past; and certainly, first and foremost in that regard is David Walker. I don't know if there is anyone who has more consistently sounded the alarm about the impending concern over a number of long-term obligations to our Federal Government, Social Security being one of them—many obligations that he has highlighted for coming in a siren sort of way. We appreciate his continued vigilance to bring that to our attention. I told him before the hearing today—he really gets to showcase that.

Oftentimes in the past, he has had to deal with that along with 10 or 20 other issues that he has brought to our attention. Today we get to focus the way we wanted to last September 13.

Dealing with the problem and focusing on the consequences does not have to be political. You know, I have heard all sorts of tactics used on many people's parts: privatization, scaring people, doing all sorts of things. It is scary, but it is not a matter of the reform being scary; it is a matter of the consequences of inaction being quite frightening, particularly taken in context with what Mr. Walker and others will be presenting today.

So I look forward to the opportunity to somberly take a look at that issue. Fortunately, we don't have the collegialities that people can use that as a way to forward anybody's particular political agenda; we can just look at this in the careful context that I think it deserves, particularly given all of the priorities that Congress has to deal with.

Again, I would like to compliment Mr. Spratt for his specific suggestion and all members who have chimed in on needing to focus on this issue. And I would recognize him for any comments he would like to make at this time.

Mr. SPRATT. Thank you, Mr. Chairman. It is hard to believe that 18 months ago we had within our reach the first phase at least of a plan that would have helped us save, salvage Social Security. That plan had bipartisan support.

The first phase of it was that we would dedicate the surpluses building up in the Social Security trust fund solely to the repurchase of outstanding Treasury bonds and notes, and thereby add about $3.5 trillion to the national savings, and at the same time, retire most of the debt held by the public.

We also had a projected surplus of $5.6 billion, which was enough, if we husbanded our resources and budgeted right, to allocate some share, some portion, to shore up the long-term liabilities of Social Security.

Congress took another tack, preferring tax cuts. We then found that we were in the midst of a recession, and we then found ourselves challenged by terrorists. So the fiscal facts have changed dramatically. We hardly have the money to buy up any of the public debt now, much less allocate some share of the general fund to subsidizing and shoring up Social Security.

But that doesn't mean that the problem has gone away. Far from it. As we meet, 77 million baby boomers are marching to their retirement. There is no way that we can change that fact; we have got to face it. This hearing highlights that critical fact and reminds us that neither we in Congress, nor the Bush administration, has yet to address the biggest fiscal challenge that faces us all. So I think it is timely and pertinent.

Regardless of our jurisdiction I think we should be leading the way here, Mr. Chairman. I appreciate your calling this hearing.

Chairman NUSSLE. I thank the gentleman.

As I said to start with, there is no one who has in an objective, sober, somber, responsible way provided any better information to the United States Congress on this issue than David Walker, who is the Comptroller General for the United States and, of course, oversees GAO.

We appreciate your coming today with your presentation. We look forward to it, and you may proceed as you see fit. Welcome.

STATEMENT OF DAVID M. WALKER, COMPTROLLER GENERAL OF THE UNITED STATES

Mr. WALKER. Thank you, Mr. Chairman, Mr. Spratt, other members of this committee. It is a pleasure to be back before you today to talk about our Nation's Social Security program and the long-range challenges relating thereto.

I should note at the outset that while I may have been talking about this problem for a while—not only Social Security and how it fits into our long-range fiscal challenge—CBO Director Dan Crippen shares my concerns, and I know that he is going to be testifying later today.

We are two lone voices in the wilderness, and I am very appreciative of your willingness, Mr. Chairman and Mr. Spratt, to conduct this hearing, because this has to be part of a broader public education effort in order to help the public understand the nature, extent and the timing of our problems such that Congress will then be in a position to act.

Because Congress will eventually be required to act, as I will point out, the sooner the better for a variety of reasons.

I have a few graphics that I would like to use today to be able to convey a number of important messages, if we can start with the first one.

My first point would be that Social Security reform is part of a larger and very significant fiscal and economic challenge; and to make that point, I am going show two graphics. The first one is how the composition of the Federal budget has changed over the last 40 years. You can see that in 1962, when John F. Kennedy was President, 68 percent of the Federal budget was discretionary. The Congress was able to decide how that was going to be spent every year.

By 1982, that had declined to 44 percent. And in the fiscal 2002 budget, it was down to 37 percent. So the ratio has flipped during the prior 40 years.

Specifically, Congress used to be able to decide annually how $2 out of every $3 were spent. Now it is only a little more than $1 out of $3. This is going to get worse as we go forward, because much of the budget is on autopilot unless Congress and the President take certain actions.

In the second graphic is our famous "haircut, scalp and decapitation chart." I realize these labels aren't pleasant, but one can see how you get them from here. This shows results of our latest long-range budget simulation for which, importantly, we take the Social Security and Medicare trustees' best estimate, or intermediate assumptions, and we take CBO's assumptions; we don't want to compete with our sister agency—they come up with the economic assumptions—or with the trustees.

If you start with these and the percentage of our economy represented by Federal taxes, and if you assume the tax cuts enacted last year do not sunset, that spending will end up increasing based upon the Social Security and Medicare trustees' intermediate estimates; and that discretionary spending grows by the rate of the economy—this is what the future will look like.

If you look at the spending side by 2015, we will start having to haircut all other spending. By 2030, it will have to be cut significantly. By 2050, the entire Federal budget would have to be cut in half.

Now, obviously, there are alternatives. You can raise taxes, cut spending, go further into debt, or some combination thereof. But if you look at the relative order of magnitude, there is a huge long-range fiscal imbalance driven primarily by two things. No. 1, known demographic trends—as you mentioned, Mr. Chairman, the retirement of the baby boom generation—and No. 2, rising health care costs.

We are not going to change known demographic trends and not much has been done lately to help control rising health care costs. In fact, some steps will end up fueling these health care costs.

Second key point: Focusing on trust fund solvency alone is not sufficient. We need to put the program on a path toward sustainable solvency. Next graphic, please.

This graphic shows the cash flows for the OASDI combined program, Social Security, Old Age, Survivors Income and Disability Insurance program. This is the combined cash flow. Yes, we have positive cash flows now, but we are going to start going into negative cash flow position starting in 2017. And starting in about 2006, these positive cash flows start going down.

Now, what does that mean? That means that to the extent that you have had this positive cash flow that has provided some additional budget flexibility in the integrated budget, that is going to start going down in about 2006. That is not far from now. By 2017, you are going to turn a negative cash flow, which is going to be even more of a problem, because you are going to have to figure out how you are going to pay those benefits: raise taxes, cut spending or increase debt held by the public. And it gets progressively worse as time goes on.

So cash flow is key. Solvency is only one factor.

The next key point is that solving Social Security's long-range financing problem is more important and complex than simply making the numbers add up. This program, meaning OASDI, is critically important to the economic security of millions of Americans, not only in retirement but also for the disabled and others.

Given the current financial shortfall in the program, it is important to compare proposals both to current promised and to funded benefits. If you can go back, please, to the last one. There are a lot of people that want to compare Social Security reform proposals just to promised benefits. That is fundamentally flawed and unfair, because all the promised benefits are not funded.

There is a huge shortfall between what has been promised and what has been funded; and you have to figure out how you are going to close that shortfall. So any analysis, including the ones that were released yesterday that compare the benefit cuts based solely upon promised benefits, rather than to both funded and promised, is unfair, unbalanced—in my opinion, inappropriate.

Therefore, when GAO does work, which you will see in a few minutes, we compare it to both funded and promised benefits. Both are relevant. Using only one or the other is not appropriate; you need to look at both. And you need to determine how to close that gap.

Reform proposals should be evaluated as packages. We are going to have to engage in some heavy lifting. We are going to have to make some trade-offs. There is no free lunch. And, as a result, if you look at things piecemeal—retirement age, indexing, bend points, even individual accounts, if you look at elements one at a time, you are going to polarize the situation. Therefore, there is a need to look at packages and to compare them against some criteria.

And, Mr. Chairman, as you know, GAO has come up with some recommended criteria, and these are the three at the highest level. But there are a bunch of sub-criteria that we would recommend Congress use to evaluate Social Security reform proposals as a package.

Next, please. Acting sooner rather than later helps ease the difficulty of change. This graphic shows the degree of the imbalance for these periods of time. You can see that the sooner you act, then the less dramatic either the benefit adjustment is going to have to be, or the tax adjustment, or some combination is going to have to be in order to make the numbers work, because of the miracle of compounding.

Therefore, we need to be able to recognize that the longer we wait, not only the more dramatic the changes will have to be, but the more difficult they will be to make because you will have more people who are already receiving benefits; they will represent a larger percentage of the population, and therefore, it will be more difficult to be able to make needed changes in some regards.

Last point before I summarize: We believe, Mr. Chairman, that it is possible to structure Social Security reform such that you can exceed the expectations of all generations of Americans.

Let me restate that: You have the ability to exceed the expectations of every generation of Americans.

And why do I say that? Because from a practical standpoint, current retirees and people who are near retirement are afraid that Congress is going to cut their benefits. And they don't have the time or ability to make up for any such cut because they are already retired or they are near retirement. From a practical standpoint, that is not going to be politically possible nor would it be fair to do that.

Secondly, baby boomers like myself are already discounting Social Security. They are discounting it more than they should, as to what they think that they are going to get. And generation Xers and Ys, like my kids, are discounting it even more.

Therefore, if you structure a Social Security reform proposal that leaves retirees and people who are nearing retirement alone, keeps them whole, deliver on the promise, if you restructure Social Security reform such that you make gradual changes that have gradually greater effects to younger people, but gives them time to be able to adjust, you can exceed the expectations of all generations of Americans. I call that a win.

What it takes is political leadership and personal courage—political leadership and personal courage.

The last word that I will give you is, this is easy lifting compared to Medicare and health care. This is nothing compared to the challenges that we face in Medicare and health care. There is going to be a lot of pain, and the magnitude of change in the health care area is going to have to be much greater. So all of the more reason, why don't we get on with something that can be a win-win scenario?

Thank you.

[The prepared statement of Mr. Walker follows:]

PREPARED STATEMENT OF DAVID M. WALKER, COMPTROLLER GENERAL, U.S. GENERAL ACCOUNTING OFFICE

Mr. Chairman and members of the committee, thank you for inviting me here to discuss ensuring the long-term viability of our Nation's Social Security program. Social Security not only represents the foundation of our retirement income system; it also provides millions of Americans with disability insurance and survivor's benefits. As a result, Social Security provides benefits that are critical to the current and future well-being of tens of millions of Americans. However, as I have said in congressional testimonies over the past several years,[1] the system faces both solvency and sustainability challenges in the longer term. Although the Social Security Trustees now project that under the intermediate or "best estimate" assumptions the combined Social Security trust funds[2] will be exhausted 3 years later than in last year's estimates, the magnitude of the long-term funding shortfall is virtually unchanged. In their 2002 report, the Trustees emphasized that while the program's near-term financial condition has improved slightly, Social Security faces a substantial financial challenge in the not-too-distant future that needs to be addressed soon. In essence, the program's long-term outlook remains unchanged. Without reform, Social Security, Medicare, and Medicaid are unsustainable, and the long-term impact of these entitlement programs on the Federal budget and the economy will be dramatic.

Over the past few years, a wide array of proposals has been put forth to restore Social Security's long-term solvency, and last December a commission appointed by the President presented three models for modifying the current program. The Commission's final report[3] called for a period of discussion lasting at least a year before legislative action is taken to strengthen and restore sustainability to Social Security. It is not my intention to discuss the specifics of or take a position for or against any individual reform proposal, element, or approach. Rather, I hope my testimony today, which is based on a body of work we have published over the past several years, will help clarify some of the key issues in the debate. To do that, I'm going to talk about the nature and timing of the Social Security problem and a framework you might use in addressing it.

First, let me highlight a number of important points in connection with our Social Security challenge:

- Social Security reform is part of a larger and significant fiscal and economic challenge. If you look ahead in the Federal budget, the combined Social Security or Old-Age and Survivors Insurance and Disability Insurance (OASDI) program together with the rapidly growing health programs (Medicare and Medicaid) will dominate the Federal Government's future fiscal outlook. Under GAO's long-term simulations it continues to be the case that these programs increasingly constrain Federal budgetary flexibility over the next few decades. Absent reform, the Nation will ultimately have to choose between persistent, escalating Federal deficits, significant tax increases and/or dramatic budget cuts.

- Focusing on trust fund solvency alone is not sufficient. We need to put the program on a path toward sustainable solvency. Trust fund solvency is an important concept, but it is not the only perspective we need to have on Social Security's long-term financing. In fact, focusing on trust fund solvency alone is inappropriate and can lead to a false sense of security about the overall condition of the Social Security program. The size of the trust fund does not tell us whether the program is sustainable-that is, whether the government will have the capacity to pay future claims or what else will have to be squeezed to pay those claims. Aiming for sustainable solvency would increase the chance that future policymakers would not have to face these difficult questions on a recurring basis. Estimates of what it would take to achieve 75-year trust fund solvency understate the extent of the problem because the program's financial imbalance gets worse in the 76th and subsequent years.
- Solving Social Security's long-term financing problem is more important and complex than simply making the numbers add up. Social Security is an important and successful social program that affects virtually every American family. It currently pays benefits to more than 45 million people, including retired workers, disabled workers, the spouses and children of retired and disabled workers, and the survivors of deceased workers. The number of individuals receiving benefits is expected to grow to almost 69 million by 2020. The program has been highly effective at reducing the incidence of poverty among the elderly, and the disability and survivor benefits have been critical to the financial well-being of millions of others.
- Given the current financial shortfall of the program, it is important to compare proposals to both current promised and funded benefits. Comparing the beneficiary impact of reform proposals solely to current Social Security promised benefits is inappropriate since all current promised benefits are not funded over the longer term. As a result, comparisons to current promised benefits after the point of trust fund insolvency assume a payroll tax increase or general revenue infusion that have not been enacted and may not occur. Likewise, comparisons of reform proposals solely to funded benefits after the point of trust fund insolvency are also inappropriate since that assumes a reduction in benefits that has not been enacted and may not occur. The key point is that there is a significant gap between promised and funded benefits that must be closed. In fact, a primary purpose of most Social Security reform proposals is to close or eliminate this gap.
- Reform proposals should be evaluated as packages. The elements of any package interact; every package will have pluses and minuses, and no plan will satisfy everyone on all dimensions. If we focus on the pros and cons of each element of reform, it may prove impossible to build the bridges necessary to achieve consensus.
- Acting sooner rather than later helps to ease the difficulty of change. As I noted previously, the challenge of facing the imminent and daunting budget pressure from Medicare, Medicaid, and OASDI increases over time. Social Security will begin to constrain the budget long before the trust funds are exhausted. The program's annual cash surplus will enter a steady decline beginning in 2006,[4] and from 2017 on, Social Security's annual cash deficit will place increasing pressure on the rest of the budget to raise the resources necessary to meet the program's costs. Waiting until Social Security faces an immediate solvency crisis will limit the scope of feasible solutions and could reduce the options field to only those choices that are the most difficult and could also delay the really tough decisions on Medicare and Medicaid. Acting sooner rather than later would allow changes to be phased in so that future and near retirees have time to adjust their retirement planning.
- We believe it is possible to structure a Social Security reform proposal that will exceed the expectations of all generations of Americans. Today many retirees and near-retirees fear cuts will affect them while young people believe they will get little or no Social Security benefits. We believe the time has come to craft a solution that will protect Social Security benefits for the Nation's current and near-term retirees, while ensuring that the system will be there for future generations.

Our Social Security challenge is more urgent than it may appear. Although the combined trust funds will not run dry until 2041, the Social Security program's pressure and cash demands on the rest of the Federal Government will begin much sooner. Failure to take remedial action will, in combination with other entitlement spending, place unsustainable pressure on the government and, ultimately, the economy. This problem is about more than finances. It is also about maintaining an adequate safety net for American workers against loss of income from retirement, disability, or death; Social Security provides a foundation of retirement income for millions of Americans, and has prevented many former workers from living their retirement years in poverty. As the Congress considers proposals to restore the long-term financial stability and viability of the Social Security system, it also needs to consider the impact of the potential changes on different types of beneficiaries. Moreover, while addressing Social Security reform is important and will not be easy, Medicare presents a much greater, more complex, and more urgent fiscal challenge.

To assist the Congress in its deliberations, GAO has developed criteria for evaluating Social Security reform proposals. These criteria aim to balance financial and economic considerations with benefit adequacy and equity issues and the administrative challenges associated with various proposals. The use of these criteria can help facilitate fair consideration and informed debate of Social Security reform proposals. Although making policy decisions of this importance requires appropriate deliberation, the time to act is now. Waiting only makes the problem larger, the magnitude of the required changes greater, and the time available to phase in changes shorter. Waiting also may serve to further delay the really hard decisions on Medicare and Medicaid.

SOCIAL SECURITY'S LONG-TERM FINANCING PROBLEM IS MORE URGENT THAN MAY APPEAR

Today, the Social Security program does not face an immediate crisis but rather a long-range and more fundamental financing problem driven largely by known demographic trends. The lack of an immediate solvency crisis affects the nature of the challenge, but it does not eliminate the need for action. Acting soon reduces the likelihood that the Congress will have to choose between imposing severe benefit cuts and unfairly burdening future generations with the program's rising costs. Acting soon would allow changes to be phased in so the individuals who are most likely to be affected, namely younger and future workers, will have time to adjust their retirement planning while helping to avoid related "expectation gaps." Mr. Chairman, as you heard earlier this month while hosting the Second Annual OECD International Conference of Chairpersons of Parliamentary Budget Committees, we are not alone in facing long-term budget challenges due to an aging population. Our counterparts in many European countries are debating these same issues, and a number of developed and developing countries have already engaged in fundamental reform of their systems to deal with their long-range challenges.

Acting soon will also help put the overall Federal budget on a more sustainable footing over the long term, thereby promoting both higher economic growth and more fiscal flexibility. The importance of such flexibility was brought dramatically home last September. The budgetary surpluses of recent years put us in a stronger position to respond both to the events of September 11 and to the economic slowdown than would otherwise have been the case. Going forward, the Nation's commitment to surpluses will truly be tested. None of the changes since September 11 have lessened the pressures placed by Social Security, Medicare, and Medicaid on the long-term fiscal outlook. Indeed, the events of September 11 have served to increase our long-range fiscal challenges.

Since there is a great deal of confusion about Social Security's current financing arrangements and the nature of its long-term financing problem, I would like to spend some time describing the nature, timing, and extent of the financing problem.

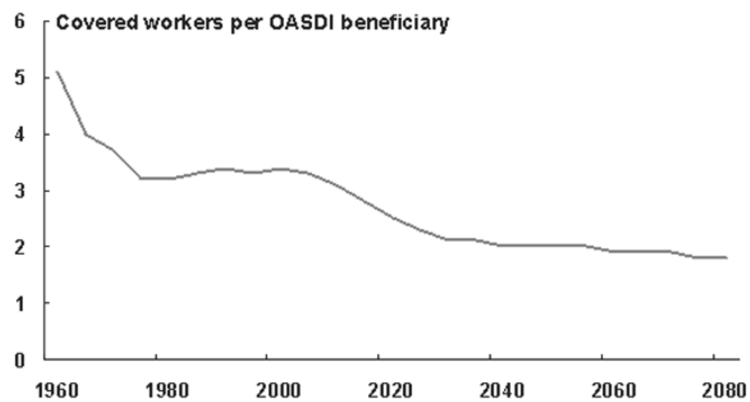
DEMOGRAPHIC TRENDS DRIVE SOCIAL SECURITY'S LONG-TERM FINANCING PROBLEM

As you all know, Social Security has always been largely a pay-as-you-go system. This means that current workers' taxes pay current retirees' benefits. As a result, the relative numbers of workers and beneficiaries has a major impact on the program's financial condition. This ratio, however, is changing. In the 1960s, the ratio averaged 4.2:1. Today it is 3.4:1 and it is expected to drop to around 2:1 by 2030. The retirement of the baby boom generation is not the only demographic challenge facing the system. People are retiring early and living longer. A falling fertility rate is the other principal factor underlying the growth in the elderly's share of the population. In the 1960s, the fertility rate was an average of three children per woman. Today it is a little over two, and by 2030 it is expected to fall to 1.95, a rate that is below replacement. Taken together, these trends threaten the financial solvency and sustainability of this important program (See fig. 1).

The combination of these trends means that labor force growth will begin to slow after 2010 and become negligible by 2050 (See fig. 2). Relatively fewer workers will be available to produce the goods and services that all will consume. Without a major increase in productivity, low labor force growth will lead to slower growth in the economy and to slower growth of Federal revenues. This in turn will only accentuate the overall pressure on the Federal budget.

This slowing labor force growth is not always considered as part of the Social Security debate. Social Security's retirement eligibility dates are often the subject of discussion and debate and can have a direct effect on both labor force growth and the condition of the Social Security retirement program. However, it is also appropriate to consider whether and how changes in pension and/or other government policies could encourage longer workforce participation. To the extent that people choose to work longer as they live longer, the increase in the share of life spent in retirement would be slowed. This could improve the finances of Social Security and mitigate the expected slowdown in labor force growth.

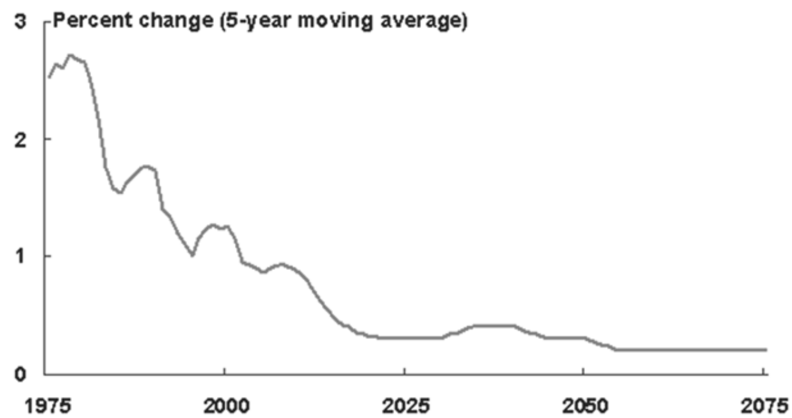
Figure 1: Social Security Workers per Beneficiary



Note: Projections based on intermediate assumptions of the 2002 Trustees' Report.

Source: *The 2002 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.*

Figure 2: Labor Force Growth Is Expected to be Negligible by 2050



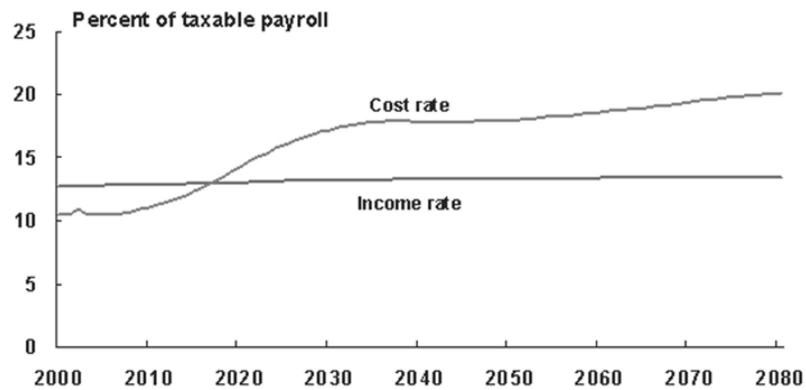
Note: Projections based on intermediate assumptions of the 2002 Trustees' Report.

Source: GAO analysis of data from the Office of the Chief Actuary, Social Security Administration.

In addition to encouraging people to work longer, a second approach to addressing labor force growth would be to bring more people into the labor force. In domestic social policy, we have seen an increasing focus on encouraging those previously outside the labor force (i.e., welfare recipients, the disabled) into the workforce. Concern about the slowdown in the growth of the labor force may also lead to discussions about immigration and its role. Increased immigration, however, poses complex issues and is unlikely to be the sole solution. For example, according to a recent United Nations study,[5] it would take more than a sustained tenfold increase in projected immigration to maintain the ratio of workers to retirees at recent levels. These are issues that the Congress may wish to explore further in the next few years.

Because of the demographic trends discussed above, current estimates show that within 15 years benefit payments will begin to exceed program revenue, which is composed largely of payroll taxes on current workers[6] (See fig. 3).

Figure 3: Social Security Cost and Income as a Percent of Taxable Payroll



Note: Projections based on intermediate assumptions of the 2002 Trustees' Report.

Source: *The 2002 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.*

SOCIAL SECURITY TRUST FUNDS, CASH FLOW, AND THE FEDERAL BUDGET

Within the Federal budget, Social Security—more properly, the Old-Age and Survivors Insurance and Disability Insurance programs (OASDI)—has two trust funds that authorize Treasury to pay benefits as long as the applicable trust fund has a positive balance. Currently, annual tax revenues to Social Security exceed annual benefit payments. The trust funds, by law, invest the resulting cash surplus in U.S. Government obligations or securities that are backed by the full faith and credit of the U.S. Government. At present, the trust funds' assets are in the form of special, nonmarketable Treasury securities that are backed by the full faith and credit of the U.S. Government and so carry no risk of default.[7] Although the trust funds cannot sell their holdings in the open market, the trust funds face no liquidity risk since they can redeem their special Treasury securities before maturity without penalty. These securities earn interest credits at a statutory rate linked to market yields, and this interest from the Treasury is credited to the trust funds in the form of additional Treasury securities.

I think it is useful to pause for a moment here and reflect on what the term "trust fund" means in the Federal budget.[8] Trust funds in the Federal budget are not like private trust funds. An individual can create a private trust fund using his or her own assets to benefit a stated individual(s). The creator, or settler of the trust, names a trustee who has a fiduciary responsibility to manage the designated assets in accordance with the stipulations of the trust. In contrast, Federal trust funds are budget accounts used to record receipts and expenditures earmarked for specific purposes. The Congress creates a Federal trust fund in law and designates a funding source to benefit stated groups or individuals. Unlike most private trustees, the Federal Government can raise or lower future trust fund collections and payments or change the purposes for which the collections are used by changing existing laws. Moreover, the Federal Government has custody and control of the funds.

Under current law, when the Social Security trust funds' tax receipts exceed costs—that is, when the trust funds have an annual cash surplus—this surplus is invested in Treasury securities and can be used to meet current cash needs of the government or to reduce debt held by the public. In either case, the solvency of the trust funds is unchanged. However, while the Treasury securities are an asset to the trust funds, they are a liability to the Treasury. Any increase in assets to the trust funds creates an increase of equal size in future claims on the Treasury. One government fund is lending to another. As a result, these transactions net out on the government's consolidated books.[9]

The accumulated balances in a trust fund do not in and of themselves increase the government's ability to meet the related program commitments. That is, simply increasing trust fund balances does not improve program sustainability. Increases in trust fund balances can strengthen the ability to pay future benefits if a trust fund's cash surpluses are used to improve the government's overall fiscal position. For example, when a trust fund's cash surpluses are used to reduce debt held by the public, this increases national saving, contributes to higher economic growth over the long term, and enhances the government's ability to raise cash in the future to pay benefits. It also reduces Federal interest costs below what they otherwise would have been, thereby promoting greater fiscal flexibility in the future.

