HEARING ON ALTERNATIVES TO STRENGTHEN SOCIAL SECURITY

HEARING

BEFORE THE

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U.S. HOUSE OF REPRESENTATIVES

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CONTENTS

	Page
Advisory of May 26, 2005 announcing the hearing	2

WITNESSES

Cato Institute Project on Social Security Choice, Michael Tanner	78
Center on Budget and Policy Priorities, Jason Furman	62
Free Enterprise Fund, Institute for Policy Innovation, Lawrence A. Hunter	54
The Lindsey Group, Hon. Lawrence B. Lindsey	6
Lyndon B. Johnson School of Public Affairs, University of Texas at Austin, Hon. Kenneth S. Apfel	48
MFS Investment Management, Robert C. Pozen	10
Urban Institute, Tax Policy Center, C. Eugene Steuerle	35
Watson Wyatt Worldwide, Sylvester J. Schieber	16

SUBMISSIONS FOR THE RECORD

American Enterprise Institute, Alex Pollock, statement	155
California Retired Teachers Association, Sacramento, CA, Eva Hain, statement	160
Elia, Joyce, Mission Viejo, CA, statement	162
Englesby, Sue, Boise, ID, letter	164
Fronek, Donald, Toney, AL, letter	164
Galvin, Cecile, Laguna Niguel, CA, statement	165
Gould, Francis, Vista, CA, statement	166
National Association of Disability Examiners, Lansing, MI, Martha Marshall, letter	166
National Committee to Preserve Social Security and Medicare, Barbara Kennelly, statement	167
National Education Association, statement	169
Taniashvili, Patricia, Surry, ME, statement	173
Tucker, Deborah, Boynton Beach, FL, statement	173
University of Oklahoma College of Law, Norman, OK, Jonathan Forman, statement	174
Ward, Douglas E., Oberlin, OH, statement	177

HEARING ON ALTERNATIVES TO STRENGTHEN SOCIAL SECURITY

THURSDAY, MAY 12, 2005

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

The Committee met, pursuant to other business, at 10:17 a.m., in room 1100, Longworth House Office Building, Hon. Bill Thomas (Chairman of the Committee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE CONTACT: (202) 225–1721
May 12, 2005
No. FC–8

Thomas Announces Hearing on Alternatives to Strengthen Social Security

Congressman Bill Thomas (R–CA), Chairman of the Committee on Ways and Means, today announced that the Committee will hold a hearing on alternatives to strengthen Social Security. **The hearing will take place on Thursday, May 12, 2005, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.**

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

BACKGROUND:

In their 2005 report, the Trustees of the Social Security Trust Funds again reported that the Social Security program faces long-term financial challenges. In just three years, the leading edge of the baby-boomers will reach early retirement age. In 2017, just over a decade from now, Social Security will pay out more in benefits than it collects from payroll taxes. To make up the shortfall, the Treasury bills credited to the trust funds will have to be redeemed. Because no money has been set aside to pay these obligations, the government will have to raise taxes, cut spending, or increase the debt to honor these obligations, which are backed by the full faith and credit of the Federal government.

By the time today's 26-year-olds are eligible to retire in 2041, the trust funds will be exhausted and Social Security taxes will only cover about three-fourths of promised benefits. In other words, inaction will lead to a 26-percent benefit cut.

If Social Security's financial challenges are not addressed soon, temporary solutions—such as those adopted in 1983 when Congress last acted on Social Security—or dramatic benefit cuts or tax increases will be the only options available. According to the Social Security Trustees, the Comptroller General of the United States, and the Federal Reserve Board, the sooner lawmakers act, the more options are available to strengthen Social Security.

Social Security's Trustees have urged Congress to address Social Security's financial challenges sooner rather than later. For more than a decade, several bipartisan councils and commissions, as well as many individual experts and policymakers, have laid out options and comprehensive proposals for strengthening Social Security. In addition to bringing the program's finances back into balance, experts have also called for updating Social Security benefits to better protect families, given changes in our society that have occurred since the program was created 70 years ago.

In announcing the hearing, Chairman Thomas stated, "The American people understand Social Security cannot meet its obligations in the future unless Congress takes action. We will examine potential solutions that will preserve Social Security for seniors and Americans nearing retirement, while improving retirement security for younger workers."

FOCUS OF THE HEARING:

The hearing will focus on solutions designed to strengthen Social Security to better meet the needs of 21st-century families.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, *http://waysandmeans.house.gov,* select "*109th Congress*" from the menu entitled, "*Hearing Archives*" (*http://waysandmeans.house.gov/Hearings.asp?congress=17*). Select the hearing for which you would like to submit, and click on the link entitled, "*Click here to provide a submission for the record.*" Once you have followed the online instructions, completing all informational forms and clicking "submit" on the final page, an email will be sent to the address which you supply confirming your interest in providing a submission for the record. You ***MUST REPLY*** to the email and ***ATTACH*** your submission as a Word or WordPerfect document, in compliance with the formatting requirements listed below, by close of business Thursday, May 26, 2005. **Finally,** please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225–1721.

FORMATTING REQUIREMENTS:

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

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

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

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

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

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

Chairman THOMAS. I would like to move to the principal order of business before the Committee, and that is to begin to examine particulars within the area of our jurisdiction of Social Security. The last time this Committee looked seriously at Social Security was in 1983. To give you an idea of how much the world has

changed, all you have to do is look at this Committee. There are only a few Members that are currently on this Committee that were on the Committee in 1983, the gentleman from New York, Mr. Rangel, the gentleman from California, Mr. Stark, and myself. I was the only Member of the Committee apparently here on the Subcommittee on Social Security. At that time, to a very great extent, our effort was to literally save Social Security and, in fact, had to delay the Cost of Living Adjustments (COLA) to be able to meet payments. That truly was in any definition of the term a crisis. What probably disappointed me the most was—and notwithstanding our response to meet that need—we never did do what I thought we should have done at that time; to examine some of the, I think you could use the term "inequities" that occurred over time as society aged; the way in which people work, especially women in terms of the home and outside of the home; the age difference in terms of longevity of our seniors; and a number of other aspects that were internal to Social Security that probably needed adjustment at that time. Now, as the chairman of the Committee on Ways and Means, I feel very strongly about what we need to address.

I am pleased that a number of our witnesses addressed them specifically. I will be asking questions directed at what some folks will think are secondary issues. If we are going to look at this stuff once every quarter of a century, I think we do need to look at how much the society has changed and how we need to change the structure. We are going to do it in the full Committee and we are going to do it in the Subcommittee on Social Security. I will recognize, for the remainder of my time, the gentleman from Louisiana, the chairman of the Subcommittee on Social Security.

Mr. MCCRERY. Thank you, Mr. Chairman. I commend President Bush for focusing on this issue and bringing the attention of the American people to this issue that begs for action by the Congress. I also commend the chairman of the full Committee, Mr. Thomas, for scheduling this series of hearings that we hope will provide the Committee with sufficient options, information, and knowledge to address the problems associated with the Social Security program. In the past, we have had a pay-as-you-go program funded by the payroll taxes of the current generation of workers to pay the current generation of retirees. In the past, that has been a reasonable approach due to the large number of workers, compared to the number of retirees.

Unfortunately for those who might really like the pay-as-you-go system, demographic changes are taking place, have taken place, and are continuing to take place in our country, which, in my opinion, makes the pay-as-you-go system less viable, and perhaps even unsustainable. So, I think it is incumbent upon this Committee, as the Committee of jurisdiction, to examine ways of financing the Social Security system that are smarter and better, particularly in view of the burden on future generations that a pay-as-you-go system might place. Mr. Chairman, I look forward to hearing from these distinguished gentlemen who have undoubtedly spent many hours thinking about the Social Security system and how to finance it and look forward to their testimony.

Chairman THOMAS. I thank the gentleman. In some instances, it is literally years, and that is why we are privileged to have the witnesses in front of us. The gentleman from New York.

Mr. RANGEL. Thank you, Mr. Chairman. Most of my time, I will be yielding to Congressman Levin to deal with the question of Social Security. I really, personally and politically, think that this sensitive issue screams out for bipartisanship. I think the President's 60 cities in 60 days did more to polarize. I thank you for your bipartisan approach to this panel. Since you have six people supporting private accounts and two that are not, this is a long way in terms of working together. We are going to have a problem here—and I think we are starting this off as a problem by not discussing with any of the Members prior to going and making privatization the one issue that we truly believe. It is like putting Kool-Aid on the table if we are going to, in a bipartisan way, try to save this system. As long as this is on the table, we are going to have a problem talking. I yield to Mr. Levin.

Mr. LEVIN. Thank you, Mr. Rangel. As you have said, this hearing is a continuation of the course that was set out upon by the President in the State of the Union; diverting money from Social Security to set up private accounts. The President set out that course, he said it in the State of the Union, he sent his Administration out on a 60-day tour to promote it, and he held, recently, a press conference at the White House, where he reconfirmed that commitment, and really smoothed the road for the middle-class benefit cuts that are inherent in private accounts. Our chairman, Mr. Thomas, is now suggesting that we surround this basic issue with assorted other issues, but in this case—and I want to emphasize this—the Democrats and the American people will not lose sight of the tree being cut down in the middle of the forest.

A brief look at history; our President when he ran some decades ago was for private accounts. In the nineties, Mr. Thomas, our chairman, introduced legislation to privatize Social Security, and, under that, half of the payroll taxes would have been diverted into private accounts and guaranteed Social Security benefits would have been cut in half. Today, as Mr. Rangel mentioned, the six witnesses who are brought forth by the Republican majority have all supported privatization of Social Security. So, let me just say, clearly, with that as the primary goal here of the Administration, we will stand in opposition to that, united with the American people, not because we oppose more ideas, but because we are opposed to bad ideas, including: the deep benefit cuts, the diversion of Social Security moneys in trillions to risky private accounts, the added benefit cut to the guaranteed benefit that would come from the offset, and the huge amount of borrowing.

All of these changes will destabilize Social Security, undermining the strong public support that has insured it for generations of Americans, generations. No amount of tweaking or combining it with other provisions can make that a good idea. With private retirement programs—and we have heard this increasingly—built on shifting sands, Social Security stands as the basic guaranteed foundation for retirees, disabled workers, and surviving young children. So, I want to emphasize in closing what Mr. Rangel has said. It is our hope in this hearing that we can have a real discussion of

what privatization would mean, and in doing so, our hope is that our colleagues will come to the same conclusion that most Americans have already reached. The President should drop his demand for private accounts, and in doing so, allow us to work, in a bipartisan way, as was done 20-some years ago, to strengthen Social Security and to ensure that it continues providing guaranteed benefits in the future.

Chairman THOMAS. The Chair thanks the gentleman, and the Chair looks forward to working with the gentleman from Michigan in preparing a Members' panel for which he can provide Members of his party to discus their plans for saving Social Security on an ongoing basis. The Chair welcomes the panel. I know Members look at the witnesses' testimony prior to the hearing. I want to thank all of you, because taken in its entirety, it is one of the best syllabuses I have seen in going over the arguments pro and con. The Chair, to the best of his ability, would allow any of you to finish your sentences at this hearing. That wasn't necessarily the case at other hearings that I have noticed in terms of an attempt to discuss programs. Members are anxious to question you. We are each only going to have about 5 minutes. I don't know how long some of you can stay. The Chair is prepared to stay as long as is necessary to have as full and as complete a discussion as possible, and I will be making comments after you have provided us with your oral testimony. I will say to all of you that, without objection, your written testimony will be made a part of the record and I will just begin over to my left and we will just move across the panel. Mr. Tanner, there is no indication that the fact that you have a temporary location on the dais means anything about your presentation. It is just that this is one of our larger panels, but the Chair thought that it would be much better to have all of you together so you can actually have a dialog among yourselves, rather than, say, run two panels and then have someone say, "The previous panel said," and so forth. So, the Chair apologizes, but I think in the end, we will have a much better chance of having as full a discussion as possible in the limited timeframe that we have. With that, Mr. Lindsey, if you will address us in any way you see fit with the time that you have.

STATEMENT OF LAWRENCE B. LINDSEY, PRESIDENT AND CHIEF EXECUTIVE OFFICER, THE LINDSEY GROUP, FAIRFAX, VIRGINIA

Mr. LINDSEY. Thank you, Mr. Chairman. Thank you very much for the invitation to be here today. I must say it is a pleasure. It is a particular pleasure since on the floor of the other body yesterday, I was referred to as the late Larry Lindsey——

[Laughter.]

Mr. LINDSEY. I can assure you that it is a pleasure to be here and alive and kicking. It is surprising to me that, in the discussion of Social Security, promoting national savings has not been at the center of the debate. Last year, we Americans spent on consumption, investment, and government $1.06 for every dollar we earned. We balanced our collective checkbook only by selling assets we owned and by borrowing directly from foreigners, including institutions like the People's Bank of China, to whom one might prefer

not to be increasingly indebted. This borrowing is directly tied to an ever-growing trend for us to consume foreign-produced goods, at the expense of American production. Done right, the reform process offers enormous potential for improving our savings. The first part of any credible Social Security reform plan is to permanently eliminate the actuarial deficit in the system. Currently, the system has promised to pay out in present value terms $11 trillion more than it will collect in revenue. There are a number of ways of closing this gap, but with different implications for national saving. For example, it would take a 28-percent increase in payroll taxes enacted now to make sure that the government collected all the money it needed to make benefit promises over time. This would, if three conditions were met, temporarily increase savings. First, the government would have to not spend the extra money on non-retirement spending. Second, the adverse effects of the tax increase on the economy must not lower government revenue from non-payroll sources. Third, private citizens faced with declining disposable incomes must cover the entire shortfall from reduced consumption, not by increasing their savings.

It is unlikely that these three conditions would be met, but even if they were, the savings increase would be temporary. Once Social Security payments caught up with enhanced revenue, the plan would forever be moving money from one set of people who would spend the money, workers, to another set of people who would spend the money, retirees. So, even in the best case, a tax increase would do nothing to increase national saving over the long run. Because these conditions are unlikely to be met, the tax hike would not produce the intended amount of increased national savings even in the short run and would likely lower national savings in the long run. The combined adverse effects on existing personal saving and the disincentive effects on working and entrepreneurship are likely to be significant. This would be particularly true of ideas to raise or eliminate the wage cap that determines both Social Security taxes and Social Security benefits. For example, Martin Feldstein calculated that eliminating the cap would reduce net Federal revenue, since the behavior response by entrepreneurs to a tax hike that took their tax rate back up to nearly 50 percent would reduce Federal income tax revenue, as well as produce lower than expected payroll tax receipts. Moreover, such entrepreneurial income would be taxed and would have funded business fixed investment.

The second way to bring the system into balance is to change the formula for determining benefits now in a way that gradually reduces the current growth rate in real benefits. Currently, Social Security projects a 50-percent increase in benefits, even after inflation, over the next half-century. The system would be brought into balance by limiting future benefits to the level of benefits enjoyed by those retiring from the system now, while fully indexing those benefits to inflation. This could be coupled—and I would think it is a good idea—with a generous minimum Social Security benefit, thus making the system both more progressive and providing a better safety net, with little adverse effect on national saving. The $11 trillion in savings to the Social Security system by doing this could be viewed as a one-time improvement in the Federal Government's

balance sheet by that amount, with an equivalent reduction for future retirees, as benefits would not rise as fast as they might now expect. Still, national saving would likely rise as a result in order to maintain the level of consumption retirement that the government previously promised but could not deliver.

Individuals would have to gradually increase their personal saving during their working lives. This might not be easy for some folks. So, a second part of any Social Security reform plan that promotes national saving should include a personal account plan that helps people save and learn the benefits of saving by watching their own accounts grow. Most personal account proposals, including the President's, would allow workers to use a portion of payroll taxes currently collected and direct them into a personal account. It has been widely noted that any shortfall to meet current benefits would be met by government borrowing, and therefore, the personal accounts that are funded by government borrowing do not raise national saving directly but simply increases government borrowing to fund private saving. What is not widely understood or reported is that for individuals to establish such an account, his or her regular Social Security benefit would be adjusted prospectively by the amount of any payroll tax that was diverted into the personal account plus interest. As a result, there is no added strain on Social Security resources. In fact, the system as a whole is made better off since funds are automatically transferred from years where the system has a surplus or a relatively modest shortfall to years where the shortfall is much bigger. Properly designed, Social Security personal accounts strengthen and do not weaken the solvency and safety of the Social Security system. So, long-term——

Chairman THOMAS. Mr. Lindsey, let me indicate, since you are the first and all of you really want to put a pound-and-a-half of sugar in a one-pound bag, that hopefully, as we discuss, the other points will come out. To be fair, because I am going to hold Members to 5 minutes as much as I can, if you will kind of sum it up, the Chair would appreciate it.

Mr. LINDSEY. I will do that, sir. What I would recommend, as a personal account plan to promote savings, is that what we need is for individuals to make an additional contribution, that would be matched in a progressive way from the government revenue. The resulting accounts would buildup much more quickly, generate more earnings, and provide far more funds for retirement. The employees' contribution would not affect their Social Security defined benefit in any way, but, as in the President's plan, the Social Security system as a whole would be made whole for any diversion of existing payroll taxes. This proposal is not a carve-out. Nothing is carved out or removed from the Social Security system. The dollars allocated to personal accounts impose no additional strain on the system. This proposal is not an add-on. There is no new entitlement. In fact, adding yet another entitlement to our system would be among the worst things we could do for national saving. So, given the critical importance of saving for our Nation's future, I think this approach is the best way of promoting savings over the long run. Thank you, Mr. Chairman.

[The prepared statement of Mr. Lindsey follows:]

Statement of The Honorable Lawrence B. Lindsey, President and Chief Executive Officer, The Lindsey Group, Fairfax, Virginia

Mr. Chairman, members of the Committee, I am honored to have been asked to testify today on the issue of Social Security reform. It is surprising that the issue of promoting national saving is not at the center of the current debate over Social Security reform, and that will be the focus of my comments today.

Last year Americans spent—on consumption, investment, and government—$1.06 for every dollar they earned. We balanced our collective checkbook only by selling assets we owned and by borrowing directly from foreigners, including institutions like the People's Bank of China, to whom one might prefer not to be increasingly indebted. This borrowing is directly tied to an ever growing trend for us to consume foreign-produced goods at the expense of American production. Done right, the reform process offers enormous potential for improving our national saving rate and thus reducing the amount we will be borrowing from foreigners over the next century.

The first part of any credible Social Security reform plan is to permanently eliminate the actuarial deficit in the system. Currently the system has promised to pay out, in present value terms, $11 trillion more than it will collect in revenue. There are a number of ways of closing this gap, but with different implications for national saving.

For example, it would take a 28 percent increase in payroll taxes to make sure that the government collected all the money it needed to meet benefit promises over time. This would, if three conditions were met, temporarily increase saving. First, the government, in contrast with historical evidence, must not spend the extra revenue on non-retirement spending. Second, the adverse effects of the tax increase on the economy must not lower government revenue from non-payroll tax sources. Third, private citizens, faced with declining disposable incomes, must cover the entire shortfall from reduced consumption, not by reducing their saving.

Even if these three conditions were met, the saving reduction would be temporary. Once Social Security payments caught up with the enhanced revenue, the plan would forever be moving money from one set of people who would spend the money—workers—to another set of people who would spend the money—retirees. So, even in the best case, a tax increase would do nothing to increase national saving over the long run.

But, because these conditions are unlikely to be met, a tax hike would not produce the intended amount of increased national saving even in the short run, and would likely lower national saving in the longer run. The combined adverse effects on existing personal saving and the disincentive effects on working and on entrepreneurship, are likely significant.

This would be particularly true of ideas to raise or eliminate the wage cap that determines both Social Security taxes and Social Security benefits. Martin Feldstein calculated that eliminating the cap would reduce net federal revenue since the behavioral response by entrepreneurs to a tax hike that took their tax rate back up to nearly 50 percent would reduce federal income tax revenue as well as produce lower than expected payroll tax receipts. Moreover, much of the entrepreneurial income that would be taxed would have funded business fixed investment. Thus, this particular tax idea would likely lower both national saving and economic growth.

The second way of bringing the system into balance is to change the formula for determining benefits now, in a way that gradually reduces the current growth rate in real benefits. Currently Social Security projects a 50 percent increase in benefits, even after inflation, over the next half century. The system could be brought into balance by limiting future benefits to the level of benefits enjoyed by those retiring from the system now, while fully indexing those benefits to inflation. This could even be coupled with a generous minimum Social Security benefit, thus making the system both more progressive and providing a better safety net, with little adverse effect on national saving. The $11 trillion saving to the Social Security system of doing this could be viewed as a one-time improvement in the federal government's balance sheet of the same amount, but with an equivalent reduction for future retirees, as benefits would not rise as fast as they might now expect.

But, national saving would likely rise as a result. In order to maintain the level of consumption in retirement that the government previously promised, but could not deliver, individuals would have to gradually increase their personal saving during their working lives. This may not be easy for some folks. So, a second part of any Social Security reform that promotes national saving should include a personal account plan that helps people save and learn the benefits of saving by watching their own accounts grow.

Most personal account proposals, including the President's, would allow workers to use a portion of payroll taxes currently collected and direct them into a personal account. It has been widely noted that any shortfall to meet current benefits would be met by government borrowing, and that personal accounts that are funded by government borrowing do not raise national saving; it simply increases government borrowing to fund private saving.

But it is not widely understood that for an individual to establish an account, his or her regular Social Security benefit would be adjusted prospectively by the amount of payroll tax that is diverted into a personal account plus interest. As a result, there is no added strain on Social Security resources. In fact, the system as a whole is made better off since funds are automatically transferred from years where the system has a surplus, or a relatively modest shortfall, to years when the shortfall is much bigger. Properly designed, Social Security personal accounts strengthen, and do not weaken, the solvency and safety of the Social Security system. So, long term national saving is not harmed in any way by this approach, and is likely to be increased.

Still, the national saving opportunity of Social Security reform could be further enhanced. The best way is to allow workers to choose a plan where they would contribute more to their retirement in return for gaining ownership and a higher return on their existing payroll taxes. In effect, the government could match private contributions. Many companies successfully use this approach for their own 401(k) plans, but the Social Security match could easily be more generous.

Consider, for illustrative purposes, a plan that asked employees to contribute 1½ percent of their wages to their own personal account, with no change in their current taxes. For only a slightly higher short run budget effect than the President's proposal, Social Security could offer a four-for-one match on employee contributions made on the first $10,000 of earnings and a one-for-one match on contributions made on earnings above that amount. A worker making $10,000 would thus contribute $150 a year to his account and be matched $600 from existing payroll tax revenue—producing a $750 account. A worker making $50,000 would contribute $750 a year and be matched $1,200, producing a $1,950 personal account. The resulting accounts would build up much more quickly, generate more earnings, and provide far more funds for retirement. The employee's contribution would not affect their Social Security defined benefit in any way. But as in the President's plan, the Social Security system would be made whole for any diversion of existing payroll tax revenue.

Best of all, national saving would be enhanced unambiguously. The funds being contributed by workers would largely be net contributions to national saving. They would also involve the real attributes of ownership of capital since the worker would unequivocally have some "skin in the game." A high initial match rate would also create the right kind of incentives to change long term attitudes toward national saving, as well as being more progressive than the current Social Security system.

This proposal is not a "carve out." Nothing is carved out or removed from the Social Security system. The dollars allocated to personal accounts impose no additional strain on the Social Security system. This proposal is not an "add on." There is no new entitlement. In fact, adding yet another entitlement to our system would be among the worst things we could do for national saving.

Given the critical importance of saving to our nation's economic future, it is important to make the most of the once-in-a-generation opportunity to promote national saving offered by Social Security reform. The combination of gradual reductions in the promised rate of real increase in future benefits and a personal account system that promotes national saving—that is neither a carve out, nor an add-on—is the best approach.

Thank you.

Chairman THOMAS. Thank you, Dr. Lindsey. Mr. Pozen?

STATEMENT OF ROBERT C. POZEN, CHAIRMAN, MFS INVESTMENT MANAGEMENT, BOSTON, MASSACHUSETTS

Mr. POZEN. Thank you very much, Mr. Chairman, for this opportunity to testify. Let me begin by explaining progressive indexing, my proposal, and then I will address some issues that have been raised about that proposal. Progressive indexing divides workers into three main groups: low-wage workers, high-wage workers,

and median-wage workers. Low-wage workers would be everyone at $25,000 in average career earnings and lower; we would preserve, totally, all of their scheduled benefits. We would also preserve everyone's benefits who is in retirement or who would retire before 2012. High-wage workers would be defined as $113,000 in average career earnings and higher and we would price index their initial Social Security benefits so they would grow, but they would grow more slowly than the current schedule. Everyone in between, the median-wage workers, would receive a mix of price and wage indexing. That means that all of them would have their benefits grow by more than the Consumer Price Index, but not as much as the current schedule.

What is the rationale for this proposal? I believe that when Social Security was passed, there were no Individual Retirement Accounts (IRA) or 401(k)s; there weren't really even very many defined benefit plans. Now, in 2004 alone, the tax revenue foregone for IRAs and 401(k)s was roughly $55 billion; if we include all private retirement programs, it was $100 billion in that year alone. Most of those tax subsidies go to high-wage and to some degree middle-wage workers, and so, I believe in order to create neutral government support among wage groups, we need to do more for low-wage workers in Social Security. Very few of them have retirement programs like 401(k)s or IRAs and they are totally dependent on Social Security.

There are three main questions that have been raised. Also, there are technical questions that I deal with in my testimony. One is, some people say, "it is nice that you protect the low-wage worker, but what about the middle-wage worker?" At $25,000 in career earnings, that constitutes roughly 30 percent of all workers who retire in the United States. If we look at the median-wage worker, I think it is really too easy a criticism, and, I think, an unfair criticism to say that those people are going to get less than scheduled benefits. If we have a large deficit and we protect low-wage workers, we are going to have to grow Social Security benefits slower for someone. If we look at the median-wage worker in 2045, then yes, it is true that person would get, under progressive indexing, 16 percent less than the schedule of benefits. However, if the system is not subject to a major reform, there would be an automatic, across-the-board, cut in 2042 and that person would suffer a 27 percent decrease in benefits. So, we really need to think about any "cut" relative to that 27 percent decrease. Another criterion is purchasing power. In 2045 under progressive indexing, the median worker would be looking at a 20-percent increase in the purchasing power of their Social Security benefits relative to today. So, yes, there is a reduction from the schedule, but it is actually much less than if the system defaulted, and, most importantly, for almost all workers under progressive indexing, they would get a substantial increase in purchasing power.

Second, people say that they would like to have milder reductions from the schedule in the middle-wage workers, and I think that is a fair point. It is a political point that you will have to address. I think we have to just be realistic about what are the other alternatives. I suggested in my testimony that you could have a milder version of progressive indexing if Congress were willing to

do something on the retirement age and I suggested, for instance, between the years 2055 and 2079, you could move the retirement age back gradually from 67 to 69. That would be consistent with longevity expectations and it would allow you to put less freight on progressive indexing. We also know that people have suggested increases in payroll taxes, bringing more revenue into the system. Again, I think it is something that can be seriously considered, but people need to be realistic about how much you could get from various payroll tax increases. For example, if by 2012, the year progressive indexing begins, if we were to raise the payroll tax base from $90,000 to $150,000 and apply 12.4 percent to that increment, that closes roughly one-quarter of the deficit of Social Security. So, we would still have to do a substantial amount of work on the benefits side. I believe that such an increase in the base from $90,000 to $150,000 is unfair to the workers in that wage group and that a fairer way to proceed would be to have a much lower rate, like 2.9 percent, and have that applied from $90,000 all the way up to include all earnings, roughly on the Medicare model. Again though, that would only reduce the long-term deficit by about a quarter. So, we have to get realistic; even if we bring more revenue into the system, which some Members want to do, we still would have to combine that with some benefit constraints.

The third issue, and it is clearly the most controversial issue, as a number of Congressmen have made clear, is the personal account. I have shown in a number of papers how progressive indexing could be combined with a 2 percent account along the lines of what the President has suggested. However, I want to make clear—and I have tried to in my testimony—that progressive indexing can stand alone. It alone closes 70 percent of the long-term deficit of Social Security, going from $3.8 trillion to $1.1 trillion, or it can be combined with various sorts of personal accounts. I strongly believe that it is useful as part of a package to have personal accounts because it is very difficult to say to people that we are just going to have some benefit constraints and some payroll tax increases. I think we need to be creative in thinking about the personal accounts. I know Chairman Thomas has suggested that we broaden the discussion and I have tried to suggest a number of ideas. We could have, basically, enhancements to IRAs if we are going to slow the growth of benefits for median and higher workers. We could take the cap off the Roth IRA. That would be a measure that would match with slowing the growth of benefits of high-wage workers. We could also increase the low-income tax credits that are now available for people with income below $30,000 or $35,000 per year. We could expand these credits to help the median workers.

Last, I would say that we can take this idea of a 2.9 percent surcharge above the base and we could think of it in two parts. We could think of the 1.45 percent from employees going toward solvency and the other 1.45 percent from employees as being actually something similar to what Larry Lindsey just suggested, as sort of a presumptive enrollment in IRAs so that 1.45 percent could go into an IRA. If people didn't want to enroll in an IRA, if workers didn't want to do this, they could opt-out. So, you could think of an IRA approach as applying to a part of the payroll tax a sur-

charge above the $90,000 base, and you could also think of a similar approach applied to all workers. All workers could have 1.45 percent of their wages presumptively put into an IRA, but if they didn't want to do that, they could opt-out. This would be a way in which we could encourage retirement savings, get over the inertia that a lot of people have in saving for retirement, and help buildup these other sources of retirement income if, as I think we will have to come to grips with, we are going to have to slow down the growth of Social Security benefits somewhat. Thank you very much, Mr. Chairman.

Chairman THOMAS. Thank you, Mr. Pozen. I indicated I would try not to interrupt witness, so I didn't do so and cut you off.

Mr. POZEN. I appreciate that.

[The prepared statement of Mr. Pozen follows:]

Statement of Robert C. Pozen, Chairman, MFS Investment Management, Boston, Massachusetts

Mr. Chairman and Committee Members:

Thank you for this opportunity to testify before the Committee on Ways and Means. I strongly support the Committee's efforts to reach a bipartisan consensus on solvency for Social Security. We must first address solvency and then focus on what type of personal accounts (including add-on as well as carve-out accounts) might be appropriate as part of a legislative package.

Our best chance of developing a viable legislative package is to link Social Security reform with enhancements to private retirement accounts, such as the 401(k) plan and the individual retirement account (IRA). In the past, Social Security and private retirement plans have been treated as separate legislative subjects; yet these are two sources of retirement income that are considered together by most workers. In 1933 when Social Security began, the 401(k) plan and IRA were unknown; today, these programs play an important role in helping to provide retirement security. So today we should evaluate the Social Security system in light of the existing incentives for private retirement programs, and we should consider possible expansions of these programs in connection with any Social Security reforms.

In this testimony, I will first explain progressive indexing and respond to a few early observations about the proposal; second, evaluate the impact of progressive indexing on the middle class viewed from different perspectives; third, outline several alternatives for adding revenue to Social Security in connection with milder benefit reforms; and fourth, discuss a few approaches to increasing retirement income by enhancing different types of personal accounts.

I. *Summary of Progressive Indexing*

Progressive indexing is a strategy to move toward Social Security solvency (with or without personal accounts) by reducing its long-term deficit from a present value of $3.8 trillion to $1.1 trillion. In general, progressive indexing would change the formulas for computing initial Social Security benefits at retirement for different groups of earners. In specific, progressive indexing would divide earners into three main groups as of 2012 (when progressive indexing begins): low earners with average career earnings of $25,000 per year and lower; high earners with average career earnings of $113,000 per year and higher; and, middle earners with average career earnings between $25,000 and $113,000 per year.

Under progressive indexing, all low-wage earners (as well as all those retiring before 2012) would receive the current schedule of initial Social Security benefits—which increases average career earnings by the rate that American wages have risen over their working careers. By contrast, under progressive indexing, all high-wage earners would receive initial Social Security benefits that grow more slowly than the current schedule because their average career earnings would be increased by the rate at which prices have risen over their working careers. The initial Social Security benefits of median-wage workers would be increased by a proportional blend of price and wage indexing.

The rationale for progressive indexing is simple. Low-wage workers are almost entirely dependent on Social Security benefits for retirement income; they have minimal participation in 401(k) plans and IRAs. On the other hand, almost all high-wage workers as well as most middle-wage workers do participate in private retire-

ment plans. In 2004, the federal tax revenues forgone for 401(k) plans and IRAs were $55 billion.

Several technical concerns about progressive indexing have been raised. First, it has been observed that a flat benefit would result if progressive indexing were continued into the 22nd century. My proposal for progressive indexing runs until 2079, the end of the conventional period for measuring system solvency, at which time the benefits of the top-paid workers would still be 20% higher than the benefits of low-wage earners.

Second, some have questioned whether wages will continue to rise on average 1.1% faster than prices over the next century, as they have over the last century. This concern can be met by applying to the initial Social Security benefits of the top earners an index designed to reflect the historic difference between wage and price growth—for instance, the average annual increase in wages over their careers, minus 1.1% per year.

Third, the argument has been made that progressive indexing is not progressive since its benefit reductions would constitute only a small fraction of the pre-retirement income of a millionaire. In fact, the reductions in Social Security benefits for a maximum earner would be significantly larger, in both dollar and percentage terms, than those of a median-wage worker under progressive indexing. These larger benefit reductions are justifiable precisely because they constitute only a small fraction of the income of any millionaire before or after retirement.

II. *Impact on Median Workers*

Others have expressed a more substantive concern about the impact of progressive indexing on the median-wage worker, who will earn $47,000 in 2012 ($36,500 in 2005). It has been noted that such a worker retiring at age 65 in 2045 would receive 16% less under progressive indexing than scheduled benefits—$16,417 rather than $19,544 (in 2004 constant dollars). Is this reduction from the schedule a "benefit cut"? The schedule represents the benefits we have promised but do not have the money to deliver—this is why the long-term deficit of Social Security has a present value of $3.8 trillion. If the test of a politically viable reform plan is not reducing scheduled benefits for median-wage workers as well as for low-wage workers, then every politically viable plan to restore Social Security will fail.

One relevant criterion is how a reduction in scheduled benefits compares to the reduction that would occur if the Social Security system goes into default. If Congress does not enact Social Security reform of a major nature, the system will default in 2041 and benefit levels will automatically be reduced by roughly 27% for all workers in 2045. Thus, judged relative to payable benefits, the $16,417 received by the median-wage worker in 2045 would actually be an increase in benefits—$2,150 more than the $14,267 that the system can afford to pay in 2045 absent major reforms (in constant 2004 dollars).

A second relevant criterion is whether that $16,417 received by the median-wage worker in 2045 under progressive indexing constitutes an increase or decrease in purchasing power relative to today's benefits for a similarly placed worker. That worker in 2045 would receive a 14% increase in purchasing power as compared to a similar worker today—from $14,384 in 2005 to $16,417 in 2045 (expressed in 2004 constant dollars). In other words, median workers would be able to buy 14% more goods and services with their monthly checks from Social Security under progressive indexing in 2045 than they can buy with these checks today.

A third criterion is the impact of Social Security reform on replacement ratios—the percentage of pre-retirement earnings replaced by post-retirement benefits. Under the current schedule for Social Security, the replacement rate would be 36% for a median-wage worker retiring at age 65 in 2045; under progressive indexing, the replacement rate for that same worker would decline to 30%. However, the above replacement rates do not include any post-retirement income from private retirement plans like the 401(k) and IRA. A majority of median-wage workers already participate in such plans, and I would strongly support legislative measures to enhance participation rates for median-wage workers.

III. *Increases in Payroll Taxes*

Notwithstanding the above evaluations of the proposal for progressive indexing under alternative criteria, if Congress concludes that the reductions from scheduled benefits for median-wage workers are too large under the proposal, these can be softened by modifying the bend points and PIA factors utilized by the actuaries to implement the proposal. In that event, Congress could restore Social Security to solvency by adopting other benefit reforms (such as moving back the normal retirement age from 67 to 69 between 2055 and 2079), or by increasing revenue flow into the system. With regard to the latter approach, it may be helpful to calibrate the

differential impact of various possible increases in payroll taxes on the system's solvency.

As you are aware, the payroll tax rate of 12.4% currently applies to all earnings up to $90,000 per year. Should Congress decide to close the whole long-term deficit of Social Security through payroll taxes, it would have to extend this 12.4% rate to all earnings (assuming minimal retirement benefits were paid in connection with these new payroll taxes). Thus, attaining solvency for Social Security in this manner would require one of the largest tax increases in American history for all workers with earnings above $90,000 per year.

Since such a huge extension of payroll taxes at 12.4% to all earnings does not appear to be politically viable, some commentators have suggested that the 12.4% rate be levied on all earnings up to $130,000 per year in today's dollars—which would automatically rise under current law to $150,000 per year by 2012. Yet even such a sharp jump in the earnings base subject to a 12.4% tax rate would close only one-fourth of the long-term deficit of Social Security. Moreover, this type of extension would be very unfair to those workers earning between $90,000 and $200,000 per year. Most of their earnings would be subjected to the 12.4% payroll tax, while most of the earnings of millionaires would escape this tax.

If Congress chose to raise payroll taxes as part of a reform package, a more workable structure would be a surcharge of 2.9% on all earnings above $90,000—loosely based on the model of the Medicare tax. This structure would more fairly spread the burden among all high-wage earners, and would have roughly the same solvency impact as applying a 12.4% tax rate to all earnings up to $130,000 per year in 2005. In both cases, the long-term deficit of Social Security would be cut by only one-fourth. Therefore, significant constraints on benefit growth would still be needed in order for the system to become solvent later this century.

IV. *Types of Personal Accounts*

Progressive indexing can stand alone as a strategy to move toward Social Security solvency, or it can be combined with various types of personal accounts. In this context, personal accounts can play two useful roles. First, they can increase the retirement income of workers, especially those who would experience slower growth in their Social Security benefits under progressive indexing. Second, they can provide a political "sweetener" to a legislative package otherwise containing benefit constraints and tax hikes.

A. Carve-out Accounts

Since progressive indexing would slow the growth of Social Security benefits for some workers, it could be combined with a personal retirement account (PRA) involving a voluntary allocation of a modest portion (such as 2% of earnings) of the 12.4% in payroll taxes. Any worker who made such an allocation to a PRA would have to accept lower traditional Social Security benefits since he or she would be paying in lower amounts to the traditional system and receiving the returns on his or her PRA in addition to traditional benefits. These lower traditional benefits should be calculated using an offset rate that is the same as the actual real rate of return on 30-year U.S. Treasury bonds, rather than an artificially selected rate such as a 3% real return. A PRA would have an excellent chance of providing a higher return than this actual real rate of return by investing consistently in a low-cost balanced account, comprised 60% of an equity index fund and 40% of a bond index fund, throughout the 30 to 35 years of someone's working life.

Some have expressed concern that carve-out PRAs would not improve the solvency of the Social Security system and would increase government borrowing. However, as calculated by the Social Security actuaries, a combination of progressive indexing and a carve-out PRA with an allocation of 2% of earnings (limited to $3,000 per year with the limit indexed to prices) would make Social Security solvent by the end of 2079. No government borrowing would be needed until 2030 to finance this combination, and such borrowing would be completed before 2079. Moreover, the government borrowing needed to finance this combination would be $2 trillion less than the government borrowing needed to finance the current schedule of Social Security benefits through 2079.

B. Add-on Accounts

For those who oppose carve-out PRAs, progressive indexing could be combined with various forms of add-on accounts in a legislative package. It bears emphasis that add-on accounts themselves would not make Social Security solvent and would increase the budget deficit. However, a combination of progressive indexing and modest expenditures for add-on accounts could be designed to substantially improve the solvency of Social Security. Instead of creating a new set of add-on accounts,

Congress should enhance the existing structure of IRAs in order to promote more retirement savings in the most efficient manner.

One suggestion would be to transform the low-income tax credit for IRA contributions into a partially refundable tax credit. This would make the tax credit more effective for families with incomes below $40,000 per year, who often do not pay federal income taxes. Another suggestion would be to remove the income ceiling from the Roth IRA, which currently starts to phase out for families with incomes of more than $120,000 per year. Removing the income ceiling would be a political quid-pro-quo for high-wage earners with the slowest growth of Social Security benefits under progressive indexing. Yet another suggestion would be to allow all taxpayers to earmark a portion of any federal income tax refund for investment in an IRA. This would be a low-cost way to encourage retirement savings.

C. Opt-out Accounts

As mentioned above, if Congress chose to raise the payroll tax base, the fairest approach would be to impose a 2.9% surtax on all wages above $90,000 per year. Under this approach, what kind of retirement benefits should be associated with such a surtax? One possibility would be to dedicate the 1.45% of the surtax that would be paid by employers to improving Social Security solvency (worth about 0.25% of payroll), and allocate the 1.45% paid by the workers to a personal account invested in market securities. Since the allocation of this 1.45% would not divert existing payroll taxes from Social Security, the funding of these personal accounts would not involve incremental borrowing by the federal government. But such a personal account would effectively impose a mandatory IRA contribution on high-wage earners. A more flexible form of this approach would be to allocate 1.45% of earnings above $90,000 to an IRA, subject to an opt—out by the worker.

If this more flexible approach were attractive to Congress, it could also be applied to workers with earnings below $90,000 per year. For example, employers could be required to presumptively allocate to an IRA 1.45% of the annual earnings of all full-time workers on the job for at least one calendar year with annual earnings of at least $24,000. This allocation would be in addition to the payroll taxes now paid by such workers, but they could opt out of the presumptive allocation of this 1.45% to an IRA simply by notifying their employer. In practice, this flexible approach would harness the forces of human inertia and tax incentives to encourage retirement savings, while allowing any worker the choice of not participating in this type of retirement program.

Conclusion

Progressive indexing provides a fair and workable foundation for legislative efforts aimed at restoring solvency to the Social Security system. Many of the observations about progressive indexing can be resolved by careful legislative drafting, and the impact of progressive indexing on median-wage workers can be softened if Congress is prepared to adopt other benefit constraints or revenue raisers. Moreover, progressive indexing can be combined with various type of personal accounts that may be helpful in enacting a legislative package of Social Security reforms and encouraging retirement savings for American workers.

Thank you again for this opportunity to testify on Social Security reform. I recognize that this subject is politically challenging for any elected official and greatly respect your efforts. I would be glad to answer any questions you might have on progressive indexing or related points discussed in this testimony.

Chairman THOMAS. Dr. Schieber, it is nice to have you with us. Thank you for your testimony.

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

Mr. SCHIEBER. Thank you very much, Mr. Chairman, Members of the Committee. In my day job, I work for a company, Watson Wyatt Worldwide, that often works with employers on the redesign of their retirement plans. In these projects, there is a tendency in many cases to move right to restructuring the plan without stepping back and thinking about the principles that are being pursued in doing so. In my prepared testimony, I actually lay out a set of

principles that you might consider. I arrived at these by considering the historical goals that have been behind the system. One thing many people do not realize is that Franklin D. Roosevelt (FDR) played an extremely active role in formulating his proposals on Social Security. One aspect of his recommendation that was most important to him was that the system be funded as benefits were accrued. He said to do otherwise would lead to massive unfunded obligations that would burden future Congresses unfairly. The original legislation called for substantial funding of the pension obligations, yet FDR's wishes were never fulfilled. Some policy makers wanted to use the accumulating trust funds to increase benefits to early recipients. Others were concerned that the accumulating trust funds were not true funding, that the money was not being saved. By the early fifties, the system was running on a pay-as-you-go basis. This issue arose again after the 1983 amendments and has arisen as the trust funds have grown to more than $1.5 trillion. Yet few people believe these assets are true pension funding.

Social Security today provides four kinds of insurance for active workers. It insures that workers who die and leave juvenile children, that their dependents will be taken care of economically, because they are no longer there to provide the means for their children's needs. No one is suggesting that this protection be significantly altered. It also insures against disability. While this program deserves careful review because it itself is underfunded, and because it is still relying on a definition of disability that is now a half-century old and because there are significant administrative problems, no one is suggesting that we eliminate this sort of protection from our system. It insures against bad labor market outcomes in that it provides relatively larger benefits to low-wage workers. This is a form of insurance that is a public good and will only be provided by government. If anything, this form of insurance should be bolstered. It also insures all of us against our own inability, or unwillingness, to begin preparing adequately for our retirement needs on a timely basis. It is this element of the system that FDR was adamantly committed to funding, and I believe he was absolutely correct in his insistence. It is here, more than any other element, that I believe our current system is badly flawed. Leaving aside whether today's trust fund is real funding, according to the Social Security actuaries, last year, the value of accrued benefits already earned under the system increased by $1 trillion more than the increase in the trust fund balances. As FDR said, this is unfair to future generations.

Some people argue that the transition costs from moving to a system that accumulates assets and allows them to be sequestered from other governmental fiscal operations will create massive transition costs. They are confusing the transition costs that we have with the current system with the costs associated with personal accounts. By the Social Security actuaries' estimates, the 75-year pay-as-you-go system is underfunded by $4 trillion in present value terms. That means we need an extra $4 trillion in assets today, or the present value of equivalent reductions in benefits or increases in taxes, in order to balance the system. We have a $4 trillion transition cost to deliver on with current law. The costs of the sort of

individual accounts that President Bush has proposed, by comparison, is trivial, as I show in Table 5 in my prepared remarks. Having studied this system for nearly a quarter of a century now, I am totally convinced that FDR was extremely prescient in anticipating our current difficulties in failing to fund this program. Having grown up in Missouri as a boy, I am particularly impressed by FDR's successor, Harry Truman, who often said that those who ignore history are condemned to repeat it. We ought not leave the next generation the problems we are now incurring because we now know that FDR was right and are paying the price for not living by the insurance principles that he demanded as the basis for Social Security. Thank you.

[The prepared statement of Mr. Schieber follows:]

Statement of Sylvester J. Schieber, Vice President, Watson Wyatt Worldwide

Mr. Chairman and members of the Subcommittee on Social Security of the Ways and Means Committee of the U.S. House of Representatives, the following is a discussion about issues I believe you should consider during 2005 in your deliberations about the future operations of our Old-Age, Survivors and Disability Insurance system—what most people in our society call Social Security. This discussion does not include a specific proposal for reform of our existing system. If you want a specific proposal, I can offer you one but there are already many proposals available including a number of them that I have helped develop over the years. Before offering you a new proposal, I would need to know what you wish to achieve with our Social Security program in the future including a set of principles that would serve as its foundation for future generations.

I have a set of principles that I offer as a starting point for discussion. The remainder of my testimony here supports these principles. In brief:

- The early survivor and disability insurance programs are term insurance and should be preserved and modified as appropriate.
- The important "safety net" or progressivity of the existing Social Security system is insurance for workers against bad labor market outcomes and should be preserved and enhanced.
- "Retirement savings" under the auspices of Social Security should be real savings and not loans to be redeemed out of our children's consumption budgets.
- We should improve equity in the structure of benefits, especially between one and two-earner couples.
- We should continue to provide a floor of protection against longevity risk by providing basic benefits in the form of annuities.
- We should improve economic efficiency in the system, especially the linkage between contributions and benefits beyond foundation levels.
- We should assure long-term solvency, not simply postpone insolvency.
- We should assure that risks borne by individual participants are diversified and at tolerable levels—including skewing financial market risks toward those who are more able to bear it.
- Administrative costs should be kept at tolerable levels.
- Finally, fixing the system soon is extremely important.

Among other things in my career, I have studied the history of our Social Security program to a somewhat greater extent than most people who will come before you. I wrote a book on Social Security in 1982 entitled, *Social Security: Perspectives on Preserving the System* published by the Employee Benefit Research Institute. In 1998, I wrote a second book on the same subject with Professor John B. Shoven of Stanford University, *The Real Deal: The History and Future of Social Security* published by Yale University Press. For the sake of full disclosure here, I advocated in both of these books that our Social Security pension system should include an element of personal accounts in its structure. I did not come to this conclusion in either of these books because of ideological reasons. I reached the conclusion because I believe that it is ultimately the only way that one of Franklin D. Roosevelt's original and deeply held goals for the system can ever be realized. I continue to believe that today and I continue to advocate that personal accounts should be part of our Social Security system because I agree with FDR's strong belief in funding pension obligations as they are earned.

In the following discussion, I touch on a number of issues that I believe are important to your deliberations. I start with FDR's statement about what our Social Security pension system was intended to achieve. I start here because I believe that FDR chose his language about this system carefully and that he deliberately meant what he said. I move on to discuss a problem that arose in the implementation of FDR's goals, a problem that many proposals today are attempting to correct. Next, I revisit the "insurance principles" that FDR espoused in his vision of the system because I believe we would benefit to a great degree by returning to them. I then take up a discussion about transition costs associated with reform of our Social Security system because I believe there is a great deal of confusion about how costs should be assigned to the rebalancing of the current system's financing versus the costs associated with individual accounts. In the final section of the discussion, I explore the differences in "carve-out," "add-on" and hybrid financing of personal accounts.

Background

In June 1934, President Roosevelt established the Committee on Economic Security (CES) to explore the way in which our society could provide "security against the hazards and vicissitudes of life," especially those associated with "unemployment and old age."[1] FDR indicated that he thought a program of "social insurance" was the way to address these problems. The CES report, although dated January 15, 1935, was not formally submitted to President Roosevelt until two days later, January 17. He transmitted it to the Congress on the latter date along with recommendations on legislation. The reason that there is a discrepancy in the dates on the CES report and its submission to the president is important in understanding FDR's intentions about the operation of our Social Security program.

President Roosevelt's submission of the Social Security proposals to Congress was not the first time that he had been involved in developing public policy to provide income security to the elderly population. While he had served as governor, New York had implemented a state assistance program for the elderly. FDR considered the patchwork of state assistance programs as only a partial solution to the problems of income insecurity among the elderly. In November 1934, he addressed an advisory committee to the CES and laid out certain tenets of the evolving legislation. He said that when signing the Old-Age Pension Act while governor of New York he had expressed the "opinion that the full solution" to the old-age-income security problem could be achieved only on the basis of "insurance principles. It takes so very much money to provide even a moderate pension for everybody, that when the funds are raised from taxation [that] a means test' must necessarily be made a condition of the grant of pensions."[2] By referring to "insurance principles" he was saying that he believed the new Social Security benefit would have to be funded in order to be viable on any grounds other than means testing.

On the afternoon of January 16, 1935, President Roosevelt was reviewing the final package that had been prepared by the CES for submission to Congress when he discovered a table in the report showing that the old-age insurance program would be running a significant deficit after 1965 that would require a government contribution over and above the payroll tax sometime later, around 1980. He immediately suspected an error in the report and summoned Secretary of Labor, Frances Perkins, and the executive director of the CES, Edwin Witte, to help sort out the matter. Upon being informed that the deficit was an element of the package as designed, FDR insisted that it had to be changed. In regard to the prospect that the old-age insurance program he was proposing would require government subsidies in the future, Frances Perkins quotes FDR as saying: "This is the same old dole under another name. It is almost dishonest to build up an accumulated deficit for the Congress of the United States to meet in 1980. We can't do that. We can't sell the United States short in 1980 any more than in 1935."[3]

FDR's statement ties back directly and consistently with his feelings at the time he had signed the old-age assistance law in New York while serving as governor when he said the full solution to the old-age problem could only be achieved through a program based on "insurance principles." It also follows from his statement to the Advisory Council the prior November when he said the old-age system had to be based on such principles. FDR clearly envisaged and intended to develop a plan that was contributory and self-supporting with an accumulation of a trust fund roughly commensurate with accruing benefit obligations.

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[1] Franklin D. Roosevelt, "Message to Congress Reviewing the Broad Objectives and Accomplishments of the Administration," June 8, 1934.

[2] Franklin D. Roosevelt, Address to the Advisory Council on the Committee on Economic Security on the Problems of Economic and Social Security, November 14, 1934.

[3] Frances Perkins, *The Roosevelt I Knew* (New York: The Viking Press, 1946), p. 294.

After the meeting between FDR, Secretary Perkins and Witte at the White House on the afternoon of January 16, the report was withdrawn from the President. Secretary Perkins set about polling the members of the CES and all agreed that the President's wishes on the funding matter were to be addressed. At the President's insistence, the offending table was taken out of the report and the package was modified to indicate that the schedules of tax rates and benefits included were merely one approach to providing old-age benefits that Congress might consider. The report was filed with the President the morning of January 17.[4]

The final provisions in the Social Security Act adopted in 1935 called for a schedule of payroll taxes to begin at a rate of 1 percent each on workers and their employers on the first $3,000 of annual earnings. The initial payroll tax rate paid by workers and their employers was to increase in half-percentage point increments every three years until it reached 3 percent of covered wages in 1949. The contributory funding was projected to be adequate so that no added government contribution would be required to finance the old-age insurance benefits. By 1980, the trust fund was projected to grow to $47 billion.[5]

Under the proposal that had been put forward by the Roosevelt Administration, the trust fund was to invest only in government bonds. For many people the thought of this accumulation, especially in the form of government bonds, was too fantastic to comprehend. At the time it was being considered, the total outstanding federal debt was only $27 billion and no one thought of the government running future deficits that could accommodate such accumulations. After all, the government had accumulated only a total of $27 billion in debt in its first 159 years of operations, and no one expected it to accumulate another $20 billion in the succeeding 45 years. Further, contemporary policymakers thought of paying down the debt after getting out of the Depression rather than seeing it grow in the future. There were a number of potential problems in the projected accumulation of the Social Security fund.

From one end of the political spectrum, the critique of the Social Security Act focused on the relative levels of benefits that would be provided through the federal Old-Age Benefits program in its early years of operations and the state administered old-age assistance programs. The funding provisions, which President Roosevelt had insisted on when the Act was under development, meant that the old-age insurance program was not going to pay significant benefits until many years into the future. From the other end of the political spectrum, the critique of the original legislation focused on the notion that a trust fund invested in government bonds is, in reality, a scheme to borrow from future generations at the expense of fiscal discipline today. This argument was summarized by Senator Arthur Vandenberg:

> The Treasury collects [a] billion in pay-roll taxes—The Treasury gets a billion in cash. It goes into the general fund—Congress then takes it out of the Treasury by appropriating a billion to the reserve—So the Social Security Board hands the billion in cash back to the Secretary of the Treasury and takes from him a special—IOU—The Secretary of the Treasury has the billion of money—He can use the billion either to retire regular Government-debt obligations in the general market or—he can apply it on his current operating deficit. As things are now going, we shall have deficits——
>
> What has happened, in plain language, is that the pay-roll taxes for this branch of social security have been used to ease the contemporary burden of the general public debt or to render painless another billion of current Government spending, while the old-age pension fund gets a promise-to-pay which another generation of our grandsons and granddaughters can wrestle with, decades hence.
>
> It is one of the slickest arrangements ever invented. It fits particularly well into the scheme of things when the Federal Government is on a perpetual spending spree. It provides a new source of current revenue, which while involving a bookkeeping debit, providentially eases the immediate burden of meeting current debts and deficits.[6]

The funding principles espoused by Franklin D. Roosevelt began to unravel as early as 1939. Because of the concerns about the implications of funding the system, President Roosevelt agreed to convene an Advisory Council to study the matter. Based on its recommendations, Congress adopted several amendments to the original 1935 legislation. Payments would begin in 1940 rather than 1942. The system

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[4] Edwin Witte, *The Development of the Social Security Act*, pp. 74–75.

[5] *Senate Report No. 628,* 74th Congress, May 13, 1935, p. 9.

[6] Arthur H. Vandenberg, "The $47,000,000,000 Blight," *The Saturday Evening Post* (April 24, 1937), vol. 209, no. 43, pp. 5–7.

would pay out benefits to spouses and other dependents of retirees or workers who died before retirement. Under the 1939 Amendments, the trust fund was projected to hold a balance of $6.9 billion in 1955 compared with $22.1 billion projected under the original legislation.[7]

During World War II, the system shifted even further away from advance funding. Although President Roosevelt had gone along with the 1939 Amendments' three-year delay in increasing the payroll tax, he opposed the subsequent delays. When Congress was considering the delay in the tax increase scheduled for January 1, 1943, FDR wrote the chairmen of the Senate Finance and House Ways and Means Committees. He argued that "a failure to allow the scheduled increase in rates to take place under present favorable circumstances would cause a real and justifiable fear that adequate funds will not be accumulated to meet the heavy obligations of the future and that the claims for benefits accruing under the present law may be jeopardized."[8] President Roosevelt vetoed the Revenue Act of 1943 because it included a delay in the payroll tax increase, but the veto was overturned. At the end of 1944, in signing H.R. 5565 which delayed the increase in the payroll tax from January 1, 1945 to January 1, 1946, the President's accompanying statement noted, "I have felt in the past and I still feel that the scheduled rate increase, which has been repeatedly postponed by Congress, should be permitted to go into effect. The long-run financial requirements of the Social Security System justified adherence to the scheduled increases."[9]

On April 12, 1945, President Roosevelt died leaving behind the Social Security program as the central foundation of the welfare state in America. By the time he died, Social Security was well on its way to operating on the pay-as-you-go financing basis. By the mid-1950s, the concept was completely abandoned.[10] After that, the program ran largely on a pure pay-as-you-go basis until the mid-1980s.

At the beginning of the 1980s, the system was facing the prospect of coming up short on regularly scheduled benefit payments. Early in 1983, Congress intervened just in time to avoid a partial default on current benefits, adopting a number of provisions to secure the program. At that time, there was absolutely no consideration of individual accounts as part of the solution. Over subsequent years, the trust fund has grown to approximately $1.7 trillion dollars. The trust funds are projected to peak at $3.6 trillion or so in 2022 in 2005 dollars ($5.7 trillion nominal that year), after which they will begin to decline.[11]

The implications and import of the accruing trust fund assets continue to be controversial. The general consensus seems to be that they do not add to national savings according to a number of empirical analyses. Several researchers have concluded that surplus revenues generated in national retirement income systems held in government bonds result in larger deficit spending in other elements of those governments' general fund accounts.[12] That conclusion is not universally embraced,[13] although the folks that dispute it have not presented comparable empirical evidence to bolster their conclusion.

Interestingly, in the political arena, this modern day debate is the same one that the Arthurs Altmeyer and Vandenberg carried on back in the 1930s. In almost the identical setting where Altmeyer and Vandenberg conducted the original debate,

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[7] *Senate Report No. 628,* 74th Congress, May 13, 1935, p. 9 and *Senate Report No. 734,* 75th Congress, 1st session, p, 17.

[8] Franklin D. Roosevelt, letter to Honorable Walter F. George, Chairman, Senate Finance Committee, and Honorable Robert L. Doughton, Chairman, House Ways and Means Committee, October 3, 1942.

[9] Franklin D. Roosevelt, Statement accompanying the signing of H.R. 5564, "An Act to fix the tax under the Federal Insurance Contributions Act, on Employer and Employees for calendar year 1945," December 16, 1944.

[10] Sylvester J. Schieber and John B. Shoven, *The Real Deal*, early chapters.

[11] *2005 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.*

[12] For example, see Kent Smetters, "Is the Social Security Trust Fund Worth Anything?" unpublished memo, The University of Pennsylvania, June, 2003; Sita Nataraj and John B. Shoven, "Has the Unified Budget Destroyed the Federal Government Trust Funds?" a paper presented at a conference sponsored by the Office of Policy, Social Security Administration and Michigan Retirement Research Consortium, Washington, D.C., 12–13 August 2004; and Barry Bosworth and Gary Burtless, "Pension Reform and Saving," a paper presented at a conference of the International Forum of the Collaboration Projects, Tokyo, Japan, 17–19 February, 2004.

[13] For example, see Henry J. Aaron, Alan S. Blinder, Alicia H. Munnell and Peter Orszag, "Perspectives on the Draft Interim Report of the President's Commission to Strengthen Social Security," (Washington, D.C.: Center on Budget and Policy Priorities and the Century Foundation, 2001); Paul Krugman, "2016 and All That," *New York Times* (July 22, 2001) p. 13; Alicia H. Munnell and R. Kent Weaver, "Social Security's False Alarm," *The Christian Science Monitor* (July 19, 2001), p. 11.

some 60 years later Senator Bob Kerrey (D–NE) and Ken Apfel, the Social Security Commissioner who served during the later years of the Clinton Administration, engaged in a parallel discussion in a Senate Finance Committee hearing. In this more recent version of the debate, Senator Kerrey summarized the conclusion that many observers have drawn over the last couple of decades:

> We are not prefunding . . . Are we holding the money in reserve someplace? We are not prefunding! The idea in 1983 was that we would prefund the baby boomers. We began to use it immediately for the expenditures of general government. We didn't prefund anything. What we are doing is asking people who get paid by the hour to shoulder a disproportionate share of deficit reduction. That's what we're doing! And the beneficiaries on the other hand, they suffer under the illusion inflicted by us very often, that they have a little savings account back here. They are just getting back what they paid in. They don't understand that it's just a transfer from people that are being taxed at 12.4 percent.[14]

Revisiting the Insurance Principles That FDR Embraced

In 1935, when President Roosevelt insisted that what he called "my Social Security program"[15] be based on insurance principles he was thinking about the program in the context of providing retirement benefits. The original law did not provide many of the sorts of protection that are included in today's system. Indeed, in signing that original law, Roosevelt spoke of the system it created as being "a cornerstone in a structure which is being built but is by no means complete."[16] Despite the fact that we have built on that cornerstone over the years, it may be worthwhile to review what FDR had in mind when he insisted that "insurance principles" be followed in the construction of Social Security.

Insurance is a mechanism whereby a group of individuals can join together to spread the risk that they each individually face in regard to some contingency that creates an economic loss for those who incur that particular "vicissitude" of life. Consider, for example, a society comprised of 1,000 households where each family lives in their own home. Assume, for simplicity, that every family's home is worth $100,000 and that each year fire strikes one family's home completely destroying it. If every family attempted to cover this risk by itself, then each year one family would be faced with a devastating $100,000 loss. On the other hand, if all of the families pooled together and each contributed $100 to a home-owners' fire insurance fund, each family would invest $100 per year to assure that no family incurred such a devastating loss.

In order to understand what should be done in reforming our Social Security system, it is important to understand what it currently does and to rationally design reforms that preserve those elements we wish to preserve and to modify those that need to be changed to secure its ongoing operation. The current Social Security provides insurance for four hazards that workers face. It provides insurance for workers:

1. Who die and leave juvenile dependents;
2. Who become disabled and can no longer earn a living;
3. Who experience bad labor market outcomes; and
4. Who suffer from the myopia that workers have about making adequate protection for their own retirement needs.

In addition, for retirees Social Security provides:

1. Longevity insurance because the benefits are paid in the form of an annuity;
2. Income protection against inflation in retirement because the annuity is indexed to account for increasing prices; and
3. Survivor benefits.

In an insurance context, the nature of risks that are insured under Social Security vary considerably from one aspect of the program to the next.

Early-survivor insurance

The early survivor program provides insurance protection against the vicissitude of workers dying and leaving juvenile children with insufficient resources to meet

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[14] Senator Robert J. Kerrey, CSPAN2 tape of Senate Finance Committee Hearing on Retirement Income Policy, August 1998.

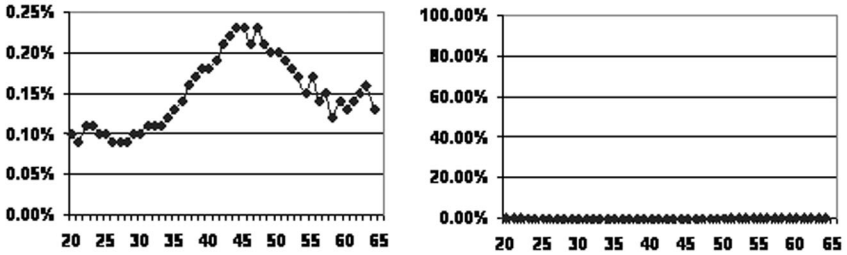
[15] Arthur M. Schlesinger, Jr., *The Age of Roosevelt: The Coming of the New Deal* (Boston: Houghton Mifflin Co., 1959), vol. 2, p. 310.

