SOCIAL SECURITY'S GOALS AND CRITERIA FOR ASSESSING REFORMS

HEARING

BEFORE THE

SUBCOMMITTEE ON SOCIAL SECURITY

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

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CONTENTS

SOCIAL SECURITY'S GOALS AND CRITERIA FOR ASSESSING REFORMS

THURSDAY, MARCH 25, 1999

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

The Subcommittee met, pursuant to notice, at 10 a.m., in room 1100, Longworth House Office Building, Hon. E. Clay Shaw, Jr. (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
Date March 18, 1999
No. SS–5

Shaw Announces Hearing on Social Security's Goals and Criteria for Assessing Reforms

Congressman E. Clay Shaw, Jr., (R–FL), Chairman, Subcommittee on Social Security of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing on the Social Security program's goals and criteria for assessing reform proposals.The hearing will take place on Thursday, March 25, 1999, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.

Oral testimony at this hearing will be from invited witnesses only. Witnesses will include representatives of the U.S. General Accounting Office and the Social Security Administration Office of the Actuary, and other program and pension experts. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

BACKGROUND:

Despite its remarkable success in combating poverty among the elderly, Social Security faces increasing hurdles in paying promised benefits in the coming years. As Social Security's Trustees stated in their April 1998 report, "Beginning with the year 2013, the tax income projected under present law is expected to be insufficient to cover program expenditures." By the year 2032, when the Trust Funds are projected to be depleted, tax collections will cover only 72 percent of benefit obligations. The U.S. General Accounting Office has reported that maintaining solvency would require immediate across-the-board benefit cuts of 14 percent or tax hikes of 16 percent. If changes are delayed until the year 2032, benefit cuts of 45 percent or payroll tax hikes of 25 percent or more would be required to maintain solvency.

In the face of these challenges, a number of proposals have been made to reform Social Security's financing, benefits, or both. Proposals vary on policy specifics, with some stressing benefit cuts, tax increases, or some combination. More recently, some proposals, including the reform "framework" offered by the President, have suggested relying on budget surpluses to extend program solvency. In general, reform proposals claim to reinforce Social Security's fundamental purposes and goals, while preserving the program for future workers and families.

As the Subcommittee assesses the impact of alternative solutions to Social Security's financing problems, it needs to gain an appreciation of the effects that changes to Social Security will have on the economy, national savings, the Federal budget, and the retirement security of every participant.

In announcing the hearing, Chairman Shaw stated: "Social Security impacts the lives of nearly every American and has a direct effect on the economy and the Federal budget. Ultimately, we must decide what are the most important criteria to use in evaluating specific proposals to ensure Social Security's future. As we move forward, we should constantly focus on Social Security's original goals. And by considering reform proposals in that light, we will know whether or not we are staying true to the vision of our parents and grandparents that has worked so well for generations."

FOCUS OF THE HEARING:

The Subcommittee will hear the views of a wide range of experts in retirement policy regarding the fundamental goals of the current Social Security program and criteria to use when evaluating options for Social Security reform.

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 six (6) single-spaced copies of their statement, along with an IBM compatible 3.5-inch diskette in WordPerfect 5.1 format, with their name, address, and hearing date noted on a label,* by the close of business, Thursday, April 8, 1999, 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, by close of business the day before the hearing.

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 submitted on an IBM compatible 3.5-inch diskette in WordPerfect 5.1 format, typed in single space and may not exceed a total of 10 pages including attachments. Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.

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

3. 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, company, address, telephone and fax numbers where the witness or the designated representative may be reached. 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.

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Chairman SHAW. If the Members and our visitors could take a seat, we will proceed.

Good Morning. A wise man once said, "Laws and institutions must go hand-in-hand with the progress of the human mind. As manners and opinions change with the change of circumstances, institutions must advance also and keep pace with the times." That wise man was President Thomas Jefferson. His words should easily apply to our task of preserving and strengthening Social Security.

As a scholar and a lawmaker, I am sure that President Jefferson understood the need to have sound criteria for assessing government changes and their impact. That is the topic of our hearing today. We have a distinguished, almost Jeffersonian, group of witnesses to help us think about how to evaluate Social Security reform and proposals.

Many questions are on my mind as we proceed today and in the coming weeks. How will the various proposals affect the retirement security of all Americans, the economy, national savings, and the Federal budget? Do certain proposals raise taxes? Do certain proposals cut benefits; raise the retirement age? Should we be concerned that under the President's plan Congress would still have to vote to raise the debt ceiling in 2 years? Should we be concerned that under the President's plan we are faced with the problem of raising taxes or cutting benefits in 2013?

We have to analyze every plan very carefully. We shouldn't just save Social Security for the next election. We must and will save it for the next generation. There are just a few of the important questions to be answered. In the end, though, we must remain true to Social Security's original goals: guaranteeing lifetime benefits, protecting all families—especially low-income families—against death and disability, and guarding against inflation.

As I have said before, our challenge is to find a way to preserve these core features while keeping Social Security sustainable and affordable for our children and our grandchildren. That is a tall order, but one we can and we must achieve. In recent weeks, we have joined together to pledge to avoid raising taxes or cutting benefits to maintain solvency. This week, the House and Senate will collectively agree on reserving 100 percent of the Social Security surplus—even more than the President—for saving Social Security and Medicare. Hopefully, we can expand on these measures and build on the framework the President laid out to keep the ball moving forward in the weeks and the months ahead.

Before turning to Mr. Matsui for his opening statement, I would like to point out something about the President's plan. Yesterday, not a single U.S. Senator voted for President Clinton's plan to have the government invest Social Security dollars in the stock market. Not a single one. So, 45 Democratic Senators, each and every one of them, said that the President's Social Security plan in that regard was wrong, and that it was the wrong way to go.

This is a good bipartisan beginning. We must be able to examine, in a very objective way, all proposals, no matter if they come from the Democratic side of aisle, the Republican side of the aisle, or from the White House.

Mr. Matsui.

Mr. MATSUI. Thank you, Mr. Chairman. I appreciate your holding these hearings. I do wish that we can get these same witnesses back, and perhaps they can testify in a similar fashion after Chairman Archer and you actually introduce your bill. Then we can have something to make comparisons.

As you indicated, there was a vote in the Senate yesterday on a 99-to-0 vote to prevent—or at least a precatory motion to prevent—the President's proposal in terms of government investment in the market from becoming law. It was kind of a meaningless act, but, nevertheless, it did have some relevance to it. We really need to have some comparison. Because unless and until we have some comparison, we are basically working pretty much in a vacuum.

I really look forward to seeing the document that you and Chairman Archer plan to introduce. Perhaps we can have the same kind of vetting system for that legislation as we had for the President's.

In the meantime, I am assuming we have to deal with the Feldstein plan. I keep hearing rumors that the Feldstein plan is the one that the plan that you and Chairman Archer plan to introduce is based upon. Perhaps we can enter into that debate today.

I might just point out that there are essentially four matters that we have to look at with respect to any reform proposal: one, the degree to which it increases national savings; two, the extent to which it maintains fiscal discipline; three, the capacity that it creates for the Nation to address other important pressing priorities; and four, its success in preserving Social Security's fundamental social insurance character.

These four criteria and the criteria that Mr. Walker talked about, and others that people will be talking about this morning, are very important. But, then, it really comes down to some fundamental questions. Social Security provides a safety net for our senior citizen population. We have estimated that today anywhere from 35 to 50 percent of the seniors would be in poverty without Social Security. In addition to that, it provides a safety net in case the breadwinner in a family should die. The surviving spouse and the children will have, at least, some minimum level of sustenance, should that occur. Social Security pays for that. Also, if the breadwinner becomes disabled, a family is able to at least get by with Social Security benefits through the disability payment system. Disability and survivors benefits are about one-third of the entire Social Security payout.

Any system would have to take into consideration those factors, as well as the four or five criteria that the Chairman mentioned. Mr. Walker, I think, has 6 or 7 or maybe up to 10, and the four that I mentioned as well. I hope these issues are adequately addressed. Perhaps as the speakers testify and critique the President's plan, they perhaps will critique the Feldstein plan as well, in fairness to this particular process. Unless we see this in comparison, we really won't know how to address this fundamental issue.

We all realize that we do want to deal with Social Security this year. Although time is running short, I understand that Chairman Archer and Mr. Shaw plan to introduce a bill. I hope it is, as they say, sometime before May. The calendar year is moving. We are starting to work on our appropriations bill. We will pass, presumably, a budget today. Once we get into the appropriations process, it is really hard to focus the mind on something as big and as significant as Social Security, that affects almost every family in America.

I look forward to this. I look forward to working with those helping to, at least, discuss and develop standards and criteria. On the other hand, I would hope that when the plan offered by the two Chairs is before us, we have the same kind of opportunity to review those plans as well. Thank you.

Chairman SHAW. Bob, I would just like to clear one thing up. I, too, am hopeful that there will be a plan in place for this Subcommittee to start studying before the end of next month. I would also invite you and the Democrats to put forth a plan and we will give you the same courtesy, I can assure you. Or we invite you to examine whatever plan we might come up with. Hopefully, we can get together in a bipartisan manner.

I think these things are starting to evolve. I think people are beginning to realize—I think the American people are very, very aware of what we are doing. I think today we can say the third rail of politics is for Congress to do nothing. I think that would be the tragedy of this Congress.

I intend to aggressively put forward—and work toward a Social Security plan that I am confident will be in place, not only for our children, but also for our grandchildren. I welcome you to join with us.

Mr. MATSUI. I appreciate this. If the Chair would yield to me for just a moment, I don't want to prolong this debate. We do want to hear from our witnesses.

Chairman SHAW. I am not debating.

Mr. MATSUI. Well, it sounds to me that there was a little challenge in that. But that is OK. I am really looking forward to the Chair and, again, Chairman Archer's proposal. I think we spent the last 3 months—90 days, believe it or not—critiquing the President; now about 30 hours of hearings just criticizing the President's proposal. It, surprisingly, has stood up pretty well, in spite of all those criticisms. Now we need to see some other proposals out there. It is just a question of maybe a little leadership; you know, rolling up our sleeves and sitting down and seeing if we can come up with something. We need to see a proposal. I appreciate the fact the you are going to try and get one before the end of the month. I hope that time doesn't slip, because we really are running out of time.