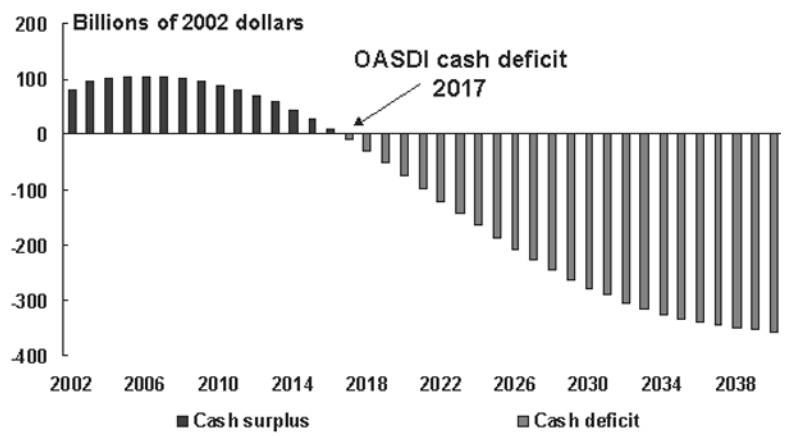
According to the Trustees' intermediate estimates, the combined Social Security trust funds will be solvent until 2041.[10] However, our long-term model shows that well before that time program spending will constitute a rapidly growing share of the budget and the economy. Ultimately, the critical question is not how much a trust fund has in assets, but whether the government as a whole can afford the promised benefits in the future and at what cost to other claims on scarce resources. As I have said before, the future sustainability of programs is the key issue policymakers should address—i.e., the capacity of the economy and budget to afford the commitment. Fund solvency can help, but only if promoting solvency improves the future sustainability of the program.

SOCIAL SECURITY'S CASH FLOW IS EXPECTED TO TURN NEGATIVE IN 2017

Today, the Social Security trust funds take in more in taxes than they spend. Largely because of the known demographic trends I have described, this situation will change. Under the Trustees' intermediate assumptions, annual cash surpluses begin to shrink in 2006, and combined program outlays begin to exceed dedicated tax receipts in 2017, a year after Medicare's Hospital Insurance trust fund (HI) outlays are first expected to exceed program tax revenues. At that time, both programs will become net claimants on the rest of the Federal budget (See fig. 4).

As I noted above, the special Treasury securities represent assets for the trust funds but are future claims against the Treasury. Beginning in 2017, the trust funds will begin drawing on the Treasury to cover the cash shortfall, first relying on interest income and eventually drawing down accumulated trust fund assets. Regardless of whether the trust funds are drawing on interest income or principal to make benefit payments, the Treasury will need to obtain cash for those redeemed securities either through increased taxes, spending cuts, increased borrowing from the public, or correspondingly less debt reduction than would have been the case had Social Security's cash flow remained positive.[11] Neither the decline in the cash surpluses nor the cash deficit will affect the payment of benefits. However, the shift affects the rest of the budget. The negative cash flow will place increased pressure on the Federal budget to raise the resources necessary to meet the program's ongoing costs.

Figure 4: Social Security's (OASDI) Trust Funds Face Cash Deficits as Baby Boomers Retire



Source: GAO analysis of data from the Office of the Chief Actuary, Social Security Administration, based on the intermediate assumptions of 2002 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.

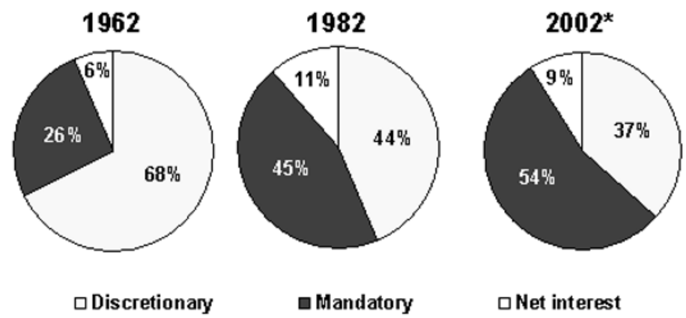
DECLINE IN BUDGETARY FLEXIBILITY WILL BE SEVERELY EXACERBATED ABSENT ENTITLEMENT REFORM

From the perspective of the Federal budget and the economy, the challenge posed by the growth in Social Security spending becomes even more significant in combination with the more rapid expected growth in Medicare and Medicaid spending. This growth in spending on Federal entitlements for retirees will become increasingly unsustainable over the longer term, compounding an ongoing decline in budgetary flexibility. Over the past few decades, spending on mandatory programs has consumed an ever-increasing share of the Federal budget. Prior to the creation of the Medicare and Medicaid programs, in 1962 mandatory spending plus net interest accounted for about 32 percent of total Federal spending. By 2002, this share had almost doubled to approximately 63 percent of the budget (See fig. 5).

In much of the last decade, reductions in defense spending helped accommodate the growth in these entitlement programs. This, however, is no longer a viable option. Even before September 11, reductions in defense spending were no longer available to help fund other claims on the budget. Indeed, spending on defense and homeland security will grow as we seek to combat new threats to our Nation's security.

Our long-term budget simulations continue to show that to move into the future with no changes in Federal retirement and health programs is to envision a very different role for the Federal Government. Assuming, for example, that the tax reductions enacted last year do not sunset and discretionary spending keeps pace with the economy, by midcentury Federal revenues may only be adequate to pay Social Security and interest on the Federal debt. Spending for the current Medicare program—without the addition of a drug benefit—is projected to account for more than one-quarter of all Federal revenues.[12] To obtain balance, massive spending cuts, tax increases, or some combination of the two would be necessary (See fig. 6). Neither slowing the growth of discretionary spending nor allowing the tax reductions to sunset eliminates the imbalance.

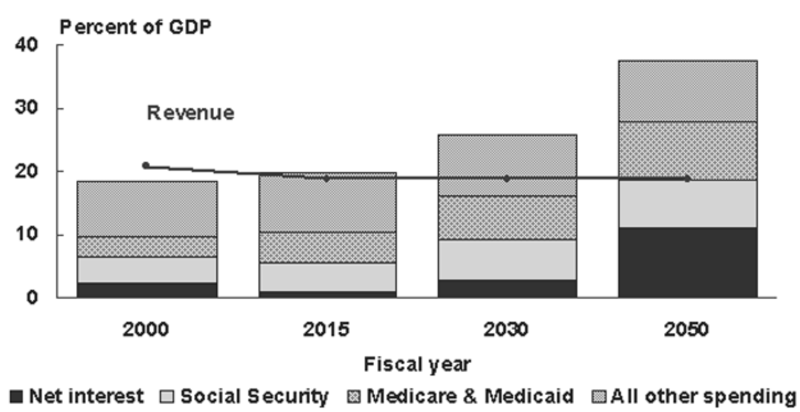
Figure 5: Federal Spending for Mandatory and Discretionary Programs, Fiscal Years 1962, 1982, and 2002



*Office of Management and Budget current services estimate.

Source: GAO analysis of data from the Office of Management and Budget.

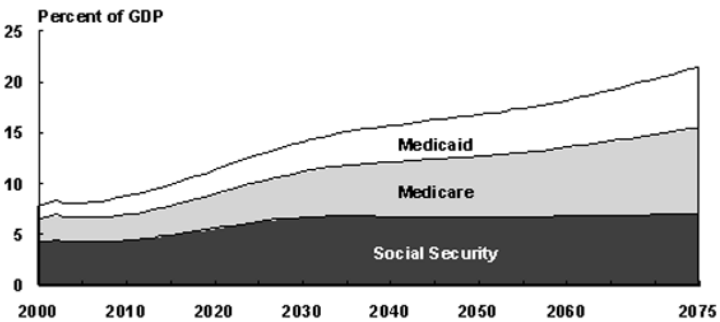
Figure 6: Composition of Spending as a Share of Gross Domestic Product (GDP) Assuming Discretionary Spending Grows with GDP and the Tax Cuts Do Not Sunset



Source: GAO's March 2002 analysis.

It is important as well to look beyond the Federal budget to the economy as a whole. Figure 7 shows the total future draw on the economy represented by Social Security, Medicare, and Medicaid. Under the 2002 Trustees' intermediate estimates and the Congressional Budget Office's (CBO) most recent long-term Medicaid estimates, spending for these entitlement programs combined will grow to 14.1 percent of GDP in 2030 from today's 8.3 percent. Taken together, Social Security, Medicare, and Medicaid represent an unsustainable burden on future generations.

Figure 7: Social Security, Medicare, and Medicaid Spending as a Percent of GDP



Note: Projections based on intermediate assumptions of the 2002 Trustees' Reports and CBO's January 2002 long-term projections under midrange assumptions.

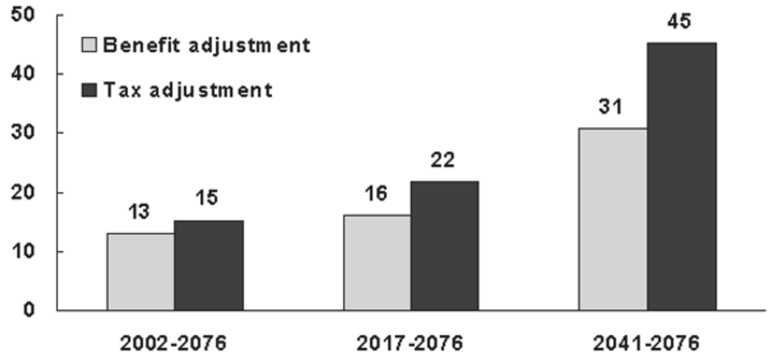
Source: Office of the Chief Actuary, Social Security Administration; Office of the Actuary, Centers for Medicare and Medicaid Services; and CBO.

This testimony is not about the complexities of Medicare, but it is important to note that Medicare presents a much greater, more complex, and more urgent fiscal challenge than does Social Security. Unlike Social Security, Medicare growth rates reflect not only a burgeoning beneficiary population, but also the escalation of health care costs at rates well exceeding general rates of inflation. Increases in the number and quality of health care services have been fueled by the explosive growth of medical technology. Moreover, the actual costs of health care consumption are not transparent. Third-party payers generally insulate consumers from the cost of health care decisions. These factors and others contribute to making Medicare a much greater and more complex fiscal challenge than even Social Security.

When Social Security redeems assets to pay benefits, the program will constitute a claim on real resources in the future. As a result, taking action now to increase the future pool of resources is important. To echo Federal Reserve Chairman Greenspan, the crucial issue of saving in our economy relates to our ability to build an adequate capital stock to produce enough goods and services in the future to accommodate both retirees and workers in the future.[13] The most direct way the Federal Government can raise national saving is by increasing government saving. Ultimately, as this committee recommended last fall, we should attempt to return to a position of surplus as the economy returns to a higher growth path. This would allow the Federal Government to reduce the debt overhang from past deficit spending, provide a strong foundation for future economic growth, and enhance future budgetary flexibility.

Similarly, taking action now on Social Security would not only promote increased budgetary flexibility in the future and stronger economic growth but would also make less dramatic action necessary than if we wait. Perhaps the best way to illustrate this is to compare what it would take to achieve actuarial balance at different points in time by either raising payroll taxes or reducing benefits.[14] Figure 8 shows this. If we did nothing until 2041—the year the trust funds are estimated to be exhausted—achieving actuarial balance would require changes in benefits of 31 percent or changes in taxes of 45 percent. As figure 8 shows, earlier action shrinks the size of the necessary adjustment.

Figure 8: Size of Action Needed to Achieve Social Security Solvency



Note: The benefit adjustments in this graph represent a one-time, permanent change to all existing and future benefits beginning in the first year indicated.

Source: GAO analysis of data from the Office of the Chief Actuary, Social Security Administration.

Thus both sustainability concerns and solvency considerations drive us to act sooner rather than later. Trust fund exhaustion may be nearly 40 years away, but the squeeze on the Federal budget will begin as the baby boom generation starts to retire. Actions taken today can ease both these pressures and the pain of future actions. Acting sooner rather than later also provides a more reasonable planning horizon for future retirees.

EVALUATING SOCIAL SECURITY REFORM PROPOSALS

As important as financial stability may be for Social Security, it cannot be the only consideration. As a former public trustee of Social Security and Medicare, I am well aware of the central role these programs play in the lives of millions of Americans. Social Security remains the foundation of the Nation's retirement system. It is also much more than just a retirement program; it also pays benefits to disabled workers and their dependents, spouses and children of retired workers, and survivors of deceased workers. Last year, Social Security paid almost $408 billion in benefits to more than 45 million people. Since its inception, the program has successfully reduced poverty among the elderly. In 1959, 35 percent of the elderly were poor. In 2000, about 8 percent of beneficiaries aged 65 or older were poor, and 48 percent would have been poor without Social Security. It is precisely because the program is so deeply woven into the fabric of our Nation that any proposed reform must consider the program in its entirety, rather than one aspect alone. Thus, GAO has developed a broad framework for evaluating reform proposals that considers not only solvency but other aspects of the program as well.

The analytic framework GAO has developed to assess proposals comprises three basic criteria:

- The extent to which a proposal achieves sustainable solvency and how it would affect the economy and the Federal budget;
- the relative balance struck between the goals of individual equity and income adequacy; and
- how readily a proposal could be implemented, administered, and explained to the public.

The weight that different policymakers may place on different criteria will vary, depending on how they value different attributes. For example, if offering individual choice and control is less important than maintaining replacement rates for low-income workers, then a reform proposal emphasizing adequacy considerations might be preferred. As they fashion a comprehensive proposal, however, policymakers will ultimately have to balance the relative importance they place on each of these criteria.

FINANCING SUSTAINABLE SOLVENCY

Historically, Social Security's solvency has generally been measured over a 75-year projection period. If projected revenues equal projected outlays over this time horizon, then the system is declared in actuarial balance. Unfortunately, this measure is itself unstable. Each year, the 75-year actuarial period changes, and a year with a surplus is replaced by a new 75th year that has a significant deficit. This means that, changes that restore solvency only for the 75-year period will not hold. For example, if we were to raise payroll taxes immediately by 1.87 percentage points of taxable payroll today—which, according to the 2002 Trustees' Report, is the amount necessary to achieve 75-year balance—the system would be out of balance next year. This is the case because actions taken to close the 75-year imbalance would not fully address the projected deficit in year 76 of 6.49 percent of taxable payroll. Reforms that lead to sustainable solvency are those that avoid the automatic need to periodically revisit this issue.

As I have already discussed, reducing the relative future burdens of Social Security and health programs is essential to a sustainable budget policy for the longer term. It is also critical if we are to avoid putting unsupportable financial pressures on future workers. Reforming Social Security and Federal health programs is essential to reclaiming our future fiscal flexibility to address other national priorities.

BALANCING ADEQUACY AND EQUITY

The current Social Security system's benefit structure strikes a balance between the goals of retirement income adequacy and individual equity. From the beginning, benefits were set in a way that focused especially on replacing some portion of workers' pre-retirement earnings. Over time other changes were made that were intended to enhance the program's role in helping ensure adequate incomes. Retirement income adequacy, therefore, is addressed in part through the program's progressive benefit structure, providing proportionately larger benefits to lower earners and certain household types, such as those with dependents. Individual equity refers to the relationship between contributions made and benefits received. This can be thought of as the rate of return on individual contributions. Balancing these seemingly conflicting objectives through the political process has resulted in the design of the current Social Security program and should still be taken into account in any proposed reforms.

Policymakers could assess income adequacy, for example, by considering the extent to which proposals ensure benefit levels that are adequate to protect beneficiaries from poverty and ensure higher replacement rates for low-income workers. In addition, policymakers could consider the impact of proposed changes on various subpopulations, such as low-income workers, women, minorities, and people with disabilities. Policymakers could assess equity by considering the extent to which there are reasonable returns on contributions at a reasonable level of risk to the individual, improved intergenerational equity, and increased individual choice and control. Differences in how various proposals balance each of these goals will help determine which proposals will be acceptable to policymakers and the public.

IMPLEMENTING AND ADMINISTERING PROPOSED REFORMS

Program complexity makes implementation and administration both more difficult and harder to explain to the public. Some degree of implementation and administrative complexity arises in virtually all proposed changes to Social Security, even those that make incremental changes in the already existing structure. However, the greatest potential implementation and administrative challenges are associated with proposals that would create individual accounts. These include, for example, issues concerning the management of the information and money flow needed to maintain such a system, the degree of choice and flexibility individuals would have over investment options and access to their accounts, investment education and transitional efforts, and the mechanisms that would be used to pay out benefits upon retirement. Harmonizing a system that includes individual accounts with the regulatory framework that governs our Nation's private pension system would also be a complicated endeavor. However, the complexity of meshing these systems should be weighed against the potential benefits of extending participation in individual accounts to millions of workers who currently lack private pension coverage.

Continued public acceptance and confidence in the Social Security program require that any reforms and their implications for benefits be well understood. This means that the American people must understand why change is necessary, what the reforms are, why they are needed, how they are to be implemented and administered, and how they will affect their own retirement income. All reform proposals will require some additional outreach to the public so that future beneficiaries can adjust their retirement planning accordingly. Yet the more transparent the implementation and administration of reform, and the more carefully such reform is phased in, the more likely it will be understood and accepted by the American people.

With regard to proposals that involve individual accounts, an essential challenge would be to help the American people understand the relationship between their individual accounts and traditional Social Security benefits, thereby ensuring that any gaps in expectations about current or future benefits are avoided. In addition, increasing the public's level of sophistication and understanding of how to invest in the market, the relationship between risk and return, and the potential benefits of diversification presents an education challenge that must be surmounted so that the American people have the necessary tools to secure their future. The Enron collapse helps to illustrate the importance of this, as well as the need to provide clear and understandable information so that the public can make informed retirement decisions.

CONCLUSION

Early action to address the financing problems of Social Security yields the highest fiscal dividends for the Federal budget and provides a longer period for future beneficiaries to make adjustments in their own planning. The events of September 11 and the challenges of combating terrorism do not change this. In fact, the additional spending that will be required to fight the war on terrorism and protect our homeland will serve to increase our long-range fiscal challenges. It remains true that the longer we wait to take action on the programs driving long-term deficits, the more painful and difficult the choices will become.

Although the program does not face an immediate solvency crisis as it did in 1983, the fundamental nature of the program's long-term financing challenge means that timely action is needed. The demographic trends recognized in 1983 are now almost upon us. It is these demographic trends—and their implications for both Social Security and Medicare—that lead to the conclusion that the program faces both a solvency and a sustainability problem. For the American people to understand why change is necessary, a public education campaign will be needed that focuses not just on Social Security but also on our long-range fiscal challenges.

We will face many difficult choices in making Social Security sustainable. Focusing on comprehensive packages of reforms that protect the benefits of current retirees while achieving the right balance of equity and adequacy for future beneficiaries will help to foster credibility and acceptance. This will help us avoid getting mired in the details and losing sight of important interactive effects. It will help build the bridges necessary to achieve consensus.

Today I have described the three basic criteria against which GAO thinks Social Security reform proposals may be measured. These may not be the same criteria every analyst would suggest, and certainly how policymakers weight the various elements may vary. However, if comprehensive proposals are evaluated as to (1) their financing and economic effects, (2) their effects on individuals, and (3) their feasibility, we will have a good foundation for devising agreeable solutions, perhaps not in every detail, but as an overall reform package that will meet the most important of our objectives.

Today many retirees and near-retirees fear cuts that will affect them while young people believe they will get little or no Social Security benefits. As I said at the start of my testimony, we believe it is possible to structure a Social Security reform proposal that will exceed the expectations of all generations of Americans. Yes, we believe there is a window of opportunity to craft a solution that will protect Social Security benefits for the Nation's current and near-term retirees, while ensuring that the system will be there for future generations. However, this window of opportunity will close as the baby boom generation begins to retire. As a result, we must move forward to address Social Security because we have other major challenges confronting us. The fact is, compared to addressing our long-range health care financing problem, reforming Social Security will be easy lifting.

It is my hope that we will think about the unprecedented challenge facing future generations in our aging society. Relieving them of some of the burden of today's financing commitments would help fulfill this generation's stewardship responsibility to future generations. It would also preserve some capacity for them to make their own choices by strengthening both the budget and the economy they inherit. We need to act now to address the structural imbalances in Social Security, Medicare, and other entitlement programs before the approaching demographic tidal wave makes the imbalances more difficult, dramatic, and disruptive.

We at GAO look forward to continuing to work with this committee and the Congress in addressing this and other important issues facing our Nation.

Mr. Chairman, Mr. Spratt, members of the committee, that concludes my statement. I'd be happy to answer any questions you may have.

END NOTES

1. U. S. General Accounting Office, Social Security: Criteria for Evaluating Social Security Reform Proposals, GAO/T–HEHS–99–94 (Washington, D.C.: Mar. 25, 1999); Social Security: The President's Proposal , GAO/T–HEHS/AIMD–00–43 (Washington, D. C.: Nov. 9, 1999); Budget Issues: Long-Term Fiscal Challenges, GAO–02–467T (Washington, D.C.: Feb. 27, 2002).

2. In this testimony, the term "trust funds" refers to the Old-Age and Survivors Insurance and Disability Insurance Trust Funds.

3. Strengthening Social Security and Creating Personal Wealth for All Americans (Dec. 21, 2001; rev. March 19, 2002).

4. This calendar year estimate is based on projected tax receipts and outlays in constant 2002 dollars under the intermediate assumptions of the 2002 Trustees' Report.

5. United Nations Population Division, Replacement Migration: Is it a Solution to Declining and Aging Populations? (March 2000).

6. Income tax revenue resulting from taxation of up to 50 percent of Social Security benefits for certain higher income beneficiaries is credited to the OASI and DI trust funds and provided a little more than 2 percent of total income in 2001.

7. Under current law, the Secretary of the Treasury as trustee may purchase marketable Treasury and agency securities if the Secretary determines that such purchase is "in the public interest." Such purchases have been rare. As of the end of calendar year 2001, about 0.003 percent of OASDI trust fund holdings were in marketable Treasury securities.

8. For a discussion of trust funds and other earmarked funds in the budget, see U.S. General Accounting Office, Federal Trust and Other Earmarked Funds: Answers to Frequently Asked Questions, GAO–01–199SP (Washington D.C.: Jan. 2001).

9. Under current accounting standards, the long-term funding gap—the difference between promised benefits and expected contributions—for Social Security and Medicare is reported as required supplementary stewardship information but not treated as a liability in the government's financial statements. The recognized liability is the amount of benefits due and payable to or on behalf of beneficiaries at the end of the reporting period.

10. Separately, the DI fund is projected to be exhausted in 2028 and the OASI fund in 2043.

11. If the unified budget is in surplus at this point, then financing the excess benefits will require less debt redemption rather than increased borrowing.

12. This simulation assumes that all promised benefits would be paid in full throughout the 75-year projection period.

13. Testimony before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, July 24, 2001.

14. Solvency could also be achieved through a combination of tax and benefit actions. This would reduce the magnitude of the required change in taxes or benefits compared to making changes exclusively to taxes or benefits as shown in figure 8.

Chairman NUSSLE. Thank you.

As I said, this is one of the first things that Mr. Spratt suggested to me when I took over as chairman of the committee; that he wanted to focus on this and highlight this and have a hearing on this, and so, I would like to invite him to go first in the questioning.

Mr. SPRATT. General Walker, obviously one way to restore some solvency to Social Security for the long run is to increase the rate of the return on the assets in the trust fund.

Have you given any thought or analysis to how we might do that, using the traditional structure that we have now, a trust fund invested in government bonds? Have you considered the possibility that it might be invested in equities or corporate bonds in order to increase the yield or return of the trust fund?

Mr. WALKER. Obviously, to the extent that the Congress decided to more actively invest these funds, then based upon modern portfolio theory, having a diversified portfolio of assets, one should be able to achieve a greater rate of return over time.

At the same point in time, Mr. Spratt, as you know, that also has implications on the budget. Because my understanding is, under the current budget rules—and Director Crippen can verify this or correct me—that if you end up using that cash, and then make an investment, that is counted as an expenditure at the present point in time.

So, from an economic standpoint, your point is well taken. In fact, one of the things I think that this committee needs to think about is, how do we keep score? We currently keep score based upon, largely, cash flow concepts and 10-year horizons, which ignore the economic reality and which also ignores the fact that most of our budget challenges are, after 10 years, big budget challenges.

Mr. SPRATT. Well, we can easily change that rule and simply stipulate by another rule that if economic assets are purchased, they should not be treated the same as if a consumable service or commodity was purchased.

Have you calculated what we would need to realize as a rate of return on the trust fund, the return that we can expect under existing circumstances in order to keep it solvent for the next 70 years?

Mr. WALKER. Well, what we can do is, we can make some assumptions, where we would end up taking, for example, the number in the financial statements of the U.S. Government, which is the discounted present value of the unfunded liability that exists right now, over the next 75 years. And we could compare what a more likely return would be on a more diversified portfolio of assets versus that and come up with what the difference in the number would be.

That might be helpful to you. I think it would illustrate your point.

[The information referred to follows:]

GAO'S CALCULATED RATE OF RETURN ON TRUST FUND ASSETS

In response to your request, we calculated the rate of return on trust fund assets that would be necessary to achieve trust fund solvency for 75 years. Our calculations are based on the data and intermediate assumptions presented in the 2002 Trustees' Report. In order to simplify the calculation, we assumed immediate investment of all current and projected future assets of the combined Old-Age and Survivors Insurance and Disability Insurance (OASDI) trust funds. We found that the rate of return over the 75-year projection period would have to be increased 2.5 percent from the 3 percent real rate of return assumed by the Trustees to a real rate of 5.5 percent to achieve combined trust fund solvency through 2076. We discussed this estimate with the staff at the Office of the Chief Actuary, Social Security Administration, who agreed that our estimate was reasonable.

As noted, this calculation assumes that the entire combined trust fund balance of more than $1 trillion is immediately invested and earns that rate of return over the entire 75-year period. Hypothetically, the trust fund could redeem its existing balance of more than $1 trillion in Treasury securities, but its investment could potentially be disruptive to financial markets. In addition, investment of trust fund assets in private markets would have immediate consequences for the Federal budget. Social Security cash surpluses would not be available to finance other government activities. In addition, reinvesting existing trust fund balances would mean that the Treasury would have to repay money previously borrowed from the trust fund. In 1998, GAO issued a report that examined issues raised by government investment of Social Security funds in the stock market with the intention of earning higher returns.* Our 1998 report stated that allowing the Social Security trust fund to invest in the stock market is a complex proposal that would have potential consequences for the trust fund, the U.S. economy and Federal budget policy. Additional information and analyses on related issues can be found in our 1998 report.

Mr. SPRATT. Well, if you can do that for the record, if you can demonstrate what we would need to realize as a rate of return on the trust fund in order for the trust fund to meet its obligations through the stipulated time period, I think—what is it, 75 years?

Mr. WALKER. Yes. We will have to make some assumptions; we will disclose those.

And I think the other thing, as you know, Mr. Spratt, which is very important is that part of the problem with Social Security is that even if you come into actuarial balance for the 75-year period today, you know you are going to be out of balance next year because of the way the numbers work. I mean, the deficit is escalating each year.

Mr. SPRATT. Well, obviously the problem with going out that far is a lot of things we don't know about 2075.

Mr. WALKER. That is true, although I think we have to also learn some lessons that it is even tough to project 10 years, much less 75. On the other hand, I think that we can't be overly optimistic, because we know that some of these trends, like demographics, aren't going away.

Mr. SPRATT. You mentioned the net present value of the shortfall in Social Security today. I have seen the number $3.3 trillion. Is that your calculation of what the shortage is on a net present value basis?