[16] Franklin D. Roosevelt, Presidential Statement at the Signing of the Social Security Act, August 14, 1935.

their economic needs. There are two factors that define the risk that workers incur in this case. One is the probability that they will die and the second is the probability that they have children. Over most of the working-age years, the probability of dying for most workers is quite low but rises gradually as workers age. In the younger years of the working career, the probability of having children under the age of 18 is relatively high but drops off significantly as people approach retirement age. To show what the exposure is here, I used the 1950 birth cohort life table from the Office of the Actuary and the incidence of individuals by age with dependent children under age 18 to derive Figure 1. The left panel shows the variation on a scale of 0.00 to 0.25 percent. It is intended to show that there is some variation in the exposure here. In no year does the line get as high as 0.25 percent meaning that in no year were there more than 2.5 people per 1,000 dying in this birth cohort and leaving juvenile children over most of their exposure period. The right panel in Figure 1 shows the same distribution on a scale of 0.00 to 100 percent. It is intended to show that the risk exposure to this particular contingency is extremely small in the overall scope of things. That is not to say that when the contingency actually strikes a family that it has a devastating effect. Indeed, this is a case a lot like our opening hypothetical example of people having house fires.

The probability of workers dying and leaving juvenile children with the need for economic support is a contingency that can be covered without significant expense to active workers. Indeed, there has been virtually no discussion of significantly modifying this element of the current system in any of the discussion about reforming it. As we look at reform options, we need to make sure that modifications made to the existing system do not result in unintended consequences in this area. There are certain public good features to the existing benefits and there are likely relative efficiencies that are realized by running them through government on a nationalized basis with mandatory participation for virtually all workers.

Figure 1: Probability of Death from One Year of Age to the Next for the 1950 Birth Cohort Times the Probability of Individuals Having Dependent Children under Age 18 in 2003



Sources: Calculated by the author from data published by the Office of the Actuary, Social Security Administration and U.S. Department of Commerce, U.S. Census Bureau, *Current Population Survey.*

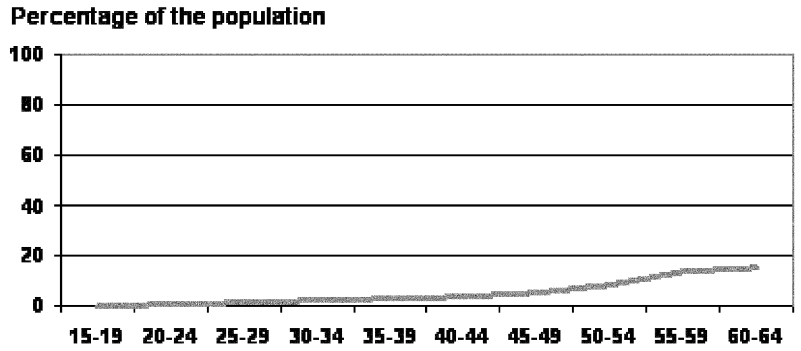
Disability insurance

The case of disability insurance provided through our existing Social Security program is similar to early-survivor benefits. The incidence of disability under the Disability Insurance (DI) program by age in 1968 is reflected in Figure 2. Once again, the DI program has not been widely discussed in the same context that reform of the retirement system has been although a number of proposals would have implicit implications on benefit levels in the program. Part of the reason that DI has not been part of the discussion is that the incidence of disability is relatively low across much of the age spectrum and the overall cost of benefits is significantly less than in the case of the old-age retirement aspects of the system. As with early-survivor benefits, there are almost certainly public good features to the existing benefits and there are likely relative efficiencies that are realized by running them through government on a nationalized basis with mandatory participation for virtually all workers.

Just because the DI system has escaped the same scrutiny as the retirement program in recent discussion about Social Security reform does not mean that the current disability program should not be included in these discussions. This element of the system is underfunded and contributes to the total underfunding in the combined systems. In addition, the determination of eligibility in the current system is tied to a concept of being unable to work that may have made sense in the mid-

twentieth century when it was postulated but makes much less sense in the "knowledge economy" of the twenty-first century. Finally, there are a variety of administrative issues that also plague the existing Disability Insurance system. The potential reform of the disability programs is an issue that should be considered outside the realm of reform to the retirement plan or basic benefit structure of Disability Insurance or any other facet of Social Security.

Figure 2: Incidence of Disability under the Social Security DI Program in 1998 by Age



Source: Office of the Actuary, Social Security Administration, "Social Security Disability Insurance Program Worker Experience," Actuarial Study No. 114, June 1999).

Insurance against bad labor market outcomes

While we have not characterized it that way, the redistributive structure of our Social Security benefit formula is the primary way we provide insurance against bad labor market outcomes. At the outset of our careers, none of us knows for sure that we will succeed. It is not hard to find many examples of people born into the most modest circumstances who go on to be dramatically successful in their careers. It is not hard to find many other examples of people who seem to set off on a career marked for success who fail miserably along the way. The element of our Social Security system that pays a relatively higher monthly benefit to people who have not been as successful in the labor market as those who have is our way of helping the less fortunate have a reasonable standard of living in their latter years.

Table 1 shows estimated internal real rates of return that will be realized by a set of prototypical Social Security program participants reaching age 65 in 2008 according to estimates developed by the Social Security actuaries. These workers are classified according to their marital and earning status and earnings levels over their working careers. If you focus on any particular column, you will see that the rate of return on lifetime contributions declines the higher up the earnings distribution that a worker ends up. This sort of "social insurance" provided by Social Security is not something that we can ever expect private insurance markets to provide. To the extent that there is a concern that people who are unsuccessful in their working careers not be forced to live out a retirement at a socially unacceptable level of living, this sort of mechanism almost certainly will have to be part of our retirement structure. Many reform proposals would maintain or strengthen this element of the current system. Part of the reason for that general support is the result of the broad dependence on Social Security for income security among the portion of the workforce at the lower end of the earnings distribution.

Table 1: Internal Real Rates of Return for Various Earnings Level Scaled Workers Who Will Turn Age 65 in 2008

Qualitative earnings level	Career average indexed Earnings [a]	Real rates of return in percentages			
		Single male (percent)	Single female (percent)	One-earner couple (percent)	Two-earner couple (percent)
Very low	$8,314	4.00	4.42	6.59	4.57
Low	14,965	2.87	3.35	5.42	3.39
Medium	33,256	1.82	2.35	4.40	2.31
High	52,624	1.18	1.74	3.73	1.64
Very high	69,418	0.57	1.19	3.25	

Source: Office of the Actuary, Social Security Administration, "Internal Real Rates of Return under the OASDI Program for Hypothetical Workers," Actuarial Note, Number 2004.5, March 2005, p. 6.
[a] Career average earnings level wage indexed to 2003.

The extent to which selected workers benefit from the insurance against bad labor market outcomes can be seen from Table 2 which shows a distribution of Social Security Primary Insurance Amounts (PIAs) for actual workers who retired in 2003 in comparison to the PIAs of the prototypical workers considered in Table 1. It is clear from this table that female workers tend to be skewed toward the lower end of the earnings distribution so they get a somewhat disproportionate share of this form of insurance provided by Social Security. While it is not reflected in the table, we know from other sources that older women in particular are at risk of living out their final years in poverty. Reform options that move the Social Security system more toward operating purely as a retirement savings system should include elements to maintain or enhance the income security protections built into the existing system for some particularly vulnerable members of our society, namely those who have not had a particularly successful working career.

Table 2: Distribution of PIAs of Actual Workers Who Retired in 2003 Relative to Prototypical Scaled Workers Developed by SSA Actuaries

Qualitative earnings level	Career average indexed earnings [a]	Percent with PIA closest to qualitative group level		
		All males (percent)	All females (percent)	Total, all workers (percent)
Very low	$8,314	9.4	34.0	20.8
Low	14,965	14.1	32.6	22.7
Medium	33,256	26.3	24.2	25.4
High	52,624	38.1	8.5	24.3
Very high	69,418	12.1	0.7	6.8

Source: Office of the Actuary, Social Security Administration, "Internal Real Rates of Return under the OASDI Program for Hypothetical Workers," Actuarial Note, Number 2004.5, March 2005, p. 3.
[a] Career average earnings level wage indexed to 2003.

There is another feature of Table 1 that policymakers ought to consider in any deliberations to modify Social Security. Earlier we looked at the columns in the table to consider the insurance feature in the system intended to protect low earners. It is also important to consider the lines in the table. One thing that is apparent when looking at the table in this fashion is the disproportionately high returns that single-earner couple participants in the system receive. This may have been an intended consequence back in the 1930s and even as recently as the 1960s and 1970s when most female spouses spent much of their prime working years as homemakers. In a modern era when the vast majority of women work outside the home during their prime working years, it is no longer clear that this characteristic is equitable especially taking into consideration that many non-employed spouses live in households where total income is relatively high. In this regard, spousal benefits may be considerably dampening the intended insurance feature of the system intended to skew benefits toward lower earners.

Another aspect of modern times that is remarkably different than when Social Security's insurance features were configured back in the 1930s, 1940s and 1950s is the prevalence of other income protection features in our retirement system. The dependence on Social Security for retirement security is not randomly distributed. That means that some types of reform have the potential to disproportionately dis-

advantage certain groups. This point can best be understood by looking at people on the cusp of retirement as James Moore and Olivia Mitchell have done.[17] Their analysis uses *Health and Retirement Study* (HRS) data. The HRS is collecting longitudinal information on a representative sample of the U.S. population between the ages of 51 and 61 in 1992. Sample members are being interviewed every two years.

Moore and Mitchell used the 1994 wave of the HRS interviews to estimate the participating households' wealth levels just as most of them were approaching retirement. They included four classes of wealth in their calculations: 1) net financial wealth, including savings accounts, investments, business assets, and non-residential real estate less outstanding debt not related to housing; 2) net housing wealth; 3) pension wealth, or the present value of employer-sponsored retirement benefits; and, 4) the present value of Social Security benefits under current law.

Table 3 has been derived from Moore and Mitchell's analysis. The wealth measure used here does not include net housing wealth because most homeowners do not sell their homes at retirement, or if they do, they tend to buy another one. This definition of wealth includes business assets and non-residential properties. We are interested in looking at the assets of these households that can be expected to generate a stream of income that can be used to finance consumption during retirement.

Table 3: Distribution of Wealth among the Near Elderly

Position in the Wealth Holding Distribution	Retirement Purchasing Power from:			
	Personal Financial Wealth (percent)	Social Security Wealth (percent)	Pension Wealth (percent)	Total Wealth (percent)
Bottom 10th	3.4	93.6	3.0	100.0
⅓ from bottom	18.1	63.4	18.5	100.0
⅔ from bottom	29.9	35.7	34.4	100.0
Top 10th	65.2	10.2	24.6	100.0

Source: James F. Moore and Mitchell, Olivia S., "Projected Retirement Wealth and Savings Adequacy," in Olivia S. Mitchell, P. Brett Hammond, and Anna M. Rappaport, eds., *Forecasting Retirement Needs and Retirement Wealth*. Philadelphia: University of Pennsylvania Press, 2000, p. 72.

Table 3 shows that the people at the bottom tenth percentile of the wealth distribution hold almost all of their wealth in the form of Social Security retirement benefits. Social Security benefits still account for almost two-thirds of total wealth for those households one-third of the way up the wealth distribution. Those two-thirds of the way up have a rough parity in their wealth holdings between their social security annuity, employer-sponsored pensions and other financial wealth. Those at the top of the wealth distribution have very limited dependence on Social Security. The point of the analysis here is to show that for many workers reaching retirement age in our society, a disproportionate portion of their wealth has been accumulated under the auspices of Social Security. For many workers, however, Social Security is a relatively small share of their retirement security portfolio. We should be mindful that rebalancing Social Security by means of across the board reductions in benefits will have a highly skewed effect on future retirees. A 20 percent across the board reduction in Social Security benefits would reduce the total retirement wealth of those at the bottom 10th of the wealth distribution in Table 12 by nearly 19 percent. For those at the top 10th of the wealth distribution, it would reduce the total retirement wealth by about 2 percent. To the extent that we might shift toward individual accounts as a portion of the national base of our retirement security system, we should be mindful of how such a change might alter the insurance protection provided to those with low lifetime earnings.

Insuring that workers make adequate provision for retirement income needs

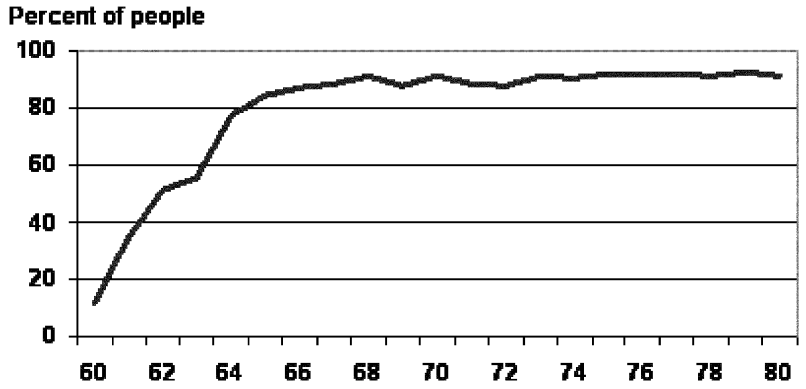
The fourth sort of worker insurance provided by Social Security is distinctly different than the first three. For the overwhelming majority of workers, the prospect of reaching an advanced age is a near certainty and retirement patterns developed during the twentieth century suggest most people will end up with a period at the end of their lives when they no longer earn a direct wage. To the extent there is

[17] James F. Moore and Mitchell, Olivia S., "Projected Retirement Wealth and Savings Adequacy," in Olivia S. Mitchell, P. Brett Hammond, and Anna M. Rappaport, eds., *Forecasting Retirement Needs and Retirement Wealth*. Philadelphia: University of Pennsylvania Press, 2000, pp. 68–94.

a public interest that elderly people maintain some minimum standard of living, it is reasonable to force people to "save" some portion of their earnings to provide for their needs when they no longer work. If we do not require that workers save, they may fail to do so on their own and become wards of the state. That was one of the most fundamental motivations for Social Security from Franklin Roosevelt's perspective.

One of the amazing achievements of the U.S. Social Security pension system is that it has succeeded so well in providing a broad base of protection for our elderly citizens. Figure 3 shows the percentage of people ages 60 to 80 who reported receiving Social Security benefits in 2003. When one takes into consideration that some 4 or 5 percent might still be in public pension plans outside of Social Security and that some simply failed to report correctly about their sources of income, it is clear the system is providing close to universal protection for those it is intended to cover.

Figure 3: Percentage of People by Age Who Reported Receiving a Social Security Benefit in 2003



Source: Author's tabulations of Current Population Survey

Given the relative certainty that most workers will get old andmost will quit working before death this element of the program deserves separate and careful consideration. If one harkens back to the example that we described at the outset the implications of the phenomenon in Figure 3 become apparent. There, we had a case where one family in a thousand had their house burn down each year causing them a catastrophic loss. In that case, the risk of such a loss could be pooled across a large number of people and everyone could be protected by small annual contributions. Now consider trying to provide this same sort of protection where houses burned with certainty at a given age and where as many as one third to one half of them burned each year. The cost of providing protection explodes with the virtual certainty of the contingency occurring for everyone and the approach for securing against this sort of loss would be significantly different than where the incidence of the problem is small.

Given FDR's fiscally conservative nature and the strong position he had taken on funding of the *social insurance* elements of the Social Security Act in 1935, he saw this legislation "as protection to future Administrations against the necessity of going deeply into debt to furnish relief to the needy."[18] We know that FDR felt strongly about the funding of "retirement" benefits when he first submitted Social Security proposals to the Congress. His statements at the time he submitted the legislation and when he signed the bill indicate a clear concern about the long-run fiscal implications of running a pay-as-you-go system. We know that he repeatedly resisted the shift toward pay-as-you-go financing of the system once it was up and in operation. When he vetoed the Revenue Act of 1943 because of its provisions that shifted away from Social Security funding toward pay-as-you-go operations, it was

[18] Franklin D. Roosevelt, Presidential Statement at the Signing of the Social Security Act, August 14, 1935.

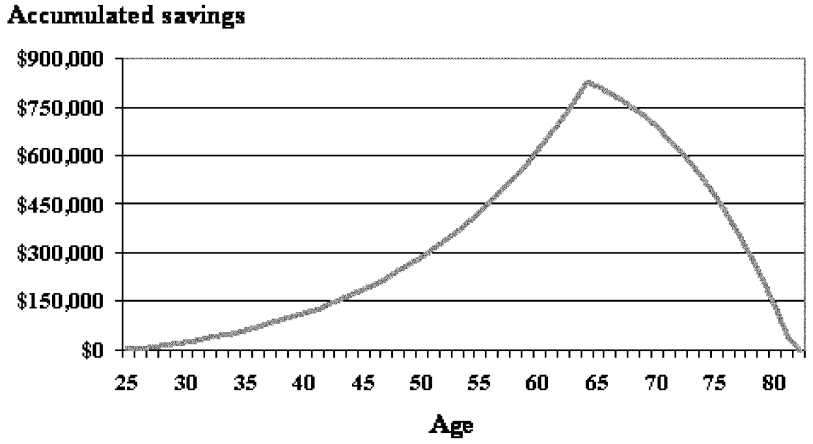
only the second bill that he had vetoed in his 10-year tenure as president at the time.

To show how alternative pension structures operate from an economic perspective, consider a theoretical worker who begins working at age 25 earning $35,000 per year and attempts to save a bit of her annual earnings to provide for income needs during retirement. Assume this individual has perfect foresight and knows that her pay will increase 4 percent per year until she reaches age 65, when she will retire and receive a pension that is 35 percent of her gross earnings in here last year of employment, a pension indexed for inflation which we assume to be 3 percent per year. To simplify the process of determining how much the worker should save, we assume she knows that she will live to be 81.5 years of age. We also assume the worker anticipates receiving an annual rate of return on his assets of 5 percent per year. At retirement, roughly 60 percent of accumulated assets are attributable to interest earned on the lifetime contributions the worker has made.

If everything goes according to plan, this worker will earn roughly $161,600 in her last year of employment. After her retirement savings are put aside, her disposable income will be approximately $135,700 that year. As it turns out, this worker will need to save 10.3 percent of her annual earnings each year in order to fulfill her work and retirement plans. If she does that, she should be able to receive an annuity of $56,550 per year, a benefit that will grow from year-to-year during retirement at the rate of price inflation. The initial benefit will be about 39 percent of her disposable income in her final year of work where disposable income is her total wage minus what she has to contribute to a pension in order to finance her retirement income.

This pattern of asset accumulation and net balances are reflected in Figure 4. Over the working period, the worker's steady saving plus interest accruing on accumulated assets gradually accelerate the growth in total assets. From a macroeconomic perspective, while the worker or the employer is contributing to the plan, these contributions are reflected as savings accruing in the economy. After retirement, the assets are steadily depleted over the worker's remaining lifetime and run out when he dies. Net savings over the worker's lifetime, in this example, are zero. Had she wished to leave a bequest to heirs, the worker would have had to save more during her working life or spend less during retirement.

Figure 4: Accumulated Savings of a Hypothetical Worker Participating in a Funded Pension Plan

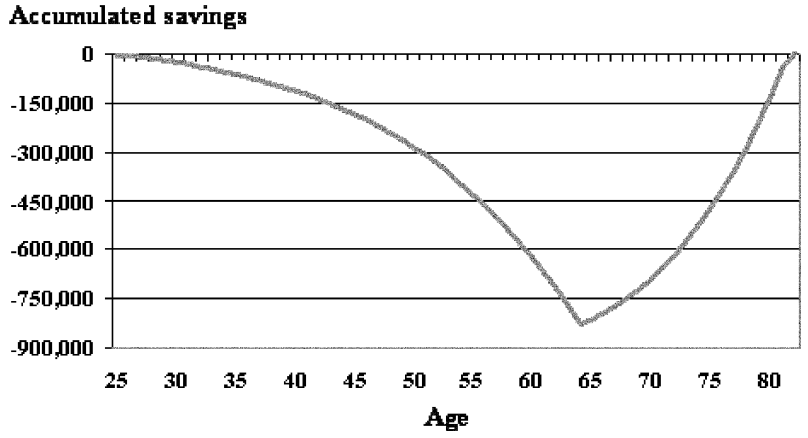


Source: Calculated by the author.

If the same worker described above is covered by a pay-go retirement plan, the dynamics of her accumulating retirement wealth are considerably different than those in a funded pension plan. First, her annual contributions to the retirement system are paid out to current retirees. Second, rather than becoming part of an accumulation of capital that can be invested in the economy, in most cases her contributions merely purchase an entitlement to a retirement benefit. In other words, it results in an unfunded obligation—what Paul Samuelson has characterized as a

"consumer loan"[19]—that future participants in the system are obligated to pay when the current worker retires. The pattern of this transaction is reflected in Figure 5, which turns out to be a mirror image of Figure 4. In this case, the worker's "accumulated savings" from the worker's perspective is the sum of the obligations she is owed. It grows on a gradually accelerating basis until the worker reaches age 65, and then is paid off over the remainder of her lifetime as annual retirement benefits. From a macroeconomic perspective, however, deducting payroll taxes from a worker's compensation may reduce his or her consumption at that time, but the benefit paid to a retiree is usually used largely for consumption purposes. Thus, it has no positive effect on net savings in the economy.

Figure 2: Accumulated Savings of a Hypothetical Worker Participating in a Pay-As-You-Go Pension Plan



Source: Calculated by the author.

From the worker's perspective, the accumulation of pension rights through a pay-go social security system is no different from accumulating wealth through personal savings or a funded pension. In the life-cycle context, the primary motivation for workers to save is to provide for their consumption after they retire.

In both the funded and pay-go pensions, the worker is deferring consumption from the working period to the retirement period. In an economic context, however, there is an important distinction between the two approaches. In the funded plan, the deferred consumption is used to purchase assets that will finance post-retirement consumption. In the pay-go plan, the deferred consumption establishes a claim on the productivity of the next generation of workers. If a significant share of their retirement consumption needs will be met by a mechanism that does not require savings, and indeed actually creates substantial liabilities, it has the potential to lower national savings rates. A funded pension system generates real savings.

In recent years, there has been a considerable debate among economists about whether our accumulating Social Security trust funds represent real savings that will help to ameliorate the burden that the baby boom generations pose on the retirement system. Looking at this discussion in the context of the comparison of funded versus pay-as-you-go financing helps to clarify the issue being debated.

Looking back to Figure 4, it is clear that a retirement plan's aggregate contribution to savings is the extent to which assets accumulate to cover its net obligations. In an aggregate context, it is not the net of the annual contributions into a trust fund minus the payout of current benefits and administrative expenses. It is the extent to which accruing obligations in the plan are covered by the assets in the plan. In the case of private pensions, actuaries are required to estimate the accrued benefit obligations at each valuation, and plan sponsors are required to report the results to the federal government. These periodic tallies of assets and obligations in plans can be used to track the contributions of the system to national savings. Along

[19] Paul A. Samuelson, "An Exact Consumption-Loan Model of Interest with or without the Social Contrivance of Money," *Journal of Political Economy* (December 1958), vol.66, pp. 467–482.

similar lines, the Social Security actuaries have calculated something they have labeled the "maximum transition cost" for that system in recent years. The actuaries report that this measure "represents the transition cost for continuing the Social Security program in a different form, with all payroll taxes for work after the valuation date credited to the new benefit form. The maximum transition cost is equivalent to the unfunded accrued obligation of plan designed to be fully advance funded at the time of plan termination."[20] Once again, the tally of assets in the system and the accruing obligations allows us to assess the net effect of Social Security on national saving.

The results of the Social Security liability calculations and funding levels are presented in Table 4. The results that are shown there are as of the beginning of each year listed in the table. The asset values actually reflect those reported by the Social Security Actuaries as of the end of the prior year but one day's income would be relatively trivial in the context of the discussion here. The table shows that trust fund assets in the Social Security system grew by nearly $1.2 trillion between the beginning of 1996 and 2005, while total obligations increased by $6.8 trillion over that same period with unfunded obligations climbing by $5.6 trillion. Some people look at the trust fund growth and conclude that, between 1996 and 2005, Social Security contributed $1.2 trillion to U.S. saving. A number of studies cited earlier suggest that this accumulation of trust funds has actually been used to hide deficit expenditures elsewhere in the federal fiscal operations.[21] Even if those dollars were accumulated to claim that they have added to national savings completely ignores the added $6.8 trillion of obligations created over the last decade for future generations of workers to finance. I strongly believe we need to find a savings mechanism to secure future benefit accruals for this sort of insurance. We need to return to the "insurance principles" that Franklin Roosevelt was advocating when he adamantly demanded that his Social Security program be funded. My own personal conclusion is that the only way we can do that is to create a system of personal accounts that are part of our Social Security program that will allow us to segregate the assets and keep them from being used to finance other government operations.

Table 4: Social Security Unfunded Accrued Obligations, Trust Fund Assets and Under Funding

	Plan obligations (billions)	Trust fund assets (billions)	System under funding (billions)
1996	$9,421.60	$496.1	−$8,925.5
1997	9,293.60	567.0	−8,726.6
1998	10,167.80	655.5	−9,512.3
1999	10,933.20	762.5	−10,170.7
2000	11,726.00	896.1	−10,829.9
2001	12,756.40	1,049.4	−11,707.0
2002	13,374.30	1,212.5	−12,161.8
2003	14,007.30	1,378.0	−12,629.3
2004	15,027.00	1,530.8	−13,496.2
2005	16,225.60	1,686.8	−14,538.8

Sources: Author's calculations of total plan obligations as sum of trust fund assets from the *2005 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* plus the unfunded accrued obligations from unpublished data from the Office of the Actuary, Social Security Administration.

Insurance protections provided in the retirement period

It is also important to consider the post retirement benefits in the current system and how they might be addressed in Social Security reform proposals. The current system provides at least three sorts of insurance protection to the retiree population. The first is longevity insurance—protection against outliving one's resources—by providing its benefits in the form of an annuity. The second form of insurance in this aspect of the system is protection against erosion against the standard of living achieved while working by providing a benefit indexed for inflation during retirement. The third form of insurance is spouse and survivor protection provided to people in annuity status.

[20] Steve Goss, Alice Wade, and Jason Schultz, *Unfunded Obligations and Transition Cost for the OASDI Program* (Baltimore, MD: Office of the Chief Actuary, Social Security Administration, 2004), Actuarial Note 2004.1, p. 3.

[21] See footnote 12 above.

One characteristic of individual accounts is the strong sentiment of ownership that develops around the accounts. This sense of ownership has the potential to be in conflict with the public interest in using the accumulated funds to provide retirement security on a broad basis. For example, if policymakers wish to assure that people achieve a level of income at least equal to the official poverty line, they may require that some portion of accumulated account balances be annuitized when a worker reaches retirement age. If policymakers do not impose an annuity requirement, some retirees will likely spend their resources prior to dying and then potentially present themselves for additional support at a cost to the public fisc—the classic moral hazard problem that often arises in situations like this. Similar concerns arise in regard to joint and survivor benefits. These issues will have to be explicitly addressed if individual accounts are part of Social Security reform.

Transaction Costs Associated with Social Security Reform

In the discussion about Social Security reform and the prospect that individual accounts might be part of it, there has been a great deal of misinformation spread about the costs associated with transition that we will incur in implementing such reforms. In understanding the dynamics of transition costs associated with reform, it is important to segment the costs associated with various aspects of any reform.

For the sake of discussion, consider the potential for reforming the current system without including any element of personal accounts as part of that reform. Each year the Social Security actuaries calculate the "open group unfunded obligation."[22] This measure is an estimate of the funding shortfall under current law to deliver benefits now scheduled over the projection period. Traditionally, the actuaries have estimated this amount over the 75-year projection period covered in their annual valuation of the program. At the beginning of 2005, they estimated the present value of this unfunded obligation to be $4.0 trillion. The interpretation of this value is that, if the trust funds held an added $4.0 trillion on January 1, 2005, then the scheduled collection of taxes over the next 75 years in combination with the trust fund balance and expected returns would cover expected expenditures over the period.

So, we face a $4.0 trillion transition cost under current law no matter what we do with the program. Under law, the program does not have deficit spending authority, so benefits over the projection period must be fully financed through program revenues and assets. In other words, to comply with the law over the next 75 years, we must come up with an additional $4.0 trillion in new revenues in 2004 dollars, cut scheduled benefits by that amount or some combination of the two.

In the 2005 annual trustees' report on the Social Security system, the open group unfunded liability was also calculated for an "infinite" time frame. The estimate in this case was $11.1 trillion. This estimate has come under considerable criticism in some circles, although it was included in the annual report at the Trustees' insistence. The problem is that our demographics today are far more favorable than they will be in the future. That being the case, calculating adequate financing for the 75-year valuation period was different last year than it is this year. The basic valuation released in early 2004 covered the period 2004 through 2078, and the one released in April 2005 covers the period 2005 through 2079. Last year's valuation included 2004 and this year's valuation did not. This year's valuation includes 2079 and last year's did not. In terms of the actual calculations of the funding status of the program, 2004 was a good year because revenues exceeded expenditures, but in 2079, anticipated expenditures will significantly exceed revenues. If policymakers devise a reform that balances the program's finances over the current 75-year valuation period, it will be out of balance again next year because of this limited time period focus.

In 1983, policymakers adopted policies they believed would fully finance the program over the 75-year valuation period. But lo and behold! We are once again confronting a program that is underfinanced, and a substantial share of the shortfall is due to the passage of time and the difference in valuation periods. This is why many policy analysts have advocated that we consider policy options that will provide financing stability well beyond the fixed valuation period. One way of measuring whether a particular adjustment to the program will deal with the long-term underfunding is to look at the infinite period. An alternative way is to focus on

[22] The actuaries make a distinction here between the phrase "unfunded obligation," which is the focus of their calculation, as opposed to "unfunded liability," which is the measure often calculated for underfunded employer-sponsored pensions covered under the Employee Retirement Income Security Act (ERISA). They note that the obligations under ERISA plans are contractual in nature but that is not the case with Social Security since Congress has retained the right to modify the plan in the future, including by cutting benefits accrued under existing law.

whether a particular adjustment results in sufficient financing to get through the traditional 75-year valuation period in a way that there is a substantial trust fund balance at the end of the projection period and that projected net income to the system at that time will be in relatively close balance to projected expenditures.

Financing the transition costs embedded in current law

The most straightforward way to finance our way out of a $4.0 trillion pension hole reflected by the unfunded obligations from an "ongoing" perspective might appear to be either increasing contributions to the plan by that amount over some reasonable period, reducing benefits by that amount or some combination of the two. Proposals to accomplish any one of these options in the context of the current plan structure should be relatively transparent in terms of revealing how the transition costs will affect various segments of the population.

We could simply raise the payroll tax rate starting virtually immediately by something around 1.9 percent of payroll. This would bring in approximately $4.0 trillion over the next 75 years in current present value terms, theoretically solving the financing problem for the formal 75-year valuation period. But it would not resolve the structural weaknesses in the system in the out years, and 15 or 20 years down the road, the program would likely be facing as big a problem as it is today. It would also lead to an even larger accumulation of trust fund assets over the next two or three decades than is now projected under current law. Given that we have never been able to find an effective way to actually "save" these trust fund accumulations, I do not believe this approach will actually help us solve the current financing problems.

An alternative to raising the payroll tax rate would be to eliminate the cap on covered earnings against which payroll taxes are assessed. This would represent a significant deviation from the underlying philosophy that has been the foundation of the program since its conception and initial passage in the 1930s. Specifically, the system has always based benefits on the range of earnings covered under the payroll tax with the understanding that it made little sense to provide the foundation benefit intended under Social Security all the way to the top end of the earnings distribution. If we are simply going to take the cap off of earnings covered under the system without providing a commensurate increase in benefits to high earners, we will be converting the program into a welfare transfer program. To quote Franklin Roosevelt, the program would simply be the "dole under another name." He never intended it to be that and it will likely lose further support if that is what it is to become. If we intend to move in that direction, then one must ask why we would want to finance it simply by taxing high wage earners and not include general tax revenues from all people with high incomes. While there may be resistance to completely eliminating the cap on earnings covered under the payroll tax, some proposals would significantly increase the tax cap or apply a partial tax on up the earnings distribution.[23]

Another option for covering the costs of retaining the existing program is to reduce benefits. President Bush and most other advocates of reform have established principles that would largely concentrate any benefit reductions on future retirees. The one potential exception to this generally accepted guiding principle is the occasional suggestion that the consumer price index (CPI) be modestly adjusted to correct for what many economists believe is a tendency to overstate the rate of price inflation. The more likely mechanisms for reducing benefits would be to adjust the current benefit formula in some way or to raise the age(s) for benefit eligibility under the program. Once again, without an effective way to actually "save" the resulting trust fund accumulations, I do not believe this approach will actually help us solve the current financing problems.

Finding a way to partially fund Social Security obligations

An Italian proverb says: "If a man deceives me once, shame on him. If he deceives me twice, shame on me." In 1982, after my earlier reading of Social Security's history and the difficulties of funding pension obligations as they accrued in the fashion that Franklin Roosevelt wanted, I proposed transferring trust fund accumulations projected for the baby boomers' working careers into individual accounts. Further, I proposed that these accounts remain locked until workers reached retirement age, at which point the benefits would offset a portion of the benefits from the traditional Social Security pension.[24] We did not institute such accounts when we

[23] Peter A. Diamond and Peter R. Orszag, *Saving Social Security: A Balanced Approach* (Washington, DC: Brookings Institution Press, 2004).

[24] Sylvester J. Schieber, *Social Security: Perspectives on Preserving the System* (Washington, DC: Employee Benefit Research Institute, 1982), pp. 259–261.

amended Social Security in 1983 nor did we seriously consider them. In the intervening period, we have accumulated a trust fund that is estimated to be at $1.7 trillion today but we have not changed the fundamental pay-as-you-go nature of the foundation to our national retirement system. If we insist on ignoring history, we will once again be condemned to repeating it.

Unquestionably, we could craft legislation tomorrow that would mathematically rebalance Social Security within the program's existing framework. But balancing the system in its current configuration would build up a much larger trust fund without doing anything to ensure that accumulations would be saved rather than squandered this time around. My objection to these approaches is that history has proven that we cannot actually save these trust fund accumulations to pay retirement costs down the road. What's the point of pursuing approaches that will do nothing to resolve the basic dilemma?

The Road to Accounts: Carve Out's, Add-On's and Hybrid Approaches

There has been a great deal of discussion about the costs associated with creating personal accounts in the context of Social Security reform. Once again, I believe that the discussion has added little illumination to the policy matters that need to be addressed in reforming the system. Part of the problem is the use of the terms "carve out" and "add on" do not precisely describe what is often being accomplished under various proposals.

President Bush's general framework for financing individual accounts has generally been described as a "carve out" from the existing system. Indeed, his critics suggest that financing the benefits in the way he proposes to do so would cost trillions of dollars over the next decade or two. I believe that this assertion is confusing the transition costs associated with rebalancing the current system that the President proposes with the costs associated with creating the individual accounts themselves.

In the earlier discussion about dealing with the transition costs associated with rebalancing the current system, we looked at those transition costs without considering the implications of individual accounts. Now to understand the implications of establishing individual accounts, it is important to look at them in isolation. To the extent we are concerned about interaction effects, we can come back and consider them later.

Assume for the sake of discussion that we have a worker at age 55 direct $1,000 of his payroll taxes into the sort of individual account that President Bush has suggested. Table 5 sorts out how this $1,000 will be treated under two alternative scenarios. In both scenarios, I assume that the worker retires at age 65. For the sake of developing this example, I have assumed there is no inflation. Adding it would change the numbers but not the substance of the outcome. Under the president's proposal, at retirement, this worker would have his Social Security benefit determined under whatever benefit formula applies at that particular point in time. The lifetime value of his Social Security annuity would be reduced by $1,343.92 based on the accumulated value of the $1,000 he had withdrawn from Social Security at age 55—that is, $1,000 compounded at 3 percent per annum over 10 years.

Table 5: Benefit Dynamics Associated with Personal Accounts in President Bush's Social Security Reform Recommendations

Social Security lifetime benefit reduced by:	
$1,000 compounded at 3 percent per annum from the time of deposit to retirement date	$1,343.92
Case 1:	
Individual account value assuming 5 percent compounded annual return	$1,628.89
Segment of individual account that is required to be annuitized at retirement	$1,343.92
Retiree has extra lump sum of	$284.97
Case 2:	
Individual account value assuming 1 percent compounded annual return	$1,104.62
Segment of individual account that is required to be annuitized at retirement	$1,104.62
Retiree realizes benefit loss of	($239.30)

Source: Derived by the author.

In Case 1, we assume that the worker has received annual returns of 5 percent per year on his account. Under this assumption, the account would accumulate to $1,628.89 by the time he reaches age 65. Under the president's proposal, the worker would be required to annuitize $1,343.92 of that to replace the withdrawal he or she had made at age 55. The extra $284.97 that is left after the required

annuitization would be left for the worker to dispose of as he or she saw fit. As I look at this example, I do not see that there is any cost associated with this transaction. Instead of characterizing this approach as a "carve out," it would be more appropriate to characterize it as a diversion of the payroll tax. This individual has simply carried out an asset swap in his retirement portfolio, moving from a share of his retirement assets held in the form of Social Security accumulations to that share being held in an alternative form of financial asset. In this particular case, the extra $284.97 would be the return for undertaking this swap. Some analysts contend that we cannot consider this $284.97 a benefit from modifying the current system because the worker has taken on added risk in investing in assets in the financial markets.[25]

In Case 2, I assumed that the individual received only a 1 percent annual return per year on his investment in assets in his personal account. At retirement, his $1,000 has accumulated to only $1,104.62 and he would be required to annuitize the whole amount. Since this is less than the annuity reduction to his Social Security benefit of $1,343.92, this worker would end up with $293.30 in reduced lifetime benefits under the modified system relative to staying completely in the central defined benefit system. In this case, the worker incurs a benefit reduction because he has decided to put a portion of his payroll taxes in the financial markets. President Bush's proposal would seek to minimize this sort of loss by requiring that workers invest in broad index funds and that they move toward fixed income investments as they approach retirement age.

In the aggregate, I believe the added benefits associated with this sort of system would outstrip the losses but there is a concern about the distribution of gains and losses that policymakers should consider in constructing a complete reform package. No matter which of these two outcomes were to play out, to attribute the diversion of $1,000 from the Social Security fund to the personal account as a $1,000 transition cost associated with the reform of the system is wrong. Substantial numbers of workers would definitely benefit by participating in this sort of system. Even for those who realize a loss, that loss would be relatively minor to the overall size of the diversion of assets from the Social Security fund to their personal account.

Another issue that has been somewhat controversial in considering the diversion of payroll taxes to finance personal accounts is the prospect that that it will exacerbate the expected cash-flow shortfall in Social Security financing in the transition period. When commentators suggest that introducing individual accounts as part of Social Security reform will incur massive amounts of new debt, they generally do not consider the net ramifications of reform on the system. The principles that President George W. Bush has stipulated for reform have frequently led to this criticism.

President Bush has said that he wants individual accounts for younger workers but that he opposes benefit reductions for current retirees or those close to retirement age. He has also said that he opposes new taxes. Some prognosticators look at this combination of principles and conclude that individual account financing has to come out of the current revenue stream supporting the system. They contend that a system that is already under funded cannot sustain an even further drain on revenues to finance the individual accounts. While that may prove to be true, the principles also imply that modifications on the benefit side of the current system will reduce revenue requirements over the long term. In an economic sense, using a government bond to temporarily finance a shift in the structure of financing Social Security so as to reduce "statutory obligations" by an amount at least equivalent to the bond amount does not create a cost. Once again, it is simply a swap of one sort of obligation for another.

Using government bonds to help finance the transformation of Social Security may create larger federal budget deficits in the near term than would exist under current policy, even if the transformation eliminates the long-term financing shortfall. This is because we do not account for Social Security obligations on an accrual basis, and issuing bonds would formally recognize obligations that are not recognized in the budgetary process today. It is not clear how financial markets might react. In one highly publicized private case a couple of years ago, a company issued billions of dollars of corporate bonds to raise the funds to cover unfunded pension obligations, and the financial markets seemed to recognize that the borrower was simply swapping one sort of obligation for another without any real financial implications. It is not clear that the financial markets or the public would react any differently if the federal government did exactly the same thing in restructuring Social Security.

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[25] Peter A. Diamond and Peter R. Orszag, *Saving Social Security: A Balanced Approach* (Washington, D.C.: Brookings Institution Press, 2004)

Some policymakers and analysts argue that instead of having the sort of transaction that President Bush has proposed, we should have "add-on" financing of the personal accounts. This implies that new monies would be found to finance the accounts. President Clinton actually proposed the establishment of USA accounts outside the scope of Social Security to give low-wage earners a mechanism to accumulate personal account wealth. He proposed that these accounts be financed out of general revenues. A number of Social Security reform proposals would use "add-on" funds to create personal accounts within the scope of a reformed system. In most cases, these proposals would use money from general revenues to help finance the accounts. Personally, I am skeptical about such proposals because of the paucity of spare general revenues for as far as my eyes will allow me to see.

I personally have been associated with two reform proposals that would require new contributions on covered earnings as a part of the transition to a system that includes personal accounts. Under these proposals, a portion of the current payroll tax would also be diverted to the personal accounts. In that regard, such proposals might be characterized as a hybrid to the proposals that might depend on financing personal accounts through one mechanism or the other. The reason that I favor some new money to help finance the individual accounts is because I believe our retirement system generally is underfunded. The creation of personal accounts alone under the auspices of Social Security will not sufficiently ameliorate our savings shortfall. I also believe that the added contributions should be mandatory because there are individuals all across the earnings spectrum who are saving inadequately to meet their future retirement income needs. Possibly my biggest problem with the suggestion that we can tap general revenues to finance individual accounts is that I was born and raised in the Show Me State. Someone is going to have to show me the source of the significant general revenues that will be required to solve this problem.

A number of interesting opportunities to address a myriad of concerns present themselves when new money is introduced into the system. First among these is that the saving shortfall for workers who are not adequately saving for their retirement today can be ameliorated. Second, it gives policymakers greater opportunities to create meaningful personal accounts while maintaining the desirable insurance features in the current system. Third, it provides an opportunity to solve the current system's financing problems without having to intrude on any other revenue sources to get through the necessary transitions from the current system to the new one. Even to the extent there is some transition borrowing that might be required in this sort of reform, that borrowing could be financed completely with a temporary requirement that a portion of workers' personal account balances be invested in temporary transition bonds that would gradually be paid off over a 30 or 40 year period.

The analysis, conclusions and recommendations presented here are the authors and do not necessarily represent those of Watson Wyatt Worldwide or any of its other associates.

Chairman THOMAS. Thank you very much. Eugene Steuerle, welcome back. I hope you and Mr. Apfel like the paint job. We have redone the room since you folks were with us, but nice to see you and we look forward to your testimony.

STATEMENT OF C. EUGENE STEUERLE, SENIOR FELLOW, URBAN INSTITUTE

Mr. STEUERLE. Thank you, Mr. Chairman, Mr. Rangel, Mr. McCrery, Mr. Levin, and other Members of the Committee and the Subcommittee on Social Security. My testimony is largely driven by one major concern. Every year, we spend greater shares of our budget in areas where needs have actually declined, and yet we claim that we don't have enough money leftover for our children, for education, for young adult men and others whose real needs are growing or remain unattended. Right now, our legacy is to bequeath a government to our children whose almost sole purpose is our consumption in retirement. In my testimony, I address four

major issues largely neglected in the debate on Social Security so far. First, close to one-third of the adult population is scheduled to be on Social Security. People already retire for about one-third of their adult lives and that percentage is growing. If people retired for the same number of years as when Social Security was young, they would retire about age 74 today and about age 78 in another 60 years; that is, 150 years, approximately, from when the system was first built. Every year, larger shares of benefits are going to those who are middle-aged and smaller shares are going to those who are old. I have begged top officials from the White House to the AARP not to take the retirement age off the reform table. This is an arithmetic point, it is not an advocacy point. At any given tax rate that you are willing to compromise on, an increase in the retirement age allows us to increase lifetime benefits, it allows us to increase replacement rates, it allows us to increase annual benefits, and it allows us to devote more resources to the truly old. One reason is that people work longer. There are more revenues in the system to be distributed.

For similar reasons, if there are to be benefit cuts, an increase in working years causes among the least hardships of almost any benefit adjustment because there are more revenues in the system. Some groups have shorter than expected life expectancies and we need to be concerned about them, but come on. It is hardly protecting them to make it a national priority to give you, me, and those among us who are healthy a 20th, a 21st, and a 25th year in retirement, so that we can supposedly protect the vulnerable. The way to protect vulnerable groups is to target provisions to them to through devices like minimum benefits. Now, a related means that we could use to increase the labor supply and make your job of reform easier is to backload benefits more. That is, to provide higher benefits to those who are truly old in exchange for lower benefits up front for those who are a bit younger.

A second major concern I raise in my testimony is that Social Security is often quite unfair. Single heads of household—including these welfare recipients who we have now decided should work, as well as two-earner couples—face significant discrimination in the system. Each can receive hundreds of thousands of dollars less in benefits than people who pay less tax, work less, raise less children, and have less need. Some people are penalized for remarrying. Others get bonuses for marrying trophy spouses, and still others are rewarded for having or siring children later in life. These problems can be addressed by applying, to middle and upper income retirees, the types of equal justice benefit rules that we apply in private pension plans. Again, through devices like minimum benefits, we can actually improve the lot of the vulnerable at the same time. A third approach to reform is to change the default. Regardless of what other Social Security reform is undertaken, some rule should be adopted that automatically reacts to persistent projected deficits with balancing increases in retirement ages and/or reductions in the rate of growth of benefits for higher-earning workers. Last, a final set of proposals attempts to integrate in some pension and employee benefit reform, especially finding ways to increase pensions for lower- and middle-income workers. One conservative-liberal compromise that has many side benefits would be

to combine a higher wage base for Social Security with a cap on the inefficient tax subsidies now going for health insurance. In conclusion, we can and should fix a system that now favors middle-age retirement; that reduces the share of resources every year that go to the truly old; that discriminates against single heads of households and working couples; and that, by default, automatically reduces the share of revenues available for children and for working families. Thank you.

[The prepared statement of Mr. Steuerle follows:]

Statement of C. Eugene Steuerle, Senior Fellow, Urban Institute, Codirector, Tax Policy Center, and Columnist, *Tax Notes Magazine*

Mr. Chairman and Members of the Committee:

Thank you for the opportunity to testify on alternatives to strengthen Social Security. I must confess my frustration at how narrowly the Social Security debate has usually been focused. It's as if the public is being asked to choose a dog from the pound by looking only at its tail—or at best its hind legs—but not the whole dog. Since Social Security was first enacted, vast changes have occurred in the economy, life expectancy, health care, the physical demands of jobs, the labor force participation of women, the percentage of women who are left on their own to both raise children and work, the age at which one can be considered old, the consumption levels of the elderly relative to the non-elderly, and poverty levels of children relative to the old—to mention only some factors. Yet we often debate Social Security as if the type of system we want in 2080 should be determined by perceptions and measures of needs of a society in 1930, or 150 years earlier.

The Social Security debate could and should be part of a larger one in which we engage our fellow citizens in choosing the best direction for society as a whole as better things happen to us in the way of longer lives and new health care goods and services. How can we really take best advantage of these new opportunities? How can we spread the gains from this increased level of well-being and wealth to create a stronger nation with opportunity for all? And how should we share the costs?

Instead, the debate is upside down. Due to the ways we have designed our programs and our budgets, every year we spend greater shares of our national income in areas where needs have declined, and then claim we don't have enough left over for areas—such as education, public safety, children, and anti-terrorism—where real needs remain and have often grown. I sometimes imagine sitting in the Ways and Means Committee room when someone from the National Institutes of Health comes in claiming to have found a cure, though expensive, for cancer. The members of committee, trapped in the logic of our current budget, find that instead of celebrating this advance, they commiserate among themselves about the increased cost for Social Security.

As a member of the baby boom generation, I remember youthful conversations among my cohort, regardless of political persuasion, that centered on what type of government we could help create to best serve society. As now scheduled, our legacy is to bequeath a government whose almost sole purpose is to finance our own consumption in retirement. Not only haven't we come close to paying for the government transfers we are scheduled to receive, but we plan to pay for them by dwindling almost to oblivion the rest of government that would serve our children and grandchildren.

With the exception of the World War II period, programs for the elderly have been absorbing ever-higher shares of national income and of the budget for almost seven decades. Define "lifetime benefits" as the value, at age 65, of Social Security and Medicare benefits as if they were sitting in a 401(k) account that would earn interest but be drawn upon over retirement. In today's dollars, lifetime benefits for an average-income couple have risen from about $195,000 in 1960 to $710,000 today ($439,000 in Social Security and $271,000 in Medicare) to over $1 million for a couple retiring in about 25 years (over $1/2 million in both Social Security and Medicare—see figure 1). We cannot provide a very large portion of the population $1/2 to $1 million packages of benefits and simultaneously encourage them to drop out of the workforce for the last third of their adult lives without affecting dramatically the services that can be provided through the budget to our children and to working families.

The impact on the budget is especially large beginning around 2008 because it is then that so many start moving from the working-age population into the retired population. Assume merely that Social Security, Medicare, and Medicaid continue on automatic pilot, that interest on the debt is paid, and that as a percent of GDP existing levels of revenues are allowed to rise only moderately and defense expenditures decline only modestly. Then by about 2015 no revenues are left for anything else—not for justice or transportation or education, not for wage subsidies or education or environmental clean-up or community development, not for the IRS or national parks—not even to turn on the lights in the Capitol. The pressure on the budget is not awaiting some magical date like 2018 or beyond. Social Security and Medicare are already spending much more than the Social Security tax for Social Security and Medicare, and even this accounting does not include all the other programs for the retired and elderly in the budget. The pressure on programs for children and working families is being felt right now, and the fight over the fiscal 2006 budget makes this glaringly apparent.

Social Security is only part of this problem, but it is an important part for four reasons:

1. It sets the standard for how long we should work and who covers the costs associated with our longer lives and the new medical care we receive;
2. There are many inequities and inefficiencies in Social Security that are independent of its size;
3. By default (in absence of new legislation), Social Security is designed to absorb ever-larger shares of our national income, thereby squeezing out other programs, particularly discretionary expenditures, that are not treated equally in the budget process.
4. A number of related employee benefit reforms would likely increase private saving, enhance the well-being of low- and average-income workers in retirement, and improve the solvency of Social Security.

MAJOR ISSUE ONE: LABOR FORCE PARTICIPATION

The facts are simple. Social Security's current dilemma centers almost entirely on labor force issues—the drop in scheduled workers per retiree. Although more saving would be nice, whether in trust funds or accounts, we are not going to save our way out of this problem. Consider some of the consequences of the current system.

The system has morphed into a middle-age retirement system.

- Close to one-third of the adult population is scheduled to be on Social Security within about 25 years. Including adults on other transfer programs, we are approaching the day when the majority of the adult population will depend upon transfers from others for a significant share of its support.
- People already retire on average for close to one-third of their adult lives.
- The average Social Security annuity for a man retiring at 62 lasts 17 years, for a woman 20 years, and for the longer living of a couple at least 25 years. The numbers are even higher for those with above-average lifetime earnings.
- When Social Security was young—for instance, in 1940 and 1950—the average worker retired at about age 68. To retire for an equivalent number of years on Social Security, a person would retire at age 74 today and age 78 in another 60 years (figure 2).

Almost every year a smaller share of Social Security benefits goes to the most vulnerable.

- By constantly increasing benefits to middle-age retirees, at least as defined by life expectancy, smaller and smaller shares of Social Security benefits are being devoted to the elderly (figure 3). If progressivity is defined by how well the vulnerable are served, the system is becoming less progressive every year.

The economy gets hit several ways, not just in terms of costs.

- Among the most important, but ignored, sides of the Social Security budget equation is the decline in growth of the labor force, national income, and revenues (figure 4).
- When a person retires from the labor force at late middle age, national income declines. But the decline is borne mainly by other workers, not by the retiree. For instance, when a $50,000-a-year worker retires a year earlier, national income declines by approximately $50,000, but most of those costs are shifted onto other workers as the retiree starts receiving about $23,500 in Social Security and Medicare benefits (much more in the future) and pays about $18,300 less in taxes (figure 5).

- Saving declines because people retire in what used to be their peak saving years. For instance, when a person retires for 20 years versus 15, he both saves for 5 years less and spends down his or society's saving for 5 years more.

Believe it or not, there is tremendous opportunity in all of this. People in their late 50s, 60s, and 70s have now become the largest underutilized pool of human resources in the economy. They represent for the first half of the 21st century what women did to the labor force for the last half of the 20th century. I believe the labor demand is there, and it is mainly our institutions, public and private, that are blocking us from making full use of these valuable and talented people.

What are some of the reforms that can address these problems?

Increase the early and normal retirement ages. We should do this even if there were no long-term imbalance and even if all the saving were devoted back to Social Security. Increasing the retirement age would allow us to devote greater resources to the truly old, since it has no effect on benefits at later ages. Relative to other benefit cuts, it would provide higher annual benefits, since a delay of even one year in retiring can often increase annual income by 8 to 10 percent for many individuals. At any given tax rate, it provides for a higher lifetime benefit since it results in increased revenues from working longer. It also provides relief for Medicare through higher Medicare taxes, and for the rest of the budget through higher income tax revenues.

For all these reasons, an increase in the retirement ages (including the early retirement age, else it is just an across-the-board benefit cut) causes the least hardship of almost any benefit cut.

I recognize that some people are concerned about groups with shorter than expected life expectancies. But attempting to address their needs by granting many of us who are healthy a 20th and 21st and 22nd year of transfer support and tens, if not hundreds, of thousands of dollars in extra benefits for retiring early is a very bad form of trickle-down policy. As discussed below, an increase in the retirement age can be combined with other provisions that help, rather than hurt, groups with shorter life expectancies.

Backload benefits more. Whatever the level of lifetime benefit that is settled upon in a final reform package, actuarial adjustments can provide more benefits later and fewer earlier. These adjustments can take various forms: adjust benefits upward at the point that Social Security predicts that average life expectancy has fallen below, say, 12 years (about age 74 in 2005) and downward in earlier ages; provide a lower up-front benefit in exchange for post-retirement wage indexing. This type of adjustment has all the right effects. It progressively moves benefits to later ages when people have less ability to work, lower income, and less help from a spouse to deal with impairments. It puts labor force incentives where they are most effective—in late middle age, including the 60s, when most people report being in fair, good, or excellent health.

Provide a well-designed minimum benefit. A minimum benefit can be designed to help most lower-income households and to reduce poverty rates (using a poverty standard that is adjusted for living standards or wage-indexed) among the elderly. With such a minimum benefit in place, any of the age-of-retirement adjustments can actually increase, rather than decrease, the relative share of benefits for those groups with lower life expectancies, since their life expectancies are correlated with lower lifetime earnings. In fact, with a good minimum benefit, we can increase the income of low-income people and reduce poverty rates, even relative to current law.

MAJOR ISSUE TWO: SIGNIFICANT INEQUITIES AND INEFFICIENCIES IN THE EXISTING SYSTEM

Social Security consistently violates notions of equal justice by taxing more or paying less to those who are equally situated. Many of these inequities also have extremely perverse anti-work and inefficiency aspects. I have approached many analysts and advocates across the ideological spectrum, and none so far has disagreed that these problems ought to be addressed. Their one excuse for failing to tackle these problems is political: that to restore equal justice affects some current winners whose winnings might be reduced.

The major cause of many of these problems is provisions that initially were meant to help some of those who might be vulnerable, but in fact did so in a poorly targeted way. These provisions are equivalent to going to a poor area of the city and dropping money off a roof. In particular, the Social Security spousal and survivor benefit—unlike that in private pensions or even public pensions in most countries around the world—provides "free" transfers whose generosity increases the richer the person one marries. This benefit is free in the sense that no additional contribution is required; in the private pension system, standards of fairness argue for deter-

mining spousal and survivor benefits actuarially through higher contributions or a lower initial worker benefit. Nor was the "free" benefit designed around any measure of need. Listed below are some of the problems that result:

Single heads of household face especially egregious discrimination (the anti-welfare reform effect).

Who doesn't get the "free" spousal or survivor benefit? The answer, of course, is those without spouses (from marriages with ten years duration or longer). Here are some of the consequences:

- When a mother is abandoned by her spouse, Social Security reduces her expected Social Security benefits without any change in the worker benefit owed to the father or to the spousal benefits he can pass onto to a new wife.
- Fewer benefits are paid to many single heads of household who work more, pay more taxes, and raise more children than to many spouses who don't work, don't pay taxes, and don't raise children. For instance, a single head of household who works for $20,000 a year for 40 years and raises her children will get lifetime benefits of about $95,000 while paying taxes of $50,000, whereas a nonworking spouse who doesn't raise children but happens to marry someone making $100,000 a year will get about $250,000 in lifetime benefits and pay $0 in taxes.
- Low-income minority and less-educated women are among the groups most likely to need additional help—the original purpose of the spousal and survivor benefit—and the least likely to receive it.

Two-earner households often receive substantially fewer benefits than one-earner households (the anti—working woman effect).

The design of spousal and survivor benefits also discriminates against two-earner families, with women more likely than men to get no additional benefits for their additional contributions.

- A couple with each spouse earning $15,000 annually will get lifetime benefits of about $177,000, whereas a couple with one spouse earning $30,000 but paying no more in tax will get about $273,000—close to $100,000 more.
- If a single earner in a family increases his average earnings subject to tax, higher benefits are provided to the household. But if a spouse also works, the additional taxes she pays often do not increase the household's Social Security benefits. Many of these penalties tend to hit female labor force participants more than males, and couples who share child-rearing responsibilities more than those where one spouse takes on most of this effort. For example, a one-earner couple with annual earnings of about $30,000 can expect a total lifetime benefit of around $273,000, whereas a couple with the $30,000 split $25,500/$4,500 will get lifetime benefits of about $243,000—little different than the amount if one spouse earned $25,500 and the other earned nothing.
- Benefits for the divorced are highly variable and often unrelated to need or contributions (the divorce roulette wheel effect).
- For the same contributions, someone who marries several times can multiply benefits relative to someone who marries only once. In the extreme, a worker can generate additional benefits for every spouse of 10 years or more—with no reduction in his or her own benefits. For example, if a high-wage male worker has three former spouses, all from marriages that lasted 10 years or longer, the spousal and survivor benefits payable on his earning record would be $710,000. Spousal and survivor benefits would be only $237,000 if he had only one spouse. In both cases, he is not required to share any portion of his own benefit.
- Someone who divorces after 10 years, less one day, of marriage gets nothing from the shared responsibility of the marriage, even if she is left taking care of the children. She will receive hundreds of thousands of dollars less in benefits than someone equal in all other respects who happens to divorce after ten years and one day.
- People who remarry are often subject to marriage penalties—if their new spouses have lower lifetime earnings than their former spouses (the marriage penalty effect). A woman divorced from a high-wage man after more than 10 years of marriage would receive about $237,000 in spousal and survivor benefits. However, if she remarries and her new husband is a low earner, her benefits would fall to about $101,000—a steep penalty for remarrying.
- A divorced person is often better off if her former spouse dies (the Agatha Christie effect). Upon death of a former spouse, the divorced person can start receiving the much larger survivor benefit; before death, only the smaller spousal benefit is provided. For example, a divorced woman whose high-wage spouse

has died before she reaches normal retirement age would receive $373,000 in benefits. However, if both she and her husband live into retirement and then she dies at average life expectancy but her husband outlives her, she can only expect $186,000, as she will never receive his more generous survivor benefits.

People who marry significantly younger spouses will find that their contributions are much more likely to generate a higher package of benefits for the household than are the contributions of people who marry others of a similar age (the trophy wife and husband effect).

Again, Social Security spousal and survivor benefits are not actuarially adjusted for age. If a person marries someone a lot younger, he will be more likely to generate additional survivor benefits for which he has paid nothing extra.

People who have children later in life are much more likely to receive additional benefits, no matter how rich they are (the Hollywood effect).

With longer lives, higher divorce rates, and births at later ages, it is becoming more common for older people, especially men, to still have children in the home when they start receiving retirement benefits. Under current law, they often become eligible for children's benefits at the same time, regardless of need.

People with long work histories face discrimination in the system (the anti-worker effect).

Someone who works 45 years at $35,000 a year gets substantially fewer benefits than someone who works 35 years at $45,000 a year—for a single male, $165,000 in lifetime benefits versus about $200,000. The system counts only 35 years of work, a rather perverse way of trying to achieve progressivity.

Of course, there are ways to reform this system while still protecting the vulnerable.

Determine family benefits for middle- and upper-income individuals in an actuarially neutral manner. Actuarial neutrality would apply private pension standards to middle- and upper-income households in making sure that benefits were shared equitably. Different forms of benefit sharing or earnings sharing could be tried. While transitioning to this type of system, cap existing types of family benefits that are not paid for out of additional contributions. Similarly, extend toward divorced persons the types of equity rules that apply in the private pensions system.

Provide a minimum benefit that extends to spouses and divorced persons as well as workers. For the same level of expenditure, higher minimum benefits for lower-earning workers—as well as for spouses who have generated low worker benefits on their own records—would provide additional protections for the vulnerable. One should first require the actuarial adjustment, then figure out where additional levels of protection can best be granted. This would reduce the amount of transfers that are going free—without any additional contribution—to higher-income households. For those concerned with low-income women, whether single or survivors, it would improve their status overall.

Count all years of work history. No one would think to deny some people their employer's 401(k) contributions because they worked more than 35 years. There is no legitimate reason in Social Security that all years of work should not be counted. Redistribution can always be made to low-earning workers through the benefit formula or a minimum benefit. This change would have an additional work incentive effect as well; under current law, many years of work result only in a pure additional tax, with no additional benefit generated.

MAJOR ISSUE THREE: CHANGING THE DEFAULT

Under current policy, spending of the federal government grows automatically, by default, faster than tax revenues as the population ages and health costs soar. These defaults are threatening the economy with large, unsustainable deficits. More important, they deny to each generation the opportunity to orient government toward meeting current needs and its own preferences for services. Only by changing the budget's auto-pilot programming can we gain the flexibility needed to continually improve government policies and services.

Rudolph L. Penner (also a senior fellow at the Urban Institute and a former director of the Congressional Budget Office) believes there is no way to get the budget in order without addressing the issue of these defaults. They apply to a number of programs of government, but the largest are linked to Social Security and Medicare. As currently structured, these programs are designed to rise forever in cost faster than national income and revenues—an impossible scenario. In Social Security, the problem is caused by the combination of a constant retirement age as our health and life expectancy improve and wage indexing for annual benefits.

Regardless of what Social Security reform is undertaken, some rule should be adopted that would put the program back into balance over the long term should, for instance, the trustees report for three consecutive years that the program is likely to be in long-run deficit. This trigger should force the system's automatic features to move back toward budgetary balance.

With the trigger pulled, two of many options at that point strike me as particularly simple and easy to implement. First, the early and normal retirement ages could be automatically increased two months faster per year than under current law for everyone younger than, say, 57 in the year the trigger is pulled. Second, in those years, the benefit formula could be indexed to the lower of price or wage growth in a way that allows average real benefits to increase but more slowly than wages.[1] This approach could be supplemented by a new special minimum benefit indexed to wage growth. Other approaches to this option can also be devised to reduce the growth rate of benefits more for high earners than for low earners.[2]

Of these two options, I prefer increasing the retirement ages, since that allows more revenues for the system and, consequently, for the same tax rate, a greater level of lifetime benefit to be generated. Other benefit reductions, as noted, hit the oldest beneficiaries with their greater needs as well as everyone else. For similar reasons, among the "progressive price indexing" options, I prefer creating a wage-indexed minimum benefit, since that is more likely to protect the more vulnerable, including survivors, than is a form of progressive price indexing that continues to spend larger shares of revenue on increasing benefits for those with well-above-median income. But, regardless, the system must be redesigned so that, when on automatic pilot, the default option is one that leads to a responsible and sustainable budget.

There is, of course, no reason to believe that these types of automatic changes will alone lead to a socially optimum Social Security system. For instance, they do not deal with the discrimination I noted above against single heads of households. The point of changing the defaults is, rather, to migrate from a system in which the Congress has little choice but to enact painful benefit cuts to one in which Congress has the opportunity to provide more generous benefits from time to time—that is, to play tax Santa Claus rather than Scrooge sometimes, as politics requires.