Chairman SHAW. Does the President really have a proposal that is out there? I know he has thrown out a couple of ideas. Is he going to bring a bill to us or a complete proposal?

Mr. MATSUI. There will be a bill. It is more than a couple of ideas. I think we all know that. We would not have spent 30 hours on it if it was just a couple of ideas. We have spent a lot time on the President's proposal.

Chairman SHAW. I want to make one thing very clear. I give the President high marks for bringing forward the concept that somehow in this mix we are going to have to change the investment structure of Social Security retirement funding. He did that. I know that it was controversial. I think that, by his having done that, he is going to make it easier for us, on both sides of the aisle, to bring a plan forward that won't appear to be radical. It will appear to be sensible and will be sensible, and will be drawn in a most careful manner. So, I do give the President high marks for that.

I have been very careful not to trash the President and his proposal. Every time I do make some comment that isn't altogether with the President, I am always very careful to point out that he has opened the debate on investment in the private sector, which I feel is an important contribution to the debate.

Mr. MATSUI. And I would say, Chairman Shaw, I agree. You have been very, very even-handed in your comments and critique of the President's proposal. Not all of your Members on your side of the aisle have, but at least you have. I thought and feel you have been reasonably restrained. So, I appreciate that.

Chairman SHAW. I thank you and hope you feel that way at the end of the debate, and if and when we are joined in hands, hopefully, in going forward with a proposal that I think all of us can embrace.

For our first witness this morning, we have Hon. David Walker, who is Comptroller General of the United States. He is no stranger to this Subcommittee and it is a pleasure to welcome you back. Mr. Walker.

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

Mr. WALKER. Thank you, Mr. Chairman and Members of the Subcommittee. I would ask that my full statement be entered into the record.

Chairman SHAW. Without objection, the full statements of all the witnesses today will be placed in the record. The Subcommittee would invite each witness to summarize. Thank you.

Mr. WALKER. I appreciate, Mr. Chairman, the opportunity to come back before this Subcommittee in the ongoing discussion on how best to ensure the long-term viability of the Social Security program.

As you know, Social Security forms the foundation of our retirement income system. In looking at reform, we need to consider that it provides benefits that are critical to the well-being of millions of Americans. A wide array of proposals have been put forth to restore this program's solvency. The Congress will need to determine which proposals best reflect our country's goals for this important national program.

Today, I would like to provide an analytic framework for assessing any proposal that might be put forth. I would like to begin by discussing the purpose of the Social Security system; the role that the program currently plays and certain criteria and questions that should be considered in assessing any reform proposal. I would like to, then, talk about certain other elements, including appropriate benchmarks that are necessary to compare any reform proposal, too.

Mr. Chairman, we have to keep in mind that the current Social Security program has certain promised benefits, but those promised benefits are not adequately funded. Therefore, in comparing any particular reform proposal, in fairness, we need to make sure we are comparing apples to apples—not unfunded benefits—as the basis for doing all the comparisons.

My statement today is based on work that GAO has already done and work that we have ongoing for this Subcommittee. I do not take any position, nor does GAO, on any particular element or any particular proposal. That would be inappropriate. Candidly, what we are trying to do, Mr. Chairman, is to try to help the Congress by providing a framework for moving forward to get action, hopefully, in this Congress on this important subject.

While there are many reform proposals with a wide range of features and options, all proposals to restore long-term solvency involve some combination of modifying benefits, raising revenues, or capturing increased returns from investing contributions. We will face many difficult choices in making Social Security not only solvent, but sustainable over the long term. Our strong economy gives us a historic opportunity to address this problem.

Focusing on comprehensive packages of reforms that protect the benefits of current retirees while achieving a balance of equity and adequacy for future beneficiaries will help us to foster credibility and acceptance. This is the best way to meet our obligations and achieve the overarching goal that we seek, which is to ensure the retirement income security of not only current, but future generations of Americans.

I am going to skip, now, several things in my testimony, Mr. Chairman. I think the first thing we have to recognize is the importance of Social Security as the foundation of retirement security. In my testimony, under figure 1, we talk about the percentage of benefits that Social Security represents for many Americans. All too many Americans rely upon Social Security as their primary or sole means of retirement. We note in figure 2, the tremendous job that Social Security has done in helping to contribute to reduce poverty rates among the elderly. We talk about the declining ratio of workers to retirees in figure 3, which is the demographic problem that we face. In figure 4, we note the difference between the projected OASDI income and the cost rates, which illustrates the financing imbalance that we face in this program.

Having looked at the background information, which I would commend to you, I think it is important now to look forward. Over the course of the last several years, various reform proposals have been crafted with specific goals in mind, articulated in terms of solvency, economy, individual equity, and income adequacy. Two primary criteria have been used to evaluate these proposals: the extent to which they achieve sustainable solvency and what their effect would be on the economy and the budget, and the balance that they strike between the twin goals of individual equity and income adequacy.

These are two important elements, but I would add a third: the details. The details do matter. That is, how would such changes be implemented, administered, and explained to the public? That is a critical third dimension that, I believe, must be addressed in connection with any Social Security reform proposal.

With regard to the first element, crafting a sustainable solution to Social Security's financing problem involves more than ensuring long-range actuarial balance, although actuarial balance is a goal that we should achieve. It also means making sure that the program is sustainable into the future, and that we deal with the so-called "cliff effect", where as time passes, each year that is eliminated is a "good year"—a surplus year for Social Security—and is replaced at the 75th year with a big deficit year. So, we are taking off a good one and adding a bad one every year. Figure 6 graphically demonstrates that in a fashion that, I think, should be helpful.

The second element is balancing equity and adequacy in the benefit structure. The current Social Security system's benefit structure is designed to address the twin goals of individual equity and retirement income adequacy. Differences in how various proposals balance these competing goals will help determine which proposals will be acceptable to policymakers and the public. To restore solvency only via changes to current benefits or payroll taxes would reduce the implicit rates of return that future cohorts or beneficiaries will receive on their contributions. This would serve to reduce individual equity, and depending upon which exact measures are taken, to compromise adequacy as well.

The third element—implementation, administration, and public understanding—forms another important area to consider. Although some consider these issues merely technical or routine, compared with macroeconomic or other policy concerns associated with benefit adequacy and financing, implementation and administration issues are important. They have the potential to delay, if not derail, reform if they are not adequately considered and properly planned. Moreover, such issues can influence policy choices, both as to feasibility and cost. As a result, they should be integral factors in the ultimate decisions regarding the Social Security program.

In addition, potential transparency and public education needs associated with various reform proposals should be considered. Reforms that are not well understood could face difficulties in achieving broad-based acceptance and support. Regardless of the reform proposal being considered, there will also be a need for enhanced public education. While any changes to the Social Security program must be explained to the public, the need would be especially acute if individual accounts were a feature of the chosen reform package. Public understanding may not necessarily bring about public acceptance of Social Security reform, but the credibility of any reform package will be enhanced to the extent that the American public understands the changes being made and the impact that these changes will have on their personal retirement planning.

In conclusion, Mr. Chairman and Members of the Subcommittee, restoring solvency to the Social Security system is a formidable challenge. Addressing it in a sustainable fashion today could help us to avoid similar challenges in the future, rather than leaving difficult choices for our children. The health of our economy and the projected budget surpluses offer us a historic opportunity to meet these challenges from a position of financial and economic strength. Such good fortune can, indeed, help us to meet our historic responsibility—and our fiduciary obligation, if you will—to leave our Nation's future generations a financially sustainable and sound system.

We must also move forward to address Social Security because we have other equally serious and, in fact, more challenging issues to address, namely, healthcare financing. Reforming Social Security will be easy lifting as compared to reforming Medicare. It is critically important that we get on with Social Security because that is a solvable problem.

We have offered three basic criteria to use in considering reform proposals. I would commend to the Members a series of questions that are attached as an exhibit, key questions which we believe should be asked about every reform proposal in order to have a common foundation to analyze the pros and cons. Obviously, different Members will feel that different questions are more important than others. In the end, we believe it is critically important to consider reform proposals as a package. We are very concerned that a tremendous amount of time and attention is placed on debating single elements, rather than looking at comprehensive packages.

We believe it is critically important to have a framework to analyze comprehensive packages because, as you know, there are tradeoffs in packages. In many cases there are interactive effects of individual elements, and some can serve to smooth some of the hard edges associated with those elements.

We believe, Mr. Chairman, that it is possible for this Congress to exceed the expectations of all generations of Americans in conjunction with Social Security reform. Why do I say that? Because the people that are most concerned about Social Security reform are today's elderly and near-retirees.

From a practical standpoint, most reform proposals talk about doing little or nothing to affect their benefits. At the same point in time, baby boomers such as myself and Generation Xers, such as my children, don't have a high degree of confidence in the current system. They are discounting their benefits under the system to a great degree. Therefore, by reforming Social Security in a prudent manner and on a timely basis, it is possible to exceed the expectations of all generations of Americans.

Mr. Chairman, the GAO and I stand ready to help this Congress move forward in this important area. Hopefully, this framework for consideration by the Congress in evaluating all reform proposals will prove to helpful. Thank you, Mr. Chairman.

[The prepared statement and attachments follow:]

Statement of David M. Walker, Comptroller General, U.S. General Accounting Office

Thank you for inviting me here today to continue the ongoing discussion on how best to ensure the long-term viability of our nation's Social Security program.[1] According to the OASDI Trustees' 1998 mid-range estimates, the program's cash flow is projected to turn negative in 2013. In addition, all of the accumulated Treasury obligations held by the Trust Funds are projected to be exhausted by 2032. The financing problems facing Social Security pose significant policy challenges that should be addressed soon in order to lessen the need for more dramatic reforms later.

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[1] Social Security refers here to the Old-Age, Survivors, and Disability Insurance program, or OASDI.