Mr. WALKER. It is around $3 trillion. I will provide it for the record. And again that doesn't count Medicare, which is a big one.

[The information referred to follows:]

PRESENT EXCESS VALUE OF THE OASDI PROGRAM

According to the 2002 Financial Report of the United States Government, for the OASDI program, the present value of the excess of income (excluding interest) over expenditures for the 75-year period 2001–2075, taking into account the beginning trust fund balances and the cost of attaining a target trust fund balance at the end of the period, is $3.394 trillion.

Mr. SPRATT. I understand that.

I don't have any further questions at this time. Thank you very much.

Chairman NUSSLE. Let me start with what may be—what may sound like good news, the trustees' report. I guess part of why I am asking this is to highlight why it may not be good news and why sometimes this gets confusing.

But this year's trustees' report shows that the dates of cash flow deficits and insolvency for Social Security are gradually receding, and that is often reported as good news and assumed to be good news. Every time a year is added onto that, or a period of time is added onto the solvency date, that is championed or that is reported as being good news.

Can we really afford to feel secure about the fact that that solvency date appears to be receding slightly?

*NOTE.—Social Security Financing: Implications of Government Stock Investing for the Trust Fund, the Federal Budget and the Economy. April 22, 1998, GAO/AIMD/HEHS–98–74.

Mr. WALKER. In my opinion, Mr. Chairman, solvency is one measure that you should look at. However, it is only one. And, in fact, if you just look at the solvency measure, it can give you a false sense of security and potentially a misleading picture as to what the condition of Social Security is.

I think you also have to look at, when does Social Security turn a negative cash flow? Because once it starts, you know, turning a negative cash flow, that has a very real impact on the budget.

In addition to that, you have to look at what percent Social Security is to the overall budget and the overall economy. Furthermore, you have to look at, how does Social Security fit into the overall budget picture and the ability to be able to deliver on not just Social Security promises, but other promises that have been made.

So my personal view is that solvency is something to track, but by no means is it the primary measure that Congress should focus on.

Chairman NUSSLE. Why is it the primary measure that Congresses focus on, or for that matter, the media? I mean, that is the date that is reported. Banner headlines, that is what is talked about. You will see it in every publication and rag and everything else. Why is that the date that—should we be tracking other dates or times or measures as primary factors, as opposed to, seemingly, highlighting just that one date or factor?

Mr. WALKER. I would argue that there are at least two dates that are important. One date is when you turn negative cash flow; another date is the insolvency date. I think those are two key dates as a point in time. If you look at negative cash flow, that is 2017, based on the most recent trustees' report.

If you look at when the cash flows start declining—right now we are building positive cash flows—when they start declining, that is 2006, based on the latest trustees' report.

I think this is part of the public education plan. First, what does solvency mean? What does that date mean? What that means is that if we don't do anything to Social Security by that date, which is, I believe 2041, which is the insolvency date——

Chairman NUSSLE. We have got a chart on this. I am not trying to use—I am not trying to make you accept this chart, but this is a chart that may—here is the chart.

This is, I think, what you are referring to. Just so we can put it in some kind of a graphic, charted way, is this what you are talking about?

Mr. WALKER. I think what you are talking about here is the blue line represents the trust fund. And the green line represents cash flow income. The outgo is obviously expenditures. And the date, as I recall, is—2041 I believe is the date that the combined OASDI trust fund is supposed to be insolvent.

What that means is, if Congress does nothing between now and then, if all trustees' intermediate assumptions prove to be valid as of that date you would end up having to decide what you are going to do about the approximate 25-percent shortfall between the revenues that are coming in in that program every year and the promises that have to be paid in that year.

That is obviously not a desirable state, to wait until you spend every last dime. Then, all of a sudden, you have this significant shortfall that has to be addressed, which shortfall increases year by year because of some of the demographic trends and other factors that we talked about.

Mr. SPRATT. Thank you, Mr. Chairman.

When you speak of a cash deficit in 2017, are you including in the income to the trust funds interest payments and income tax transfers?

Mr. WALKER. The interest on the bonds I believe is not included in that, because that is not a cash item. I believe if you take total income, it would be about 2027.

So it is truly just what I said; it is cash flow. As you know, the interest on the bonds is an accounting entry but it is significant because it is a government commitment to pay in the future.

Mr. SPRATT. But we book the interest on the bonds as income and use it to purchase other bonds, don't we?

Mr. WALKER. That is correct.

Mr. SPRATT. So it is treated as an asset by the trust fund?

Mr. WALKER. It is an asset, it is income, but it is not cash. In other words, what we do count is, we count payroll taxes, we count the taxation that is attributable to taxation of certain Social Security benefits where they are cash amounts, but we don't count the notational interest on the bonds because it is a non-cash item.

Chairman NUSSLE. Two more things quickly. One is the Nation's gross domestic product is obviously going to be growing. Some would possibly predict that it would grow much more substantially than is being used as the basis for the arguments that you are making, or that others make, about the concern.

I have heard those who would suggest that we could grow out of this, that somehow that there may be a bump for the baby boomers; but by and large, this could be taken care of by growth in the economy.

Would you address that either in favor or against?

Mr. WALKER. Well, first, this does assume growth in the economy generally consistent with CBO's assumptions. So you can ascertain whether you believe they are reasonable or not. There is growth in the economy that is assumed as part of this analysis.

My personal opinion is that reasonable people can differ as to whether or not you can grow out of part of, or all of, the Social Security problem. What you are not going to grow out of, in my opinion, is the larger fiscal problem. In other words, if you look at the degree of imbalance that I showed up there on the "haircut, the decapitation and the disembodiment" chart, there is something you are not going to grow out of in my opinion.

Chairman NUSSLE. The last thing I would like you to just address is your second-to-last page of your presentation. If you want to put it up, that would be great. It is basically your criterion for evaluating Social Security reform proposals. You went over that very quickly.

Would you just expand on your three points for the members, what you mean by those three points as we begin to possibly take a look at some solutions in the near future?

Mr. WALKER. Well, these are very high levels. We have a number of sub-elements for each one. It is available on our Web site. But at the highest levels, financing sustainable solvency, the idea that we have been talking about, solvency has some significance, but it is not everything. It can be misleading. You need to look at what has to be done not only to be able to make the program solvent, but to be able to make the program sustainable as a percentage of the budget, as a percentage of the economy over time.

Secondly, balancing adequacy and equity in the benefit structure. Whatever changes you make, consideration has to be given to different income levels and different resource levels of the individuals involved and what likely effect that is going to have on them, and then equity between generations, equity between different classes of individuals in whatever changes you are considering making.

And then thirdly, implementing and administering reforms. To what extent are there going to be transition challenges? To what extent are there going to be administrative challenges associated with whatever reform proposals you may consider?

To the extent that you are talking about reforming the existing defined benefit structure, that is one thing. To the extent that you are considering individual accounts, either as an optional or as a mandatory element of reform, then that raises a whole new range of implementation issues that you need to think about from the standpoint of how are you going to end up handling the recordkeeping, what are you going to do about the investments, what are you going to do about investment education?

Those are solvable problems, but they are significant challenges that have to be adequately focused on both as to the structure and the timing of implementation of any such proposal.

Chairman NUSSLE. Thank you.

I would just observe before I recognize, I guess Mr. Bentsen, Mr. Spratt and I just had a 15-minute conversation with the Comptroller General, and I don't think politics was invoked once. I don't know if that can be sustained, but I will tell you, if we can't have a conversation about this in this country, about this challenge, and do it in a non-political way, we are not going to address it. I think we have proven that we can. Maybe that is, in part, why we don't have jurisdiction. I don't know.

But I am very serious about that. I think there are ways that we can have conversations about this, even though people can have their differences of opinion.

Mr. WALKER. Can I touch on that, Mr. Chairman?

Chairman NUSSLE. Please.

Mr. WALKER. In a prior life, I was a trustee of Social Security and Medicare. I was Assistant Secretary of Labor for pensions and health and head of the Pension Benefit Guaranty Corporation. And because I have a lot of background in pensions and health, as well as other areas, I was afforded the opportunity to participate in some of these town hall meetings that former President Clinton, former Vice President Gore and other bi-partisan leaders held around the country as part of an education effort to try to educate the American people on the nature, extent, and timing of the problem, and to try to put it in context. That has to happen.

What I found is, the American people are a lot brighter than sometimes we give them credit for. And, if you give them the facts, they can understand the need for some type of change.

Reasonable people can differ on what those changes should be. But one of the things that has to happen is, there needs to be a public education effort which is part of that political leadership and personal courage that has to happen to get a little bit out front, because realistically, Congress is not going to act until the American people have a better understanding of the nature and extent and magnitude of the problem, because you obviously have to stand for reelection.

By the way, Mr. Spratt, the interest is included in the trust fund balance; it is included in that. But, it is not included in the cash flow analysis.

Mr. SPRATT. That is kind of a quirk of our accounting. I mean, if we booked interest as a real cost, even though we were paying it to ourselves, usually as trustee, our bottom line would look a lot different today.

I think it is one of the anomalies in Federal bookkeeping that we really ought to give more serious attention to.

Mr. WALKER. I think you are right. One of the things that we need to do is, we need to take another look at the accounting and disclosure for Social Security and Medicare obligations. Right now, under generally accepted accounting principles for the Federal Government, the bonds that are held in the trust fund are not shown as a liability in the consolidated financial statement of the U.S. Government.

The reason it is not shown as a liability is because the right hand owes the left hand. Just as in the private sector, you eliminate those types of transactions on consolidation.

At the same point in time, the unfunded obligation between promised benefits and funded benefits, that approximate $3.4 trillion number that we talked about before, just for Social Security, is not shown as a liability. It is disclosed. It is contained in a separate statement, which is a positive step.

But I think one of the things that we need to do—and I have shared with this with my colleagues on the Joint Financial Management Improvement program, including the Secretary of the Treasury and the Director of OMB—is that we need to have a discussion and debate about whether or not the current accounting treatment should go further.

I expect that that will end up happening within the next year or so.

Mr. SPRATT. Thank you, sir.

Chairman NUSSLE. Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

Mr. Walker, I don't want to debate what are on the margins, but I do think on the interest that Mr. Spratt brings up, there is a legal obligation for that interest.

You are right, we don't account for it in the same way that we don't account for some other trust funds we have out there: the BIF fund, the Safe fund and other things like that. But there is a legal obligation that presumably Congress is going to honor; otherwise, it would probably have somewhat catastrophic effects on the Treasury market and others. So I think we have to count it.

But you are right. In a $3.4 trillion present value deficit, we are debating on the margins here. When you talk about this gap, this deficit, the cash flow deficit and the long-term cash flow deficit, and you say we are going to have to have either benefit reductions or increased revenues, or some combination thereof; and you—but you do that based upon demographic projections, which I think—I think your assumptions—I don't know whether your assumptions are accurate, but I think your ingredients are accurate that you have to look at that.

Is it true that regardless of whether there was a—and I am not trying to make it political or anything—when we had the Social Security task force a couple of years ago, and we had Alan Greenspan come and talk to us about this in an off-the-record luncheon, he made this point. This is more of a societal problem, where you have a universal pension safety net program; and whether it was—whether it is operated through a Federal Government trust fund program, as it is right now, or whether or not it was operated through a private sector or privatization concept of some sort, where there was a guaranteed benefit level, which is the case right now, that deficit would exist. Is that correct?

I mean, one way or the other, the economy has to pick it up? It scores against GDP, whether it is governmental or non-governmental?

Mr. WALKER. Yes.

But the way to really look at it is, we call this a "trust fund." This is not a traditional trust fund in the sense that you and I or, frankly, the American people would normally refer to as a "trust fund."

What "trust fund" means in this context is an accounting device. It is a sub-account within the overall financial statements of the U.S. Government.

Now, don't get me wrong. The fact that this trust fund holds government securities backed by the full faith and credit of the U.S. Government, guaranteed as to principal and interest, has not only legal significance; it has, economic and moral significance as well.

But, you know, this is not a fund that is backed by hard assets that are actively invested.

So you really have several options. When you turn a negative cash flow to deal with the long-range problem, you need more income, less benefits, more debt held by the public; or to try to figure out a way that you can increase rate of return. Through actively funding, you might end up helping to reduce the problem on a discounted present value basis over time.

Mr. BENTSEN. I guess I agree with that.

But I guess my question is this: Isn't there generally an unfunded liability of pension obligations, both within the government and outside of the government, that we are having to make through either—through either income-generating assets, or whatever, we are having to make up?

So this is more of a societal program that other nations around the world, as they age, are starting to face as well. And whatever you end up with—with whatever proposal, the cost—there is a cost associated with it whether you privatize, or don't privatize, whatever. That cost is either in the form of a reduction in benefits or an increase in up-front contribution.

Mr. WALKER. I think your point is that it has a macroeconomic impact, it has a broader impact, which is true.

There is one bit of good news here, but let's not get too enthusiastic. The one little bit of good news is that we are a lot more open and transparent about our challenges in this regard, and in fact, our challenges in this regard are not nearly as great as some other industrialized nations. That is the good news.

The bad news is that some developing countries are ahead of us. Some developed countries are also ahead of us in trying to deal with this long-range problem.

Mr. BENTSEN. Thank you.

Chairman NUSSLE. Mr. Gutknecht.

Mr. GUTKNECHT. Thank you, Mr. Chairman.

Mr. Walker, thank you for coming up. I am reminded, listening to your testimony, of something that Winston Churchill said almost 70 years ago. He said, Americans always do the right thing, once we have exhausted every other possibility.

I am afraid what I see happening is, we are sort of going down that path again. I have asked to put this pie chart up that you started your remarks with. This is a troubling pie chart, at least it is to me, when you see how much of our total Federal budget has gone basically to entitlement programs. What troubles me is, with all due respect to friends on the Ways and Means Committee last night, they passed a bill claiming to spend roughly $350 billion over the next 10 years on a new entitlement called prescription drugs.

Your colleague—or your partner in crime, sitting beside you there—Mr. Crippen and his people, recently did a study. They estimate that seniors alone will spend over $1.8 trillion on prescription drugs over the next 10 years. My concern is, we are doing almost nothing on what I think is the big issue. That is, affordability.

We are allowing the pharmaceutical industries to literally take all of their profit, all of their research dollars, all of their marketing dollars from the pockets of American consumers. We are doing very little in terms of opening up free markets to allow Americans access to drugs at world prices which are dramatically lower than here in the United States. But that is for another day.

But my issue is, when you look at these charts—first question: do you estimate that the net interest—and there is some good news/bad news in these charts—the net interest went from 6 percent to 11 percent. We are now down to 9 percent, roughly.

As you go forward, what is your estimate? Will that percentage go up, stay the same, or will it come down?

Mr. WALKER. If you go to the next chart, you will see it.

Mr. GUTKNECHT. OK.

Mr. WALKER. The next one, interest is the dark blue. And so you can see as a percentage of the economy rather than as a percentage of the budget—it goes down and then starts to escalate after about 2015. It rapidly escalates after that.

Part of that has to do with the fact that you turn negative cash flow in both Social Security and Medicare. And if you don't end up doing something on the revenue side and/or the benefit side, then it assumes you are going to increase debt held by the public, which means that your interest expense is going to start going back up.

So that is how it looks over those periods of time.

Mr. GUTKNECHT. That is my concern, that as we go forward if we open up more and more entitlements under Medicare, which we are not adequately funding today—when I talk to my rural health care providers, they are not happy; in fact, more than a hundred providers in Colorado have now said that they won't take any new Medicare recipients.

So we have got a whole lot of things that are converging. I do want to close though and come back.

You mentioned in your testimony just recently, in response to the last question, there are other countries that are moving forward. Germany is one of them, under the leadership of what we would describe as a liberal government in Germany. They did begin the process of creating a personalized retirement system; and I just want to share with you and my colleagues what they have done.

Originally, Germans were allowed to put up to 1 percent of their pay into these retirement accounts. That will rise to 4 percent by 2008. And the amazing news—this is according to the German press—is that their original estimates—they are going to dramatically surpass their original estimates in terms of how much these accounts are going to be worth.

Deutsch Bank is now estimating, by 2009, the new capital that will be included in these new accounts could reach 160 billion Euros, which is roughly US$138 billion by 2009. So the point is that there are other governments, clearly left-of-center governments that are moving forward with reform of their Social Security systems. And it may well be that there is hope that we in the United States will ultimately do the right thing.

Mr. WALKER. One of the things that we have done at GAO is issued reports on what some other countries have done in this area. I believe it is important for us to do that, not just in the area of Social Security, but health care, the environment and a number of other areas, because we live largely in a borderless world where we face many shared challenges.

So, therefore, it is important to try to learn from others. What did they do? What worked? What didn't work? But we obviously have to apply that to our system and our culture and our values and, hopefully, we will do that in time.

Chairman NUSSLE. And just to remind members that we had an excellent hearing and summit of budget chairmen just this last week, the OECD, that discussed this very topic. And another example of—maybe not the exact model Mr. Gutknecht approved, but as a political way to handle it, Sweden may be a good example. They held hands together in a total partisan way, in a total political way, and decided to make the decision.

So there are some models out there that are worth taking a look at. We tried to highlight that at the committee.

Ms. Hooley.

Ms. HOOLEY. Thank you. Would you do just a little explaining to me about—and I apologize if this question has been asked. But as you look at privatization for Social Security, what kind of cuts are we going to have to make to benefits to make that happen? And when do we ever get a return on that? And do individuals have their own accounts, or is that—or are those accounts pooled where they have some choices within that pooling?

Mr. WALKER. Well, first, one would have to have a specific proposal, because obviously there are a number of different proposals out there for different individual accounts. In my personal opinion, having an individual account is not equivalent to privatizing Social Security.

But the fact of matter is, to the extent that Congress would decide, as a part of more comprehensive Social Security reform, that it wanted to have individual accounts as an element, first it would have to decide, is it going to be voluntary? Is it going to be mandatory?

Is it going to be an add-on to the defined benefit? Is it going to be a substitute for a portion of the defined benefit? If so, are you going to make other changes?

Are you going to do something with the retirement age? Are you going to do something with the indexing, something with the bend points in calculation of the replacement ratios?

And so there are a lot of questions that would have to be answered in order to be able to—for me to give any specific numbers or percentages in that regard.

We have analyzed several past Social Security reform proposals, and we are in the process of analyzing the three Social Security reform proposals that the Commission came out with for another committee, which we expect will be available late in the year.

Ms. HOOLEY. Do you have these?

Mr. WALKER. No. We are running them through an economic model.

We have an economic model we use for Social Security reform. We will have the results later this year, but we don't have the numbers yet. But that would be helpful to you.

Ms. HOOLEY. Since we spent all this surplus, what would be your opinion about the best things to do with Social Security to make sure that it is there in the future, and that we do not lower the benefits?

Mr. WALKER. Well, I think there are several reasons we don't have the surplus now.

Ms. HOOLEY. I know, but let's just talk about, we don't have it. So what would be your solution to making sure that Social Security is there in the future, and that we do not lower the benefits?

Mr. WALKER. I think part of it is to create additional fiscal discipline over the budget and the spending process going forward. Being able to look at what the longer-term implications of current or proposed actions as to whether or not they are making our situation better or worse in the long term; and then obviously trying to do what can be done to fuel economic growth.

And to the extent that there are surpluses generated, to use that in a way that starts reducing debt—in order to provide additional fiscal flexibility going forward.

I have testified on behalf of GAO before as to the range of options that Congress has to try to help deal with the long-range fiscal challenge and the different levels of risk; and I would be happy to provide that to you, which I think would be helpful.

Ms. HOOLEY. Do you think it should be privatized?

Mr. WALKER. I don't know of anybody who is talking about, quote, unquote, "privatizing the Social Security system"—I mean, a situation where it would not be a government program and where there wouldn't be any government guarantees, where there wouldn't be any government involvement.

I do know a lot of people who are talking about the possibility of using individual accounts as an element of more comprehensive Social Security reform. I think that is something that is worth serious consideration. But I think it has got to be a piece of an overall package.

I wouldn't want to make a hypothetical recommendation. I don't think it is appropriate for me to do.

Ms. HOOLEY. Thank you.

Chairman NUSSLE. Thank you.

Mr. Toomey.

Mr. TOOMEY. Thank you, Mr. Chairman. I would like to follow up on this line of questioning that my colleague just began, because specifically, I think it is important that we address head on this question of whether personal accounts somehow necessitate benefit cuts.

If you stop and think about where we are today, the current system in its current form, it seems to me if we don't do anything to reform this system, if we leave it exactly as it is, then we are assured of benefit cuts, either in the form of absolute cuts, because the cash flow isn't there to pay the promised benefits or, at a minimum, dramatic cuts in the rate of return on the money that people put into the system, because it would require a dramatic tax increase in order to fund the benefits as currently promised.

Is that a fair way to characterize the current system?

Mr. WALKER. I think—to be balanced, I would have to say that if you don't do anything, it assumes you are going to have to significantly increase taxes or cut benefits.

Mr. TOOMEY. Which drives down returns.

Mr. WALKER. Or significantly cut benefits, or some combination.

Mr. TOOMEY. So as I see it, the current season, unreformed, if we pretend that we don't have a problem here and we leave it unaddressed, that leads to dramatic cuts, at a minimum, in the return to workers or in the absolute benefits.

I would also like to touch on this issue of whether there is something somehow inevitable about a major societal problem in any kind of retirement plan, and I would appreciate your comment on this. It seems to me that it, rather, depends very much on the structure of the plan.

And we have a plan in which we have an unfunded defined benefit system, and we are relying on an ever-growing work force to fund it, which we know we are not going to have in relation to the number of retirees; and that an alternative system in which you have a prefunded, essentially—at least if a component of this were to be prefunded—invested in the economy, able to generate market rates of return, and then that that would provide some component.

If you move in that direction, you can indeed solve the solvency problem permanently. Is that your view, that this can done?

Mr. WALKER. Not by itself.

I think what you have to do is, if you go to an individual account structure, then you have to decide how you are going to handle the transition obligation. You are going to have to solve a number of administrative issues. Then you are going to have to decide whether or not you are going to allocate additional general revenues, or whether or not you are going to change the benefit structure as a way to close the gap.

You can help close the gap, you can help deal with the rate-of-return issue with a funded system. That doesn't necessarily solve your problem.

Mr. TOOMEY. I didn't mean to suggest that there wasn't a significant transitional cost. There is.

My point is that it can be done in a fashion that is for a finite period of time with a finite amount of money. It is large, but it is finite and then it leads you to a system in which you have a fundamentally different structure, where you have a prefunded system, where you can assure generous benefit system. You have just got to get to that structure.

Mr. WALKER. It is possible to reform Social Security with individual accounts coupled with other reform changes and achieve sustainable solvency and other objectives over time.

Mr. TOOMEY. Thanks. I would like to go back to a chart briefly, then—I am going to run out of time soon—which is the chart that you have on page 15. If it is possible for us to bring that back up, I would appreciate that. That is the bar chart, I am thinking of.

Mr. WALKER. The one that deals with the percentage of the economy?

Mr. TOOMEY. That is correct. That is the one.

Let me ask a question. First of all, my assumption is that you are referring—those numbers refer to Federal Government spending.

Mr. WALKER. That is correct.

Mr. TOOMEY. There is no representation here, no attempt to represent State and local government spending.

Mr. WALKER. Neither spending nor taxation.

Mr. TOOMEY. Right. Now, I might be off on this, but in very rough terms, the number that comes to my mind for the total amount of State and local spending in our country as a percentage of GDP is something around 20 percent; is that around the right ball park?

Mr. WALKER. My director of budget says closer to 10.

Mr. TOOMEY. For the combined, all State and local?

Mr. WALKER. Ten to 15 percent.

Mr. TOOMEY. Education systems, 10 to 15. If we took 10 to 15, if we assume that we maintain that level and we look at the number for 2050, what are we up to? About 35, maybe more?

Mr. WALKER. About 35 percent at the Federal level alone.

Mr. TOOMEY. We added the State and local component, we would probably be—in excess of 50 percent of our GDP would be in the hands of government and outside of the private sector.

Do you think that that is a formula—under that scenario, we could probably have robust economic growth?

Mr. WALKER. No.

Mr. TOOMEY. Thank you.

Mr. HASTINGS [presiding]. Mr. Price.

Mr. PRICE. Thank you, Mr. Chairman. Mr. Walker, welcome. I apologize for my late arrival and hope that I won't be redundant in the questions that I pose, but I would like to pick up on the question of privatization.

Assuming for the purposes of discussion the three alternative privatization schemes put forward by the President's Commission, can you give some fix on the problems that privatization might pose for the cash-flow of Social Security revenues, the dates at which the cash-flow reverses, and the dates at which we really do have a solvency problem?

The dates that we often hear discussed for the cash-flow reversal are 2017, when the receipts coming in no longer exceed the benefits going out, and then around 2040 or 2041, when the trust fund is depleted. What effect would the privatization schemes that the Commission put forward have on those dates, those dates when real trouble develops?

Mr. WALKER. We are in the process of conducting a comprehensive analysis of those proposals based upon the criteria that we recommended for Congress to consider, including coming up with those dates that you are talking about, those key dates, as well as whether or not they would achieve sustainable solvency over time. That is not going to be released for several more months, and so I would be happy to make that available to you when we have it, but we don't have it yet.*

Mr. PRICE. Well, there may be some differences among the three plans. The date that has been widely discussed is 2008. That is when the cash-flow problems would develop almost 10 years earlier under a privatization scheme that would basically skim off 2 percentage points from the payroll tax. Does that seem like a plausible assumption?

Mr. WALKER. It clearly would accelerate—and only two of the three plans would restore solvency over time. I mean, we know that based upon what we have seen right now, the dates will change. We know only two of the three plans would restore solvency over time, and we also know that two of the three plans also proposed changes in the benefit structure whereas the other plan is nothing more than really an add-on feature to the existing program.

Mr. PRICE. I think the goal of giving people incentives to save for their retirement is a widely shared goal. I don't think there is any question our country needs to do that and the Congress needs to do that. The question is should that come out of Social Security or should we leave the basic structure of Social Security intact and then provide additional incentives for that kind of saving?

Nobody should assume that Social Security in and of itself is an adequate retirement plan. It was never designed that way, although many people today are solely dependent on Social Security for retirement income. We clearly need to shore up those other two legs of the proverbial three-legged stool, that is private pension plans and also private savings.

*NOTE.—This report will not be available until 2003.

Do you have any observations on the financial implications of those two tracks above and beyond Social Security as opposed to skimming off 2 percentage points from the payroll tax, which would be a major change in Social Security?

Mr. WALKER. Let me give you some general remarks on that. First, you are correct in noting that Social Security is only one leg of the so-called three-legged stool. You are also correct in noting that we need to increase personal savings because our personal savings rate is abysmally low, especially as compared to other developed countries. I would respectfully suggest that we are headed to a future where there is going to be a four-legged stool for retirement income security. And, that fourth leg is earnings from part-time employment. If people don't end up doing more from the standpoint of trying to increase their personal savings and given the fact that we have been stuck at about a 50 percent coverage rate under the private pension system and I think unrealistic—I mean I think it is unrealistic to expect you are going to get much higher than that under a voluntary system, and I am not saying it shouldn't be voluntary. Why? Because of health care costs. The No. 1 benefit of choice on behalf of employees is health care. No. 2 is health care, No. 3 is health care. To the extent that employers have to end up spending more money on health care, they have less money for pensions and individuals have less money for savings.