By creating a system in which the budget automatically becomes ever more responsive and responsible to future taxpayers and beneficiaries, the door is also open to spending more now on programs for people who aren't elderly—especially children—and on public investments. Or Congress might use the freed-up resources to make Social Security benefits more generous to those with low average lifetime earnings or to provide more cash to lower-income elderly to help pay for medical payments. And, of course, Congress can always choose to raise taxes to provide a higher benefit growth rate in each year, though remaining responsible means making each year's decision to increase benefit levels independent of the next year's.

MAJOR ISSUE FOUR: RELATED PRIVATE RETIREMENT AND EMPLOYEE BENEFIT REFORMS

We can only consume what we produce. That production comes from labor and capital. I have indicated that I consider the primary economic problem for Social Security is to take advantage of the vast pool of human talent and capital that we are wasting. There are a variety of ways to fix our private employment systems to enhance their ability to hire older workers and to induce greater saving.

Most middle-class retirees—not just the poor—depend primarily upon government in their retirement.

Over two-thirds of those approaching retirement have less in accumulated wealth in all forms—retirement plans, housing, and saving accounts—than the value of their Social Security and Medicare benefits (figure 6).

The personal account debate reflects a search for something between a mandated Social Security system that for the most part is pay-as-you-go and discourages saving by individuals, and a private pension system that is not mandated, but generates little in retirement saving for most citizens.

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[1] Technically, the so-called bend points in the benefit formula could be indexed to the lower of wage or price growth. This approach to price indexing differs from some recent proposals that ratchet down future benefits derived from the current benefit formula by the difference between the rate of growth of wages and prices.

[2] The term "progressive price indexing" has sometimes been applied to this effort, but there are many ways it can be implemented.

I had hoped that the personal account debate would evolve toward figuring out how to address the difficult problem of promoting saving effectively. Our private pension system is not doing an adequate job of promoting saving, nor is our Social Security system. Some hybrid system may well be needed on this score.

The Social Security tax base has been eroding for some time and in ways that are causing other problems—such as the government actually paying tax benefits in ways that increase the number of uninsured.

The earnings base for the Social Security tax has been eroding over time for two reasons: first, the earnings distribution has become more unequal; and, second, smaller percentages of compensation are being paid in the form of cash, rather than tax-deferred, compensation. In the latter case, the primary problem has been the growth in the percent of compensation paid in the form of health benefits. To make matters worse, the tax subsidy for employer-provided health insurance is expected to cost an additional $100 billion annually (in both income tax and Social Security tax revenues) within a few years. And that additional expense will likely increase, rather than decrease, the number of persons who lack health insurance. As designed, the subsidy encourages excessive growth in the cost of medical care, thus leading more employees to drop insurance.

It is hard for government to force people to save or to control the dynamics of the bargains between labor and management. However, some prudential steps can be taken.

Reduce the tax gaming. Taxpayers now borrow and take interest deductions, while deferring tax on interest and other capital income in their retirement accounts. In effect, they get tax breaks for making deposits, not for saving. Such interest deductions should be restricted when the interest and other capital income is not being subjected to tax.

Provide an additional incentive for plans that do a better job at providing a portable benefit for all workers. Here is one example. Many types of contributions to 401(k) and other plans do not benefit from the FICA exclusion accorded many defined benefit plans. Making use of this FICA tax is an alternative way of financing increased deposits to retirement accounts—although it, too, should be paid for. I suggest that some additional incentive be made available to all plans where all workers in the firm are guaranteed that they will walk away at least with 6 percent of pay compounded over time by some reasonable interest rate. I would apply such a rule to employer and employee contributions and to any type of plan, whether defined benefit or defined contribution. Other pension tax benefits might be gradually reduced for plans that did not provide such a portable benefit. Adopting this type of rule could also allow for a simplification of pension discrimination rules.

Make clearer in the law that employers can use opt-out, not just opt-in, methods of encouraging participation—without threat of lawsuit. Evidence seems fairly strong that the former method—where employees are included in a plan unless they formally choose to be excluded—results in much higher participation rates. In addition, default options can allow the employee contribution rate to rise when pay rises.

Focus retirement plan incentives more on lower-wage workers. This might be done, for instance, through an increase in the savers credit. However, that credit should be reformed so the monies are more likely to make their way into retirement accounts (currently the credit is just a tax reduction that can easily be spent). The credit should also be made available for employer, as well as employee, contributions.

Provide safe harbors for employers hiring or retaining older workers. Our current pension and retirement plan rules are designed for a world in which people had much lower life expectancies and labor force demands could more easily be met by all the baby boomers and women entering the workforce. That period is swiftly passing. Still, employers today are often fearful of retaining or hiring older workers because of threats of lawsuits under ERISA, the tax law, and age discrimination laws. Even when employers feel they are clearly acting within all these laws, the threat of lawsuit deters them from acting. Congress should provide safe harbors for the types of employee benefits that firms can provide when hiring or retaining older workers.

Restore or at least prevent further erosion of the Social Security earnings base. The president and some others have offered to consider restoring the Social Security wage base to compensate for some of the former effects. But long-term projections of Social Security's solvency are also affected significantly by income and Social Security tax incentives to receive more and more compensation in nontaxable forms. A cap on employer-provided health insurance would go a long way not just

to improve Social Security's solvency (allowing for higher benefits for the same Social Security tax rate), but also to help the health insurance market and help prevent the erosion of private health insurance coverage. One should also consider extending the Social Security tax to other preferred forms of employee benefits in an administrable way.

Note that the combination suggested here—a higher wage base to compensate for the more uneven distribution of earnings, a cap on tax subsidies for health insurance to promote a more efficient market and greater health insurance coverage, and reduction in other inefficiencies caused preferences for other employee benefits—may represent a classic conservative—liberal compromise that has many side benefits to restoring solvency to Social Security.

CONCLUSION

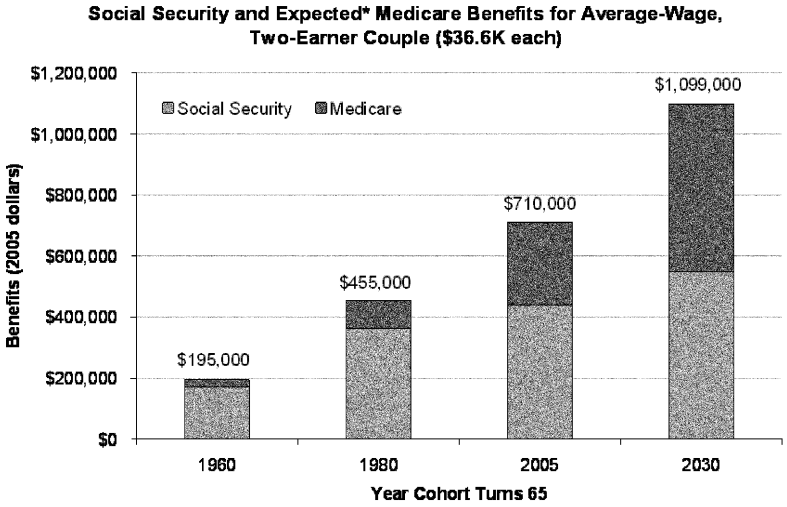
Social Security reform is possible, but focus needs to extend far beyond the narrow confines of the current debate. Many reforms are consistent with legitimate principles accepted by individuals of all political persuasions. We can and should fix a system that favors middle-age retirement in ways that reduce shares of resources for the truly elderly; that discriminates against single heads of households, working couples, and many others; and that by default automatically reduces the share of revenues available for programs for children and working families. We should also consider changes in the tax and related laws affecting employee compensation to restore solvency, increase private saving, make it easier for employers to hire older workers, and in other ways complement Social Security reform.

Summary of Recommendations

- Increase the early and normal retirement ages so that at any given tax rate, the system provides fewer subsidies for middle-age retirement and increased revenues, higher annual benefits in retirement, higher lifetime benefits, and a greater portion of resources to those who are truly old.
- Backload benefits more to older ages, such as the last 12 years of life expectancy, so as to progressively increase benefits in later ages when they are needed more and to increase labor force incentives for individuals still in late-middle age, as defined by life expectancy.
- Provide a well-designed minimum benefit to help low-income households and groups with less education and lower life expectancies, while simultaneously reducing poverty rates (relative to living standards or wages) among the elderly.
- Determine family benefits for middle- and upper-income individuals in an actuarially neutral manner by applying private pension standards, making sure that benefits are shared equitably, and reducing or removing significant discrimination against single heads of household, many abandoned spouses, two-earner couples, many divorced persons, those who marry others close to their own age, some who pay significant marriage penalties for remarrying, and those who bear children earlier in life.
- Provide a minimum benefit that extends to spouses and divorced persons as well as workers to provide additional protections for groups that are particularly vulnerable, and as an alternative to free and poorly targeted transfers to higher-income households.
- Count all years of work history, providing an additional work incentive and removing the discrimination against those who work longer.
- Ensure responsible budgetary policy by changing the default rules to guarantee the system automatically moves toward balance—say, through adjustments in the retirement ages or the rate of growth of benefits for higher-income households—whenever the Social Security trustees repeatedly report a likely long-run deficit.
- Reduce the tax gaming used with retirement plans when taxpayers simultaneously report interest deductions while deferring or excluding interest and other retirement plan income from taxation.
- Provide additional incentive for plans that do a better job at providing a portable benefit for all workers, such as using the FICA tax exclusion to finance increased deposits to retirement accounts and guaranteeing all workers in a qualified plan a minimum level of portable benefits.
- Make clearer in the law that employers can use opt-out, not just opt-in, methods of encouraging retirement plan participation—without threat of lawsuit.
- Focus retirement plan incentives more on lower-wage workers, for instance, through an increase in a modified savers credit, which should be adjusted so that it is available for employer, as well as employee, contributions and so that the credit is deposited in retirement accounts.

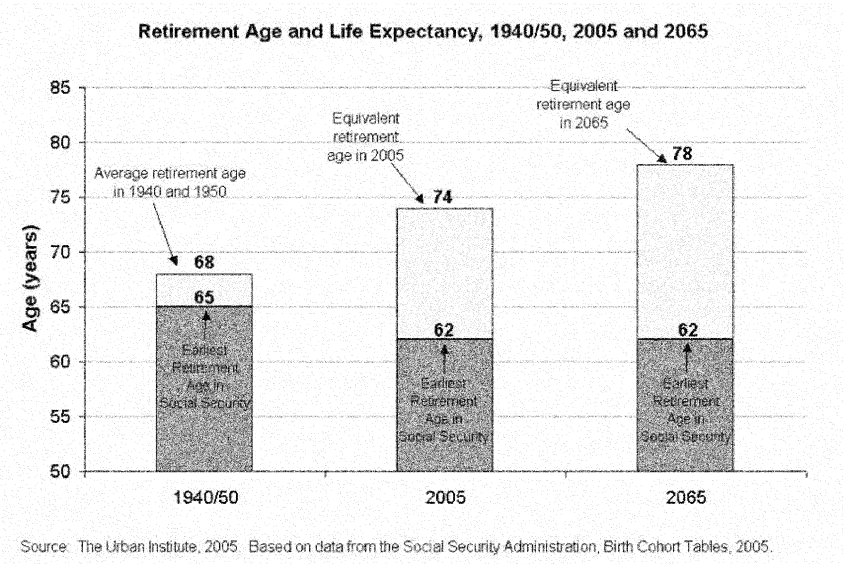
- Provide safe harbors from lawsuits for designated types of retirement and other benefit plans offered by employers who hire or retain older workers.
- Restore the earnings base for Social Security by increasing the portion of cash wages subject to Social Security tax, capping the tax-free levels of health insurance that can be provided, and dealing with tax preferences for other employee benefits.

FIGURE 1



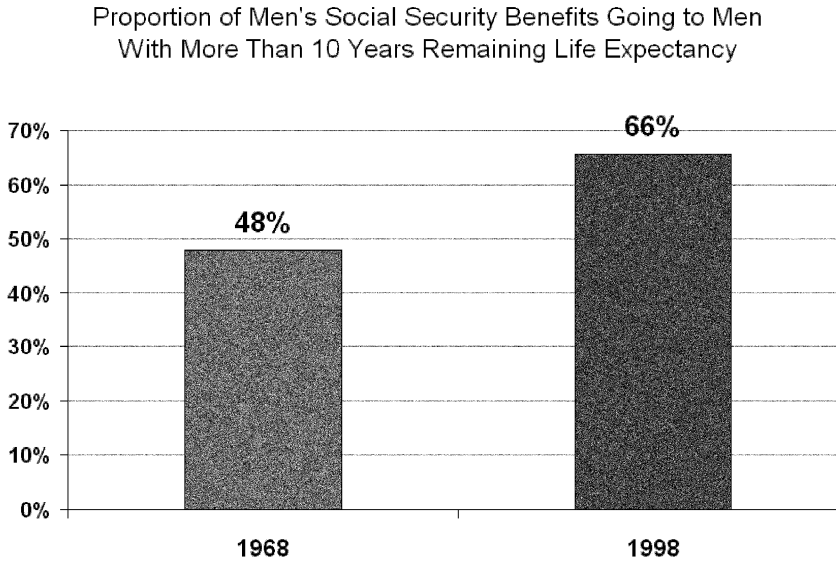
* Expected rather than realized benefits. Notes: The "high" and "average" wage profiles are those hypothetical profiles routinely employed by the Social Security Administration in its analyses. Lifetime amounts, rounded to the nearest thousand, are discounted to present value at age 65 using a 2 percent real interest rate and adjusted for mortality. Projections based on intermediate assumptions of the 2005 OASDI and HI/SMI Trustees Reports. Includes Medicare Part D. Source: Adam Carasso and C. Eugene Steuerle , The Urban Institute, 2005.

FIGURE 2



Source: C. Eugene Steuerle and Adam Carasso, The Urban Institute, 2002. Based on data from the Social Security Administration's 2001 Annual Statistical Supplement, Table 5A.1.

FIGURE 3



Source: C. Eugene Steuerle and Adam Carasso, The Urban Institute, 2002. Based on data from the Social Security Administration's 2001 Annual Statistical Supplement, Table 5A.1.

FIGURE 4

Labor Force Projections

Annual Growth Rate (% over Period)		
2000-10	2010-20	2020-30
1.08	0.38	0.38

Note: Projections assume no change in patterns of retirement by age and sex.

Source: C. Eugene Steuerle and Adam Carasso, The Urban Institute, 2002. Based on data from the U.S. Bureaus of Census and Labor Statistics.

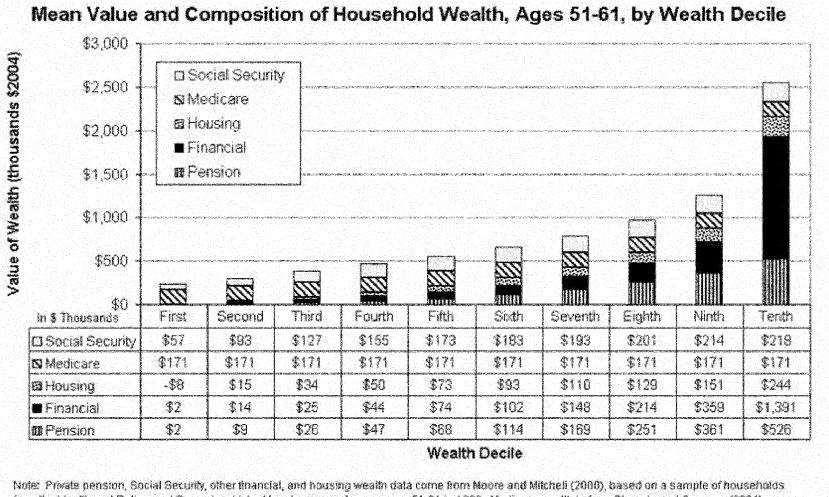
FIGURE 5

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 otherwise available to meet current and future needs	$31,700

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

FIGURE 6



In $ Thousands	First	Second	Third	Fourth	Fifth	Sixth	Seventh	Eighth	Ninth	Tenth
Social Security	$57	$93	$127	$155	$173	$183	$193	$201	$214	$218
Medicare	$171	$171	$171	$171	$171	$171	$171	$171	$171	$171
Housing	-$8	$15	$34	$50	$73	$93	$110	$129	$151	$244
Financial	$2	$14	$25	$44	$74	$102	$148	$214	$359	$1,391
Pension	$2	$9	$26	$47	$68	$114	$189	$251	$361	$526

Note: Private pension, Social Security, other financial, and housing wealth data come from Moore and Mitchell (2000), based on a sample of households from the Health and Retirement Survey in which at least one member was age 51-61 in 1992. Medicare wealth is from Steuerle and Carasso (2004).
Source: Moore, James F., and Olivia S. Mitchell. 2000. "Projected Retirement Wealth and Savings Adequacy." In *Forecasting Retirement Needs and Retirement Wealth*, edited by O.S. Mitchell, P.B. Hammond, and A.M. Rappaport. Philadelphia: Univ. of Pennsylvania Press; C. Eugene Steuerle and Adam Carasso. 2004. "The USA Today Lifetime Social Security and Medicare Benefits Calculator: Assumptions and Methods." Washington, DC: The Urban Institute.

C. Eugene Steuerle is a senior fellow at the Urban Institute, codirector of the Tax Policy Center, and a columnist for *Tax Notes Magazine*. Any opinions expressed herein are solely the author's and should not be attributed to any of the organizations with which he is associated.

Chairman THOMAS. Thank you very much, Gene. Welcome back, Mr. Apfel. The time is yours.

STATEMENT OF HON. KENNETH S. APFEL, SID RICHARDSON CHAIR IN PUBLIC AFFAIRS, LYNDON B. JOHNSON SCHOOL OF PUBLIC AFFAIRS, UNIVERSITY OF TEXAS AT AUSTIN, AUSTIN, TEXAS

Mr. APFEL. Thank you, Mr. Chairman. Mr. Chairman and Members of the Committee, I have many, many memories of time spent in this historic room. This room has been witness to many historic events when Members of Congress with differing views came together for the common good. There are sharply divergent views today on how to proceed on Social Security and my remarks today are designed to make clear my very deep concerns about the two key proposals now being put forward by the Administration. My hope, however, is that as the debate unfolds, that this room will again be witness to action that brings us together for the common good. The first proposal, of course, relates to the privatization of Social Security. The Administration has proposed that private accounts be established and then paid for through cuts in future Social Security benefits. Some workers may do better than current law and some worse. The winners and losers will be decided by the market. In the case of a death of the worker, the private account would be passed on to heirs, but so would the future Social Security benefit cuts. It is, therefore, also entirely unclear which

spouses or family Members will be better off or worse off under this scenario.

With privatization, trying to retire at a time of down market conditions can be a very risky proposition and trying to buy an annuity at a time of economic instability can also be a risky proposition. Frankly, I would hate to see a future U.S. Social Security Commissioner urging America's older workers to just keep working until the markets come back. Social Security ought to represent a foundation of support that can be counted on in retirement no matter what happens to the markets. Now, the White House argues that current retirees will be unaffected by privatization proposals. I do not in any way question the sincerity of the White House on this matter, but the hard reality is that redirecting current payroll tax revenues erodes financing for Social Security, even if those revenues are somehow made up through trillions of dollars in government borrowing. These changes destabilize Social Security's current financing mechanisms and call into question whether and how benefit commitments made to current retirees will be made in the years ahead. Privatization is simply not a safe bet for current retirees.

The President has also suggested that we change over to a system of sliding-scale benefit reductions to reduce future benefit commitments. About 70 percent of future retirees, those with earnings over $20,000 a year, would face major cutbacks. Replacement rates would plummet. In addition, many lower income survivors, divorced spouses, and others would see their benefits reduced. Once fully phased in, almost all workers would receive the same benefits regardless of lifetime earnings. This is a dramatic shift in Social Security policy because it breaks the link between what workers paid into the system based on their earnings and what they would earn in Social Security benefits. Now, it is true that the proposal exempts low-income workers from this aspect of the proposed benefit cuts, and I want to point out that the core objective of a progressive reform is basically sound—to make Social Security benefits structure more progressive and to soften the burden on low-income workers of restoring solvency. In addition, people with higher earnings are, on average, living increasingly longer lives than low-income workers, so higher-income workers are receiving an increasingly higher share of benefits over time. While I have argued that modest benefit changes could be made in this area, Social Security benefit cuts of the magnitude contemplated by the President's proposal, I believe, are inappropriate and risk the long-term economic security of the middle class.

Lastly, combining private accounts with these sliding-scale benefit cuts, as proposed by the White House, would lead to even more drastic change. After paying a lifetime of payroll taxes into Social Security, millions of persons would receive little or no Social Security defined benefits. This is due in part to deep and broad middle-class Social Security benefit cuts combined with the fact that the private accounts would be paid for through even deeper reductions in Social Security defined benefits. If adopted, where would such a policy lead us? I believe the long-term sustainability of the Social Security retirement system would be in peril if such an approach

was enacted. This assertion is not empty rhetoric. I believe it from the bottom of my heart.

What should we do? First and foremost, I do not believe that progress will take place until the decision to drop privatization has been made. We should drop consideration of privatizing part of Social Security. Once privatization is off the table, if added retirement savings is desired, and it should be, it should not come at the expense of Social Security. Second, Congress and the Administration need to come to a general agreement on whether added resources should be brought to bear to resolve the financing gap. In addition, an agreement is needed on the overall magnitude of the problem that you are trying to resolve. I am reminded of President Clinton's words after the failure of health reform. He bit off more than he could chew. I urge the Committee not to fall into the same trap. Rather than looking for permanent solvency by trying to solve a potential problem that may exist in 2100, I urge you to establish a more modest goal of success that would clearly be more easily achievable. Frankly, no one knows what our fertility rates or economic growth rates will be like 100 years from now. Third, once privatization is no longer under consideration, I believe that Congress and the Administration need to come to agreement on the overall proportional mix of benefit and revenue changes needed to strengthen solvency. At that point, coming up with the detailed proposals for change, while clearly still a significant task, is one that I believe can be accomplished, taking into account the need for a more progressive benefit structure. And fourth, reform must be truly bipartisan. During my tenure as Commissioner at Social Security, I advised the Clinton Administration and Members of Congress on both sides of the aisle that a strong coalition for change must be truly bipartisan. I do not believe that changes should be enacted now, as some have recently been advocating, through a strong majority of Republicans, buttressed by a sliver of Members from the Democratic side of the aisle. Changes to Social Security must represent all Americans. Any other approach would only sow the seeds for future discord, when a long-term resolution of this issue is what the public really wants. In short, let us all come together and solve a manageable problem, not create a much bigger one by privatizing Social Security. Let us keep the word "secure" in Social Security for current and future generations.

[The prepared statement of Mr. Apfel follows:]

Statement of The Honorable Kenneth S. Apfel, Sid Richardson Chair in Public Affairs, Lyndon B. Johnson School of Public Affairs, University of Texas at Austin, Austin, Texas

Mr. Chairman and Members of the Committee, it is an honor to be asked to testify today about the future of Social Security. I have many, many memories of times spent in this historic room. I sat through many hearings and mark-ups in the early 1980's the last time Congress made major changes to Social Security. In the late 1980's, I sat behind the dais when I served as a staff person to Senator Bill Bradley during the House/Senate Conference Committee on the Medicare Catastrophic Care legislation. And during the late 1990's and in 2000, I testified many times in this room during my service as the Commissioner of Social Security.

This room has been witness to many historic moments—when Members of Congress with differing views came together for the common good. I have deep respect for what you do here, and I know first-hand how seriously you take your responsibilities to the American people.

The future of our Social Security system is one of the most important issues facing this Committee in the early part of the 21st Century. There are sharply divergent views on how to proceed. From my experience, covering up the differences gets us no closer to coming together. My remarks today are designed to make clear my deep concerns about the two key proposals now being put forward by the Administration. My hope is that as the debate unfolds in the future that this room will again be witness to action that brings us together for the common good.

It is clear that steps need to be taken to strengthen Social Security, given the demographic and economic changes that are now underway in America. I urge the Members, however, to be very careful in this area, because our Social Security laws serve as the foundation for our entire retirement system.

It is hard to overstate the importance of Social Security. Without those monthly benefit payments, about half of all seniors in America would be living in poverty. Social Security provides the foundation of support for about one in six Americans—with benefit protections available over a lifetime, no matter how long one lives. Given the continued shift of retirement risks away from employers and toward individuals, the importance of that monthly inflation-protected Social Security benefit—something that can be counted on over a lifetime—becomes all the more important for future generations. Our social insurance programs are critically important not only for today's older Americans, but also for the disabled, for widows, for families and for future generations.

As the Committee deliberates on changes to Social Security, there are five issues I would like to address today. First, is the financing shortfall so large that drastic changes are needed in Social Security? Second, do private accounts help to strengthen Social Security? Third, does privatization in any way put the benefits of current retirees at risk? Fourth, are proposals to dramatically cut benefits—either alone or coupled with privatization—in the best interests of the young? And lastly, could the two key Social Security proposals made by the Administration—private accounts coupled with "sliding scale" benefit cuts—undermine the long term sustainability of our Social Security system?

Are drastic steps needed?

On the first issue, the Social Security financing shortfall is manageable without drastic changes. A doubling of the senior population will certainly place strains on financing Social Security, but it's certainly not Armageddon. The system is now generating very large surpluses—about $150 billion this year. It's been running surpluses for more than the past two decades and will likely stay in surplus for many years to come. Legislative changes enacted in 1983 provided stability for about a half a century. That was a remarkable accomplishment.

According to projections by the Social Security Trustees and the Congressional Budget Office, the Social Security trust fund will not be exhausted for several decades. The system will not be "bankrupt" after that time. Social Security revenues will still be sufficient to pay between 70 percent and 80 percent of today's benefit commitments. Social Security **will** be there in the future. I realize that many young people believe that Social Security will not be there for them, but the fact is that it will be there unless we choose to dramatically restructure our system.

Social security's deficit over the next 75 years translates into about a half of one percent of GDP. Even if one uses an even longer time frame to measure the shortfall—into *eternity*— a concept strongly rejected by the actuarial profession—then the shortfall is still only a little over 1 percent of GDP. Compare this shortfall to the fact that Social Security revenues now amount to about 5 percent of GDP. Does a 1 percent shortfall represent a long-term challenge? Of course. Does it represent a crisis necessitating drastic action? Of course not.

I've said for years that Social Security clearly faces a long-term and manageable challenge, and it's a challenge that we should face up to sooner rather than later. The continued drum beat that we are hearing, however, about an imminent crisis and bankruptcy seems aimed at eroding support for our social insurance system and *building* support for radical restructuring of the program.

Do private accounts help?

The second question relates to whether the privatization of Social Security will help to solve the long-term Social Security shortfall. Absolutely not. Taking payroll tax revenues out of Social Security to create individual savings accounts makes the long-term financing problem bigger, not smaller. Unless benefits are drastically curtailed or other revenues increased, privatization only makes the financing problem worse.

If a portion of payroll taxes is redirected away from paying Social Security benefits, Social Security's financing is weakened. Rather than running surpluses for

many years into the future, the system may start running deficits almost immediately. Rather than a problem that is about a half a percent of GDP over the next 75 years, the shortfall could easily be more than double this size. And rather than trust funds having resources to pay benefits for several decades, the trust funds could be exhausted a decade earlier.

Future benefit commitments will most likely have to be sharply curtailed if we privatize parts of Social Security. The Administration has proposed that these accounts be paid for through cuts in future Social Security benefits. Under the proposal, for every dollar in payroll taxes diverted from Social Security, the worker's future Social Security benefit would be cut by an equal amount, plus an interest charge equal to 3% above inflation. Under this proposal, some workers may do better than current law if they can beat the 3% above inflation cut. Some workers will do worse. The winners and losers will be decided by the market. In the case of the death of the worker, the private account would be passed on to heirs, but so would the future Social Security benefit cuts. It is therefore also unclear which spouses or family members will be better off or worse off under this scenario.

There has been much debate over how many people will end up winners and how many will end up losers. Yale economist Robert Shiller predicts that about one third to two thirds of workers may be losers under the plan. I am not an expert in this area, but it is clear to me that there will be losers, and we won't know for sure how many would end up losers for decades to come, after we see how the markets actually perform.

It can be argued that the benefits of individual accounts may offset some of these problems, but they do so by shifting more retirement risk to individuals. With privatization, a growing share of retirement income will be based on the returns of the market. Certainly stock market investments can lead to high returns over time. We all know, however, that what goes up also sometimes comes down. With privatization, trying to retire in a time of down market conditions can be a risky proposition. And trying to buy an annuity in a time of economic instability can also be a risky proposition.

It is difficult to come to terms with the real life implications of these big shifts in policies. Let me provide an example. For years, the supporters of privatization have extolled the virtues of the Chilean privatized system. During my years as Commissioner, I met the head of Chile's system during a time of steep interest rate reductions in Chile. At the time, he was publicly urging older workers to delay retiring until the economic conditions improved so workers would not be forced into receiving inadequate annuities in retirement. This senior government official was urging older people to keep working until the bond markets came back.

Do markets bounce back quickly? Sometimes they do. And sometimes it takes many, many years for markets to come back. The problem, of course, is that we can't predict future market conditions. If we privatize a part of our Social Security system, we could find ourselves in the same situation as Chile. Frankly, I would hate to see a future U.S. Social Security Commissioner urging America's older workers to "just keep working until the markets come back." Social Security ought to represent a foundation of support that can be counted on in retirement no matter what happens to the markets.

Does privatization put the benefits of current retirees at risk?

The White House argues that current retirees will be unaffected by privatization proposals. I do not in any way question the sincerity of the White House on this matter, but the hard reality is that redirecting current payroll tax revenues erodes financing for Social Security, even if those revenues are somehow "made up" through massive government borrowing. These changes destabilize Social Security's current financing methods.

The creation of private accounts within Social Security calls into question whether and how benefit commitments made to current retirees will be made in the years ahead. Adding $5 trillion in new borrowing over the next couple decades could put added pressures on the benefit promises made to current Social Security beneficiaries—maybe not today or tomorrow, but very possibly over the next decade or so. The risks are real not only for Social Security commitments, but also for Medicare commitments. Privatization is simply not a safe bet for current retirees.

How will the benefit cuts if made through "sliding scale" benefit reductions affect young workers?

The proposal for private accounts in and of itself does not restore long term solvency to Social Security. The Administration has now suggested further benefit cuts to make up for most of the shortfall. Will private accounts, coupled with major alter-

ations in the benefit structure, be in the best interests of future beneficiaries? Again, the answer is no.

The President has suggested that we change over to a system of "sliding scale" benefit reductions to reduce future benefit commitments. This idea of simply using a sliding scale to calculate future benefit payments sounds appealing; the supporters of this change argue that for future generations, lower income workers would be protected and higher income workers would still be receiving the same level of Social Security benefits in real terms as current retirees.

Let's put this proposal in proper context. Benefits for the average earner who is now age 25 would be cut by about 16% and the average newborn would see benefit cuts of about 28%. About 70% of future retirees—those with earnings over $20,000 a year, would face major cut-backs. In addition, many lower income survivors, divorced spouses, and others would see their benefits reduced. Once fully phased in, almost all workers would receive the same benefits regardless of their lifetime earnings. This is a dramatic shift in Social Security policy because it breaks the link between what workers paid into the system based on their earnings and what they would earn in Social Security benefits.

Social Security currently replaces a little less than 40 percent of pre-retirement earnings, with somewhat lower levels projected for the future. Financial planners indicate that an adequate income in retirement requires post-retirement income to replace at least 70 percent of pre-retirement income. If we moved to a sliding scale benefit cut scheme, Social Security's "replacement rate" for average workers would be about 25% in 75 years, falling to much lower levels in the future. The foundation of support that Social Security provides would be seriously eroded.

It is true that the proposal exempts low wage earners from this aspect of the proposed benefit cuts. And I want to point out that the core objective of a progressive reform is basically sound—to make the Social Security benefit structure somewhat more progressive and to soften the burden on low income workers of restoring solvency. In addition, people with higher earnings are on average living increasingly longer lives than lower income workers, so higher income workers are receiving an increasingly higher share of benefits over a lifetime basis. In effect, the Social Security benefit structure over time is becoming less progressive. While I've argued for years that modest benefit changes could be made in this area, Social Security benefit cuts of this magnitude I believe are inappropriate and risk the long term economic security of the middle class.

The proposal also has the inadvertent affect of failing to keep revenues and expenditures in balance as economic conditions change in the future. The Congressional Research Service recently concluded that "—paradoxically, if real wages rise faster than projected, price indexing would result in deeper benefit cuts, even as Social Security's unfunded 75 year liability would be shrinking." In other words, the smaller the long term shortfall, the larger the benefit cuts. That makes no sense.

Will private accounts coupled with "sliding scale" benefit cuts destabilize Social Security?

Combining private accounts with sliding scale benefit cuts as proposed by the White House would lead to even more drastic results. For the medium wage worker retiring a half century from now, the defined Social Security benefit would be cut by two thirds. For higher wage earners—those averaging about $60,000 today—Social Security defined benefits would be cut by about 90%.After paying a lifetime of payroll taxes for Social Security, millions of persons would receive little or no Social Security benefits. This is due in part to deep and broad middle class Social Security benefit cuts coupled with the fact that the private accounts would be "paid for" through even deeper reductions in Social Security defined benefits.

If adopted, where would such a policy lead us? I believe the long term sustainability of the Social Security retirement system would be in peril if such an approach was enacted. And if Social Security goes away, so does the economic security of tens of millions of Americans. I urge the Committee to seriously consider the full implications of these measures before acting.

What should we do?

I believe the path that we should follow is as follows:

- First and foremost, I do not believe that progress will take place on this issue until there is agreement to drop consideration of privatizing part of Social Security. Privatization makes the financing problem that we face much worse. It's not in the best interests of young and old alike—likely leading to drastic cuts in promised benefits for younger workers, as well as erosion in Social Security's financing, which could also put the benefits of current retirees at risk over time. We need a foundation of support that will be there no matter what happens to

the markets. Once privatization is off the table, if added retirement savings is desired—and it should be—it should come not at the expense of Social Security. I suggest that the Committee consider 401-k and IRA changes to help low and moderate income workers save through changes in default rules or added retirement savings tax incentives targeted at low and moderate income families.

- Second, Congress and the Administration need to come to general agreement on whether added resources should be brought to bear to resolve the financing gap. In addition, an agreement is needed on the overall magnitude of the problem that you are trying to resolve. I am reminded of President Clinton's words after the failure of health reform: he bit off more than we could chew. I urge the Committee not to fall into the same trap. Rather than looking for "permanent solvency" by trying to solve a potential problem that may exist in the year 2100, I urge you to establish a more modest goal of success that would clearly be more easily achievable. Frankly, who knows what our fertility rates or our economic growth rates will be 100 years from now? I certainly don't.
- Third, once privatization is no longer under consideration, I believe that Congress and the Administration need to come to agreement on the overall proportional mix of benefit and revenue changes needed to strengthen solvency. I believe the American people will support a balanced approach. At that point, coming up with the detailed proposals for change, while clearly a significant task, is one that I believe can be accomplished, taking into account the need for a more progressive benefit structure.
- And fourth, reform must be truly bipartisan. During my tenure as Commissioner of Social Security, I advised the Clinton Administration and Members of Congress on both sides of the aisle that a strong coalition for change must be truly bipartisan. I do not believe that changes should be enacted, as some have recently been advocating, through a strong majority of Republicans, buttressed by a sliver of members from the Democratic side of the aisle. Changes to Social Security must represent all Americans. Any other approach would only sow the seeds for future discord, when a long-term resolution on this issue is what the public really wants.

In 1983, the American people supported a balanced approach to legislative changes to the Social Security system that ensured solid financing for decades. I was an active participant in that process on the Senate side—I witnessed some of the debates that took place in this historic room. During my tenure as Commissioner and now as a professor in Texas, I have met with Americans to discuss the ongoing challenges we face. I believe that the American people will again support a balanced and bipartisan approach to strengthening Social Security for future generations.

To summarize, a major restructuring of Social Security is unnecessary, given the manageable size of the long-term problem. Privatization makes the financing problem that we face much worse. It's not in the best interests of young and old alike—likely leading to drastic cuts in promised benefits for younger workers, as well as erosion in Social Security's financing, which could also put the benefits of current retirees at risk over time. Privatization coupled with sliding scale benefit cuts leads to very deep cut-backs in Social Security benefits for future middle class retirees and runs the risk of unraveling the entire Social Security system.

In short, let us all come together and solve a manageable problem, and not create a much bigger one by privatizing Social Security. In the process, let us keep the word "secure" in Social Security for current and future generations.

Chairman THOMAS. Thank you very much, Mr. Apfel. Dr. Hunter?

STATEMENT OF LAWRENCE A. HUNTER, VICE PRESIDENT AND CHIEF ECONOMIST, FREE ENTERPRISE FUND, AND SENIOR RESEARCH FELLOW, INSTITUTE FOR POLICY INNOVATION

Mr. HUNTER. Thank you, Mr. Chairman. Thank you for allowing me to express the views of the Free Enterprise Fund and the Institute for Policy Innovation. In addition to my written statement, I have a set of design principles that the Committee asked that I submit for the record, and I do so.

Chairman THOMAS. Without objection.

[The information was not received at the time of printing.]

Mr. HUNTER. In my written statement, I explain why we believe the only way to make Social Security permanently solvent is to allow workers to invest about half the payroll tax through large personal retirement accounts. I point to the bill introduced by Committee Member Paul Ryan, H.R. 1776, as illustrative of how, contrary to conventional wisdom, properly designed, sufficiently large personal retirement accounts are the solution to Social Security's solvency problem. I call the Committee's attention to the way the Ryan bill improves retirement benefits for all workers and eliminates Social Security's long-run deficits without cutting promised future Social Security benefits, without raising taxes, and without hiking the retirement age. I also explain why, again, contrary to conventional wisdom, the transition to fully funded personal accounts is similar to a corporate workout. No new debt is required. Existing debt is simply refinanced to provide time and to free up cash to restructure the operation, making it more efficient and more productive in the future so that it is capable of providing better retirement benefits while repaying all of the debt. Part of that restructuring should be spending growth restraint in the rest of the budget and tax reforms to improve the Federal tax code and increase economic growth. I show in the statement why the notion of so-called "transitions cost" is a fallacy and how misconceptions about the nature of Social Security, as it has evolved through the years, have led the debate over personal accounts into what I believe is now a political cul-de-sac. I conclude that in the current political climate, it is highly unlikely that Congress will be able to generate a sufficient bipartisan consensus this year to fix Social Security permanently and that attempting to force too much too soon, before the time is right, is likely to be harmful and counterproductive. It may require another election, perhaps another Presidential election, before the country is ready to embrace comprehensive reform that transforms Social Security into a permanently solvent, prefunded market-based retirement system based on personal retirement accounts.

Fortunately, it is not necessary to solve the entire problem this year. What Congress can do, and I urge the Committee to take the lead in doing, is to make a downpayment on solvency by stopping the 20-year-old raid on the Social Security surpluses and devoting those surpluses and interest due the trust fund to personal retirement accounts. Stop the raid; start the accounts. The Federal Government takes the Social Security surplus each year and uses that money to help finance all of its other programs, from foreign aid to welfare. The time has come to stop this inexcusable raid and return the surplus to workers to start their own individual personal accounts. The trust fund should not be treated as a slush fund. Indeed, the new version of the Ryan-Sununu bill introduced just a couple of weeks ago, phases in the accounts so that over the first 2 years, the account option is about half of its full size. The Ryan-Sununu phase-in allows workers, on average, to shift about 3.2 percentage points of the full 12.4 percent payroll tax into the accounts. The total annual Social Security surpluses projected over the next 10 years, counting tax revenues and interest on the trust fund

bonds, is more than sufficient to finance this Ryan-Sununu phase-in option during that period. Mr. Chairman, I have attached to my testimony an appendix, which is a table that compares expected surpluses and the first 10-year phase-in of the reduced accounts.

Congress should stop the raid on the Social Security trust fund and use that money to finance the first 10 years of Ryan-Sununu. The surplus money would then go to finance the future retirement benefits of today's workers, as it was intended, rather than for other government spending. As Federal Reserve Chairman Alan Greenspan has observed, personal accounts are the only way to enact a true lockbox where the government can't get its hands on the money and individual workers hold the key. To free up the surpluses for the accounts, Congress must reduce its spending by an amount equal to the surplus of Social Security taxes or expenditures each year. That would amount to about $85 billion this year. That money belongs to the future retirement of working people, and Congress should never have been spending it in the first place. The government currently pays the interest on Social Security trust fund bonds by issuing new bonds to the trust funds each year. To the extent needed to finance the Ryan-Sununu accounts for the first 10 years, those bonds would be issued instead into the accounts of each worker across the country. The bonds would be backed by the full faith and credit of the U.S. government and be marketable. Workers, consequently, would be free to choose, to sell those bonds on secondary markets and invest the proceeds in broader mutual funds if they desire. Those bonds, of course, would not represent new debt, but rather money the government already would owe to the trust fund under the current system. It would be highly desirable, also, to phase-in the budget process reforms over the next ten years contained in the Ryan-Sununu proposal. Even the smaller accounts adopted for the first 10 years would make a substantial downpayment on solvency by reducing long-term deficits. Mr. Chairman, it is time for Congress to focus on what Social Security reform should be about, providing a better deal for working people. It is time for Congress to stop the raid on Social Security and use the surpluses to start personal retirement accounts. Thank you.

[The prepared statement of Mr. Hunter follows:]

Statement of Lawrence A. Hunter, Ph.D. Vice President and Chief Economist, Free Enterprise Fund and Senior Research Fellow, Institute for Policy Innovation

Introduction

Thank you, Mr. Chairman for allowing me to express the views of the Free Enterprise Fund on ways to strengthen Social Security through personal retirement accounts.

The basic structure of Social Security has changed very little over the years but two things about the program have changed dramatically, both of them as a consequence of attempting to maintain the pay-as-you-go system in the face of a steeply declining worker-to-beneficiary ratio. First, contribution rates (FICA tax rates) now comprise a greater share of workers' income than financial analysts say is necessary to pre-fund an adequate retirement income if funds are invested in real assets. Second, the rate of return workers enjoy on the FICA taxes they and their employers pay has gone from hugely positive to barely greater than zero.

A seeming paradox arises. Everyone is coming to realize that Social Security is a very bad deal for today's workers at the same time many politicians who must confront Social Security's looming insolvency insist Social Security benefits are ex-

travagant because they soon will exceed the revenue the system generates. It is disconcerting that politicians from both sides of the partisan divide propose making a bad deal worse for workers by cutting promised future benefits as a means of making Social Security "solvent," which is to say they are proposing what works for Washington rather than what works for workers.

When politicians are forced to reconcile their claim that Social Security currently makes extravagant promises with the painfully obvious reality that workers realize pitiful rates of return on their FICA contributions, they usually resort to a non sequitur. They point out that under the current benefits formula, which indexes future initial Social Security benefits to the rate of real wage growth in the economy, the level of initial Social Security benefits increases faster than inflation, as if that result somehow is unreasonable. Zero real growth in retirement benefits is a curious benchmark to set for a new pre-funded, market-based retirement system and an especially odd position for advocates of personal retirement accounts to take given that one would expect private investment income to increase over time at least as fast as private-sector wages. Moreover, this explanation fails to reconcile how benefits can be at the same time both a bad deal and extravagant.

I urge the Committee to critically examine the logic behind the argument that the initial level of retirement benefits should not increase faster than the rate of inflation. If you do, I believe you will discover that underlying this belief is an unwarranted presumption that workers should not expect a positive real rate of return of any magnitude on the FICA contributions they make throughout their working careers. To appreciate how odd this sounds to workers being urged to support market-based personal accounts, consider the reaction one would get if he made a similar argument to investors in the private sector that they should not expect a rate of return on their investments greater than inflation. Such a suggestion would be met with incredulity. After all, dividends and capital gains are not welfare. Here, I suspect, is the crux of the matter. The only logical basis for concluding that Social Security retirement benefits should not increase faster than the rate of inflation is the premise that Social Security benefits are a form of welfare.

While characterizing Social Security as welfare may have been valid in earlier days, when benefits far outstripped what workers paid into the system, it no longer applies. Moreover, low- and many middle-income workers today pay so much of their income in FICA contributions that they find it difficult or impossible to save much more for their retirement outside Social Security.

American workers have a very keen sense of inconsistency on the part of politicians. They will become confused and then suspicious and eventually rebellious when they hear politicians on the one hand confirm their own sense that Social Security is a bad deal but then turn around and lecture them on the need to cut promised future benefits even more. In my opinion, a majority of the American people never will support a Social Security reform plan that is built on these contradictory notions.

Current Social Security Contribution Rate is Higher than Necessary to Fund Full Blown Retirement Plan

We still think of Social Security as a supplemental, back-up retirement program—and the benefits it promises certainly are less than adequate as the sole source of retirement income. The reality is, however, the FICA tax burden the program imposes on workers substantially exceeds the contribution rate a full-blown retirement plan would require to generate higher retirement benefits. While many people continue to think of Social Security as "social insurance," it has, in fact, evolved into a very poorly designed, inadequate government-operated defined benefits plan built on a mountain of government debt and teetering on the brink of bankruptcy. Protestations of scholars and politicians to the contrary, that is how the vast majority of American workers perceive Social Security today.

Workers have good reason to view Social Security this way. If the 12.4 percent of their income workers and their employers currently contribute to Social Security were invested through personal retirement accounts in real, productive assets, the investment income from the accounts would be more than adequate to provide workers a secure and prosperous retirement at a level substantially above what Social Security currently promises but can't pay. So much so, in fact, that a portion of that 12.4 percent could be reserved by the government as true "social insurance" against disability and other calamities that might make it impossible for a relatively small number of workers to accumulate sufficient assets by the end of their working careers to enjoy retirement benefits at least as generous as Social Security currently promises.

The personal retirement accounts plan introduced by Congressman Paul Ryan (H.R. 1776) and its Senate companion introduced by Senator John Sununu (S. 857)

demonstrate this point conclusively. By allowing workers to invest between five and ten percent of their wages through personal retirement accounts—lower-wage workers would be able to save a larger share of their income—it is possible to generate sufficient investment income from the accounts to raise retirement benefits substantially above what Social Security currently promises but cannot pay. The Ryan/Sununu plan leaves in place more than enough of the current 12.4 percent FICA contributions (about four percentage points) to finance the disability program and a secure government safety net equal to the level of Social Security benefits currently promised while also reducing payroll taxes eventually about two percentage points.

The large personal accounts created under the Ryan/Sununu plan would be so powerful they would eliminate Social Security's long-term financial crisis and eliminate Social Security deficits completely over time without the benefit cuts or tax increases or hikes in the retirement age. That is because so much of Social Security's benefit obligations, ultimately 95 percent, are shifted to the accounts, thus reducing the federal government's need to pay Social Security benefits. As the Chief Actuary stated in his analysis of the Ryan/Sununu plan, "the Social Security program would be expected to be solvent and to meet its benefit obligations throughout the long-range period 2003 through 2077 and beyond."

Social Security Is a Bad Deal for Today's Workers

For most workers in the workforce today middle aged and younger, the real rate of return Social Security promises to pay them on the taxes they and their employers pay into the system would be one percent to 1.5 percent, or less. For many workers, it would be zero or negative.

Allowing workers to invest a substantial portion of their FICA contributions in real assets through personal retirement accounts is the only way to avoid forcing workers to labor their whole lives for a pittance of a handout from the government in retirement. Attempting to overcome the declining worker-to-beneficiary ratio by raising the cap on the payroll tax would reduce the currently pitiful rate of return from Social Security even more for higher income workers. Cutting future benefits through so-called "progressive price indexing" would reduce that rate of return for all but the lowest income workers. Even for the low-income workers it supposedly "protects," "progressive price indexing" would do nothing to improve their return. Raising the retirement age is just another way to reduce everyone's rate of return by making them work longer to receive the same level of benefits.

All three conventional attempts to outpace the declining worker-to-beneficiary ratio, i.e., to make Social Security as we know it "solvent" without introducing personal retirement accounts, simply make a bad deal worse for workers by asking them to pay more, work longer and get less. This is precisely what the Congress did in 1977 and again in 1983. It didn't work then, and it won't work now.

President Bill Clinton recognized this reality back in 1998 when he said, "We all know that there are basically only three options: We can raise taxes again, which no one wants to do . . . We can cut benefits . . . Or we can work together to try to find some way to increase the rate of return. . . . Even after you take account of the stock market going down and maybe staying down for a few years, shouldn't we consider investing some of this money, because, otherwise, we'll have to either cut benefits or raise taxes to cover them, if we can't raise the rate of return."

Small add-on accounts won't solve the problem either. Supplemental add-on accounts that attempt to fill in for cuts in guaranteed Social Security benefits (such as progressive price indexing) may succeed in maintaining the overall level of a worker's retirement income but will do so by raising workers' combined contribution rate and lowering the overall rate of return. With add-on accounts, workers would end up contributing even more than the already excessive 12.4 percent or not using the accounts and exposing themselves to the benefit cuts under price indexing. If small add-on accounts are accompanied by tax increases as well, the contribution burden increases yet again, and the rate of return falls commensurately. Add-on accounts, therefore, are just another way to force workers to pay more for the same level of benefits with an added element of risk.

Another idea under consideration, I know, is to give workers greater incentives to save more for their retirement by reforming the tax code, expanding IRAs, 401(k)s and so forth. These are all good ideas but should not, in my opinion, be enacted as a substitute for fixing Social Security the right way, namely allowing workers to save a portion of the payroll taxes in personal retirement accounts. Eliminating the tax bias against saving and investing should be undertaken independently of Social Security, on efficiency grounds to make the tax code as neutral as possible between saving and consumption. In my opinion though, this tax reform should not be conceived as a means of offsetting cuts to promised future Social Secu-

rity benefits. As I observed above, too many workers already find it difficult to impossible to save much beyond the 12.4 percent they are forced to pay into Social Security.

Two Persistent Myths about Social Security

Just as the outdated image of Social Security as "social insurance" lingers on, so does the image of Social Security as some kind of welfare program. This image, contrary to current economic reality, has been reinforced by the legal status of the program over the years. Clearly, in the early days of the program, when workers received rates of return in excess of 15 percent, 25 percent, and even 35 percent for the earliest cohort of beneficiaries born before the turn of the century, Social Security could be considered a "welfare" program, i.e., people were getting from government far more than they contributed to it.

Today, I believe the willingness, indeed the enthusiasm, of some folks to cut promised future Social Security benefits arises from failing to take into account the reality that Social Security has evolved from "social insurance" (i.e., "welfare") into a very poorly designed, inadequate government-operated defined benefits plan perched on a mountain of debt and teetering on the brink of bankruptcy. If Social Security is viewed as welfare, workers' payroll taxes are not considered retirement contributions but rather as coerced tax payments that are used to pay welfare benefits to people who did not earn them. Thus, the welfare recipient (i.e., the Social Security beneficiary) should have no contractual right to the benefits. Neither should there be a moral, legal or political right for current workers to expect future workers to pay them welfare payments (i.e., Social Security benefits) when they retire even though they spent their entire working careers paying taxes to finance welfare (i.e., Social Security) benefits to their parents' and grandparents' generations.

By definition, then, if Social Security is viewed as welfare, benefits promised in the future that cannot be financed by payroll taxes are ipso facto "extravagant," "unsustainable," and, therefore, legitimately can be reduced since workers have no moral, legal or political claim to them.

Failing to recognize the changed reality of the situation—Social Security has evolved into a very poorly designed, inadequate government-operated defined benefit's plan built on a mountain of government debt obligations to future retirees—also leads to confusion about what actually transpires if and when the government attempts to stop the bleeding by transforming the system into a financially sound pre-funded retirement system.

There is a widespread misconception that every dollar of payroll tax revenue "redirected" or "diverted" into personal retirement accounts to begin pre-funding retirement benefits generates a new "transition" cost because it "siphons away" a dollar from Social Security that otherwise would be available to pay current retirement benefits. If personal accounts are created, that revenue must be generated from some other source (higher taxes, existing revenue reallocated away from other spending, borrowing). This formulation of the so-called "transition problem" fails to recognize that *every payroll-tax dollar directed into personal retirement accounts is actually a dollar less indebtedness incurred by the federal government*. Every payroll-tax dollar not "diverted" into paying current retirement benefits (the real "diversion" is the current diversion of FICA contributions to pay current benefits) is actually a dollar that can be devoted to pre-funding future benefits, *which in turn reduces a future liability of the federal government.*

There are no transition costs; there are only changes in cash flow, and compared to the size of the overall economy, those cash-flow changes are small.

Allowing workers to place a share of their payroll taxes into personal accounts sufficiently large enough to pre-fund currently promised benefits actually reduces federal indebtedness. The temporary cash-flow crunch that results—the short-fall in available funds to pay all currently promised Social Security benefits—arises because *the government would be borrowing less.* Therefore, *if the Congress turns around and decides to borrow funds to cover the cash-flow shortage, it would be simply substituting one form of debt with another.* The net level of borrowing is unchanged. However, the federal government's long-run, off-balance-sheet liability that must be paid out of the federal treasury to pay future retirement benefits is dramatically reduced. Devoting current payroll tax revenue to pre-funding future retirement benefits will produce greater investment income in the personal retirement accounts than the government could count on in future payroll tax revenues at current tax rates. This gain will relieve government of the obligation to spend so much on retirement benefits in the future, eventually covering virtually all future retirement benefits out of the personal accounts and eliminating the federal unfunded liability altogether.

In other words, *contrary to conventional wisdom, sufficiently large personal retirement accounts do indeed solve the problem.* It is only insufficiently large accounts—i.e., accounts not large enough to generate enough investment income to cover all promised Social Security benefits—that fail to solve the problem. Indeed, insufficiently large accounts leave a residual problem, which can only be covered by higher taxes, lower benefits or truly new borrowing.

The irony is that an aversion to borrowing (which results from a misunderstanding of the role borrowing plays in the current program and the role it reasonably could play in creating personal accounts) has led many proponents of personal accounts in the name of "fiscal prudence" to reject large accounts and embrace small accounts, which only exacerbate rather than solving the solvency problem.

This welter of confusion and disorientation has produced a fallacious chain of reasoning by even some proponents of personal retirement accounts:

False Premise:	Social Security is a welfare program so promised benefits legitimately can be cut without breaching any moral, legal or political obligation;.
False Premise:	Allowing workers to place a substantial portion of their payroll tax contributions into personal retirement accounts creates a net new cost that cannot be financed by borrowing without adding to national indebtedness;.
False Conclusion:	Personal Accounts, therefore, do nothing to solve Social Security's financing problem;.
False Corollary:	Consequently, large cuts in promised future benefits, tax increases and/or new borrowing are required to restore solvency to the system;.

A real solution can be outlined as follows:

- Create sufficiently large accounts, which will solve the solvency problem;
- Address the cash-flow crunch created when workers are allowed to invest a sufficient amount of their payroll tax contributions through large accounts by:
  - Restraining spending growth in the rest of the budget and reallocating the savings to help pay all promised Social Security benefits in full and on time;
  - Enacting tax reforms to raise the after-tax returns to work, saving and investing, which will generate a dynamic revenue feedback effect to help pay all promised Social security benefits in full and on time;
  - Refinance part of the outstanding Social Security liability by borrowing whatever is required after tax reforms and spending restraint are enacted to alleviate any remaining cash-flow crunch:
    - Borrowing first from the funds workers save in their personal retirement accounts (i.e., issuing to the accounts new inflation-protected federal bonds backed by the full faith and credit of the United States Government with no restrictions on resale in the secondary bond market), and
    - Borrowing outside the accounts in financial markets only as necessary to complete the refinancing.

Make a Down Payment on Solvency: Stop the Raid and Start the Accounts

Let me conclude by moving from the theoretically desirable to the politically practical given the current political environment. In my opinion, the time is not yet ripe to enact a comprehensive reform. Instead, I encourage you to tackle the one issue on which there is near unanimous agreement on both sides of the partisan divide, ceasing to squander the Social Security surpluses, and instead allowing workers to save the excess payroll tax revenues in personal retirement accounts.

For decades now, the Federal government has been raiding the Social Security trust fund to finance other government spending. The Federal government takes the Social Security surplus each year and uses that money to help finance all of its other programs, from foreign aid to welfare. The time has come to stop this inexcusable raid and return the surplus instead to workers to start their own, individual, personal accounts.

Indeed, the new version of the Ryan/Sununu bill introduced a couple of weeks ago phases in the accounts so that over the first 10 years the account option is half of its full size. The Ryan/Sununu phase-in allows workers on average to shift about 3.2 percentage points of the full 12.4 percent payroll tax to the accounts. The total annual Social Security surpluses projected over the next 10 years, counting tax revenues and interest on the trust fund bonds, is more than sufficient to finance this Ryan/Sununu option during that period. (See Appendix)

Congress should stop the raid on the Social Security trust funds and use that money to finance the first 10 years of Ryan/Sununu. The surplus money would then

go to finance the future retirement benefits of today's workers, rather than for other government spending. As Fed Chairman Alan Greenspan has observed, personal accounts are the only way to enact a true lockbox where the government can't get its hands on the money to fuel further runaway spending on other programs.

To free up the surpluses for the accounts, Congress must reduce its spending by an amount equal to at least the surplus of Social Security taxes over expenditures each year. That money belongs to the future retirement of working people, and Congress should never have been spending it in the first place.

The government currently pays the interest on the Social Security trust fund bonds by issuing new bonds to the trust funds each year. To the extent needed to finance the Ryan/Sununu accounts for the next 10 years, those bonds would be issued instead to the accounts of each worker across the country. Those bonds would be backed by the full faith and credit of the United States and be marketable. Workers, consequently, would be free to choose to sell those bonds on secondary markets and invest the proceeds in broader mutual funds if they desire. These bonds, of course, would not represent new debt, but, rather money the government already would owe to the trust fund under the current system.

It also would be highly desirable to phase in the Ryan/Sununu budget process reforms over the next 10 years, including the spending limitation, which would reduce the rate of growth of Federal spending by one percentage point a year for eight years. This would produce net surpluses from the reform during the first 10 years and provide the foundation for expanding to the full Ryan/Sununu accounts subsequently.

This reform would provide better benefits for working people from day one as the market returns earned by the accounts would be so much more than Social Security has even promised, let alone what it can pay. It would provide personal ownership and control for workers over their retirement funds, stopping the longstanding raid of the trust funds under the current system.

It would empower low and moderate income workers to accumulate substantial personal savings and wealth for the first time, which they can leave in whole or in part to their families through inheritance. It would greatly boost the economy through lower effective tax rates and higher saving and investment.

Finally, *even the smaller accounts adopted for the first 10 years would make a substantial down payment on solvency* by reducing the long-term deficits of Social Security as the benefit obligations borne by the old Social Security framework would be substantially reduced and taken up by the personal accounts instead. If the accounts were expanded after 10 years to the full Ryan/Sununu level of 6.4 percentage points on average, the long-term deficits would be eliminated entirely through this effect, achieving permanent solvency for Social Security. The Chief Actuary of Social Security has scored the Ryan/Sununu bill as achieving exactly this result.

This result, moreover, is achieved without cuts in future promised benefits or the tax increases that inevitably would accompany them. Since better benefits are going to be provided in the future by the accounts in place of benefits financed through the old Social Security framework, there no longer is any need to think about eliminating that old system's deficits through tax increases and benefit cuts.

It's time for Congress to focus on what Social Security reform should be about, providing a better deal for working people. It's time for Congress to stop the raid on Social Security and use the surpluses to start personal retirement accounts.

Thank you, Mr. Chairman.

Appendix

Financing the First 10 Years of Ryan/Sununu
With the Social Security Surpluses
(All figures in billions of constant 2005 dollars)

Year	Social Security Cash Flow Surplus (Taxes Minus Expenditures)	Total Social Security Surplus (Includes Interest Incomes on Trust Funds)	Annual Transition Financing Needed For Ryan/Sununu
2006	84.9	183.6	124.7
2007	88.7	194.7	137.5
2008	90.2	204.3	143.1
2009	84	206.3	148.5
2010	80.2	210.9	153.9
2011	75.6	215.1	159.0
2012	65.3	213.2	164.2
2013	52.9	209	168.9

Appendix—Continued

Financing the First 10 Years of Ryan/Sununu
With the Social Security Surpluses
(All figures in billions of constant 2005 dollars)

Year	Social Security Cash Flow Surplus (Taxes Minus Expenditures)	Total Social Security Surplus (Includes Interest Incomes on Trust Funds)	Annual Transition Financing Needed For Ryan/Sununu
2014	38.5	202.5	173.7
2015	24.3	196.3	178.4

Source: 2005 Annual Report of the Board of Trustees of the Old-Age and Survivors Insurance and Disability Insurance Trust Funds, March 23, 2005, Table VI.F.7; Office of the Actuary, Social Security Administration, Estimated Financial Effects of the "Social Security Personal Savings Guarantee and Prosperity Act of 2005," April 20, 2005, Table 1b.c

Chairman THOMAS. Thank you very much. Dr. Furman?

STATEMENT OF JASON FURMAN, NON-RESIDENT SENIOR FELLOW, CENTER ON BUDGET AND POLICY PRIORITIES, AND VISITING SCHOLAR, WAGNER GRADUATE SCHOOL OF PUBLIC SERVICE, NEW YORK UNIVERSITY, NEW YORK, NEW YORK

Mr. FURMAN. Thank you, Mr. Chairman and Members of the Committee, for inviting me here today. As you move forward on Social Security and pension reform, I would like to propose that you be guided by four goals. The first is a secure retirement. The second is ensuring the solvency of Social Security. The third is reducing our debt, both over the next decade and the decades to come, and finally, increasing our perilously low national savings rate. Social Security and pension reform can play a role in furthering all four of these goals, and it is somewhat better to act sooner rather than later. Even more important than acting in haste is to first obey the Hippocratic Oath: first, do no harm. Any proposal that moves backward on any one of these four goals, no matter how worthwhile it may seem, is something that I don't think this Committee should move forward on. In fact, one of the main proposals on the table is one that would move backward on all four of these goals simultaneously, and that is the President's Social Security plan that I would like to talk about now.

First of all, in terms of benefits, the President has proposed no new revenues for Social Security and, in fact, would drain trillions of dollars of revenues from Social Security to put them into the private accounts. This necessitates dramatic benefit cuts, and there are two benefit cuts that he has proposed. The first is a sliding-scale benefit reduction that would apply to any worker who makes over $20,000 a year—that is in 2005 dollars—and it would also, based on an analysis the White House released last week, apply to a substantial number of beneficiaries who make less than $20,000 a year. The benefit cuts would grow dramatically over time for middle-class families. By 2075, the benefit cuts would be between 28 and 40 percent of scheduled benefits. That means replacement rates would be 28 to 40 percent lower. That is just the first benefit cut. The second one is the so-called benefit offset, which is designed to eventually repay the trillions of dollars that go into the private

accounts. Every dollar you put into an account, your benefit gets reduced by that dollar, plus 3 percent interest, plus inflation. Add that all together and it could reduce your benefit by 50 percent or more. The combination of these two benefit reductions would virtually eliminate the traditional rock-solid, guaranteed Social Security benefit, leaving it at 10 percent of your pre-retirement income or maybe even less.

Would accounts make up for this difference? Numerous studies have been conducted on this issue and my reading of the conclusion is that they may make up for the second benefit cut, although even that is far from guaranteed. For middle-class workers, they are unlikely to make up for the first benefit reduction also. Bob Shiller, a Yale financial economist, found that between 32 and 71 percent of the time, workers would end up losing money as a result of participating in the accounts, on top of the sliding-scale benefit reduction. What does the President's plan do for solvency? Despite having a very large reduction in benefits, it does less for solvency than many would think. The sliding-scale benefit reduction by itself would postpone Social Security's cash flow deficits by 2 months. Social Security would still go into cash flow deficit in 2017 and would need to start redeeming money from the trust fund to pay benefits. I personally don't think that is the most important date, but for those who do, that should be a source of significant concern. The exhaustion of the trust fund would be postponed by a few years.

When the proposal is combined with private accounts, much of the benefits for solvency you would get from the benefit reductions go away and the benefit reductions are just used to pay for those accounts. In particular, the combination of the President's accounts and the President's benefit reductions would create a cash flow deficit earlier than under current law, would exhaust the trust fund earlier than under current law, and we would need to find the money to pay for the benefits, and would only solve 30 percent of the 75-year Social Security shortfall. In addition, the President's plan would entail significant increases in the debt, $5 trillion over the next 20 years. The word "transition costs" is a misnomer because the debt would continue to grow over the current decades and stay elevated for at least 60 years. As a result, national savings at best would be unaffected, and more likely, for reasons I outline in my written testimony, would end up being reduced.