Social Security forms the foundation for our retirement income system and, in so doing, provides benefits that are critical to the well-being of millions of Americans. A wide array of proposals have been put forth to restore this program's solvency, and the Congress will need to determine which proposals best reflect our country's goals for a retirement income program. Today, I would like to provide an analytic framework for assessing these proposals. I would like to begin by discussing the purpose of the Social Security system. The role that we envision for the program will be vital in deciding which proposals to adopt. Next, in response to your invitation to me to appear at this hearing, I would like to offer what I believe are the basic criteria for assessing reform proposals. I would then like to stress that the Congress needs to compare reform proposal packages. If we focus on the pros and cons of each element of reform, we will get mired in the details and lose sight of important interactive effects. It will also be more difficult to build the bridges necessary to achieve consensus. Finally, I want to point out the importance of establishing the proper benchmarks against which reforms must be measured. Often reform proposals are compared to current promised benefits, but this benchmark, while in some ways valid, has some drawbacks. Currently promised benefits are not fully financed, and so it might be necessary to use a benchmark of a fully financed system to fairly evaluate reform proposals.

My comments today are based largely on a body of work we have published as well as on ongoing work for this Committee. It is not my intention to take a position for or against any individual reform proposal or elements. Rather, my testimony is designed to help clarify the debate on various proposals to help the Congress move forward in addressing this important national debate. In choosing among proposals, policymakers should consider three basic criteria:

- the extent to which the proposal achieves sustainable solvency and how the proposal would affect the economy and the federal budget;
- the balance struck between the twin goals of individual equity (rates of return on individual contributions) and income adequacy (level and certainty of benefits); and
- how readily such changes could be implemented, administered, and explained to the public.

While there are many reform proposals with a wide range of features and options, all proposals to restore long-term solvency involve some combination of cutting benefits, raising revenues, or capturing increased returns from investing contributions. We will face many difficult choices in making Social Security a sustainable program. But our strong economy gives us an historic opportunity to address this problem. Focusing on comprehensive packages of reforms that protect the benefits of current retirees while achieving the right balance of equity and adequacy for future beneficiaries will help us to foster credibility and acceptance. This is the best way to meet our obligations and achieve overarching goal that we all seek—that is, ensuring the retirement income security of current and future generations.

Difficult Choices Are Necessary To Restore Social Security's Solvency

In the past few years, as attention has focused on Social Security's future financial situation, a wide array of proposals have been put forth. Some reduce benefits, some raise revenues; most propose some combination to restore financial solvency. The more traditional reforms seek to preserve the program's structure, restoring solvency through adjusting benefit and revenue provisions; others would restructure the system by allowing workers to fund at least some portion of their benefits through individual accounts. Regardless of structure, many proposals rely on capturing increased returns from market investments. In evaluating these proposals, it is important to understand Social Security's fundamental role in ensuring the income security of our nation's elderly and the nature, timing and extent of the financing problem.[2]

Social Security Is the Foundation of Our Nation's Retirement Income System

Social Security has long served as the foundation of our nation's retirement income system, which has traditionally been comprised of three parts: Social Security, employer-sponsored pensions (both public and private), and personal savings.[3] Social Security provides a floor of income protection that the voluntary forms of employer

[2] For a discussion, see *Social Security: Different Approaches for Addressing Program Solvency (GAO/HEHS–98–33, July 22, 1998).*

[3] For a discussion of this traditional approach to retirement income, see *Retirement Income: Implications of Demographic Trends for Social Security and Pension Reform (GAO/HEHS–97–81, July 11, 1997).*

pensions and individual savings can build on to provide a secure retirement. However, private pension plans only cover about one-half of the full-time workforce, and a significant portion of the American public does not have significant personal savings. In addition, Social Security is the sole source of retirement income for almost a fifth of recipients. (See fig. 1.)

Given Social Security's importance as the foundation of retirement income security, it has been a major contributor to the dramatic reduction in poverty among the elderly population. Since 1959, poverty rates for the elderly have fallen from nearly 35 percent to 10.5 percent. (See fig. 2.)

Figure 2: Poverty Rates for the Elderly, 1959 to 1996

Social Security's benefit structure represents a retirement income insurance program whereby workers pool the risks associated with the loss of earnings due to old age, disability, or death. It is a mandatory and almost universal program. As a result, the vast majority of American workers take Social Security credits with them whenever they change jobs. Social Security also provides inflation-protected benefits for the life of the retiree. No matter how long they live, retirees will continue to receive Social Security benefits uneroded by inflation. The program, which provides benefits not generally available as a package in the private market, includes benefits for retired workers, their spouses and dependents, and their survivors as well as for those who are disabled.

The Financing Problem Needs to Be Addressed Now

The Congress has always taken the actions necessary to ensure Social Security's future solvency when faced with an immediate solvency crisis. These actions have generally been adjustments to the benefit and revenue provisions of the program. Today, the program does not face an immediate crisis; rather, it faces a long-range and more fundamental financing problem due to demographic trends. While the crisis is not immediate, it is important to act soon if we are to avoid having to unfairly burden future generations with the program's rising costs and give these individuals time to make necessary adjustments to their retirement planning.

Social Security's financial condition is directly affected by the relative size of the populations of covered workers and beneficiaries. Historically, this relationship has been favorable, but a major reason we are debating Social Security's financing today is that the covered worker-to-retiree ratio and other demographic factors—in particular, life expectancy—have changed in ways that threaten the financial solvency and sustainability of this important national program. (See fig. 3.)

Figure 3: Ratio of Workers to Beneficiaries

Thus, while the program was put in 75-year actuarial balance just 15 years ago, Trust Fund balances now are projected to be exhausted in 2032. In addition, the program will begin to experience a negative cash flow in 2013, which will accelerate over time. (See fig. 4.) Absent meaningful program reform, this will place increased pressure on the federal budget to raise the resources necessary to meet the program's ongoing costs. To restore the 75-year actuarial balance to the program today, we would need to immediately increase annual program revenues by 16 percent or reduce annual benefit payments by 14 percent across the board.

Figure 4: Social Security Income and Cost Rates

Another way to understand the magnitude of the problem is to consider what the system will cost as a percentage of taxable payroll in the future. Consider what would happen if we did nothing and let the Trust Funds be exhausted in 2032, as estimated in the 1998 Trustees' report. It would then be necessary to find resources in the following year that would be more than 37 percent higher than the revenues projected to be available under the 12.4 percent payroll tax that currently finances the system. (See fig. 5.) Alternatively, we would have to reduce benefits in the year following Trust Fund exhaustion by 27 percent. Clearly, we must act soon in order to minimize the needed changes and maximize the fairness to future generations.

Figure 5: Changes Needed to Maintain Solvency—Proposals Rely on Different Benefit Adjustments and Financing Arrangements

A variety of proposals have been offered to address Social Security's financial problems. Some would reduce benefits by modifying the benefit formula (such as increasing the number of years used to calculate benefits), reducing cost-of-living adjustments (COLA), raising the normal and/or early retirement ages, or revising dependent benefits. Others have proposed revenue increases, including raising the payroll tax that finances the system; increasing the taxation of benefits; or covering those few remaining workers not currently required to participate in Social Security, such as older state and local government employees. A number of proposals would incorporate investment returns to increase revenues and to reduce benefit cuts, or tax increases that would otherwise be required, or both.

In fact, almost all proposals combine benefit reductions and changes designed to gain increased investment returns. The proposals differ not only with regard to specific benefit changes but also in how investment returns are captured. Some would change the Trust Fund's investment policy so that the government could purchase equities or other instruments besides Treasury securities; others would restructure the Social Security system so that participants could invest at least part of their own contributions. The latter approach creates individual accounts as a means to finance and accumulate future benefits, rather than relying entirely on payroll tax financing through a centrally managed government trust fund account.

These proposals also differ in how such increased returns would be financed. Some would use a portion of current payroll tax collections—a "carve-out" from the Trust Fund—while others would "add-on" federal budget surpluses (that is, general revenues) or additional payroll taxes as a means to finance either current benefits or individual accounts. These choices carry with them implications for individual beneficiaries, the Social Security program, the federal budget, and the national economy. Such implications should be well understood before a policy choice is made.

CHOOSING AMONG REFORM PROPOSALS

Proposals that restore solvency to Social Security necessarily combine several or even a multitude of changes to the program. Although these changes are presented in a comprehensive package, debate often focuses on individual aspects that, on their own, are undesirable. For example, many criticize proposals to raise the normal retirement age without considering the other, potentially offsetting elements of the proposals of which this change would be a part. Although such criticisms are legitimate and can contribute to the public debate, it is critically important to evaluate the effects of an entire package before considering whether these proposed changes add up to acceptable program reform. If a comprehensive package of reforms meets policymakers' most important goals for Social Security, individual elements of the package may be more acceptable. After all, individual reform elements can drive interactive effects that can tend to smooth the rough edges of the individual elements. In addition, it's important to look at a complete puzzle before rendering final judgments and understand how it would stand up against relevant reform criteria. For example, phasing in an increased normal retirement age coupled with adding individual accounts could result in more flexibility and benefit levels for baby boomers and generation Xers compared with the current system.

Evaluating such packages can be complex, however. What factors or elements should such evaluation measure? What weight should be placed upon particular factors? I would not presume to tell policymakers which factors or elements should prove decisive for them in choosing among proposed reform packages. I am, however, in a position to suggest what factors to *consider* in making these choices.

Over the course of the last several years, various reform proposals have been crafted with specific goals in mind—articulated in terms of solvency, the economy, individual equity, and income adequacy. Two primary criteria can be used to evaluate these proposals: (1) the extent to which they achieve sustainable solvency and how their effect on the economy and the federal budget and (2) the balance they strike between the twin goals of individual equity and income adequacy. I would also add a third criterion, which, although not addressing a goal of Social Security reform, focuses on the important practical aspects of reform—that is, how readily such changes could be implemented, administered, and explained to the public. These elements provide a basis to address a range of more detailed questions (see attachment 1) that help describe and measure the potential effects of various proposals on important policy and operational aspects of public concern. Measuring proposals against these three criteria can help shed light on the important choices we face; I will discuss each in turn.

CRITERION 1: FINANCING SUSTAINABLE SOLVENCY

Crafting a sustainable solution to Social Security's financing problem involves more than ensuring long-range actuarial balance, although actuarial balance is also a goal to be achieved. Simply taking the actions necessary to put the Social Security system back into an exact 75-year actuarial balance could result in having to revisit these difficult issues again in the not-too-distant future. For example, if we were to raise payroll taxes 2.19 percent—which, according to the 1998 Trustees' annual report, is the amount necessary to achieve 75-year balance—the system would be out of balance almost immediately and the 2013 cash problem I cited earlier would move forward only to the year 2020.