So one of the things we have to do here is to recognize that this Social Security problem is a subset of a much bigger problem, and the biggest problem is probably Medicare, Medicaid and other health care issues.

Mr. PRICE. My time has expired. Thank you.

Mr. HASTINGS. Mr. Walker, thank you for being here and, Mr. Spratt, thank you for encouraging this hearing to happen. I just want to ask or make an observation and ask you to elaborate on a statement that you made earlier. But before I do that I have to say that I am a bit optimistic that something can be done because there was a time not too ago that I can recall where people were to even mention Social Security, that you could almost be assured that if you are in a political season there could be ads, leaflets or something saying that if an individual talked about reforming Social Security that that individual was throwing old people out on the streets. We have come a long, long way from that.

In fact, the 2000 election, this was part of the debate and there were potential solutions out there. So I tend to be optimistic. I am not foolish enough to think that this won't be a political issue in the future. But your observation with your experience in the past having town hall meetings where the American people understand I think is very encouraging. I, too, have had the experience that you have suggested when I have had my town hall meetings, and I will say in every one of my town hall meetings the issue of Social Security comes up. And my response has been, well, if we keep three principles in mind as we start this process of reforming, number one, those that are in the system or very near the system you don't change the benefits. My parents, for example, are in their late 80s. You simply can't change the rules. But for the boomers coming in you have to figure out a time period when you say you are not a boomer, but you give them flexibility.

That is the term I use with Social Security, and then we can have some resolution to this. But the maximum of flexibility has to be the younger generation. My children are in their early 30s and 20s and they know this is not a good deal over a period of time. They instinctively know that. I think you alluded to that observation because where we are heading unless we try to reform this system is we are going to have a political debate of pitting grandparent against grandchild, and the country simply ought not to get into that debate.

What I would like you to do is elaborate more because you said this is really an easy solution compared to the others when you responded to Mr. Price of the Medicare challenges that we have. Would you elaborate more on how you say this is easy and what we should take from that from your perspective in order to try to resolve this?

Mr. WALKER. Part of it is building on what you just said, and that is in my opinion, first, that Social Security is a defined benefit promise. It is not like health care where it is a defined level of coverage and where you really don't know what your costs are going to be. So you have a lot more of an ability to estimate what the current cost of this program is likely to be than you do for Medicare and some other health care programs. So that is a good start.

Secondly, if you assume that for people who are currently retired and nearing retirement, you are not going to change the promise. You are going to deliver on the promise. You are going to give them what they expect. Then you take away the fear factor that a lot of people have about Social Security reform. If you then say baby boomers like myself who are discounting Social Security—because they know there is a difference between promised benefits and funded benefits—if you look at my kids, you know Xers and Y generation who know it; who are discounting the program even more, that means you have an opportunity to reform the program with or without individual accounts, although younger people are more accustomed to individual accounts and that is something they can identify with, and you could potentially use the power of compounding over time to help deal with the problem. If you end up reforming the program so you make relatively more dramatic reforms and provide additional choices potentially for younger people, then you have a way to reform the program which provides for sustainable solvency over time and allows people to do what they need to do to adjust for any changes in the program that otherwise are going to occur. That, to me, is exceeding the expectations of all generations of Americans. On the other hand, Medicare is the opposite, but that is the subject for a different hearing.

Mr. HASTINGS. Would you say as evidence of your observation of how the boomers and the Gen X and Yers would respond to this is the evidence of more people that have investments, whether it is 401(k)s or IRAs or you name it, than what we have seen in the past, would that be evidence to support your position?

Mr. WALKER. Well, I think I try to base mine on facts, and if you just look at the facts from the standpoint of what percent are private employers have pension plans for their employees and what is the nature of those plans, on a relative basis there is a larger portion of defined contribution plans today than there used to be

20 and 30 years ago. In addition, there has been an increase in the percentage of those plans that have 401(k) type salary reduction features where the individuals have an opportunity to be able to select among several different investment choices for the future.

One example of that is the Federal Thrift Savings Plan. The Federal Thrift Savings Plan is the Federal Government's 401(k) plan. I wouldn't call that as being privatized per se. It does have individual accounts. It does have active investment, but the government obviously is running it and it has a government oversight board, although the assets are largely managed by private sector investment managers.

So those would be a few of my thoughts on the subject.

Mr. HASTINGS. Thank you. Mr. Moran.

Mr. MORAN. Thank you, Mr. Chairman. We have gotten so high tech and these new chairs now—has it been asked of the witnesses—I am sorry, we were in an appropriations markup earlier this morning—the relative cost of these proposals, because I would like to measure the effect of the tax cuts versus having used part of that tax cut for financing the general revenue requirements for a reasonable privatization proposal.

Mr. WALKER. Mr. Moran, we are in the process of analyzing the three proposals that came out of the President's Commission on a variety of bases, including some of the factors that you talk about, but that has not been completed and won't be completed for several months. But when it is I will be happy to make it available to you.

Mr. MORAN. I appreciate that, Mr. Walker. I appreciate everything you do and Dan and all of the witnesses we are going to be hearing from. The problem is that—and at least it is my concern about these proposals, all of which I think have some merit, some more than others—is that the option of doing this was precluded by the premature actions that we have taken by reducing Federal revenue flow by $2 trillion for the next 10 years and by 4 to $7 trillion for the subsequent 10 years. It seems to me we are going to need something in the range of a trillion dollars to pay for the creation of individual savings accounts to complement Social Security and eventually transition to those accounts, those complementary accounts. But to do so you can't reduce benefits, so you have to have an infusion of general revenue money. And by the rate cuts which take effect—start to take effect in a few years and hit us most strikingly just as the baby boom generation joins the Social Security rolls, that was the money that we had the option of putting into a privatization proposal that could have worked.

Politically, I don't think you can do any of these proposals without that infusion of general revenue money, and that is my problem with these proposals. By the actions that the Congress took over the last 2 years, I think we have precluded that option, particularly the actions that we have just taken the last couple of weeks to make permanent all of these rate cuts in the estate tax cuts.

So I would like to hear your response to that.

Mr. WALKER. Well, as you know, Mr. Moran, I am not going to get into the business of whether or not tax cuts are a good or bad idea.

Mr. MORAN. Well, in the context of the money we need to make this work.

Mr. WALKER. I can provide some information. If you look at where we are today versus where we were a year ago there are at least three contributing factors. One, the economy is weaker than it was projected to be. No. 2, revenues are lower in part due to the economy and in part due to tax changes and stock market declining. Finally, expenditures are greater partly in response to the tragic events of September 11. So if you look at the combined effect of all of those, what was projected which was going to be a significant excess of funds that would be available to fund a transition obligation, to pay down debt held by the public or some combination thereof, is largely gone.

But that still doesn't mean that we shouldn't be engaging in a fundamental debate about how this system should be reformed and whether or not from an economic standpoint, not from a budget scoring standpoint, but from an economic standpoint, using discounted present value analyses and all, what makes the most sense for how you end up reforming this program over time.

One of the real concerns that I have, Mr. Moran, is the way that our budget rules work is they are largely cash-flow based and they are based on a 10-year horizon. And so I think some of the things we need to be thinking about are, how can we bring additional metrics to bear. How can we bring longer range horizons to bear and how can we consider other options that could cause you to reach different solutions as to what the right thing to do is? You need another set of metrics to be able to consider the long range implications of different alternative actions rather than just the implications over the next 10 years.

Mr. MORAN. I don't want to be argumentative with you and I don't have any problems with you or your judgment nor with Mr. Crippen's, and I know we are going to hear from Mr. Steuerle and I am anxious to hear from him, representing the Urban Institute, and he was a member of the Commission. But I am going to ask the same question of everyone. But when you say even longer term, I don't know how far out you are going unless it is 2030 or something like that. But even at that with these lower revenue flows, given the reduction of the work force, not just in quantity, but in quality, a much higher proportion of our work force is non-native born, and nothing wrong with being nonnative born, but less likely to have the benefits of a quality education and as a result probably less capable of the value-added productivity that gives us the growth.

So I am afraid we have set in motion a situation where we are always going to be too strapped to achieve the kind of transition that I agree in the long run makes sense. I appreciate your response and I know that you don't want to get into the tax cut itself, but I do think that has the most relevance to the option the Congress has before it.

But I won't belabor the point and I thank you, Mr. Chairman.

Mr. HASTINGS. Thank you.

Mr. MORAN. Did Mr. Walker want to respond?

Mr. WALKER. I would commend to you, Mr. Moran, a couple of the charts that are in the testimony and that we showed, one of which is how the composition of spending has changed as well as what our simulation shows for the long range budget outlook, which underscores some of the concerns you have. But I would also come back and say that shows that we need to start dealing with some of these problems sooner than later because the longer we wait the tougher it is going to be and the more dramatic the changes are going to have to be.

And your comment about the workforce is very relevant. We have now moved into a knowledge-based economy. With a knowledge-based economy it is people and brain power that make the difference in connection with ours competitive advantage. So things like education and things like other skills and knowledge are going to be key to help fuel economic growth, enhance productivity and help us deal with these longer range problems.

Mr. MORAN. There was a scientific study that came out confirms that it was directed primarily at third world countries, but they said it applies equally to the United States, that investments in education and health care create economic growth in themselves to a greater extent than the reverse economic growth creating greater investments in education and health care. They find that the former is an even stronger impetus than the latter. And I am concerned that we are not going to have much money to invest in non-defense discretionary domestic programs.

But with that, thank you Mr. Walker, and thank you Mr. Chairman.

Mr. HASTINGS. Mr. Bentsen wanted to have a follow-up question. But I wanted to ask one very direct question in line of the question with the gentleman from Virginia, and that is this: Did the tax relief plan that we passed have a direct relationship—negative or positive—on the Social Security trust fund?

Mr. WALKER. On the Social Security trust fund itself, no, because the Social Security trust fund obviously just deals primarily with payroll tax revenue.

Mr. HASTINGS. Has the tax relief plan that we passed had a positive or negative effect on any benefits that anybody is receiving?

Mr. WALKER. Not at the present time, no.

Mr. HASTINGS. Thank you. Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman. Mr. Toomey in his line of questioning and your response talked about, if we go to privatization, individual account, prefunded program, although I don't know that prefunded is the right term, but we would—he alluded that in effect future retirees would be held harmless or perhaps even better off. You responded "well, of course you have transition costs that have to be accounted for and you have other issues that have to be accounted for." And Mr. Toomey—and I don't want to characterize his comments, particularly with him not being here, he said "fine, well, let us lay off the transition costs." Assume those are absorbed over a period of time. And if you make that assumption, I think you still said, and what I would like you to do is clarify for us, that there are other costs associated with this. One are the administrative costs that you talked about, but are you also stating that—and this is a perception that is out there that needs to be clarified, the more—that whatever Congress does with Social Security needs to be addressed because there is an argument being made that well, if you stick with the current defined benefit system through the trust fund, you are either going to have to raise payroll taxes, cut benefits, increase debt substantially or a combination thereof. But if you go to a privatized account you can make a one-for-one transfer and in fact you may well be better off.

Isn't it true you are just as likely to be worse off than better off? And we get into discussions about return on investment. And if you look at Treasury return versus an S&P index return, the S&P index is always better, which of course is not true, because for the last 2 years the S&P has been below the Treasury return. So my question is, what are the other—are you stating that you would have to go through a wholesale benefit plan change, which very likely could result in no longer a guaranteed minimum benefit or a benefit reduction of some sort?

Mr. WALKER. It obviously depends on the assumptions. Let me give you a specific example. As you know, the President's Commission's proposals that we are analyzing involve the creation of an individual account element under the current system. But in order to achieve sustainable solvency over time, they propose certain other changes to the benefit structure of the current defined benefit system. One of the proposals proposes to index benefits based upon cost of living rather than wages, which is a change. The other proposal talks about indexing benefits based upon longevity and makes certain other adjustments. This comes back to the point that I made before. When you are comparing Social Security reform proposals, I think to be fair you have to look at how does that reform proposal compare against not just promised benefits, but also funded benefits, because a lot of the promised benefits have not been funded. So what is going to happen when you have run out of money?

Mr. BENTSEN. With the chairman's indulgence, one, the change in the indexing would apply not to just Social Security benefits but benefits under the new privatized program?

Mr. WALKER. Defined benefit portion.

Mr. BENTSEN. Of the non-cut, 10 percent.

Mr. WALKER. Right.

Mr. BENTSEN. But there would be a reduction in using a new indexing method?

Mr. WALKER. In other words, they would receive less money under the defined benefit program than otherwise they would have as is currently promised. But not all of those promises are funded, but in addition to that, they would receive an individual account that would earn a rate of return.

Mr. BENTSEN. I think it is very important and I am glad you are making this—the other point is whether we should look at this in comparison to funded benefits, not in relation to promised benefits because funded benefits are far below—it is an unfunded liability, because a lot of times in the debate over this issue advocates of individual accounts and privatization make the assumption or the argument that we are replacing promised benefits with a new promise that will be fulfilled, and that is not necessarily accurate. I mean the magic of compounding interest is there, but it is not always there.

Mr. WALKER. I think to be fair and balanced about it, you have to look at the proposal against the criteria that we established and you have to consider both funded benefits as well as promised benefits. If you don't do that, you are effectively assuming either a tax increase or a general revenue infusion or a benefit cut that may or may not happen. Now under the current system under current law, you can only pay Social Security benefits to the extent that you have got assets in the trust fund. So therefore, if you waited until 2041 when all the bonds were gone, unless there was a change in the law that would allow for additional revenue infusion, general revenues or whatever else, you couldn't pay all the benefits.

Mr. BENTSEN. What you are saying is whether you keep the current system the way it is or you change it or you privatize it or whatever you do, these changes are coming. So anyone who is making the assumption that there is a magic fix out there that can give you what you have today and even more in the future does not exist except for a huge cost on the economy?

Mr. WALKER. I don't think many Americans are assuming that there aren't going to be changes that won't affect their future benefits. I am talking about baby boomers and generation Xers. I don't know very many boomers or generation Xers that don't think there is going to be a significant change to this program that will affect them. What is important is that people that are currently retired and are nearing retirement, I would argue it wouldn't be fair to change the deal for them because they don't have time to make adjustments. Obviously you get elected and I don't, so you have to make these decisions, but there are obviously political problems with changing promises for people who don't have time to make adjustments.

Mr. BENTSEN. Thank you. Thank you, Mr. Chairman.

Mr. HASTINGS. Mr. Walker, thank you very much for your testimony. If it wasn't already done, without objection, your full report will appear in the record. And I appreciate very much your candor and your work on this and we will dismiss you.

Mr. WALKER. Thank you very much.

Mr. HASTINGS. Next we will hear from three experts who have a great deal of knowledge of the annual report of the Social Security trustees. First will be Mr. Gene Steuerle, who is a Senior Fellow at the Urban Institute; Maya MacGuineas, Senior Fellow at the New America Foundation; and third and certainly not least, a former colleague of ours, Barbara Kennelly, who is currently the President of the National Committee to Preserve Social Security and Medicare.

I want to thank all of you for appearing here today, and why don't we just go—without objection, your full statements will appear in the record. Let me recognize first Mr. Steuerle.

STATEMENTS OF C. EUGENE STEUERLE, SENIOR FELLOW, THE URBAN INSTITUTE; MAYA C. MACGUINEAS, SENIOR FELLOW, NEW AMERICA FOUNDATION; AND THE HON. BARBARA B. KENNELLY, PRESIDENT, NATIONAL COMMITTEE TO PRESERVE SOCIAL SECURITY AND MEDICARE

STATEMENT OF C. EUGENE STEUERLE

Mr. STEUERLE. Thank you, Mr. Chairman and members of the committee. It is indeed a privilege to testify before you today on the trustees' report on Social Security. And let me mention also that I am an admirer of both of my colleagues, one of whom I used to testify before, so it is nice to testify with her. My testimony will assess several points which I will only summarize here.

The integrity of the process leading to the trustees' report is indeed a national asset. There is a question that arises as to why we make projections for 75 years, and the simple answer is we make projections for that long because past Congresses and Presidents have essentially built internal growth into these programs, and one simply has to account for what one is promising.

Now when it comes to Social Security, another question that arises is what are the key dates we want to emphasize. I would argue that the key dates are today and 2008, when the baby boomers start retiring. The main economic issue, as opposed to an accounting issue, is that programs for the elderly and near elderly are absorbing ever increasing portions of the national income and of the Federal budget, and when they absorb more of these resources, that burden has to be paid for.

The fundamental new long-term problem facing Social Security is a rapidly declining number of workers relative to beneficiaries, and it is a mistake to believe that this labor market problem is going to be easily solved by any capital market solution, whether we are talking about trust funds or individual accounts. Scheduled declines in the Nation's employment rate affect the affordability of Social Security not simply through Social Security taxes and benefits, which is what the trust funds measure, but also because the declining number of workers reduces income taxes, it reduces national output, and it reduces the private assets and income of the elderly as well.

Now there are several other items that are in my report that I am only going to very briefly summarize and I believe need to be highlighted. One is that Social Security continues to provide smaller and smaller shares of total benefits to those people who are most needy; that is, those people who are most elderly. The tables showing annual benefit levels need to take into account lifetime, not just annual benefits, which for Social Security and Medicare are now approaching for younger couples about $1 million in current dollars in terms of their value. The disability insurance program is often forgotten, and yet it is showing increasing prevalence of disability insurance receipts even while we have improved health care. And this program also has widely disparate payments according to geographic location. Social Security and Medicare already depend a good deal on general revenue financing.

My final additional point is the uncertainty of projections, which we often debate but pay little attention to, is something that is amenable to reform, for instance, by having years of benefit receipts simply indexed for how long people are living.

Having given that summary, let me go quickly through the main points. The public policy process behind the issuance of the trustees' report is one of the most balanced and non-partisan in this Nation. This achievement is made possible by the involvement of a variety of institutions and individuals. I was fortunate enough to participate in two technical panels and to Chair one of them.

Let me also mention the national asset that is involved in the integrity of the Office of the Actuary of the Social Security Administration. Now there are some who question why this process leads to projections for 75 years, given that many factors are hard to estimate for so long a period of time. The most obvious answer is that we project for so long because past Congresses and Presidents have made promises for so long, indeed for centuries into the future. As members of this Budget Committee, you are well aware that this can be contrasted with what we do on the discretionary side of the budget, where promises are generally made for 1 year only. Making promises that can only be met uncertainly in the far distant future requires projections that have a great deal of uncertainty.

Now from an economic perspective the key Social Security issue facing the Nation is what share of the Nation's economic resources are demanded by programs for the elderly. If that share goes up, then mathematically some other share must go down. Someone must pay. In terms of the elderly share it has been going up for some time and it is projected to continue for a considerable period of time. That is shown in figure 1 in my testimony. Of course the rate of increase for the elderly share begins to accelerate once the baby boomers begin to retire in 2008. Many of the dates in the trustees' report are mainly key points, markers, or signposts along that path.

Now built-in growth in particular programs act as a serious impediment to shifting resources to meet other new needs and priorities, whether that is education or reinvigoration of our foreign policy in defense of freedom. But I also want to note that it also deters us from fixing up the programs themselves, such as to additional aid those who have significant impairments in old age, to provide a drug benefit—which you have already discussed—or to remove some of the very strong discrimination in Social Security against single working heads of households. I discuss this discrimination in my testimony, but I will not go into the details here.

Even the budget debates in Congress this year prove how the pressure of these growing entitlement programs affect discretionary choices. These issues are not postponed until some year like 2017.

Now several times I have mentioned the labor market problem. Social Security faces a significant labor market problem that is hidden in trust fund accounting. Indeed, too much emphasis on the trust funds implies that there is some sort of capital market solution to this issue. Simply put, it is the scheduled decline in the number of workers to retirees that forms the core of the new dilemma facing Social Security. The typical worker now fully retires in late middle age, at least if we define old age and middle age by life expectancy. When he does so, our current Federal programs encourage him to become dependent upon other taxpayers because we have a pay-as-you-go system. His drop in output reduces the amount of transfers that is making to support government programs, but it is not just Social Security that he no longer finances, it is also other programs that he used to finance through Federal income and other State and local taxes. Meanwhile his own after-tax income falls, the rate of growth of GDP falls, and it is this multiple hit that affects the Social Security and Medicare affordability.

The United States was lucky in the post-World War II period. Despite substantial decreases in the male labor force participation as males acquired more and more years of retirement, females entered the labor force in increasing numbers. So if you look at the numbers on the employment rate that is a later graph in my testimony, you will see that the adult employment rate actually increased over this post-World War II period and is scheduled to decline quite rapidly. In fact, the rate of decline, assuming there is no adjustment in this labor market behavior, is so strong and so long that it is equivalent to an increase in the unemployment rate of just short of one-half of 1 percent of the labor force every year for almost 20 years running. And we have not had that type of labor market hit since the time of the Great Depression.

Now, as I mentioned, I have several other issues in my report but there is no time to discuss them here in depth. So I would just give one or two sentences on each one.

First, the program is now designed to provide continually higher and higher levels of benefits to those further and further from likely death. I don't believe that is necessarily a good way to have a program adjust over time.

Second, the expected value of lifetime benefits reveals much more about the program and much more about what needs to be reformed than annual benefits. As I mentioned, these lifetime benefits have climbed from about $290,000 for an average income couple in 1970 to close to $540,000 today and to nearly a million dollars for a couple retiring in 2030.

Third, prevalence rates of disability insurance coverage are actually expected to grow in a population that is growing more healthy over time. Meanwhile, there are vast geographical differences in the incidence and prevalence of DI receipts, and these issues need attention as well.

Fourth, Social Security and Medicare depend already to a significant extent on general revenues, and these need to be highlighted, I believe, better in the trustees' reports.

And finally, the trustees' reports do not make clear that the uncertainty of projections is itself an item that can be reformed through the process itself. The most obvious example is that these predictions are uncertain in part because we don't know how long people will live in the future. If we simply index the program for life expectancy, we can remove this source of uncertainty in the program. There are countries like Sweden that have also reduced the uncertainty in projections by adjusting their systems not simply for life expectancy but even for fertility rates and the amount of taxes that will be available in the future.

In summary, the process leading to the development of the trustees' reports is one of the finest in government. Here I have emphasized that the key economic dates coming out of the report are today and 2008, when the baby boomers begin to retire, basically any date when the programs for the elderly are growing and taking an increased share of national income out of the budget. I have also suggested that Social Security funding problems relate primarily to a remarkable drop in labor force participation, and the trust fund accounting tends to hide that problem.

Various aspects of the Social Security program could also be better clarified in the trustees' reports: How increasing shares of total benefits are being spent on those who are younger and with less relative needs; how growth in cost is better reflected in lifetime than annual benefits; how prevalence rates in disability insurance are growing but are masked by the way they are reported today; how much these programs are scheduled to be supported by general revenues over time; and finally, how the uncertainty of actuarial estimates can actually be reduced through policy design.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Steuerle follows:]

PREPARED STATEMENT OF C. EUGENE STEUERLE, SENIOR FELLOW, THE URBAN INSTITUTE, FORMER CHAIR, SOCIAL SECURITY TECHNICAL PANEL ON METHODS AND ASSUMPTIONS, PRESIDENT OF THE NATIONAL TAX ASSOCIATION

Mr. Chairman and members of the committee, it is privilege to testify before you today on the Trustees' Report on Social Security. Through the various Social Security and Medicare Trustees' Reports we gain a fuller understanding of the long-run costs and benefits reflected in the current design of these programs. My testimony will emphasize several basic points:

- The integrity of the process leading to the Trustees' Report—including the input of the highly respected Office of the Chief Actuary—is a national asset. The report must contain projections for 75 years or longer because past Congresses and Presidents have built eternal growth into these programs, and one should try to account for what one is promising.
- When it comes to Social Security, the key dates that one should emphasize are today and 2008, when the baby boomers start retiring. The main economic issue is that programs for the elderly and near-elderly continue to absorb increasing portions of the Nation's output and of the Federal budget, which necessarily means that other portions are already being reduced, soon at ever faster rates.
- The fundamental new long-term problem facing Social Security is a rapidly declining number of workers relative to beneficiaries, and it is a mistake to believe that this labor market problem can easily be solved by a capital market solution. Scheduled declines in the Nation's employment rate affect the affordability of Social Security not simply through increases in Social Security benefits and declines in Social Security taxes (a "trust fund" concept), but through declines in national output, income tax collections, and the private assets and income of the elderly, as well.

There are several additional items that I believe are worthy of highlighting within the Trustees' Reports:

- That Social Security continues to schedule smaller and smaller shares of benefits to those with greater needs, such as people near poverty and the truly old (say, those with less than 10 years of life expectancy);
- That tables showing annual benefit levels tend to disguise the promised growth in lifetime benefits under Social Security and Medicare, which are approaching $1 million for younger couples today;
- That the Disability Insurance program projections imply increasing prevalence of disability insurance receipt in most age groups in a program with widely disparate payments according to geographic location;
- That Social Security and Medicare already depend a good deal upon general revenue financing, largely through transfers of income taxes collected on Social Security benefits, through the financing of Part B, Medicare, and through future interest payments;
- That the uncertainty of projections is a consequence of program design, such as the failure simply to adjust years of benefit receipt by changes in life expectancy.

THE PROCESS

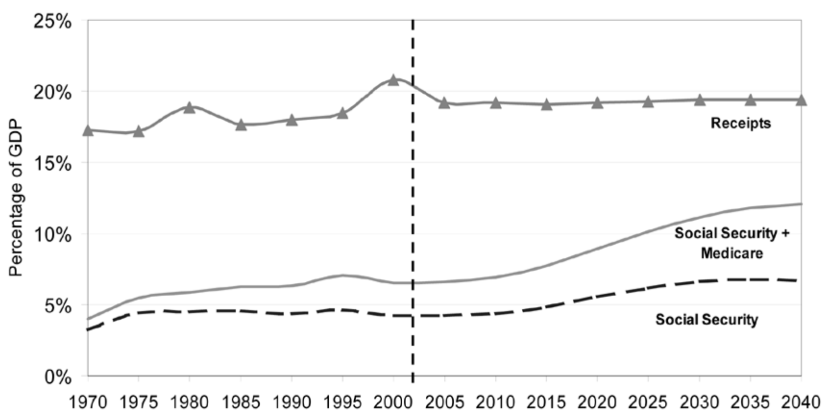
The public policy process behind the issuance of the Trustees' Report is one of the most balanced and nonpartisan in this Nation. The achievement is made possible by the involvement of a variety of individuals and institutions: trustees from the Cabinet, outside "public" trustees, and departmental staffs, such as the Office of Economic Policy within the Treasury Department. Special note should be made of the long-standing reputation for integrity of the Office of the Chief Actuary of the Social Security Administration (SSA). I have also been privileged to participate in two technical panels, one of which I Chaired. These panels are invited by SSA to provide an external review of its methods and assumptions—a process now called by the Social Security Advisory Board and in which SSA cooperates fully.

There are some who question why projections are made for 75 years when certain factors are very hard to predict for such a long period of time. The first answer is the most obvious one: we project for that long because past Congresses and Presidents have made promises for so long—indeed for centuries—into the future. This can be contrasted with the discretionary side of the budget, where promises are generally made for 1 year only. Making promises that can only meet uncertainly in the far distant future requires projections filled with uncertainty, not the other way around. Second, we do know a fair amount about the future since birth rates today affect such matters as the maximum number of non-foreign born 50-year-olds who will be alive in 50 years or 75-year olds alive in 75 years. Some of these demographic factors can be projected with a modest degree of certainty for well into the future.