There is a much better approach that this Committee could take. The first principle of that approach would be no debt-financed accounts, not whether they call themselves carve-out accounts, not whether they call themselves add-on accounts, nothing that increases the national debt, not in the next decade, not in the next 50 years, not over an infinite horizon. Second, Social Security reform should be a balanced process, balanced both politically and balanced in the form that restoring Social Security solvency takes. Finally, we can do more to encourage people to save, even to help them save, separately from Social Security, and there are a number of bipartisan reforms to make savings easier, more automatic, and to increase incentives for moderate-income families while paying for those incentives that I would be happy to talk more about with the Committee at a future time. I look forward to your questions.

[The prepared statement of Mr. Furman follows:]

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

Mr. Chairman and other members of the Committee, thank you for the invitation to address you today. America currently faces major budget deficits and perilously low national savings. These problems are expected to grow significantly over the coming decades. At the same time, Americans are struggling to plan for their retirements. Reforming Social Security and our private pension system, if done correctly, can play a meaningful role in addressing these challenges.

It is better to act sooner rather than later. But even more important than acting sooner is to obey the Hippocratic Oath: first, do no harm. If done in the wrong way, Social Security and pension reform could worsen our long-run fiscal outlook, depress national savings, and make retirement even less secure. President Bush's Social Security proposal would have all of these effects.

In my testimony I will first discuss the fundamental goals of Social Security and pension reforms. Second, I will explain why President Bush's Social Security plan fails to satisfy these goals. Third, I will evaluate the idea of replacing the President's "carveout" accounts with what proponents call "add-on accounts." I favor ways to encourage moderate income families to save more, but if add-on accounts are not focused on that goal and fully paid for by offsets, they could set back our fiscal system and Americans' retirement security. Finally, I conclude.

I. Goals of Social Security and Pension Reform

Social Security and pension reforms should be guided by four principal goals:

1. **Restore Social Security Solvency.** If no changes are made, the Social Security Trust Fund is projected to become exhausted in 2041 and tax revenues will be sufficient to only pay 74 percent of scheduled benefits in that year.[2] The pre-eminent goal of Social Security reform is to ensure that Social Security is sustainably solvent while using only dedicated revenue and avoiding abrupt and dramatic tax increases or benefit reductions in the future.
2. **Address America's Fiscal Challenge—Both in the Short Run and Long Run.** In fiscal year 2004, the federal government ran a unified deficit of $412 billion, or 3.6 percent of Gross Domestic Product (GDP). Over the coming decades, the combination of phased-in tax cuts, rising health costs, and demographic changes will inexorably lead to significantly larger deficits and debt. Deficits of this magnitude reduce economic growth, increase the likelihood of an economic crisis, and will inevitably require higher taxes or lower government spending in the future. Although Social Security is not the principal source of these deficits, well-designed Social Security reform can and should play a modest role in reducing deficits both in the short run and in the long run.
3. **Strengthen Retirement Security.**[3] Financial planners recommend having enough income in retirement to replace about 70 percent of pre-retirement income. Social Security plays a critical role in guaranteeing a comfortable retirement for most Americans: more than two-thirds of retirees rely on Social Security for more than half of their retirement income.[4] But, the current Social Security system has some deficiencies, including high poverty rates for widows, high poverty rates for older beneficiaries, and the lack of an effective minimum benefit to ensure that retirees do not fall below the poverty line. To supplement Social Security, workers rely on defined contribution plans like 401(k)s and personal savings through IRAs and other vehicles. But about half of Americans work at companies that do not offer pensions and the current system provides little or no tax incentive to help moderate-income families save. Reform can strengthen retirement security by ensuring that future Social Security benefits are adequate, sustainable, and supplemented by additional savings.
4. **Increase National Savings.** Increased national savings would lead to more investment, augmenting the capital stock and thus future economic output. Or,

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

[2] Board of Trustees, Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, *The 2005 Annual Report of the Board of Trustees of the Federal Old-age and Survivors Insurance and Disability Insurance Trust Funds*, ("2005 Trustees Report"). All estimates in this testimony are based on the Social Security Trustees' assumptions.

[3] Strengthening disability security is also a critical priority but one that is beyond the scope of this testimony.

[4] Thomas Hungerford *et al.*, "Trends in the Economic Status of the Elderly, 1976–2000" *Social Security Bulletin* 64:3, January 2003.

higher national savings would reduce the need for foreign borrowing, which means that Americans would be able to consume more of our future economic output. Increasing national savings is the only way to expand the economic pie. This is the only way to ameliorate the potentially painful tradeoff between future consumption by the young and future consumption by the old. In the last three years, net national savings has averaged 1.6 percent of GDP—the lowest level in seventy years. At the same time, investment was financed by an average 4.8 percent of GDP in capital inflows from abroad, the highest level on record. Borrowing at this level is unsustainable and eventually this debt will need to be repaid. Social Security and pension reform can help increase private savings and reduce government dissaving (i.e., by reducing budget deficits).

Reform should advance these four goals. Any reform that impedes progress on any of these goals must be rejected. For example, it would be easy to make Social Security sustainably solvent by transferring trillions of dollars to the Trust Fund, but that would be a fiscal disaster and it would hinder efforts to increase national savings. To give another example, it would be easy to provide new tax incentives for savings. But if these tax incentives are not fully paid for and well-designed they could worsen the long-run fiscal outlook and reduce national savings.

II. The President's Social Security Reform Proposal

The President has announced two parts of his Social Security plan. In his State of the Union Address on February 2, he proposed private accounts, to be paid for by reductions in traditional Social Security benefits.[5] In his April 28press conference, the President proposed sliding-scale benefit reductions modeled on investment executive Robert Pozen's "progressive price indexing" plan (the White House fact sheet described this proposal as a "sliding scale benefit formula").[6] The White House has not provided the full details of this plan, nor has it released the traditional Social Security actuaries' memo, which provides 75-year estimates of the financial effects of the proposal and its impact on beneficiaries.[7] Nevertheless, the details the White House has released are sufficient to permit analysis of the proposal and its ability to meet the four principal goals of Social Security and pension reform.[8]

A. The President's Proposal and Social Security Solvency

Normally the actuaries' analysis would show the impact of the President's proposal on solvency and the fiscal situation. In the absence of the traditional Social Security actuaries' analysis, I assessed the proposal using the data in the 2005 Social Security Trustees Report, as well as standard actuarial and fiscal estimates. My analysis is based on the actuaries' analysis of the Pozen proposal, the actuaries' analysis of similar private-account plans, and the actuaries' analysis of the President's private accounts through 2015.

The Impact of Sliding-Scale Benefit Reductions on Solvency

The President has proposed sliding-scale reductions in Social Security benefits for retirees and survivors. Reductions would start in 2012 and grow over time. This proposal would postpone Social Security's cash flow deficits by only about two months—Social Security would go into cash flow deficit slightly later in 2017. Although I do not believe the date of the onset of cash flow deficits is an analytically meaningful way to measure Social Security's challenges or the impact of alternative reforms, those who do believe the 2017 date is meaningful should be concerned about the negligible impact of the President's proposal.

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[5] White House, "Strengthening Social Security," February 2005 and Stephen Goss, Chief Actuary, Social Security Administration, "Preliminary Estimated Effects of a Proposal to Phase In Personal Accounts," February 3, 2005.

[6] White House, "Fact Sheet: Strengthening Social Security for Those in Need," April 28, 2005. This analysis assumes that the President's plan would have the same magnitude of benefit reductions for retirees and survivors as the Pozen plan and that his plan would add a modest minimum benefit. This assumption is consistent with the White House fact sheet's explicit claim that "this reform would solve approximately 70 percent of the funding problems facing Social Security."

[7] The White House has released an actuaries' memo showing the financial effects of the first 10 years of individual accounts portion of the proposal.

[8] All estimates are based on the assumptions of the Social Security Trustees, unless indicated otherwise. Additional details underlying this analysis are available in Jason Furman, "The Impact of President Bush's Proposal on Social Security Solvency and the Budget," Center on Budget and Policy Priorities May 10, 2005 and Jason Furman, "An Analysis of Using Progressive Price Indexing' To Set Social Security Benefits," Center on Budget and Policy Priorities, May 2, 2005.

Any measure that does not eliminate the entire 75-year shortfall in Social Security will result in the Trust Fund becoming exhausted at some point in the next 75 years. The President's sliding-scale benefit reduction plan would push back the exhaustion of the Social Security Trust Fund by 6 years, to 2047. After that date, a roughly 15 percent across-the-board benefit cut—on top of the benefit cuts that the President has proposed—would be required to achieve solvency.

The White House states that its "reform would solve 70 percent of the funding problems facing Social Security".[9] But the White House has subsequently acknowledged that this statement refers to the *deficit in the 75th year—2079—not to the cumulative deficit over the next 75 years*.[10] Unlike the President's proposal, the Pozen proposal, as Robert Pozen states, would "close the long-term deficit of Social Security by over 70%." One-sixth of the improvements in solvency in the Pozen plan come from reductions in disability benefits. Taking into account the President's promise to shield disability benefits and the President's promise to provide a modest minimum Social Security benefit, the President's plan will only close 59 percent of the 75-year deficit.[11]

The Impact of Individual Accounts on Solvency

The President also proposes to allow workers to divert 4 percentage points of their payroll taxes (up to a maximum amount) into individual accounts. The President's proposal would require workers, in effect, to repay the "loans" these contributions represent through a reduction in their traditional defined Social Security benefit.

Diverting payroll tax revenue to private accounts would reduce the revenue available to pay Social Security benefits and thereby advance the date when the program's benefit costs exceed its non-interest income.

The combined effects of the President's benefit reductions and private accounts proposals would accelerate the date when Social Security's tax revenues no longer are sufficient to pay benefits to 2011.[12] As a consequence of the President's plan, Social Security will have to start using interest on the Trust Fund to pay benefits 6 years earlier than under current law. Under the President's benefit reductions and private accounts proposals, the Trust Fund would be exhausted in 2030—11 years earlier than under current law.

Moreover, the President's Social Security accounts would increase the program's projected 75-year actuarial deficit by about 0.56 percent of payroll. The Social Security actuaries estimate that the deficit will be 1.92 percent of payroll. So, taken alone, the accounts would increase the size of the 75-year shortfall by nearly one-third.

The accounts would substantially worsen Social Security's projected shortfall over the next 75 years because under the President's proposal reductions in Social Security benefits to repay the Trust Fund for the funds diverted into accounts would be made with a lag. Some of the funds diverted from Social Security to accounts over the next 75 years would not be repaid until after the end of the 75-year period.

Because the accounts would increase Social Security's shortfall over the next 75 years, the net effect of the President's proposed benefit reductions and accounts would be to close only *30 percent* of Social Security's 75-year shortfall. More than

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[9] White House Fact Sheet, April 28, 2005.

[10] This is *not* the standard measure used to evaluate the effect of a proposal on Social Security solvency. It is, at best, a secondary measure, and one with significant weaknesses. One could design a plan that would not *start* until 2079, with no changes until that date, but that would eliminate the entire Social Security shortfall in 2079. Such a plan would fail to restore solvency over the 75-year period or to improve the fiscal outlook for the next seven and a half decades.

[11] Based on Peter Diamond and Peter Orszag, "Reducing Benefits and Subsidizing Individual Accounts: An Analysis of the Plans Proposed by the President's Commission to Strengthen Social Security," June 2002. In addition, this analysis assumes the President's minimum benefit is similar to the ones proposed in Commission Models 2 and 3.

[12] This analysis updates the projections in the actuaries' memo for the new projections in the 2005 Trustees Report. This date was 2012, according to estimates by the Social Security actuaries based on the 2004 Trustees assumptions, see Stephen Goss, Chief Actuary, Social Security Administration, "Preliminary Estimated Effects of a Proposal to Phase In Personal Accounts," February 3, 2005. This memo estimated that the accounts would cost $95 billion in 2011. This is larger than the $88 billion cash surplus for 2011 projected in the 2005 Trustees Report.

two-thirds of the shortfall would remain.[13] To close this gap, the President's plan would require general revenue transfers amounting to $3 trillion in present value.[14]

The accounts would also worsen projected solvency over the infinite horizon, but by a smaller percentage. This is because in a significant percentage of cases the benefit offset required to make the accounts actuarially neutral will not be collected. For example, if an unmarried worker dies prior to retirement his or her entire account goes to his or her estate and the benefit offset is not collected.[15] Or take the case of the higher-earner. In many cases, his or her entire Social Security benefit would be less than the benefit offset associated with the account. In those cases, the higher earners' entire traditional benefit would be wiped out but the Trust Fund would not collect the remainder of the benefit offset and solvency would be worsened. This case would apply to anyone with steady earnings at or above the payroll tax cap (now $90,000 a year) who retires after 2060. There are other such examples.[16]

B. The Fiscal Impact of the President's Proposal

The President's Social Security proposal would result in a large increase in the debt held by the public, in the near-term and over the longer-term (i.e., the next 60 years).

According to the Social Security actuaries, the President's accounts would cost $743 billion over the first seven fiscal years (from 2009 to 2015). Even this estimate is not fully reflective of the seven-year cost because the accounts would only be available to all workers for the last four of these seven years.[17]

Over longer periods, the effect on the debt would be far greater. The President's accounts would add $1.5 trillion to the debt over the first ten years that the plan is in effect (from 2009 to 2018.) The accounts would cause the debt to increase by another $3.8 trillion in the decade after that, for a total of $5.3 trillion over the first twenty years.

The sliding-scale benefit reductions that the President is proposing would reduce the debt by relatively modest amounts in coming decades. Over the first twenty years, those benefit reductions would reduce the debt by $400 billion. The combined effect of the accounts and the sliding-scale benefit reductions the White House is proposing would be to add $4.9 trillion to the debt over the first twenty years.

The debt would continue to rise after twenty years, both in dollar terms and as a share of GDP, as shown in Figure 1. The accounts, by themselves, would lead to *permanently* elevated debt. Although the sliding-scale benefit reductions would eventually start to bring that debt down, the debt would remain elevated through 2067. This would lead to higher interest payments on the debt, increasing the burden for future taxpayers.

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[13] Some may try to argue that there would be a small cash-flow surplus in 2079 under the plan. This is misleading because it ignores the substantial interest payments—either by the general fund or by Social Security—associated with the accounts. The interest on the $3 trillion in general revenue transfers that would be necessary to pay benefits through 2079 would be 4.2 percent of taxable payroll in 2079.

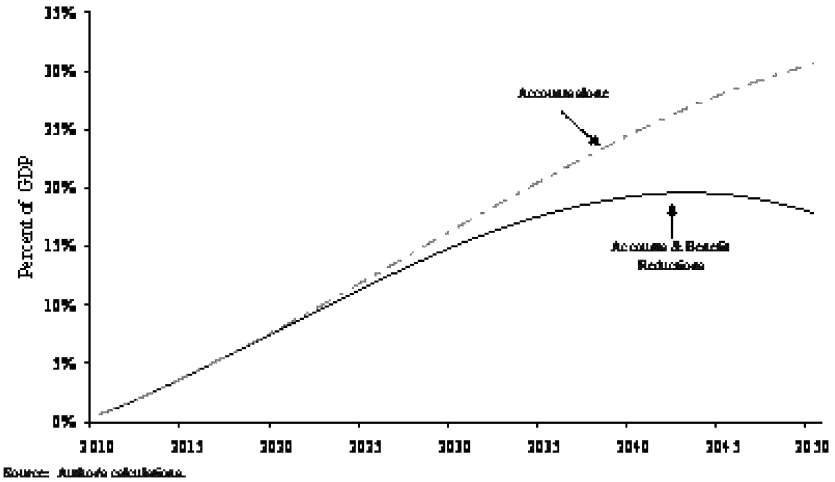
[14] According to the actuaries' memo, the Pozen plan would entail $1.9 trillion in general revenue transfers. The transfers under the President's plan are larger both because he is proposing larger accounts (Pozen has two percent accounts) and smaller benefit reductions (Pozen's plan would reduce disability benefits and does not contain a minimum benefit).

[15] In the case of the Pozen plan, the benefit offset is taken directly out of the account and the account, if anything remains, is given to the estate.

[16] For a further discussion of this issue, see Peter Orszag, "Social Security Reform, Testimony Before the Senate Finance Committee," April 26, 2005.

[17] The accounts would not be available to all workers until 2011 and they would not be phased fully in until 2041. That is the year in which the cap on the maximum amount that could be diverted to a private account each year would rise to a high enough level so that all workers could contribute a full 4 percent of their taxable earnings to the accounts.

Figure 1. Additional Debt Held by the Public



Some have argued that the additional debt associated with the accounts would not be a source of concern for financial markets or the economy more broadly. They argue that, over an infinite horizon, this debt diminishes or disappears and that as a result even the initially high levels of debt should be considered neutral from an overall fiscal position. The accounts causing no fiscal harm is the best case scenario. No one has argued that the debt associated with the accounts has any fiscal benefits.

There is a significant probability that the debt associated with the accounts would harm the economy.[18] The borrowing to pay for the accounts would take the form of "explicit debt," that is government bonds. These bonds cannot be defaulted on and must be rolled over or serviced on an annual basis. This explicit debt would replace "implicit debt" in the form of reduced future Social Security obligations. Implicit debt, however, is very different from explicit debt. It does not need to be rolled over or serviced on an annual basis. The total amount of implicit debt is based on projections and is not legally binding, unlike the tangible debt issued in the form of Treasury bonds.

Financial markets, both in the United States and abroad, are likely to be more troubled by the explicit debt than they currently are by the implicit obligations of the U.S. government. Federal Reserve Chairman Alan Greenspan testified that if financial markets did not distinguish between implicit and explicit debt, then the borrowing associated with accounts would have no impact on the market. But he went on to say, "But we don't know that. And if we were to go forward in a large way and we were wrong, it would be creating more difficulties than I would imagine."[19]

The record is replete with nations undergoing fiscal crises because of explicit debt. No nation has undergone a fiscal crisis because of implicit debt.

Furthermore, rational financial markets would understand that the eventual repayment of the debt associated with the President's accounts would be decades in the future and would depend on large and potentially politically unsustainable benefit reductions. To the degree that financial markets partially discounted these benefit reductions or factored in the possibility of a government bailout in the event of a major stock market crash, this added debt would have a significant impact.

In summary, the accounts portion of the President's plan would result in *permanently* higher debt than the same plan without accounts. Even when combined with sliding-scale benefit reductions, the debt would be elevated for more than sixty

[18] For an extended discussion of these issues see Jason Furman, William G. Gale and Peter R. Orszag, "Should the Budget Rules Be Changed To Exclude the Cost of Individual Accounts," *Tax Notes* January 24, 2005.

[19] Alan Greenspan Testimony, February 16, 2005.

years. It is important to remember that even from the vantage point of 2067, when the debt would be the same as under current law, the proposal would be judged a failure. The goal of Social Security reform is not to leave the debt the same as under current law, it is to significantly reduce the debt in order to help relieve future fiscal pressures. The debt associated with the President's accounts proposal would have no upside benefits and substantial downside risks.

C. The Impact of the President's Proposal on Retirement Security

The President has not proposed any revenue increases for Social Security but instead is proposing to drain revenue from Social Security into individual accounts. Together, this necessitates very large reductions in traditional defined Social Security benefits. The President's plan includes two sets of benefit reductions. The first benefit reduction is a sliding-scale benefit reduction that would apply to all workers making over $20,000 per year (and, as explained below, to some beneficiaries making even less than $20,000 per year). The second benefit reduction is the benefit offset that would apply to workers who opt for private accounts. Together, as explained below, these proposals would greatly diminish Social Security—the core tier of retirement security. The large majority of Americans would rely on investments that are subject to market risk for the large majority of their retirement income. Accounts will not necessarily make up for benefit offsets. As a result, workers would be left with substantially lower retirement income than they enjoy under the current-law formula.

The First Benefit Reduction: Sliding-Scale Benefit Reductions

The President is proposing to reduce benefits relative to the current-law benefit formula. This proposal would apply to the large majority of beneficiaries, whether or not they opt for accounts. Under the President's proposal Social Security would replace a smaller and smaller amount of recipients' pre-retirement income. These replacement rates are the most meaningful way to compare Social Security benefits over time.[20]

Social Security replacement rates would be reduced for *all* beneficiaries who make over $20,000 annually.[21] In addition, as explained below, replacement rates would be reduced for some beneficiaries who make less than $20,000 annually.

The replacement rates would be reduced more for higher-income beneficiaries. The Social Security actuaries have estimated that the average worker (someone who currently earns $37,000) would see his or her replacement rate reduced by 16 percent in 2045 and 25 percent in 2075 (see Table 1). A so-called "high earner," someone with income 60 percent above the average (or current earnings of about $59,000) would see his or her replacement rate reduced by 28 percent in 2045 and 42 percent in 2075. The percentage reduction in benefits would be only slightly larger for people making $90,000 or $9 million annually.

The percentage reductions in replacement rates for average workers under the President's proposal are larger than the reductions in any Social Security reform previously undertaken.

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[20] Some have proposed comparing price inflation-adjusted benefit levels over long periods of time. This, however, is an inappropriate standard in measuring a *retirement* benefit. The expectations and needs for retirement income grow with income. The amount of money that was necessary for a secure retirement in 1940 would not provide enough today. According to the Congressional Research Service, price inflation was 58.6 percent lower than wage inflation since 1940 (Congressional Research Service, "Memorandum: Estimated Effect of Price-Indexing Social Security Benefits on the Number of Americans 65 and Older in Poverty," January 28, 2005). Applying this adjustment to benefits would reduce the initial retirement benefit from $15,000 to $6,000. The later might be enough to meaningfully contribute to a secure retirement in 1940, but it would fall well short in 2005.

[21] Pozen specifies that the plan would effect people who make over $25,000 annually in the year 2012 in 2012 non-inflation adjusted dollars. This number is adjusted to 2005.

Table 1

Social Security Benefits Under Sliding-Scale Benefit Reductions
For Workers Retiring at Age 65 in Various Years
(inflation-adjusted 2005 dollars)

	Current-law Formula		Proposal		Change	
	Benefit	Replacement Rate (percent)	Benefit	Replacement Rate (percent)	Reduction	Percentage Reduction (percent)
Scaled Low Earner (45 percent of the average wage, or $16,470 in 2005)						
2025	$9,718	49	$9,718	49	$0	0
2045	12,041	49	12,041	49	0	0
2055	13,413	49	13,413	49	0	0
2075	16,599	49	16,599	49	0	0
Scaled Medium Earner (average wage, or $36,600 in 2005)						
2025	16,009	36	14,984	34	−1,025	−6
2045	19,837	36	16,584	30	−3,253	−16
2055	22,097	36	17,545	29	−4,552	−21
2075	27,344	36	19,715	26	−7,629	−28
Scaled High Earner (160 percent of the average wage, or $58,560 in 2005)						
2025	21,228	30	19,190	27	−2,038	−10
2045	26,302	30	19,858	23	−6,444	−25
2055	29,296	30	20,214	21	−9,082	−31
2075	36,254	30	21,100	18	−15,154	−42
Steady Maximum Earner (taxable maximum, or $90,000 in 2005)						
2025	25,929	24	22,999	21	−2,930	−11
2045	32,153	24	22,829	17	−,324	−29
2055	35,751	24	22,666	15	−13,085	−37
2075	44,236	24	22,428	12	−21,808	−49

Source: Author's calculations based on Social Security Administration, Office of the Chief Actuary, "Estimated Financial Effects of a Comprehensive Social Security Reform Proposal Including Progressive Price Indexing—INFORMATION," February 10, 2005 and Social Security Trustees, *2004 Annual Report*. Note that all percentage reductions in benefits are taken directly from the actuaries' memo.

The President's Social Security proposals have been widely reported as protecting benefits for the bottom 30 percent of the population, people earning less than $20,000 today. But a document that the White House gave reporters in a press briefing on May 4 contains charts which show that the bottom 20 percent of beneficiaries *lose* benefits, on average, under its plan.[22] This happens because although the President's plan protects retirees who earn benefits based on their own earnings histories, it does not protect people who earn benefits based on someone else's earnings history. A substantial number of low-income beneficiaries, such as widows, surviving children and ex-spouses, would thus be subject to benefit reductions.

The White House analysis shows that average Social Security benefits for the bottom quintile of beneficiaries (aged 62 to 76 in 2050), would be $866 a month under the current benefit structure, but only $822 a month under the President's plan. This represents an average benefit reduction of $528 a year for beneficiaries in the bottom quintile. In fact, the White House numbers are likely to understate the benefit reductions for these groups for reasons described in more detail elsewhere.[23]

[22] White House, "Interpreting the Benefit Estimates for the Pozen Provision," May 2005. For further analysis of this White House document, see Jason Furman, "White House Distortions Mask Social Security Benefit Reductions," May 6, 2005.

[23] Jason Furman, "New White House Document Shows Many Low-Income Beneficiaries Would Face Social Security Benefit Cuts Under the President's Plan," Center on Budget and Policy Priorities, May 10, 2005.

The Second Benefit Reduction: The Benefit Offset for Private Accounts

In addition to the first benefit reduction, workers who opt for the President's proposed private accounts would be subject to a second reduction in their traditional defined Social Security benefit.

Under the President's proposal, workers could contribute up to 4 percent of taxable wages to private accounts. These contributions would be capped at $1,000 in 2009, with the cap increasing thereafter by $100 per year, plus wage inflation. By 2041, all workers would be able to contribute a full 4 percent of taxable payroll to their accounts. Workers who elect private accounts would have their traditional Social Security benefit reduced by their contributions to the accounts, plus an interest charge set at 3 percent above the inflation rate.

The combination of the sliding-scale benefit reductions and the benefit offset associated with private accounts would radically transform retirement, leaving the average worker with a fraction of the benefit he or she is entitled to today. Consider an average worker retiring in 2055, the first worker who would be eligible to participate fully in the President's proposed accounts. The sliding-scale benefit reduction would reduce this worker's scheduled benefit by 21 percent. The benefit offset would reduce the scheduled traditional Social Security benefit by 45 percent. Together, these two benefit reductions would reduce the traditional defined benefit by 66 percent. This worker would have a guaranteed benefit of only $7,500 annually. The majority of the workers' retirement income would come from the individual account, pensions, and other savings—all of which is subject to market risk.

These double reductions in benefits grow dramatically for higher income workers and workers retiring later, as Table 2 shows. For example, a worker making the equivalent of $59,000 in today's wage-adjusted dollars and retiring in 2075 would see a 97 percent reduction in his or her traditional defined Social Security benefit. Virtually all of this workers retirement income would come from the individual account and other savings.

Table 2

Annual Social Security Defined Benefits (Excludes Account Value)

(inflation-adjusted 2005 dollars)

	Current-law Formula	Sliding-Scale Benefit Reduction	Benefit Offsets for 4% Accounts	Total Defined Benefit	Percentage Change
Workers Retiring in 2055 At Age 65					
Low earner	$13,413	−$0	−$4,507	$8,906	−34%
Medium earner	22,097	−4,522	−10,062	7,513	−66%
High earner	29,296	−9,082	−16,464	3,750	−87%
Maximum earner	35,751	−13,085	−19,949	2,717	−92%
Workers Retiring in 2075 At Age 65					
Low earner	16,599	−0	−5,577	11,022	−34%
Medium earner	27,344	−7,629	−12,414	7,301	−73%
High earner	36,254	−15,154	−19,867	1,233	−97%
Maximum earner	44,236	−21,808	−32,557	0	−100%

Source: Author's calculations based on Social Security Administration, Office of the Chief Actuary, "Estimated Financial Effects of a Comprehensive Social Security Reform Proposal Including Progressive Price Indexing—INFORMATION," February 10, 2005 and "Preliminary Estimated Financial Effects of a Proposal to Phase In Personal Accounts—INFORMATION," February 3, 2005. Note that the 4 percent accounts are assumed to have a maximum contribution of $1,000 in 2009, growing by $100 per year plus wage inflation, along the lines proposed by the President.

When Medicare premiums are deducted from Social Security benefits, the results are even more dramatic. Subtracting these premiums would leave little or no traditional Social Security benefit for anyone retiring after 2055 with an income that is above the equivalent of about $35,000 today. These workers would have to rely entirely on their private accounts for all of their other needs.

The combination of sliding-scale benefit reductions and carveout accounts raise very serious concerns about the unraveling of Social Security. The benefit offset for the accounts is designed in such a manner that it would lead participants to devalue their traditional Social Security benefits (and all the associated disability insurance, life insurance, and other advantages) and overvalue their private accounts. Many Americans would appear to get little or nothing from their traditional Social Secu-

rity contributions, while lower-income families would still get relatively more substantial benefits. This could lead to significant political pressure to shift more of Social Security into private accounts and reduce defined benefits for lower-income workers.

Would Higher Returns on Accounts Make Up for These Benefit Reductions?

Would the accounts the President is proposing help make up for these benefit reductions? The way the accounts are structured, a participant would need to get a rate of return (after subtracting administrative costs) that is more than 3 percent above the inflation rate to make up for the second benefit reduction, the benefit offset. A rate of return well above 3 percent would generally be needed to make up for both sets benefit reductions.

In effect, the President's accounts are structured like a margin loan. If you do not get a high enough return to make up for the margin interest, you lose money on the account. If you come out ahead of the margin interest rate, your net retirement benefit only goes up by the degree to which your return exceeds 3 percent above inflation, not by the entire value of the account. In the words of former Securities and Exchange Commission Chairman Arthur Levitt Jr.:

Every dollar you take out of traditional Social Security and put into a PSA must be paid back out of your Social Security benefit—plus interest. If this sounds a lot like margin investing, it should not be a surprise since the PSA plan is modeled on that concept: A worker investing in a PSA would hope—like a margin investor—that assets accrued were greater than debts (money lent plus interest). If not, he would end up with a smaller Social Security benefit than if he stayed in the traditional system. To come out ahead, then, an investor would have to earn a rate of return that exceeds the interest of the loan, plus expenses.[24]

The President has proposed to set up "lifecycle" accounts as the default option for investors. These accounts would switch portfolio allocations towards bonds as a worker nears retirement. The goal is to capture potentially higher stock market returns while reducing the risks associated with stock market investment. Noted financial economist Robert Shiller, author of *Irrational Exuberance*, however, showed that "lifecycle" accounts do not provide a free lunch and are still subject to considerable risks.

Shiller conducted a simulation using historic returns from 1871 to 2004 to answer the question of whether or not workers would come out ahead of the 3 percent hurdle required to make up for the second benefit reduction.[25] Using actual historical returns, Shiller found that workers opting for a "lifecycle account" modeled on the President's proposal would end up losing money 32 percent of the time. That is, 32 percent of the time workers would not even make enough to overcome the benefit offset. They would be worse off as a result of opting for the accounts.

Shiller found a median rate of return with the lifecycle accounts of 3.4 percent above inflation. That is above the 3 percent hurdle required to break even on the private accounts but well below the 4.6 to 4.9 percent rate of return assumed by the Social Security actuaries. In most cases, this would not be enough to make up for the sliding scale benefit reduction.

Shiller also conducted the simulation using what he considers more "realistic" returns reflecting international experience. He finds that workers would lose money on the accounts 71 percent of the time. The median rate of return would be 2.6 percent. Professor Shiller concludes that the accounts are a bad deal. This is also the conclusion reached by Goldman Sachs Chief Economist Bill Dudley who concluded that the accounts are "not an attractive proposition."[26]

Even the more realistic returns assumed for the second part of Shiller's study are *higher* than the returns projected by a wide range of financial economists surveyed by the *Wall Street Journal* in February.[27] In addition, a recent paper by economists Dean Baker, Brad DeLong, and Paul Krugman demonstrates that if economic growth slows as much as the Social Security Trustees project, stock returns are likely to be lower than in the past.[28]

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[24] Arthur Levitt Jr., "Reform is Good, PSAs Are Not So Good," *Wall Street Journal*, April 26, 2005.

[25] Robert Shiller, "The Life-Cycle Personal Accounts Proposal for Social Security: An Evaluation," March 2005.

[26] William Dudley, "Social Security Reform: Are Personal Savings Accounts Attractive?" *Goldman Sachs U.S. Daily Comment*, February 23, 2005.

[27] Mark Whitehouse, "Social Security Reform Plan Leans on Bullish Market," *Wall Street Journal*, February 28, 2005.

[28] Dean Baker, Brad DeLong and Paul Krugman, "Asset Returns and Economic Growth," March 2005.

Moreover, even these lower rates of return do not take into account the additional risks associated with equity investment. Virtually all economists agree that any assessment of the likely outcome of this margin loan should take into account the additional risks associated with investing in equities. As Gary Becker, a Nobel Laureate in economics and supporter of individual accounts explains: "There are no freebies from such investments since the higher return on stocks is related to their greater risk and other trade-offs between stocks and different assets."[29]

The Congressional Budget Office (CBO) uses what is known as "risk adjustment" in estimating the featured returns on private accounts established under Social Security plans. This means that CBO adjusts stock returns to reflect the higher risk that stock investments carry. Under CBO's analyses, private accounts "are expected to earn an annual return of 3.0 percent [above inflation]," after adjustment for risk.[30] Risk adjustment makes the balances in private accounts (which are subject to market risk) comparable to the value of the guaranteed Social Security benefit (which is not subject to market risk).[31] Without adjusting for risk, comparing the certain balance in a traditional benefit to the uncertain balance in a private account is misleading and economically meaningless.[32]

Both CBO and the Office of Management and Budget use this risk-adjustment methodology when estimating the returns that the Railroad Retirement Fund will earn on its stock investments for the purposes of official government accounting.

From the perspective of risk adjustment, workers would not come out ahead if they opt for private accounts.[33] Private accounts simply introduce substantial additional risk into the core tier of retirement security without doing anything to lessen the sliding-scale benefit reductions the President is proposing.

Table 3 summarizes the scenarios described in this section for an average earner retiring in 2075 under the President's proposal. This worker is subject to a $7,629 sliding-scale benefit reduction and a $12,414 benefit offset. The table shows the account annuities the worker would get under alternative investment return scenarios.

In the risk-adjusted case, the featured case in CBO analysis, the account exactly makes up for the benefit offset—leaving the worker subject to the full sliding-scale benefit reduction. Using what Shiller describes as "realistic" returns on a lifecycle account, the account would only get a 2.6 percent return and thus fall short of even making up for the benefit offset leaving the worker even further behind. Actual historical returns with a lifecycle account or the returns forecast by leading economists surveyed by the *Wall Street Journal* are both 3.4 percent—enough to make up for the benefit offset but not nearly enough to make up for the sliding-scale benefit reduction.

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[29] Gary Becker, "A Political Case for Social Security Reform," *Wall Street Journal*, February 15, 2005.

[30] Congressional Budget Office, "Long-term Analysis of Plan 2 of the President's Commission to Strengthen Social Security," July 21, 2004. CBO assumes a risk-adjusted rate of return on investment of 3.3 percent, which is CBO's projected return on Treasury bonds, minus 0.3 percent for administrative and management fees.

[31] Some have argued that the benefit under the traditional system is subject to political risk. But these same political risks also apply to total benefits under the system with accounts. The remaining traditional benefit could be reduced further, a tax could be applied to individual account accumulations or withdrawals, or the government could modify the interest rate used to calculate benefit offsets. There is no sense in which this political risk disproportionately applies to the current system and thus it does not effect the comparison of the level of benefits under the two plans.

[32] Office of Management and Budget, Analytical Perspectives, Fiscal Year 2006 Budget, February 2005, p. 421.

[33] This is true to the degree that Treasury yields are 3 to 3.3 percent, as projected by the Social Security Trustees and CBO respectively. Workers, however, would be slightly better off from opting into the accounts because of the leakage: there is a chance they would not have to repay their full offset due to pre-retirement death, a high income, or other factors. All of these benefits, however, would be reflected in the reduction in solvency and thus would require correspondingly larger reductions in the traditional benefit. These would not be *net* benefits, just reallocations of existing benefits.

Table 3

Effect of Alternative Account Returns on Total Benefit

(inflation-adjusted 2005 dollars)

	Sliding Scale Benefit Reduction	Benefit Offset	Annual Account Value	Net Change
Low Return Case (2.0%)	−$7,629	−$12,414	10,316	−9,727
Realistic Lifecycle Return (2.6%)	−7,629	−12,414	11,774	−8,269
Risk-Ajusted Returns (3.0%)	−7,629	−12,414	12,414	−7,629
Historical Lifecycle Return (3.4%)	−7,629	−12,414	14,125	−5,918
Wall Street Journal Survey (3.4%)	−7,629	−12,414	14,125	−5,918
High Return Case (4.6%)	−7,629	−12,414	18,779	−1,264

Notes: Lifecycle returns are the annual internal rates of return on lifecycle accounts estimated by Shiller. For the "historical" sample the average stock return is 6.8 percent annually and the average bond return is 2.7 percent annually. The *Wall Street Journal* returns uses the median returns from the *Wall Street Journal* survey on February 28, 2005, assuming the same portfolio proposed by the President's Commission to Strengthen Social Security.

D. The Impact of the President's Proposal on National Savings

Raising net national savings should be a fundamental goal of any proposal to reform Social Security and pensions. This goal was unanimously accepted by the 1994–96 Advisory Council and endorsed by the President's Commission to Strengthen Social Security. Higher national savings leads to increased investment and/or reduced foreign borrowing. Either way, higher savings is the only way to increase consumption by the elderly without reducing consumption by the young.

The President's accounts proposal (by itself and not counting the benefit reductions), does nothing to raise national savings and could even result in lower national savings.[34] The President's plan would put money into accounts (representing saving) while contemporaneously financing these contributions with higher federal borrowing (representing dissaving). The net effect would be no increase in savings.

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

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

However, there is no reason to believe that privatization by itself would raise national savings. The government by itself has to finance its deficit one way or another. In order to induce private investors to accept government bonds that would have been bought by the Trust Fund, their yield has to go up (increasing the debt burden on taxpayers), or the yield on stocks must fall, or both. *At the end of the day, all that takes place is a swap of public and private securities between the Trust Fund and private markets—no new savings is created.*[35] (emphasis added)

The primary effect of the President's accounts proposal is no change in national savings. As a result, the proposal fails to meet one of the principal goals for Social Security reform—increasing national savings. Further, two secondary effects could be important.

First, the accounts would reduce savings if individuals treat them as net wealth and consequently decrease their 401(k)s and IRAs savings. The completely rational actor that inhabits economics textbooks should not change his or her savings as a result of the accounts: every dollar contributed to the account is matched by a dollar reduction in present value terms in future Social Security benefits. As a result, the accounts do not represent net wealth but are instead a loan. Workers will still need to save as much of their own money to enjoy a dignified retirement. But, the design of the President's accounts (and the way in which they are often described) could lead many people to ignore the benefit offset associated with the account and to in-

[34] The benefit reductions in the President's plan could lead to modest increases in national savings over time, although they would do relatively little to pre-fund Social Security by substantially increasing up-front savings. This subsection is concerned with the question of whether the accounts in the President's proposal would further or set-back the effort to increase national savings.

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

correctly assume that the accounts represent new wealth. Such people could feel less need to save in the form of 401(k)s and IRAs.[36] This would not just reduce national savings, it would also leave these people *even less* prepared for retirement.

Second, in theory the accounts could increase savings if the higher deficits associated with accounts lead to lower government spending and/or higher taxes. In this case, the government would not be completely financing the accounts with borrowing and national savings would increase. This theory depends on the behavior of the current government and future governments. The Bush administration has not claimed that if accounts were passed it would propose additional reductions in federal programs or higher taxes to offset the increased deficit. In fact, administration officials emphasize that they do not believe there is any need for such steps because, they contend, the accounts are fiscally neutral over the infinite future. In addition, the Bush administration has not included the short-run deficit impact of the accounts in its budget submissions. It would be imprudent to base a major policy on the hope that future government spending and/or taxes would change as a result.

As a result, the President's accounts proposal, by itself, is likely to reduce national savings permanently. Even with the potentially offsetting effect of the sliding-scale benefit reductions, national savings would likely be lower and America as a whole would be poorer for several decades.

III. Alternative Approaches to Encouraging Savings

To encourage savings some have proposed "add-on" accounts for Social Security, additional savings incentives, and other pension reforms. Advocates argue that these approaches could sweeten a Social Security reform package that contains strong medicine such as the benefit reductions that the President proposed. But, if the sweetener is funded through deficit spending or does nothing to help make retirement more secure for most families, it could instead become a poison pill. Furthermore, if add-ons are poorly designed, they could reward the existing saving by those who need it least, while doing little to encourage future saving by the families who need help most. There are, however, promising approaches that could encourage savings and be enacted with or without Social Security reform.

A. The Fiscal Impact of Add-On Accounts

In evaluating add-on accounts, the first and most important question is: do they increase the deficit and the debt? If the answer is yes, then the add-on accounts would be a step backwards.

Any voluntary add-on accounts for Social Security would likely be ineffective and counterproductive. Only 5 percent of Americans are currently contributing the maximum to their IRAs and 401(k)s.[37] There is no reason that a worker would make additional contributions to an add-on account when they already have other tax-advantaged ways to save. The only way to encourage add-on contributions would be to provide new tax incentives for contributions to the Social Security accounts. But if the new tax incentives are not fully offset by other changes, they would worsen the long-run fiscal situation and thereby undermine the main goal of Social Security reform.

One example is Congressman Clay Shaw's proposal. He proposes to allow individuals to contribute 4 percent of payroll, up to a maximum of $1,000, into "Social Security Guarantee Accounts." Instead of deducting this amount from payroll taxes and the Social Security Trust Fund (as the President proposes), the Shaw plan would instead fund these contributions with general revenue. The distinction between this approach to funding accounts and the President's carveout proposal is purely a matter of accounting; there is no economically meaningful difference.[38] Both plans would fully fund individual accounts with contemporaneous borrowing. In fact, if anything the Shaw approach could be more problematic because it is less transparent about recording the costs of the new accounts.

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

[37] Craig Copeland, "IRA Assets and Characteristics of IRA Owners," EBRI Notes, December 2002

[38] The President's plan and the Shaw plan have different mechanisms for repaying the account. This difference, however, is not inherent to whether or not the plan is structured as an add-on or a carveout.

Another type of add-on account would graft proposals like Retirement Savings Accounts (RSAs) onto Social Security. For example, some Social Security reform plans have included a provision to allow workers at any income level to make up to $5,000 per year in additional contributions to their private accounts. Contributions get preferential tax treatment—neither interest earned on them nor withdrawals made in retirement would be taxed. (This tax treatment is the same as that is accorded to Roth IRAs.)

These new tax savings would have little cost in the traditional 5—or 10-year budget window because most of the tax benefits are deferred.[39] The long-run cost, however, is substantial. A preliminary estimate is that creating a new $5,000 tax-free account would cost about 0.28 percent of payroll over 75 years or about $600 billion in net present value, over 75 years.[40] This would worsen the long-run fiscal outlook.

Even otherwise desirable new tax incentives for savings—like extending and improving the saver's credit—could be counterproductive if they promoted retirement savings while increasing the long-term budget deficit.

B. Reforms to Promote Retirement Security

Roughly half of households do not have an employer-sponsored pension. The typical household approaching retirement has a defined contribution account balance of $10,000.[41] The assets and participation rates for moderate- and middle-income households are even lower.

The economic evidence shows that savings incentives can be most effective at creating *new* savings when they target moderate-income families who are not saving much currently.[42] In contrast, higher-income families are generally saving a substantial amount already. Expanding savings incentives for these families is likely to lead them to shift their existing saving into tax preferred vehicles. As a result, no new savings is created.

The current tax system is "upside down"—it gives the largest incentives to families that need them the least and are the least likely to save more as a result.[43] Tax preferences for retirement savings, like deductions or exclusions, benefit families based on their marginal rates. If a family is paying no income taxes at all, then it does not benefit at all from tax incentives for savings. But these are precisely the families who need the most help saving and there is the most potential to genuinely increase savings among these moderate-income families. Yet, families in higher tax brackets benefit more from the tax preferences for saving. In total, the Federal government incurred $184 billion in costs on annual tax expenditures in 2003 (in present value terms). Of this only 3 percent goes to the bottom 40 percent of Americans while 49 percent goes to the top 10 percent of Americans.[44]

Carveout accounts would not change the current system at all and would not encourage new saving; they simply represent, in effect, a loan that must be repaid out of defined Social Security benefits.

Add-on proposals modeled on RSAs would make the current system even worse by giving more than 90 percent of the benefit of the tax expenditures to the top 10 percent of Americans. Expanding the maximum annual contribution to IRAs (raising it to $5,000 per person) would do nothing for the 95 percent of Americans who currently contribute less than the limit to their existing IRAs. Eliminating the income limit on Roth IRAs (currently set at $160,000 for married couples) would only provide benefits to high-income Americans.

Expanded tax incentives could provide a windfall for high-income families that more than makes up for the reduction in their Social Security benefits. At the same time, these expanded incentives would not do anything to offset the reductions in benefits for middle-class families. To illustrate this point, consider the two hypothetical families. Both are subject to the President's sliding-scale benefit reductions

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[39] In fact, if the proposal allows workers to convert deductible IRAs to Roth-style savings accounts it can even appear to raise money in the first few years by, in effect, borrowing from the future at unfavorable rates.

[40] This is based on an extrapolation of a preliminary 10-year estimate by the Urban Institute-Brookings Tax Policy Center.

[41] Peter Orszag, "Progressivity and Saving: Fixing the Nation's Upside-down Incentives for Savings," Testimony Before the House Committee on Education and the Workforce, February 25, 2004.

[42] Eric Engen and William Gale, "The Effects of 401(k) Plans on Household Wealth: Differences Across Earnings Groups," NBER Working Paper, 2000.

[43] For further discussion see Gene Sperling, "A Progressive Framework for Social Security Reform," January 10, 2005.

[44] Leonard Burman, William Gale, Matthew Hall, and Peter Orszag, "Distributional Effects of Defined Contribution Plans and Individual Retirement Accounts," Tax Policy Center Discussion Paper No. 16, August 2004.

and both have the option to contribute up to $5,000 annually to an account that accumulates tax free and can be withdrawn at retirement tax free:

- The Smiths make $400,000 annually and retire in 2055. Under the sliding-scale benefit reduction, their annual Social Security benefit is reduced by $13,085. At the same time, the Smiths put $5,000 annually into the new tax-free savings account (previously they had saved this money in a taxable account). By the time they retire, the tax benefits associated with this account save them $250,000 in inflation-adjusted 2005 dollars.[45] That is enough to buy a $17,000 annuity—more than making up for their benefit reduction and leaving them ahead by $3,915 annually.
- The Jones make $37,000 annually and retire in 2055. Like 95 percent of families today, they do not make enough money to contribute the maximum to their existing 401(k) or IRA. They have no additional money to contribute to this new tax-free savings account and get no tax benefits from it. As a result, they do not have any additional money to make up for the $4,522 reduction in their Social Security benefit, leaving them behind by $4,522 annually.

Expanded tax incentives could even make middle-class families worse off if they lead businesses to drop their existing pension coverage, hurting middle-income Americans. On reason owners and executives of small businesses offer pensions to their employees is to take advantage of the tax-favored savings themselves. If they had alternative options for themselves, they would have less incentive to set up plans for their employees. According to an analysis by the Congressional Research Service, "some employers, particularly small employers, might drop their plans given the benefits of private savings accounts."[46]

In contrast, other proposals could enhance retirement security by overcoming obstacles to saving. Some proposals would not require any new tax incentives; they would simply make the process of saving easier and more automatic, overcoming a key obstacle to saving for many families. These proposals include making 401(k) contributions automatic and allowing taxpayers to split their tax refunds so that one part is deposited directly into an IRA.[47]

Alternatively, incentives for saving could be expanded. Currently, the saver's credit provides matching contributions for joint filers making up to $50,000 This credit is scheduled to expire in 2006. The credit could be extended and reformed to make it refundable and more effective. New research from the Retirement Security Project conclusively demonstrates that matching incentives encourage families to save more and that larger matches lead to more savings.[48] But the research also suggests that institutional changes, like a simple matching plan that deposit money directly into the savings account, can be a more effective way to encourage savings. More work on translating this into policy is needed.

C. Designing Proposals To Increase National Savings

Two features are essential in any plan to provide new incentives to raise national savings:

1. First, the plan should be fully paid for without increasing the debt in the short run or the long run. Increased government borrowing, by itself, decreases national savings.
2. Second, the plan should be targeted at encouraging genuinely new savings, not simply at rewarding existing savings.

RSA-style proposals fall short on both counts. They provide windfall tax breaks for people who are already saving and as a result do little to increase personal saving. And, if they are not paid for, RSA-style proposals result in increasing public dissaving over time. The net result is lower national savings, leading to a smaller capital stock and more foreign borrowing.

In contrast, pension reforms and savings incentives that make it easier and more affordable for middle-class families to save would help raise personal savings. And, if these proposals are fully paid for without increasing the deficit, they would also contribute to higher national savings.

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[45] A family making the maximum tax-free contributions to a balanced portfolio would have $750,000. If the contributions had been taxable, the family would only have accumulated $500,000. The difference is the cost of the tax cut.

[46] Jane G. Gravelle, Congressional Research Service, "Effects of LSAs/RSAs Proposal on the Economy and the Budget," January 6, 2004.

[47] See the Retirement Security Project at www.retirementsecurity.org for more details on these and other proposals.

[48] Esther Duflo *et al*, "Saving Incentives for Low- and Middle-Income Families: Evidence from a Field Experiment with H&R Block," Retirement Security Project No 2005–5, May 2005.

IV. Conclusion

Social Security faces a challenge and it is better to address this challenge sooner rather than later. But before tackling Social Security's long-term solvency we should mind the words of the Hippocratic Oath and first, do no harm. Carveout accounts would do substantial harm: they would reduce the solvency of Social Security and add trillions of dollars to the debt while making retirement less secure and potentially reducing national savings. Add-on accounts that are financed by increasing the debt—either in the short run or the long run—would also be counterproductive and harmful.

A balanced set of reforms that modestly increases Social Security's revenues while modestly decreasing benefits could ensure that Social Security is sustainably solvent. Such reforms would help reduce long-term budget deficits and increase national savings. A series of reforms could also help strengthen retirement security by making it easier for families to save.

Helping ensure that every American can have a stable and comfortable retirement must be foremost in our minds as we move forward to shore up Social Security for future generations.

Chairman THOMAS. Thank you very much, Dr. Furman. Mr. Tanner?

STATEMENT OF MICHAEL TANNER, DIRECTOR, CATO INSTITUTE PROJECT ON SOCIAL SECURITY CHOICE

Mr. TANNER. Thank you, Mr. Chairman, Members of the Committee. I do appreciate the opportunity to appear before you today and I would like to congratulate the Committee on holding this hearing. I hope that it is an indication that we have moved beyond the sterile and unproductive debate about whether Social Security is facing a crisis or just a big problem, because as frightening as Social Security's financial problems are—and they truly are severe; the program will begin running a deficit in just 12 years and is facing unfunded obligations of about $12.8 trillion, if you include the cost of redeeming the Social Security trust fund as well as its other unfunded obligations after 2041—I believe, however, that Social Security reform must be about more than just achieving technical solvency. Now, that is not to downplay the importance of solvency. Any responsible Social Security reform would start the program toward sustainable solvency, not just in the short-term but over the long-term. While it is necessary, Social Security solvency is not sufficient.

We could be seizing upon this opportunity to build a new and a better retirement program, and that program should be based on the fundamental American values of ownership, inheritability, and choice. Under the current Social Security system, you have no legal, contractual, or property right to your benefits. What you receive from Social Security is entirely up to the 535 Members of Congress, but personal retirement accounts would give workers ownership and control over their retirement funds. The money in a worker's account would belong to that worker, and it is money that the politicians, with all due respect, could never take away. In short, workers would own their retirement. Because we don't own Social Security benefits under the current system, they are not inheritable. Millions of workers who die prematurely are not able to pass anything on to their loved ones, but with personal retirement accounts, workers would be able to build a nest egg of real inheritable wealth. For middle- and low-income workers, this may be the

first time in their lives that they are able to accumulate such a nest egg.

Finally, I point out that choice is part of the essence of America, yet when it comes to retirement, Social Security forces all Americans into a one-size-fits-all, cookie cutter retirement program; a system that cannot pay the benefits it has promised, and under which we have no right to the money we pay in. With personal retirement accounts, workers who want to remain in traditional Social Security would be free to do so, but workers who wanted a choice to save and invest for their retirement would have that option. With this goal in mind, not just to restore Social Security to solvency, but to build a better retirement program that would give workers more ownership, control over their money, and create an inheritable nest egg, the scholars at the Cato Institute developed a comprehensive proposal for creating privately invested, personally owned accounts as part of an overall reform of the Social Security system. This proposal is reflected in legislation, H.R. 530, that has been introduced by your colleague, Representative Sam Johnson, along with Representative Jeff Flake and 15 cosponsors.

Under this proposal, workers under the age of 55 would have the option of diverting their half of the Social Security payroll tax, 6.2 percent of wages, to an individual account. The employer's portion of the payroll tax would continue to be paid into the Social Security system to provide survivors' and disability benefits, as well as to partially fund continuing benefits for those already retired or nearing retirement. Workers who choose the individual account option, and it would be a choice, completely voluntary, would forego any future accrual of Social Security retirement benefits under the traditional system. However, those workers who have already paid into the current Social Security system and, therefore, have accrued benefits, would receive credit for those benefits in the form of a recognition bond. Workers who do not choose the individual account option would continue to pay into and receive benefits from traditional Social Security. However, for those workers, the initial Social Security benefit formula would be adjusted to reflect price indexing rather than the current wage indexing. While we have called for this price indexing change across the board, and it is so reflected in the legislation by Representatives Johnson and Flake, I would also suggest that we look seriously at the proposal by Mr. Pozen for making this change progressive. The plan also calls for establishing a new minimum Social Security benefit, equal to 100 percent of the poverty level, providing for a significant increase over the current minimum benefit. I have attached and entered into the record an original copy of a Cato study setting out the details of this proposal and the rationale, as well as a report on the Social Security actuaries' estimates that this program would restore Social Security to permanent sustainable solvency. I would suggest that, in the end, if our goal is more than technical solvency, more than just getting the lines on a chart to cross, if we really want the best possible Social Security system, then we need to have a Social Security system that gives workers ownership, control, inheritability, and choice as part of their retirement. Thank you, Mr. Chairman.

[The prepared statement of Mr. Tanner follows:]

Statement of Michael Tanner, Director, Cato Institute Project on Social Security Choice

Mr. Chairman, Members of the Committee

I would like to applaud the Chairman and the Committee for holding these hearings today, and for your determination to go forward with trying to reform our nation's troubled retirement system. I hope that this means we are at last moving beyond the sterile and unproductive debate about whether Social Security is facing a "crisis" or just a big problem.

Because whatever we call it, we cannot deny the fundamental facts. Social Security will begin to run a deficit in just 12 years—that is, it will begin to spend more money on benefits than it brings in through taxes. At that point, in order to continue to pay promised benefits, it will have to draw on the Social Security Trust Fund. We have seen much debate about the Trust Fund recently, with some suggesting that it guarantees Social Security's solvency until 2041, or even 2052. However, as Congressional Budget Office director Douglas Holtz-Eakin has noted "[The Trust Fund] has no real economic resources—.The key moments for Social Security are in 2018. Cash-flow benefits will equal cash-flow payroll taxes, and then after that, the Social Security Administration will have to come back to the rest of the budget for additional resources to pay promised benefits."

Or as the Clinton Administration made clear in its FY2000 budget:

"These Trust Fund balances are available to finance future benefit payments—but only in a bookkeeping sense—. They do not consist of real economic assets that can be drawn down in the future to fund benefits. Instead, they are claims on the Treasury that, when redeemed, will have to be financed by raising taxes, borrowing from the public, or reducing benefits or other expenditures. The existence of Trust Fund balances, therefore, does not by itself have any impact on the government's ability to pay benefits."

This is not to say that the Federal government will default on the bonds in the Trust Fund. I am not doubting the "full faith and credit" of the U.S. government. However, that does not relieve the Federal government from the obligation to find the money with which to redeem those bonds, currently $1.6 trillion in present value terms. To put it in perspective, think of it this way. In 2018, the first year after Social Security begins running a deficit, the shortfall will be roughly as much as the Federal government spends on such programs as Head Start and the WIC program. The cost rises rapidly thereafter. By roughly 2023, the cost of redeeming enough Trust Fund bonds to pay all the promised Social Security benefits would be nearly as much as the cost of funding the Departments of Interior, Commerce, Education, and the Environmental Protection Agency. By 2038, well before the theoretical exhaustion of the Trust Fund, you can add the Departments of Veterans Affairs, Energy, Housing and Urban Development, Justice, NASA, and the National Science Foundation. Simply redeeming the Trust Fund will begin to squeeze out all other domestic spending priorities.

Beyond 2042, once the Trust Fund is exhausted, the deterioration in Social Security's finances only increases—and never gets any better. Overall, the present value of Social Security's unfunded obligations run to nearly $12.8 trillion (approximately $1.6 trillion to redeem the Trust Fund, and $11.1 trillion in unfunded benefits thereafter).

However, as troubling as these numbers may be, I believe that the debate over Social Security reform should not solely—or even primarily—be a discussion of solvency. Yes, solvency is important, and any responsible Social Security reform plan should restore the program to solvency, not just short-term actuarial solvency, but permanent, sustainable solvency.

Still solvency is not enough. Instead, Social Security reform should strive to build the best possible retirement system for our children and our grandchildren. Thus, Social Security's current situation should not be seen as either a crisis or a problem, but as an opportunity to build a new and better program, based on the fundamental American values of ownership, inheritability, and choice.

Under the current Social Security system you have no legal, contractual, or property rights to your benefits. What you get receive from Social Security is entirely up to the 535 members of Congress. But personal retirement accounts would give workers ownership and control over their retirement funds. The money in your account would belong to you—money the politicians (with all due respect) could never take away. In short, they would own their retirement.

Because you don't own you Social Security benefits, they are not inheritable. Millions of workers who die prematurely are not able to pass anything on to their loved ones. But personal retirement accounts would enable workers to build a nest egg of real, inheritable wealth.

Choice is part of the essence of America. Yet when it comes to retirement, Congress forces all Americans into a one-size-fits-all, cookie-cutter retirement program, a system that cannot pay the benefits it has promised and in which we have no right to the money we pay in. With personal retirement accounts, workers who want to remain in traditional Social Security could do so. But younger workers who want a choice to save and invest for their retirement would have that option.

With this goal in mind, not just to restore Social Security to solvency, but to build a better retirement program that would give workers more ownership and control over their money, scholars at the Cato Institute drew on our 25 years of experience studying SocialSecurity, and developed a comprehensive proposal for creating privately invested, personally owned accounts as part of an overall reform of the Social Security system. This proposal became the basis for legislation introduced, on July 19, 2004, by your colleague Rep. Johnson along with 18 original co-sponsors.[1] Rep. Johnson, together with Rep. Jeff Flake and 11 co-sponsors, reintroduced the bill in the 109th Congress, on January 21, 2005.[2]

Under this proposal, workers under the age of 55 would have the option of diverting their half of the Social Security payroll tax (6.2 percent of wages) to an individual account. The employer's portion of the payroll tax would continue to be paid into the Social Security system to provide survivors and disability benefits, as well as to partially fund continuing benefits for those already retired or nearing retirement. Workers choosing the individual account option would forgo any future accrual of Social Security retirement benefits. However, those workers who have already paid into the current Social Security system, and therefore have accrued benefits, would receive credit for those benefits in the form of a recognition bond. This fully tradable bond would be a zero coupon note maturing on the date of the recipient's normal retirement age.

Workers who do not choose the individual account option would continue to pay into and receive benefits from the current Social Security system. However, for these workers, the initial Social Security benefit formula will be adjusted to reflect price-indexing rather than the current wage-indexing. The result will be to restore Social Security benefits to a level payable with Social Security's available revenue, while ensuring that future retirees continue to receive the same level of benefits as those retiring today, on an inflation-adjusted basis. This change will be phased in over a 35-year period, beginning in 2014.

This should not be seen as a benefit "cut." Indeed, benefits will be higher in the future than they are today. While it is true that future benefits would be less than what Social Security promises, such comparisons are meaningless because unless there is a substantial increase in taxes, the program cannot pay the promised level of benefits.

That is not merely a matter of conjecture, but a matter of law. The Social Security Administration is legally authorized to issue benefit checks only as long as there are sufficient funds available in the Social Security Trust Fund to pay those benefits. Once those funds are exhausted, in 2041 by current estimates, Social Security benefits will automatically be reduced to a level payable with existing tax revenues, approximately 73 percent of current benefit levels.[3]

This, then, is the proper baseline to use when discussing Social Security reform. Social Security must be restored to a sustainable level regardless of whether individual accounts are created.

As the Congressional Budget Office puts it:

A number of recent proposals to reform Social Security call for changes in the program's benefits. The effects of those proposals are frequently illustrated by comparing the new benefits to those expected to arise under the policies put in place by current law—showing whether they would be higher or lower and by how much. However, because of scheduled changes in benefit rules, a growing economy, and improvements in life expectancy, the benefits prescribed under current law do not represent a stable baseline. Their value will vary significantly across future age co-

[1] HR 4895.

[2] HR 530.

[3] In practice, rather than reduce each check sent to beneficiaries, the Social Security Administration would stop sending out checks altogether until it accumulates sufficient funds to pay "full" benefits. When those funds are exhausted, checks would again be withheld until sufficient funds accumulate, leading to checks starting and stopping several times over the course of a year. The net effect would be that total annual benefits would be reduced by the same amount as if each month's benefits had been proportionally reduced.

horts. Thus, focusing on differences from current law will not fully portray the effects of proposed benefit changes.[4]

I would also note that, although the Cato Plan and HR 350 apply the wage-index/price-index change to all income levels, if I were rewriting the proposal at this point, I would give very serious consideration to the blended approach advocated by Mr. Pozen. Doing so would refocus Social Security benefits on those who need it most, and make the system more progressive.

The plan also called for establishing a new minimum Social Security benefit equal to 100 percent of the poverty level, providing a significant increase over the current minimum benefit. I have attached the original Cato study setting out the details of the proposal and their rationale.

The plan has been scored by the Social Security Administration's Office of the Actuary (OACT), which concluded that it would eliminate Social Security's long-range actuarial deficit" and would restore the system to permanent "sustainable solvency." I have attached a study that the Cato Institute released last month exploring OACT's findings in detail, as well as a copy of OACT's original actuarial memo. However, to summarize, OACT found that:

- The "transition cost" (in present value) would be approximately $6.5 trillion. This is roughly half the $12.8 trillion unfunded liability of the current system. That is, the "6.2% Solution" ultimately saves taxpayers $6.3 trillion.
- The legislation also compares very favorably to other Social Security reform plans. In terms of giving workers more control and ownership of their retirement funds, the "6.2% Solution" clearly provides the most "bang for the buck."
- On a cash-flow basis, the legislation does require significant short-term transfers of General Revenue. However, by 2046, the system would begin running surpluses, allowing any short-term debt to be repaid. Indeed, by the end of the 75-year actuarial window, the system would be running surpluses in excess of $1.8 trillion (in constant $2005)
- Much of the short-term cash-flow shortfalls are due to the redemption of recognition bonds, not to the diversion of payroll taxes to the individual accounts. These recognition bonds convey many benefits in terms of ownership as well as speeding the date at which Social Security changes from deficit to surplus. They are essentially a prepayment of future Social Security benefits, and not a new expense. The Johnson-Flake bill is the only Social Security reform bill with recognition bonds. The costs of Johnson-Flake also include the cost of increasing the minimum Social Security benefit to 100% of poverty, a significant increase over the current minimum Social Security benefit.
- Individual accounts would eventually accumulate assets in excess of $38 trillion (in constant $2005). That would lead to substantial new savings, new investment, and economic growth.
- Once short-term debt is paid off, the employer portion of the payroll tax could be reduced to 3.04%. This would pay for disability and survivors' benefits.

