THE FUTURE OF SOCIAL SECURITY FOR THIS GENERATION AND THE NEXT

HEARING

BEFORE THE

SUBCOMMITTEE ON SOCIAL SECURITY

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

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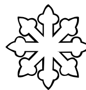

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THE FUTURE OF SOCIAL SECURITY FOR THIS GENERATION AND THE NEXT

TUESDAY, JUNE 24, 1997

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

The Subcommittee met, pursuant to notice, at 9:59 a.m., in room B–318, Rayburn House Office Building, Hon. Jim Bunning (Chairman of the Subcommittee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON SOCIAL SECURITY

FOR IMMEDIATE RELEASE Contact: (202) 225–9263
June 17, 1997
No. SS–6

Bunning Announces Fourth Hearing in Series on "The Future of Social Security for this Generation and the Next"

Congressman Jim Bunning (R–KY), Chairman, Subcommittee on Social Security of the Committee on Ways and Means, today announced that the Subcommittee will hold the fourth in a series of hearings on "The Future of Social Security for this Generation and the Next." At this hearing, the Subcommittee will examine the views of Social Security policy experts on Social Security reform. The hearing will take place on Tuesday, June 24, 1997, in room B–318 Rayburn House Office Building, beginning at 10:00 a.m.

In view of the limited time available to hear witnesses, oral testimony will be from invited witnesses only. However, any individual or organization may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

BACKGROUND:

The Subcommittee's first three hearings in the series have focused on the recommendations of the Advisory Council on Social Security, the fundamental issues to consider when evaluating options for Social Security reform, the findings of the 1997 Social Security Board of Trustees, and the views of organizations with different generational perspectives on Social Security reforms.

A wide range of approaches have been proposed to restore Social Security's financial solvency. These range from maintaining the program's current structure to revamping the system entirely. Various Social Security policy experts and policy institutes or "think tanks" have led the debate on Social Security reform. Many of these experts, who represent a wide-range of perspectives, have been key presenters and organizers of forums and conferences aimed at examining reform proposals.

In announcing the hearing, Chairman Bunning stated: "Engaging the public in Social Security reform is vital. Many Social Security policy experts are at the cutting edge of the debate. Their views have been carried by the media to the American public. Extensive knowledge and years of experience have shaped the thoughtful views of these experts. The Subcommittee looks forward to considering their perspectives."

FOCUS OF THE HEARING:

The Subcommittee will receive the views of policy experts on Social Security reform. Specifically, Members would like to hear the views of each expert regarding: (1) the degree to which Social Security reform is necessary, (2) an assessment of the Advisory Council recommendations and other reform proposals, (3) specific recommendations for Congress to consider as it moves forward, and (4) how soon Congressional action is needed.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) copies of their statement and a 3.5-inch diskette in ASCII DOS format, with their address and date of hearing noted, by the close of business, Tuesday, July 8, 1997, to A.L. Singleton, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Subcommittee on Social Security office, room B–316 Rayburn House Office Building, at least one hour before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit 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 statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages including attachments. At the same time written statements are submitted to the Committee, witnesses are now requested to submit their statements on a 3.5-inch diskette in ASCII DOS format.

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. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are available on the World Wide Web at 'HTTP://WWW.HOUSE.GOV/WAYS__MEANS/'.

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 BUNNING. The Subcommittee will come to order.

I want to inform the panel and the participants and all of our guests that I must be on the floor for the debate for most-favored-nation status for China and that Congressman Rob Portman is on his way here to start this hearing. I apologize, but I did not do the floor planning; I have little to say about what bills come up on the floor at what time, but I am committed to being on the floor to de-

bate most-favored-nation status for China, and Mr. Portman will be here as soon as possible, and we will recess until he gets here.

[Recess.]

Mr. JOHNSON of Texas [presiding]. The hearing will come to order.

Welcome. I guess you all are aware that Mr. Bunning is down doing the large work on the floor of the House, and Mrs. Kennelly I think has to leave too, fairly soon; but without objection, we will enter his statement in the record, and in the interest of our expediting affairs, we dispense with opening statements, normally; however, I will at this time recognize the Ranking Democrat Member, Mrs. Kennelly.

[The opening statement of Mr. Bunning follows:]

Opening Statement of Hon. Jim Bunning

This morning we begin our fourth hearing in the series "The Future of Social Security for this Generation and the Next." The testimony we hear today will focus on the views of policy experts on Social Security reform.

Engaging the public in Social Security reform is vital. Various Social Security policy experts and policy institutes—or "think tanks" as we all know them—have been leaders in the debate on Social Security reform.

These witnesses bring to our Subcommittee a broad range of extensive academic resources and professional experience of their respective organizations and constituency groups.

Comprehensive knowledge and years of experience have shaped the thoughtful views of our policy experts today. It's nearly impossible for Members of Congress to gather all of the facts on every issue that arises. For that purpose, I am very grateful that these witnesses, who have dedicated so much time and talent to further these discussions, will share their perspectives with the subcommittee this morning.

Mrs. KENNELLY. Thank you, sir.

At our last hearing, we heard from the Public Trustees of the Social Security Trust Fund. They urged us to act as soon as possible to restore the solvency of the Social Security system. The longer we wait, the more difficult the task will become, and I know our witnesses are very aware of that today.

Many proposals have been offered to resolve the problem. The Social Security Advisory Council offers us three plans. The Council on Economic Development, the Cato Institute, and several Members of Congress have put forward additional options. These hearings have allowed us to delve deeply into each of these proposals. We have had the opportunity to question their authors and to consider the many advantages and disadvantages of each approach.

Among our past witnesses was the Congressional Research Service, which set out a series of criteria by which any Social Security reform proposal ought to be judged. I intend to raise some of these issues here today. They include questions about trust fund solvency, the impact on the deficit and the debt, the growth of entitlements, impact on national savings, and risks versus returns to the individual.

One thing is certain—there are many issues yet to be resolved, some of them technical, some of them philosophical, and many of them, if not all, are important. But I believe we can work together on an answer. I am optimistic that ultimately, we will find a solu-

tion which will assure the retirement security of both current and future generations.

I look forward to hearing the witnesses today, and I apologize to you for what is happening. Most-favored-nation status for China is on the floor today, and it is a very contentious issue. The votes are possibly very close. Mr. Bunning, of course, is there now, and I am the third speaker, so I will have to go very shortly. But I want to tell our witnesses and make them very aware that the reason these hearings are held is to get on the record the witnesses' testimony; it is then distributed to Members of Congress. So be sure that you know today that maybe the attendance is not exactly what you might expect, but the fact of the matter is your words will go into every office and be read by every Member, and I want you to know that.

Mr. JOHNSON of Texas. Thank you, Mrs. Kennelly.

Thank you all for being here today. We appreciate it. For the two of you who have just arrived, if you have a statement that you wish to enter into the record, without objection, we will allow you to do that.

Mr. NEAL. Mr. Chairman, I simply want to acknowledge the presence of the scholarly gentleman from my State, Dr. Kingson, from one of the greatest institutions in America, Boston College. We eagerly await his testimony.

I am going to follow Mrs. Kennelly on the floor, but I am also anxious to hear what he has to say about IRAs, since I am the lead Democratic sponsor of IRAs in the House. I read his testimony last night, and there will be some genuine room for disagreement on that issue.

But we welcome a great friend of Congressman Tierny as well, I believe.

Thank you, Mr. Chairman.

Mr. JOHNSON of Texas. Thank you for that introduction.

Now we will go ahead and proceed. We will allow each of you to make your statements, and we would request that you keep them as short as possible. You will be able to enter your entire statement in the record. Then we will ask you some questions.

Stephen Moore, director of fiscal policy studies at the Cato Institute.

STATEMENT OF STEPHEN MOORE, DIRECTOR, FISCAL POLICY STUDIES, CATO INSTITUTE

Mr. MOORE. Thank you, Mr. Chairman.

First of all, let me commend the Members of this Subcommittee for holding a hearing on the future of Social Security. I commend you for your courage to talk about this issue in an honest and open way.

First of all, in compliance with the truth in testimony provisions passed by this Congress, let me say that the Cato Institute does not receive one penny of government funds.

Let me concentrate my remarks this morning on the issue of the rate of return of Social Security. I am not going to get into the issue of the financial viability of the system. I want to talk about whether we can do better for our workers if we chose another option other than Social Security.

And let me get right to the heart of the matter. Social Security, especially for our young workers, the Generation X workers, if you will, and especially workers under the age of 40, is a very bad deal. It is a bad deal for virtually every worker in virtually ever circumstance.

If I may, if you have copies of my testimony, let me ask you to turn to the chart that I presented, because this really does get to the heart of the matter. Basically, what we have done—this is the chart I am referring to, just so you are aware—what we have done essentially at Cato is looked at the rate of return that a worker might get if, rather than putting that money into the Social Security Trust Fund, that workers were allowed to put that money into an individual, what we call a personal security account.

Essentially what I would like you to do is concentrate for a moment on the panel on this chart, "Year of Birth 1970." What this shows, if you look at the first panel—let us concentrate for a minute on a low-wage worker. If you see this little panel here that says $769, that is essentially the monthly benefit that a low-wage worker will receive from Social Security. This is someone who was born in 1970. This low-wage worker, by the way, is someone whom we assume is going to make roughly the minimum wage their entire lifetime.

So we ask the question, OK, what happens if, rather than put the money into the trust fund, we allowed that worker to put that money into private capital markets. In terms of rate and return, since obviously, we are projecting into the future, we looked at the rate of return that you could get in the capital markets over the last 75 years and projected out that—essentially, the assumption here is that you can get the same rate of return in the next 50 years that people have gotten in financial markets over the last 75 years.

Let me just make the case that over the last 15 years or so, the financial markets have been much, much higher than actually the average over the last 75 years.

If you buy that assumption, which I think is very reasonable, what you find is that if that low-wage worker were able to put all of that money into bonds, which would be a very risk-averse portfolio—no one would put all of his savings into bonds—but if he did, he would still get a benefit from a bond portfolio that would be about 50-percent higher than what that worker would get from Social Security.

If that low-wage worker were to put all the money into stocks, which would be a much riskier portfolio, he would get a rate of return about three times higher from a stock portfolio than what they would get out of Social Security.

Now, obviously, as the worker's income rises, the benefit of opting out of the system is higher. So that, for example, if you look at the second half of this panel, that is a high-wage worker; that is anyone who makes over $62,000 a year who essentially caps out on the amount he pays into Social Security. That worker could do roughly three times better if he invested in bonds and, incredibly, about a six times higher rate of return if he could put the money into stocks.

Let me make a couple of points about this. I think these are very powerful numbers, and when I show these especially to young workers, they say, "I want this option. I want this option of getting the best deal I can on the money that I am putting into my retirement account."

I think a couple of points need to be emphasized. First of all, it is very true that Social Security is an income redistribution program. There is a progressive feature to the benefits. And some people who are opposed to this idea say, well, this would not be a good deal for young, low-wage workers because they are going to lose the progressive feature of the benefit.

And a point I want to emphasize to you is that if we were to allow even the lowest wage workers in our society to put money into private capital markets, even the lowest wage worker would do substantially better, even given the progressive feature of the benefit structure than if they stayed in Social Security. So, there is not a single worker in the system who is young today who would not do better if they could opt out and go to the private account system.

Let me make one other point, and then I will pass the microphone over to the next speaker, and that is, realize also that this is essentially the worst case scenario for personal savings accounts, because the assumption that is made in this analysis is that we are going to make no changes to Social Security. That is, we are not going to reduce the benefits, and we are not going to increase the taxes. But everyone here knows that that is unrealistic; even the people who are advocates of maintaining the status quo agree that essentially we are going to have to do something about the tax rate and reduce future benefits.

If you do that, that essentially simply makes the point that that worker, if he were able to—well, let me put it like this. If you raise the tax, if you allowed that worker to put that additional money into private accounts, then the deal would be all the better for that young worker.

So what I am trying to say, I guess, is that all the conventional reforms to Social Security—raising the tax rates, increasing the retirement age, and lowering benefits in the future—only make Social Security a worse deal for our young workers. The only deal that makes it a good deal for young workers is to allow them to start to put at least some of this money into personal security accounts.

Thank you.

[The prepared statement and attachment follow:]

Statement of Stephen Moore, Director, Fiscal Policy Studies, Cato Institute

Mr. Chairman, my name is Stephen Moore and I am Director of Fiscal Policy Studies at the Cato Institute. In keeping with the new truth in testimony rules, let me first say that the Cato Institute does not receive a single penny of government funds.

Thank you for the opportunity to comment today on the future of Social Security. I wish to commend this Committee for its willingness to explore the long term prognosis for Social Security.

As everyone on this Committee knows, the long term financial outlook for Social Security is bleak. Depending on how it is measured the unfunded liability of the system ranges from $3 trillion to $5 trillion. This is much like a second national debt. Yet the financial sustainability of Social Security could be assured with a series of conventional reforms that include raising payroll taxes and reducing future

benefits. Though young people, of course, are none too enthusiastic about these "pay more in, get less out" solutions.

But the major point that I wish to communicate to you this morning is that the case for converting Social Security into a system of Personal Security Accounts (PSAs) is not primarily based on the system's financial problems. The real economic and political crisis looming over Social Security relates to the issue of rate of return. For baby boomers and especially for Generation X workers, Social Security offers a low rate of return—even negative for many workers.

I would ask each of you to review for a moment the attached charts from a recent Cato Institute study. They compare the rate of return for Social Security versus investment in private capital markets? The data was compiled for the Cato Institute by Bill Shipman principal of State Street Global Advisors in Boston. It has been reviewed by professional actuaries and certified as accurate.

To derive an estimated rate of return from capital markets in the future, the study assumes that over the next forty to fifty years, workers will be able to obtain a rate of return in capital markets equal to the average historical rate of return on bonds and stocks from the past 70 years (1926–95). For stocks that annual historical rate of return has been 10 percent (nominal); while for bonds the return has been 6 percent (nominal). (Incidentally, over the past twenty years, the financial markets have far exceeded the historical average.

The chart shows that a typical baby boomer born in 1950, will pay over his or her lifetime several hundred thousand dollars more in payroll taxes (plus interest and a normal rate of real return) than the benefits he or she receives.

But the real losers are those in the Generation X cohort—or those born after 1970. These young workers can expect to pay $2 to $5 of taxes (including the foregone normal rate of return on those dollars) for every dollar in benefits collected. Or to state the point differently: if Congress were to allow a 25 year old working woman today to invest her payroll tax contributions in private capital markets, her retirement benefit would be two to five times higher than what Social Security is offering. For our young workers, these are very powerful numbers.

Consider the situation of a low wage worker—someone whose lifetime salary is near the minimum wage. Because of the progressive benefit feature of Social Security, this is typically thought to be the worst case scenario for personal security accounts. It turns out that based on current law, for that worker Social Security promises an annual benefit of roughly $9,000 a year (1995 dollars). If that money were invested in private markets in a portfolio with half stocks and half bonds, the worker would receive an annual benefit upon retirement in the form of an annuity of almost $20,000 per year—or well over twice what Social Security offers. If the money were put entirely into stocks, the worker would have an annual benefit of more than $25,000—or three times what Social Security offers.

Not every worker, obviously will obtain the "average" rate of return. By definition, some workers will do better, some will do worse. But under a PSA system, Congress could place reasonable restrictions on how the money were invested, to protect against losses. For example, Congress might restrict the investments to a select number of mutual funds, where a certain portion of the fund is invested in corporate bonds and treasury bonds. Hence, low-wage workers who might not know much about financial markets, would not choose individual stocks. But a critical point here is that even if these accounts were restricted to an unrealistically risk-averse portfolio, in this case 100 percent corporate bonds, the rate of return would still be higher than under Social Security. In fact, it is virtually impossible to construct an investment scenario where even the lowest income worker does better under Social Security than under a PSA.

So here is the critical point for the members of this Committee to bear in mind when crafting proposals for the future of Social Security: even if the trust fund were entirely solvent—and even if every dollar of promised benefits were to be paid with no tax increases—the system would be a bad deal for our young workers.

Now let's return to the situation of a low-wage worker. I have discovered in conversations with members of Congress and with working Americans that there is an understandable concern about how this will impact our lowest income workers who are most likely to depend exclusively on Social Security payments when they retire. To be viable, any PSA plan must make these most disadvantaged workers better off, not worse off. The chart presented above actually understates the advantage of Social Security privatization to the poor and to minorities. The reason that it understate the benefits of PSAs to the poor and minorities is that these are the workers who are most likely to have started their working years at an earlier age, to have worked more years over their career, and to die earlier after retirement. For precisely these reasons, even accounting for the progressive nature of the benefit struc-

ture, low-income and black workers actually pay in the most relative to the benefit they forego from a private system.

Social Security offers the worst rate of return for that part of the population that it is supposedly most benefited from the system: minorities and the poor. Moreover, it is precisely because the poor elderly tend to have no other source of retirement income, that they stand to gain the most from a privatized system that would yield them a 30 to 50 percent higher monthly payment.

I have attached for the record a recent Cato study by my colleague Michael Tanner that explains in greater detail why the poor would gain the most from PSAs.

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

Incidentally, the Tanner study is also relevant to the spurious argument that workers can not be given the right to opt out of the system because of an "adverse selection" problem. There is no adverse selection problem associated with a voluntary Social Security Personal Security Account plan, since with very few exceptions, every worker in America would be financially better off investing in private capital markets than by staying in the current system.

The argument is sometimes made that there are always risks involved in investing money privately. The stock market doesn't always go up in the short term—though in the long term it must or America will be a very poor country in the next century. Rates of return are not guaranteed. Stock markets crash. Bear in mind, however, that the historical rate of return assumed in this analysis takes into account the Depression-era stock market crash, the 1987 crash and the decade long sag in the market from the late 1960s to the early 1980s.

So yes, there are investment risks associated with PSAs. But remember, from the point of view of the worker, there are also huge political risks associated with staying in the government-run Social Security system. There is the risk that benefits will be cut in the future or that the payroll tax will be raised.

In fact, I would maintain that given the current financial plight of Social Security, it's a virtual certainty that Congress will enact either or both of these Social Security "reforms." Hence, the rate of return comparisons presented above are an unlikely "best-case scenario" for Social Security. The charts assumes that no change in promised benefits and no change in the payroll tax rate will occur over the next forty years.

Even the staunchest opponents of privatization and the most vocal advocates of maintaining the structure of the current system agree that benefits and taxes need to be revised. Former Social Security Commissioner Robert Ball, a leading foe of privatization, advocates a slight rise in the payroll tax, an increase in the retirement age, and other assorted reductions in future benefits. Each of the proposals advocated by the Advisory Council suggested benefit reductions and future tax increases.

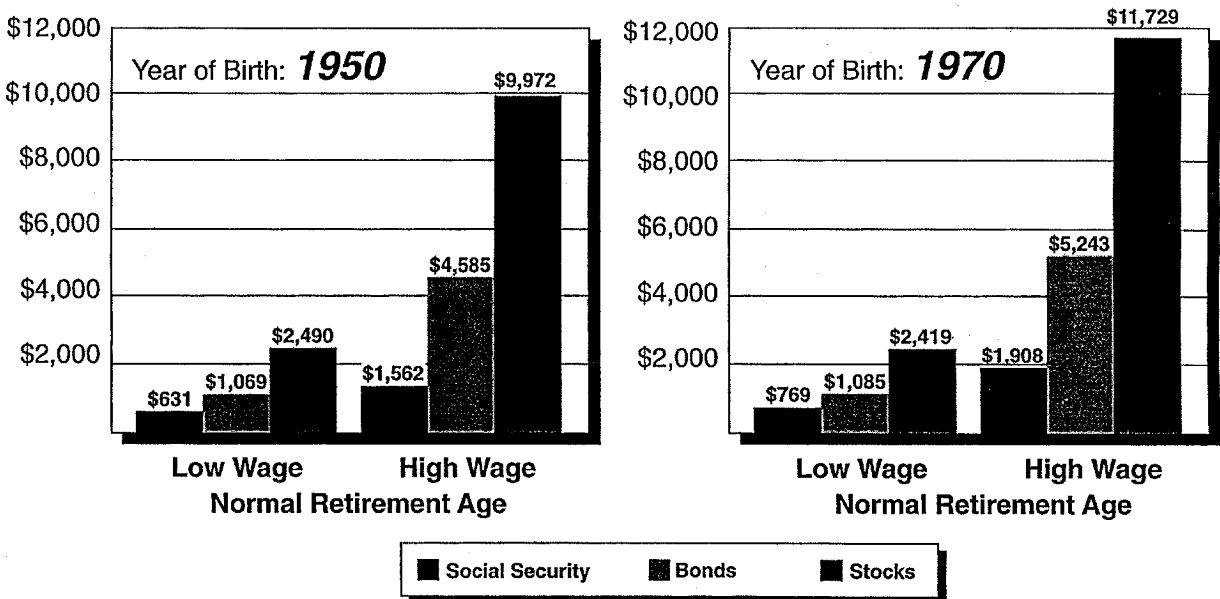
It is imperative for this Committee to understand a critical point about the future of Social Security: any or all of the conventional "fixes" to the program will only make the system a worse deal for young people.

Consider, for example, the proposal to raise gradually the payroll tax by two percentage points (above the current 15.3 percent rate) and a gradual rise in the retirement age before collecting benefits (as is now being considered for Medicare). If this combination of reforms were enacted, rather than paying $2 to $5 of taxes for every dollar of benefit received, our young worker would now pay $3 to $6 of taxes for every dollar of benefit.

This is why all conventional fixes, if they are not tied to an exit strategy that allows young workers to capture the returns from private markets, are a bad deal for the young. This also explains why the 18–30 year old demographic group is the most enthusiastic about a private alternative to Social Security. A personal security account (PSA) system is the only option available to Congress that improves the financial situation of young workers. All of the rest of the leading proposals make the young financially worse off.

I believe that most of the members of this Committee would be in favor of moving gradually to a PSA system if there were a way to do so without blowing a hole in the deficit. We all agree that benefits to current retirees (and soon to be retirees) cannot and should not be cut. We must keep the promises that have been made to seniors.

Monthly Benefit Comparison of Social Security and the Capital Markets by Date of Birth, Income, and Age of Retirement (1995 Dollars)



Source: William G. Shipman, "Retiring with Dignity: Social Security vs. Private Markets," Cato Institute Social Security Paper no. 2, August 14, 1995.

If we allow workers to place all or a portion of payroll tax revenue into private accounts, and we continue to pay benefits to the elderly, then the budget deficit will rise in the short term. To overcome this paradox the members of this Committee must keep in mind that the $3 trillion of unfunded Social Security liabilities are sunk costs. Sunk costs are sunk. The liabilities will need to be paid off regardless of whether Social Security is privatized or not. PSAs simply push those liabilities forward, making them transparent, so they are recognized and dealt with today, not 25 years from now. The budgetary impact of PSAs is the equivalent of paying off a future liability immediately, as companies often do to get unfunded pension liabilities off their books.

Much of the problem stems from the fact that the United States government is about the only institution in the world that still uses a cash-flow accounting system. If the federal government ran its books—using accrual accounting—as every business does, all of the bookkeeping problems with Social Security PSAs would disappear. Tax revenues would decline, but so would offsetting future liabilities—because today's workers would no longer be accumulating rights to benefits. If any individual worker wished to exit from the system and stop paying the tax, then the financial impact on the system would be roughly a wash—unless that worker pays more into the system than he gets out of it. If the worker could be impelled to pay the government to get out of the system, then the impact on the government's balance sheet would be positive.

And herein lies the way out of the dilemma facing Congress. It starts with the recognition that the financing problem of converting to a privatized Social Security system is a short-term cash-flow problem, not a balance sheet problem. From a public policy standpoint, what Congress should be primarily concerned with is how to improve the federal government's balance sheet. It turns out that the gains are so large from privatization of Social Security—Martin Feldstein of the National Bureau of Economic Research estimates that the net economic benefit from Social Security privatization is $10 trillion—that a plan could easily be devised whereby the gains are shared by the government and the worker—to the benefit of both.

Here is one potential method of sharing the gains. What if we offered the following deal to every American worker? If you promise to forfeit any claim on Social Security benefits—even those you have already accumulated—we will let you invest all of your future payroll taxes into private markets. Since the rate of return is so much higher in the private markets than with Social Security, many workers would gladly accept this deal. It turns out, for example, that the age of ambivalence between staying in the system and continuing to pay the tax, versus forfeiting future benefits and putting the subsequent payroll tax revenues into a PSA, is roughly 40 years old—for an average income worker.

For a worker just now entering the workforce, the decision would be clearcut. For example, take a typical female worker who just started working and earns a salary of $22,500, which will go up with the rise in average wages over her lifetime. When she retires Social Security will pay her a $12,500 annual benefit in today's dollars—assuming no change in benefits. If she were permitted to simply place her payroll taxes in a mutual fund with a 7 percent real rate of return (the average rate over the past fifty years), she would have a nest egg worth $800,000 to $1 million at retirement age. This would allow the worker to draw a $60,000 benefit per year until death (assumed at age 80). This is five times higher than what Social Security offers for the same level of investment.

For workers in their 20s and 30s the rate of return is so much higher in private markets than under Social Security that most would be willing to pay in effect an exit tax for the right to invest payroll tax payments privately. The exit fee is the forfeiture of benefits already accrued. There is no adverse selection problem under this scheme because the government makes money on every worker who opts out—regardless of their income.

How big are the gains to the government from this opt-out transition system? Bill Shipman and Marshall Carter with State Street Global Advisers calculate that if every worker under 40 opted out, the reduction in the unfunded liability of Social Security would be on the magnitude of $1 to $1.5 trillion. Hence, up to one-third of the current unfunded liability would be eliminated through this transition plan.

In summary, allow me to enumerate the economic advantages of converting out of our pay-as-you-go government-run Social Security system to a program of PSAs:

(1) Privatization offers a much higher financial rate of return to young workers than the current system.

(2) Privatization gives workers—rather than politicians—control over their own retirement nest egg. The funds deposited in private retirement accounts, are funds that can never be easily taken away by the government.

(3) A privatized system will increase worker ownership in American businesses and assets. This is a "share the wealth" strategy that will help create a nation of capitalists and raise the level of savings and investment.

(4) Privatization is the equivalent of a tax cut for workers. Currently the Social Security payroll tax is treated by many young workers as simply a tax, not a deferred form of compensation. The tax reduces their take-home pay—and thus reduces the incentive to work. Since the privatization option deposits these funds into a personal account, they are now "owned" by the worker.

(5) The increased flow of funds into private capital markets will reduce the cost of capital, and thus increase capital formation, business creation, and ultimately wages and living standards.

(6) By sharing the trillions of dollars of economic gains from the higher rate of return from private accounts, Congress could adopt a strategy that would improve the financial status of individual workers and the federal government. This establishes a win-win situation for the government and the worker.

Thank you again for the opportunity to testify before this Committee.

Mr. JOHNSON of Texas. Thank you.

Dr. Kingson, Associate Professor at Boston College, as enunciated by Mr. Neal. Go right ahead, sir.

STATEMENT OF ERIC KINGSON, ASSOCIATE PROFESSOR, GRADUATE SCHOOL OF SOCIAL WORK, BOSTON COLLEGE, CHESTNUT HILL, MASSACHUSETTS

Mr. KINGSON. Thank you, Mr. Chairman, and thank you, Mr. Neal, for a nice, warm introduction from Massachusetts.

Today, I would like to make six main points. I guess I should begin by making a very important point. It is an honor to be here, and I am very appreciative of the opportunity and pleased that you are taking a very careful look at the Nation's Social Security Program and its future.

The six points that I would like to make today are, first, that there is a significant financing problem, and in my opinion, it should be addressed sooner rather than later. Under the best estimates, the most commonly accepted estimates, the combined Old-Age, Survivors, and Disability Insurance, OASDI, Trust Fund, as you are well aware, has sufficient funds to meet all obligations through the year 2028, and after that, the income is roughly three-quarters of anticipated outgo. Clearly there is a problem, and clearly we should address it.