KEY DATES

From an economic perspective, the key "Social Security" issue facing the Nation is what share of the Nation's economic resources are demanded by programs for the elderly. If that share goes up, then mathematically some other share or sets of shares must decline. It turns out that the elderly share has been going up for several decades and is projected to continue along that path even today (figure 1). When the elderly share of the budget was much smaller, it put less pressure on other parts of the budget. Now that the share is more than half of all non-interest domestic spending and growing, the pressure on other programs is rising. Of course, the rate of increase in the elderly share begins to accelerate once the baby boomers start retiring in 2008.

FIGURE 1. Federal Receipts Versus Social Security and Medicare Spending as Percentages of GDP, 1970-2040



Source: C. Eugene Steuerle and Adam Carasso, The Urban Institute, 2002. Based on data from the 2002 Trustees Reports and the "FY 2003 Budget Briefing Book," OMB, February 6, 2002. Various Tables.

Many of the dates in the Trustees' Reports are mainly signposts along this path and have no great meaning relative to the path itself. Some have meaning for individuals—such as 2043 when current law requires a reduction of more than one-quarter in annual Social Security benefit payments to all retirees then alive.

Built-in growth in particular programs acts as a serious impediment to shifting resources to new needs or priorities, whether it be education or reinvigoration of our foreign policy in defense of freedom. But it also largely deters a shifting of resources within elderly programs themselves, such as to help those with significant impairments because of old age, to provide a drug benefit, or to remove some of the clear discrimination in Social Security against single working heads of household—who may work, pay taxes, and raise children, and yet get lower benefits than other beneficiaries who do none of these activities. These are issues for today, not just decades into the future. Even the budget debates in Congress this year prove how the pressure of these automatically growing entitlement programs affects discretionary choices. The issues aren't postponed until some year like 2017.

THE LABOR MARKET PROBLEM

Social Security faces a significant labor market problem that is somewhat hidden in trust fund accounting. Indeed, too much emphasis on "trust funds" implies that that there is some sort of capital market solution. Simply put, it is the scheduled decline in the number of workers to retirees that forms the core of the new dilemma facing Social Security.

Now it is true that our mandated retirement system—unfortunately in my view—has always had only very modest funding or saving levels relative to potential liabilities. This has led to a worthy debate both about saving the temporary and relatively small surpluses now being generated on a cash flow (but not liability) basis or trying to put more money aside in individual accounts or in the trust funds. But, quite bluntly, the adoption of dozens of saving incentives over the past few decades has shown that the government of a free society has trouble mandating net increases in national saving rates, since private individuals may with one hand offset what the government does or requires them to do with their other hand.

The typical worker now fully retires in late middle age—at least if old age and middle age are defined by life expectancy. When he does so, our current Federal programs encourage him to become dependent upon other taxpayers. His drop in output reduces the amount of transfers he is making to support government through Social Security taxes, Federal income taxes, and other taxes, including those paid to State and local governments. In addition, his own after-tax income falls, thus reducing the amount of earnings he has to spend that year or to put aside to support himself more in later years (see example in figure 2). It is this multiple hit that so dramatically affects the affordability of Social Security and Medicare.

The United States was lucky in the post-World War II era. Despite substantial decreases in male labor force participation due to more and more years in retirement, females entered the labor force in such numbers that the employment rate among adults still increased. If no adjustments in retirement behavior are made, however, this Nation faces the reverse situation—a decline in the percentage of adults employed along with an increase in the percentage of those more dependent upon government. The potential scheduled decline in the employment rate is so strong and so long that it is equivalent to an increase in the unemployment rate of about 0.4 percentage points per year every year for over two decades running (see figure 3).

OTHER ISSUES

Serving the Less Needy. The Social Security Trustees report is mainly focused on whether assets and liabilities of the system come into balance. However, it does contain some data on projected benefit levels for workers and couples at different income levels. These data tend to show some aspects of the distribution of benefits but mask a number of potential problems and inequities in the program. In particular, the program as now designed continually provides higher and higher percentages of benefits to those further and further from likely death (see figure 4). The antipoverty effectiveness of each additional dollar spent is declining.

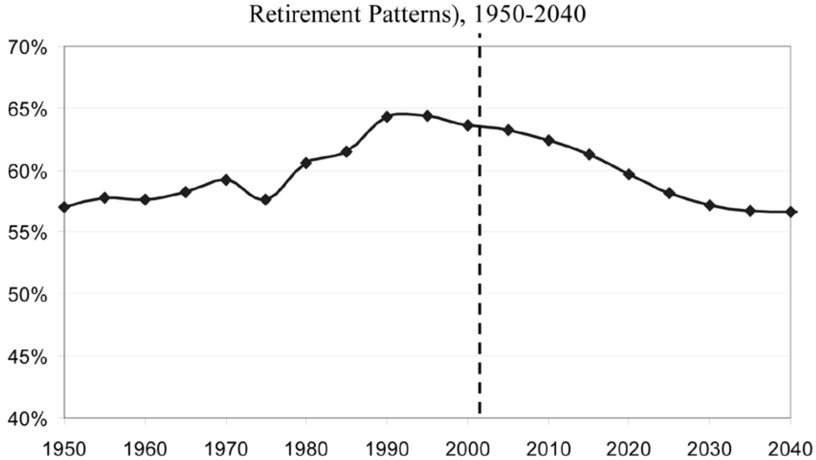
FIGURE 2. Example of Shift In Resources Upon Retirement

For a worker who earns $50,000...

Increases in Resources Transferred from Others	
Social Security Benefits	$18,500
Medicare Benefits	$5,000
Total 1	$23,500
Decrease in Resources Transferred to Others	
Social Security Taxes	-$7,700
Federal Income Taxes	-$6,600
Other Taxes (Including State and Local)	-$4,000
Total 2	-$18,300
Net Change in Transfers Received (Total 1 - Total 2)	**$41,800**
Addendum: Additional decline in retiree's after-tax earnings otherw ise available to meet current and future needs	$31,700

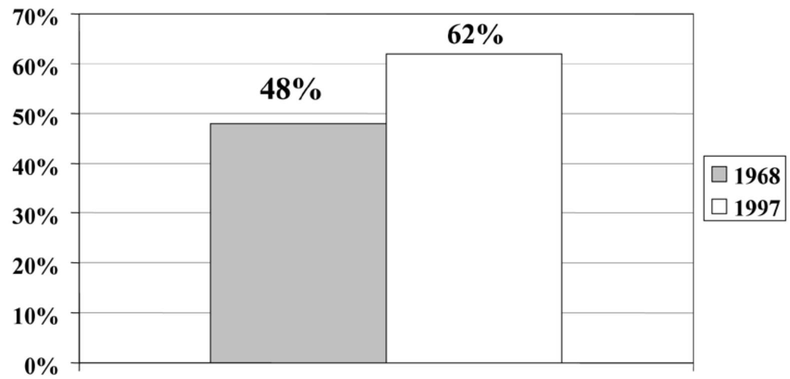
Source: C. Eugene Steuerle and Adam Carasso, The Urban Institute, 2002.

FIGURE 3. Adult Employment Rate (Absent Changes in Retirement Patterns), 1950-2040



Note: Projections show what happens if there is a change in age-specific employment rates as the population ages.
Source: C. Eugene Steuerle and Adam Carasso, The Urban Institute, 2002. Based on data from the U.S. Bureaus of Census and Labor Statistics.

FIGURE 4. Proportion of Social Security Benefits for Males Going to Those with More Than 10 Years of Life Expectancy



Source: C. Eugene Steuerle, The Urban Institute, 2000.

The system also strongly discriminates against divorced and unmarried individuals, many of whom work, pay taxes, and raise children by themselves, yet in the end get fewer benefits than individuals who do none of these. The discrimination is caused by the design of spousal and survivor benefits, which are available for no additional tax contributions but only to certain individuals (those who remain married to a worker for more than 10 years). Another problem caused by this same structural design of spousal and survivor benefits is that smaller levels of benefits are provided for two-earner couples than for one-earner couples with the same amounts of earnings and taxes paid into Social Security.

Lifetime benefits. The Trustees' Reports have traditionally shown the value of annual Social Security benefits over time. However, a large share of the growing costs of Social Security (as well as Medicare) has come from an expansion in the number of years of benefit support. The expected value of lifetime benefits conveys much more about the nature of Social Security promises being made than do annual benefits, and I—along with the technical panel I chaired—have recommended inclusion of these amounts in the Trustees' Reports. These lifetime benefits have climbed from about $290,000 for an average-income couple retiring in 1960 to about $650,000 today and are scheduled to grow to over $1 million for an average-income couple retiring in 2030 (figure 5).

An additional reason for showing these lifetime figures is that policy makers considering reform should focus considerable attention on what type of package of benefits they want to provide for the future, not just on individual pieces of a package. A benefit of $25,000 a year for 20 years, for instance, might provide more protection against poverty than a benefit package of $20,000 a year for 25 years, even if the lifetime cost is the same.

FIGURE 5. Social Security and Medicare Benefits for Average-Wage, Two-Earner Couple

—Real 2002 Dollars—

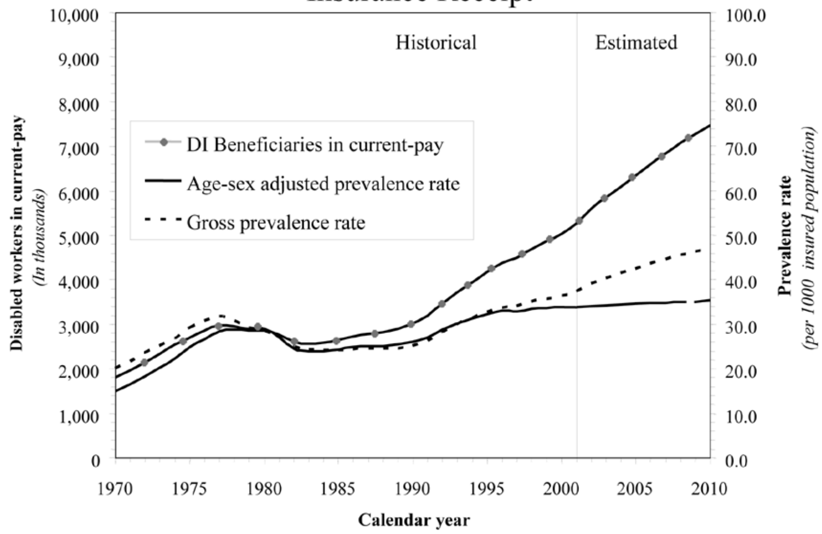
Year Cohort Turns 65	Soc. Security Annual Benefits	Soc. Security Lifetime Benefits	Medicare Lifetime Benefits	Total Lifetime Benefits
1970	$15,000	$210,000	$80,000	$290,000
2000	$20,000	$300,000	$350,000	$650,000
2030	$30,000	$460,000	$600,000	$1,060,000

Notes: Data are discounted to present value at the normal retirement age (NRA) using a 2 percent real interest rate. Table assumes survival to NRA. Projections based on intermediate assumptions of the 2001 OASDI and HI Trustees Reports.
Source: C. Eugene Steuerle and Adam Carasso, The Urban Institute, 2002.

Directions for Disability Insurance (DI). Almost all the recent public attention to OASDI is on the old age or OASI part of the program. However, the Trustees' Report on OASDI does cover DI, and it demonstrates, among other things, the incidence levels of disability insurance. Incidence levels reflect mainly the number of new recipients added per year to the system, and these projections tend to show a leveling out in the program for numbers of new beneficiaries. However, this can be misleading, as can be understood theoretically by thinking about moving from 99 percent to 100 percent of the population being covered. Upon hitting 100 percent, the incidence rate would show a decline to zero, but the program clearly would not be declining in cost or in percentage of the population covered. In other words, the incidence of new recipients must be added to the stock of people who remain in the program to figure out the prevalence of DI within the population. A steady incidence rate can mean a growing stock or prevalence rate.

The Social Security Administration calculates prevalence—the percentage of the population of different ages who receive DI (figure 6)—but it doesn't show these figures in the Trustees' Reports. These prevalence rates are projected to grow in most age groups even while health care improves. That age-adjusted prevalence rates of disability insurance go up over time even while there is no projected increase in age-adjusted prevalence of actual disability implies either that people today are being under-served or people tomorrow are being over-served. These difficulties within DI, as well as the wide geographical differences in incidence and prevalence of DI recently brought to light by the Social Security Advisory Board, imply that serious thinking needs to be applied to this program as well.

FIGURE 6. The Growing Prevalence of Disability Insurance Receipt



Source: Social Security Administration, Office of the Chief Actuary.

Dependence Upon All Revenue Sources. One issue often debated with Social Security and other elderly programs is whether they are adding to net saving or not. Although the answer is unclear, any potential savings of these programs are reduced substantially by the general revenue sources that they already tap. Other than interest payments, the largest among these are those that derive from the income taxation of Social Security benefits and the general revenue financing of the Supplementary Medical Insurance (SMI) program (figure 7).

Interest payments to Social Security also essentially come out of general revenues. The trust fund concept tends to hide the nature of all these general revenue obligations, although the reports do show the figures in separate tables on income and cost. The total effect should be shown together in a separate table, perhaps following along the lines of presentation of general revenue effects already in the HI and SMI report. After all, the more that comes out of general revenues, the less that such revenues are available for other societal needs and obligations.

One can graphically display the dependence of Social Security and Medicare on all tax sources. Figure 1 shows the demands of Social Security and Medicare over time. Of course, if all obligations in elderly programs were to be counted, we would also add in Medicaid (long-term care) and civil service and military retirement systems. These elderly programs as a whole are essentially scheduled to absorb almost all taxes, which remain relatively constant as a percentage of national income.

The Uncertainty of Projections. Commendably, SSA calculates projections not only for some average or intermediate set of circumstances but for various alternatives as well. Following upon the advice of several groups, including the Technical Panel which I chaired, SSA is investigating ways to improve upon its measures of the risk that the system will do worse or better than projected.

As currently presented, however, policy makers who focus almost entirely on intermediate projections ignore most of this analysis. What the Trustees' Reports do not make clear is that these risks and uncertainties about future imbalances are a consequence of program design. Therefore, they can largely be built out of the program. For instance, there is significant risk that people will live longer (or shorter) lives than projected and the system will be further out of (or in) balance than projected. But there is no reason this financial risk has to be in the program. If the program were "indexed" so that as people lived longer, they did not receive more years of benefits, then that additional "risk" of imbalance would be eliminated (figure 8).

FIGURE 7. Primary Sources of General Revenue Transfers Obligated to Social Security and Medicare in 2011

— In Billions of Nominal Dollars —

	OASDI	HI	SMI	Total
Income Taxation of Benefits	27.6	18.9	—	**46.5**
Government Contributions to SMI	—	—	145.2	**145.2**
Interest Payments*	204.6	42.0	3.3	**249.9**
TOTAL	232.2	60.9	148.5	**441.6**

* Other payments not shown in table also include transfers like the cost of noncontributory wage credits, the cost of benefits for some uninsured persons turning age 72 before 1968, and one-time transfers between the Treasury and the Trust Funds.
Source: C. Eugene Steuerle and Adam Carasso, The Urban Institute, 2002. Calculations based on tables in the 2002 Trustees Reports.

FIGURE 8. Sensitivity of OASDI Actuarial Balance To Changes in Mortality

Under Current Retirement Age Schedule
+0.66% to -0.80% of Taxable Payroll (+/- $40 Billion annually at 2002 income levels)

With Retirement Age Adjusted for Increases in Life Expectancy
+/- $0

Source: Based on Trustees' "high" and "low" cost assumptions in Table VI.D2 of the 2002 Trustees Report

Similarly, it is possible to adjust the system over time so that it pays out benefits according to the number of workers and taxpayers in the economy, which itself is affected by demographic and economic factors such as the fertility rate. Sweden recently enacted a sweeping reform that makes that type of adjustment so that the risk of long-term imbalance is significantly reduced, if not eliminated, for a whole variety of demographic and economic factors.

By the way, the current Social Security system already is essentially adjusted for changes in economic growth levels. For instance, when the rate of wage growth declines, then so does the rate of future benefits—which is why the sensitivity of the system to changes in economic assumptions is not great (see p. 151 of the 2002 OASDI Trustees' Report). On the flip side, when wages increase unexpectedly, so do future benefits. It turns out that if unexpected growth in wages in the last part of the 1990s hadn't been allowed to raise substantially the level of future benefits promised to such people as those of us sitting in this room today, then the long-run actuarial deficit of Social Security would have been cut almost in half. Thus, Social Security could have shared in the same budgetary gains that in the late 1990s created substantial slack in the non-entitlement part of the budget.

SUMMARY

The process leading to the development of the Trustees' Reports is one of the finest in government. That individuals like myself are able to make recommendations on improvements speaks well of the process itself. Here I have emphasized that the key economic dates coming out of the reports are today and 2008, when the baby boomers begin to retire—basically any dates when the programs for the elderly as a whole force reduced shares of national income to be spent on other items. I have also suggested that Social Security funding problems relate primarily to a remarkable scheduled drop in labor force participation, and trust fund accounting tends to hint a bit misleadingly that this problem can be met by a capital market solution.

Various aspects of Social Security programs could also be better clarified within the Trustees' Reports: how increasing shares of total benefits are being spent on those who are younger and have less relative needs, how growth in costs is better reflected in lifetime than annual benefits, how prevalence rates of Disability Insurance are growing but are masked by more constant "incidence" rates, how much these programs are scheduled to be supported by general revenues over time, and how the uncertainty of actuarial estimates can be reduced through policy design.

Mr. HASTINGS. Thank you, Mr. Steuerle.

Ms. MacGuineas.

STATEMENT OF MAYA C. MACGUINEAS

Ms. MACGUINEAS. Good morning. My name is Maya MacGuineas, and I am a Senior Fellow at the New America Foundation, a nonpartisan think tank in Washington, where I work on fiscal policy. Thank you for inviting me to testify. It is a privilege to appear before the committee today.

I have been asked to talk about the trustees' report in particular. The trustees' report is the single most important and influential source of information about the financial health of the Social Security programs. And given the attention the report receives, it is certainly worthwhile to discuss not only the implications of the findings, but whether there are ways to improve either the content or the presentation.

Furthermore, given the unbiased analysis, the trustees' report can and should provide a framework for comparing various reform proposals as we move forward with the necessary discussion about how best to reform Social Security.

In my comments today, I am going to discuss ways to provide more information about Social Security's effect on the unified budget, an analysis that extends beyond the actuarial window, a more detailed breakout of the sensitivity analysis of various economic and demographic assumptions and additional information with regard to benefits.

The main purpose of the annual report is to shed light on the overall financial health of Social Security, and the report is unquestionably the most comprehensive source of such unbiased information. In addition to evaluating short range trust fund adequacy, the analysis relies primarily on five measures, those being: trust fund exhaustion dates, income and cost rates, trust fund ratios, actuarial balance and Social Security as a percentage of GDP.

In my opinion, some of these are more useful than others. Income and cost rate, for instance, are reasonably straightforward. They show that benefits will exceed taxes as a percentage of payroll by 6.42 percent at the end of the 75-year period. Likewise, viewing Social Security as a percentage of GDP is extremely useful because it shows the level of resources the program will transfer across the entire economy, and this transfer will grow from 4.5 percent today to 7 percent at the end of the time period.

On the other hand, trust fund ratios, actuarial solvency and exhaustion dates seem to cause as much confusion as they do clarity. And while I do not take issue with the assumptions, these numbers are based on, or the methodological approaches used to derive them, I am concerned they may divert attention away from some of the more relevant issues. The trust fund ratio is expected to peak at 471 percent in 2015 and decline thereafter. The trust fund exhaustion date is 2041. The actuarial balance, which measures Social Security's financial status over a 75-year time period and expressed as difference between expected income and cost rates as a percentage of taxable payroll in present value, is in a deficit of 1.87 percent.

These numbers, however, do not convey the full burden to the budget or the economy of meeting future obligations, and their inclusion of the trust funds, while appropriate in an accounting sense, masks the extent of the larger problems. To illustrate this point, you merely need to look at the idea that has been floated occasionally to increase interest rates. Such a change would improve trust fund ratios, extend exhaustion dates and decreases the actuarial deficit. Increase the interest rate by a fraction and the problem would improve. Increase the interest rate by enough and it would appear on paper to disappear completely.

Would we have really made any meaningful improvements in the situation we are facing? Of course not. The overflowing trust funds would not do a thing to make the task of paying benefits any easier. The money to pay the higher interest cost would have to come from somewhere, but neither trust fund ratios, actuarial solvency or exhaustion dates reflect this.

So on to this table. One of the recommendations I do have would be to include a year-by-year cash-flow analysis in the report. This table shows it in 10 years, but I would suggest that it be done for every year. Also this table is in 2002 dollars. One would want to include both current and constant dollars. Such a cash-flow table would show the tax revenues that will flow to the Social Security as well as their sources and the annual costs. The surplus or deficit numbers I believe are particularly helpful because they illustrate how much Social Security contributes to the rest of the budget in the short run and how much it will drain from the rest of the budget in the future. It is also useful to view how these deficits translate into payroll tax increases or benefit reductions necessary to keep the program balanced.

In addition to showing the cash-flow numbers in dollars, I suggest showing them as a share of total government revenues. And by incorporating CBO assumptions one can see that spending on Social Security will rise from 23 percent of the budget today to 33 percent by 2025 and continues to rise thereafter. The cash-flow deficit will grow to 6 percent of total revenues over the time period and then double over the next 50 years.

While in my mind viewing these numbers as a share of the budget is the most helpful, you could also calculate it as a share of GDP or covered payroll or any other denominator deemed appropriate.

I also in my written testimony include how this would be helpful in improving the details that we receive on the sensitivity analysis. The actuaries include this in Appendix D, but they do so for only certain time periods. I think it would be helpful to look at this on an annual basis, particularly because reporting these results in a cash-flow framework would be very useful in conveying both the timing and magnitude of the effects and also, I think, clarifying some common misconceptions such as the notion that we can actually grow our way out of this problem without changes to the program or that the financing challenges result solely from a demographic bubble that we can weather with a few minor changes.

Furthermore, these cash-flow tables would be extremely helpful in comparing and contrasting specific policy recommendations. In evaluating the effect of increasing the payroll tax cap, for instance, one could see how much the top line, income from payroll tax, would increase. Similarly, this analysis would convey the extent to which shifting from wage indexing to price indexing would affect benefits over time.

And finally, proposals to create private accounts could also be evaluated in the same manner. If a private account plan specified revenue or benefit changes they would be reflected above the line. To the extent the plan depended on general revenue transfers, that would be reflected below the line and shown as a share of the budget. Over time the money available from the accounts would provide another source of income to be added to revenue on top of the line.

In addition to cash-flow tables, I think there are a few other changes that could be helpful, and I will speak to these briefly. One, the concept of actuarial solvency is somewhat confusing, both because it includes the trust funds as assets without showing where the money to pay for them will come from and, two, because it is calculated over a 75-year time period, which can produce a "cliff effect," where if you extend this evaluation period for a single year, new policy changes are necessary and the whole program again falls out of balance. Arguably, I believe it would be better to show actuarial solvency in perpetuity. Calculations reported in recent work by Kent Smetters and Kevin Brennan of the University of Pennsylvania have found that this would alter the calculation of the present value of the unfunded liabilities from $3.3 trillion to $6 trillion.

Additionally, the trustees could consider including tables that show both lifetime benefits and net transfers on a generational basis. Gene spoke about lifetime benefits and gave some examples of how dramatic it would be to see how these benefits grow with life expectancies. Net transfers, the present value of a generation's benefit less the taxes they pay, would be useful at looking at the program from the perspective of generational equity. We could, for instance, make Social Security appear to be healthy by all evaluation techniques, including cash-flow by simply passing a law that the payroll tax would be increased as necessary to cover promised benefits. The program would be actuarially solvent, cash-flow deficits would be zero, and the trust fund would never be depleted. But younger workers and future generations would suffer huge losses which would be captured in a net transfer evaluation while missed in other assessments.

To conclude, the integrity with which the trustees' report is constructed and its unbiased content play a crucial role in providing the information needed to evaluate the financial health of Social Security. My suggestions here should in no way be taken as a criticism of the work that is currently done but rather a suggestion of other information that might be useful for purposes of comparison and analysis.

[The prepared statement of Ms. MacGuineas follows:]

PREPARED STATEMENT OF MAYA C. MACGUINEAS, SENIOR FELLOW, NEW AMERICA FOUNDATION

Good morning, Mr. Chairman and members of the committee. My name is Maya MacGuineas and I am a Senior Fellow at the New America Foundation, a nonpartisan think tank here in Washington, where I work on fiscal policy. Thank you for inviting me to testify today. It is a privilege to appear before the committee.

The Social Security Trustees' Report is the single most important and influential source of information about the financial health of the Old-Age and Survivors Insurance and Disability Insurance programs. Given the attention the report receives, it is certainly worthwhile to discuss not only the implications of the findings but also whether there are ways to improve either the content or presentation. Furthermore, given its unbiased analysis, the Trustees' Report can and should provide a framework for comparing various proposals as we move forward with the discussion about how best to reform Social Security.

In my comments today, I am going to discuss ways to provide more information about Social Security's effects on the unified budget, an analysis that extends beyond the actuarial window, a more detailed breakout of the sensitivity analysis of various economic and demographic assumptions, and some additional information with regard to benefits.

The main purpose of the annual report is to shed light on the overall financial health of the Old-Age and Survivors Insurance and Disability Insurance programs. The Trustees' Report is unquestionably the most comprehensive source of such information. In addition to evaluating short-range trust fund adequacy, the analysis relies primarily on five tools including: 1. Trust fund exhaustion dates; 2. Income and cost rates; 3. Trust fund ratios; 4. Actuarial balance; and 5. Social Security costs as a percentage of GDP.

In my opinion, some of these are more useful than others. Income and cost rates for instance, are reasonably straightforward and quite useful. They show that while taxes as a percentage of payroll currently exceed benefits by 1.88 percent of covered payroll, this relationship will deteriorate over time and that by 2025, benefits will exceed non-interest income by 2.90 percent. By 2080, the number will have grown to 6.68 percent. Likewise, viewing the Social Security program as a percentage of GDP is an extremely useful tool because it shows the level of resources the program will transfer across the entire economy. The Trustees report that Social Security will transfer 7 percent of the economy at the end of their 75-year valuation period as opposed to 4.5 percent today. Both of these sets of numbers are relatively easy to understand.

On the other hand, trust fund ratios, actuarial solvency, and exhaustion dates seem to cause at least as much confusion as clarity. While I do not take issue with the assumptions these numbers are based on, or the methodological approaches used to derive them, I am concerned they may divert attention away from more relevant issues.

The trust fund ratio is expected to peak at 471 percent in 2015, and decline thereafter. The trust fund exhaustion date, 2041, is the year when the trust funds' assets will be depleted. Actuarial balance measures Social Security's financial status over a 75-year time period, expressed as the difference between the expected income and costs as a percentage of taxable payroll in present value terms. Currently, the actuarial deficit is 1.87 percent.