In short, the SSA analysis shows that Johnson-Flake can provide large individual accounts while restoring Social Security to permanent sustainable solvency, and can do so in a fiscally responsible manner. While the up front costs will be significant, they will be less than for other big account plans, and eventually those costs will be more than offset by the savings to the system.

In addition, younger workers who chose the individual account option could receive retirement resources substantially higher than what traditional Social Security can actually pay them.

Finally, Johnson-Flake gives workers ownership and control over their retirement income. It would give low- and middle-income workers the opportunity to build a nest egg of real, inheritable wealth. It provides younger workers with greater choice. In short, if we measure a Social Security program not just as a matter of dollars and cents, but as a matter of human liberty and individual dignity, Johnson-Flake provides a better way to take care of our retirement.

Thank you.

Chairman THOMAS. Thank you very much, Mr. Tanner. I know all of us want the best system, and part of this is reflected in the fact that more than 20 years ago, there were some things I thought

[4] David Koitz, "Measuring Changes to Social Security Benefits," CBO Long-Range Fiscal Policy Brief no. 11, December 1, 2003.

we ought to do and we didn't get to them. As the least Ranking Member of the minority party at the time, I didn't have a whole lot of influence on what we did or how we did it. Do you agree, in essence—and Dr. Furman, this is a quote that I found from you in the May 5th Wall Street Journal article basically saying, although everyone has a plan and there are going to be criticisms for or against various approaches—and obviously that is our job, to listen to all of the approaches and then, to the best of our ability, decide what we do.

Basically, the gist of Dr. Furman's quote was that the dumbest possible plan you can imagine is doing nothing. Is there general agreement that that is probably a good starting point for us? So, for those who just wish the issue would go away, maybe we do owe a bit of a debt of gratitude to the President for being up front on this issue. I know we had no time to contemplate other changes we might want to make back in 1983, and the idea that we are going to wait a Congress, or we are going to come back two Congresses, or we will wait for a Presidential change, it is amazing how quickly 20 years go by. Right now, I think 20 years, in my opinion, is a fairly luxurious timeframe that we can't afford. Does everyone agree with that, basically? Okay.

Mr. FURMAN. If I can, I certainly don't know anyone who thinks that we should let the trust fund get exhausted in 2041 and cut benefits by 26 percent across the board. I know I don't support that. I don't think anyone does. What I think would be even worse, though, is actually adding to the debt and exhausting the trust fund even earlier and making Social Security's financial position worse. That is something that the President's plan would do.

Chairman THOMAS. Well, I understand, but obviously, we don't think that is our goal, nor did any of those folk in earlier times when they made decisions that, in fact, I think have exacerbated our situation. They didn't intend to do that, and to a certain extent, they didn't anticipate the changing society. Next question—very briefly, Mr. Apfel.

Mr. APFEL. I just wanted to say that it would be good to do something, absolutely, but doing something that takes us in the wrong direction would be a bad thing to do. We have three options: to do something that is basically good, do nothing, and do something that would be basically contrary to the economic security of middle-class Americans. I would urge that we should take a little more time before doing something very bad, and clearly, the two proposals that are before us, I think are very risky.

Chairman THOMAS. Hopefully, we would take all the time in the world not to do something bad. In fact, we would never do it, rather than waiting a while and then doing it. In his testimony, Dr. Steuerle was a bit more specific about changes within the Social Security structure, although many of you alluded to it in your testimony. Do you think if we are going to undergo an attempt to solve the problems of Social Security, and, of course, solvency—and I will ask you a question about that in a minute—is our goal, outside, an ultimate goal? Should we be looking at those anomalies in part created by an aging society on the question of widows and their compensation, versus non-working widows of well-off husbands, versus widows of not-well-off husbands, two-earner versus one earner, the

low-income floor? That is a worthy pursuit, isn't it, in terms of inside Social Security? Does anyone say we shouldn't waste time looking at those issues to try to get fairness within the structure? Okay, see? There is a plus; we are all together here.

In one way or another, some explicitly addressed the question of time and age. We did that in 1983 and it was a very difficult political problem. We created a 10-year hiatus on our way to 67, which ironically means that people are going to beat the distance between 65 and 67 in the 1983 plan actuarially before the plan actually reaches the 67. So, we have fallen behind, in essence, in trying to create a time-relationship. There are a couple of ways of looking at it, and I know there is a lot of controversy, so I think most Members understand the downside. If you raise the early minimum age, you jeopardize folks on a disability question. If you raise the age higher, you have to work longer, but it is clear that some adjustment there should be looked at. The narrow question I want you to address is, should we continue to chase the age change? I think, Mr. Pozen, you suggested going from 67 to 69. Dr. Furman, when I read your March 21st analysis from your Center on Budget and Policy Priorities, I was intrigued by a phrase you had on page nine which said, "Changes in the benefit or tax structure under which benefits, payroll taxes, or the normal retirement age are indexed to longevity would be much better at directly tying the size of the benefit or tax changes to the program's solvency needs." I don't know whether that was because of space, but that was dropped out of your more recent editions. Should we look at the question of age extension and/or longevity? Is that inevitably something that you have got to look at?

Mr. POZEN. Yes, Mr. Chairman, I think it is something that needs to be looked at. I think the idea of modifying retirement age through longevity indexing would give people more choice. Rather than saying that the retirement age is moved back from 67 to 69, you would say you can choose to retire at 67, 68, or 69, but if you retire at 67, we now give you the actuarial equivalent of retiring at 69. That means that you get lower monthly benefits, but you get more monthly benefits because you are retiring earlier. So, I think that is probably a better way to proceed than just moving the retirement age back absolutely. Then the second issue with which you are very familiar with, is how soon can you do this? Any such change would have to be phased in.

Chairman THOMAS. Any strong objection? He, in his testimony, said 69, and I think I sold him on longevity. So, are we moving in a way in which we are coming together? Dr. Schieber?

Mr. SCHIEBER. I think we probably do agree. If you compare where we are today to, say, 1960, if you look at a typical male, he is retiring about 3 years earlier today than he retired back then and he is living about 3 years longer. We have extended his retirement period by about 50 percent. Well, if you are going to extend the retirement period by 50 percent, then it is going to cost a lot more. If you are in a situation where you are being stressed for funds to finance this, as we continue to add to life, one of the things that we ought to look at is whether or not people could remain engaged a bit longer. It would be awfully hard to make a case

that work today is of such a nature that we ought to be retiring a lot earlier than we used to, because we can't bear the burden.

Chairman THOMAS. I would tell the gentleman, just be a little cautious in that statement. For those of us who came from families in which physical labor was the way in which the bread was put on the table, I know that my father, in terms of his plumbing activities, was pretty—the phrase, I guess, would be pretty "used up"—by the time he was 65. Of course, he went through the Depression, as well, and had grown up on a farm, so he got some early wear and tear.

Mr. SCHIEBER. The number of those jobs in our economy are diminishing, and many of the tools that are available to people who have those kinds of jobs are reducing the burden upon them. Maybe we do need a transition benefit of some sort for people who do have physical labor jobs, but I think we have to be careful about making the rules for all because we have got a small number who have that problem.

Chairman THOMAS. The one thing that I am interested—I know how difficult it was politically for us to make that age shift in 1983. If you did do something like longevity, you wouldn't have to visit it as frequently to make adjustments with the assumption that people are going to continue to live longer. Gene?

Mr. STEUERLE. Mr. Chairman, I think we have to be honest—I can say this because I don't have to run for office, but this system has evolved or morphed into a middle-age retirement system. As long as we say 62 is old, then it sounds like those of us who say we can increase the retirement age sound like we are hitting on the old; and for a long time, being old was correlated with being poor.

The people who are old, who are more likely to be poor, are those in their late seventies, eighties, and nineties. Many retirees, I think, now, are being deluded. They are going into retirement at 62 with a decent income and, for a typical couple, just a typical couple, their annuity lasts 25 years. For a longer-living couple, it often lasts 30 or 35 years. They often don't have the resources when one of them lives to 85, 90, and beyond, that they thought would be available at 62. Sometimes the government comes in the back door and has to back up the system with Medicaid and a lot of other supports. I tried to make very clear in my testimony that, even if we devoted all of the revenues from increasing the retirement age back to Social Security, and even if we had a current system that was totally solvent, if we increased the retirement age, we get more revenues in the system. We can increase replacement rates. We can protect the old better. We can actually give a higher package of lifetime benefits on an actuarial basis because we would have more revenues to spend. Increasing the retirement age just moves everything in the right way in terms of protecting the old, the needy, and everything else, and I think we just have to be honest about that basic fact.

Chairman THOMAS. Well, being honest and getting enough votes to pass it are sometimes two different things and I am trying to deal in that world. My time is running short, so I want to focus you on a couple of other arguments, and Dr. Schieber, I think some of it came from your excellent history, which was condensed in a useful way from FDR and the origins of Social Security, and his

very strong belief that it shouldn't be a part of the dole. The irony of increasing the payroll taxes is, in fact, a form of that direct transfer from the rich to the poor. Personal accounts, and I have heard a number of descriptions of personal accounts, I know particular personal accounts are the target of much discussion. Just the concept of personal accounts, does anyone here disagree with the idea that the concept of personal accounts is more consistent with the concept of a retirement insurance system than basically our current pay-as-you-go system? Don't personal accounts kind of really talk about an insurance system on an annuity or a premium? I am asking questions. I think that is the role of the Committee.

Mr. SCHIEBER. If you—insurance is a process of pooling risks across a large group of people where there is a relatively small probability of something happening. If you look at our disability insurance program, there aren't a lot of people as they go through their working careers who become disabled. There aren't a lot of people who die and leave juvenile children. So, let us say you had a thousand people living in a society and they had a house, each of them, worth $100,000, and one of those houses in this society burns down each year. There are two ways that losses can be covered. One, they can each put $100 into a pool each year and then there will be resources to cover the damage, and nobody suffers a catastrophic loss. Alternatively, there is no insurance and when the house burns down, one family in the society has a $100,000 loss and everybody else is perfectly fine. When you have a small contingency of something happening, you can do that through the sort of system we are running to cover disability. When you have a high probability—95 percent of the people who start to work at the early 20s end up retiring at some juncture—we are no longer talking about 1 in 1,000. We are talking about 95 percent. If you want to secure those benefits over time, especially given the demographics that we have, you have to figure out how to save. You have to figure out how to accumulate some wealth so there is something financial that actually secures that benefit in retirement, and this is a mechanism to do it.

Chairman THOMAS. Okay. Personal accounts——

Mr. FURMAN. If I——

Chairman THOMAS. Dr. Furman——

Mr. FURMAN. Yes, that question——

Chairman THOMAS. You mentioned the question of increased net savings. Dr. Lindsey talked about increased net savings. Is it a high priority, medium priority, or a low priority that if we talk about personal accounts, we take into consideration making sure that however they are structured, they increase net savings?

Mr. FURMAN. Let me just say, right now, families have a tremendous number of opportunities to save and invest, if they want to play the slot machines, they can do that as well. They only have one rock-solid retirement guarantee and that is their Social Security benefit. That is not a—you don't have a choice of getting a Social Security benefit if it is not in the law. That is not an option you have. You have lots of other options. So, taking that option away from people——

Chairman THOMAS. I understand what you said——

Mr. FURMAN. Reducing that benefit to pay for something that you can do already, which is to invest, is not something that I think makes very much sense at all.

Chairman THOMAS. I understand your concern about a particular type of personal account, but I thought you mentioned in your testimony the idea of making sure that we increase net savings.

Mr. FURMAN. I think that is an important goal of any reform, and you are only going to get that if we ensure that any new incentives we have are paid for, or that we better utilize our existing savings.

Chairman THOMAS. I understand, but you can also set up personal accounts that don't create net savings.

Mr. FURMAN. If you don't pay for your accounts, you will not increase savings.

Chairman THOMAS. Yes, but I am saying you can do that. There are people here fully capable of doing that. Dr. Lindsey?

Mr. LINDSEY. Mr. Chairman, I think it is a high priority, I think it is important that when the Committee thinks through dealing with this problem, it consider not just Social Security, but broader economic issues. What I would like to add to what Mr. Furman said in response to your earlier question, the way to think about a personal account, I think, is as a discretionary account. Some people want to retire earlier. Some people want to retire later. Some people want to be prepared for their nineties. One of the distinctions that came from your question about early retirement is that a personal account within the Social Security system allows the worker or retiree more discretion over when he or she retires than a one-size-fits-all solution.

Chairman THOMAS. Finally, in partial response to my friend from Michigan and from others who couldn't possibly comprehend why, if the President has offered us an opportunity to look at Social Security we shouldn't look at other retirement aspects in an aging society, I want to refer Members to, if you haven't noticed it, page 20 of Dr. Schieber's testimony. In terms of distribution of retirement structure: on the bottom tenth, from personal financial wealth, 3.5 percent; from Social Security, 94 percent; from pension wealth, three percent; and at the top tenth, 65 percent from personal, 10 percent from Social Security, and 25 percent from pension. If, in fact, you have that significant difference between the lowest tenth to the top tenth, to only address Social Security and say you have addressed retirement in an aging society is to miss the point that some people count on two-thirds of their money from personal financial—in fact, 90 percent of their money from personal and retirement pension funds and others 90-plus percent from Social Security. To only deal with Social Security is to ignore what else is going on in the society and simply to make the point, read the paper about United Airlines and the question of pensions, the changing world of defined benefit versus defined contribution, and your ability to put your own money away.

Dr. Furman, I agree there are a lot of ways to do it, but frankly, we haven't been as creative or focused as we should, because to a certain extent, you have to incentivize people to put their money away. They have to see a reason to give up a current consumption

for deferred gratification. My last question, how many of you believe it is fair, it is appropriate, and it is a responsible thing to do that, if we are going to offer volunteer programs, in whatever area we are beginning to make changes in the retirement package, that we create a system in which, even in a voluntary structure, people are automatically put in and they have the option of opting out? Does anyone think that is not something we should look at?

Mr. FURMAN. Again, Mr. Chairman, unless you know what they are opting into, it is impossible to answer that question, so——

Chairman THOMAS. Well, they wouldn't be opting into it. They would be opting out, because we would put them into it and they would have the option of coming out——

Mr. FURMAN. Right. If your plan is to say your future Social Security benefit is going to be reduced if you are in this account, then opting people into that account, in fact, even having that option in the first place, I think would be a mistake. So, we are talking about——

Chairman THOMAS. Even with their ability to opt out——

Mr. FURMAN. A 401(k), their participation in 401(k) is more automatic, I think that is a very good idea, and Congressman Emanuel has——

Chairman THOMAS. Mr. Apfel?

Mr. APFEL. If it is opting out of parts of the defined benefit of Social Security, then I would have some deep concerns——

Chairman THOMAS. No. I wouldn't think that that would be what we are talking about. We would not do that.

Mr. APFEL. I would like to come back to the retirement age issue, I hope before the end of the hearing, which is one of the questions——

Chairman THOMAS. There are a lot of people anxious to ask a lot of questions and I have used my Chairmanship. Last response, and then I will recognize the gentleman from New York.

Mr. STEUERLE. I will just comment briefly. As you know, there is a broad liberal-conservative coalition examining this opt-in/opt-out issue, not with respect to, say, Social Security, but with respect to putting employees into 401(k) plans. You will also note in my testimony that I think one way to try to get through this divide over personal accounts is to think of them more as a private pension rather than a Social Security issue. Politically, the fight over personal accounts really is not over personal accounts. President Clinton had a personal account proposal, as does President Bush. The fight is actually over revenues for the remaining system. That doesn't mean we can't separately work on a system to try to beef up assets, real assets, for people. Yes, real assets contain risk—that is a legitimate concern—but we don't want a world where we don't have real assets.

Chairman THOMAS. I want to thank you all because you have helped this Committee in shaping future full Committees and Subcommittees with the subject matter, especially that in which you all agree we ought to be looking at it. Thank you very much. The gentleman from New York?

Mr. RANGEL. Thank you, Mr. Chairman. Let me thank all of you for being here. It is so difficult to frame the questions because we don't have a bill before us, but just for openers, how many of

you believe that the Congress cannot fulfill its responsibilities to present and future beneficiaries of Social Security without having a private account as a part of that bill? Two of you believe that we cannot deal with the subject of fulfilling Social Security, that we have to have private accounts on the table, right?

Mr. TANNER. I believe that if you try to come up with the gap between promised benefits and the amount of expected revenue in the system, some $12.8 trillion, and you try to do that simply through the tax side or through benefit side——

Mr. RANGEL. I didn't say that——

Mr. TANNER. Then you are going to either cripple the economy or severely reduce benefits for workers in ways that I think would be disastrous.

Mr. RANGEL. We could do it, though. That would be our political decision, since one of you made it——

Mr. TANNER. I question whether the economy could sustain the type of tax increases that would be required.

Mr. RANGEL. Okay. Well, let me say this. A lot of you are using Roosevelt and Moynihan and Truman, but I haven't heard one live Republican yet that is telling us what they want to do. When the Chairman and other Members of Congress met with the President, he asked us not to do anything until he put his plan together. Since that time, he has gone to 60 cities in 60 days, not to sell private accounts, which I thought he was going to do, but to educate the American people how serious the problem is, and now he says the Congress should come up with the answer. So, I guess he is out of it.

So, I don't know, with all of the great ideas that you gentlemen have, as to what this has got to do with where the President wants us to end up—except he made it clear to me that with anything that he is going to sign, private accounts has to be made a part of it. We hear a lot from Chairman Pozen when the President speaks, as opposed to most of the other White House people. I think that they always describe you as the Democrat. Now, I have been in Congress a long time and I have had a lot of distinguished people testify before the Committee, but I don't ever recall since I have been here where they identify a professional by his party label, assuming you are a Democrat.

Mr. POZEN. I am a Democrat. I am proud to say that there are certain people on the Committee that I have supported, Congressman Neal, Congressman Emanuel——

Mr. RANGEL. Is that intellectually——

Mr. POZEN. It is a political issue as to why the President chooses to do that, but I do think that the concept of progressive indexing is supported by page 20 that the Chairman pointed to in Syl Schieber's testimony, because what it shows is that for the bottom one-third——

Mr. RANGEL. I am not getting to the substance. I am just saying, since you are so proud of being a Democrat, that really doesn't help in terms of intellectually being right or wrong on the issue, does it?

Mr. POZEN. I agree, Mr. Rangel. I am not the one who touts my being a Democrat. I am a registered Democrat and——

Mr. RANGEL. That doesn't really improve or diminish you——

Mr. POZEN. No, it doesn't improve or diminish the quality of my ideas. I agree with that.

Mr. RANGEL. The White House goes out of its way to identify you more by your party label than by what you are saying. Having said that, I think all——

Mr. POZEN. I would hope that the White House agrees with the concepts in progressive indexing.

Mr. RANGEL. Take my word for it, your name would not have been projected as much as it is if you were not a Democrat, but I am proud of the fact that you know how to deal with them because we may have to come to you for communication, because we don't know where they are coming from, or what they want to do. I totally believe that all of you should believe that an issue as sensitive as this, where most of the people on Social Security, no matter what any of you say, believe that their benefits are guaranteed, and their kids believe it, and their grandkids who are interested believe that they are entitled to this benefit. If we are going to have any type of revolutionary change, if we are going to repair the system, there has to be some pain involved in it, some political pain. How you can do this in a partisan way, I have no idea. How the President can say it is up to the Congress to repair it, I have no idea.

Having said this, I think the reason people believe that these benefits are guaranteed is that we are borrowing $2 trillion to give the tax cuts to the wealthiest people in this country. How do we, in a partisan way, share with them that this system that didn't take into consideration wealth or poverty, but substitute it with dignity, to say that at the end of the day, whether you are disabled, whether you are a survivor, whether you are retiring, there will be a cushion for you and you can depend on it. Now we have a situation, Mr. Pozen, where—I assume most of your training has been in investment banking. You understand that, and closing budgets. Clearly, in looking at your biography, there is no indication that you have dealt with social services, or the problems of the poor, or people that are surviving, or how many kids went to school, and I suppose other people have different views about it, but basically, your background has been in the investment market, is that true?

Mr. POZEN. My background has been in the investment market, though I have worked with various nonprofits in the Boston area on a series of——

Mr. RANGEL. When I retire, that is what I hope to run, a nonprofit. That is where the real money is.

[Laughter.]

Mr. RANGEL. Having said that, it would seem to me that if we are going to work together on this, we are going to have to find some way to communicate and try to see how we can get people to believe that they will be better off with the changes in the private sector. Do you believe that, if people believe that they have some benefits guaranteed, that you could guarantee that the market is going to work for them? That is, if the market fails, as we see things happening today with the airlines, that there would be a safety net for those people who found their benefits reduced by Social Security, but found an increase in the private accounts? Could you give any type of suggested way that you in this business

can say, trust us, that you are going to be better off with this system?

Mr. POZEN. I do believe in the safety net of Social Security and I think——

Mr. RANGEL. No, no. I was talking about the private sector——

Mr. POZEN. The private sector. I think that what I am trying to propose is that we keep the defined benefit, the guaranteed benefit for the low-wage worker, who——

Mr. RANGEL. I understand that——

Mr. POZEN. Is not able to deal with this risk very well.

Mr. RANGEL. I am just saying that if the bottom falls out and the market doesn't work, is there some way that we politically can say not to worry because your government will never let you down? Can we do that?

Mr. POZEN. I think that is what we are trying to do, by preserving the schedule of benefits for all low-wage workers.

Mr. RANGEL. I am not talking about low-wage workers.

Mr. POZEN. If we were to try to guarantee against a fall in the stock market fall, I think that would be a bad idea.

Mr. RANGEL. Okay. So, I am not disagreeing with you, but at the end of the day, if someone was to tell me in a townhall meeting: Rangel, I know you are not thinking about coming home and telling me I am not going to get my check. Even though there are people that believe that the system is going to collapse, the day that we don't provide some benefit is the day we are out of business. They believe that they are entitled to these benefits. There is no way legally that we can tell them that, even if they are successful with the private accounts, there is going to be a guarantee in whole or in part, is there?

Mr. POZEN. I think to the extent that we bring in private accounts, and they are invested in the stock market, we will not be able to guarantee the return.

Mr. RANGEL. So, I would be stuck with the position that, we are asking you to trust us, because, we think by taking a gamble on the market, you will get a higher yield. The truth of the matter is, we can't give you a guarantee. Now, the President oftentimes talks about the moneys that people have contributed to the general revenue funds, that what they get or have given has been an IOU or bond. Really there is a trust fund that is not worth the paper it is written on. You, being a lawyer and recognizing what full faith and credit means, do you agree with the President that the trust fund IOUs that have full faith and credit of the U.S. Treasury and this country are not worth the paper that they are written on?

Mr. POZEN. I don't know if that is what the President really meant to say——

Mr. RANGEL. We will straighten that out. What do you think about the bonds?

Mr. POZEN. I believe that the special Treasury bonds that are now held by the Social Security trust fund are good money. They will be repaid. As we all know, at some point, they are going to run out and I think that the crucial thing——

Mr. RANGEL. I am not talking when they run out. Everything runs out——

Mr. POZEN. They are good, but we know——

Mr. RANGEL. Anyone running a bank that would tell you that your deposits aren't worth anything should be run out of the bank, wouldn't you think?

Mr. POZEN. I don't know about——

Mr. RANGEL. It would be misleading the people in believing that their money won't be there when they need it. Well, we will get to that. Let us talk about this poverty stuff. My mom threatened to disinherit me and my sister when we tried to get her to leave her apartment. She had her pension check from the Internal Ladies Garment Workers Union and she had her Social Security check. She was so proud of having this because she never considered it welfare. She considered herself independent, having worked all of her life. We hear a lot of talk on the other side about class warfare, but the dignity of people that have enjoyed Social Security—they knew they were Americans, that they put into the system, and they weren't treated as though—especially by the Congress as though you get what you get when the Committee on Appropriations decides what it is going to be. Do you believe that this is a very sensitive area, to separate those who made $20,000 and have them as low-income and the other people over $20,000 as middle income, and then you have the higher income? Don't you think you are taking away something from the integrity of the system from a social point of view by means testing it?

Mr. POZEN. Means testing would mean that people with incomes over a certain amount would get nothing, but progressive indexing is not means testing. What I am proposing is to create a progressive scale of benefits. We already have differentials for people's benefits based on the level of contribution, based on their wage level. What I am trying to say is that, given the point that was made by either Ken or Jason that longevity for higher-wage workers is going up faster than for low-wage earners, given the fact, as Mr. Schieber points out, that one-third, the lower one-third of wage earners, are more dependent on Social Security and have few IRAs or 401(k)s, what we are trying to do is provide a sliding scale of benefits, which we already do, but make it more of a sliding scale to help make sure that the people who need Social Security the most are getting the most.

Mr. RANGEL. They used to call that means testing, but I assume that we have to find words to——

Mr. POZEN. I don't think we really——

Mr. RANGEL. No? Okay. Well——

Mr. POZEN. We have a sliding scale——

Mr. RANGEL. The benefits will be based on income.

Mr. POZEN. Benefits are now based on wage levels. We would just be making it a little more of a sliding scale in light of these other factors.

Mr. RANGEL. Now, the President often talks about those people in Congress that have 401(k)s and Thrift Savings Plans, and if it is good enough for them, it should be good enough for the American people. Do you believe the way he uses the statement is accurate? Is he offering the people the same thing that we enjoy as Members of Congress?

Mr. POZEN. I understand that you, as a Member of Congress, have Social Security, and that the 401(k)s and IRAs would be supplemental to Social Security.

Mr. RANGEL. That is——

Mr. POZEN. So, I am not sure——

Mr. RANGEL. That is true——

Mr. POZEN. Congressman, I am not representing the President here——

Mr. RANGEL. Well, he is representing you.

[Laughter.]

Mr. RANGEL. Now, if you want to put some distance from it, we can talk, but as long as he is projecting you, who truly understands what he wants to do—he hasn't given us anything. He said the problem is ours. He promised us a bill. We don't have it. So, we have the Thomas plan, we have the Shaw plan, we have got the McCrery plan, we have got your plan, and——

Chairman THOMAS. You got any that way?

Mr. RANGEL. Well, the thing is that, I don't really think that we should rush out and do more harm than good. As long as you have got to come up with something, we are prepared to say that we really think that this plan here is a detriment to us coming together in a bipartisan way. Having said that, you made it clear that the President is not talking about what the Congress has got. We have our plan in addition to Social Security. We can take money out of our plan. Out of your plan, you can't take money out, is that correct?

Mr. POZEN. As I said, my plan for progressive indexing stands with or without private accounts. I have tried to make clear in my testimony how it could be combined with certain types of accounts. It can be combined with IRAs and 401(k)s. It can be combined with other things. In itself, it would reduce the long-term deficit by 70 percent and it would provide more of a sliding scale than we have now for benefits.

Mr. RANGEL. My last question is, do any of you believe that we can successfully come up and pass a bill without a bipartisan support for it? Any of you? I don't have any further questions.

Chairman THOMAS. Does the gentleman from Florida wish to inquire?

Mr. SHAW. Yes, I do, Mr. Chairman. Mr. Apfel, you made a statement which troubles me. You mentioned that you think that private accounts, personal accounts, individual accounts, should be off the table. Now, as you recall the days when you were with the Clinton Administration, and I was Chairman of the Subcommittee on Social Security, never once did anybody in the U.S. Congress, that I am aware of, say to President Clinton that he had to take certain things off the table or put it on the table as for purposes of trying to negotiate. I don't think that is the right way to negotiate. I also recall that President Clinton did support some form of individual accounts. He saw the need for that. In fact, Mr. Archer met with him individually in his office, as I had met with him, and discussed moving the plan forward.

So, I think that we need to clear the air here, and I think for anybody who is serious about negotiation, whether they are head of the Democrat party, the Republican party, whoever they are,

who really care about saving Social Security should come to the table. I think also that it is important, and I think that the Chairman said something just offhand at the end of Mr. Levin's remark a while ago, that he would be glad to listen and have hearings for any of the Democrats that had a plan that would save Social Security. Unfortunately, the silence is deafening. There is no plan. The only plan that is out there that I can see that the Democrats have is they want the President to negotiate with himself and then lose, and that is a tragedy.

Dr. Furman, you mentioned something that troubles me greatly. You said that people have the option of investing right now into individual accounts. I am sorry. People who are going paycheck to paycheck do not have that option. Their option, the only option they have is to pay their rent and light bill and their grocery bill, and those people have no chance of ever accumulating any personal wealth unless we go forward with a plan of Social Security that takes care of these people. So, saying that these folks, these low-income people can take care of themselves is an absolute fallacy and I think it is a tragedy when we see that Members of Congress here would pass up the opportunity for low-income people to create some wealth during their lifetime. It is indeed a tragedy.

Mr. APFEL. Mr. Shaw, you——

Mr. SHAW. Now I want to address the question of guaranteed plans. There are two guaranteed plans that have been put forward by Members of this Committee. I put one forward and Mr. Ryan put one forward. In either plan, they had individual accounts, yes, but they also had a guarantee by leaving the existing structure in place that existing obligations would be adhered to not only for today's retirees, but for future retirees. This has to be the objective. It is very important that when you try to negotiate and push something together that you know what you are going after. You know what you are working toward instead of just absolutely sitting back and criticizing each other. That is a tragedy. One of the Members of Congress said not long ago that the party of the New Deal has become the party of the No Deal, and that is too bad. That really is too bad. I think that even Roosevelt himself recognized that future changes would have to be made.

The point has been made by some of the Members of the panel, and I think a very good point, that maybe we should look forward to 20, 30, 40, 50 years instead of 75 years and beyond, and perhaps that is where we will have to go at the end of all of this, because none of the plans out there contemplate a cure for cancer. None of the plans out there. The lifespan of the American people is going to be expanded tremendously over the next decades, and it is a wonderful thing. Anything we do and anything we accomplish here today is going to have to be modified by future Congresses to make allowances for this great gift of life that is going to be extended by medical research. This is a wonderful time that we live in, but it is a troubling time. We need to be sure that our older Americans are taken care of. That should be the objective of every Member of this body and every Member of this Committee. Let us get rid of the politics. It is about the next generation. It is not about the next election.

Mr. APFEL. Could I address the question of Mr. Shaw?

Mr. SHAW. I yield back.

Chairman THOMAS. The gentleman's time has expired, and this will occur with a number of witnesses. The Chair would encourage anyone who wishes to make a response in a written way, and it will be shared with the full Committee. I also believe that, for those of you who wish, return arrangements can certainly be arranged for you, both at the full Committee and the Subcommittee level. The Chair recognizes the gentlewoman from Connecticut, and would the gentlewoman yield just very briefly?

Mrs. JOHNSON. Yes, sir.

Chairman THOMAS. I thank the gentlewoman for yielding. I would respond to my colleague and others about the 75-year solvency question versus sustained solvency. We are all familiar with the usual 10-year window that we use, which means no one looks at the 11th year, and a lot of things can happen over an 11-year life that you don't see in the 10-year life. My only concern about not focusing on, to a degree, sustained solvency is that when you look at 75 years, this year is good, next year is good, 2008 gets kind of worrisome, but every time you move along the current time line, 2008 meaning baby boomers begin coming in, we are adding at the back end of the 75 years, a much less desirable year. What we did in 1983 was focus on 75 years. We just didn't pay attention to what happens over the first 20, and when you add the last 20, the 75 years disappear.

So, if you are going to really try to make it 75 years, you have to look through. You have to run through the tape. You have to look beyond the 75 years to make sure that the bottom doesn't fall out the next year. So, when you say sustained, it may be 80 or 85 or 90 and you are going to fall short. Everyone knows that, but if you don't take that approach to it, it isn't going to be 75 years, it will be 20, and I thank the gentlewoman for yielding.

Mrs. JOHNSON. Thank you, Mr. Chairman. Mr. Apfel, I would urge you to provide us in writing some better understanding of the proposals that President Clinton put forward, because he put forward a number that involved reaching into the private market to expand the resources of Social Security, both in the individual account or indirectly investing government money. How he governed those mechanisms are vague in my mind, so that would be helpful to us. Also, Mr. Furman, I would like to ask you to provide in writing some enlargement of the last sentence of the conclusion of your testimony. You were eloquent in shooting down most of the ideas that had been brought up. You also say at the end of your testimony—first of all, you say it is better to address this challenge sooner rather than later, and then you say, a balanced set of reforms that modestly increases Social Security revenues while modestly decreasing benefits could ensure that Social Security is sustainably solvent. I would certainly like for you to fill that out for me. There is not time for me to do it on my questioning time, which is now depleted anyway, but we need to know, what does a person like you, who raises some interesting points about the components of a solution that have been put on the table, thinks might be a modest program that could provide us with sustainable solvency.

[The information follows:]

Additional information from Jason Furman

Congresswoman Nancy Johnson asked me to elaborate on my statement in my written testimony that "A balanced set of reforms that modestly increases Social Security's revenues while modestly decreasing benefits could ensure that Social Security is sustainably solvent."

Social Security benefits are expected to exceed Social Security revenues by 1.92 percent of payroll over the next 75-years. The *only* way to restore solvency to Social Security is to reduce benefits or raise revenues. Every dollar raised in revenues is one dollar less required in benefit reductions.

A variety of plans restore solvency over 75 years using Social Security trustees assumptions, including a plan developed by economists Peter Diamond and Peter Orszag and another plan developed by former Social Security Commissioner Bob Ball. In addition, Congressman Wexler has submitted a plan that appears to restore 75-year solvency under Congressional Budget Office assumptions. All of these plans merit serious consideration.

All of them include very progressive new sources of revenue, including raising the ceiling on payroll taxes and/or charging a lower tax rate above the cap. In addition, the Ball plan dedicates revenues from a reformed estate to Social Security. In addition, both the Diamond-Orszag and Ball plans gradually raise payroll tax rates.

The Ball and Diamond-Orszag plans include modest benefit reductions, including correcting the Consumer Price Index used to calculate Cost-of-Living Adjustments (COLAs). In addition, the Diamond-Orszag plan increases benefits relative to the current schedule for workers with low incomes and reduces them for workers with middle—or higher incomes. Specifically, the Diamond-Orszag partially applies longevity indexing to benefits in addition to reducing the 15 percent PIA factor and making benefit adjustments to stabilize the "legacy debt" associated with Social Security. These benefit reductions are substantially less than the reductions proposed by investment-executive Robert Pozen.

Even more important than the individual provisions is the overall balance. Specifically any plan should be:

- Balanced between revenue increases and benefit reductions.
- Protect replacement rates to the greatest degree possible to ensure that Social Security remains a key component of the core tier of retirement security.
- Progressive, ensuring that the highest-income Americans contribute their fair share to restoring the solvency of Social Security.
- Economically sound so, for example, the plan robustly restores solvency in the face of uncertainty about the future and does not, for example, deliver larger benefit reductions when Social Security is more solvent.

I want to add something to this debate, because we cannot reform Social Security without addressing some of the inequities of the program, and they were not intentional inequities. Life was different. Now, life involves most women working before they have their children, after they have their children, or maybe just after they have their children, and it involves women living many, many decades on their own after retirement. I have been working on an idea that would overcome, to me, one of the really absurd aspects of our current Social Security system. No matter how hard I work, the fact that I stayed home 20 years to take care of my children gives me 20 zeroes in 35-year calculation. So, I think, frankly, that was much harder work than anything I have done since then, and I think we need to impute some level of income to women for at least 10 years of being home with their children because the evidence is just overwhelming in terms of the importance of parents in children's lives. So, I want to correct that injustice by changing the way we calculate earnings for women. I know this will have cost impacts, but do you have any thoughts on other inequities that we need to address? The President has proposed having no Social Security benefit that is below the poverty income. I absolutely agree with him on that, and the guarantee of that. How would you propose we recognize the changes in women's lives and the terrible

disparity—some of you mentioned the problem for couples, but on this particular issue of imputing income to women, I would be interested in your thoughts. Mr. Apfel?

Mr. APFEL. First, I would say I remember our discussions on this in Connecticut when I held a town meeting with you in Connecticut. This issue came up and you had the same passion on this issue that you have now.

Mrs. JOHNSON. That is right.

Mr. APFEL. I think that this is an issue that needs to be looked at carefully. I think that there are a number of things that Social Security does that are very, very important for women, but there are also some problems that need to be looked into. So, there is nothing wrong with trying to figure out a way to improve a system to make it better. These are profoundly important benefits for women. Women are the majority of all beneficiaries and live longer than men. We all know these things. Something in this area, I think, should be looked into. I would also point out that President Clinton's proposals were in addition to Social Security, not taking away from the Social Security defined benefits. The core question here is not whether more individual savings is needed. It is whether we want to have a system——

Mrs. JOHNSON. My time has expired, but I just would remind you that money coming into Social Security now goes into the general fund, and you all know that. You also know what we do with general fund dollars; it accumulates debt. Money going into a private account would go into an account. It is tangible. There has got to be some difference between flowing dollars into a tangible account that can be cashed in and dollars going into the general fund. If China wants to recoup a bond, they sell it in the private market and we pay China. We can't do that with Social Security. There is a difference between the money that goes into an account. This is a longer discussion, but thank you for all your ideas and we will continue to pursue this.

Chairman THOMAS. Does the gentleman from California, Mr. Stark, wish to inquire?

Mr. STARK. Thank you, Mr. Chairman. I just want to set to rest this issue of Democrats coming up with a plan. When one party controls the White House and the Senate and the House and they can't get anything done, they tend to blame the minority, and that is kind of—that is a cop out. Republicans control the entire Federal government, and if they can't get something done with Social Security, then it rests on their shoulders. When it came time to pass a lousy prescription drug benefit, or the budget, they got their leadership back with the lobbyists from those foreign trips, and they kept us there and, by golly, they got it done. So, if you could get your leadership back with those lobbyists who are going to write your legislation and get to work, then the Republicans don't need us. They could go ahead and pass a plan. To suggest that the reason they are not passing a plan is because we don't have one is sophistry. It just doesn't wash. They are in charge, and if they can't run the place, then they ought to quit and we will get back and run it well as we used to.

Mr. Furman, the President has proposed some benefit cuts for the middle class. In this stacked jury, and when I get up in front

of a jury, I certainly hope the Chairman won't select my jury, but in this stacked jury, I have been hearing this discussion of income relating. Now, that is really a euphemism for cutting middle-class benefits, but you may call it in your answer, Mr. Furman, what you please. In these benefit cuts, he had a benefit cut for everyone who earned more than $20,000 a year—that is $10 an hour—and an additional privatization tax which further reduces the benefits. Can you give me an overview of the impact of all these cuts that are supposedly progressive cuts and whether they are due to the guaranteed benefit for the middle class, which the Republicans don't care much about?

Mr. FURMAN. I will be happy to, and very briefly, before that, a lot of people who make less than $20,000 a year, probably about half the people that make that, would also see their benefits reduced by this plan. The particular types of people are widows, children whose parents have died, divorced spouses, people who are getting the benefit on the basis of someone else's work history who might have made $30,000 a year and is thus middle class by this definition. They themselves are very poor and are seeing their benefits cut, so I would not accept the assumption that people less than $20,000 a year are protected by this plan. They are not. In terms of middle-class families, the types of benefit reductions you would see relative to the benefits scheduled in current law are for a middle-class family retiring in 2055, 21 percent to 31 percent, and those benefit reductions would grow over time. On top of that, what you described as the privatization tax, or the benefit offset, would be another $10,000, $15,000 taken out of your benefit. It would leave you with a benefit of a few thousand dollars a year plus an account on top of that, but only a few thousand dollars of rock-solid——

Mr. STARK. Do you mean $2,000 or $3,000?

Mr. FURMAN. If you take a family making about $50,000, $60,000 a year retiring in 2055, they would get a benefit of $4,000 a year——

Mr. STARK. Members of Congress get that in 2 months.

Mr. FURMAN. That is all they would get. In addition, they would have an account, and that would be subject to market risk. In terms of the traditional defined benefit, it would be a few thousand dollars.

Mr. STARK. What would that account pay them, if anything?

Mr. FURMAN. The account is subject to market risk, and Professor Shiller's studies say that 32 to 71 percent of time, you would end up losing money by choosing to participate in those accounts.

Mr. STARK. Suppose it made money. You put part of your payroll tax in over a period of time. Take a quick cut at that apple. What would that be, if you would annuitize that great account in the sky.

Mr. FURMAN. You would get a certain amount. Table 3 in my written testimony goes through a variety of rate of return assumptions. If you take one from a survey that the Wall Street Journal did of ten prominent financial economists, if you got the rate of return that those ten people were projecting, not even counting the extra costs of risk, they found out you would come out about $6,000

behind if you were retiring in 2075 and you take into account both benefit reductions.

Mr. STARK. It sounds like a heck of a deal. Could I yield the balance of my time to Mr. Levin?

Mr. LEVIN. There isn't much time. Thank you.

Chairman THOMAS. I tell the gentleman he has 6 seconds left.

[Laughter.]

Mr. LEVIN. To Mr. Hunter, you say——

Chairman THOMAS. The gentleman's time has expired.

[Laughter.]

Chairman THOMAS. When we come back to you, Sandy, I will be generous on your five, okay? Does the gentleman from California, Mr. Herger, wish to inquire?

Mr. HERGER. Yes. Thank you, Mr. Chairman, for putting together this panel, this outstanding panel, for so aggressively—in a positive role—going after this issue which affects our Nation, our children, and our grandchildren. I applaud you for your efforts. Dr. Lindsey, critics of the President's plan to create personal accounts assert that it would cost trillions of dollars. Would you explain why the U.S. economy would not be worse off, and would likely be better off, under the President's proposal to establish personal accounts?

Mr. LINDSEY. The personal account plan leaves the Social Security system whole because the benefit adjustment that occurs saves Social Security money for all the money that is moved into the personal account. So, I don't think that it is an accurate statement to say that there is a cost here or that Social Security is made weaker. In fact, the Social Security system is made whole under the personal account proposal.

Mr. HERGER. Thank you. Mr. Pozen, your plan has been accused of cutting benefits for middle-income Americans. Under your plan, would future retirees get less than today's retirees, even after adjusting for inflation?

Mr. POZEN. No, they would get considerably more on a purchasing power basis. They would get 20 to 30 percent more on purchasing power. The "cuts" mean less than the scheduled benefits that we can't afford.

Mr. HERGER. Mr. Pozen, again, which promises a higher rate of benefit growth to medium-wage workers, aggressive price indexing,or benefits that are payable under current program?

Mr. POZEN. If we don't have major reform, the benefits payable under the current program would be about 26 percent less in 2041 and progressive indexing would give them a better deal than that.

Mr. FURMAN. If I could say one thing about that, on the progressive price indexing, the trust fund would be exhausted in 2047. At that point, an additional 15 percent across-the-board benefit cut on top of the sliding scale benefit reductions would be required. When you take both of those into account, it is no longer necessarily the case that you are better off under payable. If you are doing a genuine apples-to-apples comparison, comparing the current system and what would happen when the trust fund was exhausted, you have to apply the same standard to the President's plan, and you look at what happens when the trust fund is exhausted in that plan.

Mr. POZEN. Mr. Herger, I would disagree strongly with that.

Mr. HERGER. Mr. Pozen, would you like to comment?

Mr. POZEN. Yes. I would disagree strongly. I think that we do not—that analysis is only correct if we think we have to get to a zero percent present value——

Mr. FURMAN. The payable benefits do. They are based on zero——

Mr. HERGER. Mr. Chairman, I have asked Mr. Pozen to comment. Thank you.

Mr. POZEN. My plan with progressive indexing slows down the growth of entitlements so that in 2079 as scored by the chief actuary, the amount of money coming into the system would be roughly the amount that goes out. I don't think it is necessary to reach zero present value of the deficit today. What we need to do is to get the financing of the system to the point where we can carry the mortgage, and we can carry the mortgage if we reduce the entitlements and benefit growth by roughly 70 percent.

Mr. HERGER. Dr. Steuerle, would you like to comment?

Mr. STEUERLE. Yes, Mr. Herger, I would just like to comment that there are a variety of ways of doing what is called progressive price indexing. The bottom line is that we all know the system is imbalanced and we all know that, one or another, the middle class and the upper class are going to pay to bring it back in balance. We are not going to impose reform costs on the poor. We can cut benefits, we can increase taxes, and we can pick which generation is going to pay, but one way or the other, we are going to have to pay to get it back in balance. What we then need, given the variety of ways we can do things like progressive price indexing, is to sit down, roll up our sleeves, and look at the data on who we can protect, how we can protect them, and alternative ways of doing it. This is not, again, an advocacy stance. There are a variety of ways to deal with these issues, but we have to admit up front that one way or another, either through slower growth in benefits or higher taxes, somebody has got to pay to restore balance, and I am guessing it is going to be the middle class or the upper class.

Mr. HERGER. Well, I want to thank you again. This idea of doing nothing and the fact that the Democrats have no plan, and with knowing how we have more and more people retiring with fewer people paying in, I want to thank those of you who are presenting a plan with the courage of coming forward, and I thank you very much. Thank you, Mr. Chairman.

Chairman THOMAS. I thank the gentleman. Does the gentleman from Louisiana, the chairman of the Subcommittee on Social Security, wish to inquire?

Mr. MCCRERY. Yes, Mr. Chairman. Thank you. Mr. Pozen, I believe, or at least you have been quoted as saying that under your progressive indexing plan, that workers making under some figure, I don't know if it is $20,000 or $23,000 or $25,000, would continue to have their initial benefit calculation indexed to the wage index.

Mr. POZEN. That is correct, but progressive indexing doesn't begin until 2012.

Mr. MCCRERY. Right.

Mr. POZEN. People $25,000 a year at that point would be fully protected under progressive indexing as to their current schedule.

Mr. MCCRERY. Could you explain what you mean by people making $25,000 or less?

Mr. POZEN. Those would be people who, at retirement, would have average career earnings per year of $25,000 or less. When the actuaries compute your initial Social Security benefits, they calculate your average career earnings and then they adjust it upward by the amount that wages have gone up during your career.

Mr. MCCRERY. Thank you. So, Dr. Furman's comments about your proposal affecting people who make less than—in fact, he used some high percentage, half, maybe, of all people making less than $20,000 a year would be cut, that is simply apples and oranges, isn't it?

Mr. POZEN. I think it is a very different analysis that he is making and he is trying to bring in people who might be widows of somebody who was in a certain situation. These are complex issues that should be dealt with, but I think the basic thrust of the protection is still at $25,000.

Mr. FURMAN. I would be happy to provide for the record a White House document showing the bottom 20 percent get their benefits reduced.

Mr. MCCRERY. It doesn't matter. If you are talking about two different things, it doesn't matter. You can provide all the back-up you want. Mr. Pozen, I would hope as——

Chairman THOMAS. If the Chairman would suspend briefly, does the gentleman refer to a document that responds to Mr. Pozen's plan?

Mr. FURMAN. The White House did an analysis—it was released last week—entitled, "Interpreting Benefit Estimates for the Pozen Provision." That is the title of the White House analysis——

Chairman THOMAS. Does Mr. Pozen agree with the——

Mr. FURMAN. It shows that low-income, the bottom 20 percent, get less under——

Chairman THOMAS. Dr. Furman, I want to know if Mr. Pozen——

Mr. POZEN. I haven't had a chance——

Chairman THOMAS. If the participants on the panel could just get along, we could move a lot——

Mr. POZEN. I haven't had a chance to study that, Mr. Chairman.

Chairman THOMAS. Well, obviously, the Chair will take whatever official documents are listed, but the description of those will be suspended, to analyze if, in fact, it is an attempt to respond to the plan that Mr. Pozen has, because he is here. Thank you, gentlemen, and it won't count against him on his time.

Mr. MCCRERY. Thank you, Mr. Chairman. It should be clear that Mr. Pozen, when he talks about people, whose incomes are less than $25,000 will continue to get the wage index calculation, it is referring to retirees who have an average monthly wage of $25,000 or less.

Mr. POZEN. An average annually.

Mr. MCCRERY. I am sorry, annually. That is their average over their 35 years of work history.

Mr. POZEN. Correct.

Mr. MCCRERY. Mr. Pozen, as a Democrat, I would hope that you would get a little tired of your fellow Democrats

mischaracterizing not only your plan, but the President's proposals, for example, the continued use of the word privatization. Mr. Apfel used it ad nauseam today. Democrats on the panel here use it ad nauseam. Nobody is talking about privatizing Social Security. Get over it. If you refuse to take part in this debate on honest terms, then you are going to have a hard time getting to a bipartisan solution. We are being patient, trying to work through a number of options, and we have you here today hoping to learn more about some of your ideas. Unless we discuss this in honest terms, we are going to get nowhere. We are not privatizing. We are not proposing to privatize. Neither is the President.

Means testing, another example. It is clear that Mr. Pozen's plan is not means testing. It is not means testing. It is further income-relating the benefits. The system is already—these are two different things. You either know it or you don't. The level of ignorance that is being shown is getting pretty steep here. I am beginning to think that they are doing it on purpose.

Mr. APFEL. Mr. McCrery?

Mr. MCCRERY. No. In addition to that, the double-cut that Dr. Furman talks about, there is no double-cut. If you don't choose the voluntary account, there is no double-cut. It is voluntary. We are not forcing anybody to take an account, and if they don't, there is no double-cut. Even if they do, there is no double-cut because they are getting the money up front in their account that they would have gotten later, in the off-years. So, a lot of this disingenuous and sometimes outright misleading discussion that is being done by Democrats is counterproductive. It is not helping. We want to sit down with you and talk honestly about how to solve this problem, but you are making it very, very difficult, and I would hope that you would begin to sit down and talk meaningfully and honestly and substantively about what you want to do.

President Clinton up here on an ABC program—it is in today's Associated Press (AP) release—said, "I think the Democrats should say what they are for, on Social Security, in the next couple of weeks." I do too, President Clinton, and I hope, finally, we can get somebody to make clear what benefit cuts and what tax increases, which is what Dr. Furman and Mr. Apfel have said very—that is their solution, tax increases and benefit cuts. Fine. Show us what benefit cuts and tax increases you want us to implement. Then we can begin the discussion. Thank you, Mr. Chairman.

Chairman THOMAS. I thank the gentleman. Does the gentleman from Michigan, the Ranking Member on the Subcommittee on Social Security, wish to inquire?

Mr. LEVIN. I sure do.

[Laughter.]

Chairman THOMAS. The gentleman has 5 minutes and 6 seconds.

[Laughter.]

Mr. LEVIN. Look, the person who has made this difficult is the President of the United States of America. He set the agenda. He determined the first order of business. He comes forth in his State of the Union and says, my answer to the Social Security shortfall, which he grossly exaggerated by calling it "bankrupt," is private accounts. If you don't like the term, I am sorry. It is privatization,

and the Cato Institute used to use that term. It is privatization. The problem you have is not our silence, it is our voices. We have addressed the first item on the agenda, set by the President of the United States, and so have the people of the United States of America. They don't like changing Social Security into private accounts. They don't want the replacement of the guaranteed benefits with private accounts, and you don't want to listen to this; we are going to continue to make clear what the ramifications are. Now I am going to ask Dr. Furman—Mr. Pozen, I want to go back. There is an effort to mask here—I am not saying you are doing it intentionally. I am not going to call you a Democrat or a Republican. I think you have worked for Governor Romney, who is a Republican. I don't care what you are. I want to talk about what the implications of what you have proposed.

So, I want to go back and have Dr. Furman talk about what happens when you combine major benefit cuts that fall on the middle class, and Dr. Furman, you can—at some point, somebody is going to have to do something or other. Let us talk about what has been proposed here. Dr. Furman, talk in terms of the replacement rate. By the way, you are so right, Mr. Apfel; the former President of the United States, Mr. Clinton, never talked about diverting Social Security into private accounts. So, Dr. Furman, set the record straight. What is the result of combing what Mr. Pozen has proposed, what the President of the United States said makes sense, with private accounts. Just say it straight.

Mr. FURMAN. Your traditional rock-solid guaranteed Social Security benefit would replace between about zero and 10 percent of your pre-retirement income. Everything else would be privatized, private, whatever you want to call it. Zero to 10 percent would be your Social Security benefit of your pre-retirement income, a couple thousand dollars a year.

Mr. LEVIN. So, essentially what would happen over time is that the guaranteed benefit portion of a person who opted for private accounts would shrink, shrink, shrink, is that true?

Mr. FURMAN. That is correct. You look at the equivalent of somebody making $59,000 a year, retiring in 2075, will get a Social Security benefit of $1,000. It will barely replace any of their pre-retirement income. Everything else will be private.

Mr. LEVIN. If that is the purpose here, to replace Social Security with private accounts, and you can argue about what the rate of return would be, and Dr. Shiller has put forth what the rate of return and why it would be a bad deal. The reason people are not buying what the President has proposed is a combination of what Dr. Furman has said straight out. When you combine the privatization with the sliding-scale cuts, plus what has happened to the stock market, what is happening in retirement benefits, what is happening is that defined benefits are being replaced by defined contribution plans and Social Security remains the foundation more and more of security. Mr. Pozen, when the President says someone making over $20,000, that is in today's terms, $25,000, years from now, everybody making over that is well off, the working people are saying clearly to the President of the United States and to all of you, that is a total turn-off.

We will sit down on a bipartisan basis when it is understood that we and the American people have responded to the first item on the agenda posed by the President of the United States, and that is privatization, personal accounts, whatever you want to call it. We showed that in 1983, when two-thirds of the votes in this House for shoring up Social Security came from Democrats, and Dr. Hunter, when you talk about raiding the Treasury, talk to them on the Republican side. Talk to them and don't talk to us who supported proposals in 1993 that put this country on a path to no longer raid Social Security. Talk to them.

Mr. POZEN. I would just like to clarify for the record that the chief actuary in the proposal that I made does not have these very small defined benefits left. In 2075, for the median worker——

Mr. LEVIN. This is on somebody's time. This is when you combine the private accounts.

Mr. POZEN. It all depends on what type of private account you combine with progressive indexing.

Mr. LEVIN. Okay.

Mr. POZEN. I propose the 2-percent account——

Mr. LEVIN. No, we are talking about the President's account, Mr. Pozen, the President's account.

Chairman THOMAS. The gentleman's time——

Mr. POZEN. I want to distinguish that very carefully from what I have proposed.

Chairman THOMAS. The gentleman's time has expired, and I would indicate to you, Mr. Pozen, that on any response that any witness did not feel they had adequate time to respond—as you may notice, you may have something to offer, but it is declined by the individuals. It shouldn't be declined by the Committee. So, we look forward to any written responses you may have on any question that was asked of any witness but you didn't have a chance to respond to. The gentleman from Michigan—the other gentleman from Michigan.

Mr. CAMP. Thank you, Mr. Chairman. We have had some references to artificial parameters before, my friends on the other side, before the debate. President Clinton said, and I quote, "I think the Democrats should say what they are for on Social Security in the next couple of weeks. They have got time to put together a program." He goes on to say, "I think the Democrats should have a plan and they should talk to the President and Congressional Republicans about it." We are talking about trying to help the savings rate in this country. Mr. Pozen, your plan for progressive indexing obviously does help those at lower income levels. Are there other ways of helping lower income workers, maybe through programs like the Safe Credit Program, which has a match and a retirement plan, or a 401(k), that you might also discuss?

Mr. POZEN. Yes. As I say in my testimony, I would strongly support enhancing the Low-Income Tax Credit for workers between roughly $25,000 a year and $50,000 a year because, unfortunately, given the deficit of the Social Security system, we can't preserve everybody's scheduled benefits and we could encourage them to save more. That credit just started a few years ago. Some of it needs to be made refundable. It needs to be made more attractive,

and I think that would be a very constructive way to approach a package here.

Mr. CAMP. Dr. Lindsey, in response to one of the Chairman's questions, you referenced discretion in retirement, and trying to have more discretion in retirement. Do you see any problem with actuarially affecting retirement benefits to allow retirees a variety of ages to retire from? Right now, it is 62 or 67. Is there any problem you see in a range of ages of retirement, allowing workers more choice and more discretion based on their decisions about when they would like to retire?

Mr. LINDSEY. I think one thing the Chairman said, which is quite right, is that there are a large number of people in society who either have jobs that they can't continue or have their lives change late in life. What we have is a one-size-fits-all system. One thing we should recognize, and Congresswoman Johnson said the same thing, is that life has changed. The one advantage that has not been mentioned enough about moving toward more discretion through personal accounts is that it gives people a chance to fine-tune their Social Security benefits in a way that best meets their needs, and I think the public now is more educated. The public knows what they need. We have a more diverse set of lifestyles. What we should do with personal accounts within the Social Security system is give people more power over their own lives and more discretion.

Mr. CAMP. I am interested in your views on the economic impact of raising the Social Security cap. As a former Treasury official and accomplished economist, what would be the impact on jobs, for example, of an increase in the payroll cap from, say, $90,000 to $135,000, particularly as a lot of small businesses would be in that range? Have you seen a study of that kind?

Mr. LINDSEY. I think the best study was done by Martin Feldstein, President of the National Bureau of Economic Research. What he pointed out was that the behavioral response, in the particular example he mentioned, which I think he actually did $120,000, was that the government would only take in about 30 percent of the net revenue that was anticipated. If you remove the cap entirely, the government would actually lose revenue under doing such a plan, and that is with a very modest behavioral elasticity. It is actually very similar to the elasticity model currently used by the Joint Committee on Taxation. So, I think that is a losing proposition. In addition, you mentioned jobs. You are right. That would be a tax directly on entrepreneurship. On all tax increase proposals, I would urge the Committee to think about the fact that American workers are now competing with workers all around the world, and when you raise taxes on American workers or American employers, you are making America less competitive with countries all around the world. So, the adverse effects of the way we adjust the system are very, very important to think about.

Mr. CAMP. Thank you very much. Mr. Pozen, you have the low-income earner level at $25,000 a year in your proposal and the high-income earner at $113,000. What impact would there be to moving that low-income level up to, say, $35,000 and moving those figures around? Is there a particular reason why you have those particular numbers?

Mr. POZEN. Well, $25,000 a year was chosen because it represented 30 percent of all workers. If you see Syl Schieber's chart, that lower third are the ones who are primarily dependent on Social Security. When you go up the income scale, the workers are much less dependent on Social Security. You could move $25,000 up to $35,000 or $40,000, but you will lose a considerable portion of the solvency deficit reduction because the median wage earner in 2012 will probably be about $47,000. So, you could cover workers up to $35,000 a year in career earnings, roughly another ten percent, bringing it up from 30 to 40 percent of the workforce, but you would have solvency issues. So, it is a perfectly reasonable thing to do. We just have to come to grips with the fact that then we are going to need other benefit constraints or we are going to have to have more revenue in the system. There are no free lunches here.

Mr. CAMP. All right, thank you, and I thank the entire panel for their excellent testimony today. Thank you, Mr. Chairman.

Chairman THOMAS. I thank the gentleman. Does the gentleman from Maryland wish to inquire?

Mr. CARDIN. Thank you, Mr. Chairman, and thank all of our witnesses for being here. I guess I just have a problem in that the suggestions that are being made here would bring a fundamental change to Social Security, where Social Security would be a smaller amount of an individual's retirement security for future generations, whether that individual be in the lower income or middle-income or higher-income. It is one thing if that is good policy. It is another thing if we are doing this because of the fiscal concerns that we have about the solvency of Social Security, and it seems to me that is the driving force. It is not to modernize the system for good policy, it is to deal with the fiscal challenge. So, let me just pose a caveat here or a concern here. In 2001, we passed a major tax change because we had a huge surplus that was projected, and we found out that our 5-year projections weren't very good. We missed that pretty badly, as to what happened during that 5-year period, or 10-year period.

So, when we start talking about fundamental changes in Social Security based upon 75-year projections when we can't project very well for 2 years or 5 years, I am concerned as to whether you all have looked at other projections that have been made. The Congressional Budget Office (CBO) says it is going to be until 2052 that we have money, rather than 2041, which the actuaries are using. The actuaries nine years ago had projected the Social Security solvency problems to be 12 years earlier than it is today. My point is that these are moving numbers that move pretty quickly. If we are making fundamental changes based upon the solvency numbers, have you really thought out these fundamental changes if, in fact, the financial issues aren't as dire as we think they are going to be? Maybe just to point out, in response to some of my Republican friends about what we should be doing, and I know Democrats are united and pretty strongly voice that it starts with eliminating the carve-out from Social Security for private accounts because we don't want to dig the hole deeper. We don't want to take money out of Social Security and it is difficult to come up with solutions that add more revenue or deal with benefits when the prob-

lem is made more difficult because the President's private accounts carve-out from Social Security.

One of the suggestions that has been made, I haven't heard too much discussion from the panelists, is around the Social Security trustees to act as fiduciaries—we had that discussion at an earlier time in our Committee—so that they actually take the Social Security money, invest it as any prudent trustee would for any type of a pension plan, and getting a better return; in other words, getting more revenue into Social Security and extending the solvency of Social Security without raising taxes. That would deal with a good part of the problem. Instead, we seem to be focusing on benefit cuts. It is a discussion that we need to have, but I must tell you, I get very concerned about benefit cuts that are related to income that are not predictable, and I heard you, Mr. Pozen, talk about this, but we don't know what the future is going to hold on these different indexes. These are projections and they may very well be means testing the benefits in Social Security if someone gets zero out of the Social Security system or a minuscule amount of money out of the Social Security system that Dr. Furman is talking about.

So, before we start down this path of allowing Social Security indirectly to be means tested, meaning that it no longer is a universal Social Security program, we had better be pretty sure of the numbers we are working with. Recent history has taught us that we can't make these long-term projections, and I am somewhat disappointed by the tone of the panel in being so certain about their proposals and the needs for their proposals, when history has taught us that this has not been the case in projecting the problems of Social Security. My last point, Mr. Chairman, we did make major changes in the Social Security system to deal with the baby boomer generation. That was 1983. I was not part of Congress, but they made an effort to deal with 75-year solvency. It is time for us to look at it again. It is time for us to make adjustments, but I really question whether the fundamental changes that are being suggested by some of these panelists are the right way for us to proceed. Thank you, Mr. Chairman.

Chairman THOMAS. I thank the gentleman. The Chair thinks it will be useful, and I will pass it out to all Members and make it a part of the record so that they can see the series of votes dealing with the issue in 1983 on the floor of the House. There were two particular amendments. The chairman of the Subcommittee on Social Security, J.J. Pickle, had an amendment which extended the retirement age, and the gentleman from Florida, Mr. Pepper, offered an amendment that raised the payroll tax. The gentleman might be interested in the partisan break in terms of supporting fundamental change versus raising the payroll tax, and we will make that a part of the record.

[The information follows:]

1983 Amendments

January 20, 1983 (Commission Report Issue Date)

- Report of the National Commission on Social Security Reform was issued to President Reagan on January 20, 1983.

March 9, 1983 (House passed bill)

- The House passed H.R. 1900 (Social Security Act amendments 1983) by a vote of **282** [97R, 185D] to **148** [69R, 79D].
- Pickle amendment (raise the normal retirement age to 67 for those turning age 62 in 2022): approved **228** [152R, 76D] to **202** [14R, 188D].
- Pepper amendment (raise payroll taxes from 6.2% to 6.73% beginning in 2010): failed by a vote **132** [IR, 131D] to **296** [165R, 131D].

March 23, 1983 (Senate passed bill)

- The Senate passed H.R. 1900 (Social Security Act amendments 1983) by a vote of **88** [47R, 41D] to **9** [6R, 3D].

March 24., 1983 (final passage)

- Final passage of the conference report (H.R. 1900—the Social Security amendments 1983) by both chambers.
- House vote **243** [80R, 163D] to **102** [48R, 54D].
- Senate vote **58** [32R, 26D] to **14** [8R, 6D].

Chairman THOMAS. Does the gentleman from Minnesota wish to inquire?

Mr. RAMSTAD. Thank you, Mr. Chairman. I want to thank all the experts on the panel here today. Let me ask you, Mr. Pozen, regarding your proposal for progressive indexation, a number of my constituents have come forward already at a town meeting, at several town meetings, middle-income earners, and they are concerned about projected benefits under your plan. Now, I read your testimony as saying that retirement savings would make up for reduced Social Security benefits for median-wage earners. Is that a correct statement?

Mr. POZEN. Correct.

Mr. RAMSTAD. Do you have any, aside from saying we should provide more incentives for 401(k)s and other retirement savings vehicles, do you have any empirical, or any of the other witnesses, any empirical data, projections that would support that quid pro quo that you maintain is there?