The second point is that there are no magic bullets. We cannot wish this problem away; neither should we pretend that there are pain-free solutions. Unfortunately, we are not in Lake Woebegone, where everything is above average. This is the real world, and there is going to be pain whatever we do in terms of addressing the Social Security problem. That means whether or not this Subcommittee or Congress chooses to privatize or not, there will need to be either substantial benefit reductions and/or tax increases—not impossible to do, but that is the reality we face. And in fact, if we choose to privatize, the benefit reductions or tax increases will have to be substantially larger to address the Social Security financing problem.

Regardless of whether you oppose or favor the privatization of Social Security, it is important, I believe, that you recognize that the PSA, the personal security accounts, the individual security ac-

counts, and other privatization plans greatly complicate addressing the financing problems of Social Security.

If a portion of current Social Security contributions is diverted to IRA-like accounts, new revenues must be found to finance Social Security pensions to all current and many future beneficiaries. In other words, all privatization plans must address the transition problem, the question of how to meet obligations to current beneficiaries and to older workers while simultaneously advance funding the retirement of the young and many middle-aged workers. And many of these plans, as you are aware, would increase the Federal deficit, placing pressures on other Federal expenditures.

In this respect, I think it is very important to acknowledge one of the Advisory Council proposals, which I strongly disagree with, for the honesty and forthrightness of the analysis behind the personal security account proposal. The proponents of the PSA plan do not try to hide the fact that their plan requires dramatic financing. They call for a temporary, 72-year tax increase of the equivalent of 1.5 percent of payroll, and on top of that, $2 trillion of borrowing, to address the transition problem. They acknowledge these costs up front and, by so doing, allow us to discuss the transition costs openly and honestly.

Even the more modest individual accounts plan requires much larger benefit cuts in the public program—about 30 percent for the average American worker—much larger than would otherwise be needed if we chose not to go a partial privatization route. And for those who might say, well, this plan increases national savings, indeed it does, but so would any plan that incorporates a 1.6 percent of payroll tax increase over and above the existing payroll tax, which is essentially what that plan does. We could increase national savings that way, with or without a Social Security reform.

The third major point is that Social Security is a program that protects the entire family, and this protection is well worth protecting—something we could discuss later.

The fourth point is that privatization of the Nation's Social Security Program would undermine the well-being of tens of millions of baby boomers as well as those who follow them into retirement. Private pension coverage has shown evidence of slight decline for young workers, and also, we have seen evidence that employment for American workers is less secure than it had been for earlier generations. This is precisely the wrong time to introduce additional risks in the personal lives of working Americans, the kinds of risks that would be introduced by privatization. It would also guarantee higher levels of inequality in our society—again, something that has been growing and not something we should seek to advance. This is true of even the individual account plan. Although it may sound relatively reasonable relative to the PSA plan or some of the extreme plans, it too has the potential to undermine the Social Security Program and the economic security of new retirees. It creates a political risk that those workers who do better in the system—and there will be some, given averages, who do better—will have less interest in maintaining the public portion.

One other point. There are many reasonable options, none without pain, but there are financing options that can address this financing problem without pulling apart the Nation's commitment to

a public, universal system. The Advisory Council on Social Security, with all its splits, agreed to a number of proposals that would address roughly 60 percent of the problem.

Finally, I would simply note that there are very important moral values at stake here. Social Security is a mechanism that gives expression to community, the best expression of community, according to former Senator Bill Bradley. Behind all the discussion of "bend points," "year of exhaustion," "dependency ratios," and all of this technical discussion are millions of Americans and large questions about what we owe each other as a society, how we want to encourage families to protect themselves against basic risks we all face, and what mix of private and public responsibility we want.

In other words, this is not simply a mere accounting exercise, as I know you are aware; this is an exercise that will say much about what we are as a nation, and will say much about how we see our role in terms of protecting all our neighbors and all our parents. And I think that that part of the discussion needs to be brought up front often so we do not lose sight of the moral basis of Social Security and the way different Americans may be affected by potential reforms.

Thank you.

[The prepared statement and attachments follow:]

Statement of Eric Kingson, Associate Professor, Graduate School of Social Work, Boston College, Chestnut Hill, Massachusetts

Mr. Chairman and members of the Subcommittee on Social Security of the Ways and Means Committee, it is an honor to appear before you to discuss the future of the nation's commitment to a sound Social Security program. My name is Eric Kingson. I am an associate professor of social policy at the Boston College Graduate School of Social Work. My scholarship and research address the political and economic consequences of population aging, including Social Security, the aging of the Baby Boom cohorts and issues of generational justice. I have previously directed a study for the Gerontological Society of America which examined various ways of framing policy discussion about the aging of America, and I was an advisor to the 1982–3 National Commission on Social Security Reform and to the 1995 Bipartisan Commission on Entitlement and Tax Reform.

THE MAJOR POINTS I WISH TO MAKE TODAY ARE:

- According to the best estimates, Social Security has a significant financing problem. Under the best estimates, the combined OASDI trust fund has sufficient revenues to meet all obligations through 2028. Thereafter, anticipated revenues are projected to only meet three-quarters of estimated trust fund obligations.[1]
- The projected financing problem should be addressed sooner rather than later. For several years now the Social Security trustees have been sounding the warning bell. While there is no immediate crisis, there is a need to advance policies which will put the program back into actuarial balance. Now, one could argue that we could wait 10–15 years before acting. After all, the program is currently running large annual surpluses ($71 billion in 1996 alone) and under all plausible scenarios, shortfalls do not occur for at least 20 years. But I believe it would be a mistake

[1] As the Committee knows, under intermediate assumptions as reported in the 1997 trustees report, the combined OASDI trust fund is estimated to be able to meet its commitments until 2029. However, it is not in actuarial balance for the 75 year period over which long-range estimates are made. Tax returns (payroll tax receipts and receipts from taxation of benefits) will be exceeded by outlays in 2012. Total income, including interest earnings, is expected to exceed expenditures through about 2018 and the combined OASDI trust fund is able to meet its commitments through 2029. Under the most commonly-accepted intermediate assumptions there is a projected 2.23 percent of payroll short-fall (−5.54 percent of payroll shortfall under the high cost assumptions and a +0.21 percent of payroll surplus under the low cost assumptions.) This deficit represents a roughly 14 percent shortfall over the 75-year estimating period; a 25% shortfall after 2028. Since the deficit years fall in the middle and end of the estimating period, the short-falls in the out years are substantially larger than suggested by the overall 2.23 percent of payroll estimate (i.e., −4.88 percent of payroll from 2047–2071).

to postpone action on the long-term problem. Changes that may affect the income of future retirees should be put in place with sufficient lead time to allow workers to adjust their retirement expectations and savings behavior. Moreover, postponing action will undermine public confidence in the program and fuel cynicism about the ability of the nation to address its problems.[2]

• There are no magic bullets. We cannot wish the problem away; neither should we pretend that there are "pain free" solutions. Whatever this Committee recommends and the Congress ultimately enacts—and that includes any form of privatization—will require either benefit reductions or tax increases. Privatization schemes such as the Personal Security Account (PSA) and Individual Account (IA) plans will require larger benefit reductions than would otherwise be needed in the public program and/or larger tax increases (or the equivalent of tax increases).[3]

• The rhetoric of Social Security reform is creating serious public misunderstanding about the financing problems of Social Security and how best to address these problems. Some members of the public believe nothing needs to be done. Many others offer the opinion that Social Security will not be there for them. The "language of Social Security reform" often adds to the problem. For instance, among the public and some journalists, there is an often repeated belief that the projected exhaustion of the combined OASDI trust fund equates to the total inability of the program to meet its obligations. Yet, as members of this committee are well aware, even in the unlikely event that nothing were done to correct for the projected exhaustion of the OASDI trust fund, sufficient revenues are projected to meet all obligations through 2028 and roughly 75 percent from 2029 through 2071.[4] Such exaggerations of the problem are often used by the proponents of radical change to provide rationale for privatizing or otherwise dismantling the nation's commitment to a universal and public Social Security program.

• Regardless of whether you favor or oppose privatization proposals, you should recognize that the PSA, IA & other privatization plans greatly complicate the Social Security financing problem, making it more difficult to address. If a portion of current Social Security contributions are diverted to IRA-like private accounts, new revenues must be found to finance Social Security pensions to all current and many future beneficiaries. In other words, all privatization plans must address the "transition problem"—the question of how to meet obligations to current beneficiaries and older workers while simultaneously advance-funding the retirement of young and many middle-aged workers. And many privatization schemes would also grow the federal deficit, placing additional pressures on federal expenditures.

In this respect, the architects of the PSA plan should be complimented for having the courage to acknowledge the very large costs inherent in any shift towards a private scheme. They do not try to hide the fact that the financing of their plan requires a "temporary" 72-year "transition tax" of 1.52% of payroll plus the borrowing of roughly $2 trillion dollars from general revenues in 2002 to 2034, to be paid back from 2035 to 2069. But, even so, imagine how much more difficult the balancing of the federal budget will be should the PSA plan become law. Even the more modest IA privatization plan would require an unnecessarily large benefit cut—roughly 30% for an average earner[5]—in the remaining public Social Security program. And it would mandate, over and above the current payroll tax contributions, an additional

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[2] The ability to monitor changing economic and demographic trends and anticipate the implications of such changes is a strength of Social Security. Projections provide useful indicators of probable experience, even forty, fifty or seventy-five years into the future. By doing so, they provide a useful tool for making the mid-course corrections that are necessary from time to time. Because the contours of the future are uncertain, projections—especially long-term ones—are subject to error, and, not surprisingly, actual experience is almost always more or less favorable than forecasted. In fact, the history of the program tells us that continued policy and programmatic change, in response to shifting demographic, economic and political forces, is almost the one thing that can be predicted with certainty.

[3] Public investment in the stock market of a portion of the growing trust fund accumulations such as what is proposed for consideration under the Maintain Benefits (MB) plan might increase rate of returns but it will not eliminate the need for benefit reductions and/or tax increases.

[4] The actuaries project sufficient funds to meet 67% of anticipated expenditures during the last 25-year period (2047–2071) in the 75-year estimating period (1997–2071).

[5] The benefit formula changes in the IA plan include the 3% cut from lengthening of the averaging period, a roughly 17 percent cut in future benefits for average earners—20 percent for high income and 8 percent for low earners—and a 8 percent cut from proposed increases in the age of eligibility for full Social Security. (See *Insurance Update*, Volume 1, Issue 3, December 1996, page 3. Also, Advisory Council on Social Security (1997). Report of the 1994–1996 Advisory Council on Social Security, Volume I: Findings and Recommendations. Washington, DC: U.S. Government Printing Office, page 62.

1.6 percent "employee contribution"—a tax by any other name—to a private account. In other words, there are no free lunches here.

• The nation's universal and public Social Security program protects the entire family and this protection is worth maintaining. Social Security provides widespread and basic protection to America's families and employees. It is also the main source of disability and survivors protections for America's families. For a 27 year old couple with two children under age 2 and with earnings equal to average wages, Social Security is the equivalent of a $300,000 life insurance policy; a $207,000 disability policy. It provides Americans with the equivalent of $12.1 trillion dollars in life insurance protection, more than the entire value ($10.8 trillion) of all the private life insurance protection in force. Included among its 44 million beneficiaries are three million children under 18 who receive benefits each month. In Massachusetts, my home state, about 1,036,000 persons receive benefits—totaling $670 million dollars a month. They include 730,000 of Massachusetts' retired workers and their spouses, 119,000 widows and widowers, 106,000 disabled workers and their spouses and 71,000 children. And the program is of equal importance to families in every state (see tables 2 & 3).

• Social Security is the building block that has transformed old age. Social Security is the only pension protection available to six out of ten working persons in the private sector. For the middle class, it provides the foundation of a secure retirement, ideally to be built upon by other pension coverage, private savings, sound investments, accumulated equity in their homes and, for some, work in their later years. But even for those who are relatively well off, say the roughly 4.8 million elderly households with incomes between $18,732 and $31,179 in 1994, Social Security provides nearly half of the total income (see table 4) going to their homes. For the bottom 60 percent of the elderly income distribution—those 14.6 million households with incomes under $18,731 in 1994, Social Security provides over 70 percent of all household income (see tables 4 and 5). Indeed, absent Social Security, the poverty rate among the old would increase to roughly 50 percent (see table 6). And importantly, the security of beneficiaries is protected by cost-of-living protection which assures that benefits, once received, maintain their purchasing power into advanced old age—the point in time when elderly persons, especially widows, are often at greatest economic risk.

• The well-being of baby boomers and those who follow them into retirement will be best served by financing reforms that maintain the basic structure of Social Security. We should encourage personal savings and we should seek to expand employer-based pension coverage. But neither we nor the public should accept as an untested article of faith that a privatization scheme can do more to protect the vast majority of baby boomers. With private pension coverage showing evidence of a slight decline for young workers and with employment becoming less secure for most Americans, this is hardly the time to gamble on radical changes that can only result in increased insecurity and greater disparity in the incomes of Americans. As with today's elderly populations, there is nothing on the horizon that can assure the widespread and secure protection of Social Security to the vast majority of tomorrow's retirees.

• Privatizing the nation's public Social Security program would undermine the well-being of tens of millions of baby boomers and those who follow. As my colleague at Boston College, John Williamson and I have written, "privatization places low- and moderate-income workers at significant political risk. As Social Security is currently structured low-income workers get a better return than high wage workers on their contributions, a factor that keeps millions of the elderly out of poverty during their retirement years. But in separating out the interests of higher-income workers from the public portion of the program, privatization schemes ensure erosion of political support for the program's redistributive role—an outcome which would further increase the economic and social distance between rich and poor."

"Middle and low income workers would face especially serious market risks. Long run returns on stock market investments have generally been quite favorable. But no promises can be made about what will happen to an individual's nest egg in the few years, months or even days before retirement. Low- and even many middle-income workers cannot afford good investment advice. They are more likely to make poor investment decisions, for example, investing too conservatively during early working years or taking unacceptably high risks just prior to retirement."[6] "And most privatized schemes do not provide inflation protection for retirees, yet another example of how they shift risk from government to the individual. The affluent are better positioned to tolerate such risks, but the impact on low and middle income

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[6] It should be noted that it may be prudent for low-income people to invest conservatively since they would have little to fall back on.

retired persons could end up being devastating." And there are other risks, including the possibility that a future Congress might undermine the retirement savings goal by allowing the holders of these private accounts to draw on them for medical emergencies, education or other non-retirement purposes.

Privatization may be a bad idea for most Americans, but not necessarily for everyone—at least if we assume that the winners in the "privatization lottery" do not have a stake in promoting the well-being of the rest of society. Though trading off some surety of protection, [on average] the most affluent workers would likely do better under privatization plans—at least in so far as they do not experience serious declines in their earning capacities during middle age. But without question the most certain "winners would be the banks, mutual funds and investment companies who stand to benefit from the millions of transactions and trillions in private sector investment that would follow even a small partial privatization." [7]

- Even though the IA plan may sound reasonable relative to the PSA and even more extreme privatization plans, it too has the potential to undermine the Social Security program and the economic security of new generations of retirees. Not only does it require additional benefit cuts and tax increases in the remaining public program, but it also assures that those successful investors—often the highest income workers and the nation's opinion leaders—would be tied to an expansion of the private accounts approach.

To fund a privatization and to adjust for the expectation that high income people would benefit most from a privatization, the benefit cuts in the remaining public program would be considerably larger for America's best off workers. Such workers would inevitably compare the favorable rates of return they are receiving in the private plan to the shrunken rates they would then receive in the remaining public plan. Over the long run, this would likely create splits in public support for the remaining public Social Security program. In other words, in my opinion, the IA plan is the equivalent of "the proverbial camel's nose under the tent"—the beginning of a process which will destroy the nation's public Social Security program. And for those who point out that this approach would increase national savings, I would simply say, "Of course it does! Whenever you mandate any "tax increase"—in this case a 1.6% of payroll contribution to private accounts—over and above existing taxes, you will increase national savings."

- Important areas of agreement should not be overlooked. Even among the split 1994–6 Advisory Council, its members unanimously agreed that there is a manageable financing problem, and that it should be addressed sooner rather than later. They also unanimously agreed with maintaining some redistribution to low income persons, that means-testing Social Security is not desirable, that full COLA protection is critical to the financial well-being of beneficiaries and that any "sacrifice in bringing the system into balance should be widely shared and not borne entirely by current and future workers and their employers." [8] And they agreed that additional income protection is needed for aged widows—a group of elders at substantial economic risk. All three plans improve the rate of return for future beneficiaries through some form of investment of the growing Social Security trust fund assets in the private sector. All three call for increased tax revenues or their equivalent although the MB plan would not initiate a 1.6% of payroll increase (0.8% on employer and employee) until 2045 and the PSA plan calls for a 72-year increase of 1.52 beginning in 1998.

- Many financing reform packages can be put together without violating the basic commitments to the nation's public Social Security program. For example, Council majorities supported four changes that addressed 60 percent of the financing problem. There was strong support for extending coverage to all new state and local workers; reducing benefits by roughly three percent through a technical change in the benefit formula; and taxing Social Security benefits in roughly the same manner as income from contributory defined-benefit plans. And there was majority support for a proposal to accelerate the planned increase in the normal retirement age to 67 in 2011 instead of 2022, and to index it to changes in life expectancy thereafter.[9]

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[7] See John B. Williamson and Eric R. Kingson (January 10, 1997), "The Pitfalls of Privatization," *Boston Globe.*

[8] See Advisory Council on Social Security (1997).

[9] This proposal to increase the age of eligibility for full benefits represents an 8 percent cut in benefits. This and other proposals to raise the age of eligibility for full benefits provide an example of the need to carefully assess the distributive implications of proposed benefit reductions (and/or payroll tax increases). In many respects this type of benefit reduction represents a fair and understandable way of reducing expenditures. Life expectancies, and hence the number of years beneficiaries receive retirement benefits, have increased and are expected to in-

Continued

Taken, together, these four changes address sixty percent of the projected financing problem (+1.31 percent of taxable payroll)—arguably a pretty substantial down-payment on the projected shortfall for those seeking moderate approaches to addressing the financing problem. And many other options exist as well.

For example, the MB plan suggests considering the gradual investment of up to 40 percent of OASDI trust fund assets in broad private market funds, a change that would indirectly increase rates of return to individuals while also eliminating about two-fifths (+0.90 "percent of taxable payroll") of the projected financing problem. Some have suggested moderate across the board benefit cuts or even further increases in the age of eligibility for full benefits. Others might treat some portion of fringe benefits as taxable for Social Security purposes [10] or incorporate a modest increase in payroll taxes forty or fifty years from now. Still others would restore and maintain the proportion of wages covered by the payroll tax at the 90% level by 2000, addressing about 14% of the projected financing problem (+.31 percent of taxable payroll).[11] My purpose is not to advocate any particular package, but to point out that the financing problem can be addressed without privatizing or otherwise altering the basic structure of the program.

- A public Social Security program is, to paraphrase former Senator Bill Bradley, the best expression of community in America today. Indeed, more is at stake in this discussion than the technical aspects of how to address the financing problems of Social Security. Behind all the discussion of "bend points," "year of exhaustion," "dependency ratios," and "percents of taxable payroll," this debate is fundamentally about our sense of responsibility to each other; about the basic protection that each working American should be assured of for themselves and their families in old age, disability or on the death of a loved one; about the mix of public and private efforts we should encourage to assure that security. In other words, the disturbing tendency in media and public discourse to reduce Social Security discussions to mere accounting exercises of the financial cost of the program overlooks the benefits this program provides and the real consequences to the well-being of individuals and families of various possible changes. Social Security is an institution that has strengthened the nation's families and communities. In a very fundamental way it is an expression of the moral commitment of our nation to serve as our brothers' and sisters' keepers and to honor thy mothers and fathers. In the process of addressing long-term financing problems, it is important that we not lose sight of this moral dimension of the program which is one of the joining institutions of our society.

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crease even further. Even after age 67 is phased in as the new normal retirement age, as planned under the current law, beneficiaries of the future will generally receive retirement benefits for more years than current beneficiaries. Moreover, this change, some suggest, will encourage work effort on the part of the old. However, others point out that there is little evidence that workers will substantially increase their work effort, even if employment opportunities are available. Of most concern, this change undermines the adequacy goal of Social Security, with much of the long-term savings to the trust fund coming disproportionately at the expense of future lower-income persons who may be unable to work due to limited employment opportunities and health problems. Among both proponents and opponents of retirement age changes, there is recognition that such changes will have potentially deleterious effects on some marginally-employable older workers of the future, leading many to suggest the need to consider ameliorative policy interventions if the normal retirement age is increased. For example, Congressman Pickle's bill (H.R.4275) proposed pairing an increase in the Social Security retirement age to 70 with a reduction in the SSI eligibility age to 62.

[10] Edith Fierst, a member of the Advisory Council, notes that Social Security's actuaries estimate that taxing "the cost of employer-provided group health and life insurance ... as though it were cash compensation" would address roughly one-third of the predicted shortfall). (See E.U. Fierst (1997). Supplemental statement. In Advisory Council on Social Security (1997), pp. 135–154).

[11] During the 1980s as the income distribution widened (with more people being pushed well above average wages), the proportion of wages covered by the payroll tax dropped from roughly 90% to 88%. It is projected to drop to 85.5% ten years hence. (Alternatively, some would suggest giving consideration to treating 100% of employer payroll as taxable for Social Security purposes. This approach would address nearly one-half of the projected financing problem and is consistent with the view that the employer's contribution is part of a pool of funds that promotes the social goals of Social Security.)

TABLE 1. Year of Trust Fund Exhaustion[a]

Set of Assumptions	OASDI	DI	OASDI	Projected OASDI Deficit as % of Taxable Payroll
Alternative I (Low Cost)	Never	Never	Never	+0.21
Alternative II (Best Estimate)	2031	2015	2029	−2.23
Alternative III (High Cost)	2022	2007	2018	−5.54

[a] "Exhaustion of a trust fund means that its accumulated assets are depleted. Payroll tax and other income will continue to flow into the fund, however."

Source: 1997 Trustees Report

Table 2

Table 2.—Amount of OASDI benefits in current-payment status, by type of benefit, by sex of beneficiaries aged 65 or older, and by State, December 1994

[In thousands]

State and county	Total	Retirement benefits			Survivor benefits		Disability benefits			Aged 65 or older	
		Retired workers [1]	Wives and husbands	Children	Widows and widowers [2]	Children	Disabled workers	Wives and husbands	Children	Men	Women
United States, total	$26,935,427	$18,415,223	$1,101,116	$136,060	$3,528,749	$850,406	$2,620,948	$43,246	$239,679	$9,889,379	$11,003,747
Alabama	435,445	266,497	17,933	3,009	65,670	18,566	56,751	1,138	5,883	143,492	168,201
Alaska	25,132	16,076	816	187	2,550	1,923	3,210	46	323	9,109	7,881
Arizona	440,344	312,252	18,653	1,944	48,615	12,076	42,566	651	3,585	171,116	170,901
Arkansas	281,646	176,868	11,199	1,531	38,174	9,996	39,103	715	4,059	97,036	106,268
California	2,533,919	1,771,463	111,820	13,642	298,118	76,677	239,639	3,169	19,391	967,917	1,027,847
Colorado	297,271	196,119	14,232	1,194	37,598	9,601	34,821	528	3,177	109,226	114,011
Connecticut	396,454	298,584	12,144	1,774	43,741	9,524	28,225	294	2,169	153,229	174,902
Delaware	77,587	55,167	2,966	350	9,481	2,361	6,640	93	529	29,141	31,025
District of Columbia	42,363	29,206	1,177	189	5,327	1,879	4,340	21	224	13,730	19,888
Florida	1,882,692	1,385,150	74,628	7,634	214,815	42,316	143,664	2,323	12,162	756,301	773,040
Georgia	575,729	365,947	19,499	3,007	75,534	25,932	77,041	1,179	7,590	185,477	224,558
Hawaii	101,717	77,746	3,639	936	9,606	2,902	6,290	89	509	42,996	39,724
Idaho	106,673	73,550	5,172	535	12,874	3,565	9,849	180	948	42,118	40,538
Illinois	1,226,895	855,484	46,018	5,905	166,034	38,091	104,330	1,340	9,692	452,820	525,293
Indiana	636,861	435,617	24,834	3,126	85,764	20,105	60,548	951	5,917	228,562	263,474
Iowa	342,549	238,447	17,752	1,417	49,000	8,607	24,751	350	2,224	131,850	147,552
Kansas	279,335	196,492	13,062	1,179	37,715	7,974	20,720	252	1,941	107,118	120,122
Kentucky	395,079	229,970	17,364	2,095	60,982	14,509	62,094	1,547	6,517	127,795	146,833
Louisiana	389,929	219,174	20,837	2,730	68,112	19,774	51,469	1,573	6,261	131,902	142,627
Maine	135,662	92,193	5,529	605	17,181	3,641	15,015	252	1,246	49,435	54,559
Maryland	427,549	298,717	16,044	1,943	56,991	15,560	35,086	396	2,812	155,008	181,578
Massachusetts	668,938	476,410	22,091	2,775	80,428	15,841	65,424	786	5,183	242,464	295,213
Michigan	1,063,854	715,113	45,095	5,959	144,842	34,647	105,826	1,683	10,688	387,346	424,163
Minnesota	444,062	311,997	20,994	1,998	58,691	12,029	34,907	379	3,066	169,873	186,112
Mississippi	258,333	153,643	8,823	1,909	35,389	12,655	40,392	840	4,683	81,000	95,766
Missouri	598,763	405,775	23,778	2,784	80,666	18,710	60,405	924	5,721	213,597	247,183
Montana	90,417	60,050	4,475	419	11,900	2,960	9,526	185	902	34,630	34,499
Nebraska	175,315	122,793	8,765	701	24,389	4,744	12,539	165	1,219	67,578	75,712
Nevada	142,723	103,401	4,616	658	14,012	4,052	14,769	165	1,049	57,077	51,311
New Hampshire	117,032	85,283	3,770	454	12,692	3,074	10,653	143	962	43,721	48,301
New Jersey	919,526	677,911	26,656	3,799	108,543	24,705	71,159	921	5,832	346,940	402,686
New Mexico	142,312	91,818	7,206	929	18,185	5,796	16,293	410	1,675	52,612	51,715
New York	2,003,274	1,427,423	62,539	10,382	235,811	56,997	191,617	2,836	15,668	716,381	865,055
North Carolina	714,930	482,719	22,396	3,132	84,464	24,437	88,963	1,090	7,730	241,797	285,033
North Dakota	67,774	44,774	4,442	320	11,003	1,925	4,821	72	417	27,344	27,819
Ohio	1,220,278	800,974	59,574	6,126	188,680	35,983	116,201	2,007	10,731	448,877	500,305
Oklahoma	341,190	226,615	15,322	1,595	49,089	11,865	33,066	586	3,052	122,394	138,905
Oregon	346,717	249,297	14,869	1,486	40,596	8,988	28,717	441	2,324	135,965	140,490
Pennsylvania	1,536,345	1,084,278	64,096	6,360	222,899	38,024	110,374	1,844	8,471	579,886	667,619
Rhode Island	121,964	90,795	2,999	443	13,063	2,665	11,074	133	793	44,848	54,403
South Carolina	358,230	234,045	11,324	1,924	42,377	15,059	48,204	680	4,617	118,405	136,682
South Dakota	76,847	51,979	4,312	349	11,264	2,242	6,035	97	568	30,316	31,635
Tennessee	529,680	336,785	20,662	2,780	73,513	19,365	68,929	1,170	6,477	177,569	207,723
Texas	1,450,845	935,450	73,222	8,671	220,103	61,274	135,604	2,846	13,676	529,292	569,137
Utah	136,613	94,355	6,735	886	15,392	5,908	11,804	179	1,355	53,109	52,101
Vermont	59,686	41,274	2,351	276	7,465	1,661	6,008	104	546	21,894	24,259
Virginia	557,668	371,414	21,709	2,600	74,654	19,141	61,431	1,177	5,543	193,041	226,748
Washington	513,608	362,808	22,991	2,255	59,980	14,276	46,781	642	3,875	198,886	205,682
West Virginia	232,164	134,027	11,752	1,412	40,437	7,776	32,310	1,055	3,396	78,416	87,994
Wisconsin	572,050	405,368	23,410	2,716	73,157	15,088	47,196	642	4,473	217,848	236,479
Wyoming	43,808	30,029	1,887	178	5,434	1,602	4,195	68	413	16,874	16,427
Outlying Areas:											
American Samoa	1,281	456	37	60	177	222	274	9	45	284	242
Guam	2,646	1,522	165	66	315	339	200	5	34	1,079	633
Northern Marianas	240	99	12	11	25	62	27	0	3	67	26
Puerto Rico	234,370	116,610	12,015	3,108	29,688	13,183	51,643	1,618	6,505	72,727	64,057
Virgin Islands	5,762	3,782	196	82	567	433	613	11	77	2,015	1,912
Foreign Countries	155,335	93,423	10,512	1,526	34,975	7,094	6,810	243	750	57,845	68,894

[1] Includes special age-72 beneficiaries.
[2] Includes nondisabled widows and widowers, disabled widows and widowers, widowed mothers and fathers, and parents.