Historically, the program's solvency has generally been measured over a 75-year projection period. If projected revenues equal projected outlays over the 75-year time horizon, then the system is declared in actuarial balance. Unfortunately, this measure of solvency is highly transient and involves what could be called a "cliff effect." (See fig. 6.) Each year, the 75-year actuarial period changes and a year with a surplus is replaced by a new 75th year that has a significant deficit. As a result, changes made to restore solvency only for the 75-year period will result in future actuarial imbalances almost immediately.

Moreover, the problem is not one that is 74 years away because the program will begin running annual cash deficits long before the trust funds actually deplete their assets. Add to this the possibility that adverse economic or demographic conditions could accelerate the depletion of the trust funds, and the time when the Congress would need to address the problem moves even closer. Therefore, simply restoring 75-year actuarial balance today could mean that the Congress would have to visit these issues again in just 15 or 20 years. In fact, today's debate is a testimony to this fact. About 16 years ago, the President and the Congress thought they had saved Social Security for current and future generations. That reform package did save us from the brink of bankruptcy, but it did not address the cliff effect.

Solutions that lead to sustainable solvency are those that avoid the need to periodically revisit this difficult issue, but they have implications for the risk borne by individuals. To the extent that a worker's future retirement benefits are funded in advance—in that they will depend on contributions and the earnings (rates of return) on those contributions—the system is at less risk of insolvency from unfavorable demographic or economic trends. While pre-funding benefits has obvious advantages with respect to sustainability over the largely pay-as-you-go system currently in place, individuals bear more risk under such an approach, and the social insurance aspects of the program could be weakened.

Reforms that provide sustainable solvency could also have positive effects for the economy at large. To the extent that pre-funding worker retirement results in increased savings and investment, the overall future economy would be larger, making it easier for the nation to support a larger elderly population. Simply put, if the dollar that the worker contributes today is invested in private assets (stocks and bonds), there is a reasonable chance that the dollar will contribute to a growing economy. The dollar invested will grow in value and provide a return to the owner of the asset. Thus, investment returns will, in general, help us finance a given benefit in the future more cheaply (that is, with less expenditure today) than the way we currently finance Social Security.

How the measures to achieve solvency are financed can have important implications for the federal budget and the national economy. In addition, federal fiscal policy itself can be an important element in fostering economic growth. Our work on the long-term fiscal outlook shows that replacing deficits with surpluses increases national income over the next 50 years, thereby making it easier for the nation to meet future needs and commitments. Thus, it is important to consider the interaction of federal fiscal policy with measures to restore program solvency in laying a foundation for a sustainable Social Security program. For example, proposals using budget surpluses to fund individual accounts, to purchase private stocks or bonds for the trust fund, or reduce publicly held debt would all have some positive effects on national saving and economic growth. Yet, considerable debate exists over the relative extent of the economic benefits under these different alternatives. Using the projected budget surpluses to reduce publicly held debt alone would indirectly make the Social Security system more sustainable but would not reform or restructure the existing program. I have discussed this at greater length before this Committee several weeks ago in the context of the President's budget proposals.[4]

Furthermore, some proposals must finance what most analysts call "transition costs," and how these are financed matters as well. When proposals incorporate some degree of pre-funding—either via individual accounts or through the current program structure—current workers would, in effect, contribute both to their own accounts and pay for the benefits of current retirees under the existing defined benefit program. The resulting incremental transition costs must be financed. If transition costs are financed by borrowing or with projected budget surpluses, the effects on Social Security participants would be mitigated, but the positive effects of pre-funding on national saving could be neutralized in the near term by additional public borrowing.

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[4] See *Social Security and Surpluses: GAO's Perspective on the President's Proposals (GAO/T–AIMD/HEHS–99–96, Feb. 23, 1999).*

Sustainable solvency is an important criterion in assessing reform proposals but may require trade-offs between short-run and long-run gains. Further, it is not the only criterion by which to evaluate reform proposals. The economic and financing considerations that achieve sustainable solvency should be measured against equity and adequacy concerns as well.

Criterion 2: Balancing Equity and Adequacy in the Benefit Structure

The current Social Security system's benefit structure is designed to address the twin goals of individual equity and retirement income adequacy. Individual equity means that there should be some relationship between contributions made and benefits received (that is, rates of return on individual contributions). Retirement income adequacy is addressed by providing proportionately larger benefits to lower earners and certain household types, such as those with dependents (that is, a progressive and targeted benefit structure). Virtually all reform proposals address the concept of income adequacy, but some place a different emphasis on it relative to the goal of individual equity. Differences in how various proposals balance these competing goals will help determine which proposals will be acceptable to policymakers and the public.

Policymakers could assess this balance by considering the extent to which proposals address the following concerns:

—*Adequacy*: (1) adequate benefit levels to protect the elderly from poverty and (2) higher replacement rates for lower-income workers.

—*Equity*: (1) reasonable returns on contributions, (2) improved intergenerational equity, and (3) increased individual choice and control.

The weight individual policymakers may place on different concerns would vary, depending on how they value different attributes. For example, if offering individual choice and control is less important than maintaining replacement rates for lower income workers, then reform proposals emphasizing adequacy considerations might be preferred.

Each proposal for reform will have an impact on individuals and families, whether limited to changes within the current program's structure or whether some portion of the program's financial gap is to be closed through access to equity markets. To restore solvency only via changes to current benefits or current payroll tax revenues reduces the implicit rate of return that future cohorts of beneficiaries will receive on their contributions. (See fig. 7.) This serves to reduce individual equity and, depending on what exact measures are taken, could compromise adequacy as well. To preserve the existing protections and income adequacy for certain types of beneficiaries under this approach, it could be necessary to reduce the benefits of other types of beneficiaries. To avoid such a result, payroll taxes (or the maximum taxable ceiling) might be raised, but this could make current or future workers worse off. Adding the prospect of additional earnings to the system, either from market investment returns or from some other external source, could boost individual equity while reducing the necessity for other changes to the program, depending on how the investment returns or other revenues are shared.

In considering this balance, it helps to understand that Social Security is currently structured as a *defined benefit* program and that restructuring this program to include individual accounts would add, in effect, a defined contribution element to the system. Under Social Security, workers' retirement benefits are based on lifetime records of earnings, not directly on the payroll taxes they contributed. Based on the current design of the Social Security program and known demographic trends, the rate of return most individuals will receive on their contributions is declining. In addition, as noted previously, current promised benefits are not adequately funded over the 75-year projection period.

Alternatively, those who propose individual accounts as part of the financing solution emphasize the potential benefits of a *defined contribution* structure as an element of the Social Security program or financing reform. This approach to Social Security focuses on directly linking a portion of worker contributions to the retirement benefits that will be received. Worker contributions are invested in financial assets and earn market returns; the accumulations in these accounts can then be used to provide income in retirement.

Under this approach, individual workers have more control over the account and more choice in how the account is invested. This control might enable individuals to earn a higher rate of return on their contributions than under current law. But, of course, these opportunities for higher returns exist because the investor assumes some measure of risk that the return expected may not actually be realized.

Some reform proposals incorporating individual accounts address the need for protecting individuals and ensuring income adequacy by combining the defined contribution and defined benefit approaches into a two-tiered structure for Social Security. Under such a structure, individuals would receive a base defined-benefit amount with a progressive benefit formula and a supplemental defined-contribution account benefit. The benefit that would be earned through individual account accumulations would either be added to a restructured defined benefit amount (that is, supplement) or subtracted, in whole or in part, from the benefits that would otherwise be provided through Social Security's defined benefit structure (that is, offset). Either approach could require redesigning the benefit structure to ensure the types of protections currently provided by Social Security. Such a structure could include a modified version of the current defined benefit program or could incorporate various types of guarantees based on the current or some alternative benefit structure. Such guarantees would, however, create contingent liabilities and incremental costs for the government.

Clearly, the number of proposals and features can make it difficult to sort out exactly what should be done and what effects various actions would have on individuals and families, although such effects may represent the most important considerations in evaluating reform. It is critical, therefore, that the extent to which proposals achieve solvency—admittedly an easier criterion to measure—not overshadow the balance of equity and adequacy.

Criterion 3: Implementing and Administering Proposed Reforms

Implementation, administration, and public understanding form a third important area to consider. Although some consider these issues merely technical or routine compared with macroeconomic considerations or concerns about benefit adequacy, implementation and administration issues are important because they have the potential to delay—if not derail—reform if they are not considered early enough for planning purposes. Moreover, such issues can influence policy choices—feasibility and cost should be integral factors in the ultimate decisions regarding the Social Security program. In addition, potential transparency and public education needs associated with various proposals should be considered. Reforms that are not well understood could face difficulties in achieving broad public acceptance and support.

Feasibility of Implementation and Administration

Degrees of implementation and administrative complexity arise in virtually all proposed reforms to Social Security. The extent to which these issues present true challenges varies with the degree to which reform proposals step away from current practices. Hence, proposals that would make changes to revenues or to benefits without restructuring the current defined benefit structure of the program are less difficult to implement and less costly to administer than those that would create new tiers of benefits or of beneficiaries. For example, reducing COLAs, either by improving the accuracy of the calculation or by limiting COLA increases directly (such as by capping, delaying, or eliminating the COLA) would not require significant administrative change. Similarly, raising the retirement age, in effect a recalculation of benefits, would not represent a large increase in ongoing administrative costs, although some implementation costs would accrue and would include the costs of educating the public about the changing rules. Both these changes, however, would have a ripple effect on certain private sector pension and saving plans that are integrated with the benefits provided under Social Security. If the private sector plan formulas are not adjusted, these changes would result in additional benefit costs under the private sector plans. Alternatively, to the extent that private sector employers act to adapt their pensions to an altered Social Security benefit, these actions represent private administrative costs as yet unmeasured.