But these numbers do not convey the full burden to the budget or the economy of meeting future obligations. Their inclusion of the trust funds, while appropriate in an accounting sense, masks the extent of the larger problem. One must also consider the burden the trust funds represent in order to view the funding problem in its entirety. To illustrate this point, you merely need to look at the idea that has been floated occasionally to increase the rate of interest paid on the bonds in the trust funds. Such a change would improve trust fund ratios, extend the exhaustion date, and decrease the actuarial deficit. Increase the interest rate by a fraction, and things would look a bit better. Increase the rate by enough, and all problems would appear on paper to evaporate. Would this change make any meaningful improvements to the situation we are facing? Of course not. The overflowing trust funds would not do a thing to make the task of paying benefits any easier. The money to pay the higher interest costs would have to come from somewhere, but neither trust fund ratios, actuarial solvency, or exhaustion dates reflect this.

One recommendation I would make, then, is to include a year-by-year cash flow analysis. Almost all of the information necessary for such an analysis is contained in the Trustees' Report but could be combined in a way that illuminates some important issues (See Table 1).

A cash flow presentation would lay out the tax revenues that will flow to the program as well as their sources, and the annual costs. I show the numbers here in 2002 dollars; if this format were adopted, they would presumably be shown in both current and constant dollars. The surplus or deficit numbers are particularly helpful because they illustrate how much Social Security contributes to the rest of the budget in the short run and how much it will drain from it in the future. It is also useful to view how these deficits translate into payroll tax increases or benefit reductions necessary to keep the program balanced on an annual basis.

In additional to showing the cash flow numbers in dollars, I would suggest showing them as a share of total government revenue. Since the government's actual tax base is only a little more than half the value of GDP, showing cash flow numbers as a share of total government revenue gives a more realistic picture of the tax rates required to achieve balance. By incorporating Congressional Budget Office assumptions, one can see that spending on Social Security will rise from 23 percent of the budget today to 33 percent by 2025 and continues to rise thereafter. The cash flow deficit will grow to 6 percent as a share of total revenues over that time period and then double over the next fifty years. While in my mind viewing these numbers as a share of the budget is most helpful, they could also be calculated as a share of GDP, covered payroll, or any other denominator deemed appropriate.

This format would not only be helpful in viewing trends in a way that is relevant to Social Security and the unified budget, it could also serve as a useful benchmark for comparing the effects that changes in assumptions or policies would have on the program. For instance, the Trustees include in their report high, low and intermediary cost assumptions for their underlying economic and demographic assumptions. In Appendix D of the report they perform a sensitivity analysis by altering one variable at a time. The findings are reported in terms of summarized income and cost rates and actuarial balance over 25, 50, and 75-year periods. Reporting these results using the annual cash flow framework would be more useful in conveying the timing and magnitude of these effects. This analysis would be helpful in clarifying some misconceptions, such as the notion that we can grow our way out of the problem without other changes to the program, or that the financing challenges result solely from a demographic bubble that we can weather with a few minor changes.

Furthermore, cash flow tables would be extremely helpful when comparing and contrasting specific policy recommendations. In evaluating the effect of increasing the payroll tax cap, for instance, one could see by how much the top line—income from payroll tax—would increase. Similarly, this analysis would convey the extent to which shifting from wage indexing to price indexing would affect benefits over time. Proposals to create private accounts could be evaluated in the same manner. If a private account plan specified revenue or benefit changes, they would be reflected above the line and to the extent a plan depended on general revenue transfers, that would be reflected below the line and shown as a share of the budget. Over time, the money available from the accounts would provide another source of income to be added to tax revenue.

In addition to adding cash flow tables, there are a few other changes that would be helpful. First, actuarial solvency is somewhat confusing not only because it takes into account the Social Security trust funds while ignoring where those funds will come from, but also because it is evaluated over a 75-year period. This focuses attention on policy changes necessary to keep the program balanced over that period and that period only. This approach to reform suffers from the problem of the "cliff effect" where when the evaluation period is lengthened by a single year, the program promptly falls out of balance, thus making further changes necessary. It would arguably be better to evaluate the program's well being in perpetuity, shifting attention away from actuarial solvency over a limited time period to sustainability—a far more important objective. Calculations reported in recent work by Kent Smetters and Kevin Brennan show that the actuarial shortfall is twice as large when evaluated in perpetuity. In particular, the shortfall increases from around $3.3 trillion over the next 75 years to over $6 trillion when evaluated in perpetuity.

Finally, the Trustees should consider including tables that show both lifetime benefits and net transfers on a generational basis. Lifetime benefits rather than average annual benefits would be helpful in reflecting how costs rise along with increases in life expectancies.

Net transfers—the present value of a generation's benefits less the taxes they pay—would be useful in evaluating generational equity. Smetters and Brennan show that this measure gives a more objective view of liabilities than standard trust fund accounting.* We could, for instance, make Social Security appear to be healthy by all evaluation techniques including cash flow by simply passing a law that the payroll tax would be increased as necessary to cover promised benefits. The program would be actuarially solvent, cash flow deficits would be zero, and the trust fund would never dip below zero. But younger workers and future generations would suffer huge losses, which would be captured in a net transfer evaluation while missed in other assessments.

To conclude, the integrity with which the Trustees' Report is constructed and its unbiased content play a crucial role in providing the information needed to evaluate the financial health of Social Security. My suggestions here should in no way be taken as a criticism of the work that is currently done, but rather as suggestions about other information that might be useful for the purposes of analysis and comparison. I look forward to your questions, and once again, thank you for holding this hearing and inviting me to testify.

Mr. HASTINGS. Thank you very much for your testimony. And now it is my pleasure to recognize our former colleague Barbara Kennelly.

STATEMENT OF THE HON. BARBARA B. KENNELLY

Ms. KENNELLY. Thank you, and as a former member of this committee, I want to say to you that I know you are here, you are the unsung heroes of Capitol Hill.

For nearly 70 years, Social Security has guaranteed working families that they would have income in the event of old age, death of a family wage earner, or a disability. Social Security provides benefits in a manner that is both progressive and fair. No other wage replacement program, public or private, offers the protections of the Social Security old age, survivor and disability insurance program. In addition to retirement income, I want to emphasize this: that 38 percent of all Social Security benefits are paid to the disabled individuals, spouses of the disabled individuals or dependent children or survivors. I emphasize that because of the earlier conversation that this committee had with the previous witness. I don't know how many of these people, this 38 percent, had low expectations of having Social Security there for them, but I do know they probably had no expectation that they would have an early death or be disabled.

Today Social Security, as you know, continues to meet the challenge that it faces and it still has a surplus. And even, in fact, with the recent economic sluggishness, it continues to keep that surplus. We know from the Social Security trustees' report that we can probably expect full solvency until 2041. By 2017, Social Security will have accumulated over $5 trillion in Treasury bonds backed by the full faith and credit of the United States of America. And I think I can speak with certainty that the millions of members of the national committee certainly expect that these bonds can be

*NOTE.—See, Smetters, Kent and Kevin Brennan. "Analyzing Social Security Reform on a Cohort Basis: Toward Objective Accounting." University of Pennsylvania, Manuscript, Forthcoming.

collected upon because they understand that is the law. In 2017, the program will begin to call in its interest on these bonds.

Beginning in 2027, as we said often this morning, interest and tax revenues combined will be insufficient to meet demands and the program will need to redeem the bonds that we have been talking about. In the year 2041, if no changes are made, the trust fund will be exhausted and incoming revenues will meet only about 72 percent of current benefit obligations. Even at this point, Social Security isn't broken.

What is happening to Social Security is because of longevity and because of low birth rates. It has a cash shortfall, as has been mentioned. Benefit adjustments and/or new revenues equivalent to 1.86 percent of payroll or 0.72 percent of the gross national domestic product would be sufficient to cover the costs of currently promised benefits for the next 75 years.

Long range Social Security solvency is directly linked to the strength of the economy. But continued economic growth alone will not solve all Social Security's long-term problems. We must begin a real debate, beyond the debate of privatization, to make the adjustments that can be made today to ensure that the program will be intact for future generations, and the sooner we begin to do it the better.

And as I look at the Members of Congress here, I know that John Spratt and I are probably the only two here that were in the Congress in 1983. I know Mr. Spratt remembers, like I do, how we waited too long to address the problems of solvency in Social Security. You have to remember how hard it was to vote for what we had to vote for because in that 1983 vote that we had to vote for was for the first time to tax Social Security and citizens are still outraged by that. For the first time, we said if you go to college full time you can have Social Security, which had been up to that point the fact. And for the first time, we raised the age from 65 to 67. So if we don't start acting sooner rather than later, some very difficult decisions will have to be made as were made in 1983. And in the meantime we must move back toward efforts to pay down our mounting Federal debt not attributed to the trust funds.

During the last year of the previous administration, the Clinton administration, and during the first year of the Bush administration, our Nation was on track to completely repay public debt by 2012.

This would have taken a tremendous burden off future generations expected to repay obligations to Social Security trust funds, and also cover their needs as well.

Last year's 10-year $1.7 trillion tax cut, combined with the sagging economy and the subsequent need to respond to the horrific events of 9/11 completely erased a projected 10-year $5.7 trillion surplus.

Now, instead of paying down debt, we are increasing debt, and the related interest cost to our younger generations. Therefore, the National Committee, the committee that I am president of, opposes efforts to extend last year's tax cuts beyond 2010.

This extended tax cut is estimated by the Center on Budget and Policy Priorities to cost an additional $4 trillion to the general fund in the decade beginning in 2012. Ironically, that decade is at the same time that those baby boomers that we constantly refer to are coming down the pike. We must put our priorities in order.

All of the demands of future revenue should be laid aside until this task is accomplished. Diverting Social Security payroll taxes to private individual investment accounts also worsens Social Security's long-term projected shortfall and requires even more revenue to maintain current promises.

Funneling even 2 percentage points of payroll tax out of Social Security and into private accounts more than doubles the long-term shortfall, today's promised benefits.

Of the three plans put forward by the President's Commission to Strengthen Social Security, the Social Security actuary has found that if implemented today, during the period from 2003 to 2012, the plan boosts the unified deficit by $1.2 trillion, plan 2 by $1.5 trillion, and plan 3 by $1.3 trillion.

All three plans called for large reductions in the guaranteed benefit as great as 43 percent for those retiring in 2075. Even for those who do not opt for the voluntary account, this happens. Thus, the solution proposed by private accounts only digs the hole deeper, requiring even greater cuts in defined benefits and lawyer demands on future revenue sources.

While the goal of expanding national savings is laudable, private accounts in lieu of guaranteed benefits merely substitutes one form of retirement savings for another. We must improve incentives for younger workers to invest and save on top of, not in place of, currently promised Social Security benefits in order to expand both individual and national savings.

In closing, I say to the members of the Budget Committee, I agree with Chairman Nussle that this has been a marvelous, educational conversation. I hope you will keep having this conversation about future solvency, because there is no doubt in my mind that a developed country like the United States of America is going to have some sort of retirement-guaranteed government program for the old and the disabled.

But, I do hope that you can keep the debate separate, the conversation separate between these—you know, some of us disagree about how you go about ways, we often have honest disagreements. But the fact of the matter is, there are those who want to have a different system, who want to have a different structure. And there probably will be many other suggestions along the way. But I urge you to continue to think about solvency. Continue to think about the fact that there always will be elderly people. There always be poor and disabled people.

I thank you very much for allowing me to speak today.

[Prepared statement of Ms. Kennelly follows:]

PREPARED STATEMENT OF HON. BARBARA B. KENNELLY, PRESIDENT AND CEO, NATIONAL COMMITTEE TO PRESERVE SOCIAL SECURITY AND MEDICARE

Chairman Nussle, Ranking Member Spratt, members of the committee, I appreciate the opportunity to testify before the House Budget Committee on this issue of critical importance, the long-term budget outlook for Social Security. On behalf of the millions members and supporters of the National Committee to Preserve Social Security and Medicare, I am delighted to be back in the halls of Congress with my former colleagues. Thank you for holding this timely and important hearing.

Most Americans who have any recollection of the Great Depression will understand that Social Security was created to guard against what President Franklin

Roosevelt described as the "hazards and vicissitudes of life." For nearly 70 years Social Security has guaranteed working families would have some income in the event of old age, death of a family wage earner or disability.

Social Security provides benefits in a manner that is both progressive and fair. No other wage replacement program, public or private, offers the protections of the Social Security Old Age, Survivors and Disability Insurance program. In addition to retirement income, 38 percent of all Social Security benefits are paid to disabled individuals, spouses of retired and disabled workers, dependent children and survivors.

Today Social Security continues to meet this challenge, and despite recent economic sluggishness, the 2002 Social Security Trustees' Report shows an improved forecast for the system with full solvency extended another 3 years to 2041. By 2017, Social Security will have accumulated over $5 trillion in treasury bonds, backed by the full faith and credit of the United States Government.

In 2017, the program will begin to tap its interest on these bonds. Beginning in the year 2027, interest and tax revenues combined will be insufficient to meet benefit demands and the program will need to redeem bonds held by the trust funds. In the year 2041, if no changes are made, the trust funds will be exhausted and incoming revenues will meet only about 72 percent of current benefit obligations. Even at this point, Social Security will not be "broken." This shortfall, if addressed today is quite manageable. Benefit adjustments and/or new revenues equivalent to 1.86 percent of payroll or 0.72 percent of GDP would be sufficient to cover the cost of currently promised benefits for the next 75 years.

Long-range Social Security solvency is directly linked to the strength of the economy. The prosperity of the late 1990s dramatically improved the financial outlook of Social Security, with the date of insolvency improving 14 years (2027 to 2041) in the past 6 years, on the strength of the economy alone.

But continued economic growth alone will not solve all of Social Security's long-term problems. We must begin a real debate, beyond privatization, to make the adjustments that can be made today, to ensure that the program will be intact for future generations. The sooner we begin, the less difficult the decisions will be.

First, we must move back toward efforts to pay down our mounting Federal debt not attributed to the trust funds. During the last year of the previous administration, and the first year of this one, our nation was on track to completely repay public debt by 2012. This would have taken a tremendous burden off of future generations expected repay obligations to Social Security trust funds and cover their other needs as well.

Last year's 10-year, $1.7 trillion tax cut combined with a sagging economy, and the subsequent need to respond to the horrific events of 9/11 completely erased a projected 10-year $5.6 trillion surplus. Now instead of paying down debt, we are increasing debt and the related interest costs on our younger generations. As the power of compound interest also works in reverse, this huge change in our budget outlook will mean $1 trillion in new interest on the debt in just the next 10 years.

Therefore, as the National Committee opposed the tax cuts enacted last year, we must also oppose efforts to extend of those tax cuts beyond 2010. This tax package is estimated by the Center on Budget and Policy Priorities (CBPP) to cost of an additional $4 trillion to the general fund in the decade beginning in 2012, ironically the same decade in which we are concerned about the general fund's ability to cover the cost of interest owed to the Social Security trust funds. In fact, the CBPP analysis has found that the cost of the tax cuts, if extended 75 years, is more than twice as large as the long-term deficit in Social Security.

It is not that we oppose tax cuts in principle, but more a recognition that we must place our priorities in order. If meeting our future obligations to Social Security and Medicare without having to resort to painful benefit cuts is our number one priority, we strongly believe that all other demands on future revenues should be laid aside until that task is accomplished.

Today Social Security remains fully self-financed and is not responsible for even one penny of the Federal debt. While Social Security surpluses accumulated since 1983 were intended to pay down debt held by the public to reduce future burdens related to the retirement of the baby boom, with the brief exception of the past few years this has not happened. Our recent return to spending Social Security trust funds on general needs marks a return to using the regressive payroll tax to finance general revenue programs.

Although we have many fundamental problems with the concept of privatization, perhaps the biggest argument against transforming part of Social Security into a system of individual retirement accounts is the tremendous cost of the transition. Although individual accounts are often presented as a way to "save" Social Security, diverting money to individual accounts actually worsens Social Security's long-term projected shortfall and requires even more revenue to maintain current promises. Indeed, funneling 2 percentage points of payroll out of Social Security and into private accounts more than doubles the long-term shortfall for today's promised benefits.

Of the three plans put forward by the President's Commission to Strengthen Social Security, the Social Security Actuary has found that, if implemented today, during the period from 2003–2012 plan 1 boosts the unified deficit by $1.2 trillion, plan 2 by $1.5 trillion, and plan 3 by $1.3 trillion. All three plans call for large reductions in the guaranteed benefit as great as 43 percent for those retiring in 2075, even for those who do not opt for the voluntary account. Plans 2 and 3 have been deemed "solvent" only because they call upon the general fund for trillions of dollars in general revenue transfers with no specified source. Under plan 1, program expenses exceed tax revenues as early as 2009, plan 2 by 2006, and plan 3 in 2011. Thus the "solution" proposed by private accounts only digs the hole deeper, requiring even greater cuts in defined benefits and larger demands on future revenue sources.

Further, the level of individual risk privatization would introduce to Social Security is unacceptable. Although proponents of privatization like to talk about market averages, there is no such thing as an investor who earns the market average every year. Even if individual accounts could work well for upper-income earners and earners without dependents, they would not work as well for low-income workers, people of color, disabled workers or families.

While the goal of expanding national savings is laudable, private accounts in lieu of guaranteed benefits merely substitutes one form of retirement savings for another. We must improve incentives for younger workers to invest and save, on top of, not in place of currently promised Social Security benefits in order to expand both individual and national savings.

SOLVENCY ALTERNATIVES

I urge you to keep the security in Social Security and focus on changes that do not dismantle its principles of shared risk. A few of the solvency alternatives (in addition to debt retirement) we have suggested Congress consider include:

1. Supplementing payroll taxes with general revenue. An influx of dollars from general revenues would help meet the increased demands of an aging population. If the same level of general revenue commitment contained in various private account proposals now on the table were directly applied to solvency of the current program, solvency could be extended without exposing beneficiaries to benefit cuts or the vagaries of the market.
2. Increasing the maximum wage base. Currently, the first $80,400 of earned income is subject to payroll tax. The base could be increased so that 90 percent of covered earnings are taxable and indexed thereafter.
3. Expanding coverage. Newly hired state and local workers could be brought into the Social Security program. This would provide these workers with increased retirement security, greater freedom in changing jobs and added protection from the eroding effects of inflation on income.
4. Government investment of a portion of the trust fund reserves. Private investment of a portion of the reserves should be seriously considered and debated. We could invest some of the reserves in an indexed selection of stocks and allow Social Security to realize a higher return on its investments, without appreciably increasing individual risk.

Chairman Nussle, Congressman Spratt, thank you for holding this important hearing today. We look forward to working with you toward a truly bipartisan effort to reinforce Social Security as the bedrock safety net for all of America's working families. I would be pleased to answer any questions you may have.

Mr. HASTINGS [presiding]. Thank you. I want to thank all three of you for your testimony. Mr. Spratt, in line with the precedent that the chairman started, I will recognize you first.

Mr. SPRATT. Well, I first want to first say to Gene Steuerle and Maya MacGuineas, I didn't put the question to you about the trust fund report, and about the actuaries. But I think you have added something to the understanding of our process by devoting your attention to it, both in terms of process and particularly as to the integrity of it. When Tim Penny spoke to me about the possibility of being on the President's Commission, and asked me if I had any ideas about it, my only recommendation to him was that they should use the Social Security actuaries to do whatever analysis they did. We need to have one scorekeeper so that we can keep some commonality and comparability about the wealth of different proposals that have been put out there.

Gene Steuerle, you have actually proposed a Social Security solution that has a number of different elements. I want to give you an opportunity to explain your concept of it as you formulated it several years ago. I know it appears in different versions today. I think you were probably the grandfather, if not the father of the Stenholm proposal as it is called in the House. Would you explain how it would work?

Mr. STEUERLE. Mr. Spratt, I should say that I was on the National Commission on Retirement Policy which Mr. Stenholm was the co-Chair. I agreed to sign onto that proposal. But we had disagreements on the Commission as well. So I have never come out with an exact proposal.

But I can tell you the elements of a proposal that I would tend to believe are fair and "do-able." Quite honestly, I believe there is a lot of room for compromise. I believe that this huge debate, for instance, that we have over individual accounts is exaggerated on both sides, and that there are really compromises that are available.

The fundamental way that I start off looking at this program—that I use to address the system—is, to ask myself, "what are the principles under which a system can work?" There is a core set of public finance principles. We want equal treatment of equals—which is sort of an equal justice principle—and some progressivity. We want to take care of the poor, we want the system to be efficient, and we want it to be as simple as possible.

Mr. SPRATT. You also took the opportunity, as long as you were at it, of changing the benefit structure as I recall, to deal with some inequities in it today.

Mr. STEUERLE. My fear, again, on both sides of the aisle, is the fight over preserving the system or only adding individual accounts ignores that the core of the system, which would remain, which would still be very large, whether you have individual accounts or not. That core basically needs some substantial reform. Particularly the system has substantial discrimination, as I stated in my testimony, against single heads of household who can work, pay taxes, raise children—do all of these things we think we might be worth subsidizing—and get lower benefits than people who don't do any of those things.

That is among the types of reforms. Another concern is the system at the margin does a very poor job in attacking poverty. It has become more and more of a middle-aged retirement system, and it gives higher and higher levels of benefits to everyone overtime. There is substantial money in the system already with which we could solve poverty, whether we lower benefits over time or not. We already pay out enough that we can eliminate poverty among the elderly altogether, and we don't.

So there are a lot of issues in the core Social Security program—which is going to be this pay-as-you-go system—that I think we should deal with, have been put to the side in this constant debate over individual accounts or no individual accounts.

Having said that, I think the case can be made for individual accounts as put forward in the Stenholm-type proposal. I tend to favor them, partly because as this committee would understand, it gives honest budget accounting. When the money goes into the account, it is recognized as an outlay of government, and therefore deters the type of action where people make promises in the future but don't have to fund them. So you make a promise, it has to be funded.

Now, the related problem the individual account advocates have is that if we are going to put money in these accounts, we have got to fund them. Now they are asking us how we are going to do that. That is an honest scorekeeping aspect that I don't think you have in the current system.

I also tend to favor individual accounts a little bit because it is a back-door way of dealing with some of the fundamental problems in our private pension system, which is the issue just off the table. Well over half of the population gets almost nothing or gets very little in the way of private pension benefits. We need to figure out a way to increase saving among them. So I am willing to and actually quite supportive of efforts to try to put these type of accounts in the system. But it is for these particular reasons.

In sum, I want to have a core system that does a better job in removing poverty among the elderly. I want it to remove some of this discrimination against single heads of households, and along the way, as a budget accounting rule, I tend to be someone who supports a lower growth rate of benefits, primarily because I think these entitlement programs are deterring us from spending more on education and other more vital needs of our society.

I really do not believe that giving people like myself a 17th, 18th, 19th year in retirement is a priority of our society, and it should not be. The current system has that as a priority over what I believe to be more fundamental needs.

So for that reason, I am quite willing to support a lower rate of growth of benefits, primarily, in my view, through increasing the retirement age and aiming for some fixed number of years of retirement support—15, 16, something like that.

Mr. SPRATT. Let me ask each of you: The actuaries have indicated that if 14 percent of the trust funds were invested in equities, 46 percent of the estimated shortfall would be resolved. Is that a viable solution? Let me turn first to Barbara Kennelly. Does the National Committee regard this as, at least, something worthy of consideration?

Ms. KENNELLY. Yes. And what Gene has said is what I agree with. That the debate has just got off of hand, we are not addressing the real problems. And you can disagree. But the National Committee is not saying don't do anything. The National Committee is saying, and I agree with Mr. Walker, when you do something, it has to be a package of some things that you do, because we all know come 2041, we are short 27 percent of funds we need to pay for full Social Security.

Mr. SPRATT. That was the wisdom of 1983 which you referred to. Everybody had a stake in this solution.

Ms. KENNELLY. But I really felt very badly, because when the previous Commission on Social Security came out, one of the strong recommendations, they also had three suggestions, but one of the strong recommendations was investment by Social Security, or by the government, into the market. And unfortunately practically the next day, Mr. Greenspan came out and said, “oh, no, no, we can’t do that. I mean, how could this happen? And how could we have a board that could control this?” I felt like saying, “do you think you are the only honest man in Washington? You are the Federal Reserve.”

But, it just sunk like that. But in my list of things, there are many ways of filling in the gap. I definitely say that we should look at the market.

Mr. SPRATT. Gene.

Mr. STEUERLE. I am not arguing that one can’t put stocks and bonds in the trust funds. My concern is if the goal is to have more ownership of stocks and bonds, I think that that probably is better served on the private or the individual side. And my reason is that simply transferring money to buying stocks doesn’t increase saving in society. All that happens there is, in an accounting sense, the government now lays a greater claim upon national resources than it does, say, if it is investing in bonds. So it doesn’t necessarily improve the economy.

Mr. SPRATT. But it improves the rate of return in the trust fund’s assets.

Mr. STEUERLE. Because now the trust fund owning stocks mean people in the private sector own less stock, so the private sector gets a little lower income than goes to the trust fund. Again the question is whether we increase saving in the process. If we don’t increase saving, there is no net gain for the economy or for citizens, we just get a little more money on the trust fund side.

My concern—and I have to say it is an issue of political economy and not economics, I have to be quite honest about it—is that I think every nation that has tried to do this has run into problems of how you control what the government is going to buy or not buy. Admittedly, we do it when people put money in the Thrift Saving Plan. State and local governments do it. But you do get this problem: if you invest in the Standard and Poors 500 Index; what happens if you are company number 501 and the government is not investing in you? Or you are a small start-up company, you are not listed on the stock market, you don’t get this government investment. Or the whole question of social investment in tobacco companies.

These issues will not remain off the table. So I think politically it is probably easier if we can figure out ways to resolve them with individual accounts.

I don’t necessarily mean they have to be individual accounts along the lines of any one proposal or another. You could have individual accounts along the lines of President Clinton’s proposal if you want. But I just think if you are going to control where the stock is going to be invested, it is better to leave that choice to the individuals.

Mr. SPRATT. Ms. MacGuineas.

Ms. MACGUINEAS. I will be brief because Gene made the same points I would make. But I think the suggestion suffers from the popular misconception that we can get out of this problem by merely increasing rates of return. That is not what it is about. It is not about switching investments in one place for a different kind in another place. That is purely an asset shuffle. You are going to have the government owning more stock and, therefore the public owning more of the government bonds that were there before, and the returns on the assets are going to converge as necessary.

So you can't sort of switch with one hand your investments to your other hand and resolve the problem. If the discussion is about how best to prefund the system through private accounts or centralized trust funds, that is a good discussion to have. But we have to be talking about what consumption we are going to reduce in order to improve saving. And that comes from policy changes, either in taxes or benefits, it doesn't come from shifting.

Then finally, I do tend to agree with the Greenspan concerns of the political economy issues at hand. This is trillions of dollars that would be invested centrally by the government. And I am quite concerned that it would, over time, compromise the ability of the capital markets to allocate capital as efficiently as possible.

Mr. SPRATT. Both of you have indirectly undercut an argument that Martin Feldstein makes for one of his proposals. Namely, he assumes that the transfer of Social Security assets into the equity markets would have an effect on the economy, and that the Treasury and the next stage would be able to reap higher returns from corporate returns as a result of this, cost of capital would go down, companies would become more productive and efficient, they would become more profitable, and consequently, the Treasury would reap some of the return for this in income taxes.

I take it from what you said you don't think there will be an economic effect like that by simply investing in the market, using these assets to invest in the market?

Mr. STEUERLE. In Dr. Feldstein's case, he is actually making an assumption that there is also some shift out of consumption. Under some analyses he has performed, he assumes that government spends less on other consumption items. That is really the source of the additional savings that lead to this investment. Again, if it can be done the right way, this attempt to lower consumption is in both the attempt to put Social Security off-budget on the one side and the attempt to put money in individual accounts on the other.