Source: Social Security Administration

Table 3

Table 3.—Number of OASDI beneficiaries with benefits in current-payment status, by type of benefit, by sex of beneficiaries aged 65 or older, and by State, December 1994

State and county	Total	Retirement benefits			Survivor benefits		Disability benefits			Aged 65 or older	
		Retired workers [1]	Wives and husbands	Children	Widows and widowers [2]	Children	Disabled workers	Wives and husbands	Children	Men	Women
United States, total	42,881,068	26,409,114	3,066,164	439,860	5,519,492	1,863,916	3,962,893	270,950	1,348,679	12,523,800	18,626,556
Alabama	766,743	412,797	53,774	10,291	116,040	42,562	89,103	7,440	34,736	197,339	312,283
Alaska	41,938	23,326	2,446	727	4,307	4,130	4,850	315	1,837	11,975	13,585
Arizona	686,591	442,176	51,233	6,503	73,520	26,996	62,023	3,895	20,245	214,490	287,336
Arkansas	504,210	280,482	35,020	5,641	68,579	23,396	61,979	4,760	24,353	137,349	202,307
California	3,940,220	2,489,845	305,013	44,742	448,838	168,712	358,248	19,409	105,413	1,205,958	1,704,630
Colorado	484,277	288,572	39,925	3,740	58,321	20,067	52,673	3,242	17,737	141,060	200,805
Connecticut	560,337	390,575	29,596	4,731	61,009	19,230	41,883	1,845	11,468	173,471	265,097
Delaware	116,640	75,828	7,531	1,006	14,012	4,960	9,850	558	2,895	34,832	50,318
District of Columbia	77,501	49,497	3,669	723	9,889	5,011	7,364	132	1,216	21,114	37,209
Florida	2,934,435	1,990,871	205,012	24,748	324,892	94,097	215,262	13,703	65,850	951,836	1,308,783
Georgia	989,028	559,473	56,217	10,075	131,722	58,960	120,893	7,925	43,763	248,527	404,286
Hawaii	162,463	113,269	11,026	3,271	15,435	6,401	9,495	587	2,979	56,677	68,136
Idaho	174,225	108,503	14,509	1,756	19,909	7,730	15,043	1,160	5,615	54,720	71,946
Illinois	1,827,854	1,160,346	118,048	17,186	241,161	79,714	152,671	7,837	50,891	536,021	829,988
Indiana	964,807	597,761	64,694	8,715	126,346	40,539	89,214	5,583	31,955	274,468	424,461
Iowa	539,094	341,222	48,486	4,095	74,197	17,759	38,313	2,174	12,848	166,201	252,224
Kansas	430,436	274,998	34,185	3,457	56,148	16,684	32,437	1,581	10,946	130,959	199,304
Kentucky	697,108	356,443	53,608	7,263	106,316	32,566	93,795	9,797	37,320	178,242	274,384
Louisiana	697,219	336,649	61,454	9,689	116,650	46,817	77,021	9,946	38,993	179,280	269,682
Maine	232,404	143,670	16,071	1,928	28,085	7,964	24,993	1,779	7,914	67,419	99,754
Maryland	665,196	427,315	43,143	5,739	87,071	33,781	51,835	2,263	14,049	194,203	302,312
Massachusetts	1,035,751	680,875	58,188	8,330	119,336	33,428	100,562	5,162	29,870	300,893	484,003
Michigan	1,584,968	961,450	116,063	16,561	210,043	69,487	147,353	9,497	54,514	458,534	677,124
Minnesota	710,370	456,149	59,183	5,902	90,716	24,773	54,244	2,353	17,050	219,942	323,914
Mississippi	486,325	251,027	28,151	7,398	67,378	30,982	65,674	5,873	29,842	118,365	185,630
Missouri	967,259	593,690	66,579	8,672	126,978	41,050	92,502	5,798	31,990	274,796	424,710
Montana	148,429	88,874	12,669	1,342	18,512	6,443	14,305	1,161	5,123	45,624	60,948
Nebraska	279,816	178,636	24,055	2,129	37,158	9,969	19,708	1,069	7,092	86,323	130,382
Nevada	219,206	147,280	12,689	2,126	21,076	8,355	21,336	924	5,420	72,235	85,233
New Hampshire	180,037	121,285	9,822	1,268	18,916	6,051	16,145	983	5,567	53,888	79,504
New Jersey	1,305,017	885,833	66,803	10,577	154,177	50,739	102,617	5,349	28,922	393,334	609,169
New Mexico	249,740	140,225	21,927	3,460	30,835	14,204	25,357	2,846	10,886	72,037	95,941
New York	2,955,585	1,918,426	163,233	30,808	345,772	122,186	275,202	17,117	82,841	847,887	1,334,800
North Carolina	1,204,847	733,405	65,085	10,079	149,361	55,182	141,818	7,090	42,827	324,993	509,221
North Dakota	115,232	68,209	13,166	1,046	17,771	4,275	7,848	444	2,473	37,322	52,060
Ohio	1,896,304	1,123,354	159,174	17,797	281,058	74,985	170,577	11,478	57,881	551,697	839,879
Oklahoma	569,641	341,080	44,549	5,346	80,704	26,077	50,725	3,725	17,435	164,260	246,816
Oregon	533,276	351,830	40,132	4,404	60,218	18,604	42,974	2,563	12,551	169,226	234,443
Pennsylvania	2,323,281	1,508,944	167,467	18,124	328,035	79,223	162,924	11,349	47,215	701,389	1,094,200
Rhode Island	188,366	130,571	7,998	1,357	19,613	5,670	17,471	951	4,735	55,495	89,223
South Carolina	609,827	355,855	32,468	6,225	75,653	34,544	75,341	4,404	25,337	158,305	245,521
South Dakota	133,846	81,335	13,086	1,242	18,659	5,268	9,991	629	3,636	42,534	59,401
Tennessee	909,908	513,421	60,059	9,299	126,994	43,946	110,334	7,766	38,089	239,917	375,848
Texas	2,428,626	1,383,756	210,039	31,756	356,970	137,422	207,677	18,883	82,123	692,146	1,013,099
Utah	218,862	134,423	18,233	2,722	23,018	12,705	18,197	1,166	8,398	65,997	89,420
Vermont	96,515	60,074	6,603	854	11,765	3,623	9,581	683	3,332	28,213	41,385
Virginia	926,783	558,572	62,410	8,354	124,537	41,218	94,002	7,286	30,404	257,343	400,656
Washington	778,321	500,850	60,397	6,512	87,669	29,000	69,854	3,658	20,381	241,884	338,123
West Virginia	385,526	194,410	33,773	4,598	65,870	16,752	45,878	6,066	18,179	102,217	156,007
Wisconsin	877,120	568,315	63,034	7,644	108,259	30,812	70,612	3,948	24,496	268,182	391,859
Wyoming	69,258	42,951	5,124	550	8,284	3,246	6,333	425	2,345	21,200	28,082
Outlying Areas:											
American Samoa	4,059	1,114	225	362	491	777	553	82	455	638	697
Guam	6,728	3,116	773	387	723	1,024	361	54	290	2,057	1,705
Northern Marianas	858	248	67	101	89	261	60	5	27	153	75
Puerto Rico	608,502	259,300	57,208	18,112	75,503	43,348	93,247	12,691	49,093	152,714	178,646
Virgin Islands	11,299	6,374	716	349	1,113	1,180	985	80	502	3,135	3,737
Foreign Countries	368,821	200,229	50,355	8,039	73,787	19,021	11,596	1,460	4,334	122,777	166,260

[1] Includes special age-72 beneficiaries.
[2] Includes nondisabled widows and widowers, disabled widows and widowers, widowed mothers and fathers, and parents.

Source: Social Security Administration

TABLE 4. Importance of Various Sources of Income to Elderly Households, 1994*
(ALL MEMBERS OVER AGE 65)

	All Aged Units	Quintiles				
		Units Under $7,730 (Q1)	$7,730–$12,213 (Q2)	$12,214–$18,731 (Q3)	$18,732–$31,179 (Q4)	$31,179 and over (Q5)
Number of Units (in millions)	23.9	4.9	4.7	4.8	4.8	4.8
Percent of Total Income From: **						
Social Security	42.1	81.2	81.1	65.9	48.3	22.7
Railroad Retirement	0.6	0.7	1.0	0.7	1.0	0.4
Government employee pension	8.4	0.8	2.4	5.3	10.2	10.2
Private pension/annuity	9.7	1.7	4.0	8.1	12.7	10.5
Income from assets	17.6	2.7	5.4	10.3	14.4	24.4
Earnings	18.0	0.2	2.2	6.2	10.9	28.5
Public Cash Assistance	0.9	11.0	2.0	0.8	0.4	0.1
Other	2.7	1.6	1.9	2.8	2.2	3.2

*All members of households are 65 or over. Aged units are married couple living together—at least one of whom is 65—and non-married persons 65 or older.
**Details may not sum to totals due to rounding error.
Source: US Department of Health and Human Services, Social Security Administration, Office of Research and Statistics, *Income of the Population 55 and Over* (Washington, D.C: January 1996), pp. 109–113.

TABLE 5. Share of Aggregate Income to Elderly Households,* 65 and over in 1994

	African-American Units 65 & Over	Hispanic Units 65 & Over	White Units 65 & Over
Percent of Cash Income From:**			
Numbers (in millions)	2.2	1.2	21.2
Social Security	48.4	49.3	41.9
Railroad Retirement	0.6	0.2	0.6
Government Employee Pensions	10.6	4.6	8.2
Private Pensions or Annuities	7.3	6.9	9.9
Earnings	22.6	22.4	17.5
Income from Assets	3.9	6.9	18.5
Public Assistance	3.3	6.3	0.7
Other	3.2	3.6	2.2

*Aged units are married couple living together—at least one of whom is 55—and non-married persons 65 or older.
**Details may not sum to totals due to rounding error.
Source: US Department of Health and Human Services, Social Security Administration, Office of Research and Statistics, *Income of the Population 55 and Over* (Washington, D.C: May 1996), pp. 112.

TABLE 6. Elderly Households* Below Poverty Line in 1994, With and Without Social Security Benefits, Among Households Receiving Social Security Benefit

	All Aged Units	African-American Elderly Units	Hispanic Elderly Units	White Elderly Units	Women not Married
65 and Over					
Number of Units* with SS Benefits (in millions)	23.9	1.9	0.9	19.6	9.9
Percent**					
Below Poverty line	14	29	21	10	20
Kept Out of Poverty by Social Security	42	39	40	42	44
Total Below Poverty Without Social Security	54	69	61	53	64
85 and Over					
Number of Units* with SS Benefits (in millions)	2.5	0.2	0.1	2.2	1.7
Percent**					
Below Poverty line	17	30	25	15	20
Kept Out of Poverty by Social Security	49	47	46	50	48
Total Below Poverty Without Social Security	66	76	71	65	68

Source: US Department of Health and Human Services, Social Security Administration, Office of Research and Statistics, Income of the Population 55 and Over (Washington, D.C: January 1996), p. 123

* Aged units are married couple living together—at least one of whom is 55—and non-married persons 65 or older.

** Details may not sum to totals due to rounding error.

TABLE 7. Total Money Income of Elderly Households, 65 and over, in 1994

	Married Couples	Non-Married Persons
Numbers (in millions)	9.7	14.2
Total Percent	100.0	100.0
Less than $10,000	5.3	34.4
$10,000 to $19,999	26.2	33.0
$20,000 to $29,999	24.2	12.3
$30,000 to $39,999	15.2	7.2
$40,000 to $59,999	14.3	6.9
$60,000 to $99,999	9.7	4.4
$100,000 or more	5.1	1.9
Median Income	$27,013	$13,538

* Aged units are married couple living together—at least one of whom is 65—and non-married persons 65 or older.
** Details may not sum to totals due to rounding error.
Source: US Department of Health and Human Services, Social Security Administration, Office of Research and Statistics, *Income of the Population 55 and Over* (Washington, D.C: January 1996), pp. 26, 27

Mr. JOHNSON of Texas. Thank you, sir.

Ron Gebhardtsbauer, a senior pension fellow at the American Academy of Actuaries. Go right ahead, sir.

STATEMENT OF RON GEBHARDTSBAUER, SENIOR PENSION FELLOW, AMERICAN ACADEMY OF ACTUARIES

Mr. GEBHARDTSBAUER. Good morning, and thank you for inviting me to speak today. As you mentioned, my name is Ron Gebhardtsbauer, and I am the senior pension fellow at the American Academy of Actuaries. We are the nonpartisan public policy organization for actuaries in the United States, and we analyze legislation but do not endorse or propose legislation.

Today I am going to speak to your four questions, namely: Is reform necessary and how soon do we need to act, what are our assessments of some of the recommendations and proposals, and finally, what is the next step.

For the first question, I will just second the speakers ahead of me and say Social Security does have a financial problem, because eventually, they will not be able to pay full benefits. But even sooner—which answers the second question—even sooner, the year 2008, we have some budget concerns.

Right now, Social Security brings in more than $30 billion to the system that it does not pay out right away, so it helps the deficit. This will go on until the year 2008, and that is the time when the baby boom starts retiring. At that time, the money coming in from Social Security tax income will be less that what it pays out, therefore the surplus goes down. So that if Congress balances the budget using Social Security surplus, that means that in the year 2008, it will start going out of balance because the surplus in Social Security is going down.

So that means we need to fix it by the year 2008, but we probably do not want to wait until then if Congress feels that it is also important to enact rules that help us plan for these changes, enacts rules that are less drastic and ones that we can phase into gradually and not have notches.

Your third question is what is our assessment of some of the Advisory Council recommendations and other proposals. I have a prior speech that I have made, and I have given you copies of it—and it goes into detail, so that I can just talk about the larger significant advantages and disadvantages.

All three of the Advisory Council options have the big advantage that they solve the Social Security problem. They put it into actuarial balance—and this is important—they get the trust fund to be stable at the end of the 75-year period, because if all we do is put it into actuarial balance and do not get those trust funds stable at the end of 75 years, then we will be back here in 10, 20 years, trying to fix it again.

So the Advisory Council's number one proposal, the maintain benefits proposal, creates stable trust funds by increasing contributions in the year 2045, way in the future.

The other two options increase the retirement age, and that is probably a more permanent solution because it is addressing the need, the fact that people are living a lot longer; and so as people live a lot longer, it would gradually go out of actuarial balance and increasing the retirement age stops that.

But each of the Council's proposals have disadvantages. The maintain benefits proposal increases contributions way out there in the future for a future generation and does not require it of ourselves. Can we require them to put in more than we are putting in?

In addition, it invests some of its trust funds in the stock market, which has the advantages of higher return and really saving the money outside the government, but it has governance concerns. Well, you could remedy that by delegating the responsibility of voting to the money managers, but if this system eventually has 5 to 10 percent of U.S. markets in it, it might be tempting to change those rules.

The next option is the individual account option. Its main concern is that the benefits are not as good right away, and that is because it does not take any money from Medicare, which one of the other options, maintain benefits, does. In addition, it keeps all its trust fund money invested in Treasuries and not stock, so it does not have higher benefits. And the third reason is because it has a transition. Whenever you move toward a personal account, and you have a transition, somebody has got to pay twice or more than just for themselves, and that is what happens to that system—either you pay more, or your benefits are less.

The third option is the personal security account option. It gives better benefits because they invest more money than the other ones in the stock market. Where do they come up with that money? Well, they borrow it from the U.S. Government. And in fact, in the first 7 years of this plan being in effect, it increases the deficit by over $1 trillion. So in other words, the transition cost there is paid for through increased interest rates, higher borrowing costs, higher inflation and higher taxes. So what it does is make Social Security a better deal at the expense of taxpayers and also industry.

Also, this other option will have risks. The other options, the other two, if they borrow just as much money and invest in the stock market, could do just as well and not have risks, but this one

is going to have more risk because it will put on the individual the investment risk, the inflation risk, and the longevity risk—they might outlive their money. And so the individual account method handles this by putting restrictions on some of those investments; you can only invest it here, and you have to have an annuity. But these restrictions then cause governance concerns, and the PSA group decided to opt for more risk instead of more restrictions and governance concerns.

Finally, on the PSA option, we have to discuss the issue of sustainability—can that system be sustained. Can we continue to require people to put mandatory contribution into accounts, and is this $400 benefit that it pays to everybody, that is going to have a poor money's worth, sustainable, or could that be turned into welfare?

Finally, all the proposals that we have to deal with, we should look outside Social Security and see what their effects are. What are the effects of these proposals outside the system—for instance, on retirement income of an individual, which includes personal savings and also employer benefits, which are the other two legs of the retirement stool. We do not want to heal one leg by reducing or eliminating the other legs and end up with a one-legged stool.

So we may have a way to use employers, and I cannot go any further, but maybe we can talk about it later, how we can use employers.

Finally, I want to thank the Subcommittee for having this hearing and educating the public on some very important and complex issues.

Thank you.

[The prepared statement follows:]

Statement of Ron Gebhardtsbauer, Senior Pension Fellow, American Academy of Actuaries

Chairman Bunning, committee members, staff, and fellow panelists, Good Morning. My name is Ron Gebhardtsbauer and I am the Senior Pension Fellow at the American Academy of Actuaries. The Academy is the non-partisan public policy organization for actuaries in the United States that analyzes, but does not endorse or propose legislation.

In order to save time, I have provided the subcommittee with copies of a more comprehensive presentation on this subject, so that I can focus on the four questions the subcommittee has asked the Academy to address regarding the Old-Age Survivors and Disability Insurance program, or Social Security.

The subcommittee's first question concerns the degree to which Social Security reform is necessary. To the extent that this nation wants to sustain the successes of the current Social Security program (e.g., alleviating poverty among the elderly), Social Security needs to be modified sooner rather than later. Without changes in the law, the government's actuarial predictions show that only 75% of benefits will be payable from income after the Trust Funds are exhausted in 2029, and as our country ages, this becomes 69%. This can be easily seen by looking at the demographics. Today there are about 3 workers for every beneficiary. In 2029, when virtually all the baby boom cohort will be retired, there will be about 2 workers for every beneficiary. This projection is quite accurate because it is based mostly on people already born.

There is also a U.S. budget concern which occurs much sooner, and this is responsive to the next question posed by the subcommittee, namely, "How soon is Congressional action needed?" At present, Social Security's tax income exceeds its outgo by $30 billion, which helps the U.S. deficit look lower than it actually is. This $30 billion annual surplus starts to decrease around the year 2008, which is exactly when the baby boom generation starts to retire. By 2012, Social Security's tax income will be less than what it pays out. Thus, if Congress balances the U.S. budget in 2002 using Social Security's surplus, then Social Security could put the U.S. budget out

of balance in the year 2008. Therefore, if a balanced budget is a goal of Congress, then the Social Security fix should be in effect by 2008. But action is needed even sooner than that if Congress wants to:

- enable workers to plan ahead for the changes
- have gradual implementation (i.e., less chance of notches)
- include more people in the solution
- have a less drastic solution,
- restore faith in the system again.

Congress should analyze the potential solutions carefully, which leads to the third question: What is the Academy's assessment of the Advisory Council recommendations and other proposals?" The attachment goes into the details about most provisions, so I will just discuss the more significant ones.

The advantages of the three Advisory Council options are clear. All three options solve the financial problems of Social Security for the upcoming 75 year period and maintain a stable Trust Fund at the end of that period. It is important to stress that second part. It is not sufficient to just put Social Security back in actuarial balance over the next 75 year period. If that is the only action Congress takes, then in 20 years there will be another crisis. This is because, as future deficit years get included in the 75 year period, the system gets thrown out of balance a little each year. The Maintain Benefits group solves this by increasing contributions by 1.6% of covered pay starting in the year 2045. The other two Advisory Group options solve this by increasing the Normal Retirement Age to 67 by 2011 and age 70 by 2083. This produces a more permanent solution. Unless, the Normal Retirement Age increases with longevity, the system will eventually go out of balance.

Each Advisory Council option also has disadvantages.

The Maintain Benefits (MB) option requires future workers to contribute 1.6% of wages more into Social Security than current workers will ever pay. Furthermore, in order for their option to be in balance, the Social Security Administration would have to invest 40% of their surplus in passive equity indexes. This has advantages. For example, the additional savings from the MB option would really be saved if invested outside the government, and their long-term yields would improve. Indexes avoid the concern that Social Security would manipulate the market and proxy voting could be delegated to the money managers, like at PBGC and the Federal Thrift Savings Board, two other government agencies that have equity investments. However, with an estimated 5% to 10% of the domestic market, there are concerns that these restrictions could be loosened in the future. Other alternatives with less governance concerns (but also smaller returns) would be to invest in other indexes, such as those for mortgages (but that would entail competition with banks), municipal bonds (their lower returns would be supplemented by less tax expenditures), and corporate bonds (this would have an advantage of lower borrowing costs for industry).

The Individual Account (IA) option gradually reduces OASDI benefits by up to 20% for middle and upper income workers in order to keep costs within current contribution levels. The reason these reductions are so much more than the MB option, is because their Defined Benefit portion invests only in Treasuries and thus, has a lower return on investment, or a lower money's worth, for middle and upper-income Americans. However, when combined with annuities from their Individual Accounts, their money's worth ratios generally increase up to those of the MB plan. Eventually, as their savings in stocks exceeds those of the MB plan, their money's worth ratios could eventually be better for many people. This demonstrates the point that any transition from a DB-type plan toward a DC-type plan will take many years and one group must pay "twice." The Individual Account option does this by increasing contributions by 1.6% of covered pay.

The Personal Security Account (PSA) option has greater yields and benefits for most people, because this system invests the most money into the stock market. It must be noted, however, that it does this by increasing the U.S. deficit by over $1 trillion in the first 7 years. It is not a revenue-neutral bill. This could increase interest rates, borrowing costs, inflation, and taxes and, in fact, they pay for this transition cost through raising payroll taxes by 1.52% of pay. Another significant point is that the MB and IA options could achieve better yields and benefits than the PSA option if they also borrowed as much from the U.S. Treasury, and they would do it with less risk to the individual.

The PSA option places many more risks and responsibilities on the individual, such as investment risks, higher administrative expenses, longevity risks, leakage risks, and inflation risks. In the IA option, the risks on the individual are reduced by restrictions on investments, payroll deductions to a government clearinghouse (similar to the Federal Thrift Plan), requirements for inflation-indexed annuities, and restrictions on withdrawals before retirement. However, these restrictions in-

crease the governance concerns and create a greater bureaucracy, so proponents of the PSA plan opted for risk over restrictions.

Another concern with the PSA option relates to the sustainability of this very different view of Social Security because of the following questions. Would Congress continue to mandate both low-income and high-income Americans to invest in their accounts, without allowing them access during difficult times? Would the flat $400 monthly benefit with its poor money's worth for middle and upper income workers succeed? Would a means test eventually be applied to it and thus turn it into welfare? Would tax avoidance occur? Under the current Social Security system, the more money you put in, the more money you get out. This would not be the case for the $400 benefit. Experience from other countries shows that tax avoidance occurs when one gets nothing for the additional taxes.

Finally, it is important to look outside the Social Security system and determine the effects of the various proposals on an individual's total retirement income. This would include employer pensions, personal savings, and possibly part-time work, sometimes referred to as the other legs of a retirement stool. Diversification can be helpful here. For example, when the stock market is down, traditional employer pension plans can be more valuable than mandatory Individual Accounts. When low-income individuals have small savings and pensions, Social Security's adequacy element is more helpful. Thus, Congress should be aware of the consequences if one leg is saved by harming the other legs, and thus end up with a one-legged stool. For example, some fixes like means testing Social Security benefits and additional contribution mandates would reduce other legs of the stool, namely, personal savings and employer pensions. Congress should be careful not to eliminate the employer leg. Employer pension plans generally achieve better yields than individuals (by 150 to 250 basis points each year) and have been very helpful not only to individuals, but also to the national economy. Maybe there is a way to use employers. For example, if an employer has an adequate pension plan, then maybe the individual account mandate could be waived. Not much has been developed in this area, and the American Academy of Actuaries would be glad to discuss this further with the subcommittee.

Finally, the subcommittee asked for specific recommendations for moving forward. Some proponents of reform suggest passing some provisions now, such as reducing COLAs and mandating coverage to all state and local government employees. These changes will help reduce the U.S. deficit over the next 15 years, but will not help the financial stability of Social Security until after that. This may be an appropriate reform if the policy objective is also to reduce U.S. deficits. However, if Congress wants the additional savings to help the Social Security program and not the U.S. budget, then these provisions may need to be enacted in conjunction with private investment options. Since the concept of private investment entails a much different view of Social Security, we would suggest that Congress allow sufficient time to educate the public and consider all of the ramifications.

Once again we commend the subcommittee for taking a leading role in educating the Congress and public on a very complex, but important topic.

Mr. JOHNSON of Texas. It surely is complex, for sure.

Mr. Neal, I happen to have someone here from Dallas, Texas, that I am going to challenge you with. I am going to introduce John Goodman, of the National Center for Policy Analysis, who will speak next. He is from my area of the country.

Mr. NEAL. You have the gavel; you can do what you want. [Laughter.]

Mr. JOHNSON of Texas. Thank you.

John, go ahead.

STATEMENT OF JOHN C. GOODMAN, PRESIDENT, NATIONAL CENTER FOR POLICY ANALYSIS

Mr. GOODMAN. Thank you, Mr. Chairman and Members of the Subcommittee, I am honored to be here and would like to commend all of you for having these very important hearings. Our institute also receives no money from the government.

The key to understanding elderly entitlement programs is to recognize that they are based on the principle of pay-as-you-go finance. What that means is that every dollar of payroll tax that is collected is spent—is spent the very minute, the very hour, the very day that it comes in the door. If it is not spent on Social Security benefits, it is spent on something else, but it is nonetheless spent. No money is being stashed away in bank vaults, no investments are being made in real assets. What that means is that in order to pay promised benefits in future years, we are going to have to collect taxes from future generations of workers.

How high will those taxes have to be? Well, each year, the Social Security Trustees put out a report estimating what those taxes are going to have to be, and I have brought those numbers with me today.

According to the intermediate forecast of the Social Security Trustees, if we move out to the year 2045, when today's college students will be reaching retirement age, we are going to need a payroll tax 50 percent higher than the one we have today, just to pay Social Security benefits currently promised into law.

According to the pessimistic forecast of the Trustees, we are going to need twice the payroll tax that we need today to pay benefits already promised by law.

Now, I realize we are here this morning focused on Social Security and not Medicare, but these two programs are funded by the same payroll tax, and also, the benefits have overlapping effects, so let me just complete the unfortunate picture for you.

According to the intermediate forecast, at the time when today's college students retire, in order to pay Social Security plus both parts of Medicare, we are going to need almost one-third of the income of future workers. And according to the pessimistic forecast, in order to pay Social Security plus both parts of Medicare, we are going to need more than half of the income of future workers.

Now, what about the trust funds? The trust funds, of course, hold a special kind of government bond, and all too often there is a tendency to treat this as though it meant something real. In fact, it does not. Professor Robert Eisner has pointed out that we could, with the stroke of a pen, double or triple the number of pieces of paper in these trust funds and that would have no economic effect whatsoever. Conversely, we could with the stroke of a pen simply wipe out the trust funds, and that would also have no economic effect whatsoever.