Allowing the government to invest surplus Social Security funds would raise certain implementation issues, the most significant of which are investment vehicle and security selection and shareholder voting rights; relatively less significant concerns regarding cost or complexity would be raised. However, these issues could prove controversial to resolve because critics have expressed concern about increased government involvement in financial markets and corporate affairs.[5]

But there may be ways that we can alleviate some of the concerns about government investing. One way would be to introduce master trust principles for collective investment of base defined-benefit or individual account funds, which would be separate from other government funds. In this regard, we might be able to replicate or piggyback on a model that seems to be working well for federal workers—the Federal Thrift Savings Plan. These existing vehicles might help us limit concerns about the potential for political manipulation of investment decisions and thus foster the credibility needed to build bridges to consensus on reforms.

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[5] *Social Security Financing: Implications of Government Stock Investing for the Trust Fund, the Federal Budget, and the Economy,* (GAO/AIMD/HEHS–98–74, Apr. 1998).

The greatest potential implementation and administrative challenges are associated with proposals that would create individual accounts. Not all proposals for individual accounts clearly delineate how these accounts would be administered, but those that do vary in three key areas:

—the management of the information and money flow needed to maintain a system of individual accounts,

—the degree of choice and flexibility individuals would have over investment options and access to their accounts, and

—the mechanisms that would be used to pay out benefits upon retirement.

Decisions in these areas could have a direct effect on system complexity and who would bear the costs and additional responsibilities of an individual account system as well as on the adequacy and certainty of retirement income for future retirees. Table 1 provides a snapshot of some of the administrative functions that would accompany any system of individual accounts, the critical decisions associated with each function, and a partial list of the options that could be considered.

Table 1:—Design and Administration Issues

Administrative Function	Critical Decision or Trade-Off	Options to Consider
Managing the flow of information and money.	Centralized or decentralized record-keeping.	—Build on current Social Security tax and payroll reporting structure. —Build on employer-based 401(k) structure. —Build on individually controlled IRA structure.
Choosing investment options.	Maximizing individual choice or minimizing risk.	—Offer a small set of indexed funds. —Offer a broad range of investment options. —Combine the two options by requiring a minimum account balance before a broader range of options is available.
Paying retirement benefits.	Maximizing individual choice or ensuring preservation of retirement benefits.	—Require lifetime annuities. —Make annuities voluntary, and permit lump sum and gradual account withdrawals. —Combine the two options by requiring annuitization to ensure at least a minimum retirement income, with added flexibility for remainder of account.

Essentially, most decisions about the design of a system of individual accounts amounts to trade-offs between individual choice and flexibility and simplicity and standardization. For example, a centralized recordkeeping system, managed by government, could take advantage of existing systems and economies of scale but would not offer the wider range of alternatives for individuals that a decentralized system would. A system of individual accounts that permitted participants full and unfettered choice of investments would offer an ability to maximize returns but with attendant risk that incomes would not be adequate. Alternatively, a more centralized investment program, with fewer available choices, would be less administratively complex and would protect participants from poor investment selection; but it would also raise the risk that investment decisions could become politicized, depending on the extent of the government's role in selecting investment funds and fund managers. Flexibility in how funds are withdrawn could allow individuals choice in how to manage their own funds but creates administrative complexity and risks leaving diminished capital to support an adequate income throughout retirement. A full assessment of the implications of these trade-offs will be essential to the debate on whether and how to implement individual accounts.

Costs of Implementation and Administration

Although there are costs associated with most Social Security reform proposals, debate has focused largely and correctly on the costs of proposals that involve restructuring for two reasons. First, administrative costs of changes within Social Security's current structure could be relatively insignificant, and adding individual accounts to the structure creates the potential for much higher implementation and administrative costs. For example, there could be substantial start-up costs associated with an individual account system. Second, the risk of higher administrative costs of individual accounts would be borne by individual account holders, directly affecting their benefits. Many have expressed concerns about the administrative costs of individual accounts and how these costs would affect accumulations, especially for the small-account holder. Each of the reform decisions discussed here today can have a significant effect on the costs of managing and administering individual accounts, and it will be important to consider their effect on the preservation of retirement income.

Administrative costs would depend on the design choices that were made. The more flexibility allowed, the more services provided to the investor; the more investment options provided, the higher the administrative costs would be. For example, offering investors the option to shift assets frequently from one investment vehicle to another or offering a toll-free 1–800 number for a range of customer investment and education services could significantly increase administrative costs. In addition to decisions that affect the level of administrative costs, other factors would need to be carefully considered, such as who would bear the costs and how they would be distributed among large and small accounts.

To some extent, however, the creation of individual accounts could help ease administrative burdens in the future. They would represent an infrastructure that could allow workers to build up additional savings to meet future retirement income and health care cost needs without significant additional implementation and administrative costs. For example, workers not covered by a private pension could choose to contribute more to their individual accounts to augment their retirement savings. Workers might also contribute more to their accounts to help pay health care costs after they retire. The accounts could thereby contribute to overall retirement security, not just retirement income security.

Public Understanding

Regardless of the reform proposal being considered, there will be a need for enhanced public education and information. This effort would not focus on educating the public about choices for Social Security reform; that process began some time ago under congressional and presidential leadership and has raised public consciousness not only regarding Social Security's financing problems but also of the choices we face. Instead, enhanced education and information would serve to explain what changes have been adopted so that participants can adjust their retirement planning accordingly. Retirement planning is, in its nature, a long-term process, and we must give Americans not only the time to adapt their plans to a reformed Social Security program but also the information necessary to do so.

While any change to the Social Security program must be explained to the public, the need would be especially acute if individual accounts were a feature of the chosen reform package. Not only would participants need to be informed of this change, they would also require investor education, especially if individual accounts were mandatory. For example, individuals would need information on basic investment principles, the risks associated with available choices, and the effect of choosing among alternatives offered for annuitizing or otherwise withdrawing or borrowing accumulations from the accounts. This would be especially important for individuals who are unfamiliar with making investment choices, including those with lower incomes and less education, who may have limited investing experience.

Public understanding may not necessarily bring about public acceptance of Social Security reform. But the credibility of any reform package will be enhanced to the extent that the American public understands the changes being made and the impact these changes have on their personal retirement planning.

CONCLUSIONS

Restoring solvency to the Social Security system is a formidable challenge. Addressing it in a sustainable fashion today could help us avoid similar challenges in the future rather than leaving difficult choices for our children. The health of our economy and projected budget surpluses offer an historic opportunity to meet these challenges from a position of financial and economic strength. Such good fortune can indeed help us meet our historic responsibility—a fiduciary obligation, if you will—to leave our nation's future generations a financially stable system. We must also move forward to address Social Security because we have other, equally serious obligations before us—compared to addressing the health-care financing problem, reforming Social Security is easy lifting.

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

I believe it is possible to reform Social Security in a way that will exceed the expectations of all generations of Americans. The reports about Social Security's long-term solvency problem and the challenges it represents have caused many Americans to have decidedly low expectations about the future of their Social Security benefits. Many current retirees and those nearing retirement believe that their benefits will need to be cut to restore solvency, while some baby boomers and many generation Xers are doubtful that the program will be there for them when they retire. We believe it is possible to craft a solution that will protect Social Security benefits for the nation's current retirees, while ensuring that the system will be there for future generations. Perhaps the answer is not solely one approach or another—such as defined benefit versus defined contribution. Bridging the gap between these approaches is not beyond our ability. Doing so would represent a major accomplishment that would benefit future generations. It would also help to restore the public's respect for and confidence in its government. GAO and I stand ready to provide the information and analysis that can help the Congress meet this challenge in a way that can exceed the expectations of all generations of Americans.

Mr. Chairman, this concludes my remarks. I would be happy to answer any questions you or other Members of the Committee may have.

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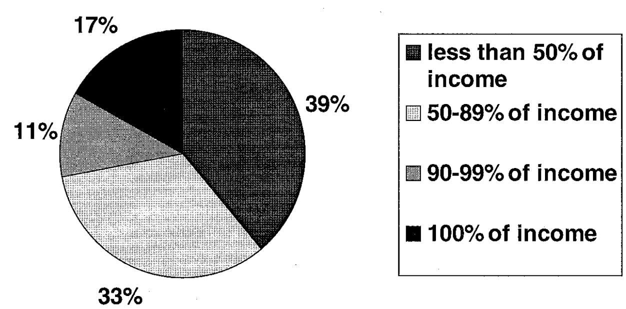
Figure 1: Relative Importance of Social Security for Those 65 and Older,1996



Source: Income of the Population 55 or Older, Social Security Administration, 1996.