The common goal is to successfully change the target, the deficit target of Congress, which both sides of the aisle attempted to do last year by defining a non-Social Security budget surplus as one way of getting there. Or individual accounts might do that by having the money counted, as I said, immediately as an outflow of government.

If you can change the accounting so Congress has a tighter target, than the savings come from the fact that Congress basically, somewhere in this system—it might be in the non-Social Security part of the system—is spending less or taxing more. But it is getting the government in more balance. And that is really the source of saving that Dr. Feldstein relies upon.

If that occurs, it probably would improve the economy. However, my concern is not that we don't work on these savings issues. I think they are vital. But I have been in this town now 30 years, essentially working on saving proposals from one administration to the next; one Congress to next. Quite honestly, we cannot totally control net national savings. We can control government saving. We can mandate individuals do certain things with one hand, but we can't control what they do on the other because we are in a democratic society.

We can only do things to try to improve net savings.

Mr. SPRATT. Let me ask each of you, do you then support, as a first step, the idea of using the surplus to buy up outstanding government bonds, pay down debt held by the public and add to national savings?

Ms. KENNELLY. We did that for 2 years. What resulted is we were going to be able to pay off the debt by 2012. We saw that in action when we did have the surplus, because by law, when you have certain amounts of money, you can only use it to pay down the debt. But I would like to go back to your previous question for a minute and say one thing—we always talk about the picture in Washington, because we are dealing with the big picture. But if you look at the individual out in the country, nothing was mentioned when you asked that question about investing in the market about risk. And why one of the reasons that we are for looking at the investing in—the government investing in the market is the risk would be shared.

In the individual accounts, the risk is there for each individual, and if they retire at a time when the market is down, they have to pay for that by themselves and they lose their dollars. And there really is no insurance for them in the individual accounts.

Ms. MACGUINEAS. From an economic perspective, I think the approach of paying down the debt was a very solid, well thought-out approach. I did, at the time we were talking about it, spend a little time worrying about what was going to happen when all of the debt was bought up, but I am not so worried in the short term any more.

Mr. SPRATT. As Larry Summers said, that was like his worrying about going on a diet and losing too much weight.

Ms. MACGUINEAS. So yes, paying down is debt is the way to increase public saving. That has the same kind of effects as creating private accounts that create new saving in the private sector. But, I think the question is, what mechanism can create the budgetary discipline necessary to accomplish this in a sustainable way. My concern is we have had those trust funds for decades. We have seen that the presence of the Social Security surplus not only leads to the use of that surplus, it may, some academic research has shown, lead to more than—spending more than just in the Social Security surplus, because of the psychological effects of feeling like there is more money at hand.

I believe one of the fundamental advantages of private accounts is that it would take that money out of the budget and wall it off, if you will, in a way that I think makes sustained savings far more likely.

Mr. SPRATT. Thank you; all three. I appreciate your participation. Let me give others a chance to ask questions.

Mr. HASTINGS. I want to thank you all for being here. Let me ask a question of all three of you, if any of you have hopefully the answer to this. All of you alluded to the 75-year projections that were in this trustees' report. Social Security is nearly 70 years old now.

Has there been a study that you are aware of going back to the—when Social Security started of what these projections would be, recognizing, of course, that there were changes in the benefits over a period of time, and obviously a new study? I mean we remind ourselves we were in the Second World War when Social Security was founded.

So are you aware of any in-depth study as to what the projections were at the time of Social Security, on what it would be, say, 75 years, I don't know if they looked at 75 years in the 1930s or not. Are you aware of any of those studies?

Ms. KENNELLY. I would go back to the previous actuary reports. Because that is exactly why we have them, so that we can do those projections. But, as you say, so much has changed. When Social Security began the lifespan was 67, say, so you were only going to be paying 2 years. The whole demographic picture continues to evolve. But I think your actuarial reports are about as good as they get.

Mr. HASTINGS. Mr. Steuerle.

Mr. STEUERLE. Early on, the system was not indexed as it is today. The early system had a tax rate of 2 or 3 percentage points of payroll. There were projections that that would be insufficient if there wasn't some funding because the costs were going to rise at that time to 6 percent of payroll.

But after that point in time, there were substantial benefit increases that were enacted by a number of Congresses.

Mr. HASTINGS. Starting when, roughly?

Mr. STEUERLE. Probably the biggest increase came early in the Eisenhower administration. Now mind you, by the way, that Social Security's long-run costs were quite moderate when it was established. Then we had these increases in the Eisenhower administration, partly to make up for the fact that inflation through World War II had substantially reduced benefits. We didn't have automatic growth. Congress was able to act a bit more in a discretionary manner as in other parts of the budget.

Then we started enacting a number of increases in Social Security. In particular, as the defense budget kept shrinking, we had more and more money that we shifted off to domestic policy and that we could afford in the broader budget context.

In the late 1970s and early 1980s, we decided to try to move more to a system of indexing because we weren't quite happy with the way that we were having these constant enactments by Congress. So there was an attempt to create an automatic mechanism that would be cleaner, in some sense, and create a more equitable benefit.

In some sense it did. But the consequence was, we built all of this growth into the system.

Mr. HASTINGS. How accurate were the projections at these times, because we are looking at a 75-year projection? We will be making decisions on this as this debate goes forward based on those 75-year projections. What I am asking is how accurate were those projections when they were made at these given times?

Mr. STEUERLE. I would have to check with the Social Security Administration. My guess is they were probably fairly accurate, that most of the changes came about because of enactments by Congress.

Mr. HASTINGS. OK.

Ms. MACGUINEAS. I would have thought if there were a study, Gene would have done it.

Mr. HASTINGS. Let me ask another question to all three of you. Mr. Walker, when he was up here, made, I thought, a rather profound observation, when he said the expectations of the boomers to some extent and the expectations of the Gen-Y and the Gen-Xs to a larger extent are of the idea that their expectations of receiving full benefits from Social Security will not be there, and therefore, the potential fix that we have may be easier than what would be otherwise thought.

I hope I characterized that correctly. I would like your observations on that.

Ms. MACGUINEAS. Two points on that. I believe that that is probably the case. Actually, though, the literature I have seen is slightly different. People's expectations tend to be wrong about what they are going to receive, but they are wrong on both sides. Many people think it is more. Many people are surprised to learn how low the benefits are.

Many people think they are going to do much worse because they think that Social Security is not going to be there for them. So I have seen huge discrepancies in our expectations as compared to reality, but on both sides and also along the income spectrum.

Mr. HASTINGS. In that train of thought, then, are those that as you described that are higher expectations, lower expectations, what percentage of the people feel that way?

Ms. MACGUINEAS. I would have to check the specific numbers. I was just struck with how few people actually knew what they should expect from Social Security.

Mr. HASTINGS. I interrupted you.

Ms. MACGUINEAS. But to your bigger point, I am not sure if the fairest way to figure out how to spread the costs of reforming the system is to say let's do it based on what people's expectations are, because you may have an expectation for something that is going to be very negative because of information they have received. I am not sure that giving somebody something that is just a tiny bit better than very negative still means that we have done the best in for making the system as fair as possible.

I think one of the crucial things in keeping support for Social Security is making people feel like they are treated fairly. And in this difficult situation which we are currently in, I think that is going to involve spreading the whole cost of reform between individuals and in particular, generations.

Mr. HASTINGS. OK.

Ms. KENNELLY. Congressman, I agree, probably that many, many young people don't think Social Security is going to be there when they get older. And one of the reasons for that is that millions of dollars have been spent on this message to say Social Security won't be there. And I have to take that a step further, these advocates of the individual account are very much active, such as CATO in saying that very thing. But I would disagree with Mr. Walker that the baby boomers don't expect Social Security to be there. I think that they do. I think the lower the income of the individual, the more they expect that it will be there for them.

We are a country that has always had a Social Security system as every other developed country has had a Social Security system. I can't imagine this great Nation not having it. I know that when I was younger, I certainly never thought about retirement.

But we have so much talk, every magazine, all of the magazines on the stand about retirement policy, about investing. This morning the talk about the 401(k) plans. But there are so many people out there. The average median income—the average income for families in this country is $30,000. People with a couple of kids can't afford some of these things that some of us take for granted, like 401(k) plans.

So I think there is certain—a great deal of expectation, middle age and lower and middle income people, that it will be there.

Mr. STEUERLE. Three very quick anecdotes on expectations. The first is that the retirement age is increasing right now. You can hardly even pick up a comment, at least on increases in what is called the normal retirement age, in the paper. Few notice this is happening. That is because it has been taken out of a political context. People's expectations haven't been dashed, at least as far as I can tell there.

Second is that the system between 1995 and 2000 basically increased its future benefits for people by about 10 percent above what they were expecting in 1995. Nobody is even aware of this, as best I can tell, essentially because the system is wage indexed. When the economy grew about 10-percent more over those 5 or 6 years than we expected, it did all sorts of wonders for the non-Social Security part of the budget.

In Social Security, it basically raised everybody's benefit, your benefits, my benefit, by 10-percent beyond what we would have projected, even in our Social Security statement in 1995. Almost no one noticed that 10 percent bonus, which was probably the largest single decision made by Congress between 1995 and 2000 in terms of spending, and it came about automatically.

So in terms of expectations, I think that people do not have great expectations.

And the final example is that few people are aware that the system is automatically increasing benefits. In the debate over reform, few people note that we are basically talking about cutting the rate of growth of benefits. We are not cutting real benefits.

Mr. HASTINGS. Maybe that leads into what you talked about, Mr. Steuerle, about the annual benefits and lifetime benefits and the differentiation between that and the focal point of our debate. Would you elaborate on that difference between the annual benefits and lifetime benefits?

Mr. STEUERLE. Well, there were two aspects to my note. The first was that I was arguing simply that we should count lifetime benefits because that is the basic insurance policy that people are getting. And people should understand what their lifetime benefits are and not just look at an annual benefit, just as if we were putting money in our 401(k) plan. We want to know what is in the account.

The advantage of that is that I think it gives a more honest accounting of how Social Security is adjusting over time. It is not just adjusting annual benefits, it is adjusting for the fact that we generally don't increase—the law actually has a temporary increase—but the normal retirement age for longevity. And the biggest growth in the system has come from providing people with more and more years in retirement.

The second reason for calculating lifetime benefits is geared toward helping those people engaged in reform actions. I would much prefer these reform commissions aim for a target of what they think lifetime benefits should offer first, and then back up to what they think the system should be in the way of annual benefits rather than first looking at annual benefits.

That way, they can decide whether we want to get more money in late old age, when people have more severe problems of long-term care. They may have lower incomes then, so do we want to boost that benefit up relative to giving more money early in their retirement.

If you start with a lifetime package of benefits, you naturally think, just as you and I would, in drawing down our 401(k) plan. When you think only in terms of annual benefits, you didn't think along those lines. You design a package, as I said earlier, where and more and more of the resources go to the younger among the elderly—really people in late middle age who really need the resources much less.

Mr. HASTINGS. Thank you very much.

Mr. Moran.

Mr. MORAN. Thank you, Mr. Chairman. In that regard, Mr. Steuerle, you have a chart here showing that in the year 2000 a two-earner couple would get total lifetime benefits of approximately two-thirds of $1 million, apparently $650,000.

Do you have a comparable figure for how much they would have paid into the system at that point?

Mr. STEUERLE. In present value, for an average income couple in Social Security, this depends on your discount rate. But if you take a 2 percent discount rate—assume a 2 percent rate on return—I think they would almost have paid in most of the Social Security money.

In terms of Medicare, they would fall far short because the Medicare tax is very low in its rate of growth, while the projected rate of growth of health costs is very high. That is what is driving the Social Security number—excuse me, I mean driving the Medicare number.

Mr. MORAN. So they would have paid in about $300,000 in terms of the Social Security, FICA taxes, but any estimate of how much less than the $350,000 they would have paid in versus benefits that they received?

Mr. STEUERLE. They probably wouldn't even have paid in a third of it. But it can get a little complex there. Some of it is coming from what they may have paid in income tax to support the Medicare Part B system that was very low cost in the past. I can send you the numbers.

Mr. MORAN. That might be useful for us to understand. Now, part of the reason that we have—at least equal to benefits, at least equal to what is being paid in, and let me ask one other question here. As we get to much later out, 2030 is the figure that you show, are we paying in a higher percentage or a lower percentage of what we are getting out of the system? I know people are living longer, and so you would assume that you are going to get a lot more back in terms of your annuity benefit that you paid in later years. Is that the case?

Mr. STEUERLE. As you move to the future, people pay at a much higher percentage. They pay in more than they get back, even at these moderate discount rates. That is because the tax rate has continually gone up over time. Social Security created very, very large windfalls to the early generations—in particular to the rich of earlier generations, interestingly enough.

But future generations don't get that windfall, because they come to the point where they have to pay more for the system now. This analysis is made very complex by the fact the system is still out of balance. So you have to ask, what is the actual tax rate that would apply in the future if you maintain this benefit? It is higher than what is in the current law.

Mr. MORAN. What I am getting at is, if you did do it on an annuity basis, what in terms of FICA taxes will it take to treat it as though it were an annuity, a tax-free annuity?

You are saying that you are actually—it is less of an annuity, less of a good investment, from the perspective of it being a private annuity, the longer you go out, because wages are going up, you are paying a higher percentage despite the income cap, and so your return is less you are telling us, except for Medicare.

Mr. STEUERLE. It is also very complex. Because ultimately Social Security is designed so that the rate of return you get in the future is determined by the birth rate. If birth rates fall, your rate of return falls. So as birth rates have fallen, our rate of return is lower than previous generations and on into the future. So that is one of the consequences of Social Security's pay-as-you-go design. Because it is not funded, it is dependent on this money coming into the system.

Mr. MORAN. Someone was saying, I remember people were talking about it for a while, that you recover after the first 2½ years of being on retirement virtually of what you have paid into the system. Now, the numbers you are telling us—that is not consistent with that assumption at all.

Mr. STEUERLE. I don't think people are counting the fact that you as an employee really pay the employer tax. The employer doesn't pay it, the employee pays it as a reduced wage. Also, I don't think they are using interest rates. If you paid money 30 years ago, it would be compounded at some rate.

Mr. MORAN. So they are just looking at what the employee has paid and not the comparable employer?

Mr. STEUERLE. I am guessing. I am almost certain that they don't compound the taxes, they don't use interest. The question whether they use employer and employee taxes, I am not certain.

Mr. MORAN. So that is a bogus statement that you are getting back from the system, in just a few years of retirement, what you paid in, the rest is coming out of subsequent generations' incomes. That is just not the case.

Mr. STEUERLE. I think for new retirees, I think the case is weak. For older retirees, it is more true——

Mr. MORAN. So it would been true for earlier retirees. That is helpful to know. I am very sympathetic with your concern about the efficiency and equity aspect of Social Security that a lot of it is going to people who don't need it. And vis-a-vis our other national priorities, it is a real question whether we should and can be continuing such a system from that perspective. But, just as the one of the principal reasons we, or at least I consistently vote against vouchers or anything else that is going to undermine the public participation in our public—widespread participation in public school system, is if you didn't have widespread benefit, then the people who need a quality school system the most are going to be less likely to be able to get that revenue flow that they need from general taxes, similar case applies to Social Security.

If you don't have widespread benefits you are going to have less political support for maintaining a system that, in fact, in the long run, really does benefit lower income people to a greater extent than it does upper. There is some income transfer taking place within the system. You probably wouldn't be able to sustain that politically if you don't have widespread benefits at the level that we are paying out. Is that not an accurate statement?

Mr. STEUERLE. I think the concept of social insurance—and I agree with it—is that you need to have a mandated system. But there is a case with individual accounts where it is also part of a mandated system. So the question is, what balance would you achieve? I agree with you, you can't allow people to opt out, because the people who opt out would be the people who are paying for some of this redistribution. So people can't opt out entirely from the system.

However, you could set up or design individual account Social Security that also deals with some of the issues you talk about, both with respect to progressivity and mandated participation.

Mr. MORAN. But my concern is any kind of testing system is going to undermine the kind of political support that you have today for the benefit distribution that you have. Let me ask one other question. I don't want to go to far beyond my time here.

But, on disability insurance—well, let's go to a broader question. If we went—if we increased the retirement age at the pace at which the health of our senior citizens is—the longevity our senior citizens is increasing, which we don't do, but if we geared it to the greater longevity that is being achieved through improved health care, a lot of it paid out of Medicare, et cetera; if we geared it to that, and you today you would probably be in the 70s because the—I think when it was established, the average length of age was only about 48 or something.

So if you geared it to improved longevity figures, the problem we would run into, and which I think is an untenable situation, is that even though it is a declining proportion, those people who work with their backs to do manual labor, men and women, and oftentimes we think of men, but it is women who are performing domestic work and so on.

The human body gives out, if you are performing that kind of work in your late 50s, your early 60s, and it is not fair really for these people to expect them to stay in the work force at a level consistent with the general health of the workforce, even through a greater proportion of people are not performing manual labor in the United States today.

I would like for you to address that, and Barbara as well, if I could have the indulgence of the chairman—thank you, Chairman Hastings—if we could have a more liberalized definition, for example, of disability so that people who are in that kind of situation could, in fact, retire early, albeit with a slightly reduced benefit level. I think we could then kick in a more rational extension of age eligibility. I am not sure, but I would like you to address that.

Ms. KENNELLY. I hear what you are saying, Congressman. If, in fact, we continue to increase the retirement age, disability claims will increase. That argument has been made. But, getting back to those individual accounts, I have read an awful lot of material on individual accounts. We understand the market, because most of us are in the market. What you put in, you get more if your stock performs well, and if your stock doesn't perform well, you get less.

I haven't figured out how you, in a practical way, can bring people on disability to make any money in the individual accounts. So I think that is a whole another avenue.

Mr. MORAN. I happen to agree with you. That is one of the major problems. But it is part of a larger problem with people who are best able to manipulate within the field of investment judgment are those that are——

Ms. KENNELLY. Even if they don't have any income. But to get back to the raising of the age, on my long list of things that you can do to address solvency, one of them is that in this increase that began to raise the age to 67, there is a gap between 66 and 67.

And possibly to bring some money in, we might be able to close that gap. But, I wouldn't like to suggest yet that we raise the age any higher than 67, because we have no studies to show exactly what you are saying. Did this make people go more to disability? Would this change help people? Take for instance the 62 retirement in regard to the 65 retirement, which will be the 67 retirement. So I think that is a very difficult question to address. But the disability question will have to be addressed.

Mr. MORAN. Well, we do know that people are living longer. But as you say, it is this issue that really has to be addressed if you are going to increase in a correlative way to longevity. Thank you.

Mr. Steuerle.

Mr. STEUERLE. If you look at the statistics when Social Security was first established—that is, when benefits were first paid in 1940—about 70 to 80 percent of men age 65 were working. That has dropped to about 30 percent. Work then was tougher. It was far more physically demanding.

Mr. MORAN. You said 70 to 80?

Mr. STEUERLE. It is something like 70 to 80 percent of men at age 65 were working when benefits were first paid. The average age of retirement in 1940 was 68. The average age of retirement today—when people have longer life expectancy and greater health—is 62 to 63 depending on how you count disability insurance. So people are retiring earlier, several years earlier, and they are living several years longer, even while the physical demands of the jobs have been declining quite substantially.

I can send you all of these data. Because I realize I am being very quick here. The difficulty is, do we really need for most people in the population, as I say, this 15th, 16th, 17th or 18th year in retirement? I understand your sympathy for this group in the population, whether it is 10 percent or 20 percent of the population—that may have some physical impairments. But it is very expensive to subsidize 100 percent of people who are not in need for the 10 or 20 percent who are in need.

It is an issue. It is just that the system has become so expensive that a number of years of support just seems to me not a tenable result. I will say, however, that increasing the retirement age does have an impact because we waited so long to reform, and people retire now so much earlier. We have allowed them earlier retirement even while they are living some much longer. We are so close to the point in time when the baby boomers retire that the adjustments have to be much faster and much more swift than just simply indexing. The adjustment is somewhat substantial.

Let me finally say that I think the main change that needs to be made is in the early retirement age, not so-called "normal" retirement age. The age of 62 is the age that needs to be bumped up more than worrying about what the so-called normal retirement age is.

Mr. MORAN. That is very helpful. Incidentally, let me say, Mr. Chairman, I appreciate your inviting Mr. Steuerle, and obviously, our colleague, Mrs. Kennelly. I don't know Ms. MacGuineas, but I know that she was a player on the Commission. Mr. Steuerle with the Urban Study has given us so much creative information that it is a pleasure to have him testify before us, I appreciate that. You have told me a number of things that I actually wasn't aware of, and some of them are counterintuitive.

Did you have anything further to add, Ms. MacGuineas?

Ms. MACGUINEAS. The only thing I would add would be that one way to think about this may be to rather than just increasing the retirement age, indexing benefits to life expectancy, but allowing for a more flexible retirement age, because obviously, I share your concerns, everyone would.

At the same time, as Gene said, it is unfortunate to not understand this as a labor market problem and not create the incentives to stay in the workforce longer when we know that that would resolve part of the problem to protect one group.

I also think ensuring that we strengthen disability so it can kick in for the people who need it is probably an important part of the equation.

Mr. MORAN. I do think that at least unless you deal with that situation, even though it may be 10 percent it is a sine qua non of reform. You have got to address that element of the workforce. Thank you. Thank you, Mr. Chairman.

Mr. HASTINGS. Mr. Steuerle, in responding to Mr. Moran's request on statistics as to retirement age, going back to, I think you said the 1940s, my assumptions is that you probably have those statistics for probably every year, that can be found some place. Am I correct in that assumption?

Mr. STEUERLE. I will try to find what I can. As you might know, in many cases, I just rely on data that are kept by the Social Security Administration. But I will be glad to.

Mr. HASTINGS. Whatever you can. I, as one Member would certainly like to have these statistics, because, inevitably as we proceed in this debate, that is going to come up. There is no question about that. As we have to make some of those decisions. I want to thank the panel for joining us. Barbara, it was good seeing you once again.

Chairman NUSSLE [presiding]. That is a good suggestion. Thank you. We do have two votes. I don't want to be disrespectful. So why don't we—first of all, we are pleased to have you. You also, as I said in the opening, there have been a few people that have just been in the forefront of sounding the alarm and letting folks know in a constructive way about some of the challenges. And you certainly have added to that greatly. I want to welcome you and thank you for your testimony today. We will accept it. And then if we have questions we will come back after the vote.

Director Crippen, welcome back to the committee.

STATEMENT OF DAN L. CRIPPEN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. CRIPPEN. Thank you, and Mr. Moran as well. I will, as I said, put aside much of which I intended to say and try and make probably just one point.

There is an advertisement running, I was reminded this morning as many of your witnesses talked on disability insurance, that uses Yogi Berra as the central figure in the ad. Among the other Yogi Berrisms, he said, when you get sick or if you can't go to work, this plan will give you cash, which is almost like money—or just as good as money.

What we heard from most of the witnesses today—I can only reiterate—is, you have to think about the cash. How we account for current taxes and future obligations is important. But when it comes down to it, it is very simple, I think. When I retire, my children will pay for my benefits.

There is no way around that. Whether it is payroll taxes up until 2017, whether it is payroll taxes and general revenues after that, income taxes to pay interest, whether we end up borrowing from my kids in order to pay my benefit, it is my kids who will be funding my benefit.

We can argue about and think about all of the accounting we want. But at the end of the day, my two kids are unfortunately going to pay for me. Those of you who don't have two kids should probably take a benefit cut.

But one way we can think about that—the way that I have been talking about it for the past 3½ years, with this poor bedraggled chart that has gone with me to virtually every hearing—is as a percentage of the economy, how much is the Federal Government transferring to retirees?

All of that has to come from workers, my children. There is no magic way, there is no dollar stuffed in a mattress, there are no offshore accounts here. It will be the current economy at the time that is important both in my children's ability to finance my benefit and, if you want to think about it another way, in producing the goods that I will be consuming, because what I consume, they can't.

So in that light, Mr. Chairman, I just want to say a couple of things about what CBO is doing that I think will help that debate when you all get around to having it in a more concrete way.

One, we have been publishing a number of documents that I hope will be helpful. We put out one last year called "Social Security: A Primer." It is aimed at policymakers, policy analysts, and press. It has a lot of charts, graphs, colors, and an attempt to explain Social Security from an economic point of view.

We have done reports—like the one that is on the screen now—looking at the uncertainty in Social Security. I think it is important to note that while introducing individual accounts, for example, might introduce new uncertainties into the system, the system is already very uncertain in many ways, and we don't know what the net effect would be.

We have just begun a series of 3- and 4-page reports—there should be about 15 of these—looking at particular aspects of the long-term implications of Social Security. We are putting out about one a week.

Last and most important, we have spent the past 3 years building a new long-term model that will be able to answer most of the questions that you heard raised here today. We will be able to look at the effects of reform on the economy. We will be able to look at the effects of reform on individuals, any given cohort of the population. We will be able to look at the effects of reform across populations, across generations. We will be able to do much of what Gene Steurele called for and more perhaps.

We are in the throes of finalizing that model. It should be ready for you when you are ready to do Social Security. With that I will quit.

[The prepared statement of Mr. Crippen follows:]

PREPARED STATEMENT OF DAN L. CRIPPEN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. Chairman, Ranking Member Spratt, and members of the committee, I appreciate the opportunity to appear before you to discuss the Social Security program. The Social Security Act of 1935, enacted in the midst of the Depression, is widely seen as one of the most important legislative accomplishments in U.S. history. Since its inception, Social Security has grown to become by far the largest Federal program. Over the next 30 years, the aging of the baby boom generation will pose new challenges for Social Security, the Federal Government, and the U.S. economy.

The Congressional Budget Office (CBO) has examined those challenges in a number of recent reports. Late last year, we published "Social Security: A Primer" and "Uncertainty in Social Security's Long-Term Finances: A Stochastic Analysis." Last week, we released a policy brief on the long-range picture of the Federal Government's share of the economy. My testimony today summarizes some of the findings of those reports; it will make the following major points.

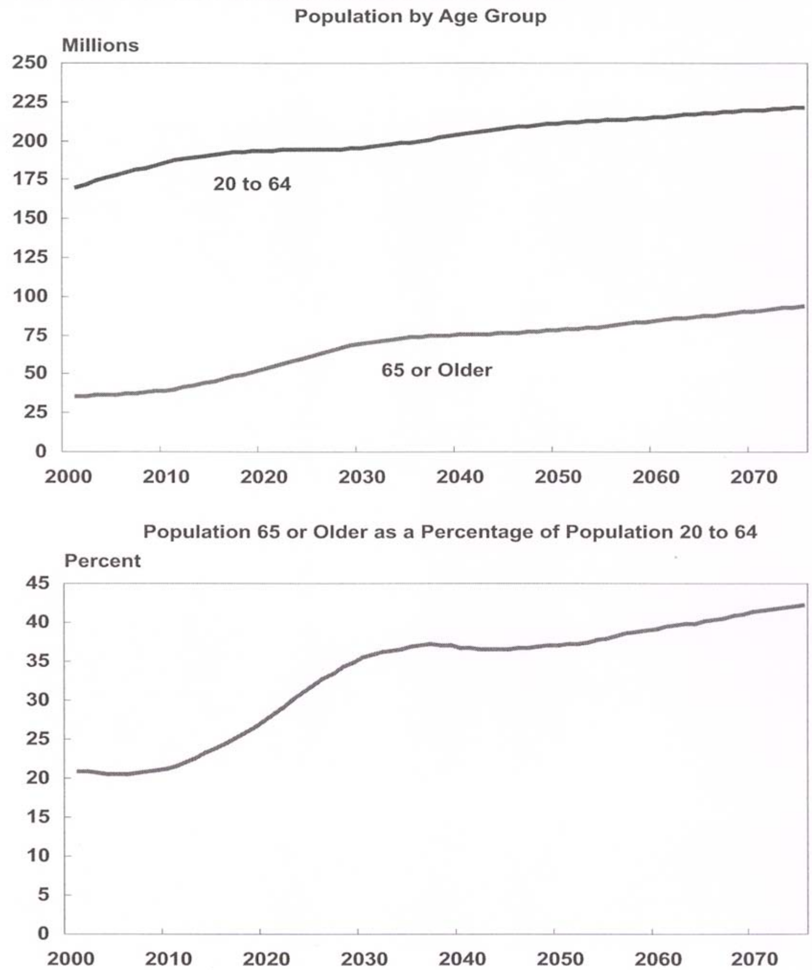
Once the baby boom generation retires, the portion of the Nation's output that the Federal Government will spend on Social Security is expected to rise by 50 percent from about 4 percent of gross domestic product (GDP) today to an estimated 6 percent in 2030.