The reason is that every bond, every asset held by the trust fund is offset by liability of the Treasury, so if you sum over both agencies of government, assets and liabilities cancel out, and you have no ability to pay any benefits.

The bonds in the trust funds—the Trustees cannot sell them on Wall Street, they cannot sell them to foreign investors. The only thing they can do is hand them back to the Treasury, and the Treasury wipes out its liability, and now it is at zero base. The only way the Treasury can pay benefits is by going out and borrowing or by collecting more taxes from future generations of workers.

Remember, every payroll check that is written for Social Security taxes is written to the U.S. Treasury, and every Social Security benefit check is written on the U.S. Treasury. The trust funds are

simply a lateral accounting device with no real economic significance.

For that reason, I must take issue with Dr. Kingson when he says in his testimony that we have sufficient revenue to pay benefits out to the year 2028. Not true. That treats these special bonds as though we could pay benefits with them, and we cannot. The Trustees very clearly have indicated in their intermediate forecast that in the year 2028, we are going to need twice the payroll tax we have today in order to pay benefits currently promised into law.

What can be done about all of this? I think the Advisory Council had some interesting ideas; I think none of them goes far enough. If we look around the world today, there are governments that are behaving responsibly, that are moving rapidly away from pay-as-you-go finance and toward a system under which each generation pays its own way.

Chile, in our hemisphere, has made the most radical change, and Chile has been copied south of our borders by Argentina and Colombia and Peru, and it is about to be copied by Mexico and Bolivia and Ecuador. Similar privatization schemes have been put into place in Hong Kong and Australia. Singapore never had a pay-as-you-go system; it always had a funded system. Britain has gone halfway toward a funded system.

These are all countries, many of them democracies, some of them with cultures similar to ours, that have moved away from pay-as-you-go finance and have realized that in order to have a sound system which can pay benefits during the retirement years, it must be based upon the principle that each generation must pay its own way.

Thank you, Mr. Chairman.

[The prepared statement follows:]

Statement of John C. Goodman, President, National Center for Policy Analysis

SOCIAL SECURITY: THE NEED FOR RADICAL REFORM

The key to understanding elderly entitlements is to realize that they rely on pay-as-you-go financing. Every dollar of Social Security tax revenue is immediately spent on payments to beneficiaries or borrowed by the federal government in exchange for special bonds that go into the Social Security Trust Fund. No Social Security tax revenues are invested in real assets. As a result, in order to pay benefits in future years, the government must collect new taxes from succeeding generations of workers.

Like our own system, the vast majority of the social security systems in the world today are pay-as-you-go. Not only do they face the same problems we face, most developed countries are in worse shape. Within a generation (by the year 2020), 16 percent of the U.S. population will be elderly. But one out of every five people will be elderly in Denmark, Finland, Greece, Italy, Sweden and Switzerland. One out of four will be elderly in Japan. Indeed, by this measure only Ireland, Australia and New Zealand are in better shape than the United States.

Less-developed countries with their higher birth rates and younger populations should be able to weather their problems for several more decades at least in principle. But because many of these countries have mismanaged their retirement systems, they too face imminent crises. Some have already acted, paving the way for others. Among the most notable alternatives to pay-as-you-go social security are the following:

- Britain allows employers and workers to opt out of the second tier of public social security by setting up private pension plans with benefits at least as generous as the government system.

• Chile requires workers to save for their own retirement by making regular deposits to private pension accounts, which are similar to the American equivalent of Individual Retirement Accounts (IRAs).

• The Chilean system has been copied to one degree or another in Argentina, Australia, Colombia, Hong Kong and Peru and will soon be implemented in Bolivia, Ecuador, El Salvador, and Mexico.

• Singapore requires employees and employers to contribute jointly to individual investment accounts, which may be used not only for retirement income but also to pay medical expenses or make the down payment on a home.

These privatized systems are fully funded, and each generation provides for its own retirement. The systems avert the long-term financial crisis inherent in a chain-letter approach. They also encourage saving, which in turn generates higher economic growth.

FUTURE TAX BURDENS

Tables I and II show how bad the future looks for the United States under our current system. These tables are based on calculations made by the Social Security Administration actuaries and contained in the Trustees Report on the elderly entitlement trust funds.[1]

Consider the year 2040, about the time when many of today's college students will be reaching their retirement years. According to the intermediate forecast, the fraction of employee earnings we will need that year to pay Social Security benefits will be almost 50 percent higher than today. We will need almost one-third of workers' incomes in order to pay Social Security plus both parts of Medicare.

Table I

Elderly Entitlement Spending As a Percent of Taxable Payroll [1]

Intermediate Assumptions

Year	Social Security	Social Security plus Part A Medicare	Social Security plus Total Medicare [2]	SS Plus All Government Health Care for the Elderly [3]
2000	11.49%	15.45%	17.07%	19.54%
2005	11.71%	16.24%	18.11%	20.95%
2010	12.15%	17.23%	19.43%	22.67%
2015	13.20%	19.02%	21.80%	25.65%
2020	14.62%	21.36%	24.13%	28.35%
2025	15.92%	23.62%	28.27%	33.89%
2030	16.78%	25.41%	30.58%	36.85%
2035	17.19%	26.47%	32.04%	36.36%
2040	17.02%	26.88%	32.65%	39.74%
2045	17.00%	27.17%	32.94%	40.16%
2050	17.16%	27.52%	33.14%	40.35%
2055	17.51%	28.05%	33.56%	40.79%
2060	17.84%	28.64%	34.19%	41.54%
2065	18.07%	29.20%	34.92%	42.50%
2070	18.26%	29.76%	35.75%	43.62%

[1] Taxable payroll used to compute all the tax rates in this table is the tax base for the Old Age, Survivors and Disability Insurance program (referred to as Social Security). It consists of wages and salaries of workers in employment covered by Social Security up to a maximum of $65,400 in 1997 for any worker. Actual taxable payroll for Medicare Part A is larger than that for Social Security because there is no maximum and more workers are covered. See 1997 Board of Trustees Report, Table III.A.2. Spending is net of the income tax revenues collected on Social Security benefits. Taxation of benefits is projected to amount to 0.21 percent of taxable payroll under intermediate assumptions and 0.27 percent under the pessimistic assumptions in 1996, increasing to 0.64 percent of taxable payroll under the pessimistic assumptions by the year 2070. See Board of Trustees Report, Table II.F.17.

[2] The Part B calculations are based on the Trustees' intermediate projections of the ratio of Part B to Part A as a percentage of gross domestic product, and assume that Part B participants will continue to pay 25 percent of this amount through premiums. See 1997 Report of the Board of Trustees of the Federal Supplemental Medical Insurance Fund, Table III.A.1.

[3] Includes spending for the elderly under all government health programs. In 1987, per capita spending by people age 65 and over from Medicaid and other government health programs was 40.4 percent of Medicare spending. This study assumes the same relationship over the 75-year projection period. See Daniel R. Waldo Sally T. Sonnefeld, David R. McKusick, and Ross H. Arnett, III, "Health Expenditures by Age, Group, 1977 and 1987." Health Care Financing Review, Vol. 10, No.4, Summer 1989, Table 4.

[1] 1997 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.

Table II
Elderly Entitlement Spending As a Percent of Taxable Payroll [1]
Pessimistic Assumptions

Year	Social Security	Social Security plus Part A Medicare	Social Security plus Total Medicare [2]	SS Plus All Government Health Care for the Elderly [3]
2000	11.97%	16.24%	1.99%	20.66%
2005	12.97%	18.27%	20.46%	23.78%
2010	13.74%	20.14%	22.92%	27.00%
2015	15.00%	22.94%	26.74%	31.99%
2020	16.77%	26.75%	32.29%	39.31%
2025	18.52%	31.01%	38.55%	47.66%
2030	19.95%	35.03%	44.06%	55.02%
2035	20.88%	38.17%	48.44%	60.96%
2040	21.45%	40.23%	51.22%	64.73%
2045	22.11%	41.73%	52.86%	66.78%
2050	22.97%	42.94%	53.78%	67.69%
2055	24.11%	44.39%	54.99%	68.89%
2060	25.29%	46.06%	56.73%	70.87%
2065	26.34%	47.78%	58.80%	73.40%
2070	27.31%	49.47%	61.01%	76.18%

[1] Taxable payroll used to compute all the tax rates in this table is the tax base for the Old Age, Survivors and Disability Insurance program (referred to as Social Security). It consists of wages and salaries of workers in employment covered by Social Security up to a maximum of $65,400 in 1997 for any worker. Actual taxable payroll for Medicare Part A is larger than that for Social Security because there is no maximum and more workers are covered. See 1997 Board of Trustees Report, Table III.A.2. Spending is net of the income tax revenues collected on Social Security benefits. Taxation of benefits is projected to amount to 0.21 percent of taxable payroll under intermediate assumptions and 0.27 percent under the pessimistic assumptions in 1996, increasing to 0.64 percent of taxable payroll under the pessimistic assumptions by the year 2070. See Board of Trustees Report, Table II.F.17.

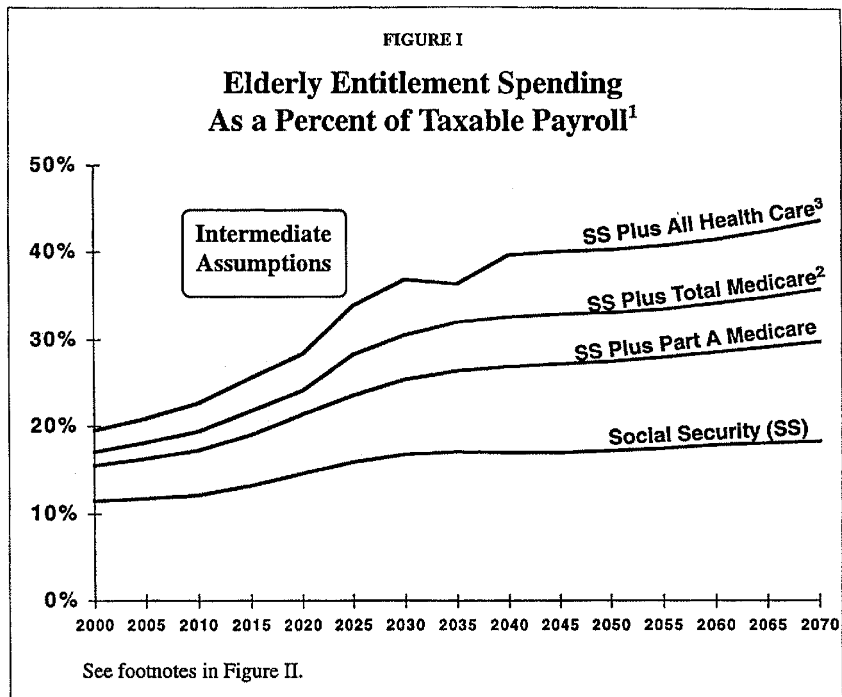
[2] The Part B calculations are based on the Trustees' intermediate projections of the ratio of Part B to Part A as a percentage of gross domestic product, and assume that Part B participants will continue to pay 25 percent of this amount through premiums. See 1997 Report of the Board of Trustees of the Federal Supplemental Medical Insurance Fund, Table III.A.1.

[3] Includes spending for the elderly under all government health programs. In 1987, per capita spending by people age 65 and over from Medicaid and other government health programs was 40.4 percent of Medicare spending. This study assumes the same relationship over the 75-year projection period. See Daniel R. Waldo Sally T. Sonnefeld, David R. McKusick, and Ross H. Arnett, III, "Health Expenditures by Age, Group, 1977 and 1987." Health Care Financing Review, Vol. 10, No.4, Summer 1989, Table 4.

Two things are especially worth noting about this projection. First, although the public focus has been almost exclusively on Social Security, government actuaries are forecasting that the burden of Medicare will be almost as large as the burden of Social Security. Second, future workers will pay a larger share of their income just to support the elderly than today's workers pay to fund all government services, including programs for the elderly and the poor, national defense, highways, etc.

Nor is this the worst that can happen. Under the pessimistic forecast, the future Social Security tax burden will be almost twice its current level and the elderly will spend more than $2 of Medicare money each year for every $1 they receive in Social Security checks. Workers will have to pay almost half of their earnings just to fund benefits already promised the elderly under current law. Put another way, under the pessimistic forecast, we have already pledged more than half the income of future workers without regard to any personal needs they workers and their families may have and without regard to the need to fund any other government program!

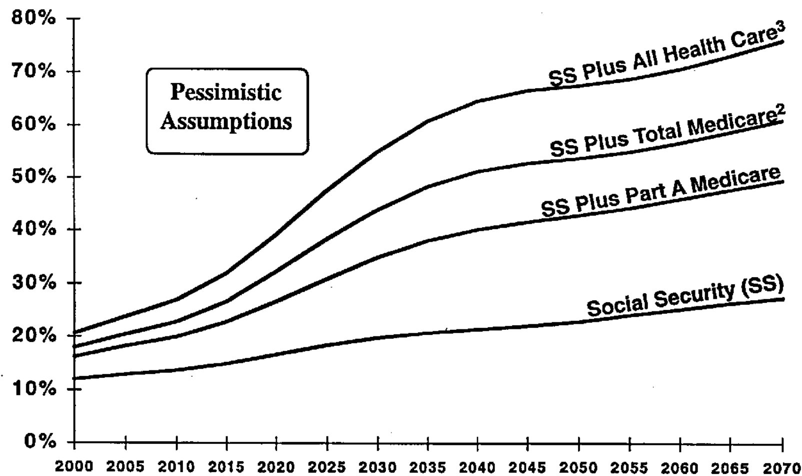
With a bit more realism, things get even worse. (See Figures I & II.) Medicare is not the only way we pay for the medical bills of the elderly. We also pay through Medicaid (for the poor), the Veterans Administration (VA) system and other programs. In addition, the federal government is increasingly trying to shift more of the Medicare burden onto private employers which means, onto workers in their role as participants in employee benefit plans.



See footnotes in Figure II.

FIGURE II

Elderly Entitlement Spending As a Percent of Taxable Payroll[1]



[1] Taxable payroll used to compute all the tax rates in this table is the tax base for the Old-Age, Survivors and Disability Insurance program (referred to as Social Security). It consists of wages and salaries of workers in employment covered by Social Security up to a maximum of $62,700 in 1996 for any worker. Actual taxable payroll for Medicare Part A is larger than that for Social Security because there is no maximum and more workers are covered. See 1996 *Board of Trustees Report*, Table III.A.2. Spending is net of the income tax revenues collected on Social Security benefits. Taxation of benefits is projected to amount to 0.22 percent in 1997, increasing to 1.31 percent of taxable payroll by the year 2070. See *Board of Trustees Report*, Table II.F.17.

[2] The Part B calculations are based on the Trustees' intermedite projections of the ratio of Part B to Part A as a percentage of gross domestic product, and assume that Part B participants will continue to pay 25 percent of this amount through premiums. See 1997 *Report of the Board of Trustees of the Federal Supplemental Medical Insurance Fund*, Table III.A.1.

[3] Includes obligations through all government health programs, including Medicaid and the Veterans Administration. In 1987, per capita spending by people age 65 and over from Medicaid and other government health programs was 40.4 percent of Medicare spending. This study assumes the same relationship over the 75-year projection period. See Daniel R. Waldo, Sally T. Sonnefeld, David R. McKusick, and Ross H. Arnett, III, "Health Expenditures by Age, Group, 1977 and 1987." *Health Care Financing Review*, Vol. 10, No. 4, Summer 1989, Table 4.

No matter what pocket the funds come out of, however, the overall burden the elderly create for the generation of working age remains the same. To assess the total burden, health economists at the National Center for Policy Analysis have estimated elderly health care expenses borne through all government transfer programs. The results (shown in the final column of Tables I and II) indicate that we have effectively pledged 40 percent of the income of future workers under the intermediate assumptions and almost 65 percent of workers' incomes under the pessimistic assumptions.

Clearly, we are on an unsustainable path.

THE CAUSE OF THE PROBLEM

Among the reasons the future looks so bleak: (1) women are having fewer children; (2) people are living longer; and (3) state-of-the-art medical care is becoming increasingly expensive.

The U.S. Fertility Rate.

In developed countries, the fertility rate must be 2.1 to keep the total population at its current size. That is, each adult man and woman must be replaced by approximately two children.[2] In 1960, virtually all developed countries had fertility rates in excess of 2.1, and most had substantially higher rates. Since then, fertility rates have dropped dramatically almost everywhere.

In the United States, the fertility rate is currently 1.9 and is expected to remain below the replacement rate for the foreseeable future. In other countries, the situation is even worse. In Italy (a Catholic country!), the rate is 1.3. In Germany, it's 1.4. Among all developed Western countries, only Ireland is above the replacement rate.

What happens to countries that are below the replacement rate? Eventually the population peaks and begins declining. Based on pessimistic assumptions, the U.S. population will peak about the year 2030 and decline continuously thereafter. If this estimate is correct, 100 years from now we will have about the same number of people in the United States as we have today. But whereas today most people are young, a century from now most people will be old.

Life Expectancy.

When our Social Security system was started, life expectancy for a male at birth was only 59 years. Reaching the retirement age of 65 was viewed as an adverse contingency sort of like becoming disabled. Supporting the few people who would be so afflicted seemed easily affordable.

Today, of course, we have a different perspective. Life expectancy at birth is 72.1 years for men and 78.9 years for women. Both men and women are more likely to reach the retirement age. And once there they can expect to draw benefits for an increasing number of years. At age 65, men can now expect to live to be 80, women to be 84. These numbers are projected to increase in future years.

The combination of fewer children and longer life expectancy produces an increased projected burden for future workers. Whereas in 1950 we had 17 workers supporting each retiree, today that number is 3, and the ratio could drop as low as one to one in the next century. In that case each worker would be producing to support himself (or herself) and his family plus one elderly person. But the elderly person would not be the worker's own parent. Payroll taxes would simply be dumped in a common (Social Security) pool.

Medical Science.

As people get older, they consume more health care. Although the elderly today constitute only 12 percent of the population, they account for about one-third of all health care spending. By the time today's college students reach their mid-fifties, one out of five people will be old and they will consume two-thirds of our health care resources. Even with existing to technology, health care for the elderly will be expensive. How much more expensive will new techniques be?

Seventy years ago, no one could have imagined the medical procedures that are commonplace today. Similarly, we cannot predict what medical science will achieve over the next 40 years. However, we do have two advantages over forecasters in the past. First, we know that modern society has given medical researchers a blank check. Implicitly we have told them: invent it; show us that it improves health care; and we will buy it. As a result, we have virtually guaranteed that the medical research and development industry will work hard at making new discoveries that

[2] The additional 0.1 accounts for childhood mortality that occurs before females reach childbearing age.

will cost us more money. Second, we have a fairly good idea of the direction in which medical science will progress.

For example, it is virtually inevitable that scientists will produce a complete mapping of the genetic code. The only question is, when. Because many life-threatening diseases are related to our genetic resistance to them, an understanding of individual genetic makeup opens the door to the prevention of disease by artificial intervention. For example, Americans are constantly exposed to carcinogens. They occur naturally in the food we eat, the water we drink and the air we breathe. But some people, partly because of their genetic endowment, resist exposure better than others.[3] Once we understand the mechanism of susceptibility or resistance (which probably will not require a complete understanding of the genetic code), we will be able to sharply reduce and perhaps eliminate death from cancer.

The greatest uncertainty is what the achievements of modern science will do to the future financial burden of income maintenance and health care for the elderly. For example, heart disease, cancer and strokes currently account for 75 percent of all deaths among the elderly. Moreover, these three diseases are responsible for 20 percent of all physician visits, 40 percent of all hospital days and 50 percent of all days spent in bed. If we could eliminate all three diseases, we would also eliminate three major categories of health care spending. But it is not clear that our total financial burden would go down, for the elderly would live longer and collect more Social Security checks. They would then eventually die of some other possibly expensive-to-treat disease.

THE ILLUSORY TRUST FUNDS

Most countries with pay-as-you-go retirement systems don't even have trust funds. We would probably be wise to follow their example. The funds not only mislead people who think their taxes are actually being invested in something they distract attention from the real funding problem.

Every payroll tax check sent to Washington is written to the U.S. Treasury. Every Social Security benefit check is written on the U.S. Treasury. The trust funds do not collect taxes; nor do they pay benefits. They are nothing more than a lateral accounting system totally unessential to any real activity.

Technically, the trust funds hold interest-bearing U.S. government bonds, representing the accounting surplus of payroll taxes collected minus benefits paid. But these are very special bonds. They don't count as part of the official National Debt. The Social Security Trustees cannot sell them on Wall Street, or to any foreign investor. They can only hand them back to the Treasury. In this sense, these bonds are nothing more than IOUs the government has written to itself.

On paper, the Social Security trust funds have enough IOUs to "pay" Social Security benefits for about 17 months on any given day; the Medicare trust fund can "pay" benefits for about one year. In reality, they cannot pay anything. Handing IOUs back to the Treasury does not increase the size of Uncle Sam's bank account one iota. In order for the Treasury to write a check, it must first tax or borrow.

The existence of the trust funds has merely served to make it appear that the federal deficit is less than it really is each year and to mask the unsustainability of our Social Security system in its current form. For example, the annual report of the Trustees of the Social Security trust funds tends to focus almost exclusively on the concept of actuarial balance. This treats bonds in the trust funds as assets (the way accountants would do if they were auditing a private pension fund) and ignores the fact that every asset of the trust funds is a liability of the Treasury. For the government as a whole these assets and liabilities net out to zero.

If the trust funds were simply abolished, there would be no effect on real economic activity. No private bondholders would be affected. The government would not be relieved of any of its existing obligations or commitments. Economist Robert Eisner has suggested that we abolish the trust funds or, with the stroke of a pen, double or triple the number of IOUs t hey hold. Either option would allow us to dispense with artificial crises and get on to the real problem: how is the Treasury going to pay the government's bills?

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[3] For example, researchers now believe that more than half of all cases of colon and rectal cancer are directly related to a genetic predisposition to such cancers. See Lisa A. Cannon-Albright et al., "Common Inheritance of Susceptibility to Colonic Adenomatus Polyps and Associated Colorectal Cancers," New England Journal of Medicine 319, No. 9 (September 1, 1988), pp. 533–37.

A PROPOSAL FOR REFORM

The Advisory Council on Social Security has proposed three possible approaches to Social Security reform. One proposal would have the government invest the trust fund surplus in the stock market. This solution is unacceptable in a free country. Government investment in private sector corporations implies government control. The other two proposals are improvements over the current system, but neither goes far enough to provide a permanent solution.

Let me direct your attention instead to the working model of social security reform in Chile, the first nation in the Western Hemisphere to adopt a social security system (1929) and the first nation in the world to completely privatize one (1981). Chile converted to a system of individual pension savings accounts, but it gave workers participating in the old system a choice of staying there or switching to the new system, and guaranteed secure pensions for those already retired. The change has resulted in both higher retirement benefits and greater economic growth for the country. Chile's reform is serving as the model for reform in a number of other countries, and it can serve us as well.

Currently, employees must pay 10 percent of their wages to an individual pension savings account, and can contribute up to another 10 percent, all tax deductible. Individuals cannot direct their own investments. However, they can choose among 20 competing private investment companies, which are somewhat similar to U.S. mutual funds. These strictly regulated funds are required to invest conservatively in a diversified portfolio of stocks and bonds to insure that the premiums grow with the growth of the Chilean economy. People dissatisfied with one fund can easily switch to another. The government guarantees a minimum pension benefit to all workers, and supplements the private benefits as necessary from general revenues to reach the minimum. Workers must also contribute to buy private life and disability insurance and to cover administrative costs, bringing the total required contribution to about 13 percent.

Retirement benefits, which depend on the rate of return earned by the private accounts, have generally been anywhere from 50 to 70 percent higher under the new system. Disability benefits are at least twice as high and survivors' benefits at least 50 percent higher. Retirees can buy an annuity with an insurance company or make a scheduled series of periodic withdrawals from the account. People who have contributed more than 10 percent can either receive a larger annuity payment or retire early. Retirees pay taxes on what they receive, but usually at a lower rate than they would have paid while working.

People who switched from the old system to the new one received special bonds called recognition bonds that credited their contributions under the old system. The bonds are indexed to inflation and earn interest, and are part of the individual's pension fund account. Chile guaranteed that no retiree would suffer from the reform, and financed the transition by selling government assets, primarily state-owned enterprises.

Not only has the private pension system benefited participants individually, but it also has helped to fuel economic growth in Chile. The individual funds now total about half of Chile's gross domestic product, the net worth of the average Chilean is about four times his annual salary and real economic growth has averaged more than 6 percent during the past decade. The Chilean savings rate has grown to 26 percent.

Chile has demonstrated by example that a nation does not have to remain tied to a system when radical reform is politically possible and economically desirable.

Mr. JOHNSON of Texas. Thank you, Mr. Goodman.

I will give you a chance to respond, Dr. Kingson, later, if you want to.

Kelly Olsen, research analyst, and Dr. Paul Yakoboski, research associate, both from the Employee Benefit Research Institute.

Which one of you prefers to proceed?

STATEMENT OF KELLY OLSEN, M.S.W., RESEARCH ANALYST, EMPLOYEE BENEFIT RESEARCH INSTITUTE; AND PAUL J. YAKOBOSKI, PH.D., SENIOR RESEARCH ASSOCIATE, EMPLOYEE BENEFIT RESEARCH INSTITUTE

Ms. OLSEN. Good morning. Since its founding in 1978, the Employee Benefit Research Institute, EBRI, has been committed to the accurate statistical analysis of economic security issues. For the past year, we have been conducting a Social Security Reform Analysis Project to provide policymakers, the media, and the public with a neutral analysis of reform options. Consistent with our mission, we do not lobby or advocate a specific policy solution.

As Dr. Kingson mentioned, the 1997 Trustees project that under intermediate assumptions, the trust fund will be depleted by 2029. At that time, the Federal Deposit Insurance Corp., FICA income alone will be able to pay about 75 percent of promised benefits, leaving a shortfall of around 75 percent of obligations. However, the shortfall could be sooner and/or larger. One reason is because the mortality assumptions used by the Trustees to calculate the projection appear relatively optimistic in comparison with those used by other government entities and academics.

For example, the high estimate used by the Census projects 13.3 million more persons over age 85 by 2050 than the high estimate used by the Trustees.

The importance of considering any projected Social Security shortfall as serious is underscored by the program's role in the income of the elderly. Because over 60 percent of the aged population depends on Social Security for at least one-half of their income, Social Security is the single most important income source for aged Americans.

While disagreement and uncertainty surround the degree to which reform is necessary, the degree to which fundamental reform is desirable presents a more contentious policy issue. Individual, participant-directed Social Security accounts, as we have heard today, are central to many current reform proposals, and while the use of individual accounts is not a necessary condition for resolving the program's projected shortfall, a majority of the Social Security Advisory Council agreed that this approach is more desirable than reforms that would exclusively fix the system by raising taxes and/or cutting benefits.

While other considerations for assessing reform options are discussed in our full written statement, we would like to focus our comments today on the increased uncertainty in benefit levels in an individual account system due to differences in individual investment choices. Clearly, if a participant's Social Security benefit is tied to the balance, it is important to ascertain how persons are likely to make investment decisions. Yet, because data has been limited before now, all who have studied Social Security outcomes under a system of individual accounts have assumed that each age cohort invests in exactly the same manner, and that is not a very realistic scenario.

Through EBRI's Employee Understanding Project, we have gathered the largest known database of individual investment data from a number of private pension plans and investment firms, and now, Dr. Yakoboski will discuss their results and the implications.

Mr. YAKOBOSKI. Our findings to date indicate that even people within the same plan and of the same age groups and similar demographics invest their retirement in very different ways. Hence, while data on averages are informative, they hide variation in investment choices.

For example, in one large plan that we examined, we found that 20 percent of participants ages 20 to 29 held absolutely no equity investments in their 401(k) accounts, while in the same plan, among the same age group, one-quarter of participants were heavily diversified in equities and had over 80 percent of their assets invested in equity-based options. And I would also like to note that this particular plan had a relatively sophisticated education program.