Figure 2: Percentage of the Elderly Who Are Poor, 1959 to 1996

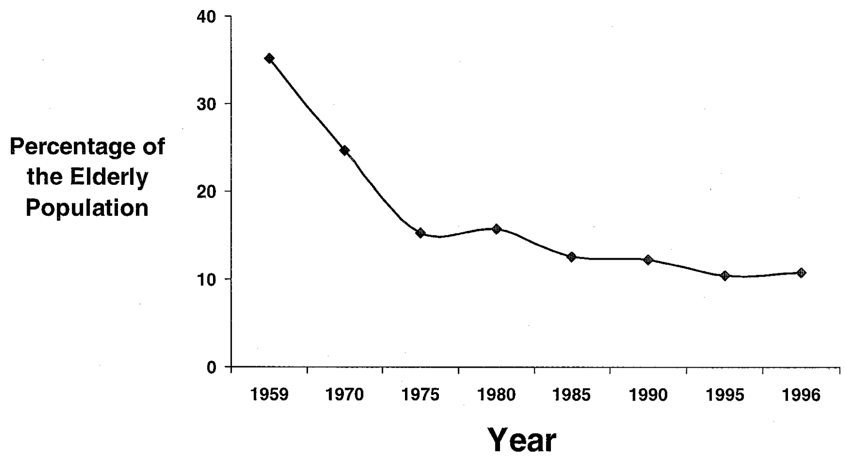


Figure 3: Ratio of Workers to Beneficiaries

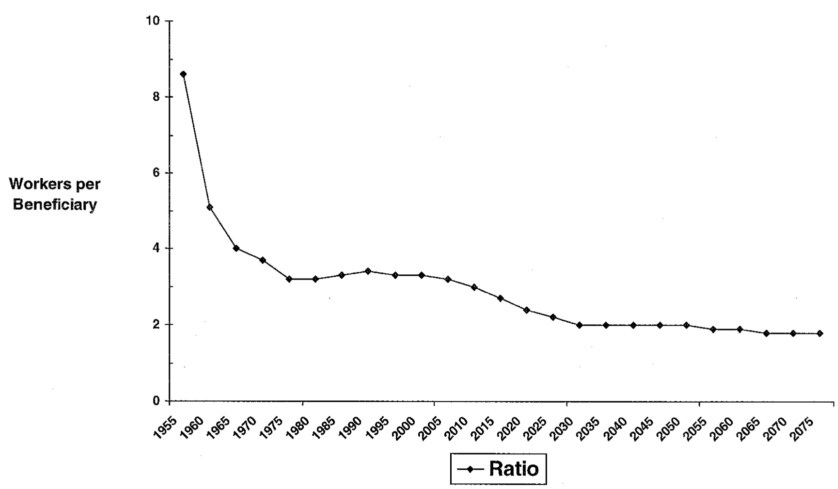
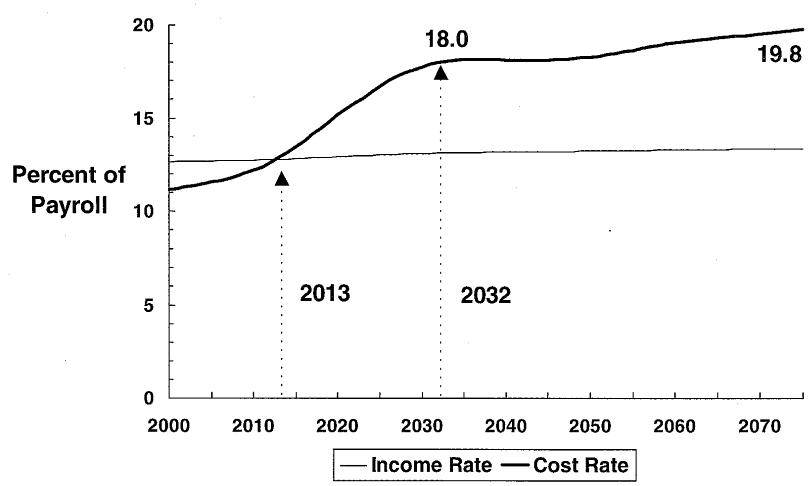
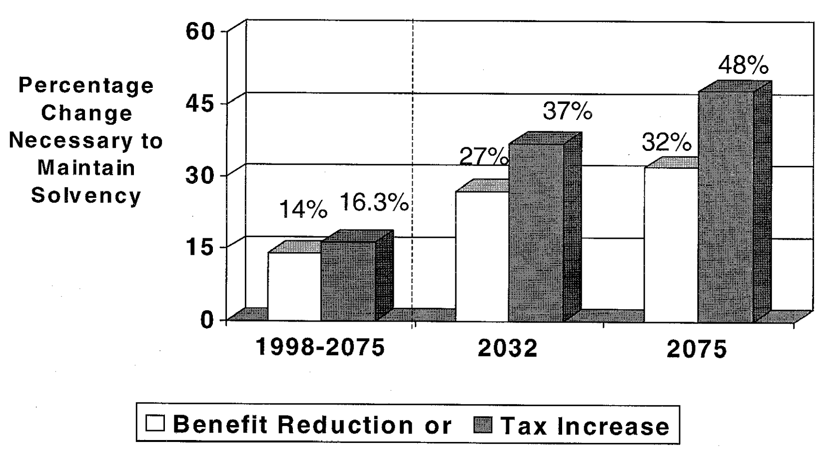


Figure 4: Social Security Income and Cost Rates



Note: Includes revenues from income taxation of Social Security benefits. By 2075, the amount would be 13.4 percent of payroll.

Figure 5: Changes Needed To Maintain Solvency



Note: Percentage changes are necessary to maintain solvency for the next year only.

Figure 6: Social Security Trust Fund Financial Outlook

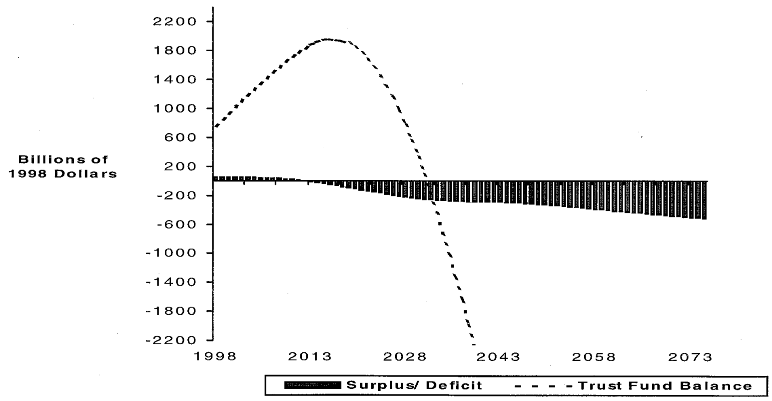
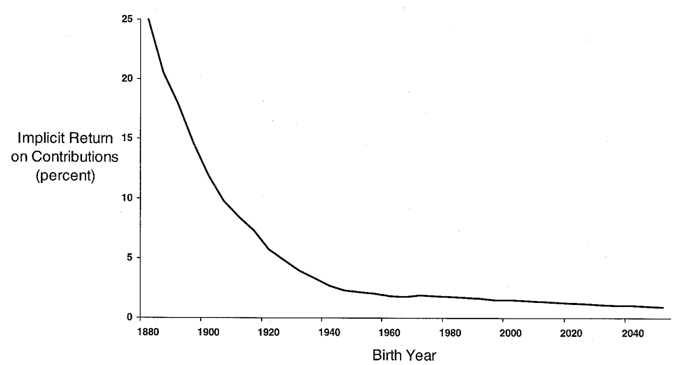


Figure 7: Social Security's Implicit Rates of Return



Note: These estimates do not include all Social Security disability contributions and benefits. They do reflect tax rates that would keep the system in actuarial balance on a pay-as-you-go basis. They use the intermediate assumptions of the 1991 Social Security Trustees' Report.

Appendix

ELEMENTS FOR EVALUATING SOCIAL SECURITY REFORMS

Financing Sustainable Solvency

To what extent does the proposal:
—restore 75-year actuarial balance?
—create a stable system beyond the 75-year period?
—increase national saving?
—reduce debt held by the public?
—draw on general revenues to finance changes?
—use Social Security trust fund surpluses to finance changes?
—result in a future budget deficit?

—require an increase in taxes?
—create contingent liabilities?

Balancing Adequacy and Equity

To what extent does the proposal:
—provide reasonable minimum benefits to minimize poverty among the elderly?
—provide adequate support for the disabled, dependents, and survivors?
—provide higher replacement rates for lower income workers?
—ensure that those who contribute receive benefits?
—provide a reasonable return on investment?
—expand individual choice and control?
—improve intergenerational equity?
—provide an opportunity to enhance individual wealth?
—set reasonable targets as to the percentage of the current and projected economy and the federal budget, represented by these costs?
—provide safety valves to control future program growth?

Implementing and Administering Reforms

To what extent does the proposal:
—provide a reasonable amount of time and adequate funding for implementation?
—result in reasonable ongoing administrative costs?
—allow the general public to readily understand its *financing* structure thereby increasing public confidence?
—allow the general public to readily understand the *benefit* structure thereby avoiding expectation gaps?
—limit the potential for politically motivated investment decisions?

Chairman SHAW. Thank you, Mr. Walker. The questions you refer to, I assume, are at the end of your full statement?

Mr. WALKER. Yes, Mr. Chairman, that is correct.

Chairman SHAW. I would like to focus on two words in your testimony and that is the question of “solvency” and “sustainability.” In doing so, I would call your attention to figure 6 in your written testimony. That is the figure in which you show the buildup of the Social Security fund until on or about 2013, and then the decline of the Trust Fund until 2030-something, in which it goes into the red. At what point is the solvency of the fund affected? At which point?

Mr. WALKER. Mr. Chairman, there are several key measures and dates, I think, that have to be kept in mind. First, from a cashflow standpoint, 2013 is the date. Starting in 2013, you either have to increase revenues, cut benefits, or increase debt held by the public in order to pay benefits.

Chairman SHAW. So 2013 is the critical date?

Mr. WALKER. The most critical date is 2013. The year 2032 represents the date by which the Trust Fund’s assets—Treasury bonds—will be exhausted. So we believe it is important to look at 2013, as well as 2032, but to recognize that you need to have a reform proposal that not only achieves actuarial balance over 75 years, but is sustainable and avoids this cliff effect that you see in figure 6.

Chairman SHAW. Would the net effect be any different with or without a trust fund?

Mr. WALKER. The trust fund is an accounting mechanism. Unfortunately, that is part of the public confusion. When most people talk about a trust fund, you talk about a separate and distinct legal entity covered by fiduciary responsibilities—funded with hard assets—stocks, bonds, government securities that back a stated promise. That is not what we are dealing with here. What we are dealing with here is a budget account. Now, the bonds that are in that account, in fairness, are guaranteed both as to principal and interest. They are backed by the full faith and credit of the United States government. But it is not a trust fund as we would normally think of it, and that is part of the public confusion, I think.

Chairman SHAW. The year 2013, that is the date that we have got to move if we don't want to increase taxes or cut benefits. That is the date we have to focus on, correct?

Mr. WALKER. We believe that is the key date. It is not that 2032 is not important. It is. We believe that 2013 is the key date.

Chairman SHAW. Would you elaborate on the word "sustainable"?

Mr. WALKER. "Sustainable" means that we deal with the so-called cliff effect. In 1983 after the Greenspan Commission, the Congress enacted legislation that they thought at that point in time was going to solve this problem. We came within days of not being able to get the checks out on time, back then. But part of the problem was that the reforms had this cliff effect that Congress evidently didn't predict. You have good years followed by progressively bad years. Therefore, when you are looking at a rolling 75-year time, simply by moving 1 year forward, the deficit over 75 years gets worse, because you are replacing a good year with a bad year. Sustainability means that we need to make sure that not only do we have actuarial balance over 75 years, but that we have actuarial balance in year 75, such that we are not going to have to be back here in 15 to 20 years—like we are now—doing the same thing again.