Mr. POZEN. We know that the replacement ratio for median workers under progressive indexing in, say, 2045 would fall from about 36 percent to 30 percent. We know that something like 50 to 75 percent of all median workers now participate in some form of private retirement program, and we know that if we want to encourage people to participate more, we have empirical evidence to support two strategies.

One is to the extent that we have any sort of matching program or refundable tax credit which plays that equivalent role, that has a big positive effect in terms of people's participation. The second strategy is the sort of proposal that has been discussed here about presumptive enrollment, in which people are presumptively enrolled in a 401(k) plan, or a program like that, and then they have to opt out, that overcomes inertia and really brings up the participation rates. So, those are two practical strategies that we could adopt to encourage people to make up the decline in the replacement rate. Most of them already are making up some, if not all of that, and we could do more to increase replacement by these private retirement plans.

Mr. RAMSTAD. I also would like to ask you, Mr. Pozen, your plan, as I read it, would apply progressive indexing to workers with disabilities, as well as retired workers. Why did you choose not to

hold workers with disabilities harmless pursuant to benefit in current law?

Mr. POZEN. That is a good question and I think that I have always tried to say that the whole issue of disability needs to be dealt with separately. Under my plan, I don't try to address all the disability aspects. I would be receptive to a hold workers with a disability harmless, but that would involve some issue in terms of solvency, which we would have to address either through other benefit constraints or increases in revenues. So, we can do that, it is just a question of enumerating the cost.

Mr. RAMSTAD. Please, Mr. Apfel?

Mr. APFEL. Mr. Ramstad, I think it is important to also look—this was mentioned briefly before, and I think we should provide something in the record—at ancillary beneficiaries, such as low-income widows. The worker may very well have been protected at the levels that Mr. Pozen has talked about, but when that person dies, that is going to have an effect on benefits. So, kids, widows, some of the ancillary beneficiaries, who are easy to forget about, need to be looked at very, very carefully. These are low-income families who would be affected by the proposal. So, it is not quite appropriate to say that low-income people are protected. It just needs—the details need to be worked out very, very carefully and I think we should try to provide some of that for the record.

Mr. RAMSTAD. Please, Dr. Steuerle.

Mr. STEUERLE. Mr. Ramstad, again, this is one of those examples where, I think if we sit down and work, we can really address the issues. As you may know, I suggested something not too different from Mr. Pozen, a wage indexed minimum. Now, there are different types of wage indexed plans. For the same cost as some forms of progressive price indexing, you can use a minimum benefit to protect people at a higher level and you can protect more disabled people, you can protect more widows and spouses. The disadvantage is for, say, someone making $70,000, you don't do as much wage indexing for their base; that is, for someone who is much higher income, you may not provide as much benefit increase over time. In Mr. Pozen's proposal, everybody gets some benefit increase over time, no matter how high their income level, until you hit the very top. I know that this is a technical issue, but there are ways to address these issues, I think, that can protect more people at the bottom and that, independently of issues like personal accounts, would please people across the table.

Mr. RAMSTAD. Well, I want to thank you again. Thank you for those responses. I must say in conclusion, Mr. Chairman, for the first time after listening to this panel and the dialog here, I am more convinced than ever that we can arrive at a bipartisan, pragmatic, and common sense solution to the Social Security dilemma which may not be a crisis today in terms of an imminent danger, but it sure as heck is a looming crisis and a problem we need to deal with. So, thank you very much, all of you gentlemen. I yield back.

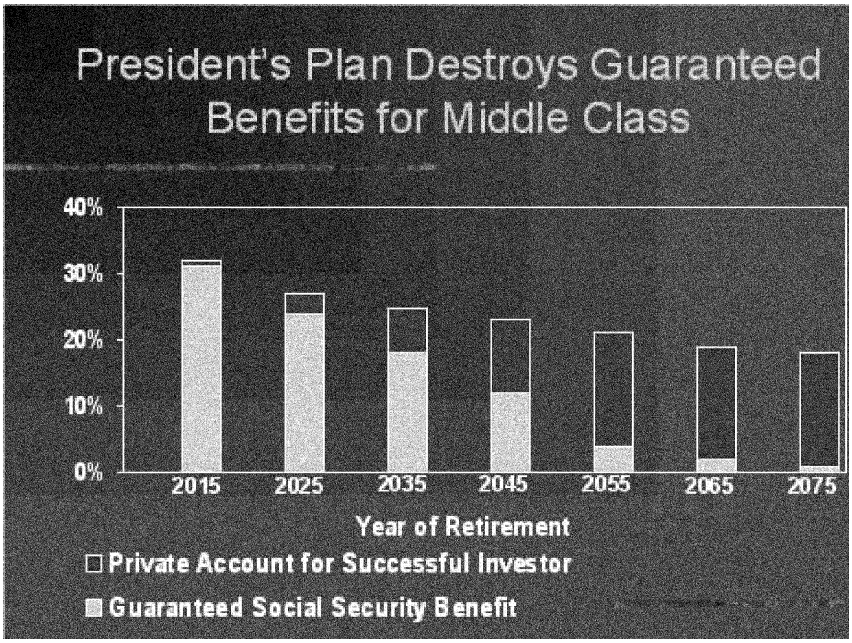
Chairman THOMAS. I thank the gentleman for his comments, and I, too, agree that we could reach that description that you just provided. My only question is, do we have enough votes to pass it? Does the gentleman from Washington wish to inquire?

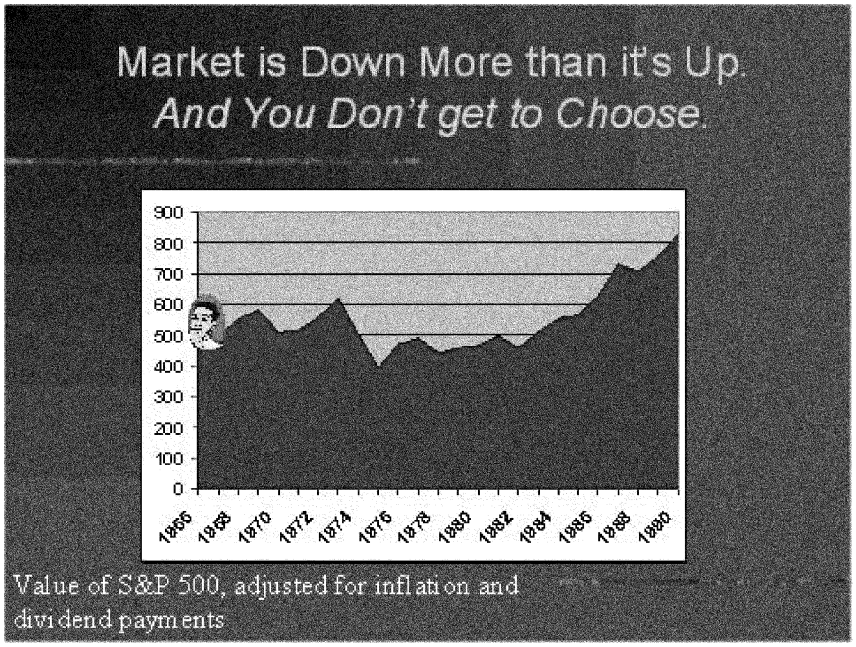
Mr. MCDERMOTT. Thank you, Mr. Chairman. Today's hearing is important because I think we really need to deal with this issue. I find it interesting that all the people picked by your staff think that privatizing Social Security is a good idea. Assuming you and the President realize that privatizing Social Security is as dead as disco, as far as Democrats are concerned, the sooner we will get to the serious business of doing something about this whole proposal. It is not going to happen until you make that decision. The President the other day, though, finally, after he was driven out of the weeds by his trip on the road, found that he had to admit that the privatization scheme required slashing benefits for the middle class. Adding insult to injury, we now know the President's plan will only close about one-third of the funding gap.

Now, here we are today, having this hearing, pretending that privatization is actually going to work. We are pretending people will be better off losing half of their benefits. Mr. Chairman, even you can't defy gravity. The President's proposal eviscerates the guaranteed benefits of Social Security. Now, let us go to the chart. What you see there, currently, Social Security provides over one-third of pre-retirement income to retirees. The President would slash——

Chairman THOMAS. If the gentleman would yield briefly, on the back chart, for those in the audience, you can see what the gentleman from Washington is talking about. We will try to get the television for us, but in the meantime, the gentleman has provided us with charts and Members can look at the charts that he has in front of them. Thank you. Go ahead.

[The information follows:]





Mr. MCDERMOTT. Social Security provides—thank you, Mr. Chairman. That is good clarification. It provides over one-third of pre-retirement income for retirees. The President would slash these benefits to almost nothing for a middle-class person that today earns $58,000. That is what Dr. Furman just talked about. Now, since when do we expect less for our children than we do for ourselves? I know some of you are saying, well, we are going to make it up with the stock market. Mr. Furman, is it likely that private accounts will make up these benefit cuts?

Mr. FURMAN. I don't know what is going to happen to the stock market. Mr. Pozen is more likely to. In my written statement, I presented six alternative scenarios, one that is used by CBO, one that is used by the actuaries, one that appeared in the Wall Street Journal, Shiller. In every one of the six, U.S. stock market returns are not enough to make up for those benefit reductions.

Mr. MCDERMOTT. Thank you. So, those numbers sound similar to what numbers I have come up with, and your point, if you get that, you will see now with your stock account, that is how much—that red is how much you are going to make up. If you are at $58,000 today, that is what is going to happen to your Social Security. Even considering the rosiest, and this is the rosiest one out of the private accounts, the returns will still not make up the benefit. Now, the President's privatization means everyone's retirement will be tied to Wall Street—everyone's. Now, Mr. Furman, or Dr. Furman, you are familiar with Robert Shiller, the Yale economist, aren't you? Is he a good, reputable man?

Mr. FURMAN. I think he is considered one of the top financial economists.

Mr. MCDERMOTT. He wrote a book called Irrational Exuberance and in it he examined the cycles of the stock market. These were the two long-term downturns in the last century. The first period begins in 1929 and the second period begins in 1967. Shiller pointed out that once you consider the impact of inflation and dividend payments, that people in the market before these slumps had to wait nearly 20 years to make their money back.

I will put up a slide here. This is the 1967 one. This slide shows the last market slump. It began in 1967. A dollar invested in stocks in 1966 would have been worth less than a dollar when you made computations on inflation and you made dividend computations. You would have to go all the way to 1985 to come back to the same value you put in. Now, this is important because you don't get to choose when you are going to retire. Just look at Bill here for a second. He looks nervous, right? He can't choose when he is going to hit retirement age. So, during 40 of the last 76 years, the market has been down. Mr. Furman, people in defined contribution plans are already at risk in the market. If we privatize Social Security, aren't we putting people in double jeopardy with having their defined contributions at their work or whatever or their 401(k)s or whatever, and then we add Social Security, it is really putting people at double jeopardy.

Mr. FURMAN. I would call it 100 percent jeopardy. The entire benefit would be in the market.

Mr. MCDERMOTT. Lastly, let me say something about——

Mr. MCCRERY. [Presiding.] The gentleman's time has expired.

Mr. MCDERMOTT. If anybody thinks that is a fair way to go, we are willing to vote on it. Just bring it up and put it on the table.

Mr. MCCRERY. I thank the gentleman. Mr. Nussle?

Mr. NUSSLE. Thank you, Mr. Chairman, and I want to thank all of our witnesses. It has been a very interesting—let me restate that. Your portion of this has been very interesting and I appreciate your testimony. I have held a lot of town meetings in Iowa and have a lot of chance to talk to a number of constituents and their concerns are much broader than Social Security. They are concerned about health care. They are concerned about their pensions. Certainly with the news that we have seen lately, they are concerned about their savings, prescription drugs, the value of their house, taxes, on and on. That, to me, is retirement security, and I think part of the reason why this debate, while certainly important, is far too focused and narrow because retirement security is much broader than that.

It is also troubling, because I do think that there is widespread understanding that we do have a challenge, a problem that we do need to deal with, and thus far, at least, we hear that there is opposition to personal accounts, there is opposition to progressive indexing. Basically, not too many changes are being suggested. The one that kind of gets hinted at, that I hear particularly from those who don't have a proposal that they are interested in questioning, is increasing taxes or changing the earnings base. In fact, I have had some Iowa constituents that have asked me that. There is kind of this popular, almost Internet, e-mail, however you want to put it, that basically goes like this. All you have to do is increase the earnings that are subject to the tax and this will take care of itself.

Just increase that and it will take care of itself, from $90,000. I guess my question would be, is that true, and let me start with Mr. Lindsey on that point.

Mr. LINDSEY. No. Even under the most narrow set of assumptions, you might delay the point of daily insolvency, if that is what you want to use as the parameter, by four to 6 years. More importantly, as just about every economic study has shown, when you raise those taxes, you create an incentive effect across the government, not just Social Security tax revenue, but also income tax revenue. To use, again, Martin Feldstein's example, he believes that we would actually see a reduction in total government revenue as a result of eliminating the wage cap completely. At the very least, whatever the number is, you will not get the projected increase. In addition, what you are doing is you are taxing American workers and American businesses and American entrepreneurs and you are not taxing Chinese workers or Indian workers or European workers or anyone else you would want to compete against. So, if we live in a globalized economy, I don't see the benefit to the American economy or American retirees of making us carry an ever-increasing burden of these costs while others do not.

Mr. FURMAN. Mr. Nussle, if I could——

Mr. NUSSLE. I actually—I am sorry. I am asking——

Mr. FURMAN. I have actual numbers for the question you asked from the Social Security actuaries.

Mr. NUSSLE. Okay. What are your actual numbers?

Mr. FURMAN. It is worth the Committee, if you are considering this proposal, being guided by that. A memo dated February 7th says that if you make all earnings subject to the payroll tax but retain the cap for benefit calculations, that would reduce the 75-year deficit by 2.2 percent of payroll. That is larger than the entire projected deficit. So, according to the Social Security actuaries' memo, eliminating the cap but retaining it for the purpose of calculating benefits would eliminate the 75-year deficit.

Mr. NUSSLE. That wasn't the question, and that is not the popular e-mail chain letter that seems to be out there. So, I appreciate—again, this is, I think, what was being discussed earlier. You are comparing apples with oranges. The second thing I wanted to just ask Mr. Lindsey about in particular is this issue about increasing the payroll tax. I think you went into this, but this is important because this whole notion that you are talking about, particularly in the lower income, lower-skilled, entry level jobs that are in direct competition right now with, as you said, China as an example, I would think that an increase in the payroll tax on the front end would be a gigantic drag on our ability to compete in that world market that you are talking about.

Mr. LINDSEY. American workers are now competing on a global basis and the assumptions we had in the past, in the thirties or the forties or the fifties, when we were creating this system, did not take that fact into account. I think what we really have to begin to do is focus on American competitiveness. That is going to be the key to the solvency of the Social Security system. The words "guaranteed benefits" have come up. Yet in 1978, with very, very little notice, President Carter and the Congress cut benefits. The same thing had to happen in 1983. So, what benefits—what those

two, I think, point out is that the solvency of the system depends on the economy, and the only way you can protect future retirees is to have a robust U.S. economy. When we did not have a robust economy, such as in 1978, we ended up cutting benefits quite a bit.

Mr. NUSSLE. Thank you.

Mr. MCCRERY. Mr. Johnson?

Mr. JOHNSON. Thank you, Mr. Chairman. Mr. Tanner, I would like to get into a little more detail with you about the recognition bonds that are an important and unique part of H.R. 530, our bill. Those bonds represent the amount of benefits that people have earned up through the time they opt into personal accounts. Everybody is saying it is your money, but as you know, it is not. The Supreme Court says it isn't. It is the government's money. We want to make it their money, and I wondered if you could talk about the recognition bond. It is a zero coupon bond and I wonder if you could describe that term, for those who might not be familiar with it.

Mr. TANNER. Certainly. We are talking, essentially, about a bond that does not have any particular attributed interest rate to it. It has a face value, if you will, equal to the lifetime accrued benefit that an individual has earned, and it is payable on a certain date. In this case, it would be their 67th birthday. So, the bond would simply be issued on a particular day, and then it would be redeemable on their 67th birthday. The value of that bond would be based on the accrued lifetime benefits that the individual has earned. As you said, this would lock in the level of benefits that the individual has earned and give them actual ownership of it. I know that there have been several people today who have said that Social Security is a guaranteed, rock-bottom guaranteed, benefit. The fact is, it is not guaranteed either legally, as you have mentioned, under Fleming v. Nesser, nor economically, since Social Security cannot pay the future level of promised benefits. Recognition bonds are a way of locking in benefits for those individuals.

Mr. JOHNSON. Well——

Mr. FURMAN. With benefits under the President's plan, the accounts wouldn't be guaranteed, either. There is an offset rate set at 3 percent that reduces your benefit.

Mr. JOHNSON. I am not talking about the President's proposal at this point, thank you very much.

Mr. FURMAN. The accounts can be taxed.

Mr. JOHNSON. That bond you talk about is fully tradable, meaning that a person can sell it in the open market, but they have to deposit the cash into a personal retirement account. So, Mr. Tanner, could you describe what people can do with their recognition bonds after they opt into personal accounts?

Mr. TANNER. Certainly. Individuals who are risk averse could simply leave that money in their account and simply, at retirement, redeem that bond and then move that into either a program payment withdrawal system, or an annuity system, or even take part of it in a lump sum above the poverty level. They would simply leave that portion in their account. Other individuals might choose to sell it on the market, as long as they redeposited the funds from that sale back into their account, and then that money would be reallocated along the lines of their portfolio, which I believe under your legislation would be a default of a 65 stock/35

bond portfolio, and thereby they would actually earn a better rate of return than what Social Security benefits would be providing them. So, that would be a boost in their benefits at retirement.

Mr. JOHNSON. A bonus, if you will, to those who are in their forties when they opt into that system.

Mr. TANNER. A premium. That money, as well as these benefits, would be fully inheritable. As you know, under the current Social Security system, if you die before retirement or after retirement, you might not be able—you can't leave the money to your heirs. Under your proposal, the recognition bonds would be property, the same way as the money in the individual account, and an individual dying in their fifties or sixties would be able to take that money and pass that on to their wife, their children, their church, or their favorite charity, wherever they want to send that money.

Mr. JOHNSON. What you are saying is, the Social Security money that has been input up to date during their working period, is their money.

Mr. TANNER. I think we have been very misleading to people in letting them believe that somehow, the money they pay into Social Security belongs to them. The fact is, as the Supreme Court ruled, it is simply a tax, and then there is a government spending program no different than, say, farm price supports that later on the government decides to allocate to individuals. There is not a connection between what you pay in and what you get out. Under your bill, what you are saying is that the money that they pay into the Social Security system, both the money they paid in the past and the money they paid in the future, would belong to them, become their property. It is a unique feature of your legislation and I think it is one of the things that most recommends it.

Mr. JOHNSON. Thank you. In your testimony, you say comparisons to Social Security's promised benefits are meaningless since current law can't be paid. Often, we see the press use the term "benefit cuts." Compared to what today's retirees are receiving or compared to what is payable, benefits aren't being reduced at all. Would you clarify that issue?

Mr. TANNER. Yes. I think this is one of the most unfair challenges that opponents of personal accounts make, or opponents of the progressive price indexing. They have been particularly unfair, I think, to Mr. Pozen in saying that, somehow, that any reduction in the growth of future benefits is somehow a cut. The fact is, the projected level of benefits in the future cannot be paid. We simply cannot meet those promises. All we are talking about doing is bringing those promises in line with reality. You might as well say that somehow the Social Security reform program doesn't send every senior to Disneyland. It would have about as much reality as saying that we are cutting Social Security benefits by simply bringing them in line with what actually can be paid.

Mr. JOHNSON. I thank the panel. Thank you, Mr. Chairman.

Mr. MCCRERY. Mr. Lewis?

Mr. LEWIS OF GEORGIA. Thank you very much, Mr. Chairman. Let me thank the Members of the panel for being here today. This debate about Social Security is really about whether we will honor the commitments we have made as a nation and as a people. Are we going to honor the commitment we have made to our sen-

iors, disabled, and the children who have lost a parent? Social Security is a sacred trust, a covenant, a guaranteed benefit. A few days ago, the President said it again, that there is no trust fund, no trust fund. As I have said, there was a trust fund when the President decided to spend it on tax cuts. There was a trust fund when he decided to spend it on the war in Iraq, but there is no trust fund when it comes to use the trust fund for its intended purpose, to pay Social Security benefits. It is amazing, unreal, unbelievable to me. I happen to believe, Mr. Chairman, we have a moral obligation, a mission, and a mandate to pay those funds back. Every working American has paid toward that surplus and we expect it to be there to pay benefits. Mr. Apfel, is there a Social Security trust fund, and when you were Social Security Commissioner under President Clinton, what happened to the Social Security trust fund surplus?

Mr. APFEL. There is a Social Security trust fund. It is, by law, available for one thing, and that is paying benefits for current and future beneficiaries. The moneys, as they are taken out of that trust fund to pay individuals, that money, therefore, is not going to be available to pay benefits for future beneficiaries. During the Clinton years, one of the very important things that took place was, we were starting to pay down debt with those trust funds, which puts us in a stronger position, I believe, to be able to grow as a nation. We were saving as a nation in terms of overall government savings. That is what took place during part of the Clinton Administration. It was one of the things that left me with some optimism that we would be able to resolve this issue, given that change in fiscal climate. So, during the years at the end of the Clinton Administration, those moneys were used to pay down debt, which put us in a stronger position in terms of overall national savings. The only purpose for those funds is to pay benefits for Social Security beneficiaries.

Mr. LEWIS OF GEORGIA. They are dedicated, destined to pay benefits and nothing else and nothing less.

Mr. APFEL. Yes.

Mr. LEWIS OF GEORGIA. Thank you. Dr. Furman, the President has described his across-the-board cut as affecting the well-off, the well-heeled, the rich. As I understand it, everyone with incomes over $25,000 would get a benefit cut. Do you, or do you think most Americans view these people as well off?

Mr. FURMAN. It is up to most Americans to decide, but I think most people making $35,000 a year probably don't consider themselves rich. Percentage-wise, the benefit reductions in the plan for someone making $55,000 or $60,000 are almost the same as they are for people making $6 million a year.

Mr. LEWIS OF GEORGIA. Dr. Furman, if I might continue with you, will young people in particular be burdened by the President's privatization plan because they face the greatest benefit reduction and also will bear the burden of all of this unbelievable, God-forsaken debt?

Mr. FURMAN. That is correct. They would see the largest change in their Social Security benefits.

Mr. LEWIS OF GEORGIA. Mr. Apfel, Dr. Furman, there is a story in the Los Angeles Times today, and I believe it ran in the

AP yesterday, that the President's proposal will reduce benefits for widows, the disabled, survivors. Could you—have you seen this story? Have you read this story? Would you like to elaborate?

Mr. APFEL. I haven't read the story, but we have talked about this today. If you do two things, you cut benefit commitments in Social Security by creating private accounts and you do the indexing proposal, the income-based cuts, it is going to have a secondary effect on lower income people, many lower income people, widows, the disabled, and so forth. So, a number of people would be affected by this who are in the lower income categories. I also point out again that this is shifting risk to individuals. It is saying that if the markets do fine, then maybe things are going to be fine, but if the markets don't do fine, then that puts individuals at risk in terms of their overall security. That will be true for every person, rich and poor, who is in the system.

Mr. LEWIS OF GEORGIA. Thank you very much. My time has expired. Thank you.

Chairman THOMAS. [Presiding.] I thank the gentleman, and obviously, we are all following various newspaper stories with great interest and I find it amazing that people prefer predictions to the future, as to reality, versus what has occurred in the past, which is certain, but that is what this is partly about. Does the gentleman from Missouri wish to inquire?

Mr. HULSHOF. I do, Mr. Chairman. Thank you for the recognition, and let me just say at the outset, the view up here is——

Chairman THOMAS. I tell the gentleman it was a real pleasure to call on him looking directly across the upper dais rather than looking down over the years, and so welcome to the upper level. Be careful. There is less oxygen up here.

[Laughter.]

Mr. HULSHOF. Thank you, Mr. Chairman. I respect the gentleman who just inquired, the gentleman from Georgia, who is a friend, and he spoke of a sacred trust and he used the word "covenant" and he used the word "promise." Many of us are going to have the opportunity—this is graduation season and many of us will speak to young graduates that are leaving the college life and getting ready to embark upon a work career, and we are going to speak of hope and optimism and promise. I wonder what my friend from Georgia or some of you on the panel would say. What is the promise that we can say to that generation that is just beginning the workforce?

Mr. Pozen, I applaud all of you being here, but I am particularly encouraged, Mr. Pozen, because I have cut out articles. Many of you have been well published, and particularly Mr. Pozen. I have got an article that you wrote that was at least published in the Wall Street Journal on Tuesday, May 3, and let me just paraphrase or actually quote the second paragraph of this editorial. "Judging any reform plan relative to scheduled benefits is misguided. The schedule represents the benefits we have promised, but do not have the money to deliver." I think as this rhetoric—the Chairman of the Subcommittee on Social Security very passionately talked about, if we really are serious about coming up with a solution to these long-term demographic challenges, I think we need to tuck away the rhetoric. Let me just—Mr. Apfel, it is great to have you

back. I got to know you, of course, when you were the Commissioner and you would come to the Subcommittee on Social Security. Do you agree with that statement, that basically judging a reform plan relative to scheduled benefits, is that misguided?

Mr. APFEL. I think that is one of two ways to look at benefits. One is scheduled benefits and one is what we have the financial resources to pay, given the laws that exist now. I think looking both ways makes sense. Looking one way or the other way alone does not make sense. I think looking—particularly when you look 30 and 40 and 50 years out—we have more uncertainty when trust funds are going to be gone because, let us face it, the further out one gets, the more uncertain one is about these projections. So, it may very well be that in the year 2040 or 2050, that the trust funds will be gone and under the laws, benefits will be lower. I think you have to look at both models if you want to be able to make accurate projections.

Mr. HULSHOF. I just got in the mail, as many, probably millions of Americans do, and that is my Social Security Administration statement. I should have brought it. I read it very carefully, because the very first page—and I would encourage not just my colleagues here, but all Americans that get that statement, instead of turning to the inside to see what that projected benefit is going to be, to spend some time and read the very beginning part of that because it is a very cogent, non-manipulative way to describe the challenges ahead. It states very clearly that under the current system, that in the year 2041, as the actuaries tell us, that only 73 percent of benefits, or thereabouts, are going to be able to be covered. I think part of what the President is trying to do is present the challenge to the American people, and then through their elected representatives, hopefully fashioning some sort of a solution.

Mr. APFEL. Mr. Hulshof, much of that language was language that I inserted during my tenure. Under current projections and under current laws, that language has been included for some time because I think it is important to help the American people understand that we do face a long-term challenge.

Mr. HULSHOF. I would just say again, as we embark upon this—to me, politics is the art of the possible, and I would look to my colleagues on the other side to fashioning a bipartisan solution. Part of that—and Mr. Pozen, let me just—the red light is on, but my final comment would simply be, what part of voluntary do we not understand? If I am, as a graduating senior from a distinguished university like the University of Missouri in Columbia this weekend, and I am entering the workforce, and if I choose—if I have more confidence in the existence of flying saucers or unidentified flying objects than the fact that Social Security is going to be there for me in its present form, why can't I opt out voluntarily if that is the path that we choose? Again, I appreciate the Chairman yielding and look forward to continuing this discussion.

Chairman THOMAS. I thank the gentleman. Does the gentleman from Massachusetts, Mr. Neal, wish to inquire?

Mr. NEAL. I do. Thank you, Mr. Chairman. Before I get to the Social Security issue, Mr. Lindsey, since you are here, is it still your position that the war in Iraq is going to cost more than $300 billion?

Mr. LINDSEY. I am not sure that was ever my position.

Mr. NEAL. Well, the Administration said it was going to cost $60 to $80 billion at the time, and I was just curious, because you seemed to suggest, with great clarity at the time, that it would be over $300 billion, and it seems to me as though your credibility is unquestioned on this issue.

Mr. LINDSEY. Thank you for the compliment, Mr. Neal.

[Laughter.]

Mr. NEAL. It is the rest of the Administration I am worried about.

Mr. LINDSEY. What I think is important with regard to the issue is that we consider not just the costs, as with all economic things, what you get for your money, and I think that is an issue that is going to play out——

Mr. NEAL. I want to thank you for that comment, based on the Administration's performance and forecast. That is very important. Also, the Chairman referenced the future of Social Security and how difficult it is to look at all these things. I know something about Social Security. My sisters and I know something about it. We would be happy to share that experience with the doubters, as to what it really means in the real world. When I hear people discuss it, particularly those in academic circles who treat it as though it is an esoteric issue, it really is important to millions of Americans. That leads me to the question I want to raise with Dr. Furman because I know that Mr. Apfel has had a chance to talk to it. Would you address the President's proposal as it relates to survivor benefits, Dr. Furman?

Mr. FURMAN. Yes. Under current law, survivors' benefits are computed in the same way that retirees' benefits are. You calculate what you are entitled to based on what you earn, and then a child gets a fraction of that or a spouse would get that amount. The President would change that formula for retirees. The exact same formula would apply to survivors, as well, so that includes small children, widows, and these are a lot of situations where you look at the benefit cuts. They can be, on the order of over a lifetime, $50,000, $100,000. The account, even if you inherit it, is not going to come close to making up for that in a lot of circumstances.

Mr. NEAL. How does the President's present calculation work?

Mr. FURMAN. The present calculation is basically, you calculate the benefit as if you are calculating a retiree's benefit, and then if there is a spouse, they would get the full amount. If there are children under the age of 18, they would get a fraction of that amount.

Mr. NEAL. Mr. Apfel, do you have any idea off the top of your head how many children across America receive survivors' benefits?

Mr. APFEL. I will have to give you the exact number for the record. There are clearly millions, about three kids. I can get give you the exact number for the record.

Mr. NEAL. So, one could argue with some accuracy that because moms and dads paid into that proposal and then died prematurely, and not because, incidentally, they wanted to die, but they died prematurely, that the children received, might we argue, insurance benefits?

Mr. APFEL. They do receive insurance benefits, social insurance benefits, progressively determined, and that provides a remarkably

important foundation of support. The life insurance component of Social Security is worth the equivalent of $400,000 per family. So, it is a critically important benefit, and I know about it. When my wife was a young girl, her dad died and she received Social Security benefits. So, this is a critically important benefit, and we have to be very careful here about what happens to those added benefits through these proposals.

Mr. NEAL. The people who are familiar with Mr. Roosevelt's initiative when he offered it in 1935, I think that half the people 65 years or older in America lived below the poverty line, is that correct?

Mr. APFEL. About half.

Mr. NEAL. About half. Today, that number is inside of 10 percent?

Mr. APFEL. That number is now 10 percent. In 1959, it was about 35 percent. So, if Social Security benefits were somehow gone tomorrow, about half of all older Americans would be back to living in poverty, the day after tomorrow. No one is proposing such a thing, thank heavens, but——

Mr. NEAL. How many women in America rely solely upon Social Security for their retirement benefit, do you know off the top of your head?

Mr. APFEL. For older, uninsured women, the figure is about a third. Social Security is for virtually all of their income, virtually all of their income.

Mr. NEAL. So, for those women perhaps in my mom's generation and others, for some women who didn't work at the time, they rely solely today on the benefit of the spouse?

Mr. APFEL. Not a majority, but it is somewhere between a quarter and a third of all these families——

Mr. NEAL. A most significant number, we would all agree?

Mr. APFEL. Absolutely.

Mr. NEAL. Yes, sir, go ahead.

Mr. APFEL. Mr. Neal, I again point out, I think there are ways, regardless of what size program you want, that we can fix up survivors' and spouses' benefits to do better by low-income survivors who are not in many cases well treated. Added benefits are paid for at the margin, with additional taxes and most benefits going to those who marry the richest people.

Mr. NEAL. I don't dispute in an academic setting that you are of good intent, pure heart, and good motive. What I am worried about is the Administration, as they try to settle benefits based upon the debt that has been run up in this country—I think that is what we have to be mindful of. I thank the Chairman for yielding me the time.

Chairman THOMAS. I tell the gentleman we have the ability to change the law, and one of the first questions I asked the witnesses was, were there areas inside the Social Security system that could be addressed because of inequities that have been there a long time—way before the 1983 changes—that weren't addressed by the 1983 changes? Frankly, if you examine on the margin, creating a much fairer, more equitable Social Security system for those who most need it costs surprisingly little money, based upon the

amounts of money that we are talking about looking for, to make changes.

That is already on the Subcommittee agenda and I am going to make sure that they look at all the ideas that were presented here and in other places because I want to state it. On the margin, given the problems we have with solvency, making the system fairer and more equitable, better especially for those who rely on it, is going to be one of the things we do, if we do anything, and I want to thank the gentleman for his focus in that particular area. Does the gentleman from Kentucky wish to inquire?

Mr. LEWIS OF KENTUCKY. Yes. Thank you, Mr. Chairman. Back in February, the government Accountability Office (GAO) prepared a statement for the Committee on the Budget, and in that statement, GAO said that absent reform of Social Security, the Nation will ultimately have to choose among escalating Federal deficits and debt, huge tax increases, and/or dramatic budget cuts. As GAO's long-term budget simulation shows, substantive reform of Social Security is critical to saving our fiscal future. Taking action soon would also serve to reduce the amount of change needed to ensure that Social Security is solvent, sustainable, and secure for current and future generations. The GAO also, before this Committee, gave us a startling number; future unfunded liabilities and debt is somewhere around $43 trillion, almost four times the size of the economy. Social Security is a big chunk of that.

It seems to me like we need to start doing something about it now rather than later. As far as personal accounts, I don't care whether you call them private accounts, personal accounts, individual retirements, whatever you call them, it seems to me like the American people would rather have the money in their hands than in the hands of politicians who are in Congress. For the last 50 years, the last few decades, Congress has been spending the Social Security trust fund money. So, who is better able to handle their money, Congress or them? I personally have faith in the American people. I have faith in my 22-year-old daughter to be able to handle her personal affairs better than politicians here in Washington.

By the way, I really take offense to anyone who challenges my concern and my interest in this issue when I have an 88-year-old father that depends on Social Security. I have a 32-year-old son and a 21-year-old daughter that is depending on a retirement sometime in their future. I am looking out for their best interest, and I think their best interest would be allowing them to make choices that—they can certainly do a better job than what has been done here, especially when we are facing $43 trillion of unfunded liabilities and debt of which Social Security is a big chunk. I just can't believe that anyone wants to stick their head in the sand and do nothing about this problem, absolutely nothing.

You talk about the stock market? Well, listen, if we do nothing, the benefits for future retirees is going to be cut 30 percent. That is not a good deal. So, looking at some of these opportunities to make it a better system and putting everything on the table and saying, oh, we are going to have to take this off, we are not going to—the Democrats have offered nothing. I really think they need to—this thing about liberal Democrats, what are they liberal about? They don't want change for anything. They want to use the

same old tired ways of governing in this country that have failed and continue to fail, and they do not want to come up with any reform, any changes. They just want to stick to the old way of doing things that are broken. I am like Jim. I think some people around here need to get a life. Thank you, Mr. Chairman.

Chairman THOMAS. I thank the gentleman. Does the gentleman from Arizona wish to inquire?

Mr. HAYWORTH. Mr. Chairman, I thank you very much for the time. To the witnesses, thank you all for this discussion. I suppose we reaffirm today that politics and policy are inseparable, and that is scarcely a profundity on my part. Hearing some of the concerns, or those notions expressed as concern, that somehow it is the intent of someone to hurt survivors or to hurt the disabled or—well, that may not be the intent, but that will be the result. I hope we can put that to rest. In terms of bona fides, if we can get away from all sorts of stereotypes on either side of the aisle, and for purposes of full disclosure, my parents are in their early seventies. They depend on Social Security as the cornerstone of their retirement. So, all the demonization and all the villainy and the venom that is going to come here inevitably at campaign time really ought to be set aside, and perhaps for the purposes of this discussion, we can do so.

Mr. Pozen, welcome. You discussed with my colleague, Mr. Ramstad, earlier the notion of holding harmless disabled workers. Now, I think it is important to reaffirm that protecting this segment of Social Security beneficiaries is vital. This is a population that depends on Social Security. We have a time-honored responsibility to those people who are disabled. What budget impact would there be if disabled workers are held harmless under what we might call Pozen indexing, or wage versus price indexing, or any form of indexing?

Mr. POZEN. I don't have the exact numbers, but my rough estimate would be that instead of solving 70 percent of the solvency gap in Social Security, you would probably bring it down to 65 percent or 60 percent. It all depends on how many types of situations you protect. I think Gene makes an excellent point. We have to distinguish in all these cases between a widow who is in poverty and the widow of a very wealthy person. Similarly, if somebody worked for Goldman Sachs for 20 years and then was disabled, we shouldn't really be spending a lot of Social Security benefits on them. So, it would depend on the exact design of the protections. I think everyone is in agreement that we need, generally, to protect these various classes, but I think we need to start to distinguish between those people in these classes who are relatively affluent, and those people who are not.

Mr. HAYWORTH. So, discernment as part of public policy and a recognition of where——

Mr. POZEN. Absolutely.

Mr. HAYWORTH. Yes, sir.

Mr. SCHIEBER. In my statement, I said the place you should start is on deciding what your principles are. If you want to protect people who have young children, then that is what your goal is and you design the plan around it. The idea that the President makes

the law, it is not in the civics lessons I took when I was young. I thought the laws were made here. They are not made here?

Mr. LEVIN. The President has input.

Mr. SCHIEBER. Well, the President certainly has input, but the laws are made here. You decide what your principles are and then you design the plan around it. You can design a plan that protects survivor benefits. You can design a plan that protects disability benefits. You are adults. You know what you want. Figure out what you want and design a plan. The people at this table, once you tell us what you want, can design a plan in a couple days for you.

Mr. HAYWORTH. I think that is important again to reiterate. At times, we are criticized for maintaining that this is a study of the obvious. What has happened here, we could look at a different venue in much the same way. When President Kennedy challenged us to put a man on the moon and return him safely to Earth in the decade of the sixties, President Kennedy didn't lay out, okay, we are going to have Project Mercury and Gemini and Apollo and a Saturn 5 will go to the moon with a lunar module. That was left to others to decide. The President proposes, the Congress disposes, and despite, sadly, some of the grandstanding and the speech making and the demonization of the intent, whether from the executive branch or here in the legislative branch, I believe there are core principles that, it may not profit people in the short-term politically to agree to, for whatever reason, but certainly would benefit this country to agree to. I think, to remind those who happen to join us to see what we are doing, we are setting up the notion of where we should go. Again, as we have this panel of experts, Mr. Chairman and my colleagues, the fact is, we can learn from all of these people and we can embrace some common goals. I thank the Chairman for the time. I thank the panel again for its testimony.

Chairman THOMAS. The Chair would indicate that on the floor of the House, we are currently in a 15-minute vote and it will be followed by a 15-minute vote. I will ask the gentleman from Louisiana if he wishes to inquire now. Otherwise, the Committee will stand in recess, or after the gentleman from Louisiana inquires, the Committee will stand in recess. We have about ten minutes, so you have 5 minutes to make it. Let me say to the panel, first of all, thank you very much. I hope you can stay. The Chair's intention is to have all Members of the Committee inquire. You will get some appropriate ironman recognition.

[Laughter.]

Chairman THOMAS. I also will tell you that during that half-an-hour, there is some food available in the back, if you would like to eat, as well, if it meets your standards, and we will reconvene one-half-hour after the gentleman from Louisiana concludes his inquiry. The gentleman from Louisiana.

Mr. JEFFERSON. Thank you, Mr. Chairman. Wow. I will briefly, in reference to someone before me, talk about—I want to talk to you about two of them. First, there is an AP story out today which quotes a White House official. It says, roughly, that 15 percent of all retirees under President Bush's plan would probably not be able to pass along a Social Security inheritance, a figure that rises to 30 percent for those with lower lifetime wages. That is fairly a

quote from a White House official. I don't know what his name is. There has been a lot of talk about the inheritability of these accounts as a principle reason why there ought to be adherence to them. So, given that that is an important idea, central to the President's privatization ideas, and given the fact that persons of color have lower lifetime wages on the average, as another example, the President has talked about the need to make these accounts available, particularly for African-Americans, who he has talked about having lower life expectancies, it seems, to take some of the progressivity out of the idea of the present plan, and out of the notion of progressive indexing being helpful to these populations. So, with that in mind, I would like to ask Dr. Furman and Dr. Apfel to comment on the effect of the President's proposal on individuals with lower lifetime wages, particularly as it affects this issue of inheritability that the President has talked so much about.

Mr. FURMAN. I will answer briefly, and then—one of the things—I don't doubt the sincerity of a lot of people, like Mr. Pozen, that they want to protect survivors and they want to protect the most vulnerable. Social Security has an exceedingly complicated formula that is used to determine benefits, and when you start changing that formula dramatically, you have dramatic effects that maybe you didn't even realize or intend. I, myself, was even surprised at the White House analysis last week showing how much of the bottom 20 percent of Americans would get their benefits reduced by the plan. It was actually beyond what I had expected. So, it is not a question just of sincerity, it is a question of executing the plan well, and there have been many, many years to address these problems and they still haven't been addressed.

In terms of your particular question, Social Security is a very progressive program. African Americans disproportionately benefit from that. Anything that reduces the traditional approach of Social Security and supplements it with something that isn't progressive, like accounts, will leave African Americans worse off. It is also important to understand how the inheritance works. Under the President's plan, you inherit the account. You also inherit the benefit cut. If your husband agreed to have his benefits cut, you don't just get his money. You get his additional benefit offset, as well.

Mr. APFEL. There is a second issue, too, that needs to be addressed which has to do with annuities. The President's proposal calls for mandatory annuities up to the poverty level. With our current Social Security system, we have a mandatory annuity system. There are tradeoffs to annuities and mandatory annuities, and there are also risks in terms of rates of return for the annuities. Trying to retire at time of down market conditions for the stock market can affect the balances coming in. Then requiring an annuity at that point in time depends a lot on what the interest rate conditions are at that point in time. So, one of the things that hasn't received a lot of attention, has to do with both market volatility as well as annuity volatility, the volatility in the annuity world. For lower income people to be required with their savings to purchase an annuity and not other people creates some issues that I think need to be fully thought through. The Social Security system is a mandatory annuity system, but to say that for prop-

erty, low-income people must buy an annuity and others do not creates some real tradeoffs.

Mr. JEFFERSON. I want to ask one other thing while I have another half-minute or so. Someone earlier read from an AP article dated Friday, May 6, with President Clinton's remarks. Just to add, there are also some remarks by Senator Lincoln Chaffee of Rhode Island, and basically what he says is that the President should call the Democrats' bluff on this private accounts business by talking his talk of personal accounts and then forcing Democrats to come to the table to discuss the plans. As they say, they will discuss them if he drops the plans. You combine that with President Clinton's remark that in 2 weeks, he feels Democrats ought to have something together in 2 weeks. So it sounds, frankly—if you read all this together and take it all in context, this is a plan that Democrats have been talking about, it sounds like to me, asking the President to drop the insistence on private accounts and, at the same time, going to the table to bargain about it. Is this what you have heard in exchanges out there from Democrats?

Mr. APFEL. Well, certainly, if it is true that privatization is being dropped, but I don't think it has been——

Mr. JEFFERSON. Oh, no, no. I am saying this is a proposal from Senator Chaffee, that the President could sharpen his pitch if he dropped these and brought Democrats to the table.

Mr. APFEL. I would think that if privatization was dropped tomorrow, there would be a greater likelihood of coming together on a benefit and tax package that will be able to strengthen Social Security for the long term. I think privatization is the biggest obstacle to seeing that take place.

Chairman THOMAS. You can sure take that statement to the bank. I think you will find that, if privatization comes off the table, then a progressive payment becomes the item that has to be dropped, ad nauseam, point after point, because frankly, there is no interest in engaging. In 1983, and I will place it in the record, the vote on the changes in Social Security, the Pickle amendment to sustain a change in the fundamental structure, i.e., increase the retirement age, had 152 Republicans voting aye and 188 Democrats voting no. That fundamental change was sustained by the minority, the Republicans. The Pepper amendment to simply raise the payroll tax even beyond the amount that we had raised plus the acceleration that we had put in the underlying bill, there were 165 Republicans that voted no and there were 131 Democrats that voted no. A hundred-and-thirty-one voted yes. The Republicans sustained not going back to the same old, same old of the payroll tax.

So, on both the idea of fundamental reform and not going back to the payroll tax, it was the minority that controlled the choice in front of Congress, not the majority who had, at the time, the opportunity to make the kind of specific changes we were talking about and to begin to anticipate the fundamental aging of the society, with additional changes. Their goal and their desire and their votes at that point was to go back to the payroll tax. The Committee stands in recess until 2:15 p.m., and the offer is available.

[Recess.]

Chairman THOMAS. The Committee will reconvene, and if all of our guests could find seats, I would appreciate it. The Chair wants to thank the witnesses, and if there is anyone who has plans that won't allow them to stay until all the Members who wish to inquire have inquired, we understand that. We appreciate the time that you have already provided us. With that, I would recognize the gentleman from Pennsylvania, if he wishes to inquire.

Mr. ENGLISH. Thank you, Mr. Chairman, and indeed, I do. I have to say, this is a panel which has been refreshing not only for its expertise but for its diversity. Taking in some of the presentations that have been made, I guess my first question would be for Dr. Steuerle. You made the point that demographically, people are living longer, and part of the solution of a reform of Social Security, through marginal change, would be to raise the retirement age. One of my concerns would have to do with the guy on the shop floor who has been working in a physically demanding job since he was in his teens and he is ready to retire, and typically, he will retire anyway around 62 years old. I believe that tends to be the pattern for most people coming through a skilled but highly physically challenging work. Given that kind of experience with blue collar jobs, is it realistic to talk about raising the retirement age? Can we expect people to continue to undertake physically demanding jobs up until the age of 70? How would you deal with the early retirement age?

Mr. STEUERLE. Thank you, Mr. English. You raise some of the very difficult issues. As I expressed earlier, my concern is that if you look at Social Security when it was first formed in 1940 or 1950, the average age of retirement when jobs were very physically demanding was 68 for men. Now the average age of retirement is 63, whereas 68 years of age in 1940, if you take into account life expectancy, is equivalent to about 74 today. So, if people today were retiring about as they did in 1940, they would be retiring at about 74, on average. Instead, they are retiring at 63. You go out another 60 years—and mind you, we are talking about fixing a system 60 years in the future—people would notice even if retiring with the same life expectancy. So, we have the dilemma that the system is becoming more and more a middle-age retirement system—is giving benefits to all of us, including you and me, to retire when we still might have 20 or 25 years of life expectancy left.

The dilemma is, how can we protect some people who really do have to retire without giving benefits to everyone to retire at middle age. Close to a third of adults are scheduled, roughly, to be on Social Security in the near future if they retire at the same age as they do now. I think there are several things you could do. One, I think you do have to retain a good disability system to help people who are disabled. For lower income people—and these include the people who have the blue collar jobs—I don't know that we can actually give them a different retirement age. I don't know how to distinguish between types of jobs that well. I do think that one can increase something like minimum benefits so that their expected lifetime benefits, even though they might have to work another year, will actually even higher. So maybe they only get 12 years of retirement instead of 13, whereas you and I only get 20 instead of 21, but we can do more for them to increase their lifetime bene-

fits, and we can increase the replacement rates a lot in those later years.

Mr. ENGLISH. That could be one piece of the puzzle. Another piece of the puzzle has to be how we generate revenue, and how we generate revenue consistent with the principles of the system. Dr. Schieber and Dr. Lindsey, I wonder if you could briefly comment with the remaining portion of my time. Many have proposed to eliminate the cap on the payroll tax as a way of generating additional revenue to address all or part of the problem in Social Security, yet it seems to me that that would have an enormous impact on the economy, particularly on small unincorporated businesses, and significantly change the extent to which individuals pay for and contribute to their own retirement. Your comment, Dr. Schieber, and then Dr. Lindsey.

Mr. SCHIEBER. This morning we heard considerable concern about turning this into a welfare program, yet we have heard discussion about a proposal that would take the cap off of earnings for purposes of raising the payroll tax but maintaining the cap for defining benefits. That would seem to me to be the ultimate conversion of Social Security into a welfare program. Today, you get benefits based on the income that you have paid taxes on, and you would now have a whole set of your income that generated no benefit at all. I would say if you want to move in that direction, why would you constrain yourself just to earned income?

Take somebody like Warren Buffet. Warren Buffet takes $100,000 in compensation, in pay, out of his company each year, but we know he takes a bit more than that out of the whole thing. Why would you just want to constrain this on people who, I guess I would characterize as having the misfortune of earning their income through their labor services as opposed to other things they do? It seems to me that would turn this into the ultimate welfare program, and if you want to do that, then you really should look at lowering benefits and making this affordable.

Mr. LINDSEY. A related question——

Mr. ENGLISH. Very quickly.

Mr. LINDSEY. Means testing. I wasn't sure whether you would continue to adjust benefits as income rises. It is a little bit like losing money on each unit and trying to make it up on volume if you do it that way. That, I think, is one of the problems. If you didn't do that, then you would, in fact, be officially means testing by any definition.

Mr. ENGLISH. Thank you.

Chairman THOMAS. I thank the gentleman. Does the gentleman from Tennessee, Mr. Tanner, wish to inquire?

Mr. TANNER OF TENNESSEE. Thank you very much, Mr. Chairman, and I want to thank the panel. This has been a very interesting exchange. I want to agree with Mr. English, the diversity and so on has been refreshing. I think we have covered Social Security to the extent that we need to. I want to change the subject, if I might, because this is a very interesting academic exercise, but in my view, Social Security is a five-mile-an-hour tropical breeze and there is a hurricane two miles offshore and we are in a beach house, and that is the budget deficit and the trade deficit. Since we started this hearing, by my figures, we have in your name and

mine, this country has borrowed from foreign sources $191-plus million just since we started this hearing. We are borrowing over $1 billion a day and have been with no end in sight under anybody's scenario. The best the Administration can offer is to cut the deficit in half in 5 years, and unless one has the ability to repeal the laws of arithmetic, I don't know how that is going to happen with the budget not including expenses that we know we are going to incur.

So, this is a very interesting academic exercise about what will happen in 2075. The problem is, the country is going to financially collapse long before then if one believes what the Director or Comptroller General said, David Walker, that, if we make the tax cuts permanent, as some in this body want to do and as some of you gentlemen have suggested we ought to do as public policy, and do nothing else, by 2040, under their calculations, every dime that comes to the U.S. Treasury will be going to pay interest on the national debt. Of course, we all know that the country will financially collapse long before that occurs. Now, the one thing I want to say, does anyone believe seriously that we can have a strong Social Security dollar and a nonexistent or weak U.S. Treasury dollar? No one would make that argument, yet that is exactly, in my judgment, where we are headed.

Just in the last 48 months, we have transferred $50 billion a year out of the tax base to interest, 84 percent of that $50 billion going overseas because foreigners have financed 84 percent of our borrowing, in terms of real money, in the last 48 months. No one, I don't think, any economist would seriously argue that this is a sustainable course of action for this country to take. So, I would simply like to ask, do you or do you not agree with David Walker's assessment of our current budget situation, and do you or do you not agree that one can never have a strong Social Security system when the underlying U.S. Treasury is broke or nonexistent? Thank you very much, Mr. Chairman, and I would be interested as to anyone who wants to respond.

Mr. FURMAN. I think that is a very good question, and we have a very large budget deficit today, $412 billion last year, the largest on record in dollar terms, and we have a projected very large deficit in the future, $43 trillion, according to GAO. I think we need to be addressing both of those. Now, first of all, some Social Security plans would reduce the deficit in 2075 and increase it enormously today. I think that is the wrong way to go.

I think it is also important to understand where these deficits come from. The deficit last year didn't come from Social Security. Social Security, in fact, ran a significant surplus. As we look forward over the next 75 years, of the $43 trillion we heard about before, $12 trillion were the tax cuts that were passed, assuming they are extended, $9 trillion was the prescription drug bill. Half of our long-term deficit was passed and signed into law in the last 5 years. Social Security is a trivial portion of it. Now, addressing Social Security could help, and I think one should do that, but you shouldn't fool yourself into thinking that that is the main source of the problem or the main way to get out of it.

Mr. SCHIEBER. The idea that Social Security ran a surplus last year is classic Enron accounting. The actuaries calculate a number

each year. They estimate what the total accrued liability is under the system. If we just shut the system today and paid off the liabilities that we owe ourselves, last year, it was around $13.5 trillion. The most recent calculation is around $14.5 trillion. We earned a trillion dollars' worth of benefits that we didn't fund at all last year.

Mr. FURMAN. Those are over—over 75 years——

Mr. SCHIEBER. Those are 75-year numbers.

Mr. FURMAN. Oh, sorry. That doesn't make any sense for a government program that we know——

Mr. SCHIEBER. It doesn't make any sense to——

Chairman THOMAS. Could we have one witness speak at a time, and I believe——

Mr. SCHIEBER. It doesn't make any sense if we don't want to look at what we are doing to ourselves. We are running up massive bills that our children simply will not be able to pay and we need to address this problem and we need to address it right now.

Mr. FURMAN. I agree with that, that the tax cuts——

Chairman THOMAS. Time has expired. Does anyone else want to give a quick response?

Mr. TANNER OF TENNESEE. Just very quickly, Mr. Chairman, I couldn't agree more that we have a problem with the size of government spending in this country. The problem is not the question of whether or not we borrow or whether or not we tax in order to fill that spending. The problem is the spending and the Congress's inability to get a rein on spending, which includes mandatory entitlement spending, including Social Security, Medicare, and Medicaid. If you can't get a handle on those programs in the future, the amount of borrowing, or the amount of taxes necessary to pay all those benefits, are going to cripple the economy.

Chairman THOMAS. We may have to shift to written statements, or if you guys are clever enough, when someone else asks a question, you can work your answer in on the next round. I would only respond, Dr. Furman, that when you talked about how much the tax cuts were going to be, you used a phrase, if they are made permanent, which clearly allowed you to extrapolate into the future. Then, when you talked about a surplus for Social Security, had you said, if they are made permanent. Since we know they are permanent, you have to extrapolate into the future, and I believe that was the point that was being made, just because we have a very short-term surplus.

Mr. FURMAN. I used the same assumption. The deficit in Social Security under current law is precisely zero trillion dollars because benefits are reduced automatically in 2041. I was assuming that we continue to pay benefits at the current level in calculating that in exactly the same way I was doing for the tax cuts.

Chairman THOMAS. I am sure colleagues on this side of the aisle will agree with you in terms of the benefit cuts that are supposed to take place in 2041, just as they are willing to support modest, understandable, and controllable adjustments beginning today. Does the gentleman from Illinois, Mr. Weller, wish to inquire?

Mr. WELLER. Thank you, Mr. Chairman. I want to express my gratitude for the patience of this panel as this has been a long but

important hearing. I would like to direct a couple of my questions to individuals on the panel and I would like to begin with Commissioner Apfel. What years were you the Social Security Commissioner?

Mr. APFEL. From 1997 to 2001.

Mr. WELLER. Okay, 1997 to 2001, so President Clinton was President during that time, correct?

Mr. APFEL. Yes.

Mr. WELLER. Because there is a lack of Democrat ideas when it comes to fixing Social Security for the long term, I thought I would discuss the one Democrat idea that has been on the table for a long time, and you probably recall President Clinton's "Save Social Security First" State of the Union speech. It got great applause, both sides of the aisle. We all thought it was great. President Clinton, at that time, proposed investing the Social Security in the stock market. Were you Social Security Commissioner at that time?

Mr. APFEL. Yes, I was.

Mr. WELLER. So, was President Clinton's proposal your idea?

Mr. APFEL. I was involved in discussions in the White House about it. I supported it. What the President said at that point in time, when we had large budget surpluses growing, was let us use those budget surpluses to save Social Security first, I believe a courageous——

Mr. WELLER. Now, did President Clinton propose using payroll taxes to be invested in the stock market or did he propose general revenue funds?

Mr. APFEL. What the President proposed is that some, about 15 percent of the Social Security surpluses, which would be payroll tax surpluses, would be invested to try to get a slightly to modestly higher rate of return. That is a debatable issue as to how much of an increased rate of return——

Mr. WELLER. As one of the architects of President Clinton's plan to invest Social Security payroll taxes in the stock market, what was your projected growth that you anticipated for those funds when invested in the stock market?

Mr. APFEL. At the time, the investing in equities—if I am remembering correctly, the actuaries projected that it would resolve about a third of the long-term shortfall in Social Security through some collective investments. Since——

Mr. WELLER. So, what was the rate of growth? Did you have a projected-percent growth? Our Thrift Savings Plan that almost every Member of Congress has, as well as our mailman, the Thrift Savings Plan stock fund has about an 8 percent rate of growth over the last 10 years. The bond fund has about a 4 percent rate of growth. That is what has been demonstrated.

Mr. APFEL. Those were projections from the actuaries. I would have to get back to you on the specifics. I would say that since that time, there has been quite a bit of debate about what those rate of returns would be. The fundamental difference between individual accounts and collective investment is the individual risk that is involved. If we have collective investment, if there is a decline in the markets, then there is, over time, a source of pooled resource to be able to use to provide benefits.

Mr. WELLER. Commissioner, you stated that you endorsed, as one of the architects, President Clinton's plan to invest Social Security trust fund dollars in the stock market, and today you stand by that endorsement. You still believe that that is a good idea.

Mr. APFEL. I think that it is one of the options that should be seriously considered. I still generally think that it is a good thing to explore, yes.

Mr. WELLER. Okay. Thank you.

Chairman THOMAS. Would the gentleman yield on that?

Mr. WELLER. Sure. I would be happy to yield to the Chairman.

Chairman THOMAS. Was that structure mandatory or voluntary?

Mr. APFEL. Pardon me?

Chairman THOMAS. Was it mandatory or voluntary?

Mr. APFEL. It was centrally invested funds by——

Chairman THOMAS. So, individuals didn't have a choice as to whether or not they were going to do the risky scheme of playing the stock market.

Mr. APFEL. What the President proposed were voluntary add-on individual savings accounts coupled with the use of surpluses——

Chairman THOMAS. No, no, no, the investment in the stock market. I was focusing on the investment in the stock market.

Mr. APFEL. It was a collective——

Mr. FURMAN. One thing to stress here——

Mr. WELLER. Mr. Furman, I am not speaking with you, but to Commissioner Apfel.

Chairman THOMAS. I thank the gentleman for yielding.

Mr. WELLER. Thank you, Mr. Chairman, and reclaiming my time, as I understand it, again, President Clinton proposed, as you say, collective, if I can use that term, investment of Social Security trust fund dollars in the stock market at that time, and Commissioner, you indicated you still feel that that is an idea that we should look at, is that correct, yes or no?

Mr. APFEL. Yes. If we look at State and local pension funds, we see not an insignificant share that is invested in diversified portfolios, and one of the things that I think is worth exploring is whether to do the same thing with Social Security. The thing that I think is new, from my perspective over the last several years, is that the question about the rates of return has received a lot more attention, and those rates of return could be less——

Mr. WELLER. Commissioner, I would note, the best way to look at projected rates of return is to look at history, and over the last 10 years, I know in my own personal Thrift Savings Plan, and my money is in the S&P 500 plan, the C plan, that has grown at a rate of 8 percent, on average, over the last 10 years. The bond funds have grown at an average rate of 4 percent. Outside economists tell us that the rate of return on Social Security is about eight-tenths of 1 percent.

Mr. APFEL. Well, it is really——

Mr. WELLER. So, as you noted when you proposed investing in the stock fund as the Social Security Commissioner, those numbers have panned out, so thank you——

Mr. FURMAN. There is a reason every Fidelity fund says, past performance is no guide to future returns.

Mr. WELLER. Mr. Furman, I did not ask for your opinion.

Mr. APFEL. Could I have the last response to that, because I think that, clearly, trying to have Social Security——

Chairman THOMAS. The gentleman from Illinois controls the time, and he gets to say if he wants you to respond.

Mr. WELLER. Thank you, Mr. Chairman. I will allow the Commissioner to—I realize my time is expired, but Commissioner, please.

Mr. APFEL. Thank you, sir. Trying to compare rates of return in a social insurance system and an investment system is apples to oranges. Trying to determine how an intergenerationally financed system that pools resources could compare if the money was available to be used in investments is comparing apples to oranges, not an appropriate comparison.

Mr. WELLER. Thank you, Mr. Chairman.

Chairman THOMAS. I thank the gentleman. I have to go back to Adam Smith and the marketplace and think that one over. Does the gentleman from Texas wish to inquire?

Mr. DOGGETT. Thank you, Mr. Chairman, and thank you to the witnesses. It is my belief that Americans ought not to be misled into viewing this hearing as representing some type of academic discourse about the best ways to preserve Social Security for future generations, nor should anyone be deluded into the notion that those who are committed to replacing Social Security with a risky privatization plan are down and out in the polls and that they have given up on that approach. Anyone who believes, as I do, that we need to preserve and strengthen Social Security and who underestimates our chairman, Mr. Thomas, and who underestimates the ideological fervor behind this privatization movement, anyone does that at their peril and at the great risk to anyone who depends on a Social Security check. One Capitol Hill newspaper has already reported that a privatization plan will be before the House in July, and only a week ago, Chairman Thomas announced that less than a month from this very moment, he would probably have a bill before us, quote, "to fix Social Security for all time." Well, we have got some steers down in Texas that have been fixed for all time and my concern is that the same thing is about to happen to Social Security.

There is no doubt that Social Security faces a clear and present danger, that Social Security is in crisis, and it is a crisis that results from those who control decision making here in Washington and who zealously believe that community solutions, as opposed to individual independent plans, are just somehow inherently flawed. They think that every initiative that has public in front of it, as in public education, or "social" in the title, such as Social Security, needs to be eliminated in the form we have known them in the past. They think that this great country can rely on the principle of every person for themselves, and if you fall behind, well, you just need to tighten your belt and get by on your own. If they can destroy a community solution that is as effective and successful as Social Security has been for this last many decades, they think they can destroy the belief in government as a source of a solution to any social problem, today is merely the prelude to a preconceived conclusion. What is driving this privatization effort has very little

to do with concerns over solvency and everything to do with the demands of ideology.

With all due respect to the testimony of all the witnesses here, whether I agree with you or not, the most remarkable aspect of this hearing is not who is sitting at this witness table, but who is not there. There is a giant gap in that witness table, as crowded as you are around it, and it is a gap unfilled by anyone who is here testifying for the Bush Administration. There is no Administration spokesperson to answer questions about specific legislation of a President who insists that privatization is non-negotiable, that it is the linchpin of his Social Security plan. Perhaps that is because the last Administration spokesperson who did sit where you are, who appeared here, Treasury Secretary Snow, admitted that this Administration plans to raid the Social Security trust fund for every dollar in it, $2.6 trillion over the next decade, and that President Bush will spend every one of those dollars. I have a question for Mr. Apfel, but Mr. Emanuel says he needs to leave and I yield a minute to him. I would like to come back if I have any more time.

Mr. EMANUEL. I would like to thank my colleague from Texas. I will pass on to former President Clinton all the warm comments that he has received from the other side of the aisle, for the fact that I am sure—if you can all sign a card, I will pass it along. When he introduced his 1993 budget, which did not receive a single vote from the Republicans, it put us on an economic plan toward reducing the deficit. We added 12 years to the life of the Social Security trust fund, which was the first step to saving Social Security. I agree with Mr. Lindsey. The best thing you can do for Social Security is to have a growing economy, and that is exactly what happened in 1993.

To all those who mentioned "Save Social Security First," take a stroll down memory lane. "Save Social Security First" was about not doing tax cuts. It was, in fact, about investing the surplus in Social Security and allowing, in fact, general investments by the Social Security Administration to get a slightly better return and also allowing us to invest in Social Security and strengthen the Nation's saving rates, as well as the individual saving rate. In fact, what has happened over the last 5 years is the reverse of "Social Security First," which was a tax cut that ended up spending the surplus, plus whatever else we had in Social Security.

So, to all those who want to claim President Clinton's mantra, in fact, in the last 4 years, we have done everything opposite of what he suggested; that is, A, build a surplus, and B, save Social Security first before you have done a tax cut that raided it. I am sure his heart will be warmed by the kind comments that were said here. As somebody who participated in the Administration and also as somebody who represents over 28,000 employees from United Airlines, they all enjoy the security that comes with Social Security after what happened to them. Thank you very much to my colleague from Texas for yielding the time.