Our data show similar results in other plans. Therefore, it seems likely that similar people are going to invest individual Social Security account assets differently and thus receive different benefit levels. A fundamental for Congress then becomes are you comfortable with people within the same income level, sharing the same demographic characteristics, receiving different levels of Social Security benefits under a national retirement system.

For some of you, the answer to this question and others hinges on ascertaining the likelihood that different people will receive vastly different benefits under a system of individual Social Security accounts. EBRI's policy simulation model that we are currently working on will present quantitative results on this issue.

The new reform proposals Congress is being presented with add complexity to the Social Security finance debate. Our model is designed to provide a value-neutral scorecard for all types of reforms to which policymakers and the public can subject their own objectives and values. We look forward to presenting the Subcommittee and its staff with the results of our model as they become available in the fall.

Thank you.

[The joint statement follows:]

Statement of Kelly Olsen, M.S.W., Research Analyst, Employee Benefit Research Institute; and Paul J. Yakoboski, Ph.D., Senior Research Associate, Employee Benefit Research Institute

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The 1997 Social Security Trustees report that, under intermediate assumptions, Social Security outgoes will exceed income beginning in the year 2018. However, since 1983, the Trustees' projections as a whole have tended to be optimistic. Given that the mortality assumptions currently used by the 1997 Social Security Trustees are optimistic in comparison with assumptions used by other government entities and academics, there may be reason to believe that Social Security outgo will exceed income before 2018.

The importance of considering any projected Social Security shortfall as serious is underscored by the program's role in the income of the older population. Because over 60 percent of the elderly depend on Social Security benefits for at least one-half of their income, Social Security is the single most important income source for aged Americans.

While disagreement and uncertainty surrounds the degree to which reform is necessary, the degree to which fundamental reform is desirable presents a more contentious policy issue for Congress. Individual, participant-directed Social Security accounts are central to nontraditional reform approaches. Using individual accounts could increase program revenue by allowing participants to invest Social Security

funds in equities, which have provided higher rates of return, on average, than the Treasury bonds in which the government currently invests Social Security funds.

The following three issues surrounding individual accounts will prove to be critical as the reform debate ensues.

- Would individual Social Security account balances be paid out in the form of annuities or lump-sum distributions? Results from the annual Retirement Confidence Survey, co-organized by EBRI, the American Savings Education Council, and Mathew Greenwald & Associates, reveal that most retirees do not purchase annuities. Moreover, the effectiveness of the majority of retirees at managing their savings throughout retirement is unknown.
- Would Congress allow access to individual account funds for purposes other than retirement? If Congress allows preretirement access, this decision will surely have negative implications for retirement income security.
- Would Congress be comfortable with people at the same income level and of the same demographics receiving different levels of Social Security benefits under a national retirement system? In addition, would it be acceptable for some individuals to end up with no individual account balance to supplement a reduced Social Security base benefit? EBRI research shows that similar people invest their Social Security funds differently, and are therefore likely to have different individual account balances at retirement. Using the data behind this conclusion, EBRI will explore the actual disparities likely to occur in a system of individual Social Security accounts through the EBRI–SSASIM2 policy simulation model, the cornerstone of EBRI's Social Security Reform Analysis Project.

Congress is now and will continue to be inundated by multiple reform proposals coming from a range of perspectives. The additional uncertainty surrounding the introduction of individual Social Security accounts will make this round of the Social Security reform debate more complex than its predecessors. The EBRI–SSASIM2 policy simulation model is designed to provide a value-neutral scorecard for all types of reforms, to which policymakers and the public can subject their own objectives and values. We look forward to presenting the Committee and its staff with results from our model.

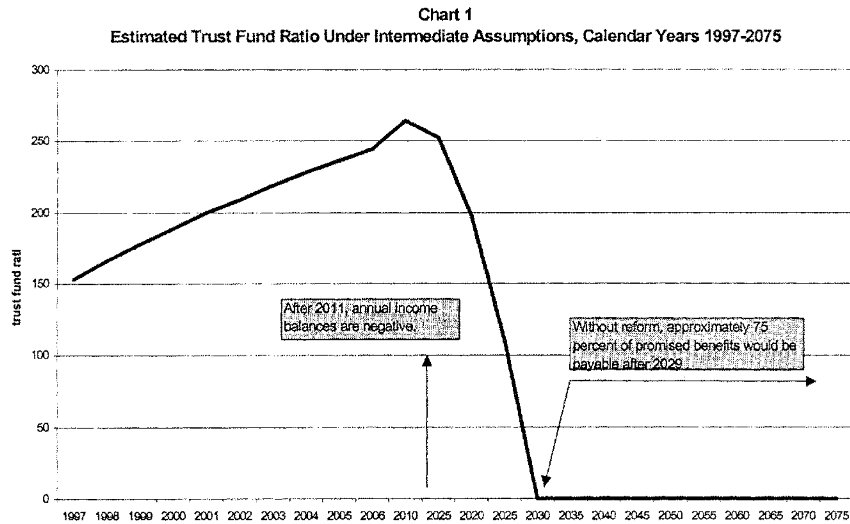
We are pleased to appear before you this morning to discuss issues of Social Security reform. I am Kelly Olsen, a research analyst with the Employee Benefit Research Institute (EBRI) and seated beside me is Paul Yakoboski, a senior research associate with the Institute.

Since its founding in 1978, EBRI has been committed to the accurate statistical analysis of economic security issues. Through our research, we strive to contribute to the formulation of effective and responsible health and retirement policies. For the past year, we have been conducting a Social Security Reform Analysis Project to provide policymakers, the media, and the public with value-neutral analysis of reform options. Consistent with our mission, we do not lobby or advocate specific policy solutions.

To What Degree Is Social Security Reform Necessary?

The 1997 Social Security Trustees report that, under intermediate assumptions, Social Security outgoes will exceed income beginning in the year 2018. The Trustees predict that by 2029, the combined Old Age, Survivors, and Disability Insurance (OASDI) trust funds will be exhausted, and FICA income alone will be able to pay approximately 75 percent of promised benefits (Chart 1). Over the next 75 years, Social Security's shortfall is projected to equal 2.23 percent of taxable payroll.

Chart 1
Estimated Trust Fund Ratio Under Intermediate Assumptions, Calendar Years 1997-2075



Source: 1997Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds (Washington, DC: Social Security Administration: 1997).

Projections under the Trustees' intermediate assumptions, however, are not necessarily fully reflective of the program's future experience. In fact, since 1983, the Trustees' projections as a whole have tended to be optimistic. Variation between projections and actual experiences has occurred in part because projections depend on many assumptions about the future. These assumptions introduce a large element of uncertainty. For example, the 1997 Social Security Trustees project the trust funds will experience anywhere from a 0.2 percent surplus to a 5.54 percent shortfall under three scenarios, each of which is based on what many experts believe to be reasonable actuarial and economic assumptions. Several of these assumptions are controversial. In addition, outcomes are quite sensitive to the value chosen for some assumptions in that small differences in value can translate into vastly different policy projections.

Mortality rates are one of the most controversial assumptions used in projecting Social Security's long-range financial status. In addition, projections are quite sensitive to different mortality values. Clearly, the longer people live, the more pressure will be placed on Social Security finances. The mortality assumptions used by the 1997 Social Security Trustees appear rather optimistic in comparison with mortality assumptions used by other government entities and academics (Chart 2).

CHART 2
ALTERNATE ESTIMATES OF US POPULATION AGES 85 and Older in 2050
(ALL ESTIMATES ARE EXPRESSED IN MILLIONS OF PEOPLE)

Estimate Source	Population 85+
Census Bureau (low)	9.6
Olshansky*	11.4
Trustees Report (low)♦	11.8
Trustees' Report (intermediate)	14.6
Trustees' Report (high) ♦	17.8
Census Bureau (mid)	18.2
Lee*	21.4
Census Bureau (high)	31.1
Vaupel*	39.0
Manton*	48.7

Source: Census Bureau estimates were published in February 1996. Research by sources marked with an asterisk (*) have been supported by the National Institute on Aging. Estimates marked with a diamond (♦) are produced by the EBRI–SSASIM2 model; all others are drawn from information supplied by the National Institute on Aging.

Should the Trustees' mortality assumptions prove optimistic by actual experience, the year that programmatic outgo exceeds income could be pushed ahead from 2018 to an earlier date. Likewise, the trust fund could be exhausted several years earlier than 2029, and FICA income exclusively might be able to cover fewer than 75 percent of benefits promised thereafter. However, only time will ultimately tell the degree to which Social Security reform is necessary.

The importance of considering any projected Social Security shortfall as serious, however, is underscored by the program's role in the income of the older population. Because over 60 percent of the elderly depend on Social Security benefits for at least one-half of their income, Social Security is the single most important income source for aged Americans. With the average annual benefit in 1997 at $8,940, the average beneficiary is maintained at just above the poverty level by Social Security. Although income from personal savings, employment-based pensions, and possibly earnings are supposed to supplement Social Security benefits for all retirees, these sources significantly supplement the Social Security benefit of primarily those among the uppermost income quintile. In fact, just 20 percent of the elderly population received a total income over $22,254 in 1995.

An Assessment of the Advisory Council's Recommendations and Other Reform Proposals

While disagreement and uncertainty surround the degree to which reform is necessary, the degree to which fundamental reform is desirable presents a more contentious policy issue for Congress. Individual, participant-directed Social Security accounts are central to nontraditional reform approaches. While the use of individual accounts is not a necessary condition for resolving the program's projected shortfall, a majority of the 1994(96 Social Security Advisory Council members agreed that this approach is more desirable than reforms that would exclusively fix the system by raising taxes and cutting benefits. Individual account reforms, which have been proposed by numerous other groups, are receiving a great deal of policy and media attention. As a result, the issues surrounding individual accounts have found new importance in the Social Security reform debate.

One important issue associated with individual Social Security accounts is whether benefits would be paid out in the form of annuities or lump-sum distributions. By conducting the annual Retirement Confidence Survey, co-organized by EBRI, the American Savings Education Council, and Mathew Greenwald & Associates, we found that only 21 percent of surveyed retirees annuitized their IRA balances, and just 12 percent annuitized their distributions from other retirement plans such as 401(k) plans. Given that most retirees do not purchase annuities, we do not know how effective the majority of retirees are at managing their savings throughout retirement. This lack of knowledge raises the following questions when considering creating a system of individual Social Security accounts: how much confidence should we have in retirees' ability to manage balances from individual Social Security accounts if Congress does not require these balances to be annuitized? If annuitization is not required, how effective can we expect individual Social Security accounts to be in providing retirement income throughout a person's retirement years?

Another issue central to individual Social Security accounts is whether Congress would allow access to individual account funds for purposes other than retirement. If individual Social Security accounts were to become the largest source of assets for most households, would voters demand access to their accounts through lump-sum distributions in times of financial hardship? If not, would Congress be comfortable letting people with large individual Social Security account balances to be evicted from their homes or be unable to afford critical medical care because they do not have access to their balances prior to retirement? On the other hand, if Congress allows preretirement access, this decision would surely have negative implications for retirement income security.

While lump-sum distribution and preretirement access issues are critical to the assessment of individual Social Security accounts, we would like to focus most intensively today on one largely unexplored aspect of individual account reforms: the increased uncertainty in individual's benefits due to differences in their investment behavior. Clearly, if a participant's Social Security benefit is tied to the balance of his or her individual Social Security account, it is important to ascertain how persons are likely to make investment decisions. It is unfortunate that to date, realistic investment data have been unavailable. As a result, all researchers who have studied Social Security reform outcomes under a system of individual Social Security accounts have assumed that each age cohort invests in exactly the same manner in terms of asset allocation.

Through EBRI's Employee Understanding Project, we have gathered the largest known database of individual investment data from a number of private pension plan sponsors and from investment firms. Although the Project is ongoing, preliminary results show that different people-even people who have similar demographic characteristics and participate in the same retirement plan-invest their money in very different ways. Hence, while these data are informative, they do not show much detail on the variation of investment preferences among workers. For example, we have found that within one employer's retirement plan, a sizeable fraction of participants do not invest any funds in equities, while another fraction has invested heavily in equities (Table 3).

TABLE 3

ALLOCATION DISTRIBUTIONS OF PARTICIPANT ACCOUNT BALANCES IN ONE LARGE EMPLOYMENT-BASED RETIREMENT SAVINGS PLAN, 1994

Total Participants (as a Percentage)	Equity Investments			
	Zero	<20%	20%–80%	80%+
Total	25.4	7.1	47.8	19.7
Ages 20–29	19.8	7.4	48.5	24.3
Ages 30–39	20.0	6.5	51.5	22.0
Ages 40–49	24.9	7.5	47.5	20.2
Ages 50–59	31.7	6.7	45.5	16.1
Ages 60 and Older	55.2	8.1	31.4	5.2

Source: Employee Benefit Research Institute, Issue Brief Number 176, August 1996.

In one large company, we found that almost 20 percent of participants ages 20–28 held no equity investments, while almost a quarter were heavily diversified in equities. Interestingly, the "problem" explaining this plan's large variance in investment behavior is not due to a lack of participant education, as this particular employer has a sophisticated employee investment education program. From this example, we can logically conclude that different people-often of the same socioeconomic group-are going to receive different returns on their individual Social Security accounts. A first question for Congress to consider then becomes: are you comfortable with people at the same income level and of the same demographic characteristics receiving different levels of Social Security benefits under a national retirement system? A second question: would it be acceptable for some individuals to end up with no individual account balance to supplement a reduced Social Security base benefit?

Recommendations for Congress to Consider as it Moves Forward

For some of you, the answer to these questions hinges on ascertaining the likelihood that different people will receive vastly different benefits under a system of individual Social Security accounts. The EBRI–SSASIM2 policy simulation model will soon present quantitative results on this issue. The model will be able to do so because of its unprecedented capabilities for modeling individual accounts as well as its ability to account for uncertainty under a range of possible economic and demographic scenarios, such as different mortality rates. In addition, the information EBRI has obtained from its Employee Understanding Project will be included in order to show how realistic individual investment patterns would affect disparities between individual benefit amounts under an individual Social Security accounts system.

Congress is now and will continue to be inundated by multiple reform proposals coming from a range of perspectives. The additional uncertainty surrounding the introduction of individual Social Security accounts will make this round of the Social Security reform debate more complex than its predecessors. The EBRI–SSASIM2 policy simulation model is designed to provide a value-neutral scorecard for all types of reforms, to which policymakers and the public can subject their own objectives and values. We look forward to presenting the Committee and its staff with results from our model. Thank you.

Mr. JOHNSON of Texas. Thank you. We look forward to that.

Dr. Kingson, do you have any remarks, quickly, like one sentence, sir? You are from Boston; you ought to know how to do that.

Dr. KINGSON. One sentence is that I cannot believe that the Federal Government will renege on its debt to the people of the United States, to be honest, in terms of Treasury bonds that we may be holding or in terms of obligations the Social Security Trust Fund has on the Treasury.

Mr. JOHNSON of Texas. No, I do not think Dr. Goodman was referring to that. I do not think we will renege on them, either. What he was talking about was a big influx all at once of trying to call those debt instruments in order to pay for what is going on.

Do you want to respond?

Mr. GOODMAN. Yes. It is a pay-as-you-go system, and I think all the witnesses here have conceded that in principle, but fail, in Dr. Kingson's case, to think through the logical consequences of that. That means that out in the year 2028, tax revenue collected in 1997 is not going to pay any benefits; you are going to have to collect revenue in that year to pay benefits in that year, and the amount of revenue you are going to have to collect is twice the payroll tax that we have today.

Mr. JOHNSON of Texas. Do you mind letting him comment?

Mr. KINGSON. I would just add, without going into the numerical issues there, the general point is that each generation of workers must pay for nonworking people, whether the claims on the resource are held publicly or privately, whether it is held through Social Security or through some private accounts. It is an inescapable law of economics—we will have to meet the obligations to our older persons, in this case, ourselves. And one way or another, whether it is through a public system or a private system, the questions that come up really relate very significantly to the distributional issues that were just raised in the last testimony—how we are going to do it and how much uncertainty we want to introduce in the future.

Mr. JOHNSON of Texas. That is a big question. I would just like to ask you quickly, you indicated that if privatization occurred, taxes would be higher, and the deficit would be higher. Does that have to happen necessarily, and wouldn't that happen if we kept the system as it is today?

Mr. KINGSON. It will have to happen if we keep the system as it is today, to some degree. We either have to reduce benefits or raise taxes or do both to a substantial extent. It depends on how we define the "substantial." We have a roughly 25-percent shortfall after 2028, and we ought to deal with that much sooner, as one of the other presenters—as I think all the presenters have suggested.

The question again, sir?

Mr. JOHNSON of Texas. Taxes higher, deficit higher.

Mr. KINGSON. Yes. The privatization proposals require additional benefit cuts in the public program or additional tax increases. The PSA is a good example of that. The personal security account includes large borrowing from general revenues to fund the transition period, plus it includes—and I say this with some humor—a temporary, 72-year tax increase of 1.5 percent—1.52. They have put it up front. They have not tried to hide it. They still believe

very honestly that it is good policy and something for you to think about.

Mr. JOHNSON of Texas. Thank you.

Mr. Portman.

Mr. PORTMAN. Thank you, Mr. Chairman. I enjoyed the dialog, and I appreciate all the testimony today.

I have some concerns over the statement that all obligations will be met until 2028, also. I think it creates among my constituents and the public at large a sense of security that, really, a bunch of politicians are now talking about Social Security and some academics, but if it is not a problem until 2028, why are we worried about it. So I think it is important that we flesh out what this really means, and Dr. Goodman got into it a bit.

The way I see it is that once those obligations are due, when the baby boomer generation—my generation, our generation—begins to retire, we will have these Treasury bonds which I agree, the Government is not going to renege on, but the Government is going to have to go out and borrow money or raise taxes in order to make good on that obligation.

So I just wish that somehow, we could refocus this debate not on 2028, and some people use the later dates, 2034, 2040, and so on, to sort of push aside this debate. I think the crisis is upon us, and I think that is something that there is a consensus at this table for, and if we do not start using numbers that have a more immediate sense, particularly as we go into the new millennium, even the year 2001 seems a long way away right now, but as we approach that time, I think we have got to focus on the 2008 and the 2010 and the 2012 timeframe.

Do you have any disagreement with me with regard to the impact when the baby boomers begin to retire? I think it is like an EEE bond or something—I do not think the Government is going to renege—but where is the money?

Mr. KINGSON. I do not disagree that we should address this problem soon, and for a number of reasons. We need to give workers an opportunity to adjust their retirement expectations to the extent there may be benefit reductions—modest ones.

The longer we wait, the more difficult it becomes to address. Right now, we are dealing with a real problem, one for which there is a range of reasonable solutions. The recent Advisory Council, while they disagreed, I think they fundamentally agreed on extending coverage for State and local workers; fundamentally agreed on further taxation of Social Security benefits, on a slight benefit cut of about 3 percent for all future beneficiaries; and while there was not a strong agreement, there was an agreement on raising the age of eligibility.

If you just start with that——

Mr. PORTMAN. You say it is about 60 percent of the problem.

Mr. KINGSON [continuing]. You deal with 60 percent of the problem. And then you have a range of choices. Some might want to raise the eligibility age further. Some might want to cut benefits through some other mechanism. Some might want to put a tax increase in, somewhere in the far future, to deal with the outyears, along with raising the age of eligibility. But you can have a serious discussion.

When we have a discussion that creates the sense of an impossible task, I think it often serves an agenda to privatize Social Security—a genuine agenda—but an agenda that is interested in radically departing from what we have. I think we ought to look at it on its own merits, because that privatization approach can be very undermining in other ways.

Mr. PORTMAN. I do think, though, that we have to have people believing that this is in fact a crisis that is upon us, and if we do not act now, the adjustment will be all the more severe. And I think all of us can stipulate as to your comments earlier as to the importance of the program. You talked about 60 percent of the people requiring more than 50 percent of their income. So stipulating that, let us assume motives are pure.

Dr. Goodman, with regard to your comments, I think you do lay out, really, a frightening prospect. You, then, do not talk about how we bridge that gap in terms of the transition period. Could you briefly give me your thoughts on the transition? How would you get from here to there?

Mr. GOODMAN. Oh, there are a number of ways of getting from here to there, and I would be happy with any of them, because they are all better than the alternative. The alternative is an unsustainable path which leads us to a very, very scary future.

I would like to just give one human example of what the future looks like.

Mr. PORTMAN. Yes, please.

Mr. GOODMAN. A college student who leaves college today and enters the labor market earning the average wage can expect to pay at least a quarter million dollars in taxes over his work life and probably a lot more than that. But when he reaches retirement age, after paying all of those taxes, will he be able to collect any benefits? Not unless future generations of workers not even yet born are willing to fork over half their income.

Are they going to be willing to do that? Well, I do not think anyone today has any assurance that they will. So what I would do is go the whole way with Social Security and Medicare, go to a private system. We are going to have to increase debt in the short run, but it is worth it, because we have to make the transition to a fully funded system.

Mr. PORTMAN. OK. Let me just make one final comment, because my time is running out.

Dr. Gebhardtsbauer mentioned earlier the issue of the three-legged stool, and you started getting into private employers and their role. You were then cutoff, as I am about to be. But I think something that is very important that we need to link here is the role that the private employer and what employees currently contribute to this in terms of 401(k)s, profit-sharing plan, the new simple plan, and so on. Do you think there is a need or a possibility of more of a link into the future with the private sector?

Mr. GEBHARDTSBAUER. That is right. Employer plans, as we know, have been very advantageous for both individuals and the Nation because of this huge pool of money that has been invested very efficiently, often getting much better returns than individuals themselves would get.

One idea, for instance, is that if you have an individual account and either employers or employees must put their money into that individual account, they will have to find that money somewhere, so they will take it out of their employer plan, or they will take it out of their 401(k) plan and lose the match. So, we maybe do not want that to happen.

Mr. PORTMAN. Right.

Mr. GEBHARDTSBAUER. Maybe there is a way to say that if your employer already has a pension plan, maybe we will waive the requirement for an individual account if this employer plan is just as good.

Mr. PORTMAN. Thank you.

I thank the Chairman.

Mr. JOHNSON of Texas. Thank you, Mr. Portman.

Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman.

Sessions like this are instructive in attempting to address, I think, one of the most critical aspects of the Social Security debate, which is building consensus for any change. And clearly, on our side, there is going to be a reluctance if not resistance and intransigence to any sort of privatization of the Social Security system. We deem that to be one of the great social accomplishments in the history of this Republic.

At the same time, we acknowledge, I think, that there are going to have to be changes in the Social Security system. And we have used the word “transition” this morning during the testimony, and at the same time, part of our job here, I think, is to encourage greater savings among the American people for retirement.

Alan Greenspan comes to Capitol Hill, and we oftentimes treat what he says to be gospel as it relates to interest rates, but we miss one of the broader arguments that he has made, and that argument simply, as he offers it, is that the most fundamental economic problem the Nation confronts is our low national savings rate.

And we have pushed hard—150 Members of the House have signed a bill that is offered by Mr. Thomas from California and myself, that deals with the issue of using the individual retirement account as kind of a bridge, not to subtract from the Social Security system—certainly, we are not making the argument to go down the road to privatization—but we are arguing that the rich are going to save anyway. Why not provide a vehicle for the middle class and for lower income groups who wish to set aside some savings for retirement?

I would be curious as to the reaction—I did see Dr. Kingson’s testimony, and he has some suspicions about IRAs and the application of IRAs—but I would be curious as to what the panelists might have to say about the use of the individual retirement account.

Mr. MOORE. Well, it is no great mystery why we have a low savings rate in this country. We severely push savings via the Tax Code. This is one of the reasons I believe we ought to move toward a flat tax proposal that exempts savings from taxation, which is sort of a super-IRA, which essentially treats all savings in the form of tax-deferred savings.

I think that the evidence is very strong from what happened in the eighties when we instituted IRAs that savings went up for people who took advantage of them. They are a very popular savings tool for middle-income Americans.

I think we made a mistake in 1986 when we restricted IRAs, and so I would urge Congress to expand them, as it looks like you are going to do to some extent in this tax bill.

Let me just make one more point, though. I know that you are not a fan of the personal security accounts, but I would just mention that countries that have moved from pay-as-you-go systems to personal savings accounts have dramatically increased their savings rate. In Chile, for example, their savings rate went from about 10 percent to 26 percent. Now, I am not saying that the whole reason for that increase in savings was due to PSAs, but I think it created—one of the things you do when you allow people to put money into these individual accounts is that you create a kind of culture of savings; and quite frankly, that culture does not exist today in the United States.

Mr. NEAL. Doesn't that subtract from the idea of community, universality?

Mr. MOORE. Well, I think the point about the PSAs that liberals should keep in mind, people who want to protect the poor and so forth, is that you will be doing better for your lowest income workers in your district if you allow them to put money into these personal savings accounts.

Let me make one last point about this that you might want to think about in terms of whether you would favor this or not, and that is you can do this kind of plan and still preserve—and I think this is an essential feature—you have got to preserve some kind of safety net mechanism where, when a person retires, if he does not have enough money in that personal savings account, you basically tax other people's accounts so that that person retires with a minimum benefit level. And you can do that very easily because the advantages to all the other workers are so high.

Mr. KINGSON. I am not sure where to begin. First, let me make one comment on Chile, because it is so often referred to, and maybe even make a comment on academics.

Unfortunately, one of the occupational hazards of being an academic is that you do look at all sides, so that when it comes to testimony, we become two-handed academics—on the one hand, on the other hand. I am going to do a little bit of that.

In terms of Chile, what is often not looked at is the fact that when this system was put into effect during a military dictatorship and with a budget surplus in general government revenues and with a radically failed Social Security Program, it was put into effect with an 18-percent mandated wage increase. That might be very popular—if we wanted to put in a mandated wage increase, who knows—maybe that would work.

Another thing that is often not mentioned by those claiming that "all" younger workers would benefit, is that the stock market collapsed in 1929, and the real value of stocks I believe did not come back to the 1929 level until 1954. That is a long time if you are depending on the stock market for your retirement security or if

economic security is to be depended upon primarily through private savings.

Now, as for the question of private savings, of course we should encourage it, and here is the other arm. The encouragement of IRAs is not unreasonable. What I worry about with IRAs, however, is the transfer of savings from one mechanism to another. Another thing I worry about is an exclusive, IRA-like system, where we do not have a public sector to do what it is designed to do—provide a floor of protection under the middle class and a base to encourage savings on top of that and a floor of protection under those who are not so fortunate to be middle class.

Another thing I would worry about with IRAs is the increased risk that people face and the unequal outcomes that would come from it.

Mr. NEAL. My time has expired.

Mr. JOHNSON of Texas. Can I just follow up for a moment? You said a lot about reduced rate for younger workers, and I wonder how we can improve public confidence in a program through a transition period and/or if we leave it like it is, how we provide a better return for younger workers in view of what you have been saying?

Yes, Dr. Kingson.

Mr. KINGSON. First, I would start by saying that we need to look at the fundamental purpose of a social insurance program as opposed to a private savings program. The basic purpose of this program is to provide broadscale protection to the American public. To then come back and assess it in terms of rate of return, in my opinion, is the wrong calculus—not that it is unimportant, but rate of return does not take into account the inflation protection; it does not necessarily take into account the survivors' benefits worth $300,000 for a young family; it does not take into account disability protections often. But mostly, it does not take into account the issue of risk. It also does not take into account that the purpose of this program early on, again, and now, is to provide widespread protection. If the goal were to provide only a fair rate of return, then we would have given previous retirees far smaller benefits when they began.

Ida Fuller was the first Social Security beneficiary in 1940. Ida lived until the midseventies and collected some $21,000. If rates of return were our main concern, what we would have said to Ida is: You are only going to get back maybe $500, because you only contributed from 1935 to 1940, or something like that. That would not have made much sense if your goal is to protect older workers. So we blanketed in the older worker. To then come back and say that rates of return are declining is assessing it from a very different perspective.

Mr. JOHNSON of Texas. Mr. Moore, do you have a comment?