You, obviously, know how difficult it is to go through this process. I would hope that we could learn from the past and try to make sure that the reforms that take place now don't have this cliff effect, and not only assure solvency, but also, sustainability.

Chairman SHAW. Thank you.

Mr. Matsui.

Mr. MATSUI. Thank you, Mr. Chairman.

Mr. Walker, have you had a chance to look at Martin Feldstein's plan? Are you familiar enough with it to comment on some of the specifics of it?

Mr. WALKER. I am somewhat familiar with it because I knew that this was a plan that we could be asked to analyze according to our criteria. I met with Dr. Feldstein last week for about an hour, when he was in town, in order to try to obtain a better understanding of it. So I am somewhat familiar with it. But I understand that it is evolving.

Mr. MATSUI. Right. Well, let me just ask you—I want to ask you about some of the more, I guess, general concepts of the plan. It basically would provide 2 or 3 percent of a tax credit, up to $74,000 or $75,000—whatever our cap is at this particular time. As a result of that, somebody making $20,000 a year would probably end up getting about $400, if in that 2 percent situation, and somebody making $74,000 ends up getting about $1,500–$1,800—somewhere within that range. Would that satisfy your criteria in terms of equity?

Mr. WALKER. My understanding is that, under his current proposal, he would take about 2.3 percent of taxable payroll and he would propose that amount come out of the unified budget surplus.

It would be allocated to individual accounts. Those individual accounts would be invested in hard assets that would buildup over time, which, presumably, would create an incremental rate of return above and beyond treasury bonds, but obviously there is some risk.

Mr. MATSUI. Maybe.

Mr. WALKER. That's right. Historically, based on long-term averages, stocks have generated about 7 percent real return, for example, as compared to 2 to 3 percent for government bonds. Over time he is assuming that there would be a incremental rate of return. It is also my understanding, Mr. Matsui, that he proposes to guarantee all current benefits, and that what would happen is that 75 percent of the buildup in these accounts would be given back to the Social Security Trust Fund to pay the existing defined benefit promises. Therefore, under his proposal, people would never get less money than they are going to get today, but they could get more money.

Now there are clearly a number of positives associated with that, but there are a number of concerns associated with that, too. I think that is why it is important to answer all these questions about this proposal and every proposal.

Mr. MATSUI. Well, would you say that what I just suggested, would that fit the equity criteria?

Mr. WALKER. Well, it clearly meets the adequacy.

Mr. MATSUI. I'm sorry?

Mr. WALKER. It clearly meets the adequacy test.

Mr. MATSUI. No, I am asking just about equity.

Mr. WALKER. There are several dimensions of equity. One dimension of equity is rates of return. When I think of equity—the way that we normally refer to equity, there are different ways you can do it—is, what rate of return does the individual get on their payroll contributions? There are other ways to look at equity. Equity in that definition would be enhanced. Adequacy would be maintained. But there are certain other things that one would have to say in the interest of full and fair disclosure. It presumes that these surpluses will occur.

Mr. MATSUI. Without getting into your conversation, did he ever talk about the maintenance cost of all this? You know, somebody who gets $400 a year in this account—$20,000 annual income, that person then invests. He has a fund manager and whatever the overhead costs to have that fund manager administer the fund. Then, obviously, after the 75 percent is taken out of that—the tax, 90 percent, or whatever it might be—that person has to get an annuity account. I guess there is a cost to that. Did he walk you through that?

Mr. WALKER. Dr. Feldstein has not really focused on the administrative aspects criteria. In fact, that is one of the elements that we include in ours that is important to focus on.

Mr. MATSUI. You know what I think would be a good idea? If you could look at the Feldstein plan as he described to you and all the paperwork, then maybe test it against your five criteria. Then, maybe give us a written response to that. I don't know what he told you and what his plan is, because it changes all the time, I understand. So, if you could look at the plan he offered you, with all the paperwork; then test it against your criteria and send us a letter. I really want this. It will help us really analyze whether Mr. Feldstein's plan meets kind of your test. I think it really would be important. Is that something you feel you could do?

Mr. WALKER. He didn't give us any paperwork. It was just an interview. I think what we potentially could do is to try to answer these questions with factual information. The Congress has to draw its own opinions and conclusions about whether or not it meets the test. I think our job is to give you facts to try to provide you with a framework, so that, hopefully, you can make decisions.

Mr. MATSUI. Oh, no, I understand that. I understand that, but we need some conclusion. We just can't throw a lot of principles up in the air and not come to a conclusion.

I know my time has expired, but let me just, if I may—again as Dr. Feldstein developed his plan to you, is that sustainable? You know, he is using this surplus. It is huge tax consequences. Then the clawback—I call it a confiscatory tax on the assets, but most people like to call it a clawback—I understand it could be up to 90 percent. That is more than confiscatory.

Mr. WALKER. If the assumptions prove valid, it would meet the test of sustainability.

Mr. MATSUI. When you say "if," I need to know what that means. That is really important. Because, otherwise, they may say you say it is valid. What are the assumptions we are talking about?

Mr. WALKER. For example, are the surpluses going to materialize or not? Second, are the incremental rates of return going to be achieved?

Mr. MATSUI. All of the surpluses are used for this purpose rather than using it for defense spending?

Mr. WALKER. The 2.3 percent. Are the incremental rates of return going to be realized? So there are certain key elements that you would have to look at. I assume that we are going to be back to testify on a variety of proposals.

Mr. MATSUI. I would hope so. I would hope so.

Mr. WALKER. And, frankly, I think that we will practice what we preach. We will use our criteria in doing that. I think that is important. But his program by design would be sustainable.

Mr. MATSUI. If you don't use any of the surplus except for the tax credit, and if, in fact, whatever the clawback percentage is is adequate—right? I mean it could be 99 percent. We don't know what it could be.

Mr. WALKER. I think one of the challenges, Congressman, that I mentioned to Dr. Feldstein is the so-called clawback. How are people going to react to that? If you have an account with your name that builds up over 20 years that has an account balance of "*x*" in it, and all of a sudden 75 percent or 90 percent of "*x*" disappears, I think there could be a real expectation gap there. Now, there are different ways to achieve that same objective, if you wanted to. I think that is a matter of concern and that is one the questions that is in this list.

Mr. MATSUI. If I could just add, I just want to make one observation. If that clawback is up to 90 percent, or even 85 percent, 75 percent, it is almost as if this is a way to avoid the government investing in the market. Basically, the government invests in the market through individuals. Then you have, obviously, the overhead costs. Because it is a big tax coming back, the government, ultimately, gets the money anyway, except it is less efficient than if the government invests directly in the market. It is kind of an interesting concept that uses individuals basically to invest for the government, because the government gets almost all the money back anyway. That is for another day, I know.

Mr. WALKER. Well, Dr. Feldstein was fairly clear with me on two points. One, he felt that it was important to preserve the surplus in a way that would increase real saving. This is one way to do it. Second, he felt that it was important to prevent political manipulation of the trust fund investments. His opinion is that individual accounts would help to prevent that. I think that is one of the reasons he constructed it the way that he proposed. There are other ways you could do it.

Mr. MATSUI. The business to go into would be fund managers. Great opportunities for young people. Thank you.

Chairman SHAW. Mr. Portman.

Mr. PORTMAN. Thank you, Mr. Chairman. I want to thank our witness for, again, giving us a sober assessment of our challenges. You are not approaching this like you approached Medicare, Mr. Walker, which you said earlier presents an even greater challenge. In fact, your statement that we can exceed the expectations of all generations—those who are already in their retirement years, those who are near retirement and then those of us who are in the baby-boom years and younger generations—is accurate. I think that makes this debate a little more fun than the Medicare debate, which is probably more difficult. I don't object to talking about the Feldstein proposal. I know it is not really the subject of the hearing. We are focusing on the goals and criteria for assessing reforms, but I think it is very interesting to go through it. I know it is evolving. I know that the specifics are not out there. It is a very interesting idea to take the notion that the President laid out back in December of last year, which is, if you don't want to raise taxes and you don't want to reduce benefits, given the demographic realities that you charted out so well, the most promising way to do that is to get a higher rate of return for beneficiaries. The question is, how do you do that? I think there is a legitimate debate to be had on that.

I think, as the Chairman said earlier, there is a lot of skepticism about the government making those decisions. We certainly heard from Chairman Greenspan on that. The question is whether an individual-directed investment does give this ability to exceed expectations and to make this an improvement of the current system without sacrificing any of the security that is currently invited in our Social Security system. I am looking forward to this debate continuing.

I will get back to your testimony and the focus of the hearing for a second. At the beginning of testimony you talk about the three-legged stool. I am going to go back to that analogy that is used a lot. I like it because I think it is realistic. As you know, probably, there was more money paid under employer-based private pensions and public pensions—403(b)s, 457s—last year than under Social Security. It is a very important part of retirement security for all

Americans. As you know, Mr. Cardin and myself and many Members of this Subcommittee have a bill that we introduced a couple weeks ago on that topic. We had a good hearing the day before yesterday where we had testimony from all sides.

Have you taken a look at that issue? I mention it because you do get into the three-legged stool at the outset. Have you had a chance to look at the legislative ideas to simplify and expand the private side to ensure retirement security?

Mr. WALKER. I need to look at the most recent bill, Congressman. As you probably know, I was Assistant Secretary of Labor for ERISA for several years—so this is an area that is very near and dear to my heart—in addition to being a former trustee of Social Security and Medicare. I do think there is a need for simplification. I know that some of the things that you have been talking about, both yourself and Congressman Cardin, would be a step in the right direction. I need to look at the bill. I will do that. To the extent that you would like any comments on that, I would be happy to talk to you about it.