[The prepared statement of Mr. Emanuel follows:]

Opening Statement of The Honorable Rahm Emanuel, a Representative in Congress from the State of Illinois

Thank you for holding this important hearing on "Alternatives to Strengthen Social Security." I also want to thank our distinguished witnesses for joining us today.

President Bush's privatization plan does nothing to address Social Security's future solvency issues. In fact, as U.S. Comptroller General David Walker said at a recent Ways & Means Committee hearing, privatization would "exacerbate" Social Security's long-term solvency problems.

The President would borrow $1.8 trillion in the first ten years alone on top of record breaking deficits and debt, and "progressive indexing" would cut benefits for middle-class families by 40 percent to pay for private accounts. That is not a recipe for economic growth or retirement security.

Although Social Security faces long-term solvency challenges, we have time to address them in a fiscally responsible, deliberative way. We should look to the 1983 bipartisan Greenspan Commission as the model for the right way to approach these issues.

Social Security is secure for the next several decades. According to the Congressional Budget Office, Social Security can pay full benefits through 2052 and more than 70% indefinitely thereafter through payroll tax receipts. Social Security is not about to go "bust" or bankrupt, as President Bush has claimed.

The more the public learns about President Bush's plan, they less they like it. The fact is that Americans like the security in Social Security. For millions, it is the linchpin of their retirement incomes.

It is clear that privatization is not going to happen. But with savings rates at historic lows, declining from 10 percent in 1980 to just 1 percent in 2004, there is an emerging bipartisan consensus on the need to work together on new initiatives to increase family savings outside of Social Security.

We need to look no further than yesterday's news about United Airlines to see the importance of Social Security's guaranteed retirement benefit. The announcement that United Airlines received permission to dump its pensions on the Pension Benefit Guaranty Corporation means reduced retirement benefits for millions of families.

First it was the steel industry, now the airlines and autos may be next. Once, individuals could build a three-legged stool for retirement: a company pension, personal savings and Social Security. But with the decline of pensions and falling savings, Social Security is now the only leg remaining for millions of middle-class families.

At the same time, middle-class families are being squeezed by job uncertainty, real wages falling at their fastest rate in fourteen years and rising gasoline, health care and education costs. Middle-class families face more risk today, not less. They believe that the "ownership society" should come with a warranty: a rock-solid, guaranteed Social Security benefit.

I commend Chairman Thomas for expanding the debate to include long-term savings. I have proposed four savings initiatives that can be implemented immediately: legislation to make it easier for employers to automatically enroll employees in 401(k) plans; a permanent and refundable saver's credit; direct deposit of tax refunds into retirement accounts; and a Universal 401(k) that is portable from job-to-job. There is no shortage of good ideas in both parties, and enough overlap that we can pass savings legislation this year.

We should work together to strengthen Social Security for the long-term while protecting its guaranteed benefit for our seniors. President Bush's vision of privatization and benefit cuts for the middle-class will take the security out of Social Security. He should remove privatization from the table and work with us on real solutions to protect Social Security and enhance family savings.

Thank you, Mr. Chairman.

Chairman THOMAS. Does the gentleman from Florida wish to inquire, and would he yield to the Chairman?

Mr. FOLEY. Yes, I would, Mr. Chairman.

Chairman THOMAS. Before my friend leaves, there was a different view on what happened, because, frankly, what happened was, the Democrat majority, along with President Clinton, passed one of the highest tax increases in the history of the United States. The American people elected a Republican Congress the didn't spend all that revenue that had been raised with that tax increase and the surpluses began after the Congress became a Republican majority and not during the Democrat majority.

Mr. EMANUEL. Will you yield, Mr. Chairman?

Chairman THOMAS. That is the view from the Congress.

Mr. EMANUEL. Will you yield, Mr. Chairman?

Chairman THOMAS. It is the gentleman from Florida's time, and he can yield if he so chooses.

Mr. FOLEY. I also want to remind our listeners that it was the tax on Social Security beneficiaries that was part of that 1993 plan. So, if you were receiving Social Security, in order to raise revenue, the President's plan was to tax Social Security proceeds. So, they played a shell game. I don't know where we came up with the fixed steer analogy from Texas, but on Social Security reform, the Democrats are truly shooting blanks.

I would like to ask Mr. Apfel, during his tenure, haven't we seen a lot of expansion of disability claims that may be not meritorious, a lot of new characteristics, a lot of new ways in which parents can enter their children in Supplemental Security Income (SSI), based on a diagnosis that is loosely constructed in order to gain family benefits?

Mr. APFEL. Generally, no. It is my belief that the disability program in the United States, relative to most other developed countries, has a relatively low disability population in terms of comparison to a lot of other countries. There were changes that were made for children in 1996. Mr. McCrery was heavily involved. I was heavily involved in those during my tenure——

Mr. FOLEY. You don't sense any fraud and abuse?

Mr. APFEL. I am sure that there has to be some, but I do not think that this is a system, the disability system, that is rife with fraud and abuse, no, I do not. Is there a need for reexamination of disability definitions given the changes that have taken place? Generally, yes. I think our system is a relatively—comparing us to many other countries, we have a relatively lean and a very inexpensive disability system. I would urge the Committee to go very, very cautiously about major changes to the disability rolls.

Mr. FOLEY. Mr. Pozen, I was humored by the Ranking Member's constant request of explaining why you have been listed as a Democrat. Well, I think it is because you are an endangered species. You are one willing to step up and at least offer suggestions, so I applaud you for that. Thank you.

I would like to ask Mr. Furman, you have gone through great detail, and I was very impressed by your thorough review of the system, your critique of the side accounts. You also stated a minute ago that in 2041, we can pay the benefits we are paying today, is that your comment, under the current system?

Mr. FURMAN. No. My comment was when you talk about there being a $4 trillion deficit or an $11 trillion deficit, you are assuming that current scheduled benefits are continued. If you did not, just looked at the deficit under current law, there is no deficit at all because benefits are automatically reduced.

Mr. FOLEY. Did you take a chance to look at any mechanism by which we can create solvency? Forget accounts. We don't go to accounts. What would they be?

Mr. FURMAN. There are a number of plans that are out there.

Mr. FOLEY. Specific, yours. You have looked very thoroughly at the numbers. You must have crunched numbers.

Mr. FURMAN. Peter Diamond and Peter Orzag have a plan. Former Social Security Commissioner Bob Ball has a plan. There are a number of plans and they are all——

Mr. FOLEY. What would your thoughts be? Raise rates, retirement age?

Mr. FURMAN. Let me——

Mr. FOLEY. Just so I know academically how you came up with your numbers.

Mr. FURMAN. The analysis of the President's plan doesn't depend on any particular plan, but these other plans I referred to, to get sustainable solvency, one of them with much, much smaller benefit reductions than what the President's plan contemplates——

Mr. FOLEY. Are they reductions?

Mr. FURMAN. Some of those plans have very moderate reductions in them.

Mr. FOLEY. Moderate reductions?

Mr. FURMAN. Moderate——

Mr. FOLEY. So, it is all in the eye of the beholder. Our reductions, your reductions, in order to save it, you have to have reductions.

Mr. FURMAN. Once you add in the private accounts, you are talking about a 97 percent reduction. I think anyone would describe that as pretty large.

Mr. FOLEY. Forget the private accounts for a minute. Let us talk about the real system. We can academically debate private accounts. I support them. I think they are good.

Mr. FURMAN. I would love——

Mr. FOLEY. They should be part of the program, but ultimately, you still have to fix the program, the system. It is collapsing under its own weight. We ignore the obvious if we sit here and say it can fix itself. Let us just skip this can down the road. I think all of our witnesses testified, there is not enough money in the system.

Mr. FURMAN. Oh, I have testified to that——

Mr. FOLEY. So, all I am looking for is some clear voice to come out of this room on either side of the aisle and say, here is how we fix the system. We will take care of these new ideas possibly later. How do we fix the system systemically?

Mr. FURMAN. If you would get the President to agree to only talk about private accounts in academic seminars, then I would agree to sit down and talk to him about what to do about reforming it.

Mr. FOLEY. The only thing——

Mr. FURMAN. It is not an academic question for him.

Mr. FOLEY. In defense of the President, if somebody tells me to bake a cake and says, I will give you every ingredient but the six eggs, the cake won't take. So, in respect to the President, I don't think you can discuss a plan without at least discussing every option. I thought Senator Leahy was profound on Fox this weekend when asked the question. He said, the President, we have got to have everything on the table, but except, but except. Well, I don't know how you do it if you don't at least have the academic exercise. We may be proven wrong. I welcome that debate, but to ignore it is a half-baked cake.

Chairman THOMAS. I thank the gentleman. Does the gentleman from Wisconsin wish to inquire?

Mr. RYAN. I do——

Chairman THOMAS. Prior to inquiring, would he yield to the Chair?

Mr. RYAN. I will.

Chairman THOMAS. I thank the gentleman. On the subject of disability, there can be some examination of the program, but as far as the Chair is concerned, there should be no discussion about the fact that once someone goes through the process of being determined disabled, they should not have to wait 24 months to go onto Medicare. The 24-month provision was put in by the former majority to save money. That is not the way you should save money in this system, and I would hope there would be no disagreement that we would make that change as we look at other unfair structures that have been there for far too long. I thank the gentleman for yielding.

Mr. RYAN. I thank the Chairman. A couple points I want to make, then I want to ask a question of you, Mr. Furman. Number one, and I just missed the last few go-arounds, so maybe this was covered, but no one is talking about undoing a Social Security safety net. No one is talking about not having a safety net. One thing that has not been discussed here today is the issue of generational fairness, and that is something that isn't discussed here. Let me give you a case in point. Current seniors, my mother, she is 70 years old. She gets about a 5 percent rate of return on her payroll taxes that she paid now in her retirement. I, at my age, and most workers in my cohort are going to get about a 1 percent rate of return on our payroll taxes that we pay. My children, I have three young toddlers, right now, they are scheduled to get a negative one percent rate of return on their payroll taxes that they pay when they retire. That is assuming we can come up with the $4 trillion today we would need to set aside to pay them their promised benefits that we don't have the money for.

So, if you do not use personal accounts as a part of the solution, then you are confining future generations for sure to get much worse benefits relative to today's seniors. Only through personal accounts can you achieve an equal measure of benefit under today's standards. Now, the word privatization has been used over and over and over and over. No one is talking about giving people some of their payroll taxes and going outside of Social Security, taking it to a stockbroker and wishing them good luck, have a nice day, hope you invest it well. That would be privatizing it. No one is talking about that. What we are talking about is a system inside of Social Security, run by Social Security, overseen by Social Security, managed by Social Security, where workers would have a voluntary option of choosing a fund within the Social Security system like we have with our Thrift Savings Plan. So, we are not talking about going outside of the system.

The last point I want to make is in the form of a question to you, Mr. Furman, and that is, looking at your testimony, on page seven, you refer to explicit debt versus implicit debt and you say that the borrowing to pay for personal accounts takes the form of explicit debt. Explicit debt are bonds that cannot be defaulted on and actu-

ally have to be paid, whereas the current system of implicit debt, the total amount of implicit debt is based upon projections and it is not legally binding. So, my question is this. If the rock-solid guarantee that we have, that you refer to, is an implicit debt that is not legally binding, yet, if you are a worker and you choose a personal account and your money goes into a Treasury bond, that is explicit debt that they actually have to pay you your benefit; isn't it more of a solid guarantee that you are going to get your benefit if you choose a personal retirement account if it is just the form of a Treasury bond?

Mr. FURMAN. Two questions. One is, financial markets treat explicit debt very differently than implicit debt. Social Security has a $4 trillion implicit debt. I have absolute faith that Congress is going to eliminate that entire implicit debt before it ever materializes——

Mr. RYAN. That guarantee is based on Congress willing to do that, right?

Mr. FURMAN. I believe Congress will do that.

Mr. RYAN. We have to hope Congress will do that, right?

Mr. FURMAN. I certainly hope Congress does that. The second thing is a private account is no more guaranteed. The Supreme Court has said you can change the tax rate. You can tax withdrawals from the account. You can tax accumulations. You can change the offset. You can change the accumulation. If you got into problems of solvency in a private account system, those private accounts could be reduced just as easily as the traditional——

Mr. RYAN. You are saying we can't bind the hands of a future Congress, right?

Mr. FURMAN. That is correct, but what we can do is insulate people against market risk.

Mr. RYAN. Right.

Mr. FURMAN. The current benefit insulates them against market risk. An account doesn't. They are both subject to the same political risk. Whether that is small or large, I leave it up to your judgment, but they are no different in the two cases.

Mr. RYAN. Let me ask you this. Since the current benefit is up to what a future Congress will do, and we can't tie the hand of a future Congress, the benefit guarantee in the future for people is whatever Congress chooses to give it——

Mr. FURMAN. Congress has historically honored those commitments——

Mr. RYAN. Sure.

Mr. FURMAN. In fact, it has generally, in the past, had raised benefits over time——

Mr. RYAN. Well, we changed benefits——

Mr. FURMAN. That benefit is not subject to market risk.

Mr. RYAN. That is the problem we are in.

Mr. FURMAN. Your account is subject to market risk. All of the other risks in terms of what Congress can do, you all could change the tax rate to 100 percent on our income, take all our income.

Mr. RYAN. Let me ask you this——

Mr. FURMAN. There are a tremendous number of risks you there. You can't get rid of all of them——

Mr. RYAN. My time is running out. Let me ask you this. You and I are about the same age and you and I are probably going to get a 1 percent rate of return if all things go well and we come up with the money to pay this unfunded liability. If you were given the personal account option, like the President's plan provides, what would you do? Would you take it?

Mr. FURMAN. It would make no financial sense for me to take it. I could do the same exact financial transaction right now by selling some of the bonds in my portfolio and using the money to buy stocks.

Mr. RYAN. Do you have a 401(k) in a portfolio?

Mr. FURMAN. I have a portfolio and I have bonds in it and I could sell them. The President's plan gives people the option of borrowing at a relatively unfavorable interest rate. I wouldn't recommend that anyone do that.

Mr. RYAN. So, you would say, I am going to trust a future politician for my benefit rather than getting a bond in my account that they have to honor?

Mr. FURMAN. That is not the way—the President's plan doesn't change that in any respect. It takes a benefit offset out of your existing benefit. It doesn't give you any more security in any meaningful political sense, and it gives you less security in a market sense——

Mr. RYAN. Mr. Schieber, do you want to respond?

Mr. SCHIEBER. Mr. Ryan, if we are going to fix your benefit by somehow filling this $4 trillion hole in, your rate of return almost certainly has to fall because you are going to have to put more taxes in to deliver that benefit, and you can't only look at the benefit side of this program. If you are going to be taking more money off of people's table, it is going to have as much of an economic effect as you are, if you adjust their benefit.

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

Chairman THOMAS. I know a lot of you want to respond. Again, I can assure you, written responses to those questions will be read by the Committee. The Chair is tempted to ask the Members of the panel which tenth are you in, in Dr. Schieber's structure, based on some of the analysis of how you really wouldn't have to rely on Social Security and, therefore, it doesn't make any difference. The gentleman from, by gosh, North Dakota?

Mr. POMEROY. Thank you, Mr. Chairman. I admire Dr. Schieber very much. I have known him many years. I would just like to take one slight issue with what you just said, that basically you cut benefits and that hurts, or you do something else and it is going to hurt the same people. One idea for filling part of the hole, for example, would be we could reference back to the debate on the estate tax that my friend, Mr. Hulshof, and I had a few weeks ago. We have an estate tax set at $6 million per couple, moving to $7 million per couple in the year 2009. That would eliminate the estate tax problem for 99.7 percent of the people in this country. We could dedicate the overage as a dedicated revenue stream into the Social Security trust fund. That would take care of—we are running the numbers—some substantial percentage of the shortfall, potentially roughly equivalent to the benefit cut proposed in this progressive indexing scheme. So, because 99.7 percent

wouldn't have any estate tax, that is one form of contribution to the trust fund that really would not be reflected in reduced economic consequence to the individual recipient. You know what? I want to get this down to brass tacks. You can respond in writing, my time is going to go so short. I expect you will respond.

It is one thing for a Ph.D. Yale economist and a smart, albeit rightward leaning, economist-type from Wisconsin to talk about how they would make these funds work and what the best investment strategies might be. I am thinking of how this all works for your average family on Social Security. In North Dakota, the benefit is $834, average benefit. As I look at the risk on the private savings side, questions about pensions, conversions of pensions to defined contribution plans, defined contribution plans that raise issues relative to whether people are participating, whether people are saving enough, whether they are investing wisely, whether they are managing the assets through their retirement years, managing their longevity risk; nothing but questions, nothing but risk.

It seems to me that an investment strategy that basically acknowledges the risk they already have on the private savings side and adds risk into the foundation of income in retirement, Social Security is a risk-on-risk investment proposition. Now, people don't really manage risk portfolios in that fashion. You augment risk by less risk. So, risk-on-risk, at the end of the day, I believe, is going to really expose people. One in three, we know, depends upon that Social Security check for 90 percent or better of their income, two in three for most of their income. Now, how much risk do you want to put into that foundation? To me, it just flies right in the face of economics. I thought it was very interesting when the Secretary of Labor was here. She denied having taken any action with the Pension Benefit Guaranty Corporation (PBGC) portfolio, but indeed, she voted and signed the minutes of a board motion that moved the equity position of PBGC from 30 percent down to 15 to 20 percent. If you look at risk, I am much more comfortable with risk in an aggregated class, like a pension fund, than one person with one account. How they do determines how they do. So, I think that there is a little schizophrenia even within the Administration. Equities are bad for PBGC, although the Secretary of Labor either didn't know or denied her action inappropriately, versus Social Security, where risk is good, let us jump all over it.

I want to get to the benefit cut issue that was discussed earlier by Congressman McDermott, and I think this really gets to the nub of the question. I would either ask Mr. Apfel or Dr. Furman to address this. The bottom line, when we talk intergenerational fairness, it looks to me like the progressive indexing reduction reduces the Social Security benefit to a dimension that that benefit, even when added to the private account, cannot produce an income replacement benefit that we presently enjoy under Social Security. In other words, the future generation is going to get less by way of a retirement benefit, private account and Social Security, than what Social Security now provides. That certainly does not seem like intergenerational fairness to me. I would like Apfel and Furman to address that.

Mr. APFEL. Briefly, it seems to me that if our goal is to replace somewhere around 70 percent of pre-retirement earnings, which

seems to be about the minimum, then there ought to be a Social Security foundation that can be counted on no matter what happens to individual investments that ought to represent a significant piece of that. Combining these two proposals as the President has, both the privatization and the reduction in the guaranteed benefit, coupled with the middle-class benefit reduction that has been proposed, means that Social Security, that foundation, is going to be replacing an infinitesimal share over time for a very large number of people and growing over time. I think that is just putting too much on individual savings for the future; that is, putting individuals at risk over time if the foundation is going to become smaller and smaller and smaller. From what I have seen of the numbers, it doesn't seem to me that many people will be living with more income. Not only will there be losers, for sure, but I think that it is likely that there are going to be a lot of losers, potentially, compared to current law.

Mr. POMEROY. I thank the Chair and yield back.

Chairman THOMAS. Thank you. Does the gentleman from Texas, Mr. Brady wish to inquire, and will the gentleman yield to the Chair very briefly?

Mr. BRADY. I would yield to the Chairman.

Chairman THOMAS. In 1983, we extended the age of retirement. Would you define that as a benefit cut?

Mr. APFEL. It wasn't actually—Mr. Chairman, I was heavily involved with those discussions, not as a Member but as a staff person——

Chairman THOMAS. It wasn't a benefit cut?

Mr. APFEL. It was a benefit reduction.

Chairman THOMAS. What percentage of the population was affected by that benefit cut?

Mr. APFEL. At that point, for the people who were then on the rolls, none. It was——

Chairman THOMAS. No, no, no. The question you just responded to was a prospective one in terms of the future, not the current rolls. I am asking you about the change in age. Is it a benefit cut? The answer is yes. How many did it affect? One hundred percent of the population. All I am doing that for is to understand, if we are going to argue on the point of no change in this structure and that certain things are ruled off the table, by definition, you cannot reach an agreement which will address the problem in front of us. That would truly reduce this discussion to an academic exercise, and one of the things we have as a responsibility, is to answer real problems, not dance on the head of a pin. The gentleman from Texas?

Mr. BRADY. Thank you, Mr. Chairman.

Mr. POMEROY. Mr. Chairman, I just have a point of inquiry, Mr. Chairman. Point of inquiry.

Chairman THOMAS. Although that is not a recognizable motion, I am certainly willing to recognize the gentleman.

Mr. POMEROY. I thank the Chairman. I enjoy my working relationship with the Chairman. I do want to inquire in terms of are we going to proceed the rest of the afternoon where you can do a counter-rebut to every——

Chairman THOMAS. I tell the gentleman, if he noticed, I gave the time to the gentleman from Texas and the gentleman from Texas yielded a portion of his time to me.

Mr. BRADY. If I may reclaim my time——

Mr. POMEROY. I thank the Chairman for that clarification.

Chairman THOMAS. The gentleman from Texas.

Mr. BRADY. I find those questions helpful, because it is important to know or at least be consistent on what effects and options there are across the board for future retirees. I have a district in east Texas that is perhaps a lot like America. It has some very wealthy neighborhoods. It has some very, very poor communities. Out of the 11 counties in my district, nine of them are heavily Democratic, some of them very strong in union areas. I have done about 30 Social Security workshops. People are smart. They get this. They know there is a serious problem with Social Security. They know the trust fund is really a debt. They know we have been spending the money. I have noticed just in the last two-and-a-half months in our workshops, whereas I used to spend the whole time on the problem, how we got there, what the future looks like, things like that, now they go right to the solutions. They want to know the ideas. They want to know real solutions to this problem.

We are thankful that we have models all around us that we can look at, not just the Federal employee retirement system, but in Texas, the Galveston model. It worked for 24 years, voted in by the workers themselves. They get, on average, about twice their retirement paycheck as Social Security would have provided. They have a disability program that would embarrass the Social Security system, and they have a death benefit of between $75,000 and $220,000 plus keeping the account, with interest, itself. So, we have got some models to look at. My seniors, my workers, even our young people we talk to, they have an interest in personal accounts. They normally come down to this. If we can make sure the workers can't touch that account, if we can make sure the government can't touch that account, and if we can find a good, responsible way to start those, they have real, real interest in it because their thought is putting real money in a real account, seeing it grow steadily over the years, as it has in Galveston and in other programs. They see that as a way, one way, of really addressing this. So my question is, to the panelists who see personal accounts as part of the long-term solution, dealing with the issue of prefunding, and perhaps I can start with Mr. Lindsey, what ideas do you have for prefunding these accounts to start them in a way that we can afford it and that really moves us forward?

Mr. LINDSEY. I think it is obviously, the more you can—first of all, the question of prefunding gets to the question about ownership. I think that if one establishes personal accounts, it is more difficult for the Congress to spend the money. Mr. Furman is technically correct that Congress can always change the rules on anything, but whereas history indicates that there has been no reluctance to spend the money when it is in a trust fund, I think in the case of IRAs or any other account or the Thrift Savings Plan, the Congress has respected private ownership, and I think that that would be one of the ways you would proceed. A necessary condition for prefunding the system would be to establish some kind of a pri-

vate claim that Congress would resist. Prefunding the system obviously increases the savings rate, obviously strengthens the economy, and it is one way that the government can use compound interest to help solve the problem. As was pointed out earlier, President Clinton proposed using compound interest, investing the Social Security trust fund in the market. The only question is, can you protect it from being spent, and the reason for a personal account is to prevent that money from being spent.

Mr. TANNER. Congressman, if I might real quick——

Mr. BRADY. Yes, sir.

Mr. TANNER. Just on that point, today, we released a letter from 450 major U.S. economists, including five Nobel Laureates, saying that the only way to really fix Social Security is to include personal accounts as part of that, that that is the only way to really build ownership rights and the only way to deal with the funding issue, and this is to include individual accounts. So, this is certainly, among economists, the respected way of achieving this.

Mr. BRADY. Well perhaps, Mr. Chairman, I could ask for a response by letter for any Members who want to respond to that and any ideas on how to fund and how to finance the prefunding response we make that work, and I yield back, Mr. Chairman. Thank you.

Chairman THOMAS. Without objection.

[The information was not received at the time of printing.]

Chairman THOMAS. I thank the gentleman. Does the gentleman from Colorado, Mr. Beauprez, wish to inquire?

Mr. BEAUPREZ. I do, Mr. Chairman. Thank you very much. First of all, Commissioner Apfel, I think an observation is necessary, not really a question, but I was intrigued by your dialog with the gentleman from Illinois earlier and specifically the part about the utilization of market forces, compound interest, as Mr. Lindsey just referred to, as a solution kicked around back during the Clinton Administration. My observation, quite frankly, sir, is that the major thing that has changed since then is that that was President Clinton, and now it is President Bush talking about using those same market forces as perhaps a portion of the solution to our Social Security challenge. I think that is the most significant change that has occurred.

A second observation, if I might, and Mr. Furman, I find this one just striking, and I am going to refer to Mr. Schieber's chart once again, the oft-cited chart today, on your page 20 of your testimony. It is fairly clear, I guess surprising to none of us, that the working poor are the ones who have the fewest options to provide for their retirement benefits, and yet, Dr. Furman—I am not going to ask you a question, sir, so you don't have to reach for the button—the observation is this, that the very portfolio which—and I was going to ask you this question, but you have already given us the answer—that you, I assume, probably have, and I assume to take advantage of the market, and I assume to build retirement benefits and wealth for yourself, you would want to deny to the working poor when we have in front of us, at least, a concept to do just that, to give these people, people like my parents and I were for a good long part of our life, frankly, an opportunity at ownership in the United States of America that formerly, and currently, tragically,

for mostly just the wealthy, has been available. You are going to deny that to the working poor who have already fewer options. I find that very inconsistent with the logic that usually prevails from that side of the aisle.

My third observation, if I might, is that when I was an employer, and I proudly was until I came to this Congress just a few years ago, one of the days of great celebration was when we instituted 401(k)s and deferred compensation plans that took advantage, Mr. Lindsey, of compound interest, rate of return, market ownership, those things that we are talking about here today, and I have no doubt why they were celebrating that. They understood that.

So, here is my question, and I don't think we have really gone this direction, although, Mr. Lindsey, you did just hint at it. If we can create these things called personal accounts that we have a concept out there of doing, and over a course of years there is another class of investors out there, and thus a pool of investment capital—something I as a banker always thought was one of the most limiting things to economic expansion—that creates jobs that the working poor say they always need, and I agree. Access to capital—do we not have the potential, Mr. Lindsey, of providing enormous economic stimulus through this newfound investment capital source?

Mr. LINDSEY. Absolutely. In fact, I think one of the points that actually Mr. Pomeroy made earlier was the need that we have in this country to save more and to be able to invest more. That is going to be the ultimate foundation here. I would commend the personal accounts, A, as a way of restraining spending, and B, in my testimony, what I recommended was a way of increasing the saving rate using Social Security reform as an option, but you are right on.

Mr. BEAUPREZ. I thank the gentleman. A further observation. If someone wants to opine in the time I have remaining, I would invite that. We have all—all of us, I am sure, on this Committee, probably every Member of Congress, have been counseled, lobbied, by all kinds of constituent groups. One thing that is absolutely obvious to me is that two groups who came to me and said, I would just assume you not change anything, were the folks from my State, Colorado, with the Public Employees Retirement Account (PERA), and the Federal employees who have the Thrift Savings Plan. I asked why is that, and they said it was because they had a personal account. I can direct that money and it is working. Does anybody want to offer an opinion contrary to that, why that is a bad idea? Sir?

Mr. APFEL. I think the Federal employees who now have that system also have Social Security. It is one of the great things about the system——

Mr. BEAUPREZ. Are we not talking about that same possibility?

Mr. APFEL. Well, I——

Mr. BEAUPREZ. Some of both.

Mr. APFEL. It seems to me that——

Mr. BEAUPREZ. Yet I have heard resoundingly today that we want to deny that choice to a substantial part of American working people, and I, for the life of me, don't get it. I yield back, Mr. Chairman.

Chairman THOMAS. I thank the gentleman. Does the gentleman from California, Mr. Thompson, wish to inquire?

Mr. THOMPSON. Thank you, Mr. Chairman. I appreciate the opportunity to talk to these witnesses today. I just want to commend my colleague from Tennessee, Mr. Tanner, who has already left us, for bringing up the issue of the impossibility of having a strong Social Security dollar and a weak U.S. dollar. I think he was right on. The fact that we have this tremendous debt, $7.7 trillion today, a $425 billion deficit, and that doesn't even take into account the $160 billion that was borrowed from Social Security to make ends meet this year, and now this discussion about Social Security, and you can call it whatever you want, privatization or personal accounts, and the fact that this adds an additional $2 trillion to that debt, I think puts us in a pretty tough spot.

We have heard from some today that Social Security is a bad deal and that private accounts will make things fairer. I don't think it is fair that we continue to pass bills that we don't pay for, that we talk about proposals that are going to cut benefits to workers and that we compile a mountain of additional debt for future generations. Mr. Tanner spoke clearly about this, but I think it is important to note that in this Committee room, we saw—and I will pass this out for you if you would like to see it, this was from the Administration—that if things continue to go the way they are going, by 2040, we will take in as many Federal dollars as it will take to pay the interest on our National debt. So, if we continue to do things the way we are, in this regard, we are going to cut everything, Social Security, Medicare, Medicaid, all other programs, and I think that is important to this discussion. Mr. Pozen, if you would be so kind to clear something up for me.

Mr. POZEN. Sure.

Mr. THOMPSON. The President in April made mention of there being no Social Security trust fund. I don't remember exactly what he said, but basically, there is no money there. There is no trust fund. It is a bunch of IOUs. I think this caused a great deal of concern, and I think it derailed the important debate that we should be having. This trust fund, is it there? Is there money?

Mr. POZEN. We do have a trust fund, but some people are under the impression that these surpluses have been building up and are invested by that trust fund. That, unfortunately, hasn't been the case——

Mr. THOMPSON. Not what view people have, but is there a trust fund and is it backed by the full faith——

Mr. POZEN. There is a trust fund, but it doesn't have the surpluses invested. Instead, it has special issue Treasury bonds which are good money. They will be redeemed, but Congress will have to appropriate the money or borrow the money to fund these redemptions. So, I think it is a bit of a confusing issue, but we should not say that the trust fund bonds will be dishonored. They will be honored——

Mr. THOMPSON. Reclaiming my time, the same action that Congress would have to take to make good on any notes that we have, debt to foreign countries——

Mr. POZEN. Yes, but this is $4 trillion debt, roughly equal to the amount of publicly held Treasury debt that has built up over the last 30 years. So, it is a big number.

Mr. THOMPSON. Thank you. Mr. Furman, in some of your work, you have suggested that, in analyzing this progressive index plan, medium-wage income folks, $36,500, will see a benefit cut of about 28 percent, is that correct?

Mr. FURMAN. In fact, that number is based on the actuaries' office.

Mr. THOMPSON. Well, this is particularly interesting to me, because the average median income in the seven counties in my district is $36,499, and Social Security tells me that the average person in my district gets a monthly check of $936. I think it is important to note that while we talk about a percentage here and a percentage there, that this means that the average benefactor in my district making $936 a month is going to see a reduction down to about $673 a month. So, that is a $260 cut that they are going to receive, and I think that is real money and I think the real dollars mean something to the people who depend upon Social Security to make ends meet at home.

Mr. POZEN. Excuse me, Mr. Thompson, but I think you are just applying a percent——

Mr. THOMPSON. No. I have got a limited amount of time. Sorry. Mr. Apfel, to explore this just a little bit more, in your testimony, you said that workers making about $60,000 will see about a 90 percent cut in their Social Security?

Mr. APFEL. That is the defined benefit cut, combining both the private account, the reduction in the Social Security benefit, and the middle-income reduction through the sliding-scale system.

Mr. THOMPSON. So, working on the same information that I got from the Social Security Administration, folks who make $60,000 a year in my district are going to see a cut of $1,750 a month from their monthly check. I just think it is important to put numbers with that, because this is critical for the well-being of folks who depend on this guaranteed benefit, whether or not they have add-on benefits, private accounts, other investments, this guaranteed benefit component of whatever their portfolio may be. Thank you.

Chairman THOMAS. Does the gentlewoman from Pennsylvania wish to inquire?

Ms. HART. I do, Mr. Chairman.

Chairman THOMAS. Prior to that, would the gentlewoman yield to the Chair?

Ms. HART. I certainly will, Mr. Chairman.

Chairman THOMAS. I tell the gentleman from California, if he is concerned about those numbers and wants to sit down and work with the Chairman to make sure that any structure we create doesn't at all entertain those kinds of numbers, the Chair is very excited to do that as long as the gentleman from California doesn't tell me what I have to not be able to think while we are sitting down and discussing, and as long as the gentleman from California doesn't tell me what I can't put on the table. I would love to sit down with the gentleman and make sure that the gentleman's concerns are completely alleviated as we address the shortfall in Social

Security. I don't know whether the ground rules that I just offered you would be acceptable.

Mr. THOMPSON. You wouldn't be able to put any wine from other States or other countries on the table.

Chairman THOMAS. It is understood that if two Californians are going to noodle over a program, it will preferably be with wine from your district. We make wine in my district, but I don't have a place called Napa in my district.

[Laughter.]

Mr. THOMPSON. I will bring the wine.

Chairman THOMAS. I will bring the ideas.

[Laughter.]

Chairman THOMAS. The gentlewoman from Pennsylvania. Thank you for yielding.

Ms. HART. Thank you, Mr. Chairman. As long as he doesn't bring the w-h-i-n-e, I would join you. I would like to give Mr. Pozen an opportunity, if he could do it in 15 seconds, to finish responding to Mr. Thompson.

Mr. POZEN. Yes. I think there would be no reduction in benefit levels from today. The Social Security benefits of the workers in these examples would all grow. Every one of them would grow, and the purchasing power of their benefits would grow. So, they would grow in real terms and in nominal terms.

Ms. HART. Thank you. I actually want to take off on some of the subject matter that Mr. Beauprez started with, but first, I want to reemphasize something that I think we are not keeping at the front of our minds that I think is important, and that is that when Social Security was set up, there were gobs of workers working for every person who was retired and receiving Social Security benefits. Those who don't see some urgency in us looking at this program and restructuring this program now, I think are ignoring the fact that the demographics have changed so drastically that we now only have 3.3 workers working for every person who is receiving Social Security benefits. That in itself is a problem, but don't forget that these people who are receiving these benefits are going to be receiving them for a much longer period of time. There is huge stress on the system and it is just going to grow. Birth rates are down. Within the next 20 years or so, there will only be two people working for every person on Social Security. We are going to get to the point where we can't even operate a pay-as-you-go system very quickly, very quickly.

Now, I understand that people in the income bracket of those here at the table, and probably the Members, are not going to be terribly affected by changes in Social Security. We are not going to be dependent upon Social Security benefits for our retirement, but let me tell you, most of the people in my district are, and I have spent a lot of time out there listening to people and talking with them and listening to their ideas about this. I can tell you that the people who seem to be the most interested in this are the people who are going to be most affected. I had a gentleman stand up at a meeting not too long ago—he probably makes about $35,000 a year—and he said to me, "Why can't I invest more than 4 percent myself?" People are a lot more sophisticated today than they were in 1935 and 1950, as far as investments, and I think some of the

panelists have actually been quite disrespectful to the American people when they suggest that these people are just going to starve if we give them the opportunity to invest some money. For God's sake, if they made enough money to set aside to invest, they would love to, and that is why this gentleman and many others have come up to me and asked for us to make sure we give them an opportunity to actually receive a little more bang for that buck.

Twelve-point-four percent is a lot of money. One of the—I can't remember which witness, but one of you said that if 12.4 percent were invested out of your paycheck in a retirement plan, that alone could pay your retirement benefit. That might have been Mr. Tanner—I am not sure—but one of you had something to that effect in your testimony, and I think that is an important point to make. The question that I would like to ask is, mostly I am going to start with Mr. Pozen because I think you work a little bit in the investment field. I would expect that most of your clients, or your company's clients, are not folks that I am talking about.

Mr. POZEN. I think most of the low-wage workers, unfortunately, don't have enough to invest.

Ms. HART. Right. I have been supportive of personal retirement accounts, and they are personal retirement accounts because we are not handing the money over so that, as Harry Reid said, they can take it and lose it in Vegas. This is a very carefully invested account. Mr. Chairman, did you use my time?

Chairman THOMAS. The Chair is watching the time and the gentlewoman hasn't been indicated—the Chairman hasn't told the gentlewoman her time has expired.

Ms. HART. Oh, thank you, Mr. Chairman.

Chairman THOMAS. However——

[Laughter.]

Ms. HART. My quick question which I will ask for a very quick answer is, does it make sense in your view that we allow people to get a piece of the pie who currently don't have enough extra money to invest?

Mr. POZEN. The answer is yes, if we can get them in a balanced account with a long-term investing program with good diversification.

Ms. HART. I yield back.

Chairman THOMAS. There you go. He saved you 2 minutes. Does the gentleman from Indiana wish to inquire?

Mr. CHOCOLA. Yes, Mr. Chairman. Thank you. Thank you all for being here. Thanks for your patience. A little later today, I hope to get on an airplane and fly back home to Indiana, and tomorrow morning, I hope to be able to take my 14-year-old son to school, to eighth grade. He retires, maybe in 2052, when I think any projection would say the trust fund is exhausted. He is actually interested in this idea, and so I look forward tomorrow morning when I take him to school to kind of share with him all your ideas on how we are going to solve this problem for him and all his classmates. As I go across the panel, I think I have a pretty good idea what I can tell him. Commissioner Apfel, I think I can tell him what at least you used to think when you were Commissioner. I am not sure I can tell him what you think today. Dr. Furman, I really am struggling on what to tell him you think the solution is.

I can tell him what you are against, but I want to be able to share with him what you are for. Can you help me out?

Mr. FURMAN. Sure. I think one idea is something we heard about before, which is to take the revenue from the reformed estate tax, raise the exemption to $7 million, get almost everyone off of the estate tax, and the remainder dedicate to Social Security. That would be a step we could move forward. I would rather do that than cut benefits of the same magnitude that have been proposed by the President for the middle class.

Mr. CHOCOLA. You think the small businessowners—we should not repeal the estate tax for the small businessowners, but let me just ask you, you earlier referred to the Diamond-Orzag plan, I think. Is that a plan that you think is a viable potential solution?

Mr. FURMAN. I think that is certainly an option that this Committee should consider. In fact, it is the only plan the chief actuary has ever scored that gets sustainable solvency without general revenue transfers.

Mr. CHOCOLA. Doesn't that plan increase taxes by increasing the taxable earnings base, increasing payroll taxes, and imposing an additional tax on all income above the taxable earnings base? So, is that essentially the solution you think I ought to suggest to my son, that we raise taxes?

Mr. FURMAN. We have a $4 trillion deficit here. Every dollar that we can get on the revenue side is one dollar less of benefit reductions. If your plan is $4 trillion of benefit reductions, that will solve the problem and that is a perfectly reasonable plan. If you think that is too much in the way of benefit reductions, then you need additional revenue. Every dollar of revenue is one dollar less of benefit reductions.

Mr. CHOCOLA. Let me ask——

Mr. FURMAN. If you aren't willing to get that revenue, you have to be willing to accept the responsibility for proposing those benefit cuts.

Mr. CHOCOLA. Let me ask Dr. Hunter, I think a long time ago in your opening statement, you said something to the effect that transition costs were not new or additional debt. Could you expand on that a little bit?

Mr. HUNTER. Every time payroll taxes come in the door today, they are, in effect, borrowed and spent. It has been characterized as an implicit debt, but it is a debt nevertheless. It is a debt obligation of the Federal government. If rather than spending that money, we invest it or allow workers to invest it in a personal account, that is a dollar less that the government is borrowing. So, every dollar that goes into personal accounts is actually a reduction in debt.

Now, that does create a cash flow crunch. So, if the government turns around and borrows a new dollar to alleviate the cash flow crunch, it hasn't borrowed an additional dollar. It simply refinanced the old debt, and that is a classic corporate workout. You refinance the debt to free up cash and then it gives you time to restructure, and what you are talking about with personal accounts is restructuring. It creates larger profits, more productive outcomes, and allows the personal accounts to generate higher benefits. It is not rocket science. It is not voodoo. It is not magic. We

do it all the time in the corporate world. People do it all the time with their homes. It is very straightforward.

Mr. CHOCOLA. One other thing I think my son and many others struggle with is that we debate these particular ideas and not a package of good ideas, and I think ultimately, the solution is going to have to be a package of good ideas, and Mr. Pozen, I think I have heard you talk about that. Could you just comment on that?

Mr. POZEN. Yes. I think the legislative solution has to be a package. If we just have benefit constraints, which I think we need, and increases in revenues by raising the payroll tax base, we have to provide some, what I call, sweetener, some positive aspect to the package so that voters will feel good. We also should enhance their retirement income through other measures, whether it be expanding the Roth IRA or the Low-Income Tax Credit. So, I think we definitely have to think of a package.

Mr. CHOCOLA. So, it is somewhat misleading to be only isolating our comments and criticisms on one particular idea at a time.

Mr. POZEN. Yes. I think that is unfortunate. I think we sometimes take one particular idea and push it to a limit when we are realistically talking about a combination of ideas.

Mr. CHOCOLA. Yes, sir?

Mr. STEUERLE. I have got a list of about 12 or more proposals in the back of my testimony—some of which have not been discussed much at all—that I think would help restore solvency. As I have indicated earlier, I think that we have a middle-age retirement system and I think before measuring success in terms of replacement rates, or in terms of giving them savings accounts, we can go an extraordinary way if we build a base system of protection that protects the people who are truly old. For people with 12 or 15 years of life expectancy left, we should give them a really good minimum benefit. We could do that in the current system. We could even wipe out poverty among the elderly. Start with that as a base, and then buildupon it. Build in private saving if we want a private saving component. If some people want more middle-age retirement, build it upon the base. That is the way I would buildup the system.

One warning I would give—and I think there is a tendency in politics to ignore it—is I don't believe there is a free lunch. I am afraid that both the trust fund accounting issue and the personal account issue at times get off into the notion that somebody can move money around and provide a free lunch. If I take money from you and give it to me, I might be better off, but you are going to be worse off. There is no free lunch. Everything you do budgetarily as our Representatives involves taking from one person and giving to the other. Hopefully, you do it in a way in the long run enhances the economy, but it is not free.

Mr. CHOCOLA. Thank you all. I yield back, Mr. Chairman.

Chairman THOMAS. I thank the gentleman. The Chair knows the gentlewoman from Ohio wishes to inquire.

Ms. TUBBS JONES. Thank you, Mr. Chairman, and thank you to the witnesses for sitting so long. Just in response to the free lunch, the poor people in this Nation have been watching the rich people and those who are better off than them have free lunch for

a lot of years and they are worried about the only free lunch that they have relied on, for years and years and years, being removed. What I am talking about, is not a free lunch; I am talking about Social Security. When I go out, and I have done probably ten or 12 sessions on Social Security, talking to the people of my Congressional district, Social Security is something they earned. It is not a welfare benefit. I think that we really need to be clear that, the people who have paid into Social Security have paid out of their checks and they are expecting that all of us, regardless of our party, are going to guarantee them that benefit that they have earned that President Roosevelt said it would not be someone that they would be administered unto, but it would be the money paid out to those who have earned it.

It is my belief that there is no way that we can continue all of the programming of Social Security disability, survivor benefit, retirement benefit, if we take money out of that pot to create a private fund. I have talked to lots of my constituents and what I say to them, in addition to that is, if your children are the age of my colleague over there, 14, talk to them about saving and creating their own retirement account and not relying upon Social Security. We should be debating and discussing, what are we going to do to increase the dollars from Social Security without causing those Social Security dollars to be indebted in order to create a private fund. It was never intended to be a private fund. It was never intended to be an individual account. It was not created like that. The people aren't expecting that from them. Those that are want to change a program that has been in place and has been good to seniors and administered for 1 percent of its cost for 75 or more years. I want to go to Dr. Furman. There were several answers you wanted to give that you cut off from. Please feel free to use a little bit of my time.

Mr. FURMAN. Well, thank you very much for that. If I went to my employees and told them I gave them a 401(k) plan, they would all cheer. If I then told them, oh, but by the way, I am taking away your Social Security benefit, I think they would be, at the very least, a little bit less excited than they were at first blush, and that is, in effect, the way the President's plan works. There are ways to encourage families to save and moderate-income families to save, and I take a back seat to no one on that. We have the Savers Credit right now. It is the only tax incentive for moderate-income families to save. It expires in 2006. The President, that is the only tax thing passed in 2001 that he has not proposed to extend. It is the only thing that helps middle and moderate-income families save, and it is the only part of the tax cut that he wants to expire. If you genuinely care about encouraging wealth creation for moderate-income families, there are a lot of ways to do it that will genuinely make them more wealthy, not just cut your Social Security benefit and give you something else, and that would be an excellent step one could take if it was paid for, so thank you.

Ms. TUBBS JONES. The difference between a Thrift Savings Plan that I and my colleagues enjoy and Federal employees enjoy and the proposal of a private account under Social Security is——

Mr. FURMAN. The difference is that somebody who retires with a Thrift Savings Plan is going to get about half of the income they

need in retirement from Social Security. That is the floor. It is a pretty minimal floor. On top of that, they are going to build using their 401(k)s and IRAs. I think more middle-income families do need to be able to build on top of that with 401(k)s and IRAs and we should be able to help them to do that. If you don't want——

Ms. TUBBS JONES. Well, the proposed private account that is being proposed under Social Security is not the same kind of—that is going to be a deduction from——

Mr. FURMAN. Those plans don't say, "here is your floor, we are building on top of it." They pull the rug out from under you, and subject you entirely to the market. That is a completely different thing from a 401(k) plan. It has nothing to do with wealth creation for moderate-income families.

Ms. TUBBS JONES. Last, deficit spending causes a dilemma for private, for Social Security going out into the future, is that correct?

Mr. FURMAN. That is exactly right. I think that is exactly right. I agree with Gene. There is no such thing as a free lunch. Private accounts don't add money to Social Security, they take it out of it. They make what you need to do even larger than what you would otherwise need to do.

Ms. TUBBS JONES. Mr. Chairman, I am giving you 2 seconds back. Thank you very much.

Chairman THOMAS. I thank the gentlewoman very much. To conclude this particular hearing, it is a real pleasure for the Chair to recognize the newest member of the Committee, and I just want to assure you, Mr. Nunes, that every other Member who is more senior to you warmly welcomes you to the Committee because all of them were at one time in your position and they aren't anymore.

Ms. TUBBS JONES. Thank God.

Chairman THOMAS. The gentleman from California is recognized.

Mr. NUNES. Thank you, Mr. Chairman, and it is a pleasure to be here with you, my colleague from California, and to come into the Committee for the first time on a very important debate called Social Security. One of the advantages of going last, if there is an advantage, is that I have gotten to hear everyone's testimony. I have been fortunate to hear Mr. Ryan, about his plan. We have heard about Mr. Shaw's plan, Mr. Bush's plan, Mr. Thomas's plan, and several plans have been discussed. Mr. Tanner pointed out that 450 economists, I think, today wrote a letter. Some of the Nation's most important economists have said that we can't solve the Social Security crisis without some type of private account, and I think there is something to be said for that. Referring back to the plans that have been discussed up here by my colleagues on the Committee on Ways and Means, I would like a yes or no answer to this question, please, and we will start with Mr. Lindsey. Did you hear any of the Democrats today offer a plan to save Social Security, Mr. Lindsey?

Mr. LINDSEY. No.

Mr. NUNES. Mr. Pozen, did you——

Chairman THOMAS. The Chair would hasten to explain the rules, and that is a Member has every right to ask whatever ques-

tion he so chooses. There is no obligation on the part of the witness to respond directly or otherwise.

Mr. NUNES. Thank you, Mr. Chairman.

Chairman THOMAS. There is an occasional free lunch.

[Laughter.]

Mr. NUNES. Mr. Pozen?

Mr. POZEN. I heard a witness say the Orzag-Diamond plan, but I haven't yet heard any Congressperson say they were willing to propose that package of several tax increases and benefit constraints. It is an honest plan, but I haven't heard a politician adopt it yet.

Mr. NUNES. Mr. Schieber?

Mr. SCHIEBER. No.

Mr. NUNES. Dr. Steuerle?

Mr. STEUERLE. Pass.

[Laughter.]

Mr. NUNES. Mr. Apfel?

Mr. APFEL. You asked whether elected officials have proposed plans?

Mr. NUNES. Any today during this hearing where we have been discussing what to do about the future of Social Security.

Mr. APFEL. I have not heard any plans that did not increase borrowing dramatically to pay for Social Security to solve the long-term solvency problem.

Mr. NUNES. Have you heard plans, at least proposed, by the Republican side of the aisle?

Mr. APFEL. That entailed drastic levels of new borrowing that I think put Social Security benefits at risk.

Mr. NUNES. That is fair enough that you have your points on the legislation, but at least there have been plans that have been offered for discussion, which I think is important to have all of you here to analyze that, these plans, and add to the discussion, and I want to thank all of you for dedicating a large portion of your life to trying to solve these problems that we face with Social Security. I appreciate your opinion that there are problems with the plans on this side of the aisle. Well, it is better than having no plan, in my opinion. Dr. Hunter?

Mr. HUNTER. I did not hear any plans from the other side of the aisle today, but I will tell you, and the good news is that, especially before this last Presidential election, I spent many hours on Capitol Hill talking to Democrats on this side and on the other side of the Capitol, and I will tell you that there are many who are very interested in personal accounts, and that is the reason I started off this morning by saying—it seems like a long time ago now—that unfortunately, the political climate may not be right to do it all, right now. That is the reason I encourage the Committee to do what I think is perhaps possible, and with the Chairman's leadership this may actually happen, because everyone, everyone in the country realizes it is wrong to spend the surplus, and a good number of your colleagues on both sides of the aisle recognize that the best thing to do with those surpluses is to invest them. We can have an interesting debate on how they should be invested, but I think we have a real opportunity here, and you may not get very many Democrats right now, but I have confidence this is a long

process and this is a beginning, and I commend the Chairman for holding this hearing.

Mr. NUNES. Thank you. Dr. Furman?

Mr. FURMAN. It has been a long hearing, and I may have missed it, but I actually didn't hear anyone on the Republican side, on this side, embrace any specific steps to improve solvency in terms of reducing benefits or raising revenues. If you want to transfer general fund revenue to Social Security, you can extend solvency, but I didn't hear any specific steps. In fact——

Mr. NUNES. You heard specific plans laid on the table?

Mr. FURMAN. The one specific step I heard from anyone here today that would improve our long-run fiscal outlook was Mr. Pomeroy and the estate tax proposal. I don't think I heard anything else that would, but you can correct me if I am wrong, if anyone—now, I have heard a lot of things from the panel, Bob Pozen's ideas, what a lot of other people have. I didn't hear anyone up there embracing them. I only heard about ideas that would cost money, not save money.

Mr. NUNES. Thank you, Dr. Furman. Mr. Tanner?

Mr. TANNER. Yes. I heard several proposals on the Republican side. The proposal by Representative Johnson, by Mr. Ryan, by Mr. Shaw, all of them scored by the Social Security actuaries as restoring Social Security to permanent sustainable solvency. From the Democratic side, I did not hear any proposals at all for restoring solvency or fixing any of the other problems within Social Security, which is really a shame, because this used to be a very bipartisan issue. Members like your former colleague, Charlie Stenholm, or Members from the other body like Senator Robb, Senator Kerry, Senator Moynihan—all who supported individual accounts at one time or another and were very willing to take up Social Security reform in a bipartisan manner—are gone and it seems to be now simply a matter of misinformation and very partisan debate on that side of the aisle and it is a shame. I say this as someone who is not a Republican, that I am very disappointed.

Mr. NUNES. Thank you, Mr. Tanner. This being my first day on the Committee, Mr. Chairman, I am a little bit disappointed to hear none of my colleagues on the Democrat side of the aisle offer any alternatives. I hope that the next hearing when I get to attend a full Committee hearing that we will actually have some ideas by the Democrats that have been laid out on the table. Until then, unfortunately, the Republicans have to debate amongst ourselves. We have many different ideas, and we are using many of your ideas and many of the proposals that have been put upon the table. It sure would be nice to have at least some input from the Democrat side of the aisle. With that, Mr. Chairman, thank you for the welcome to the Committee.

Chairman THOMAS. The gentleman's time has expired, and the Chair would hope that Members are on this Committee to, first of all, listen. Even if they have an idea of how they might want to solve the problem, have the courtesy of listening to other ideas, so that their ideas can be tested in the crucible of competition on ideas, i.e., which one does the best with the least and all the other criteria that we use to judge between plans. So, the Chair is not

upset at this time that individual Members haven't formed or are willing to come forward with a particular plan.

What the Chair is concerned a little bit about, having been on this Committee and on the Subcommittee at the time that we looked at it previously, more than 20 years ago, I can't recall at any time a Member telling another Member, you cannot come to the table with a particular idea or I won't come to the table to discuss ways in which you can deal with this issue. That is new. That is shocking to this Chairman. It is sad that people would spend the time and energy to get elected to office, the time and energy to get on this Committee, and then say, you have to drop your ideas before you get to hear mine. I have no problem with them bringing their ideas. I have a problem with people telling me I can't bring mine, and that is not to say that my idea may be an idea that is out there. I just don't think you should say that about any idea if you are here to try to solve problems for the American people.

I want to thank all of you. I think it is one of the best panels we have had in a long time, and I say that with no exception, because I don't want someone to sit there and not express how they feel based upon particular subject matter. We need the interaction between all of you very bright and talented people who have, as the gentleman from California said, spent years looking at this subject matter. It is not easy subject matter to deal with. Everybody says it is easier than Medicare. I will simply offer this evidence. We have changed the Medicare law three times, and we are probably going to change it another five. We have not addressed Social Security in more than 20 years. This opportunity, in the Chair's opinion, cannot be missed, even if the changes are at least shoring up to move on to additional discussions as we mature and grow in our knowledge about how we can make changes. More importantly, as we know we have to respond to the aging Americans, the aging society, and the fact that today's seniors, I believe, are far more competent and knowledgeable and understanding than seniors in the thirties, on the ways in which they can assist in taking care of their own lives. The hearing stands adjourned.

[Whereupon, at 3:41 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

Statement of Alex J. Pollock, American Enterprise Institute

Linking ownership of property to liberty in a free society is deeply embedded in the American political philosophy, going back to the ideas of John Locke and the Founding Fathers. Personal Social Security accounts as vehicles for the expansion of ownership of financial assets are very much in keeping with American tradition. Congress should seek to make such accounts a reality.

In the discussions of personal accounts, all proposals so far have begun with diverting cash from Social Security taxes, resulting in a diminution of receipts by the Treasury Department. Could personal accounts be created without diverting tax receipts?

Consider the mandatory savings function of the Social Security system, which currently works as follows: Social Security taxes are collected by the Internal Revenue Service and deposited in the general fund at the Treasury Department, where they are spent on benefits but also on other federal programs. All the cash is spent; nothing is saved. Upon receipt of borrowed or "invested" Social Security funds, the Treasury issues bonds to the Social Security Trust Fund. The bonds represent Treasury liabilities held indirectly for the public.

I suggest creating personal accounts without diverting any cash from payroll taxes. This could be done by changing the current structure in one key respect: the

Treasury could issue bonds directly to personal accounts, bypassing the "middle man" role of the Social Security Trust Fund, thereby creating "your own trust fund."

The personal accounts would thus be created by putting Treasury securities in them, not cash. The current Trust Fund is an unnecessary "middle man" between the citizens and the U.S. Treasury, who are the only actual principals involved. Cutting out this middle man makes the relationship much clearer and more honest, while making the citizens direct owners of top quality retirement assets.

There are perfect Treasury bonds for these accounts: Treasury Inflation Protected Securities (TIPS). Inflation poses the largest threat to retirement savings, and these default-free instruments also fully protect against that threat, thereby minimizing risk.

This should be a purely voluntary program; individuals could elect to remain in the current program or to receive TIPS in their personal accounts instead of future benefit payments of equal economic value. After a certain restricted period, individuals could choose to reinvest their assets in other financial instruments, although I believe a many would simply stay with the TIPS "default option." Ownership through personal accounts would also allow for account holders to bequeath their assets to future generations.

Think how much more meaningful direct ownership of these Treasury bonds in a personal account—in "your own trust fund"—would be for American individuals and families than the obscure operations of the current Trust Fund which few understand. In my opinion, this would be an extremely popular alternative—simple, easy to understand, and attractive. By analogy to the federal employees' thrift plan, it could be thought of as "a G–Fund for everybody."

This proposal would result in greater and more widely distributed ownership of financial assets among American households. It would provide assets with no default risk and no inflation risk, with the ability to pass them on to future generations. It would establish a stronger and more understandable financial relationship between government and citizens, since Treasury securities are much more inviolable contracts than are off-balance sheet future political promises.

Given the opportunity, I believe the majority of Americans would prefer to accumulate inflation-protected retirement assets they actually own. They should be given this choice.

A New Approach to Personal Social Security Accounts: "Your Own Trust Fund"

By transforming Social Security, at least in part, to a program of greater personal property for the average American, voluntary personal accounts would be a key structural reform.

But most current proposals for personal accounts also have serious disadvantages: they are complicated, to many people they are confusing and they require diverting a portion of payroll taxes away from the U.S. Treasury. How can there be effective management for millions of small accounts? Isn't the stock market too risky? Won't many people be confused by being forced to make choices they do not understand? Who can be sure the benefits are worth the costs and risks?

There is, however, a better way to launch Social Security reform using private accounts and inflation-indexed Treasury bonds (or "TIPS"), which will deliver all of the benefits of personal accounts with none of the costs or risks cited by their opponents.

I propose creating personal accounts with an extremely simple and clear financial structure, without diverting any payroll tax receipts away from the U.S. Treasury, and with low cost and efficient operations. The results will be greater ownership of risk-free assets throughout American households, ability for inheritance, clear links between one's own efforts and retirement savings, and complete clarity in the dealings between the government and the citizens. The transition could begin promptly.

The essential proposal is this: Social Security tax payments by individuals and employers, and Social Security tax receipts by the government would remain the same as they are now. No cash would be diverted, and the Treasury would have the same cash receipts from Social Security taxes as it does now. But in exchange, Treasury would not issue bonds to the Social Security trust fund. Instead it would issue bonds—specifically, inflation-indexed bonds or "TIPS"—directly to the personal accounts of the individual citizens themselves, which would become in effect their own personal trust funds. These accounts would not receive cash but would automatically receive the safest possible investment for retirement savings.

This is proposed as a *voluntary* alternative covering the portion of Social Security taxes which represents mandatory savings. Everyone would be given the choice to participate in the proposed personal accounts or stay in the current Social Security

program. It is very probable that a large majority would choose the personal accounts if they are designed as recommended, but this should be a purely voluntary option.

This financial structure transparently shows the real transaction which is taking place between the two real principals involved: the American citizen and the U.S. Treasury Department. It cuts out the unnecessary and confusing "middle man" role of the Social Security trust fund, which in fact is simply a Treasury liability.

The government's total obligations would not increase. Some Treasury debt would shift from being owned by the trust fund on behalf of the citizens to being owned directly by the citizens themselves in their own personal trust fund accounts. The bonds in the personal accounts would represent an increase in Treasury debt owned by the public, but would be issued, like bonds now sent to the government's trust fund, as automatic private placements.

Simplicity

The simplicity of the proposed approach would remove from the current political debates many distracting issues, such as whether we could afford the transition costs, whether personal accounts would be too risky, whether Wall Street would reap a bonanza, and whether operating costs would be too high. It would make unnecessary the proposed delay in implementation until 2009.

It would also remove a central objection made by the opponents of personal accounts: that Social Security must be a moral imperative, an inviolable promise and part of the social contract. Nothing could make Social Security more imperative, inviolable, and a contract than to turn it into a U.S. Treasury bond. Indeed, the only advantage which might be argued for the current Social Security structure over the proposed personal accounts is that the current structure leaves open the possibility for the government to renege on its promises and reduce benefits. This is presumably not an argument that opponents of personal accounts will wish to emphasize.

How much of the current structure should be replaced by the proposed personal accounts? The answer reflects the fact that Social Security has two components: first, a mandatory savings program for retirement and old age, applicable to citizens of all levels of income; and second, a welfare or safety net program providing a minimum retirement income and disability insurance.

The second component by definition requires commingling of funds and should remain as it is. This would include the disability portion of Social Security and the provision of a minimum retirement income for low income households.

The proposed personal accounts apply to the first or mandatory savings component: which is what most Americans think their Social Security payments should be. A meaningful portion, ideally the entirety, of Social Security taxes which represent mandatory savings should have available this personal account option.

The simplicity of the proposed change in the mandatory savings function is easy to see by reviewing the current structure of Social Security and contrasting it with the proposal.

Current Structure for Mandatory Savings

The current Social Security structure handles the mandatory savings function with the following process:

A. Cash from the citizen, both directly from wages and indirectly as employer contributions which could otherwise have been wages, is sent to the government as Social Security taxes.

B. Social Security cash goes to the U.S. Treasury.

C. Treasury spends the cash.

D. Treasury issues a Treasury debt obligation to the Social Security program. This debt is the trust fund. It is part of the total Treasury debt outstanding.

E. The Social Security program has an obligation to pay the citizen benefits later.

Personal Accounts and Diversion of Cash

Under all proposals for personal Social Security accounts so far put forward, some portion of the citizen's cash would not be sent to the government, but deposited instead in an individually owned retirement account.

Numerous political and financial objections have been made to this idea. Objections to current personal accounts proposals include:

1. The lost payroll taxes would take cash away from the Treasury.
2. Assuming that this cash loss would not be offset by increased taxes, the national debt must correspondingly increase.
3. This would require the bond market to absorb large increased sales of Treasury debt, perhaps pressuring domestic and foreign capital markets and result-

ing in upward pressure on interest rates and additional downward pressure on the dollar.

4. The individual accounts would impose difficult and intimidating decisions about how to invest the cash, which many people may not be equipped to make or indeed wish to make.
5. In trying to make these decisions, owners of their own retirement funds may be induced to take excessive risk—to "roll the dice" or "play the slots."
6. Personal accounts call into question the government's commitment to future Social Security benefits, which should be inviolable promises.
7. Supplying mutual funds to millions of small accounts would cause high operating costs.
8. The program would create large windfall profits for Wall Street firms.
9. Investments in personal accounts may not appropriately match the duration of investments with long-term retirement needs.
10. Transition costs mean that implementation needs to be delayed for several years.

The proposed new design for personal accounts addresses every one of these objections.

To achieve the social advantages of personal accounts, and to a significant extent enhance the philosophy of personally owned assets, is a major and highly desirable structural reform in and of itself. However, it also offers the possibility, as discussed below, to address the long run excess of social security benefit expense versus income.

A New Structure for Personal Accounts

In the proposed structure, there would be no diversion of cash from the Treasury. Social Security payroll taxes paid to the government and cash received by the Treasury would stay the same as under the current structure. If voluntarily chosen by the citizen, the portion of these taxes representing mandatory savings would be earmarked for personal accounts. However, these accounts would not receive cash, but automatically receive an appropriate Treasury inflation-indexed security.

The mandatory savings function would thus work as follows:

A. Social Security taxes would be sent to the government, as they are now. Treasury's cash receipts would be the same as they are now. There would be no cash shortfall.
B. Treasury would spend the cash, as it does now.
C. Treasury would issue a Treasury debt obligation, *but to the citizen's personal account, not to the trust fund—thereby creating "your own trust fund."*

That is all. Thus the citizen would have a risk-free investment very well suited for retirement savings: an inflation-indexed Treasury security. Treasury debt owned by the public in personal accounts has increased, but debt owned by the trust fund has decreased. Treasury owes the citizen directly and clearly, rather than indirectly and confusingly through the trust fund "middle man."