Mr. MOORE. I just want to respond to this issue of risk with personal security accounts. That is, it is, of course, true—there is risk if you invest in private markets, but we ought to realize also that, especially for young workers, there is what I call huge political risk with Social Security. Young workers who are 22 or 23 years old are taking a large risk that this program will be in existence in 50 years.

It is not well known among a lot of Americans and even a lot of Members of Congress that no individual American worker has a legal right to Social Security, even though I have already paid in $150,000 of taxes from the time I started working, if tomorrow, Congress had the votes to abolish the program, I would have no legal right to those benefits.

Now, on the contrary, however, if you allow me to put that money into a personal security account where I have my name on it, and I have ownership in that account, Congress cannot come and take that money from me.

So what you are essentially doing by moving to PSAs, I believe, is transferring from a financial risk—and Mr. Kingson is right, there is financial risk when you put your money into private capital markets, but you are transferring that to what I think is a much higher risk, and that is the political risk that you are going to raise the tax, lower the benefit, increase people's retirement age, and make the system an even worse deal than it already is.

Mr. JOHNSON of Texas. Dr. Goodman, would you like to have a quick response?

Mr. GOODMAN. I want to say something about investments in the stock market and the risk to the employee. If we wanted to for political reasons, we could say that for this generation, the generation that goes through the transition, the Federal Government will guarantee each and every worker who goes into a private system that he will not be worse off than if he had stayed in the public system. If we do it the way that Chile did it, we can make that guarantee to every worker, and we will virtually have to pay out no money from the Treasury; in other words, it's a very safe guarantee to make.

Mr. JOHNSON of Texas. But Dr. Kingson made a good point, I think, when he indicated that was a dictatorship when they did that. How can we do that in a democracy?

Mr. GOODMAN. That is a cheap shot; that is a really cheap shot. It is true, it is true—it was a dictatorship, but Australia is not a dictatorship, and they did the same thing.

Mr. JOHNSON of Texas. True.

Mr. GOODMAN. Hong Kong I guess has a dictatorship, and they did it, too.

Mr. JOHNSON of Texas. Did Australia do it in exactly the same way as Chile?

Mr. GOODMAN. Pretty much—now, they did not go from a pay-as-you-go system to a funded system. They started from a welfare system and went to a funded system. But all over Latin America, democracies are doing this—Argentina has done it, Colombia has done it, Peru has done it. Countries that have said they are now in the process of doing it are Mexico, Bolivia, and Ecuador, so it is very doable. It can be done in democracies, you do not need dictators, and it is very popular.

This is an extremely popular program in Chile. You can approach Chilean workers on the street, and they are carrying a little passbook, and they can pull it out and show you how much they have—four or five times or more of their annual wage. Most American workers cannot do that.

Mr. JOHNSON of Texas. No.

Mr. KINGSON. May I just put a point of information in on that? Having spent some time on a sabbatical studying their retirement policies in Australia, the Australian Government did make changes in the old age system. It has a means-tested system, but it is a very high means test, somewhat akin in fact to the Concord Coalition's idea, which I would also disagree with, but it has not developed a Chilean-style system at all. What it has developed is an expansion of the occupational savings by mandating additional pension savings.

The reason I am doing this is that what I find disturbing—we can all look at a problem if we know what the facts are, but it is hard to talk if we all come up with our own facts.

In reading through some of the testimony today, one of the things that troubles me are fairly inappropriate suggestions regarding the great benefit of these programs to low-income workers, with wild assumptions. In Mr. Goodman's case, there is the discussion that low-income minority persons lose out in Social Security, and the assumptions are not really presented—the problems I see—and I would like to submit this for the record—are that, one, it does not really take into account the large benefit reduction—the large benefit tilt—that favors low-income persons. Indeed, minority persons and low-income persons have shorter life expectancies, therefore, at retirement would probably get smaller benefits. But for other reasons, in our society, on average, they have lower wages and therefore get a higher rate of return in the program; they have higher participation in the disability programs, higher participation in survivors.

For example, among children under age 18 who are Social Security beneficiaries, there are roughly 3 million beneficiaries, 1 million of whom are nonwhite. Roughly 725,000 are African-Americans. Among disabled workers, 4.2 million disabled workers, about 1 million are nonwhite.

But we get only half of the story. The same thing, from my point of view as I read through the testimony of Mr. Moore. We are told that a typical female worker who just started working and earns about $22,500—and that goes up over average wages—would have a nest egg of about $800,000 to $1 million at retirement age, and this would produce roughly $60,000 a year until death, assuming she died at age 80. Well, this worker would be assumed to live 21 years at age 65, not just 13 years, as in the example. What would that changing this 13-year assumption do to the projected stream of benefits?

The assumptions need to be made explicit behind some of these projections that are being put out.

Mr. JOHNSON of Texas. I think that is why we are having this hearing, to try to get some of this sorted out. I need to have some more questions answered, but Mr. Gebhardtsbauer, if you have one quick statement to make, please go ahead.

Mr. GEBHARDTSBAUER. Yes. I just wanted to mention one more thing about Chile, and that is that whenever you switch over to this new system, you are going to have transition costs. And Chile had a fair amount of surplus at that time—not enough, but more surplus—we have deficits right now.

Our current system right now actually has $9 trillion in unfunded liabilities; it is not the $3 trillion that you sometimes see in reports. That is only on an ongoing assumption. The closed group assumptions, which is what you need to really transition, is a $9 trillion unfunded liability, and we do not have——

Mr. JOHNSON of Texas. Right. That makes our national debt right around $13 trillion.

Mr. GEBHARDTSBAUER. Yes. That is like the whole stock market, almost. But if you have some surplus, that would give you a good start—maybe you would not need the whole $9 trillion. But some of the techniques that are used in some of the proposals are to take advantage of better returns in the future so that you can get a benefit instead of being paid off your portion that is unfunded.

So there are different ways to go, and I just wanted to point that out about Chile.

Mr. JOHNSON of Texas. Thank you.

Mr. Hulsof.

Mr. HULSOF. Thank you, Mr. Chairman.

I wanted to ask Dr. Goodman particularly—we have been talking about this Chilean system—correct me if I am wrong, but at that time, the Chilean people had very little confidence in their system, and they were ready for this major reform or transition. I think Dr. Kingson quoted Senator Bradley in his testimony, that the American people believe in the concept of Social Security.

Do you think we can, as a matter of public confidence, ready the American people for such a radical overhaul of our Social Security system?

Mr. GOODMAN. Absolutely. In all of these countries, you need leadership; you need leadership to make a change. That is very important. In the United States right now, people are not all that confident about the Social Security system. Polls at least among young people show that a higher percentage think they are going to see a UFO than think they are going to receive Social Security benefits. So there is a great deal of distrust of the system among young people, and properly so. And they may not know exactly what the facts are, but I think their instincts are correct.

Now, with respect to the minority population, let me address that, because Dr. Kingson brought it up. The life expectancy of a black male at birth today is about 65 years. When that black male reaches age 65, the Social Security retirement age at that time will be 67. So we have a system that, at least on paper, has the average black male paying taxes all his work life and dying 2 years before he receives any benefits. And that is the system that Dr. Kingson says is so great for the minority population. True enough, he may have a slightly higher probability of getting disability benefits, but as a retirement system, that is lousy for minorities.

I think that if that message were more broadly understood, you would find a lot of support in the United States for moving toward a system where, if you die early, you still have something you can leave to your heirs.

Mr. HULSOF. Mr. Gebhardtsbauer, I noticed you nodding in assent through some of the question and then the answer, and I also understand that you have participated in a number of townhall meetings. Is that correct?

Mr. GEBHARDTSBAUER. That is correct.

Mr. HULSOF. In our townhall meetings, we get questions, and I have been trying to just lay the groundwork without really prodding or pushing the members of the townhall meetings or those who are in attendance in any direction.

What has been your experience as far as educating the public on what options they have available to them?

Mr. GEBHARDTSBAUER. Actually, I could not quite finish the last part of my speech, but it said what is the next step. And I would say that because using private investments is such a big change over the current method—it has lots of advantages, but we need to do a lot of education, and I commend your leadership in doing it. I guess it sounds like you have also done that in your areas.

It definitely brings up a lot of positive and negative feelings from especially seniors, who actually would be less affected; people who are more likely to be in Generation X, who believe that nothing is going to be left there for them are more likely to be interested in switching. And I guess the question also is how much are we going to switch; are we going to completely go to a system that is totally based on personal accounts? That would be more radical and harder to convince people of. Or, maybe we can just go partially.

And then the question also, whenever you go to using private investments, is you are either going to have the concern of governance issues if you have the government investing the money, and you also then have the risk issues if the individuals are doing it.

Mr. HULSOF. Mr. Moore, let me ask you—and I think I actually fall somewhere between the baby boom generation and Generation X; I am probably a lost individual——

Mr. MOORE. What year were you born?

Mr. HULSOF. Well, I would prefer to keep that private. [Laughter.]

Mr. HULSOF. 1958, actually.

Mr. CHRISTENSEN. Trust me, you are not Generation X.

Mr. MOORE. I was born in 1960, so we are both about the same age.

Mr. HULSOF. OK. Well, looking at the audience, I would suggest that probably two-thirds identify more closely with Generation X. And certainly, going back and doing the graduation speeches and talking to those folks who are going to be joining the work force soon, you mentioned that we in Congress could place reasonable restrictions on how money is to be invested or what-have-you to protect against losses. How do you think that would work, or what do you think the public reaction would be to us legislating those protections?

Mr. MOORE. Well, the libertarian in me would say that people would be able to invest it however they want, but I do not think that that is very politically realistic. I think the most realistic kind of proposal for Congress to think about is something that would essentially set up—I do not think you can allow individual workers to self-direct their money currently because of the problem that the folks from the Employee Benefit Research Institute were saying, that some people still do not have a good sense of how to invest. And hopefully, by the way, that is something that will change over the next generation.

What I would like to see is some plan where the individual worker would be able to choose between, say, one of 20 mutual funds—a fidelity fund, a Merrill Lynch fund, and so forth, so you are not picking stocks, you are essentially picking a fund. That is something that is fairly easy for workers to do. And you could set various restrictions in Congress about what kind of portfolio would be in that mutual fund. For example, maybe one-third of that fund would have to be invested in Treasury bills, one-third in corporate bonds, one-third in stocks, so that you essentially do diversify the portfolio and do protect against some of the risks that Dr. Kingson was quite importantly mentioning, that if you put all your money in stocks, you do face a risk of losing your money. So you would want to have a diversified portfolio that reduces risk, and if you do that, I think you can protect workers from the downside risks that Dr. Kingson was talking about.

Mr. HULSOF. My time has expired.

Thank you, Mr. Chairman.

Mr. JOHNSON of Texas. Thank you.

Mr. Becerra.

Mr. BECERRA. Thank you, Mr. Chairman.

Let me talk about the Chilean model, or let me return to the Chilean model, and try to get a better sense of how much we can overlay the Chilean model upon the United States.

The Chilean model, as I understand it, was one where, prior to its establishment, there really was no coherent, embedded retirement system in place for the country of Chile. Is that correct? No?

Mr. GOODMAN. What was happening in Chile, and what has happened in a lot of Latin American countries is that they start out with a Social Security system that looks very much like ours and then, because of the political pressures, they start getting separate funds, so you have a separate fund for the firemen and another one for the police officers, and then you get different benefits, and politics eventually just destroys the whole system.

So if you looked at it on paper, you would say it was a bit of a mess, but nonetheless most people were participating in some sort of pension system.

Mr. BECERRA. And that is perhaps what I mean. I do not think anyone would call our system a mess. We do know we need to make some changes, but we could go on until the year 2080 and know that at least we are going to give folks three-quarters of what they might otherwise expect.

Mr. GOODMAN. No, that is wrong. That is not right, that is not right. You cannot in the year 2080 give people three-quarters of what they have been promised unless you double and triple the current tax rate.

Mr. BECERRA. I thought we had enough funding available to take us to about the year 2028, 2029.

Mr. GOODMAN. No. That was a debate we had earlier, and maybe you were not here. Dr. Kingson said that based upon government bonds in the Social Security Trust Fund, but then I pointed out that every asset of the fund is a liability of the Treasury, so that when the trust fund hands that bond back to the Treasury, it simply cancels out; you do not have any money, you cannot pay any benefits. The only way you can pay a benefit is to borrow or tax.

Mr. BECERRA. Give me a sense, Dr. Goodman, of how long you think we could go with the current system if we were to not make any major adjustments to it.

Mr. GOODMAN. Well, what is in my testimony is right out of the Trustees' Report on how high the tax rates are going to have to be, and around the year 2030, we are going to have twice the payroll tax we have today, a 30-percent payroll tax to pay Social Security, plus both parts of Medicare.

Mr. BECERRA. If I could just get from you the response to the question: How far could we go with our current system if we did not do any major tinkering to it?

Mr. GOODMAN. Well, we are going to run out of money very quickly.

Mr. BECERRA. Define "quickly."

Mr. GOODMAN. In just a couple of years.

Mr. BECERRA. In a couple of years?

Mr. GOODMAN. Yes.

Mr. BECERRA. Do you mean by the year 1999, we will not have money in the Social Security account to pay it?

Mr. GOODMAN. Within the next 5 years, we are going to have to do something. We are going to have to raise taxes, or cut benefits. We are going to have to do something.

Mr. BECERRA. And if we do not do anything, what happens?

Mr. GOODMAN. Then the Treasury cannot send out the checks.

Mr. JOHNSON of Texas. Ms. Olsen, do you all have answers to his questions?

Ms. OLSEN. Well, in terms of the Chilean system——

Mr. JOHNSON of Texas. No, no. His question was when are we running out of money, I believe.

Mr. BECERRA. If we do not tinker with the system——

Mr. JOHNSON of Texas. Is that true?

Mr. BECERRA. Yes. If we do not tinker with the system, how long will the money be there; how long will we last in providing some form of retirement benefits under Social Security?

Ms. OLSEN. Well, as long as there is FICA income coming into the system, there will be benefits paid out.

Mr. BECERRA. OK.

Ms. OLSEN. The only way to get rid of Social Security is to eliminate FICA taxes altogether.

Mr. BECERRA. Given the actuarial projections, how long could we go providing people with the benefits that they are expecting at 100 percent of what they are expecting?

Mr. GEBHARDTSBAUER. Maybe I can help here. The reason why you are probably coming at it from different angles is because Mr. Goodman is talking about Social Security including Medicare. When you include Medicare, assuming Medicare is not fixed, then you run out of money much faster. But if you assume Medicare is fixed——

Mr. BECERRA. As far as I know, Social Security is a fund separate from the Medicare; is it not?

Mr. GEBHARDTSBAUER. Right. And if you look at just Social Security, then, yes——

Mr. BECERRA. I think this is a hearing on Social Security.

Mr. GEBHARDTSBAUER [continuing.] Seventy-five percent of benefits can be paid around the year 2030, and by the time you get out to the year 2070, about 69 percent is payable, and that is in the Trustees' Report that just came out.

Mr. BECERRA. OK. Dr. Goodman, do you disagree with that statement by Mr. Gebhardtsbauer—just a quick "yes" or "no" will be fine.

Mr. GOODMAN. No.

Mr. BECERRA. OK, then, let me move on.

Mr. GOODMAN. We are going to be able to borrow one trust fund from another, but all trust funds combined will not be able to pay benefits in the year 2000.

Mr. BECERRA. If I could move on, please—and I will probably give you a chance to answer the questions, but I want to make sure I do not see that green light turn yellow and then red.

If Mr. Gebhardtsbauer is correct that we will have moneys to provide benefits up until a certain time—2028, 2030—and then it starts to reduce until we get to about 2070 or so, we do have some time to come up with some solutions.

My understanding is that the Chilean model, while there were various programs to provide retirement benefits, I gather that no one 20 years ago could tell you that they would want to invest in any model that Chile had at that time. Things may be different now, and I think that that is a tribute to the success of the Chilean people and their economy, but I doubt until recently that anyone felt any level of comfort that the Chilean model would be one we could use.

Given that, we have a stable system that can take us some distance in, and then, hopefully, we will adjust it. But I believe most folks would say that politically and economically, we are at a stable point where we can make decisions, understanding we are not going to run out of benefits right now, and we are going to have to make some decisions, correct—but why would you want to compare yourself to a model that, until recently, was totally unstable?

Mr. GOODMAN. Let me just say that in terms of the population statistics, all Latin American countries are in better shape then we are—they are younger, they have growing populations. Therefore, if they had our system, their payroll tax would be much less than ours——

Mr. BECERRA. So isn't it the case that they do not have to worry so much about the baby boom generation as we do.

Mr. GOODMAN. That is right, that is right, but because of political pressures and other reasons, they screwed up their systems, and——

Mr. BECERRA. If I could ask my question, if you want to continue to discuss or engage in a dialog—then, why would we want to compare ourselves with Chile when they are not experiencing what we are experiencing, and that is the baby boom generation coming home to roost? And if you have to deal with that, how are you going to deal with going private, or partially private, if you have a system that you are already saying in the next several years will have to start looking for additional funds if it wants to provide for the future generations? What is the proposal if we go private to provide the services and benefits for those currently on the rolls?

Would we tax those who are still working, or would we reduce the benefits of those who would be eligible for Social Security?

Mr. GOODMAN. I think we have to guarantee benefits to those who are currently retired. Now, what we did——

Mr. BECERRA. Would you tax those who are paying, who are working and paying into Social Security? If you are going to provide the same level of benefits, and you are going to provide some form of private——

Mr. GOODMAN. We have to tax and borrow to maintain the same level of benefits during the transition period.

Mr. BECERRA. Whom would you tax?

Mr. GOODMAN. The public.

Mr. BECERRA. OK, "the public," meaning generally, or those who are working, or those who are making a certain amount of income? Everyone gets taxed?

Mr. GOODMAN. What I would do is what Chile did. I would issue recognition bonds and pay them off over a period of time. The natural growth of the economy is going to generate—the higher rate of growth, as Martin Feldstein pointed out—is going to generate more money, making it possible over a period of time to pay off those bonds.

Mr. BECERRA. I understand that, and that is what we heard in the eighties before the deficits ballooned, but——

Mr. JOHNSON of Texas. Mr. Becerra, I turned the lights off for you and gave you a little extra time. Can you wind it down?

Mr. BECERRA. Mr. Johnson, you have been quite gracious. I will go back to that if there is a second round of questioning, and I thank the Chair.

Mr. JOHNSON of Texas. Thank you, sir.

Mr. Christensen.

Mr. CHRISTENSEN. Thank you, Mr. Chairman.

I wanted to get Mr. Gebhardtsbauer's position on the Consumer Price Index, CPI. Earlier this year, we debated a little bit on both the House and Senate side on whether or not we were going to make the CPI part of the whole discussion. I wanted to get your position from an actuarial standpoint on the CPI and how it affects the Social Security system.

Mr. GEBHARDTSBAUER. OK. The Boskin Commission came out and said that the CPI could be overstated by 1.1 percent, and if in fact, then, Congress were to reduce the COLA by 1.1 percent, that would solve about two-thirds of the Social Security financial problem right there—increase the retirement age to 70, combine those two, and the whole thing is solved.

But there is a concern that maybe, if you subtract 1.1 out of the CPI, then you are oversubtracting. Right now, when people get the COLA, their buying power is actually increasing every year in retirement, at least the benefit from Social Security, because it is overstating the CPI.

The problem with subtracting a full 1.1 is that that might slightly understate it so that each year, the buying power would go down. So it does not affect you much for 1 year or 2 years, but the very elderly in their nineties and hundreds would be the ones who would be affected the most in that situation. So I guess that is why

Congress has tried to find out what is the right cost-of-living inflation index that we need to apply to this benefit.

Mr. CHRISTENSEN. Another question I have—I guess Mr. Moore is gone now, but he was talking about the percentage of investment that the Government might be able to control in terms of having 20 mutual funds chosen.

Dr. Goodman, have you looked at any ideas as far as Cato's plan on how they would go about selection of those 20 companies, how they would decide which funds to pick? Also, if they were to proceed to this, would this be a concern for the markets to have that much government influence in the markets? I am a big supporter of not burying our heads in the sand and just saying we do not have a problem; I think we need to fix this problem, and we need to move toward a system like Senator Kerry from Nebraska has been talking about. He has been the lonely voice out in the woods for some time now, and on many things I disagree with Senator Kerrey, but I think he has been very good on these entitlement areas and working hard to try to bring some sense into this area.

What about the government being involved in the private markets? How would that affect——

Mr. GOODMAN. I think we have got to be very clear about what we want to achieve, and what we are talking about is forced savings. We are talking about requiring people to put, say, 10 percent of their income every year into a savings account. Now, why are we doing that? Because we want them at retirement age to have a reasonable income during their retirement years. If you let them go off and play the futures market and make really risky gambles, many of them will have nothing at the time they have reached their retirement years, and then you have lost the rationale for the whole program.

So what Chile did—and I think it is a good model to follow, and I think this is what Cato has in mind—was they said, look, we want to put very few government restrictions on the pension funds, but you have got to have a diversified portfolio, and you have got to abide by certain other financial regulations. The government does not tell them what stocks or bonds to buy. They have perfect freedom to do that. But they do have to have a diversified portfolio, and the reason is because over time, that portfolio will keep pace with the economy, so that when an individual retires, he will have a pension that reflects the growth of the economy, which was the reason for the whole thing in the first place.

Mr. CHRISTENSEN. Dr. Gebhardtsbauer.

Mr. GEBHARDTSBAUER. I am sorry—what was the specific question?

Mr. CHRISTENSEN. Your position on the government being in the markets.

Mr. GEBHARDTSBAUER. Well, right now, there are a couple of agencies, the Pension Benefit Guaranty Corp., PBGC, and the Federal Thrift Plan, that actually are investing in the markets. The PBGC, actually, when it takes over a pension plan, keeps those assets from, say, Pan Am or Eastern—I used to be the Chief Actuary at the PBGC. They keep the assets, but they do not vote them. They give that to their investment managers.

In the Federal Thrift Plan, I guess there was the concern—I was also the Chief Actuary at OPM when we created the Federal Thrift Plan——

Mr. CHRISTENSEN. Is there anything you haven't done? [Laughter.]

Mr. GEBHARDTSBAUER. I still have lots to do—wait for my Social Security benefit.

In the Federal Thrift Plan, they invest in a stock index, and that way, the government is not picking and choosing what stock to do, so that eliminates the concern that the government could be favoring one industry or another or going into social investments.

There is also the concern about voting, so in the Federal Thrift Plan, too, they delegate that also to the individual investment managers.

I guess the concern is what happens if someday, Congress in fact would have lots more money than the Federal Thrift Plan has. I think they only have, like, $25 billion right now, and the Social Security trust funds could easily get to $1 trillion. So, what would happen if the Government had $1 trillion? Would they change the rules and start favoring one group over another?

Mr. KINGSON. If I could just add to that, sir——

Mr. CHRISTENSEN. I am just about out of time. I would just close by saying, Mr. Chairman, that the number one topic when I am talking to high school classes and seniors is the fact that they are not going to see their money. When I ask how many people are working, almost all the seniors are working, and 25 percent of their money is going into a deep, dark, black hole that they do not ever expect to see. I think it is unfortunate that we have people back here who are not willing to expand their thinking and look into ideas that will protect the system for the long term and not just the political term.

I encourage us to keep holding these kinds of hearings, and I applaud your efforts and thank Mr. Bunning as well.

Mr. JOHNSON of Texas. I think these hearings are very beneficial. A quick comment, Dr. Kingson.

Mr. KINGSON. Yes. One thing that I think is important to note is that in shifting to a private mechanism, one shifts the risk—under two of the Advisory Council plans, we shift risk onto individuals. There was a third plan discussed which takes advantage of possible higher rates of return—I would even say probable higher rates of return—but which does not shift the risk onto individuals. Under the maintain benefits plan, they suggested looking at partially investing some portion of the trust fund.

I think the other thing that is awfully important to recognize—it was just mentioned about high school students not having faith, or others—I think there is great public misunderstanding of the Social Security discussion. A lot of people think that the exhaustion of the trust funds in 2028, 2029, means that there is no money in them once that time takes place. And as we know, that is not so. It means we only have three-quarters of the funds, which is not great; we need to do something about it. But this lack of understanding, or lack of understanding affects public opinion. When young people are asked, one, they may not think it is going to be there; two, they might not really think they have to pay twice if

you shift to a private plan—once for the promises that are made and once for themselves. So that a lot of the discussion around public understanding and public opinion I think needs to be brought out carefully, as has been done today in this kind of forum.

Mr. JOHNSON of Texas. Yes. I think the transition is important to each of us, but Mr. Gebhardtsbauer, you indicated the CPI would solve the whole problem. Let me ask you a different question: Why do you think we should use the CPI, because I frankly think it is artificial.

Mr. GEBHARDTSBAUER. The American Academy of Actuaries does not endorse or propose legislation.

Mr. JOHNSON of Texas. Does or does not?

Mr. GEBHARDTSBAUER. Does not. So we cannot take a stand on something like that.

Mr. JOHNSON of Texas. OK. Well, there have been too many estimates on what it is. You said one-plus, and we are in as low as three-tenths or four-tenths of 1 percent. So nobody knows. As Dr. Kingson says, we do not have the facts on that issue yet, I do not believe.

Mr. GOODMAN. I just do not agree.

Mr. JOHNSON of Texas. You do not. You think we should use the CPI?

Mr. GOODMAN. I do not agree with the comment that an adjustment in the CPI can solve three-fourths of our problems. Once again, that is going back to this accounting that treats the bonds and the trust funds as though they are something you could pay benefits with, which they are not.

All that reducing the price index is doing, is just cutting benefits, so if you are willing to cut benefits enough, then, yes, you can solve the problem. But I do not think most of us think that is the right way to do it.

Mr. JOHNSON of Texas. I hear you; I think we all agree on that. One more line of questions, Mr. Becerra.

Mr. BECERRA. Actually, I would like to follow up on the questions you were asking on the CPI.

Mr. JOHNSON of Texas. Go ahead.

Mr. BECERRA. Have we come up with a better system to try to gauge the rate of inflation? I think everyone would agree that the CPI was never intended to be our gauge of inflation, but has become so. Have we figured out what combination of variables best gives us a read on what the real inflation rate is?

Mr. GOODMAN. Well, what I would do is what I understand the Treasury is moving toward anyway, and that is to issue an indexed bond—and this guy will know more about it than I will—but I understand it is the GNP, Gross National Product, deflator that is used to gauge the rate of inflation for the country as a whole. And I would be inclined to say, well, look, if that is good enough for the country as a whole, let it be good enough for retirees.

Mr. JOHNSON of Texas. Mr. Gebhardtsbauer, a comment?

Mr. GEBHARDTSBAUER. Since you brought it up, I do want to congratulate the Government on having those indexed bonds, because someday, we will hopefully be able to buy an annuity that will go up with inflation. So that is something that will help the private sector, actually, meet some of these needs.

But back to your concern on the CPI, I guess what the Bureau of Labor Statistics has come up with is—they have made some changes already, and I think it has already reduced the CPI a little bit—maybe 0.2 percent—and it looks like within another couple of years, they are going to implement something that will reduce it by another 0.3 percent, so in total 0.5. That is gradually getting there, but of course, it would not be used until 1999, so we do not get that over the next few years.

Mr. BECERRA. Dr. Kingson.

Mr. KINGSON. Thank you, sir.

I think it is very important that Congress move cautiously in this area for just the reasons that were mentioned, that we do not have all the facts, and there are lots of variants. We know that nobody wants to provide a cost-of-living adjustment that is in excess of what the change in the annual rate of inflation is, but neither do we want to do the reverse, because then we would have a national policy which guarantees that the longer you live, the less you have to spend. And where we have our greatest problems in terms of the economics of older people is in advanced old age, especially among aged widows, which is one reason why there was a virtual consensus among the Advisory Council to do something that would increase the benefits of aged widows, essentially, by providing somewhat higher widow/widower benefits in the program while cutting spouse benefits some. It was a relatively no-cost change. You take a bit from a group that has a relatively low poverty rate, married elders, and you add it to a group which is a greater risk, those women who live longer, primarily, single women who live longer.