Addressing the growing cost of Social Security would not by itself eliminate the economic and budgetary pressure caused by the aging of the U.S. population. The rapidly escalating costs of the government's health care programs are a major source of that pressure. CBO projects that Federal spending for Social Security, Medicare, and Medicaid combined will account for about 14 percent of GDP by 2030 nearly double the current share.

Looking farther ahead, CBO projects that government spending (excluding interest on the Federal debt) will rise from about 18 percent of GDP today to 28 percent in 2075 under current policies. If revenues remain within their historical range relative to GDP, the total cost of government (including interest) could double as a share of the economy: from about 19 percent of GDP today to about 40 percent in 2075. However, modest reductions in the growth of spending for Federal programs could significantly slow the growth of interest costs and total outlays.

Projections of Social Security's finances are highly uncertain, but the range of uncertainty is not adequately reflected in the low-, medium-, and high-cost scenarios used by the Social Security trustees.

Figure 1.
Projected Growth in the Adult Population, 2001-2075



SOURCE: Social Security Administration, *The 2002 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (March 26, 2002), Table V.A2 (intermediate assumptions).

Uncertainty about long-term budgetary outcomes derives from many factors, including rates of mortality, fertility, inflation, and real wage growth. Social Security's finances are most influenced by variables, such as mortality rates, that move independently of economic growth, because outlays are affected more than receipts when people live longer. That aspect of the system's finances is important to keep in mind when designing proposals to reform Social Security. For instance, a change in the retirement age that was linked to life expectancy could automatically resolve the budgetary consequences of any future changes in mortality rates.

The expected increase in Medicare spending highlights the divergence between economic growth and budgetary pressures even more clearly, because most of that increase results from health care costs per beneficiary growing faster than GDP per capita. No mechanism in law exists that will slow down that growth.

Although policymakers have many goals, if they want to limit the growth of Federal spending as a share of GDP, they have only two options: slow the growth of that spending or increase the growth of the economy. The Nation's ability to sustain an aging population will ultimately depend on how many goods and services the economy produces and how they will be distributed, not on how much money is credited to Social Security's trust funds.

THE PRESSURES OF AN AGING POPULATION

Over the next three decades, the aging of the baby boomers (the large group born between 1946 and 1964) will put new pressure on Social Security, the Federal Government, and the U.S. economy. The Social Security Administration projects that the number of people age 65 or older will rise by more than 90 percent during that period (from about 36 million now to 69 million in 2030), according to its intermediate assumptions (see figure 1). At the same time, the number of adults under age 65 who will largely be the ones paying the payroll taxes to support their elders will grow by only about 14 percent (from 172 million to 196 million). Moreover, even after all of the baby boomers have retired, the number of elderly people is expected to keep rising at a faster rate than the number of non-elderly people as life spans continue to lengthen.

Perhaps even more important, as the population ages, spending on Medicare and Medicaid is likely to rise rapidly because of increases in Federal costs per beneficiary as well as in the percentage of the population eligible for benefits (unless major changes are made to those programs). Medicare provides health insurance to most U.S. residents age 65 or older and to eligible disabled people, most of whom also receive Social Security benefits. Medicaid is a joint Federal/State program that provides medical assistance to low-income people; in recent years, a large share of its payments have gone to provide long-term care, mainly for elderly or disabled people.

A LONG-RANGE PICTURE OF THE FISCAL SITUATION

How will those pressures of demographics and health care costs affect the U.S. budget and economy? To help address that question, CBO has developed a new long-range model. Using the model, we recently prepared a 125 year picture of the budget that extends from 1950 to 2075. Those projections illustrate a potential path for the budget that highlights the implications of maintaining current policies. Of course, the future path of the budget is highly uncertain and subject to wide variation. Thus, the path shown in those projections is simply a representation based on an illustrative set of key assumptions.

Although my testimony focuses on long-range projections of spending under current policies, CBO is about to unveil an expanded version of the model that will be capable of simulating the budgetary and economic effects of policy changes including detailed proposals for Social Security, such as the introduction of private accounts. One of the more innovative features of the expanded model is its ability to perform stochastic simulation analysis, which shows the probabilities of alternative outcomes based on a statistical distribution of alternative assumptions about such factors as returns on stocks and bonds, mortality, fertility, and wage growth. The model will also include equations that reflect how people alter their work and saving in response to increases in taxes and cuts in benefits. We expect to begin releasing analyses from that model sometime this fall.

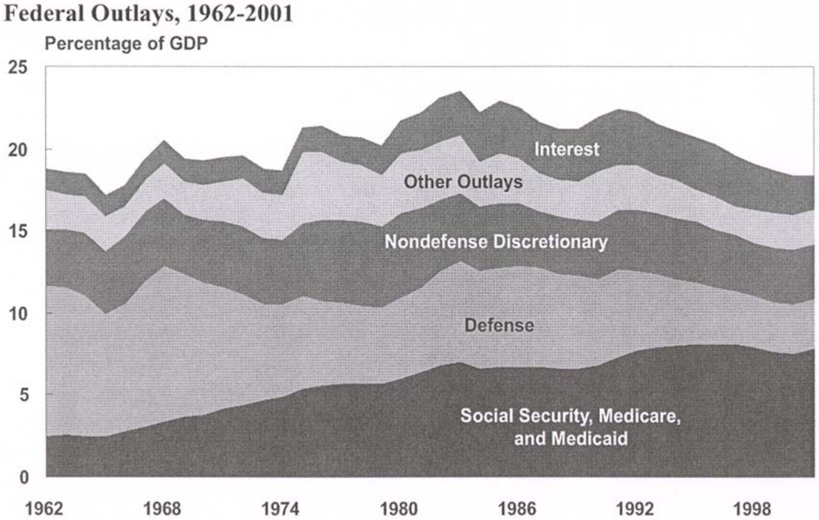
In CBO's current long-range model, Social Security spending reflects growth in the number of recipients and in wages, which determine benefits. Medicare and Medicaid spending reflects the increasing number of recipients and the age profile of enrollees as well as the rising costs of medical care. For the long-range projections described below, the growth in health care costs for each recipient of a given age is assumed to slow to a rate 1 percentage point faster than the growth rate of per capita GDP. Although seemingly high, that rate is lower than it has been in recent decades. The budget figures in these projections are expressed as a share of GDP so that the magnitude of Federal revenues and spending can be observed in relation to the country's total economic activity in any given year and over time.

The projections show that it is spending for the major entitlement programs and for interest because of the commitments involved and their sheer magnitude that has the largest potential to constrain future Congresses. Moreover, much of the government's remaining spending consists of discretionary outlays, the levels for which are determined annually. Given the wide array of discretionary programs, that category of spending (unlike the major entitlement programs) does not easily lend itself to projections that merge economic and demographic assumptions with legislative rules for the payment of benefits. Thus, CBO's long-range projections assume that defense, nondefense discretionary, and all other spending (that is, other than for Social Security, Medicare, Medicaid, and interest) will remain fixed as a share of GDP beginning in 2012, the last year of the 10-year baseline projections that CBO published in March 2002. The projections do not incorporate the recently enacted farm bill and economic stimulus package.

HISTORICAL TRENDS IN SPENDING

Spending by the Federal Government grew from approximately 3 percent of GDP in 1925 to about 16 percent in 1950. (Following the Depression, World War II abruptly boosted Federal spending to about 42 percent of GDP, but afterward, that spending dropped and resumed a less volatile growth trend). Since then, Social Security, Medicare, and Medicaid have together become the largest component of the Federal budget (see figure 2). In 1962, when Social Security outlays represented only 2.5 percent of GDP, and Medicare and Medicaid had not yet been created, spending for all other government activities made up about 85 percent of Federal non-interest outlays. The largest share was for national defense, which accounted for half of non-interest outlays and represented 9.2 percent of GDP. By 2001, total spending for Social Security, Medicare, and Medicaid equaled 7.8 percent of GDP, about triple the 1962 share for Social Security alone. Although still constituting less than half of all Federal spending, the three programs combined accounted for the largest share of total outlays. Defense spending had fallen to 3 percent of GDP, and all other non-interest spending stood at 6.3 percent. Interest costs, whose share of GDP had risen steadily from 1.2 percent in 1962 to a high of 3.3 percent in 1991, stood at 2.0 percent in 2001.

Figure 2.
Federal Outlays, 1962-2001



SOURCE: Congressional Budget Office.

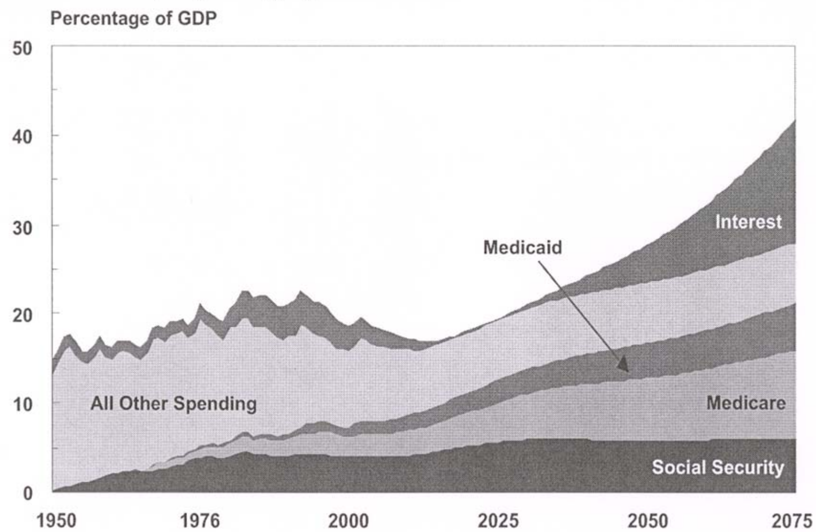
PROJECTIONS TO 2075

Looking ahead, CBO projects that outlays for Social Security, Medicare, and Medicaid (based on the current rules for benefits) could nearly double as a share of GDP by 2030, rising to about 14 percent. If spending for all other government activities in 2030 remained at roughly the same share of GDP as projected for 2012 (about

7 percent), Social Security, Medicare, and Medicaid would account for almost 70 percent of the government's non-interest spending. By 2050, outlays for the three programs would constitute nearly 17 percent of GDP, and by 2075, about 21 percent exceeding the share of GDP now absorbed by all Federal revenues (see figure 3).

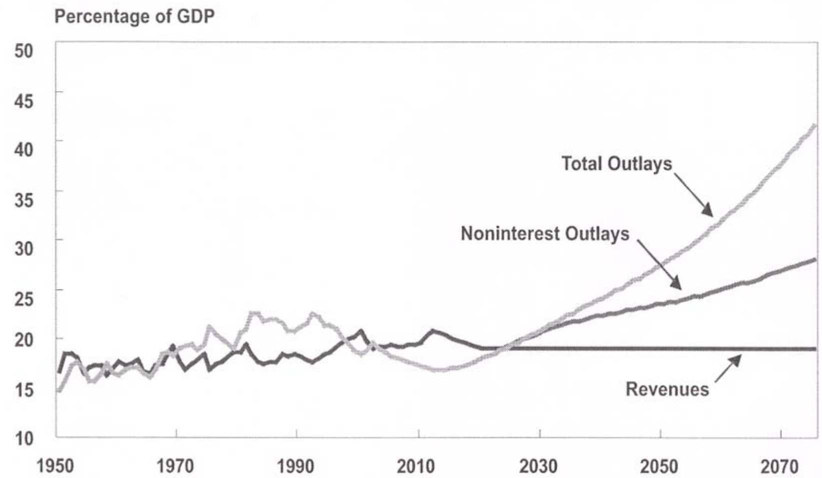
Under the assumptions that CBO made for its long-range picture of government finances, the projected rise in spending for Social Security, Medicare, and Medicaid would drive total Federal outlays well above the level seen throughout much of the post-World War II period. The government's core costs (that is, ignoring net interest on the debt) could rise from about 18 percent of GDP today to about 24 percent in 2050 and 28 percent in 2075. Left unattended, that steady escalation in spending could cause major deficits to emerge, pushing the government's debt, and its interest spending on that debt, to unprecedented levels. If revenues remain within their historical range relative to GDP, the total cost of government (including interest) could double as a share of the economy from about 19 percent of GDP today to about 40 percent in 2075 (see figure 4).

Figure 3.
Federal Outlays by Category, 1950-2075



SOURCE: Congressional Budget Office.

Figure 4.
Federal Revenues and Outlays, 1950-2075



SOURCE: Congressional Budget Office.

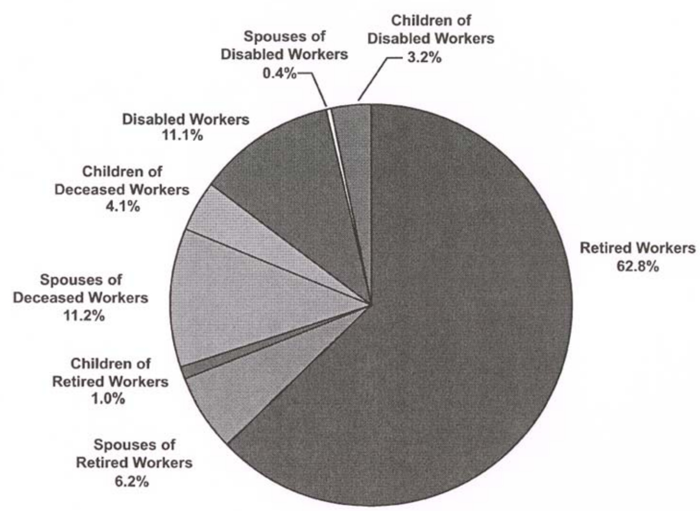
Issues to Consider in Reforming Social Security

Several aspects of Social Security and the outlook for it as the population ages are especially important in considering changes to the program. First, throughout its long history, Social Security has had multiple goals some related to redistributing income, others related to offsetting lost earnings. In 2000, only about two-thirds of Social Security's beneficiaries were retired workers; the rest were disabled workers, survivors of deceased workers, and workers' spouses and minor children (see figure 5). Policymakers will need to decide whether the program's goals are still appropriate and, if so, how changes to Social Security would aid or hinder the achievement of those goals and affect various types of beneficiaries and taxpayers. Those decisions will also need to take into account the dramatic increase in the elderly population that is expected in the coming decades.

Second, issues about how to prepare for an aging population ultimately concern the amount of goods and services that the economy will produce and how they will be distributed, not how much money is credited to the Social Security trust funds. In that sense, the projected depletion of those funds which is the focus of much of the popular debate about Social Security's future is irrelevant. The challenges of adjusting to an aging population would need to be faced even if the trust funds never existed.

Third, deciding how to prepare for an aging population is likely to require weighing the interests of today's workers and Social Security beneficiaries against the interests of future workers and beneficiaries. No matter how it is packaged, any plan to increase national saving today means that the U.S. population will consume fewer goods and services now so that consumption can be greater in the future, when a larger share of the population is retired. Gone are the days when expansion of the labor force could pay for the growth of Social Security benefits. (In past decades, Social Security's payroll tax revenues grew substantially as the baby boom generation and women of various ages entered the labor force in large numbers). As the Congress looks at policy changes, one consideration is that future workers and Social Security beneficiaries are likely to have higher standards of living, on average, than current workers and beneficiaries do, because of future increases in productivity.

Figure 5.
Distribution of Social Security Beneficiaries, by Type of Benefit Received, December 2000



SOURCE: Social Security Administration, *Annual Statistical Supplement, 2001*, Table 5.A1 (available at www.ssa.gov/statistics/Supplement/2001/5a.pdf).

Strategies for Dealing with an Aging Population

Spending more on elderly people may be appropriate in light of their increasing numbers, but questions can be raised about the extent to which that spending should rise. Policymakers have many goals, but if they want to limit the growth of spending on the elderly as a share of the economy, they can do so in only two ways: either by slowing the growth of that spending or by increasing the growth rate of the economy. Different options for reform would have different effects on economic growth. To the extent that those options boosted the future size of the economy and increased the Nation's accumulation of assets, they could lessen the burden on future workers from government programs that serve the elderly.

My testimony focuses on three ways to prepare for an aging population that have generated a lot of public attention: paying down Federal debt, creating private retirement accounts, and making changes to the benefits or revenues of the current Social Security program. Those approaches are not mutually exclusive; they could be combined in any number of ways. (In addition, many people have put forward proposals to curb the rising costs of Federal health care programs. Such proposals could also help the Nation deal with its impending demographic changes, but they are beyond the scope of this testimony).

Regardless of which approach policymakers decide to take, a number of key questions should be raised about any proposed policy option:

- How would it affect economic growth over the long run?
- Would the proposed policy improve the long-term fiscal outlook faced by succeeding generations? How would it alter the taxes they pay and the benefits they receive?
- Would the policy improve the ability of Social Security and Medicare to respond to unanticipated changes in demographics (such as life expectancy) and in the economy (such as productivity growth)? Some proposals could help make those programs more adaptable to change; other proposals could reduce their flexibility.

PAY DOWN DEBT

One strategy for preparing for the needs of an aging population is to pay down Federal debt. If the government spends less than it receives in revenues (and private saving does not fall too much in response), national saving will rise, boosting the stock of private capital and expanding the productive capacity of the economy in the long run. Indeed, Federal debt held by the public has fallen sharply in recent years from about 50 percent of GDP in 1995 to about 33 percent today. That decline has freed up funds for investment in private capital.

CBO will soon update its 10-year projections for the budget, but it does not expect any significant surpluses to be available for paying down debt for at least a few years. However, if current tax and spending policies are maintained, significant budget surpluses could reemerge at some point in the next 10 years. But even paying off all of the Federal debt available for redemption would not provide enough interest savings or additional economic growth to finance Social Security, Medicare, and Medicaid spending over the long run.

CREATE PRIVATE ACCOUNTS

A second strategy is to encourage private saving. A prominent set of proposals envisions creating private retirement accounts. Those proposals differ in many ways, but they share a common feature: the income from an account would depend on the payments made into it and the rate of return on the account's assets. Many types of accounts are possible, and their effects would vary widely.

One of the central issues is how private retirement accounts would be financed. Many proposals include a contribution from the government to help people pay for accounts. According to supporters of private accounts, diverting payroll tax revenues from the government could prevent policymakers from spending those revenues on other programs and could thus provide many of the same economic benefits as paying down debt. In addition, they argue, private accounts could allow the government to encourage asset accumulation while avoiding the problems of having the government own shares in private companies. However, because national saving consists of both private and government saving, a proposal that simply moved dollars from government saving to private saving (by financing private accounts through an increase in Federal debt) would have no direct effect on national saving or capital accumulation. To raise national saving, a proposal would have to cut either government consumption, private consumption, or both.

Some people argue that private accounts would offer higher rates of return than the traditional Social Security system does, but that argument can be misleading. Social Security has a low rate of return largely because initial generations received benefits far greater than the payroll taxes they paid. That difference would have to be made up even if the Social Security system was entirely replaced by private accounts. Moreover, investing in the stock market either through private accounts or through government purchases of stock for the Social Security trust funds would be no panacea. Simply raising the average rate of return on assets by taking on more risk would not change the economic fundamentals. Only if the investment proposal increased national saving and enlarged the economy would it reduce future burdens.

In setting up a system of private accounts, policymakers would have to address many practical issues. How much would the system cost to administer? Would it provide insurance against downturns in the stock market? Would the system require that accounts be converted into annuities and, if so, under what conditions? How would it handle benefits for workers' families, for survivors of deceased workers, and for disabled workers? Would the system give subsidies to people with low income and intermittent work histories? How would the system be regulated and investors informed?

The answers to those questions could have implications for the economy. For example, government guarantees that people would receive a minimum level of retirement income in the event of a market downturn would probably reduce national saving below what it would be without those guarantees. And subsidies to low-income workers that were phased out as wages rose could impose implicit taxes on work and could discourage some people from working more.

MAKE PROGRAMMATIC CHANGES

A third approach is to modify the current Social Security program. Changes that have been proposed include reducing benefits (for example, by raising the retirement age, calculating initial benefits using a price index rather than a wage index, or reducing annual cost-of-living adjustments) or increasing payroll taxes. The effect on the economy would depend on the particular kind of change.

Many types of benefit reductions could increase the size of the economy in the long run because they could encourage some people to save more. However, those long-term gains could take a couple of decades to materialize fully, and the effect in the near term would be uncertain. Slowing the growth of Social Security benefits could reduce the lifetime resources of some transitional generations, but it could also lead to higher wages and lower tax burdens for later generations. If benefits were to be cut, changing the law now rather than later would give workers time to adjust their plans for saving and retirement.

Raising taxes to pay for future Social Security benefits would have an uncertain effect on the size of the economy in the long run. Moreover, the effect would depend on the type of tax increase and other factors. If the revenues from a tax increase did not change the government's decisions about other spending or taxes, national saving could rise. But the extra revenues could encourage more government spending, which would limit any rise in national saving. In addition, increases in marginal tax rates on payroll or income could reduce people's incentives to work or save, also dampening any increase in national saving.

Although long-term projections of the Federal budget and the economy carry huge uncertainties, one fact seems certain: the U.S. population will age significantly over the next 30 years, and unless policies are changed, spending on the elderly will rise sharply, posing new challenges for the Federal Government and the Nation's economy.

Chairman NUSSLE. Mr. Moran, do you have any questions that you would like to ask at this time?

Mr. MORAN. Mr. Chairman, the answer is yes. But, given the fact that Mr. Crippen has been here all morning, we have got a vote, it seems to me that I can—I will have another opportunity to ask them. But I do appreciate him being here, and I appreciate all of the work that he has done in elucidating the Social Security issue for us as well as everything else with regard to the budget. Thank you, Mr. Chairman.

Chairman NUSSLE. Thank you. I appreciate your coming and your interest obviously.

Let me ask then, I just have one question so I will ask it now and then we can—we probably have more questions. This conversation will continue, I have no doubt.

In your testimony, I believe it was last December to the Special Committee on Aging in the Senate, you said the following—and I am interested in your elaboration on it. "Issues about how to prepare for an aging population ultimately concern the amount of goods and services that the economy will produce and how they will be distributed, not how much money is credited to the Social Security trust funds. In that sense, the projected depletion of those trust funds, which is the focus of much of the popular debate about Social Security's future, is irrelevant. The challenge of adjusting to an aging population would need to be faced, even if the trust funds never existed."

So would you elaborate on that just for the purposes of this hearing, and then that is basically what I was interested in hearing from you about.

Mr. CRIPPEN. Obviously, just cut me off whenever you need to leave. As many of the other witnesses said, the way to think about this clearly, I think, is to follow the cash.

There is no cash in the trust funds. There are assets; there are obligations. Those certainly will be made good. Think of 2017, when it looks like we won't have enough payroll taxes to fund benefits. The Social Security Administration will, figuratively speaking, go to the Treasury and say, "Give me some interest payments for cashing in bonds actually or debt instruments that pay interest." To do so, the Treasury will have to raise taxes, cut other spending or borrow from my kids in order to pay the interest.

If there were no trust funds, no interest, no bonds, and the Social Security Administration didn't have enough cash, they would essentially—assuming the benefit is paid—come to the Treasury and say, "we need cash." The Treasury would have to raise taxes, cut other spending or borrow from my kids.

So the effect on the economy and the budget is identical, whether or not you have these trust funds. The point is that, as that poor bedraggled chart shows, there are only two moving parts, if you think of the world the way most economists do: the level of obligations to the elderly and the size of the economy.

Anything else is noise below that; some of it is interesting; some of it is informative, some of it is useful. But it is not necessarily the right question.

I would argue that if you have reform in front of you or you are questioning policy effects, whether they are current or future, on Social Security, you have to look at the chart and say, does it change either of those two things? Does it change the obligations to the elderly, the retirees or does it change the size of the economy? Other questions are less important.

Chairman NUSSLE. One final thing that I just thought of that I am interested in your—I think I know the answer, but, I expressed, and you were here, which I appreciate, when David Walker was here, about the fact that there is a lot of focus on solvency, and that seems to be the primary focus on the part of many Members, but more especially the media which is getting this message then therefore out to the public.

Is that a proper focus? And if there are other focuses that we should have as far as just general guideposts, what should they be? Let's start with that.

Mr. CRIPPEN. I would suggest that it is not the proper focus. In fact, in some venues, I have argued that it is distracting. Indeed, I and others have perpetuated that as a policy objective for a long time. I was involved in the 1983 Commission, as I think you know. Howard Baker, who I worked for in the other body, as you say, actually proposed the Commission. He sold it to President Reagan, and we made the first call to Alan Greenspan to see if he would Chair it. So we were very much a part of that.

And the only question we asked of the Commission for any proposals was, does this ensure 75-year actuarial or long-run solvency? We didn't ask other questions about its effect on the economy, we didn't think about that. We didn't ask what the trust fund buildups were going to be invested in.

We thought only of solvency as the primary objective, because the fund was almost insolvent. I think we convinced ourselves and our constituents of the same thing—that solvency was a very important issue. But since then, at least I have come to understand better that the implications for my children are not so much what is in the trust funds, but clearly what they are able to pay for at that time.

And the difference really is one of consumption. You and I can save in individual accounts of our own or of somebody else's construction, but to do so we have to give up spending, we have to give up consumption, and hope that that helps capital investment and the economy grow. It is not necessarily true, however, that in generating trust fund surpluses the government has collectively given up consumption. And so unless we actually do something to help the economy, my share of Microsoft, which I will have to sell to my kids, will be worth more or less depending on how the economy performs largely.

And their ability to buy it from me will depend on how much they can make out of the economy. So whether the assets are so-called real in equities or whether the assets are in government bonds matters much, much less than how gib is the economy at the time.

Chairman NUSSLE. Again, thank you for your testimony. I would like to thank, again, Mr. Spratt for the atmosphere in which this hearing was held. We all, I think, came to this with an interest in trying to solve the problem, understood the problem, and start looking at some solutions. If we would start learning from that experience, Congress may be able to function in dealing with this in a much better way.

I would also like to thank Tori Gorman. This has been a good hearing. It takes a lot of staff work on both sides to get this all put together. Our witnesses have done a great job and the members participated in a very constructive way, and I appreciate that.

So with that we are adjourned.

[Whereupon, at 1:19 p.m., the committee was adjourned.]

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