Since the savings are now in the form of a directly owned, actual Treasury bond instead of future Social Security benefits, there must of necessity be an equivalent reduction in future benefits to offset the acquired Treasury security. The trust fund does not receive Treasury bonds but by the same taken has reduced future benefit obligations. For the citizen, the replacement of future benefits with actual assets of course applies only on a going-forward basis, as the personal accounts grow. All benefits earned by past Social Security taxes, before the private accounts transition, would remain unchanged.

The proposed structure is quite similar to a historically tried and true long-term savings program: payroll deduction for the purchase of U.S. savings bonds. It is also similar to a very popular option under the Thrift Savings Plan for federal government employees: the "G Fund," which invests solely in U.S. Treasury obligations.

Such analogies, as well as the basic simplicity of the structure, would make it easy for the public to understand. Would most people choose to create their own portfolio of Treasury inflation-indexed bonds rather than hoping for future payments from off-balance-sheet political promises? I think they would.

Relation to Future Benefits

If the economic value of the bonds acquired in the personal accounts is exactly equal to the economic value of the reduction in future off-balance-sheet future benefit promises, we would have created the many advantages of ownership, but the aggregate Social Security fiscal deficit would remain unchanged. However, this trade-off could be given a progressive structure, analogous to recent proposals for

progressive changes to Social Security indexation formulas, for high-income households.

In other words, for the majority of households the TIPS exchange ratio would be 1 to 1, but for high income households it could be greater than 1 to 1. Since many of these households believe that in any case, their Social Security taxes will inevitably increase or their future benefits be reduced, or both, the trade in exchange for achieving personal accounts could be viewed as advantageous. The transition to personal accounts would then reduce the Social Security deficit in addition to its other attractions.

The Specific Treasury Bond

The perfect candidate for which Treasury obligations should be issued to the personal Social Security accounts is clear: Treasury Inflation Protected Securities (TIPS). TIPS by definition preserve purchasing power against inflation, the single greatest risk and an essential consideration for retirement savings.

The TIPS would be issued in automatic private placements for each personal account. Because all the TIPS involved will be book-entry securities in fully automated form, small accounts and small amounts could be easily handled, and operating costs will be low.

Suggestions for how the details of this would work follow. Details could obviously vary around the essential structure.

The TIPS should have maturities based on the individual's expected retirement date. For example, a twenty-five-year-old with an expected retirement age of sixty-five might in the first instance receive a forty-year TIPS. Note that it is proposed to consider creating long-term TIPS to match the needs of retirement savings. All interest and inflation adjustments should simply accrue, as with typical savings bonds, so there is no problem of investing small amounts of cash. Laddering maturities as discussed below would result in a sensible pattern of cash flow during retirement.

The average real return of government bonds (i.e. the yield net of inflation) in the long term is approximately 3 percent. The long-term TIPS to be privately placed in the personal accounts with a restricted period could have a real yield of about this same 3 percent. In an average inflation of 2 or 3 percent, for example, this would result in a compound annual return of 5 or 6 percent, respectively. A 3 percent real yield would match the real 3-percent discount rate often used in calculations of the value of future Social Security benefits.

For ownership to be effective, the TIPS received in the personal accounts must be negotiable securities. However, it would make sense to have a period after each private placement during which sale would be restricted. After that, the citizen would be entirely free to sell in order to make other eligible investments, if desired, provided of course that all proceeds and investments must stay in the retirement account until qualified for withdrawal.

The appropriate length of the restricted period before the privately placed TIPS would become negotiable must be defined. A starting suggestion would be five years, to insure a smooth transition, while also allowing the future addition of private asset categories.

The maturities of the TIPS should be based on expected retirement age but should not all mature at that date, which would cause a difficult decision point and large reinvestment risk. The idea of buying an annuity upon retirement does not address this problem, since if at that time interest rates are low, annuities will be unattractive to purchase—not to mention the need to address the credit risk of the annuity writer. A preferable approach would be to automatically ladder the maturities of the TIPS in the personal accounts to spread cash receipts from maturing bonds over the retirement years. Recall in this context that the safety net component of Social Security would also continue to function.

Individuals who choose to continue working past retirement age would continue to accumulate assets in their personal accounts. This would provide an incentive to reduce the extended period of retirement which is a central cause of Social Security's fiscal deficit without having to mandate changes in retirement age that would naturally be inappropriate in many individual cases.

In sum, the personal accounts would represent a voluntary way to hold mandatory savings. Continuing to hold the TIPS past their restricted period would also be voluntary.

But *no* investment decisions or risks would be forced upon the citizen. Especially considering those who might feel confused or intimidated, no action would be required to have a very sensible and safe investment, with zero credit risk and guaranteed inflation protection, very suitable for retirement savings, automatically pro-

vided. This means that there is a robust "default case," an important element in a system of choices.

A safe prediction is that a significant proportion of these securities would never be sold, but would be held to maturity. There would be no rush and no pressure on the individual to have to do anything, unlike the case of having to invest cash. In addition, the restricted period should comfort any observers who might fear the possibility, however unlikely, of a large initial outflow of TIPS into the market.

Benefits for an Ordinary Couple

Suppose an ordinary couple signed up for the personal account option when they were both twenty-five years old, with a household income of $50,000 per year. What might their personal account retirement assets look like at age sixty-five, assuming the "default case" of simply holding their TIPS?

As an example, assume the real yield on TIPS is 3 percent, average inflation of 2.5 percent, real wage increases of 1.5 percent, and half the Social Security tax represents mandatory savings devoted to personal accounts. At age sixty-five they would own investments totaling over $800,000. If they worked to age seventy in line with their greater expected longevity and health, the personal account investments would total $1.15 million.

Now suppose two-thirds of the Social Security tax represents mandatory savings which generate TIPS for the personal account. At sixty-five, the investments would be more than $1 million; and at age seventy, more than $1.5 million.

These would be real assets, really owned by ordinary Americans.

Conclusion

The proposed approach would lead to personal Social Security accounts as a key transition and structural reform. It addresses all of the objections to private accounts, as follows:

1. There would be no cash shortfall to the Treasury.
2. There would be no increase in the total national obligations. Treasury debt owned by the public would increase, but Treasury debt owned by the "trust fund" would decrease. Off-balance-sheet future benefit liabilities would also decrease. If the suggested progressive structure were adopted, future liabilities would decrease by more than the value of the TIPS issued, thus reducing the Social Security deficit.
3. There would be no need to market more Treasury debt—the bonds involved would automatically be privately placed in the personal accounts.
4. No difficult choices would be imposed on individuals—if they do nothing, a very safe and appropriate retirement investment is automatically provided. The default case is robust.
5. There is no pressure to take risk or "roll the dice." *TIPS are the exact opposite of the rolling dice.* In particular, they directly address the biggest risk to retirement savings, namely inflation.
6. The best way to make the promises of the government truly inviolable is to make them into an explicit Treasury bond.
7. The use of TIPS would allow a low cost, efficient book entry system.
8. With investments automatically provided, there is no windfall for Wall Street, and small accounts can be handled efficiently.
9. Appropriate long-term investments matched to retirement needs are automatically provided.
10. The proposal would allow prompt implementation of personal accounts.

Moreover, the idea is simple and easy to understand. As a voluntary alternative to build personal ownership of long-term savings, I believe having "your own trust fund" would be readily chosen by a majority of Americans.

Submission of Eva Hain, California Retired Teachers Association, Sacramento, California

Chairman Thomas and members of the Committee, my name is Eva Hain and I am president of the California Retired Teachers Association. We are a non-profit organization with 53,000 members, and we represent the interests of the 170,000 retirees who receive a pension from the California State Teachers Retirement System (CalSTRS). I want to thank you for convening these hearings on alternatives to strengthening Social Security, America's fundamental safety net for retirees.

We believe that a basic premise of strengthening Social Security is to keep faith with its promise of ensuring that older Americans do not fall into poverty at the end of their working lives.

The CalSTRS system is not integrated with Social Security, so many of our members are victims of the Windfall Elimination Provision and the Government Pension Offset. These two penalties remove that financial safety net and we find our members suffering from unexpected income losses late in life. Many women are plunged into poverty when their husbands die and they are denied any survivor's benefits from Social Security due to the Government Pension Offset. Other teachers find their summer work, when they typically paid into Social Security in order to support their families during the school-year break, is discounted in retirement when they receive thousands of dollars less than they would have if they had not been teachers.

The underlying assumption seems to be that teachers have their own pension and that should protect them from poverty. The sad truth is otherwise. CalSTRS conducted analyses in 1998 and 2005 on the adequacy of the pension benefit they provide, and in both instances found many lagging behind the amount of income they need to maintain an adequate lifestyle in retirement. Even with long years of teaching service, California educators who retired before 1998 were only able to replace about 58 percent of their income—far below what experts consider to be adequate. The typical female retiree receives less than $2,000 a month from her teacher's pension, hardly sufficient in a high-cost state like California. Unlike Social Security, which provides full cost-of-living increases annually, teachers' pensions in California are only protected at 80 percent of their original purchasing power.

In addition, many of our members only found out about the WEP and GPO when they filed for their benefits. By then, it was too late to make alternative financial plans to ensure a secure retirement. Worse, many others mistakenly receive benefits for years and then are forced to pay back all money received—in one instance more than $40,000. In most instances, these people relied in good faith on estimates of benefits provided by the Social Security Administration itself. The Social Security Administration itself has admitted that it overpays upwards of $335 million a year in mistaken benefits. If Social Security doesn't know who is affected by these penalties, how can we expect that those subject to them will understand them?

Beyond the policy itself, you have to understand the personal financial suffering many people have endured because of these penalties. We have collected many, many such stories from our members and I want to share some of those with you today.

Ruth Benjamin of San Diego had planned on Social Security payments of approximately $800 per month when she retired, because that is what the Social Security Administration told her to expect. Instead, due to the GPO, she receives only $216 per month plus a teacher's pension of about $700 per month. Her husband is a retired New York City Police Department officer, who receives a police pension of approximately $1,500 per month plus a Social Security benefit of $1,000 per month. In their retirement planning, they opted to take a higher police pension without survivor's benefits because they believed Ruth would be adequately provided for with her teacher's pension and Social Security. Now, if she becomes a widow, she will have to survive on income of less than $1,000 per month due to these penalties.

Wanda Moore of Fresno was married for 38 years to her husband, a barber. He paid into Social Security for 40 years and died before collecting any benefit. She was initially told she would receive a survivor's benefit of $496 per month from Social Security before that payment was eliminated under the GPO because of her teacher's pension.

Carol Huntsman of San Diego began her teaching career at age 36 and was only able to teach for 20 years before retiring in 1996 with a monthly pension of $700. The twenty previous years she had worked in Social Security-covered employment was reduced in value by 60 percent, or $223 per month under the WEP. Fortunately in 2000 her teachers' pension was increased under a law that provided minimum pensions to teachers with 20 years or more of service.

Georgia Beno of Santa Ana taught for 32 years before she retired in 1989. She receives a pension of about $2,100 a month now. But she lost $900 a month income from Social Security when her husband died in 1999 and she was told she was ineligible for a survivor's benefit. Since then, her health insurance and rent and other expenses continue to increase. She hasn't taken a vacation in four years, digs into her savings each month to meet expenses and still has to rely on her family to help pay her bills.

Claire M. Koronkiewicz of Palm Springs taught for 30 years in California before retiring in 1986. Today she receives a teacher's pension of about $1,800 per month, after taxes. Her husband, a Purple Heart veteran of General Patton's 3rd Army, had

a modest income as a worker in the floral industry in Los Angeles for 30 years. He died at age 65 after receiving three years of Social Security benefits. Claire was told she was eligible for $374 per month in survivor's benefits—before that was eliminated under the GPO. Since then, she has had to sell her home because it was too expensive to maintain and has dipped into her savings earlier than planned to meet her living expenses.

Marylyn McInnes of Visalia taught for 31 years before retiring in 1998. Her husband owned his own carpet cleaning business for 15 years and, as a self-employed individual, paid both the employee and employer shares of the Social Security tax. He received Social Security for 2 years before he died. When Marylyn applied for her widow's benefit, she was told she did not qualify because of her teacher's pension and she lost $400 a month in income.

Elbert Bade of San Diego had a 20-year career in the U.S. Air Force. When he retired from the Air Force, he had a choice of a second career as a teacher or in the aerospace industry. Unaware of the GPO and WEP, he figured his future retirement income—assuming money from a teacher's pension and Social Security—and determined that he could afford to become a teacher. He taught for 23 years and retired in 1997. When he applied for Social Security, he was informed of the penalties and saw his retirement income reduced by $8,400 a year. "Teaching's a great career and very satisfying but no one tells you they're going to jerk your Social Security because you were a teacher," he told us.

What all of these people have in common is that they worked hard at public service jobs all of their lives. They raised families and took care of themselves. They recognized they wouldn't receive a full Social Security benefit, but they believed they would receive what they had earned and been promised.

There is yet another unintended consequence of these penalties. California, like many states, faces severe teacher shortages in the years ahead—an estimated 100,000 new teachers will be needed in the next 10 years just to replace retirees; more will be needed to accommodate our growing population. Many of our best teachers come from other professions. Typically they are unaware that they are giving up significant Social Security benefits in retirement to make a switch to public service, often at a lower salary than they were receiving from their first career. An estimated 50,000 current teachers fit this profile, and will retire with 20 years of less teaching service. That means a substantially smaller teachers' pension and a significant loss of Social Security income. They willingly make the sacrifice in salary during their working life; they are forced to sacrifice in retirement.

We recognize that there are financial challenges facing Social Security, if not a crisis. We appreciate, however, that growing numbers of Congressional Representatives understand that these penalties have not had the intended effect, that they penalize hard-working people of modest means. I would note that 251 Congressional Representatives have already signed on to HR 147, which would repeal these penalties. Any reform of the Social Security system must restore its foundation in fairness. On behalf of the California Retired Teachers Association, I would say that you can do no less.

Thank you.

The California Retired Teachers Association, founded in 1929, is the state's largest organization dedicated to protecting the interests of retired educators who receive pensions from the California State Teachers Retirement System.

Statement of Joyce R. Elia, Mission Viejo, California

Thank you for giving me this opportunity to write to you.

As the Committee reviews the multitude of issues associated with Social Security, I ask members to consider correcting a "fix" that was initiated in 1983, and, to also not make similar mistakes this time around (such as privatization which will line the pockets of Wall Street and cost billions of dollars to implement). Congress has made the same mistake as many corporations recently in the news—they have "spent" the hard-earned pension funds of workers during the stock market's heyday and have now been "caught short". Workers in this country have had enough of the corporate greed and fiscal irresponsibility of government. We are tired of "paying" for everyone's mistakes, while the corporate CEOs continue to live the "good life" with no understanding, and with a complete lack of conscience, of how the "real" people in this country live.

The private sector continues to follow the government's lead in cheating employees out of their retirement benefits (United Airlines, possibly General Motors, to

name a few), with the government's blessing. At the same time, like Congress, the retirements for the "chosen few" are preserved. The hardworking, tax-paying individuals of this country deserve better and we expect you to act responsibly. President Bush espouses a Christian ethic. There is absolutely nothing "Christian" about defrauding American workers with high taxes and erosion of their pensions.

As a current government (court) employee and former private sector employee, I am seeking your support of HR 147, "Social Security Fairness Act," to eliminate the Government Pension Offset (GPO) and Windfall Elimination Provision (WEP) to Social Security. This legislation was enacted in 1983, during a period when Congress was looking for ways to reduce the cost of Social Security. Their decision to place that burden on the backs of government workers and teachers has created a fraudulent and discriminatory solution which wrecks financial havoc on the lives of affected individuals.

The GPO and WEP will greatly affect mine and millions of other Americans' ability to collect the full Social Security benefits that they have earned and to which they are entitled. This is a non-partisan issue that transcends politics and affects voters of all parties.

Three years ago, a co-worker returned from her "retirement planning session" crestfallen to learn that the small pension which she had earned working for the Orange County Superior Court was going to dramatically impact the receipt of her earned (as well as her ability to collect her husband's earned) social security benefits. Her situation will become worse, should her spouse predecease her. She will not be eligible for **any** spousal benefits, which he worked a lifetime to earn in his effort to provide for his wife. At the time, *I was totally unaware of these two laws and their impacts*. I had worked in the private sector for many years before "retiring" to raise a family.

When I returned to the workforce in 1994, to work as a Senior Administrative Assistant to the CEO of the South Orange County Municipal Court (unified to Superior Court in 1998), *I was not informed by the County/Court* that paying into the County retirement system would negatively impact my ability to collect mine and/or my husband's hard-earned Social Security benefits. The County retirement plan is predominantly self-funded by employees, with only a small portion of the contribution coming from LOCAL (not Federal) taxes. I erroneously assumed that any pension I earned would *supplement* my earned Social Security benefits. These laws force me to either leave my job, friends and an important part of my life prior to ten years of service (vesting) or relinquish my own and my spousal rights to Social Security. It punishes me for doing what the government told me to do—plan for the future. (I would have been better off staying at home and letting the government subsidize me.) The outcome is discriminatory and dishonest, as well as disheartening, to a loyal hard-working employee.

The laws are arbitrary and selective—being particularly discriminatory to women. Women receive only half the average pension benefits received by men and these laws further reduce that small sum.

Please preserve teachers' and government workers' retirement benefits that they have paid for and deserve by passing HR147, which will repeal legislation which in actuality is **"legalized fraud,"** (i.e., the government has taken, or in many cases, continues to take monies via social security taxation, which it has no intention of returning by way of future benefits). Numerous teachers and public workers (many of whom are single Moms), have part-time employment to make ends meet. From those private-sector checks, social security is being deducted—when under current laws, that money will never be returned. If private companies acted in such a manner, they would be charged with FRAUD.

I have included a briefing paper which expands on the legislation's impacts.

I urge Congress' support and passage of this important legislation. I also urge Congress to look into other areas for savings: reduction/restructuring of Congressional retirement benefits; reduction in foreign national benefits, fairer taxation, to name but a few.

I do not support private accounts OR melding government/teacher pensions into Social Security. This practice would place yet another undue burden on this class of individuals. Their pensions should be treated in the same manner as private sector retirement plans—separate and apart from Social Security.

Additionally, Congress makes it increasingly difficult for individuals and families to save for their retirement, especially when the *interest* on SAVINGS accounts are taxed.

Boise, Idaho 83706
May 4, 2005

Members of the House Ways and Means Committee

I am extremely concerned about the future solvency of the Federal Old-Age and Survivors Insurance and Disability programs. I applaud President Bush for focusing attention on this important problem. I do not support his effort to change Social Security from a defined benefit program to a defined contribution program. Private accounts carved out of Social Security will only make the program's future insolvency worse.

I was born in 1955 in north Idaho, where my father was an independent logger. He was killed in a logging accident when I was four years old. If it hadn't been for OASDI benefits, I don't know how my family would have survived. The benefits were small, but my mother was able make every penny count. I didn't realize until I was much older just how little income we had, or how poor we were. My mother had lived through the stock market crash, the Depression and WWII—so 'frugal' was her middle name, and she taught me well. I strongly believe in individual responsibility, personal financial planning and saving for your own future. But life is not an even playing field; many events outside of an individual's control present barriers to adequately providing for your own future financial well being. We must retain the Social Security safety net's ability to help keep people who have experienced hardships out of poverty.

Because I have personal experience and know the value of OASDI benefits, I have read widely about numerous proposals to 'reform' Social Security, from many different sources, including the Social Security Board's 2004 report, the Cato Institute, Reuters, NCPERS, I follow the daily happenings through many media sources, and I. These are my thoughts concerning a sound proposal to reform SS, I hope you will incorporate them into any legislation that Congress writes:

1. Immediately end the practice of using surplus OASDI revenues to fund other government programs.
2. Immediately end the practice of purchasing apparently worthless U.S. Treasury bonds with the surplus OASDI revenues. I call the bonds 'apparently worthless' since it seems the federal government does not intend to take the actions necessary to honor the obligation to pay back the 'IOUs' when they come due.
3. Immediately begin investing the surplus OASDI revenues in low-risk equity markets to gain a higher rate of return than with U.S. Treasury bonds, but without the risks being placed on workers.
4. Raise, or better yet, eliminate the payroll cap on which SS payroll taxes are paid.
5. NO 'personal accounts' carved out of the current SS system. 402(k)s, IRAs, etc., are readily available not to everyone—make it easier if not mandatory that employers make options available for workers to contribute to retirement saving plans through payroll deduction outside of the Social Security system, and automatic that workers contribute—they would have to deliberately opt out.

OASDI is not a retirement investment program, it is a social insurance program designed to reduce poverty among those most at risk—a safety net for older people and people with disabilities who do not work, cannot work, or cannot earn enough to sustain their independence and autonomy, and the surviving family members of workers who have died. Our country cannot turn its back on these citizens.

I thank the Ways and Means Committee for this opportunity to give you my views. I ask Congress to do its job; thoughtfully, timely, and in a bipartisan way. Please, do what is right for all of our citizens. Preserve the Social Security safety net.

Sincerely,

Yvonna S. Englesby

Statement of Don Fronek, Toney, Alabama

Social Security Comments:

I am 67 and currently receiving Social Security Benefits after 40 + years as an Electrical Engineer and college professor. I have long followed the progress of the

Social Security system. I too, agree that the system needs to be changed so that others in the future may have a retirement benefit.

The current system takes in payroll money, pays out benefits, and deposits the remainder of the payroll money (called the Social Security Surplus) into the U.S. Treasury General Fund. The Social Security surplus money is spent immediately by the Federal Government and an equivalent dollar amount IOU is given to the Social Security Trust fund. When the time comes to pay back these IOU's, the Federal Government has no money set aside to do this. The first question immediately comes to mind, "why allow the Federal Government to spend the Social Security Trust Fund?" If this were not done, Social Security would be able to pay benefits longer. By investing the Social Security Trust fund in non-Government securities, the fund would last even longer.

So, it is obvious to me that stopping the Federal Government from spending the Social Security Surplus (Trust Fund moneys) would be the first step in solving the many financial problems that will occur for the Social Security entitlement program in the future years. My question is "why hasn't this happen long before now".

Statement of Cecile M. Galvin, Laguna Niguel, California

Thank you for giving me this opportunity to write to you.

Workers in this country have had enough of the corporate greed and fiscal irresponsibility of government. We are tired of "paying" for everyone's mistakes, while the corporate CEO's continue to live the "good life" with no understanding, and with a complete lack of conscience, of how the "real" people in this country live.

The private sector continues to follow the government's lead in cheating employees out of their retirement benefits. The hardworking, tax-paying individuals of this country deserve better and we expect you to act responsibly. They are defrauding American workers with high taxes and erosion of their pensions.

As a current government (court) employee and former private sector employee, I am writing to enlist your support of S-349, "Social Security Fairness Act," to eliminate the Government Pension Offset (GPO) and Windfall Elimination Provision (WEP) to Social Security.

These are penalizing social security laws that were passed some years ago. I will be affected by these laws twofold. First, I have been a judicial secretary in the court system for almost 22 years. Prior to these years, I worked as a secretary and paid into social security and am eligible to receive social security benefits. Why? because I *earned* them. Had I known that I would lose two thirds of my SS when I applied for a position with the Orange County Municipal Court, I would not have applied. This was never communicated to us in writing or otherwise.

When I married in 1957, as a wife of a brand new Ensign in the U.S. Navy I did not work. Most wives did not work at that time because of our life long commitment to our marriage and the anticipation of having children. By 1965, we were the proud parents of six children. It took every ounce of our income and loans to raise them and put them through private schools and private universities and we would not have it otherwise. Today, because of our ultimate sacrifice, we do not own a home, we do not have any savings and we live from month to month. This is our life and I will continue to work because my paycheck is not enough to cover our expenses and we are both in our 70's. Since I am still working, I am collecting S.S. and we need every bit of that along with my paycheck to make ends meet.

I am now faced with a dismal future with regards to my retirement since I turned 71 on August 17, 2004. Secondly, when I retire, why should I lose my husband's portion of SS if he qualified for it? Thirdly, if he should die before me, I would get nothing. How is that just? Would you leave your wife in the same predicament? How about your mother? Working wives should have the same rights to a spouse's *full* benefits as non-working wives. That is only right

This is not double dipping for us; it is double dipping for the U.S. Government which puts us in the poverty arena and so I will have to continue working until my demise or until I am unable. I would like your views on this topic. Have they approached you regarding these specific laws? This is a non-partisan issue and goes beyond politics because everyone has a relative, relatives or friends that will retire some day. What will you say to public employees and teachers when they find out that they are no longer entitled to the benefits of the SS system that they paid into?

Hopefully, I will be guaranteed the retirement benefits paid for and deserved. I urge Congress' support and passage of this important legislation.

Thank you very much for your attention to this matter that so greatly affects the quality of life for seniors in this country.

Social Security should be fixed—not broken.

Statement of Francis L. Gould, Vista, California

Thank you for giving me this opportunity to write to you.

I am a veteran, having served in the United States Marine Corps for 22 years with tours in Vietnam and participation in numerous combat operations.

However, my Social Security benefits are offset because of my military service and will be further offset because I work for the State of California in a judicial capacity. So I personally take a double offset from monies promised and earned legitimately under my participation in Social Security.

Further, my wife will have her Social Security entitlement, through me, reduced because of my double offset.

I wish to remind you of the millions of citizens who legitimately earned Social Security credits and are entitled to full faith and credit of our expectations.

The private sector continues to follow the government's lead in cheating employees out of their retirement benefits (United Airlines, possibly General Motors, to name a few), with the government's blessing. At the same time, like Congress, the retirements for the "chosen few" are preserved. The hardworking, tax-paying individuals of this country deserve better and we expect you to act responsibly. President Bush espouses a Christian ethic. There is absolutely nothing "Christian" about defrauding American workers with high taxes and erosion of their pensions.

As the program is now administered, we have been duped. In effect the government has committed legal fraud in inducing us to participate in this program and is now committing on an on-going basis, grand theft, in taking it from us.

National Association of Disability Examiners
Lansing, Michigan 48911
May 25, 2005

The Honorable Bill Thomas, Chairman
Committee on Ways and Means
United States House of Representatives
2208 Rayburn House Office Building
Washington, DC

Dear Mr. Thomas:

On behalf of the National Association of Disability Examiners (NADE), I want to thank you and the members of your committee for your work in investigating alternatives to strengthen Social Security. This is indeed a topic that has captured the attention of our organization and the American public.

NADE is a professional association whose mission is to advance the art and science of disability evaluation. The majority of our members work in the State Disability Determination Service (DDS) agencies and are responsible for the adjudication of claims for Social Security and Supplemental Security Income (SSI) disability benefits. Our members are very interested in what the future holds for the Social Security Disability Insurance (DI) program—both for its professionals and for its beneficiaries.

We have read with interest the testimony provided at the hearing before your committee on May 12, 2005. While there was some limited discussion regarding the Social Security disability program, we were concerned that this critical program did not receive broader consideration.

Social Security is absolutely vital to millions of Americans and the need to strengthen and preserve it for future generations has been widely discussed. However, while people with disabilities have a major stake in the Social Security reform debate, in much of the public discussion and analysis of the issue very little has been mentioned about how they, and their family members receiving auxiliary benefits, will be affected.

With the passage of the Americans with Disabilities Act, our government made a commitment to people with disabilities. That commitment must continue to be

honored by giving very careful consideration to how changes in Social Security's funding or benefit structure will impact the disability program and the beneficiaries who depend on it.

We commend your ongoing efforts to provide a thorough analysis of the myriad of challenges that confront the Social Security program. One of these challenges is to strengthen Social Security, while protecting people with disabilities. Our organization looks forward to working with you in that quest.

Sincerely,

Martha A. Marshall
President

Statement of Barbara Kennelly, National Committee to Preserve Social Security and Medicare

Chairman Thomas, Ranking Member Rangel, and Members of the Committee:

The National Committee to Preserve Social Security and Medicare represents over 4 million members and supporters who are united in their opposition to the privatization of Social Security. The members of the National Committee understand better than anyone the importance of Social Security. Every day, over 47 million Americans—one out of every four households—experience the success of Social Security firsthand. This great program is the single largest source of retirement income in the United States, and each year it keeps 12 million seniors out of poverty. Social Security, unlike virtually any other retirement vehicle, provides a sound, basic income that is adjusted for inflation and that lasts as long as you live.

The members of the National Committee are seniors who have long experience with the unpredictability of life. They understand the true value of Social Security not just for themselves, but for younger Americans as well. In fact, older Americans see Social Security as part of their legacy to their children and grandchildren.

National Committee members fervently believe in Social Security. They have experienced firsthand the "hazards and vicissitudes" of life and believe in a collective societal sharing of risk to guard against them. They also truly believe carving private accounts out of Social Security will ultimately result in the dismantling of Social Security as we know it. At a press conference on April 28, President Bush reaffirmed his determination to carve private accounts out of Social Security, placing American's retirement security at risk while passing along trillions of dollars of additional debt to our children and grandchildren.

At the same time, President Bush announced his support for a plan to cut Social Security benefits for middle and higher-income Americans. The plan would make substantial cuts in benefits for over 70 percent of future retirees. All workers earning more than a modest $20,000 a year today would see significant reductions in their Social Security checks. A worker who earns about $37,000 today—hardly a royal sum—would suffer a 28 percent benefit cut. A person who earned $60,000 would experience a reduction of over 40 percent. Ultimately, Social Security would be converted from a broad-based retirement income security plan into a retirement plan solely for the poor. Hard-working, middle-class Americans would be the big losers.

In addition to targeting middle-class Americans, the President is insisting on his plan for private accounts. Such accounts not only do nothing to improve Social Security's solvency, but, by diverting payroll taxes out of Social Security, private accounts actually accelerate insolvency. Diverting 4 percentage points of payroll taxes into private accounts, as the President has recommended, would drain the Trust Fund so quickly that the program would face a cash-flow problem in 2011 rather than 2017 as under current law. Moreover, the Trust Fund would become unable to pay full benefits by 2030, a decade earlier than if no payroll taxes had been diverted into private accounts.

The creation of private accounts requires a massive infusion of funding spanning multiple generations. These costs are often obscured but are unavoidable in such a vast systemic change. Today, Social Security is a pay-as-you-go program, which means the payroll taxes paid by today's workers go to pay the benefits of today's retirees. Under privatization, however, today's workers must also fund their own accounts.

The result of privatization is that generations of workers end up paying twice—once to pay the benefits that have already been earned by current retirees, and then again to fund their own benefits, whether through borrowing, tax increases, cuts in future benefits, or some combination. A study conducted for the National Committee

in 1997 concluded that every single generation living at the time of privatization would end up worse off financially than if nothing at all had been done to strengthen Social Security. More recent projections by other organizations, including the Congressional Budget Office, have reached similar conclusions.

The non-partisan Center on Budget and Policy Priorities has estimated that President Bush's private account proposal would cost an additional $5 trillion in new borrowing in the first 20 years alone. Our current public debt—which is the accumulation of all our nation's borrowing until this point in history—stands at $4.5 trillion. This single proposal, therefore, would double the debt we have accumulated throughout this nation's history in only two decades and require trillions of dollars of additional borrowing in future years. This ten trillion dollars in federal borrowing comes to $34,000 of debt for every man, woman and child in America. A child born today would still be repaying the debt well into middle age.

The impact of trillions of dollars in additional borrowing on financial markets is unclear, with miscalculation potentially resulting in catastrophic consequences. Acceptance of the additional borrowing requires lenders to rely on assurances by current legislators that their successors 50 years in the future will follow through on the dramatic benefit cuts privatization plans will require.

The magnitude of the cost of private accounts is so great that the dramatically larger borrowing must be accompanied by cuts in benefits. These cuts reduce benefits above and beyond any changes needed to restore Social Security's solvency. Thus, the President's private account plan not only imposes substantial middle-class benefit cuts and massive new borrowing, it subjects those people who opt for private accounts to a "retirement tax" in the form of additional reductions in their benefits. For every dollar a person transfers into his private account, he must pay back that dollar upon retirement out of his Social Security benefit—plus 3 percent interest *above inflation*, regardless of the actual balance in his account. Even a low-inflation environment like today's still generates about 3 percent inflation, so in order to come out ahead, accounts today would have to earn over 6 percent. Economists project that over time, this so-called "clawback" or "offset" of benefits will reduce the Social Security benefit by almost half. When the two types of benefit cuts required by the President's plan are combined, they effectively phase-out Social Security benefits for all but the lowest-income workers over time.

To paraphrase Arthur Levitt, former Chairman of the SEC, from a recent editorial:

"*Borrowing against one's Social Security to invest in the markets is a risky strategy that would only make sense for certain high net-worth investors who can afford to lose their entire investment. For the majority of workers who make less than $50,000 a year, private accounts are not a good investment not just because the odds of coming out behind are high, but also because* THESE INVESTORS VERY LIKELY MAY HAVE NOTHING TO FALL BACK ON IF THEY LOSE THAT MONEY."

Privatization places the risks of achieving an adequate retirement income entirely on the individual. However, markets go up and markets go down, and woe to the person who must retire in a declining market. Any system based on private accounts will necessarily place a tremendous burden of "market timing" on future retirees. Looking at markets that are averaged out over the long-term masks the dramatic fluctuations accounts experience on a daily basis. Moreover, requiring a person to annuitize his or her private account balances adds another unpredictable variable—interest rates at the time of annuitization—to an already complex calculation. As a result, workers with exactly the same salary histories would inevitably be subject to dramatically different incomes from their private accounts based entirely on their date of retirement.

The last issue I would bring to the Committee's attention is the impact of private accounts on current retirees. Many proponents of private accounts seem to believe that seniors are mostly motivated by self-interest, and, if they can simply be convinced that their own checks are not at risk, they would sit this battle out.

In my conversations with seniors, I find two schools of thought. First, there are a number of seniors who do not believe the Administration's assurances that they would not be impacted by private accounts. These seniors look at the long-term impact of the required borrowing and reach the conclusion that even if they are "held harmless" initially, carrying that amount of debt simply is not sustainable over time. They believe that, once budgetary pressures build high enough, budget cutters will necessarily look for deeper cuts in programs such as Social Security, Medicare and Medicaid. The current budget debate in Congress only serves to confirm their suspicions. Few seniors have other sources of income, so any reductions in these programs would have a dramatic impact on them.

But even those who believe they will be protected are not heading for the sidelines. That is because they truly believe in Social Security—in its guaranteed bene-

fits, in its progressivity, in its insurance elements. And they believe in Social Security so passionately, they want to preserve it for their children and grandchildren. I have seen this passion to protect Social Security at every town hall meeting in which I have participated. Senior's opposition to privatization is not dissipating—if anything, it is growing stronger.

Private accounts that replace Social Security's guaranteed benefits do not supplement Social Security, they undermine it. The more people realize the trade-offs required to restructure Social Security—the additional risk, the substantial middle-class benefits cuts, and the massive new federal borrowing—the more their support for privatization drops. Through their opposition, the American people are stating loudly and clearly that they prefer to strengthen the current system rather than entrusting their retirement security to the uncertainties of the investment markets. Because of this, Congress should renounce replacing guaranteed Social Security benefits with risky investment accounts, burdening middle-class Americans with major cuts in Social Security benefits, and saddling all Americans with massive new federal debt.

Statement of the National Education Association

Chairman Thomas and Members of the Committee:

The National Education Association (NEA) respectfully submits the following comments for inclusion in the record of the Ways and Means Committee hearing on Social Security privatization.

NEA represents 2.7 million educators working in America's public schools. Many of our members, along with millions of other public employees, rely on Social Security to help ensure a secure retirement. Teachers and education support professionals, like the majority of middle class Americans, rely on Social Security for their future. Educators are particularly vulnerable in their retirement security, both because of their comparatively low salaries and increasing attacks on their pension plans.

Social Security is more than a retirement plan. It is our nation's most successful social insurance program. Proposals to privatize the system have thus far ignored the impacts on children who receive survivor benefits and persons with disabilities who rely on Social Security to survive. The impacts on these most vulnerable populations cannot be ignored.

NEA has three priorities for any Social Security legislation moving through Congress:

- Opposing any efforts to privatize Social Security;
- Ensuring that public employees who are enrolled in and have paid into other retirement security plans are not mandated to participate in Social Security; and
- Repealing unfair offsets—the Government Pension Offset and Windfall Elimination Provision—that deny earned Social Security benefits to many public employees.

THE CASE AGAINST PRIVATIZATION

NEA strongly opposes any privatization of Social Security. Social Security is the cornerstone of the social safety net for America's retired workers and should not be subject to risky, unproven schemes. Privatization carries great risk and will jeopardize the secure retirement of many Americans.

Private Accounts Lack the Important Social Insurance Properties of Social Security

Social Security adjusts for inflation; is guaranteed to last an entire lifetime, no matter how long; is shielded from stock market losses; and is payable to multiple beneficiaries across generations (e.g., to surviving family members for their lifetime). Private accounts and defined contribution pension plans have none of these protections. Workers investing in private accounts will assume responsibility for the risks that are currently covered by Social Security protections. This could lead to many retired employees needing extra support in their elderly years—a time when they should live with a sense of peace and security.

Private Accounts Would Turn Social Security into an "Individual Insecurity" Program

Rather than just shifting "ownership" of retirement assets from the government to workers, Social Security privatization shifts an inordinate amount of risk away from the government and onto American workers. The United States' experience with defined contribution pensions and 401(k) plans shows that many people fail to understand even the most basic aspects of investment and that many make bad investment decisions (e.g., failing to diversity their investments). Unfortunately, many people simply do not have adequate financial experience, training, or time to do a good job managing their own accounts.

THE IMPACT OF PRIVITIZATION

Impact on Women

Women comprise over three-quarters of NEA's membership. Therefore, NEA has a particular concern about the impact of Social Security privatization on women. Women traditionally have lower lifetime earnings than their male counterparts, and women in the education profession face comparatively lower salaries than many other professionals.

Although privatization proposals say that participation in private accounts would be voluntary, the benefit cuts in the plan would be mandatory for everyone. These cuts would be devastating for women, who rely more on Social Security than men do. Nationally, 20 percent of adults receive Social Security benefits, including 22 percent of women and 18 percent of men. About 24 million women, 18 million men, and 3 million children rely on Social Security benefits. Women comprise 58 percent of all Social Security beneficiaries aged 65 and older.

According to the National Women's Law Center, without Social Security, more than half of women over 65 would be poor. Social Security helps level the playing field for women, who on average earn less then men and have fewer years in the workforce. In contrast, privatization would provide benefits based only on worker contributions, disproportionately penalizing women for time spent out of the workforce for childcare and care of the sick and elderly.

Social Security pays benefits that cannot be outlived, with annual cost-of-living adjustments. These features are particularly important to women because they tend to live longer than men but have fewer assets when they reach retirement. Savings in individual accounts could be drained by health costs, bad luck, or misjudgment in investments, or simply outliving one's savings.

Finally, women are much more likely than men to receive Social Security benefits as family members when a worker dies, retires, or becomes disabled. For a young family, Social Security provides the equivalent of a life insurance policy worth over $400,000 and a disability insurance policy worth over $350,000, according to the Social Security actuaries.

Impact on Ethnic Minority Communities

NEA has a diverse membership serving an increasingly diverse population. Some ten percent of NEA members are African Americans. Representation in the education profession of Hispanics is also growing. Ethnic minority students in our nation's schools have risen from 30 percent in the late 1980s to almost 40 percent today. Over the next twenty years that percentage may well reach 50 percent.

Given the diversity of our membership and the students and communities they serve, NEA has a strong interest in the impact of policy decisions on minority communities. In fact, NEA is currently engaged in an outreach project designed to strengthen partnerships with minority communities in support of public education. We are, therefore, deeply concerned about the impact of privatizing Social Security on populations such as African Americans and Hispanics.

Impact on African Americans

Proponents of Social Security privatization have claimed that the current program is unfair to African Americans. For example, President Bush has asserted that "African-American males die sooner than other males do, which means the system is inherently unfair to a certain group of people." However, while it is true that the current life expectancy for African American males at birth is only 68.8 years, this does not mean that an African American man who has worked all his life can expect to die after collecting only a few years' worth of Social Security benefits. African Americans' low life expectancy is largely due to high death rates in childhood and young adulthood. African American men who make it to age 65 can expect to live, and collect benefits, for an additional 14.6 years.

Due to certain demographic trends, African American communities benefit from the Social Security program in several ways:

- Social Security is the only source of retirement income for 40 percent of African American seniors. In 2002, the average monthly benefit for African American men receiving retired worker benefits was $850, and for women was $683. The

Social Security Administration estimates the poverty rate for elderly blacks would more than double—from 24 percent to 65 percent—without Social Security.

- Social Security survivors insurance provides significant help to African American children who would otherwise find themselves poor because of a parent's death. African Americans make up approximately 13 percent of the American population. Twenty three percent of all children receiving Social Security survivor benefits in 2002 were African American. A recent study by the National Urban League Institute for Opportunity and Equality showed that the benefit lifted one million children out of poverty and helped another one million avoid extreme poverty (living below half the poverty line). The National Urban League study also found that an African-American man dying in his thirties would only have enough in his private account to cover less than two percent of the survivors' benefits now provided by Social Security to his widow and children.
- African American families benefit from disability insurance. In 2002, 13 percent of the population was African American; however, 17 percent of disabled workers receiving benefits were African American.
- African American women in particular rely disproportionately on the non-retirement aspects of the program because they have a higher rate of disability than whites of either sex. African American women often survive deceased husbands. While African Americans make up 9 percent of all female beneficiaries, African American women constitute 18 percent of female disabled worker beneficiaries.

Impact on Hispanics

Like African Americans, Hispanics benefit from Social Security in a number of ways;

- Social Security is the only source of retirement income for 41 percent of elderly Hispanics. In 2002, the average monthly benefit for Hispanic men receiving retired worker benefits was $859, and for women was $619.
- The guaranteed benefit and cost-of-living adjustments of Social Security are important to Hispanics. An important feature of the Social Security system is its provision of a guaranteed benefit for workers and their spouses, which continues until death, with a cost-of-living adjustment (COLA) each year to index for inflation. Social Security beneficiaries cannot outlive the income, and their purchasing power does not erode over time. Because Hispanics tend to have higher life expectancies at age 65 than the majority of the population, elderly Hispanics will live more years in retirement and benefit from Social Security's cost-of-living protections. Hispanic men who were age 65 in 2004 can expect to live to age 85, compared to age 81 for all men. Hispanic women who were age 65 in 2004 can expect to live to age 88, compared to age 85 for all women.
- Social Security disability benefits are important to Hispanics. Hispanics have a higher work disability rate than other Americans. While disability data from the Census show that the overall work disability rate was 11.9 percent in 2000, the work disability rate for Latinos was 16.7 percent. Thus, Hispanics are more likely to be in need of the disability benefits that the Social Security system provides. Private accounts would not provide disability protection.

PROGRESSIVE PRICE INDEXING

NEA is also deeply concerned about the President's most recent proposal, which would alter the benefit structure through progressive indexing. While the President has described the proposal as reducing benefits for the most affluent Americans, it would result in large benefit reductions for middle-class workers, as well. In fact, seven of every ten workers would be affected.

The benefit reduction for middle-class workers such as educators would be large. A teacher making $35,000 today would be subject to benefit reductions more than half as large as those imposed on people at the highest income levels. A worker making $60,000 today would be subject to benefit reductions that are nearly as large (as a percentage of his or her promised benefits) as the reductions that would be imposed on someone making several million dollars a year. For a $60,000-a-year worker who retires in 2045, the benefit cut would equal 25 percent, or about $6,500 a year.

For many workers, cuts would be deeper than if no action were taken and Social Security became insolvent. For workers who now make about $55,000 or more, Social Security benefits would be cut more deeply under the progressive indexing proposal than if nothing were done to restore Social Security solvency. Perhaps even more troubling is the fact that the benefit cuts would apply not only to retirees, but also to survivors, and people with disabilities.

THE CASE AGAINST MANDATORY COVERAGE

NEA opposes mandating participation of all public employees in the Social Security system. Educators in twelve states (Alaska, California, Colorado, Connecticut, Illinois, Kentucky, Louisiana, Maine, Massachusetts, Missouri, Nevada, and Ohio) as well as selected districts in three additional states (Georgia, Rhode Island, and Texas) do not pay into Social Security. Instead, these states maintain separate retirement systems for educators. Some Social Security reform proponents have suggested requiring Social Security participation for all public employees as a means of strengthening the system.

A federal mandate for public employee participation in the social security system would be detrimental to teachers and other public employees and would create financial burdens for states and city governments. Mandatory coverage would weaken existing state and local retirement plans that often offer benefits superior to Social Security. Mandatory coverage would also increase the tax burden on public-sector employers, eventually leading to reductions in the number of new hires, limits on employee wage increases, reduced cost-of-living increases for retirees, and reductions in other benefits such as health care. Mandating coverage of public employees will not solve the social security system's financial difficulties. In fact, the amount of money gained by mandating coverage would be relatively small and would not solve the long-term Social Security crisis.

REPEAL OF SOCIAL SECURITY OFFSETS

NEA strongly supports full repeal of both the Government Pension Offset (GPO) and the Windfall Elimination Provision (WEP), both of which unfairly reduce earned Social Security benefits of some public employees. The GPO reduces public employees' Social Security spousal or survivor benefits by two-thirds of their public pension. The WEP reduces the earned Social Security benefits of an individual who also receives a public pension from a job not covered by Social Security.

The offsets penalize people who have dedicated their lives to public service by taking away benefits they have earned. Nine out of ten public employees affected by the GPO lose their entire spousal benefit, even though their spouse paid Social Security taxes for many years. The WEP causes hard-working people to lose a significant portion of the benefits they earned themselves. The loss of income forces some people into poverty. Some 300,000 individuals lose an average of $3,600 a year due to the GPO—an amount that can make the difference between self-sufficiency and poverty. Impacted people have less money to spend locally and sometimes have to turn to expensive government programs like food stamps to make ends meet.

The impact of the GPO and WEP is not just felt in those states in which public employees are not covered by Social Security. Because people move from state to state, there are affected individuals everywhere. The number of people impacted across the country is growing every day as more and more people reach retirement age.

Finally, the GPO and WEP discourage people from entering/staying in the profession. Individuals who worked in other careers are less likely to want to become teachers if doing so will mean a loss of earned Social Security benefits. The GPO and WEP are also causing current educators to leave the profession, and students to choose courses of study other than education. Non-Social Security states are going to find it increasingly difficult to attract quality educators as more folks learn about the GPO and WEP.

NEA supports the Social Security Fairness Act (H.R. 147), introduced by Representatives McKeon (R–CA) and Berman (D–CA). This bipartisan legislation would correct the inequities in the current system by fully repealing both the GPO and the WEP.

CONCLUSION

NEA urges Congress to:

- Reject efforts to privatize Social Security;
- Oppose mandatory Social Security coverage for public employees; and
- Repeal the Government Pension Offset and Windfall Elimination Provision.

Thank you for the opportunity to submit these comments.

Statement of Patricia Hall Taniashvili, Surry, Maine

I got my first job in the summer of 1960, working as a proofreader in a newspaper office in coastal North Carolina. Social Security taxes were deducted from my paycheck at that time.

After I received my B.A. degree in 1964, I taught Freshman Composition at Valparaiso University in Valparaiso, Indiana for a year. Social Security taxes were deducted from my paycheck at that time.

From the fall of 1965 until the spring of 1968, I taught English (all students) at Washington County High School in Valparaiso. Social Security taxes were deducted from my paycheck at that time.

After my two children were born, I returned to teaching at Hobart Junior High School in Hobart, Indiana, where I taught English and French from 1974–1979. Social Security taxes were deducted from my paycheck at that time.

In 1980 I moved to Maine, and taught English and French at Calais High School in Calais until the spring of 1989. In order to supplement my low salary, I worked during the summers at the tourist information office there. Social Security taxes were deducted from that paycheck at that time.

In 1989 I moved to Lamoine, Maine, and taught English for a year and a half at Sumner High School in Gouldsboro.

I spent 1991 teaching English as a foreign language in Tbilisi, Republic of Georgia; at that time Georgia was a member of the U.S.S.R.

In early 1992 I returned to Maine, and began teaching French and Spanish at Ellsworth High School in Ellsworth, Maine, where I am still employed. Once again, in order to supplement my inadequate teaching salary, I started working during the summers at Kneisel Hall (a chamber music school and concert series) in Blue Hill. Social Security taxes were deducted from that paycheck during that time.

I don't know when I will be able to retire. My Maine State Teachers Retirement pension will not cover my living expenses, especially since I do not own a house and must pay rent every month. I estimate that my Maine State Teachers Retirement pension) will be approximately $20,640 a year. Our health insurance cost will be well over $700 a month out of my $1,720 a month. This leaves me with $1,000 or less per month BEFORE taxes.

Thanks to the Windfall Elimination provision, my full Social Security pension to which I am entitled will be reduced to only approximately $178 a month at age 62, approximately $293 at 65 and 10 months, or $495 at age 70.

If I had stayed in Indiana to teach, I would have my Indiana teachers' retirement pension plus the full Social Security pension to which I am entitled. Why am I being discriminated against because I moved to Maine? What have I done to have my Social Security pension cut?

The final insult and irony is that after I retire from teaching, I will have to once again supplement my income by working at a part-time job—from which Social Security taxes will be deducted. **I will never be permitted to collect the full benefit to which I am entitled from this work.**

For all of my working life, I have accepted the low pay given to teachers because I love teaching and I love the kids I work with. Now I am faced with the fear that I will have to keep working for an indefinite time, because I can't afford to retire, even though I'd like to plan on it. Another fear that I have is that I will get sick and not be able to work, yet not be able to afford not to.

The WEP has put me in an untenable position financially and personally. The elimination of a portion of my Social Security pension is unfair and immoral. The repeal of this law would make a huge difference to me.

Statement of Deborah Tucker, Boynton Beach, Florida

Our government made a commitment to me which has not been fulfilled; and collected funds from me and just kept these contributions for the benefit of others. I am the widow of a bronze star holder who was in that "dependent" state for 28 years during which all and full required payments for social security were made with the clear promise for retirement benefits. Because of need, I entered full time employment as a social worker in an Illinois public school at age50. . .unable to build the quite comfortable pensions allotted to those who had been in that public sector for all, or most of their work experience. I also worked part time, paying into both the teachers' retirement system and social security at the same time. I expected that I would receive benefits in accord with payments made throughout my whole life as do all others such as friends who have never worked; those who

worked in the private sector who receive both work pensions and social security; and those who have all of their years in those public schools. Even non citizens receive benefits in line with their contributions.

I retired at age 70 and received NOTHING from the 28 years of marital payments (Why did we pay?); and then, as a second punishment I receive only 40% of what my own earned benefits should have been (Why did I pay the full amount?)..How many citizens would feel contented if they paid for something they did not receive? Everyone with whom I have spoken have been shocked and extremely grateful that they are not in my situation and enjoying the benefits of old age. I am still working part time and guess what??? I am still paying into social security. How can the members of Congress look away from the injustice and not try to affect fairness?

Statement of Jonathan Barry Forman, University of Oklahoma College of Law, Norman, Oklahoma

I am pleased to submit this statement for the record that you are compiling on Alternatives to Strengthen Social Security. I am submitting this statement in my individual capacity as the Alfred P. Murrah Professor of Law at the University of Oklahoma. This statement suggests how a two-tiered Social Security system could help ensure that every elderly American has an adequate income throughout her retirement years. The first tier would provide a basic Social Security benefit to every older American, and those benefits would be paid for out of general revenues. In addition, every worker would also earn a second-tier retirement benefit based on earnings paid for with a much-reduced system of payroll taxes and held in individual accounts. Those individual accounts could be funded, defined contribution accounts, or they could be hypothetical accounts like those found in "cash balance" pension plans in the private sector and in the "notional account" Social Security systems in Italy, Poland, Sweden, and several other countries.

REFORMING SOCIAL SECURITY

The Social Security system includes two programs that provide monthly cash benefits to workers and their families. The Old-Age and Survivors Insurance (OASI) program provides benefits to retired workers and their dependents and to the survivors of insured workers, and the Disability Insurance program provides benefits to disabled workers and their dependents.[1] A worker builds protection under these programs by working in employment that is covered by Social Security and paying the applicable payroll taxes. At present, about 96 percent of workers are working in covered employment.

The OASI Program is, by far, the larger of these two programs, and it is usually what people mean when they talk about Social Security. In November, 2004, for example, the program paid benefits to almost 40 million retired workers and their families, and the average benefit was about $898 per month.[2]

These Social Security retirement benefits are incredibly important for the elderly population. For example, in the year 2000, Social Security provided 100 percent of income for 20 percent of elderly households and more than half of the income for another 44 percent of elderly households.[3] Of particular note, Social Security has been especially successful in reducing the level of poverty among the elderly. With Social Security, only 9 percent of beneficiaries in the year 2000 were poor; without it, 48 percent would have been poor.[4]

SOCIAL SECURITY RETIREMENT TAXES

Social Security retirement benefits are financed primarily through payroll taxes imposed on individuals working in employment or self-employment that is covered by the Social Security system. For 2005, employees and employers each pay a tax of 5.3 percent on up to $90,000 of wages earned in covered employment, for a combined OASI rate of 10.6 percent (the lion's share of the total 15.3 percent of payroll

[1] See generally Jonathan Barry Forman, *Making Social Security Work*, 65 *Ohio State Law Journal* 145 (2004).

[2] Social Security Administration, *OASDI Monthly Statistics*, March 2005, Table 1 (April 2005), available at <http://www.ssa.gov/policy/docs/statcomps/oasdi_monthly/>.

[3] *Social Security Bulletin, Annual Statistical Supplement: 2001*, 18 (2002), available at <http://www.ssa.gov/policy/docs/statcomps/>.

[4] *Id*. at 9.

that is collected for OASI, DI, and Medicare).[5] Self-employed workers pay an equivalent OASI tax of 10.6 percent on up to $90,000 of net earnings (again, out of the total 15.3 percent that is collected for OASI, DI, and Medicare).

Additional revenue for Social Security comes from the income taxation of Social Security benefits.[6] The actual amount to be included is determined by applying a complicated two-tier formula. Basically, single taxpayers with incomes over $25,000 (and married couples with incomes over $32,000) must include as much as half of their Social Security benefits in income, and single taxpayers with incomes over $34,000 (and married couples with incomes over $44,000) must include as much as 85 percent of their Social Security benefits in income.

SOCIAL SECURITY RETIREMENT BENEFITS

Worker Benefits. Workers over the age of 62 generally are entitled to Social Security retirement benefits if they have worked in covered employment for at least 10 years. Benefits are based on a measure of the worker's earnings history in covered employment known as the average indexed monthly earnings (AIME). The AIME measures the worker's career-average monthly earnings in covered employment. In that regard, the AIME takes into consideration only covered earnings up to the maximum applicable annual earnings cap. For example, no more than $90,000 of 2005 earnings could count toward a Social Security retirement benefit.

The starting point for determining the worker's AIME is to determine how much the worker earned each year through age 60. Once those so-called "benefit computation years" and covered earnings for those years have been identified, the worker's earnings for years prior to age 60 are indexed for wage inflation. This indexing ensures that the same relative value is given to wages no matter when they are earned. The year that the worker turns age 60 is the year used for indexing the earnings of prior years, and this indexing makes the earnings early in the worker's career comparable to earnings in later years. Earnings in and after age 60 are not indexed but can enter into the benefit computation formula.

The highest 35 years of earnings are then selected, and the rest of the years are dropped out. The AIME is then computed as the average earnings for the remaining 35 years.

The AIME is then linked by a formula to the monthly retirement benefit payable to the worker at full retirement age, a benefit known as the "primary insurance amount" (PIA). Historically, "full retirement age" was age 65, but it is gradually increasing to age 67 for workers born after 1959 (reaching age 62 in or after 2022 and reaching 67 in or after 2027). For a worker turning 62 in 2005, the PIA is equal to 90 percent of the first $627 of the worker's AIME, plus 32 percent of the AIME over $627 and through $3,779 (if any), and plus 15 percent of the AIME over $3,779 (if any). Note that the benefit formula is designed to favor workers with relatively low career-average earnings.

A worker's benefits may be increased or decreased for several reasons. Most importantly, benefits are indexed each year for inflation as measured by the increase in the Consumer Price Index.

Also of critical importance, workers who retire before their full retirement age have their benefits actuarially reduced. For example, a worker who turned 62 in 2003 and had yearly earnings throughout her career equal to the average wage would be entitled to a worker benefit starting at full retirement age (65 and two months) of $1,258 a month.[7] If she, instead, started to draw her benefit at age 62, that benefit would be actuarially reduced by about 20 percent, to $964 per month.[8] As the full retirement age slowly increases to age 67, the actuarial reduction from the full retirement age of 67 to the early retirement age of 62 will increase to 30 percent.

On the other hand, benefits payable to workers who choose to retire after their full retirement age are actuarially increased through the delayed retirement credit. The delayed retirement credit increases the monthly benefit to be paid to a worker who delays receipt of benefits past full retirement age by 8 percent for each year of delay.

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[5] Social Security Administration, *Cost-of-Living Increase and Other Determinations for 2005*, 69 *Federal Register* 62,497 (2004).

[6] I.R.C. § 86.

[7] Committee on Ways and Means, U.S. House of Representatives, *2004 Green Book: Background Material and Data on Programs within the Jurisdiction of the Committee on Ways and Means*, Section 1, Social Security: The Old-Age, Survivors, and Disability Insurance (OASDI) Programs, 1–49 (Table 1–16) (2004).

[8] *Id.* at 1–20 to 1–21, 1–49 (Table 1–16).

Finally, the so-called "retirement earnings test" reduces the benefits of individuals who have not yet reached full retirement age and who continue to work after starting to draw Social Security retirement benefits. In 2005, for example, these early retirees will lose $1 of benefits for every $2 of annual earnings over $12,000.

Family Benefits. Spouses, dependents and survivors of the worker may also receive additional monthly benefits. These family benefits are also based on the worker's primary insurance amount (PIA). In particular, a retirement-age wife or husband of a retired worker is entitled to a monthly spousal benefit equal to 50 percent of the worker's PIA. Consequently, a retired worker and spouse generally can claim a monthly benefit equal to 150 percent of what the retired worker alone could claim. Also, a retirement-age widow or widower of the worker is entitled to a monthly surviving spouse benefit equal to 100 percent of the worker's PIA.

Like worker benefits, family benefits are subject to the retirement earnings test. In addition, under the so-called "dual-entitlement rule," when an individual can claim both a worker benefit and a benefit as a spouse, survivor, or dependent of another worker, only the larger of the two benefits is paid to the individual.

SOCIAL SECURITY IS IN FINANCIAL TROUBLE

The Social Security system operates largely on a pay-as-you-go basis. Social Security benefits are primarily paid out of current-year Social Security payroll taxes, and the Social Security Trust Funds maintain only enough reserves to cover a few years of benefits. In 2004, for example, the Old-Age and Survivors Insurance Trust Fund collected $473 billion in payroll tax contributions, paid out $415 billion in benefits, and had $1.5 trillion on hand at the close of the year.[9]

Unfortunately, however, the long-term picture is bleak. Social Security retirement and disability benefits will exceed trust fund income starting around 2017, and the system will be unable to pay full benefits after about 2041.[10] The Trustees of the Social Security Trust Funds estimate that the deficit over the traditional 75-year projection period is about 1.92 percent of payroll, and the unfunded liability of the system is $4.0 trillion.[11]

The primary reason that Social Security is in financial trouble is that people are living longer and retiring earlier. As a result, there are a lot of Social Security beneficiaries, and there are fewer workers to support them. Of course, it is great that we are living longer, and it is terrific that we can expect to have long and leisurely retirements. But it has led to the current financing problem.

Social Security must either find new sources of revenue, or benefits will have to be cut. According to the Trustees of the Social Security Trust Funds, the system could be brought into actuarial balance by an immediate increase in payroll taxes of 15 percent, an immediate reduction in benefits of 13 percent, or some combination of the two.[12] Any delay in reform will mean even larger tax increases and/or benefit cuts in the future, and that is one of the reasons that President George W. Bush has put Social Security reform at the top of his second-term agenda.

SOME THOUGHTS ABOUT REFORM

The Social Security system was designed in the 1930s, and it is time to reconsider its structure with an eye on what we want the system to do today and into the future. Ideally, the system should ensure that every elderly American has an adequate income throughout her retirement years. One way to achieve that result would be to have a two-tiered Social Security system.

The Basic Social Security Benefit. The first tier of this new Social Security system would provide a basic Social Security benefit to every older American. For example, the government might guarantee every retiree a first-tier benefit equal to, say, 100 percent of the poverty level. In the year 2005, for example, the poverty level for a single individual is $9,570, yielding a monthly benefit of about $798.[13]

That benefit, $798 per month, would be the benefit payable to every individual at full retirement age. In that regard, there is every reason to think about increasing the full retirement age to 70 and increasing the minimum retirement age to 65. If a $798-per-month benefit were payable at age 70, then the actuarially-reduced benefit at age 65 would be about 30 percent less, or $558 per month.

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[9] Social Security and Medicare Boards of Trustees, *2005 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* 19 (Table III.A1) (2005), available at <http://www.ssa.gov/OACT/TR/TR05/index.html>.

[10] *Id.* at 2.

[11] *Id.* at 59 (Table IV.B.6).

[12] *Id.* at 3, 55.

[13] Department of Health and Human Services, *Annual Update of the HHS Poverty Guidelines*, 70 *Federal Register* 8,373 (2005). $797.50 = $9,570 ÷ 12.

Benefits paid in subsequent years would be increased for inflation, as measured by the Consumer Price Index. In any event, these first-tier benefits would terminate at death.

These first-tier benefits would replace the current Supplemental Security Income (SSI) program and all of the redistributive features of the current Social Security system. Also, like the current SSI program, these first-tier benefits would be paid for out of general revenues.

An Additional Earnings-Related Benefit. In addition to the first-tier benefit, every worker would also earn an additional retirement benefit based on earnings. These second-tier benefits would be financed with a much-reduced system of payroll taxes. In effect, each worker would have an individual account—like an individual retirement account (IRA) or a 401(k) account. Each worker's payroll tax "contributions" would then be credited to her account, along with investment income on the balance in that account. The accounts themselves could be funded, defined contribution accounts. Or they could be hypothetical accounts like those found in "cash balance" pension plans in the private sector (and in the "notional account systems" now used in Italy, Poland, Sweden, and several other countries).[14]

At retirement, the balance in a worker's second-tier individual account would typically be used to purchase an additional inflation-adjusted annuity over and above the individual's first-tier benefit. Workers with large enough account balances might also be allowed to take partial lump-sum distributions. In the case of any worker who died before withdrawing all of her funds, the balance in her account would go to her spouse or other heirs.

Replace Spousal Benefits with Earnings Sharing. Finally, Social Security spousal benefits should be replaced with an "earnings sharing" system. Under earnings sharing, the current Social Security system's spouse and surviving spouse benefits would be eliminated. Instead, each spouse in a married couple would be credited with one-half of the couple's combined earnings during marriage. At retirement, each spouse's second-tier benefit would be based on her half of the married couple's earnings during marriage plus whatever she earned before or after the marriage.

Instead of tinkering with the Social Security system, I believe that we should redesign it. In the 21st century, it would make sense for Social Security to provide every elderly American with an adequate income throughout her retirement years. A two-tiered Social Security system could achieve that result, and we should be able to solve Social Security's financing problem at the same time.

Statement of Douglas E. Ward, Oberlin, Ohio

Thank you for giving me this opportunity to write to you.

I would like to state that I paid the required 40 Quarters into Social Security from the ages of 16 to 28 years old. I worked during my teen and young adult years in Illinois under Social Security. I then moved to Ohio to work at a better position, which was not under Social Security. I knew I had the required 40 quarters, else I may not have taken the new position in Ohio.

I now find that 55% of my social security, which I was counting on (i.e.: $500.00/mo has been reduced to $226.00/mo.) I have also discovered that when I die, my wife will not received any of my Social Security benefits due to the Offset provisions of Social Security.

I guess I should not have taken a career in Local Government work, since the Federal Government is taking away my legally *earned* Social Security retirement benefits. I believe that payment of my *earned* social security benefit would not bankrupt the system.

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[14] In a hypothetical account system, each worker gets a hypothetical individual account. Payroll tax contributions from workers and employers are credited to those accounts, and each year those accounts are also credited with investment interest. For example, a simple plan could allocate 4 percent of salary from each worker into her account each year and credit her account with 7 percent interest on its beginning-of-the-year balance. Each worker would receive quarterly reports showing the growing balance in her account.