And I think the caution of the Bureau of Labor Statistics is very appropriate, and I think it is important that there not be a political decision made to move on a national index base, even though I could see some great advantages, because as the gentleman to my left said, if the CPI overstates by half a percent, we address one-third of the financing problem without political—without a lot of fight.

Mr. BECERRA. Thank you.

Thank you, Mr. Chairman.

Mr. JOHNSON of Texas. Thank you all for being here today. We appreciate your participation.

Before we conclude, I would like to advise the witnesses that the Chairman may be sending you additional questions to answer for the record, if you would help us in that vein. I am sure there are more questions that will come to mind concerning the effects that your reform proposals would have on the Social Security system.

[Questions were submitted to the panel from Chairman Bunning. The responses follow:]

QUESTIONS SUBMITTED BY CHAIRMAN BUNNING TO MR. MOORE

1. You emphasize that all conventional fixes (like raising payroll taxes or raising the normal retirement age) for Social Security are a "bad deal" for young people, since these changes only worsen their rate of return. You believe these changes must be tied to an exit strategy that allows young workers to capture the returns from a private market.

To solve the transition problem, you mention that, according to Martin Feldstein of the National Bureau of Economic Research, the net economic benefit from Social Security privatization is $10 trillion, and that a plan could be devised whereby the

gains are shared by the government and the worker to the benefit of both. As you know, we need to be very careful about two issues, one being the Trust Fund balance over the long run and the other ensuring that the government's overall deficit is reduced or at least left unaffected by any proposed changes. I'm interested in knowing more details as to the justification of the net economic benefit from Social Security privatization.

2. You propose offering a deal to every American worker where they promise to forfeit any claim on their Social Security benefits—even those they have already accumulated—in order to invest all of their future payroll taxes into private markets. You estimate that under this approach, up to ⅓ of the current unfunded liability would be eliminated through this transition plan. Would you provide further details as to how this would work? Do you really believe younger workers would walk away from what they have contributed?

In your proposal, there appears to be no tier 1 basic safety net benefit, as proposed in the Personal Security Accounts plan offered by certain members of the Advisory Board. Do you see no need for a safety net?

Under your proposal, do workers have the freedom at retirement to use the proceeds of their personal savings account anyway they choose? What happens if they spend it all quickly or live much longer than they may have expected?

3. As individuals build up balances in their individual accounts, won't there be pressure on the Congress to authorize early withdrawals, since after all, the accounts really do belong to the individual?

4. How do you respond to the allegation that some investors will not do as well in terms of returns on their personal savings accounts and will be forced to turn to means-tested income support such as SSI, thus driving up the cost of these taxpayer-supported programs?

5. Of what importance are cost-of-living adjustments and should they be preserved?

6. What are your views regarding adjusting the Consumer Price Index as an option to consider as part of Social Security reform?

7. How do we restore younger worker confidence in Social Security?

8. What are your views on the Advisory Council's recommendation to study the investing of up to 40% of the Trust Funds? How would the market be affected by such a large infusion of money?

What percentage of private industry would the government own? Shouldn't the government stay out of private industry? How would this be done?

Wouldn't the government wind up taking an active role in the direction of the companies whose assets it owns? Might this role for government have a depressing effect on stock yields and therefore on the yields for seniors?

Since the government would control the investment of the Trust Funds, how do you avoid the risk that the government might ultimately influence the selection of stocks for political purposes unrelated to the best interests of the workers contributing to the plan?

9. Could you suggest a way that employers and employees together could opt to replace a personal savings account or individual account with an employer plan that would spread the risk more and yield a higher return?

10. In light of the fact that the Trustees' long-range "intermediate" projections made in 1983 now appear to have been optimistic, if one were to ask you to design a package of reforms today, would you use the "intermediate" assumptions or the "high cost" assumptions? Said another way, should we build a financing cushion in the next set of changes we make to Social Security in the event the most recent intermediate forecast proves to be optimistic?

11. Given that entitlement spending overall has been projected by the Congressional Budget Office and others to grow dramatically as a percent of GDP in the future (when the baby boomers are in retirement), do you think it would be wise to build tax increases into any Social Security reform plan?

12. Do you think the public wants, or is expecting, at least some market investment to underpin the Social Security system in the future, whether it is through personal accounts or collectively through the Trust Funds?

13. While the Advisory Council was not able to agree on everything, they did agree that any sacrifices in bringing the system into balance should be widely shared and not borne entirely by current and future workers and their employers. The council's suggestion was to apply appropriate income taxation to Social Security benefits. Do you believe the burden should be shared by all?

Response to Subcommittee on Social Security questions on Social Security Privatization

by
Stephen Moore

1. Question: what are the details of Martin Feldstein's estimate of an economic benefit of $10 trillion from Social Security privatization?

Response: Feldstein's estimate derives from two large economic advantages from privatizing Social Security. The first is that money invested in private capital accounts provides a higher return to the economy than money that is invested in government programs. Thus, diverting $200 billion to $300 billion a year into private capital markets away from government spending programs yields a very large long term benefit to the economy. The second economic return comes from the supply side effect of reducing the Social Security tax. Under a privatized Social Security system, the 10 percent of payroll that is now lost to the employee in the form of the Social Security payroll tax, would now be returned directly to the taxpayer in the form of a private investment account. This is the economic equivalent of giving every American worker a 10 percent raise in salary, because the money that was once viewed as a tax with no return, is now viewed as a form of direct compensation. This 10 percent pay premium from privatizing Social Security increases the incentive for Americans to work and to work longer hours. I have always believed that privatizing Social Security would be the most powerful supply side tax cut that we could possibly provide American workers. We saw the very positive supply side effect from Reagan's 1981 income tax cuts, but I firmly believe that the Social Security privatization payroll tax cut would be substantially larger than even the Reagan cuts of 1981. (I've enclosed a copy of the Martin Feldstein study for your review.)

2. Question: Would you provide further details of how a plan that would ask American workers to forfeit any claim on Social Security benefits in exchange for opting out of the system would work?

Response: If you review the chart that I showed in my testimony from Bill Shipman's Cato Institute study on the rate of return of privatization vs. conventional Social Security, you'll see that the average worker today would receive a 2 to 4 times higher benefit from investing Social Security money into private capital markets than he or she will get from Social Security. Given these much higher rates of return from privatized account, it stands to reason that rational workers would be willing to pay an "exit fee" to get out of the Social Security system in order to reap the higher returns from

private investment opportunities. One way of imposing this exit fee would be to ask workers to give up all of the promised benefits from Social Security in exchange for the option to choose private markets in the future. It turns out that given the results from the Shipman study, any worker under the age of 38 can earn a higher retirement benefit by giving up all of the promised benefits that they have already accumulated from Social Security, if they could in exchange invest their future payroll tax money into a private account. Obviously, the younger the worker is, the more likely he or she will be to take the government up on this deal. For example, a worker who is only 24 years old and has only worked for two years would readily give up the amount that they have already paid into the system to invest in the future privately. If you were worried that young workers would not walk away from all the money they have contributed, you could provide a recognition bond at the time that the worker opts out in order to compensate them for between 10 and 90 percent of how much they have already paid into the system. For example, a 38 year old worker who has contributed $150,000 into the system could be given a recognition bond for $100,000 that would accumulate interest over time. This would still leave the government better off by $50,000.

This recognition bond concept could work as well for workers over the age of 38. Most 45 year old workers would not be willing to give up everything they have put into the system in exchange for not receiving benefits in the future. But if we were to offer them a recognition bond of say 60 percent of the amount they have paid into the system already, they may take the government up on the deal. As long as the recognition bond is for less than 100 percent of what they've paid in, it creates a win-win situation for the government and the individual worker.

3. Question: Do I see a need for a tier one basic safety net benefit?

Response: Yes, I do believe that a basic safety net is an imperative feature of any privatized Social Security system. We have to guarantee that when workers move towards a privatized system, the government will guarantee that upon the retirement age, if they have not accumulated enough money in their private account to retire with a minimum benefit, the government will top off their account to bring it up to a minimum benefit level. The vast majority of workers, of course, will have accumulated benefits that will be substantially above the minimum safety net level. But it is certainly plausible that some workers might fall beneath the safety net level as a result of bad investing or market down turns. The way to pay for this safety net feature under a privatized plan is to impose a tax on the privatized accounts

of say 1 percent. This would generate enough revenue to pay off the workers who did not accumulate a sufficient benefit. But let me repeat, a safety net feature is an absolute political imperative to make Social Security privatization viable.

4. Question: Won't there be pressure on Congress to authorize early withdrawals, since after all, the accounts really belong to the individual?

Response: This certainly would be a potential danger. We have seen this problem arise with IRAs where Congress has authorized early withdrawals for college education, medical expenses, and first time home purchases. I do believe, however, that the personal security accounts situation would be less prone to such tinkering. Since these accounts are in lieu of Social Security, I believe that it would be the equivalent of touching the third rail for Congress to come up with proposals to allow workers to withdraw money from these accounts. One interesting question to ponder is whether workers should be allowed to withdraw money from their accounts before retirement once they have reached a level of minimum benefit.

5. Question: What about the allocation that some investors will not do as well in terms of returns on their personal savings accounts and be forced to turn to means tested income support programs?

Response: Again, this potential problem can be dealt with by adding a safety net feature to the Social Security privatization proposal. If we guarantee every worker a minimum benefit upon retirement by adding funds to their individual account if it is not sufficient to purchase an annuity that would provide a minimum benefit, then we would be protecting against seniors becoming eligible for other income support programs. Again, this safety net can be paid for through some type of taxation of the personal security accounts--either when the money goes into the accounts or when it is taken out.

6. Question: Of what importance are cost of living adjustments and should they preserved?

Response: The only relevance of the cost of living adjustment under a privatized Social Security system would be in establishing what the minimum annuity benefit level would be under the safety net provision. For example, if we were to establish today a minimum benefit of, say, $1,000 per month, then this $1,000 per month minimum benefit level should be adjusted upward for inflation each year.

7. Question: What are your views regarding adjusting the

consumer price index as an option to consider as part of Social Security reform?

Response: I would be in favor of adjusting the CPI to accurately reflect inflation. I view this as a technical fix, not a legislative remedy. However, I do think that this reform should be instituted at the same time we move towards a privatized Social Security system. In other words, all of the reforms to Social Security that are now under consideration should be adopted as part of a grand package that lowers current costs and allows young workers to at least partially move into a privatized system.

8. Question: How do we restore younger worker confidence in Social Security?

Response: Young workers today think it is more likely that they will see a flying saucer in their lifetime than a Social Security check. The great political virtue of Social Security privatization is that, almost universally, young workers view the PSA option as a substantially better deal than conventional Social Security. This is true not just because they would receive a higher rate of return, but because of the ownership feature of a privatized system. The young worker has more confidence in a privatized personal security account system, because he privately owns the money. It can never be taken away from him. This is unlike Social Security, where Congress can at any time change benefit structures, or even abolish the program if it wishes to. So the way to restore confidence in Social Security is to move aggressively toward a privatized system with a safety net feature.

9. Question: What are your views on the advisory council's recommendation study investing of up to 40 percent of the trust funds?

Response: I am adamantly opposed to any plan that would allow the government to invest trust fund revenues. There are a number of reasons that conservatives should oppose this idea. One is that it would lead to the government ownership of a huge amount of private corporations. Another is that it does not provide the kind of personalized accounts that is the real virtue of a privatized system. Finally, if we look at other countries who have had the government invest pensions funds, we find that the rate of return on those funds has been very low. I am enclosing a recent Cato Institute study on this idea and why it is so dangerous.

10. Question: What percentage of private industry would the government own if the money were invested by the government.

Response: If the government were to invest 40 percent of the trust funds in private capital markets, this would lead to $100 to $150 billion of direct government investment in the private capital markets each year. The total amount of private capitalization is estimated to be between $8 trillion to $12 trillion. But remember, these $100 to $150 billion of investments would be made year after year after year. So it would not take long before the government became a major stakeholder in many private companies. Of course, the problem here is that once the government becomes a major stock holder in American companies, then it will almost certainly succumb to politically correct measures to make sure that companies are involved in "socially beneficial" programs. For example, we can imagine that the government stock holder would require that private companies engage in racial preference hiring practices, provide all sorts of lavish benefits to workers, and so forth.

11. Question: Could you suggest a way that employers and employees together could opt to replace a personal savings account with an employer plan that would spread the risk more and yield a higher return?

Response: I'm not sure that it would make a great deal of difference whether the money were invested by the individual directly or whether it was placed in an employer pension plan. I am a strong believer that as American workers become more sophisticated in how capital markets work, that individual American workers are certainly competent to make safe investment decisions. I would note that in Chile, a country still much poorer than the United States where the per capita income is about one-third that of the U.S., Chilean workers have proven very adept at investing their money privately. Of course in Chile, as should be the case in the United States, the accounts are not self directed. That is, the worker does not choose which stocks to buy, but rather chooses among various mutual funds. If a Chilean worker can do this, then certainly most affluent Americans can be counted on to do it.

12. Question: Should we use the intermediate economic assumptions or the high cost assumptions in predicting future costs of Social Security?

Response: It is certainly true that the intermediate assumptions for the financial status of Social Security have been overly optimistic for the last 10 years. In fact, in 3 of the last 5 years the Social Security administration has had to move forward the date at which the Social Security system becomes entirely financial insolvent. On the other hand, the economic growth assumptions that the Social Security trustees use in their intermediate assumptions are, in my opinion, rather conservative. I must confess here that I am very bullish on the future of the American economy. As we move

further into a technological age, there is no question that economic growth rates can rise substantially over 2 and one half percent, perhaps to a long range of 3 to 5 percent. This would be well above the intermediate economic assumption used by the Social Security trustees. So, in sum, my advice to the committee would be to stick with the intermediate projections, as I believe these are conservative estimates about the future of the American economy.

13. Question: Should we build tax increases into any Social Security reform plan?

Response: No, I am very much opposed to any tax increases as part of Social Security reform. The worst idea of all, of course, would be to raise the payroll tax as is the conventional reform to Social Security. There is strong evidence that the Social Security tax has had a very disabling effect on the U.S. economy. It is a regressive tax; it is anti-work; and it is anti-savings and investment. The only "tax" that I would recommend with respect to a Social Security privatization plan would be to impose a very minor tax on the personal security accounts to fund the safety net expenditures that might be required for those who have not accumulated a minimum benefit, as discussed above.

14. Question: Does the public want some market investment to underpin the Social Security system in the future, whether it is through personal accounts or collectively through the trust funds?

Response: The public opinion polls show that once Americans are explained how a privatized Social Security system would work, they are strongly in favor of it. I have enclosed a recent Cato Institute study on Social Security poll results. But interestingly enough, the public is also solidly against the idea of government investment of these funds.

15. Question: Do I believe that the burden of Social Security reform should fall on current and future workers and their employers?

Response: The virtue of Social Security privatization is that it is a benefit to workers, not a burden. That is to say, unlike all of the conventional fixes to Social Security, this is the one "fix" that young people would be willing to bear some of the unfunded burden to pay for current retirees and to also pay for their own retirement. This is not a zero sum game. The gains from Social Security privatization are so enormous, that we can reduce the liabilities that are already baked in the cake and also make young workers better off. So we should break out of this mold of thinking that Social Security reform involves "shared pain." Instead, we should

start talking about shared benefit. A rational Social Security privatization plan could be adopted without raising any new taxes and without substantially reducing benefits of current retirees. This is the only alternative that leaves everyone better off.

THE RESPONSES OF DR. KINGSON

1. You argue that privatization places low-and moderate-income workers at significant political risk and that privatization "schemes" ensure erosion of political support for Social Security's redistributive role. How do you respond to Mr. Moore's comment that low-income workers will do better in a privatized system?

Mr. Moore overlooks important aspects of the Social Security program. Moreover, I find many of the assertions in Mr. Moore's testimony confusing and hard to fully assess. Some of the assumptions behind his analysis are not spelled out and others seem questionable.

In his testimony Mr. Moore gives the example of a "typical female worker who just started working and earns a salary of $22,500, which goes up with average wages over her lifetime. When she retires," he states that "Social Security will pay her a $12,500[1] annual benefit in today's dollars—assuming no change in benefits. If she were permitted to simply place her payroll taxes[2] in a mutual fund with a 7 percent real rate of return ..., she would have a nest egg worth $800,000 to $1 million at retirement age.[3] This would allow the worker to draw a $60,000 benefit per year until death (assumed at age 80)."[4] According to Mr. Moore, "This is five times higher than what Social Security offers for the same level of investment."

- I do not understand why Mr. Moore would assume death at age 80 when average life expectancy for a woman reaching age 67 in 2044 is about 20 years? What would happen to his estimates if you assumed 20 years of remaining life instead of 13?
- It is not clear whether the assumed yearly benefit includes cost-of-living protection. I do not think it does. What would happen to the estimate if it did?
- It is not clear whether these calculations include adjust for the value of disability, retirement and health benefits? Similarly, no mention is made of the possibility of a lower real rate of return (e.g., 5% instead of 7%).
- How might different interest rates change the projected "nest-egg." And even if the average rate of return is 7%, plainly some would do better and some would do worse. In the real world, might this present significant problems?

In short, I do not think Mr. Moore has presented information that supports his assertion that lower-and moderate-income persons would to well to trade-off the certainty of protection under the current system for the possibilities he suggests may exist under his proposed system. Below, please find an estimate of benefits payable under the existing system.

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[1] This is in inflation-adjusted dollars. Additionally, the purchasing power of her benefit would be protected by the COLA. Assuming this worker was 20 years old in 1997 and reaches age 65 in 2042, by my rough estimates her yearly benefit in current 2042 dollars would be $62,500. Her life expectancy on reaching age 65 under intermediate assumptions used in the 1997 Trustees report is estimated AT 21 years.

[2] From his statement it is not clear whether Mr. Moore is counting only her FICA contribution or that of her employer and employee. Neither is it clear whether he is counting only the portion of the FICA that is dedicated to disability and survivors insurance contributions, or for HI.

[3] Again, from the testimony it is not clear whether he is talking about nominal (current) or inflation-adjusted (constant) dollars. If the former, then it is greatly over-stating the real value of the "nest-egg and the yearly benefit. Also, it's not clear whether he is assuming COLA protection under his plan. If not, then $80,000 a year shrinks substantially in purchasing power over time.

[4] This seems like a peculiar assumption given that the life expectancy for women reaching age 65 in 2040 is 20.9 years (in 2045 21.1 years) under intermediate assumptions in the 1997 Trustees Report. A 21 year life expectancy would reduce the value of the estimated benefit by a significant amount as would cost-of-living protection.

Estimated Benefits Payable to Workers Reaching age 65 in 2045

Year reaching 65	Current dollars	Constant 1997	% of Earnings
Retiring at age 65			
Low Earner	$44,060	$8,510	49.4
Average Earner	$72,740	$14,049	36.7
High Earner	$96,112	$18,563	30.3
Reaching age 67 in 2047			
Low Earner	$54,903	$9,899	56.5
Average Earner	$90,888	$16,387	42.1
High Earner	$119,532	$21,552	34.6

Source: 1997 Trustees Report

2. Of what importance are cost-of-living adjustments and should they be preserved?

Cost-of-living adjustments are an important feature of the Social Security program. They assure that benefits, once received, will maintain their purchasing power no matter how long the beneficiary lives. Without COLA protection, OASDI could not achieve its goal of providing widespread protection against loss of income due to retirement, disability or survivorship. In effect, without full-COLA protection, we would have a national policy which systematically reduced the value of benefits, the longer someone lived.

3. What are your views regarding adjusting the Consumer Price Index as an option to consider as part of Social Security reform?

If the CPI still overstates inflation, then further technical adjustments will be forthcoming as an outcome of the Bureau of Labor Statistics' review of this index. I do not believe that BLS should be politically mandated to make specific changes, as this would undermine the integrity of its data gathering functions and its statistics. (For additional comment, please see the discussion that followed the statements of the witnesses.)

In the context of a Social Security financing reform package, it is not unreasonable to consider a one-time reduction (e.g., a "delay") in the COLA as done as part of the 1983 Amendments. Should Congress choose to implement such a change, then I believe it would be important to simultaneously implement a one-time increase in SSI benefits to offset the effects of this COLA cut on some of the most economically at-risk beneficiaries.

4. How do we restore younger worker confidence in Social Security?

Educate the public about the value of the existing program, the extent of the projected financing problem and the policy choices. Discourage sensational rhetoric. Address the projected financing problem. (For additional comment, please see the discussion that followed the statements of the witnesses.)

5. What are your views on the Advisory Council's recommendation to study the investing of up to 40% of the Trust Funds. How would the market be affected by such a large infusion of money?

What percentage of private industry would the government own? Shouldn't the government stay out of private industry? How would this be done?

Wouldn't the government wind up taking an active role in the direction of the companies whose assets it owns? Might this role for government have a depressing effect on stock yields and therefore on the yields for seniors?

Since the government would control the investment of the Trust Funds, how do you avoid the risk that the government might ultimately influence the selection of stocks for political purposes unrelated to the best interests of the workers contributing to the plan?

In the context of the current financing problem, I believe serious consideration should be given to this option. Yes, there are risks that the government might seek to inappropriately influence the private sector through its ownership of stocks, but as the proponents of this plan have suggested there are also safeguards that could be implemented to substantially reduce—if not entirely eliminate such a risk. I am reminded of the political events leading up to the enactment of the 1983 Social Security reforms which included the provision to treat up to 50% of Social Security benefits as taxable income. Congress had previously gone on record—unanimously or nearly unanimously I believe—as opposing taxation of benefits. But in the context of the hard choices before the Congress, taxation of benefits emerged as an important—arguably the key—element of the compromise. It was simply less painful than many of the other options under consideration.

6. Could you suggest a way that employers and employees together could opt to replace a personal savings account or individual account with an employer plan that would spread the risk more and yield a higher return?

No.

7. In light of the fact that the Trustees' long-range "intermediate" projections made in 1983 now appear to have been optimistic, if one were to ask you to design a package of reforms today, would you use the "intermediate" assumptions or the "high cost" assumptions? Said another way, should we build a financing cushion in the next set of changes we make to Social Security in the event the most recent intermediate forecast proves to be optimistic?

Use of the intermediate assumptions is perfectly appropriate for addressing the projected long-term financing problem. For a projected long-term financing problem, I would not consider the use of the pessimistic assumptions to be any more appropriate than the use of the optimistic assumptions. This said, I think the financing reforms should also seek to implement reforms that would not leave a structural deficit after the 75-year estimating period.

8. Given that entitlement spending overall has been projected by the Congressional Budget Office and others to grow dramatically as a percent of GDP in the future (when the baby boomers are in retirement), do you think it would be wise to build tax increases into any Social Security reform plan?

Just as I would give serious consideration to benefit cuts, I would also give serious consideration to some modest tax increase 25, 40 or 60 years in the future. I would also give consideration to adjustments in the maximum taxable ceiling or to the treatment of some tax-exempt fringe benefits as taxable for Social Security purposes.

9. Do you think the public wants, or is expecting, at least some market investment to underpin the Social Security system in the future, whether it is through personal accounts or collectively through the Trust Funds?

I do not know the answer to this question. I do believe, however, that the public may need more information to develop an informed opinion on this issue.

10. While the Advisory Council was not able to agree on everything, they did agree that any sacrifices in bringing the system into balance should be widely shared and not borne entirely by current and future workers and their employers. The council's suggestion was to apply appropriate income taxation to Social Security benefits. Do you believe the burden should be shared by all?

Yes, but, as members of your Committee well know, when it comes to burden sharing often there are as many different views of what is "fair" as there are people in a room.

THE RESPONSES OF MR. GEBHARDTSBAUER

1. In your testimony, you emphasized that it's not enough for Congress to just put Social Security back in actuarial balance over the next 75 year period, we must also maintain a stable Trust Fund at the end of that period to be sure we aren't dealing with this problem 20 years down the road (mostly due to the fact that individuals keep living longer.) The Maintain Benefits group solves this problem by increasing contributions by 1.6% of covered pay beginning in 2045. The other two Advisory Council proposals solve this by increasing the normal retirement age to 67 by 2011 and to age 70 by 2083. What are the disadvantages you see in raising the normal retirement age?

As you suggest, there are advantages and disadvantages to any solution for putting Social Security in actuarial balance. The following are some disadvantages to raising the Normal Retirement Age (NRA).

SAME AS A BENEFIT DECREASE:

Increasing the NRA by one year is the same as decreasing benefits by 7% (except it has the advantage of not decreasing disability benefits). For example, if the NRA is increased from age 67 to age 70, the benefit of someone who wants to retire at age 65 is reduced by almost 21%. This disadvantage (benefit decreases could adversely affect beneficiaries) can also be seen as an advantage (it corrects for the hidden benefit increase due to longer lifespans). Note that the age 70 normal retirement age is not reached until 2083 in the Individual Account (IA) and Personal Security Account (PSA) plans. Thus, the benefit decreases suggested are quite gradual (in order to reduce the effects of a notch).

BENEFITS AT 62 MIGHT NOT BE ADEQUATE:

If the current benefit structure was designed to provide the appropriate minimal benefit, then this decreased benefit will not be adequate. This is of particular con-

cern at the youngest eligibility age 62. When the NRA reaches age 70, the age 62 benefit will be 55% of the NRA benefit, and thus, probably inadequate. In order to avoid this problem, the earliest retirement age of 62 could be increased to age 65 gradually. However, this would be a disadvantage for those who wanted to retire earlier, but would now be ineligible for a retirement benefit (unless they could qualify for disability retirement).

WORKING UNTIL AGE 70:

Just because Americans are living longer, does not mean the population is healthier or can work longer. However, recent studies are showing that the elderly are healthier. Employing them would increase national productivity. In addition, many people worked beyond 65 in the past, before Social Security was available.

EMPLOYER CONCERNS:

Social Security does not exist in a vacuum. Private sector retirement systems will be affected. Employers who do not want an aging workforce may need to increase benefits for their pension plans in order to make up for the decrease in Social Security benefits (caused by the increased NRA). Aging workforces can also lead to increased unemployment, health, and disability costs for employers. On the other hand, it appears that large numbers of retirements of healthy baby-boom workers starting in 2008 may prompt employers to rethink their retirement strategies. Employers may not want their workers to retire in such large numbers. Retirement plans can encourage this strategy if retirement ages are increased in tandem with Social Security. This could reduce employer pension costs also.

SOME CITIZENS NOT AFFECTED:

The retirement age change in the IA and PSA options affect covered workers who reach age 62 on or after 2005 (i.e., those born in 1943 and later) and not those born earlier. Age 67 would apply to those born in 1949 (1960 and later under current law). Thus, this change affects baby boomers and younger workers, but not the retired or near-retired. This can be seen as a disadvantage (older workers and retirees are not sharing in this particular solution) or as an advantage (no sudden changes for those near or in retirement who can not change their plans easily). A summary of the IA and PSA retirement age changes are enclosed.

2. You mentioned that experience from other countries shows that tax avoidance occurs when one gets nothing for additional taxes. Would you provide more detail as to which other countries have this experience and what actually happened?

A paper presented by Joyce Manchester (Visiting Fellow-World Bank) at the 1997 Pension Research Council at Wharton names countries where under-reporting of taxable income occurs when people get little additional benefit from paying additional contributions. In her speech she also cited Italy as an example. She stated that people under-report income when:

- Benefits are not linked to contributions
- Benefits are only based on the last 5 years of income
- Low returns on contributions make the value of the additional benefits worth much less than the amount contributed.

Even in the United States, many self-employed women with lower wages than their husbands under-report their income, since they get little or no improvement in their Social Security benefits if they do report their income (see pages 13 and 14).

3. Of what importance are cost-of-living adjustments and should they be preserved?

If COLA's are eliminated, the effects will be most felt by the very elderly of the future. For example, if inflation is 4% over the next 30 years, someone age 95 then will have fallen behind by 4% for each of the next 30 years. Thus, their purchasing power at age 95 will be only 31% (=1/1.04 − 30) of what it was at age 65. This is quite a concern, since:

- Employer pensions often don't have COLA's,
- Medical and long-term-care expenses are higher in the last couple years of life, and
- Poverty rates are higher at the most elderly ages, especially among women, who are more likely to be widows living alone. (See attached chart on poverty rates.) Poverty rates assume it costs widows about 75% of the amount before widowed to maintain the same standard of living.

Social Security's loss of purchasing power was a concern for Congress before COLA's were automatic, so they occasionally passed ad hoc COLA's which ended up being more expensive than CPI increases would have been. Automatic COLA's were introduced as a way to reduce costs. Thus, eliminating them could also increase outlays.

4. What are your views regarding adjusting the Consumer Price Index as an option to consider as part of Social Security reform?

The American Academy of Actuaries does not endorse legislative proposals, but rather provides analysis of advantages and disadvantages. Therefore, while we do not recommend arbitrarily reducing the COLA, we do note that the Chief Actuary of Social Security has estimated that subtracting 1.1% from the CPI (and no other changes) would lower Social Security's long-range actuarial deficit by about two-thirds.[1] Coupled with an increase in the normal retirement age to 70, it would solve Social Security's current long-range actuarial deficit.

However, if the COLA is reduced by 1.1%, the problems noted in the last question will arise if this reduction sets a COLA that is lower than the actual increases in the cost-of-living. The purchasing power of retirees will fall behind each year. Thus, the very elderly of the future will be hurt the most. Currently, changes in the CPI, being reputedly higher than the actual increases in costs-of-living, helps the very elderly the most.

Finally, the Bureau of Labor Statistics has made changes to the CPI that are expected to reduce the annual COLAs by 0.2% and suggests that it might make further changes that would lower the annual COLAs by another 0.3% in 1999. If Congress lowered the 1998 COLA by 0.3%, it would reduce outlays by 0.3% in 1998, with reduced outlays in future years gradually reducing to zero over current retirees' lives.

5. How do we restore younger workers' confidence in Social Security?

Robert Friedland of the National Academy of Social Insurance made a presentation before the 1994–1996 Advisory Council entitled "Public Confidence in Social Security." In it, he discussed their focus groups, supplemented by Gallup polls in 1994. They found that most people get their lack of confidence in Social Security from experts and media saying Social Security has financial problems. Young people "wanted someone with authority to walk in the room and say" Social Security will be fixed. (See page 295 of Volume II.) Thus, fixing Social Security's financial problems would probably help restore the people's confidence in the system. The presentation also suggested that annual benefit statements might help those people that do not trust the government or its ability to manage (page 297). Private sector pension plans must furnish benefits statements upon a participant's request.

6. I'd like to know your views on the Advisory Council's recommendation to study the investing of up to 40% of the Trust Funds. How would the market be affected by such a large infusion of money?

What percentage of private industry would the government own? Shouldn't the government stay out of private industry? How would this be done?

Wouldn't the government wind up taking an active role in the direction of the companies whose assets it owns? Might this role for government have a depressing effect on stock yields and therefore on the yields for seniors?

Since the government would control the investment of the Trust Funds, how do you avoid the risk that the government might ultimately influence the selection of stocks for political purposes unrelated to the best interests of the workers contributing to the plan?

EFFECTS ON U.S.:

Most studies suggest that investing Social Security funds in private markets would probably drive up stock prices, and consequently lower their returns in the future. (The initial appreciation in stock prices would be a windfall for those already in the stock market.) Unless amounts invested in the private sector are found from reduced U.S. expenditures or additional contributions, the U.S. Treasury would have to find another source for its borrowing. In order to attract more funds, the U.S. Treasury would have to offer higher interest rates. This would increase the deficit and eventually taxes. Thus, Social Security becomes a better deal to covered workers at the expense of U.S. taxpayers.

OTHER CONSEQUENCES:

If lower market yields result, it would also affect pension plans and others that are heavily invested in the stock market. Funds in Defined Contribution plans would yield smaller benefits and Defined Benefit contributions would have to increase in order to fund the same benefits. Corporations might have higher borrowing costs to compete with the U.S. Treasury for funds. Higher corporate bond yields then might offset the lower equity yields in pension plans that had them.

[1] If the 1.1% decrease is done through BLS corrections to the CPI, the savings is not as great, because nominal wages and interest rates may also come down.

INVESTMENT RISK:

The Social Security Funds would be subject to market volatility risk. Since they are closer to pay-as-you-go than advance-funded pension plans, this risk should be analyzed carefully, to see how much funds can safely be invested in equities. On the other hand, Social Security does not allow lump sums (which some pension plans do offer) and contributions each year will greatly offset the amount needed for distribution each year. This would reduce the risk that large amounts of funds would need to be withdrawn when stock prices are down. However, when the baby boomers start to retire (from 2008 to 2030), the stock market might fall dramatically when retirement funds are pulled out to pay benefits to the large baby boomer cohort. This could lower equity returns dramatically.

GOVERNANCE CONCERNS:

The above comments also apply to the IA and PSA options. However, the Maintain Benefits (MB) option also has the governance concern that you mentioned because the government holds the equity funds (while it avoids placing the many serious risks on individuals of a more privatized system). It is very difficult to determine what percent of the market would be held by the government. Thomas Stanton's presentation to the Advisory Council (pages 423 of Volume II) compares equity amounts in 2020 with total corporate equities in 1994 by deflating the equities at 5.5% per year. Under his method, the MB equities in 2020 of $3.2 trillion (as projected on page 196 of Volume I) would deflate to $0.8 trillion in 1994 or 13% of corporate equities. He states that this amount would probably be manageable by current equity managers. However, the Advisory Council projected stocks to yield 11% annually. If the size of the stock market were to increase commensurate with this assumption, the above 13% would be much lower. Finally, we note that stocks in the IA and PSA options will eventually far exceed amounts in the MB option (but they of course are held by individuals, not Social Security). One way to decrease these percentages is to allow investments in corporate bonds, mortgages, and mutual funds. This could cut the above percentage in half, since these additional markets are just as big as the domestic equity market. Foreign markets could further reduce these percentages. These other investments would have their governance concerns too, however.

Two agencies in the federal government (the Federal Thrift Savings Plan and the Pension Benefit Guaranty Corporation) reduce the governance concern by delegating voting rights to the investment managers. The PBGC has done this successfully for over 20 years. In addition, the Federal TSP only invests in indexes. This reduces the concern that they could manipulate companies with their huge amounts of money. In addition, they are by law fiduciaries investing money in the sole interest of their beneficiaries. This keeps investment managers from having other reasons for investment decisions. However, laws can be changed by a future Congress. For example, Florida's legislature just mandated the state retirement fund to eliminate investments in tobacco.

7. Could you suggest a way that employers and employees together could opt to replace a personal savings account or individual account with an employer plan that would spread the risk more and yield a higher return?

If reform legislation mandates additional employee contributions to individual accounts, it may harm their employer retirement benefits and personal savings. Many lower-paid employees could take their contribution from their 401(k) deferrals and lose the employer match. Higher-paid employees would then be prohibited from making their full contribution to the 401(k) plan, due to non-discrimination rules. If the mandate is for additional employer contributions, then employers may reduce contributions to their pension plans.

Papers from the World Bank laud the fact that retirement income in the U.S. comes from more than one source (i.e., the 3-legged retirement stool). Diversification of the sources of retirement income is very important. However, if the Social Security leg is strengthened by harming the other legs (private pensions and personal savings), the result could be an unbalanced retirement stool.

There are ways to preserve the employer pension leg. For example, if a mandatory contribution is required, employer pension plans could be one of the options for the mandate. The government might require some special rules for the pension plan to qualify, such as:

- A minimum benefit or contribution,
- A minimum vesting schedule, or
- A minimum cash-balance-type benefit in a Defined Benefit plan, that is vested within the first year.

Employer plans (including Defined Benefit plans) with 401(k) features could qualify as an option for all employees that made a minimum contribution. Section 414(h) pickup plans could be expanded to all employer types and also qualify as an option. The private and public pension sectors already exist for over 80 million employees and would be able to handle the imposition of reform legislation much easier than if the mandate is placed on each individual. Congress may want to consider this option if it decides to go forward with mandatory individual accounts.

In addition, simplification of pension laws is still needed to encourage more plans. Most small employers still do not have pension plans (therefore it would be difficult for small employers to find the money for any IA mandatory contribution). The tax advantage of employer pension plans (over other investment possibilities, such as savings accounts, IRAs, and stocks eligible for capital gains treatment) is also necessary to preserve them. Some forms of tax restructuring would remove the tax advantages of employer-sponsored pension plans. We have attached a report which discusses how this could negatively affect individuals, employers, and the nation.

8. In light of the fact that the Trustees' long-range "intermediate" projections made in 1983 now appear to have been optimistic, if one were to ask you to design a package of reforms today, would you use the "intermediate" assumptions or the "high cost" assumptions? Said another way, should we build a financing cushion in the next set of changes we make to Social Security in the event the most recent intermediate forecast proves to be optimistic?

The Academy uses the intermediate assumptions for its monograph and issue briefs (also enclosed). Social Security's 1990 Technical Panel assumptions were practically all implemented. In addition, the 1994–1996 Advisory Council, reflecting some outside criticism, suggested assuming longer lifespans and higher fertility rates. However, their suggested assumptions approximately offset each other. As stated in the Advisory Council report, they find the assumptions reasonable in the aggregate.

In addition, as discussed in our testimony, it is not sufficient to just put the Social Security system in actuarial balance. The legislation must also create a stable fund balance at the end of the 75-year period. For example, the IA and PSA options create a stable fund balance by increasing the Normal Retirement Age.

9. Given that the entitlement spending overall has been projected by the Congressional Budget Office and others to grow dramatically as a percent of GDP in the future (when the baby boomers are in retirement), do you think it would be wise to build tax increases into any Social Security plan?

Whether or not to increase taxes (and how much) is a policy decision for Congress. If the solution is entirely on the tax side, and benefits are not reduced, the 1997 Trustee Reports of Social Security and Medicare Programs show that taxes would have to double from 7.38% of GDP today to 15.08% of GDP in 2071. This is about 40% of taxable payroll in 2071.

	1997	2071	% Increase
OASDI	4.65%	6.68%	44%
HI	1.76	4.98	183%
SMI	0.97	3.42	253%
Total	7.38%	15.08%	104%

Congress should consider how much they will need to increase taxes for Medicare (if any), before they decide to increase taxes for Social Security. It may greatly affect the thinking on this issue.

10. Do you think the public wants, or is expecting, at least some market investment to underpin the Social Security system in the future, whether it is through personal accounts or collectively through the Trust Funds?

As a result my participation in Social Security symposiums sponsored around the country by members of Congress, I have heard many attendees say who they think should invest the stocks. In general, these conversations have revealed that younger people, men, and higher-paid people may be more likely to be in favor of individual accounts, while older people, women, and the lower-paid may be more likely to not favor them. It is interesting to note that this latter category is also the same group that invests in a more conservative basis in their IRAs and 401(k)s. This is probably due to the fact that they have less future earning power to offset any possible investment losses that could occur.

11. While the Advisory Council was not able to agree on everything, they did agree that any sacrifices in bringing the system into balance should be widely shared and

not borne entirely by current and future workers and their employers. The council's suggestion was to apply appropriate income taxation to Social Security benefits. Do you believe the burden should be shared by all?

The Academy does not take policy positions. However, we do note that taxing Social Security benefits like pension benefits by eliminating the thresholds would be a big simplification for retirees calculating their taxes. One might be concerned that very low-income retirees would then be stuck with a large tax increase.

However, as pointed out in the Advisory Council report, 30% would still not be taxed. For example, exemptions and deductions for an elderly couple are $13,400 (=$2,550 x 2 + $8,300). This could easily be more than their Social Security benefit, so it would not be taxed anyway. In addition, middle income people will not be affected as much due to the progressive nature of our tax system. However, pension tax law also requires a determination of the portion paid by the employer. This portion is taxed at distribution. We note that determining the portion of Social Security benefits not taxed yet would be a detailed calculation and difficult for retirees to verify. Thus, Congress might stay with the 85% imputation rule that already exists. This 85% is quite accurate for workers at the wage base and above. For middle and low-income people, however, the untaxed portion is closer to 90 or 95%. Thus, a more exact calculation would increase their taxes. Thus, the imputation is simpler and it has the added advantage of not affecting middle and low-income people more than higher income people.

In response to your question about whether current retirees should share in the solution, we note that further taxation and COLA reductions are two ways in which current retirees could be affected. Many current retirees have received or will receive more from Social Security than they contributed. They have had a good return on their contributions. On the other hand, they are also responsible for preserving our democracy in the 1940's, caring for their parents in earlier years before some were fully covered by Social Security, and creating a very productive nation in the 1950's. They may have paid in other non-financial ways.

We want to thank you again for holding the hearing and inviting us to testify. We are more than happy to answer further questions or meet with you to discuss these and other items at any time.

THE RESPONSES OF DR. GOODMAN

1. Of what importance are cost-of-living adjustments and should they be preserved?

Cost-of-living adjustments are not included in most private pension plans. Workers who pay the taxes that provide the Social Security COLAs do not uniformly receive COLAs themselves, so the beneficiaries are doing better than the people paying for the benefits. It would be politically difficult to remove COLAs from Social Security, however. As long as we continue the current pay-as-you-go system, COLAs probably should be measured more accurately than they are now. I must point out that under the fully funded system of individual accounts that I proposed in my testimony, COLAs would be a moot point.

2. What are your views regarding adjusting the Consumer Price Index as an option to consider as part of Social Security reform?

As mentioned in answer 1, COLAs should more accurately reflect the increase in the cost of living. But this could cut two ways. The Boskin report appears to be substantially correct, but it has been suggested that there should be a separate CPI for the elderly since their spending differs from the nonelderly—and the finding might be that the COLA for the elderly should be increased. In any event, I am concerned that a quick fix based on refiguring the COLA may forestall fundamental reform of the system.

3. How do we restore younger worker confidence in Social Security?

With so much discussion of increasing the eligibility age and reducing benefits, younger workers are right to lack confidence in Social Security as currently constituted. In my view, a system of individual accounts similar to the Chilean system would restore the confidence of workers of all ages and contribute greatly to American economic growth.

4. What are your views on the Advisory Council's recommendation to study the investing of up to 40% of the Trust Funds. How would the market be affected by such a large infusion of money?

What percentage of private industry would the government own? Shouldn't the government stay out of private industry? How would this be done?

Wouldn't the government wind up taking an active role in the direction of the companies whose assets it owns? Might this role for government have a depressing effect on stock yields and therefore on the yields for seniors?

Since the government would control the investment of the Trust Funds, how do you avoid the risk that the government might ultimately influence the selection of stocks for political purposes unrelated to the best interests of the workers contributing to the plan?

Government's investing a portion of the Trust Funds is a terrible idea. First, our current Trust Fund surpluses are used to finance deficit spending and conceal the true deficit, and there is no reason to believe any return from such an investment would not be used in the same way. Second, such an investment would in effect move American industry toward nationalization at a time when the rest of the world is moving to privatize state-owned businesses. Third, the temptation to politicize a government-managed fund is too great to resist. We could be sure of political interference at every turn, particularly with the huge amounts involved. One estimate is that the Trust Funds would grow to be about 45 percent of the capital stock in the U.S., exclusive of owner-occupied housing and unincorporated businesses.

Let me refer here again to the Chilean system. In Chile, workers can invest their funds in one of about 20 pension fund administrators (called in Spanish AFPs), private entities authorized and supervised by the government. Individuals can move their accounts from one AFP to another, so the AFPs compete for business on the basis of investment returns and management costs. The AFPs are closely restricted in the types of investments they can make. At the end of 1990, the AFPs had invested 44.1 percent of their funds in government bonds, 17.4 percent in bank time deposits, 16.1 percent in mortgage bonds, 11.3 percent in common stocks and 11.1 percent in corporate bonds.

5. Could you suggest a way that employers and employees together could opt to replace a personal savings account or individual account with an employer plan that would spread the risk more and yield a higher return?

No. I think it would be more desirable to move away from employer-based retirement systems. A retirement system permitting more portability, such as one permitting larger contributions by employees and employers to IRAs and SEPs, or to similar retirement instruments, would produce a system more in keeping with the needs of today's workers and retirees. It is simple enough, with diversification, to spread the risk and gain a higher return with these instruments.

6. In light of the fact that the Trustees' long-range "intermediate" projections made in 1983 now appear to have been optimistic, if one were to ask you to design a package of reforms today, would you use the "intermediate" assumptions or the "high cost" assumptions? Said another way, should we build a financing cushion in the next set of changes we make to Social Security in the event the most recent intermediate forecast proves to be optimistic?

We did build a cushion in 1983—and the government has been spending it. The next set of changes we make to Social Security should be complete reform with a transition to a system of fully funded individual accounts and a provision for transition from the current system.

7. Given that entitlement spending overall has been projected by the Congressional Budget Office and others to grow dramatically as a percent of GDP in the future (when the baby boomers are in retirement), do you think it would be wise to build tax increases into any Social Security reform plan?

No.

8. Do you think the public wants, or is expecting, at least some market investment to underpin the Social Security system in the future, whether it is through personal accounts or collectively through the Trust Funds?

I don't know.

9. While the Advisory Council was not able to agree on everything, they did agree that any sacrifices in bringing the system into balance should be widely shared and not borne entirely by current and future workers and their employers. The council's suggestion was to apply appropriate income taxation to Social Security benefits. Do you believe the burden should be shared by all?

Yes, but not necessarily through the income tax. However, we need to be concentrating on reform rather than simply bringing the current system into balance.

THE RESPONSES OF MS. OLSEN AND MR. YAKOBOSKI

Question 1: One of the technical panels of the Advisory Council covered the issue of "assumptions and methods," and I believe one of the conclusions of this panel was that the "intermediate" projections of the Social Security Trustees provide a reasonable evaluation of the financial status. It is very confusing for the public to begin to understand the problems facing Social Security in the long run, when every day it seems we are seeing another estimate in the press or in some news story that Social Security will go bust in a different year. These years seem to range from just past 2000 to 2050? No wonder the public is confused and skeptical about the program's future. You point out some disagreement with some of the Trustees' assumptions. What can we do to inform the public of the right numbers and what are the right numbers for us to use as we address future Social Security reform?

Response to Question 1: The Chairman's uncertainty about which projections to use is very appropriate when approaching a range of differing reasonable projections about the future of the program. In fact, in order to be most flexible and sensible, policy decisions at this juncture must reflect the uncertainty surrounding the extent and timing of Social Security's financial issues. Quite simply, no one knows the "right" numbers. However, there are definitely numbers based on more reasonable and less reasonable assumptions. The trustees issue three sets of assumptions, and the conservative approach to education would be to always provide the range the differing assumptions produce. This would tell the public, for example, that benefits could exceed taxes as early at 2005 or as late as 2020.

EBRI does not have reason to believe that the range of Trustees' assumptions are unreasonable, but the range should be shown, as the intermediate assumptions are just that, one set of assumptions. Our point is that since the Census Bureau and private researchers almost invariably assume higher life expectancy among the elderly than the Trustees' intermediate assumption, the Trustees' intermediate projections may be somewhat optimistic. However, as the Chairman is aware, recognizing uncertainty does not warrant inaction, as most reasonable estimates predict that program outgo will exceed program income sometime during the first half of the next century. Instead of focusing on ascertaining a specific shortfall date, a more constructive course of action at this juncture for the Congress and the public is careful consideration of the appropriate national response. At the heart of the Social Security debate are philosophical considerations about the appropriate role of government, business, and households in meeting the challenges of an aging society that must be addressed before the Congress considers actuarial arguments about the specific date of insolvency and specific technical solutions to program shortfalls. The series of hearings on "The Future of Social Security for this Generation and the Next" pointed out many of these fundamental political and social choices that will have to be made when (and if) a shortfall occurs. We hope that your colleagues on other relevant committees will follow your lead in pursuit of such discourse.

Question 2: In your testimony you discussed research which showed that only 21 percent of those retirees interviewed annuitized their IRA balances and just 12 percent annuitized their distributions from other retirement savings plans. How can we determine how effective the majority of retirees are at managing their retirement savings throughout retirement?

Response to Question 2: Retiring with large lump-sum distributions from retirement plans is a very recent phenomenon, with most beneficiaries still in retirement. As of yet, there is unfortunately a dearth of data on these individuals. We do know, however, that effective self-annuitization requires significant thought. It is accomplished by dividing the account balance each year by one's life expectancy at that point in time and limiting annual consumption to the amount determined by the calculation. This step must be repeated each year, and the annual amount will vary from year to year depending on investment income and changing life expectancies. The extent to which it is reasonable to believe people will effectively manage their retirement savings is therefore directly proportionate to the percentage of the retired population than can be expected to self-annuitize.

EBRI has undertaken an annual retirement confidence survey for each of the past six years. The findings suggest that individuals are not well prepared for the challenge. Most have lived for a working lifetime with a regular paycheck -the equivalent of an annuity. Research by others shows that most live paycheck to paycheck, and many borrow to cover temporary shortfalls. In addition, personal bankruptcies are higher than ever, as is personal debt. Financial literacy, according to industry and independent surveys, is low. The Health and Retirement Survey (sponsored by the National Institute on Aging) finds that most respondents don't have a good understanding of their own life expectancy prospects, and have low net worth besides.

All available evidence suggests that the majority of retirees are not effective at managing their retirement savings throughout retirement.

Question 3: Of what importance are cost-of-living adjustments, and should they be preserved?

Response to Question 3: Because more than 60 percent of the elderly rely on Social Security benefits for over one-half their income, few dispute the importance of preserving cost-of-living adjustments that protect the elderly from the erosion of income that is caused by inflation. EBRI has not conducted research on the accuracy of the current consumer price index (generated by the Bureau of Labor Statistics (BLS) and used to make cost-of-living adjustments for Social Security beneficiaries). EBRI is not in a position to provide guidance on the extent to which the current cost-of-living adjustment reflects economic reality for retirees.

Question 4: What are your views regarding the Consumer Price Index as an option to consider as part of Social Security reform?

Response to Question 4: Congress must first decide what they want Social Security to provide in the future. If the objective continues to be a floor income for the lowest income workers on retirement, maintained throughout retirement, then an inflation adjustment is necessary to maintain value. Different objectives would of course lead to different answers. The Consumer Price Index per se should be an accurate measure, and BLS should be required to do the work to assure that it is.

Question 5: How do we restore younger workers' confidence in Social Security?

Response to Question 5: We suspect that restoring the program to long-term actuarial solvency would greatly contribute to restoring younger workers' confidence in the system, although we are not aware of any empirical survey data that address this question specifically. There is strong evidence in the surveys that the young do not understand the program, how it works, or its objectives. Much has been written over the past 20 years about "money's worth" from Social Security, concluding that the young will "do poorly." This analysis assumes that the program is intended to function in a way that provides a "payback," which cannot be the case with any insurance program for every participant. There will always be winners and losers. Few talk about this fact. Few talk about the degree to which Social Security supports an individual's parents or grandparents, and the money the individual would likely have to provide to them in the absence of Social Security. Few talk about survivors benefits, or disability benefits, or the fact that if you lose everything else, there is still the Social Security annuity for you or your surviving spouse and children. Instead, the focus is simply on the "fact" that the government will make good on the promise, so don't worry. This misses the fact that the young don't understand what the promises are or why they should value them.

Question 6, Part A: What are your views on the Advisory Council's recommendation to study the investing of up to 40 percent of the trust funds? How would the market be affected by such a large infusion of money?

Response to Question 6, Part A: There are few things that are not worthy of study. Clearly any such move should occur only after full study and careful consideration of all possible consequences. A recent study by Brett Hammond and Mark Warshawsky on this topic appears in a forthcoming Benefits Quarterly journal. They conclude that, under most scenarios, the market would not be overwhelmed by such an approach. We do not know of other studies on this issue, and the impact of trust fund investment in equities is an area that economists are just beginning to study.

Question 6, Part B: What percentage of private industry would the government own? Shouldn't the government stay out of private industry? How would this be done? Wouldn't the government wind up taking an active role in the direction of the companies whose assets it owns? Might this role for government have a depressing effect on stock yields and therefore on the yields for seniors? Since the government would control the trust funds, how do you avoid the risk that the government might influence the selection of stocks for political purposes unrelated to the best interests of the workers contributing to the plan?

Response to Question 6, Part B: Mark Warshawsky and Brett Hammond found that "projections based on historical trends in the growth of the stock market as well as of the indexed portion of the mutual fund industry suggest that, in the case of a centrally managed Social Security investment strategy, the portion of all equities owned through the Social Security program would be relatively small [between 1.1 and 27.5 percent]" (forthcoming, Benefits Quarterly, 1997).

The other issues you raise have been cited as reasons by organizations that are uncomfortable with the recommendation. The history of public pension fund involvement in corporate governance is often cited, along with past discussion of "economically targeted investments," as precedents for what might occur. History would suggest that movement into equities might or might not lead to such outcomes, but

there would be no guarantees. Whereas not moving to equities would assure that these things did not happen. Congress will have to decide whether the move to equities is of sufficient value to the fund to merit taking on other risks, EBRI can provide background on what other nations have done, the history of "social investment" discussions in the pension area, and attitudes, but does not take a position for or against the investment issue per se. Our goal is an informed decision, whatever it is.

Question 7: Could you suggest a way that employers and employees together could opt to replace a personal savings account or individual account with an employer plan that would spread the risk more and yield a higher return?

Response to Question 7: This is what Social Security presently does for all workers, regardless of hours worked. Larger employers have joined with workers to sponsor plans at work that allow savings (401(k), 403(b), 457). Most small firms have found these plans too expensive to administer and too complex-even employer payroll deduction to IRAs. There have been proposals in the past to create an account within Social Security to which individuals would contribute that could be placed in savings bonds. Contributions would "flow" with payroll tax contributions. While we do not have a pro or con position on this proposal, it is one that Congress might study as a means of meeting the objective implied in your question.

Question 8: In light of the fact that the Trustees' long-range "intermediate" projections made in 1983 now appear to have been optimistic, if one were to ask you to design a package of reforms today, would you use the "intermediate" assumptions or the "high cost" assumptions? Said another way, should we build a financing cushion in the next set of changes we make to Social Security in the event the most recent intermediate forecast proves to be optimistic?

Response to Question 8: As noted above, given the difficulty of taking action on Social Security, conservative assumptions are probably good to use. In fact, Congress requires private pension sponsors to use very conservative assumptions in order to assure that promises are kept. A financial reserve is not the only way to deal with this, however; Congress could also consider automatic adjustments in the COLA, in retirement age or in the benefit formula, depending on which assumptions are wrong. For example, a COLA cap would protect against being wrong on inflation. A "indexation" of retirement age would protect against being wrong on life expectancy. Again, EBRI does not support or oppose any of these approaches, but study of all options would be desirable. However, such automatic adjustments that can be communicated in advance and are known to be out of the hands of politicians, might well serve to increase confidence in Social Security

Question 9: Given that entitlement spending overall has been projected by the Congressional Budget Office and others to grow dramatically as a percentage of GDP in the future (when the Baby Boomers are in retirement), do you think it would be wise to build tax increases into any Social Security reform plan?

Response to Question 9: Objectives are what matter, and public understanding. Congress must move in a way that rebuilds public confidence in the future of whatever program is put in place. This may or may not be able to be done with tax increases as part of the package. Question 10: Do you think the public wants, or is expecting, at least some market investment to underpin the Social Security system in the future, whether it is through personal accounts or collectively through the trust funds?

Response to Question 10: No.

Question 11: While the Advisory Council was not able to agree on everything, they did agree that any sacrifices in bringing the system into balance should be widely shared and not borne exclusively by current workers and their employers. The council's suggestion was to apply appropriate income taxation to Social Security benefits. Do you believe the burden should be shared by all?

Response to Question 11: EBRI is dedicated to soundly conceived and administered public and private benefit programs. A part of sound design is equity of treatment, understanding of the program by payers and beneficiaries, and a feeling of fair treatment by those same groups. Part of maintaining support for an insurance program is a belief by all that they are being fairly treated. This would suggest that burden sharing would be advisable, but it may not be achievable.

Mr. JOHNSON of Texas. In closing, again, I thank you. We appreciate hearing your views, your specific recommendations, and we commend you for your differing opinions. Thank you for this debate.

The Subcommittee now stands adjourned.

[Whereupon, at 11:33 a.m., the hearing was adjourned.]