Mr. PORTMAN. I would love to. I don't want to overburden your folks behind you there, who are focusing on Social Security. I would just make the point that the purpose is to ensure retirement security. I think Congress, over the last decade and a half, has gone the wrong way in terms of the private side until very recently. Here is an opportunity this year with Social Security reform, which I think has to be the bedrock. Because, as you say, about 20 percent of Americans rely on it exclusively. Most Americans now are in some kind of a pension system. We want to expand that number greatly. It is, again, a tremendous opportunity. I would love for you to take a look at it. PBGC, the Pension Benefit Guaranty Corp., incidentally, testified and they are very positive both on what we do on the defined benefit side—of course, where they are more involved—but also on the defined contribution side.

One other question, if I might, quickly: When you look at your criteria at the end, which I think are good, on financing, balancing adequacy and equity, and some of the implementation and administrative aspects, if you could apply that to the various proposals, including the President's proposal, I think it would be helpful. The President didn't pretend to save the system for 75 years. It is not a specific proposal, yet, in writing. It does have some ideas in it. I think it doesn't meet the criteria that you have laid out, with a couple of exceptions.

Finally, in your testimony before the Senate, you talked a little about what you thought might need to happen with regard to Social Security reform to have it be effective. You said that the greatest array of possibilities and different approaches should be looked at. I think it was on page 15 of the February 9 testimony before Senate Finance you said that different approaches needed to be combined, including individual accounts. Do you believe that is part of the answer if it can be properly structured?

Mr. WALKER. Well, I don't believe it is appropriate for me to take a position on whether or not I think individual accounts are part of the solution or not. I think in my testimony what I said, Congressman, is that one of the things that you need to do is you need to look at a package. There are ways to take different elements and combine them in a package in a way that will achieve overall objectives. It is possible to do that with individual accounts. I don't want to take a position on whether or not I am for or against individual accounts. I don't think that is appropriate for me to do.

Mr. PORTMAN. I think that is fair. It is good to have GAO's objective analysis out there. We look forward to working with you.

Thank you, Mr. Chairman.

Chairman SHAW. Mr. Levin.

Mr. LEVIN. First of all, Chairman Shaw, I read over the resolution that you referred to—the 99-to-nothing vote—and I just don't think anybody should be under a misconception that there is no support for some system of investment of these funds other than individually. As I understand the discussion, or the approach, in the Senate it was the use of the word "directly" in front of "invest contributions" was thought by many Democrats to mean that there would not be a board of independent managers. So, no one here should think that the vote in the Senate means that there is no support for the President's proposal.

Second, I just want to say to you, Mr. Walker, I think neutrality on your part may well be important. It is going to be very difficult for you to maintain it. You are delving into issues that are complex and also controversial. Also, you may have taken positions in the past that aren't neutral on these subjects. Weren't you part of a commission that took a position on Social Security reform?

Mr. WALKER. Let me address that. Thank you. I have fully disclosed that, prior to assuming the responsibilities as Comptroller General, I have served in a number of government positions and I have been on various commissions. One of the commissions that I was on was the Center for Strategic International Studies' Commission on National Retirement Policy. Senator Breaux, Senator Gregg, Congressman Kolbe, and Congressman Stenholm were also on that Commission. That Commission did come up with a reform proposal as a package. It passed 24 to nothing. I was one of the commissioners that voted for it.

At the same point in time, there are things in it that I do not like. There are also things that I would prefer to be included that were not in it. And that was prior to assuming my current position.

Mr. LEVIN. OK, I just wanted to indicate that because of the nature of the subject matter and your past—your taking positions in the past, it is going to be difficult I think—you have a real challenge to give the perception and the reality of neutrality. I have not studied before in detail these questions, but, for example, I do not see here—maybe I missed it—a question about what would be the impact of any plan on other governmental expenditures. Now, maybe it is here, and I do not see it.

Mr. WALKER. I think indirectly it is, Congressman. For example, what is the impact on the deficit—what is the impact on the Federal budget? What is the size of the program as a percentage of GDP? I think that was our intention of trying to get to the point that you are raising, because I think it is an important one.

Mr. LEVIN. OK, well, I think those are different issues. By the way, the Feldstein plan has been in writing, as well as your having discussions. I am just curious—look at your first questions and just answer objectively. Does the Feldstein plan restore 75-year actuarial balance?

Mr. WALKER. If his assumptions prove valid, the answer is yes.

Mr. LEVIN. Does it reduce the debt held by the public?

Mr. WALKER. No. You cannot spend the money twice, in other words.

Mr. LEVIN. OK. And in terms of requiring an increase in taxes, that depends on its assumptions, right?

Mr. WALKER. Right, it would use part of the surplus, which is general revenue financing, but——

Mr. LEVIN. It does?

Mr. WALKER. Correct.

Mr. LEVIN. OK.

Mr. WALKER. Well, it does not require a current increase in taxes, no. It uses part of the surplus, which would represent general financing, but it does not necessarily require a current increase in taxes, no.

Mr. LEVIN. One last question: you say one of the key things is whether a plan could readily be explained to the public. How can you explain to the public convincingly a plan that would take three-quarters back of any return? You think you can go before the public and explain that persuasively?

Mr. WALKER. I think that it is one of the largest challenges associated with this proposal, and I mentioned this to Dr. Feldstein; that from a practical standpoint, if you have an account that accumulates in your name over a number of years, and you have a clawback of a material percentage, I think that is a problem.

Mr. LEVIN. Seventy-five percent.

Mr. WALKER. That is right. I think it is a real problem.

Mr. LEVIN. Or more. OK.

Mr. WALKER. I think there are ways you could get the same thing done different ways, if you wanted to, but I think that particular approach is a real problem.

Mr. LEVIN. Thank you.

Chairman SHAW. I would like to point out, Sandy, that on the bottom of the first page of Mr. Walker's testimony, it says that—in talking about the basic criteria—the extent to which the proposed proposal achieves sustainable solvency and how the proposal would affect the economy and the Federal budget is important. I think that is about as inclusive as you can get. And I think, also, it is important to point out that, if we start thinking that we are to only bring people into the Federal Government who do not have any opinions, we are going to end up with a lot of stupid people.

Mr. LEVIN. Let me just say, I do not suggest that for a moment. I do think that everyone should be aware, though, of what they bring to the government. And, in your case, I am urging your neutrality—you come as having expressed an opinion in favor of a particular proposal. And you—I mean, everybody knows that. I am just saying that I think it makes your job all the more difficult.

Mr. WALKER. One thing I could tell you, Congressman, if I had to draft a proposal of my own, it would be a different proposal. I think that is one of the things that the Congress needs to focus on here, quite candidly, is that reform has to be considered as a package. There are tradeoffs in packages. There is a statement that I included in the record of the CSIS report that I would commend to you to look at. But I have been a trustee of Social Security and Medicare. I have been Assistant Secretary of Labor for ERISA. I have never ever had anybody question my integrity or objectivity. I can assure you that you won't need to. Thank you.

Chairman SHAW. I am absolutely sure of that. You are CPA, are you not?

Mr. WALKER. Yes, I am, among other things. I won't say that necessarily does it, but I appreciate the thought.

Chairman SHAW. Mr. Tanner.

Mr. TANNER. Thank you, Mr. Chairman. I just have one question.

When Chairman Greenspan was here, he said the single best thing this government could do now "to save Social Security" would be to reduce the outstanding debt, nongovernmental debt. Do you agree?

Mr. WALKER. We are on record as saying that paying down debt held by the public is the most certain way to increase future economic capacity and growth.

Mr. TANNER. Thank you. I yield back.

Chairman SHAW. Mr. McCrery.

Mr. MCCRERY. Mr. Walker, I want to, first of all, point out that, at the time that you and Mr. Stenholm and others were working on that proposal, we were still expecting deficits at the Federal level. Times have changed quite a bit since you all developed that proposal, and I think you would say that the change in the fiscal condition of the Federal Government presents other options perhaps for dealing with Social Security than you all had to look at when you were putting together that proposal.

Mr. WALKER. There have been material subsequent events, and that is one of them that I think obviously the Commission would have considered.

Mr. MCCRERY. I want to get back a point made by the Chairman. He said that the 2013 date is important because, in 2013, we would either have to raise taxes or cut benefits. Well, that is not exactly correct, is it? If the country is running a surplus through 2013, another option would be to simply pay down less of the Federal debt, the public debt, in order to redeem the bonds in the trust fund?

Mr. WALKER. That is correct from a macroeconomic perspective.

Mr. MCCRERY. We could do that without raising taxes or without cutting benefits, is not that correct?

Mr. WALKER. From a macroeconomic standpoint, yes. I think what the Chairman was referring to was you need to deal with it at two levels: macro, which is the unified budget, which is what you are referring to; and micro, which is the program itself, which is intended to be self-financing and self-sustaining. It won't be self-financing and self-sustaining starting in 2013, at least from a cash perspective.

Mr. MCCRERY. Well, yes, it will, because it will have bonds in the trust fund, backed by the full faith and credit of the United States government, that are redeemable. So, it is self-financing. The fact that we have to draw cash from the general fund to redeem the bonds should not make us say that the trust fund is a fiction. It is not a fiction.

Mr. WALKER. Well, I think that is an important point, Congressman.

Mr. MCCRERY. It is internal debt. It is fully redeemable.

Chairman SHAW. Would the gentleman yield?

Mr. MCCRERY. Surely.

Chairman SHAW. You are taking something out of context. I said, would the result be different with or without the trust fund. And, clearly, it would not be because, where is the money coming from that is being paid out in benefits? It is coming from a combination—right now, it is coming out of the payroll taxes, FICA. After 2013, it is going to have to be a combination of general revenue from the government and the FICA tax; or, in the alternative, increasing the FICA tax. So let me be sure the record is very clear on that. And the result is the same, whether you have the trust fund or not.

Mr. MCCRERY. You are correct on that. But it is not correct to say that in 2013 we will either have to raise taxes or cut benefits.

Mr. WALKER. Well, I think I responded to that. But I think you are making an important point, which needs to be made, and that is there is substance to these obligations. These obligations are guaranteed as to principal and interest. They are backed by the full faith and credit of the U.S. Government. In effect, what we have in Social Security is certain obligations. The obligations represent the promises that are made for benefits under current law. Some of those obligations are backed by payroll tax revenues. Some of those obligations are backed by government bonds. And then we have a financing gap, which has to be closed.

I do not want people to think that those bonds are not worth anything. They are. But from a macroeconomic standpoint, you have got to pay off those bonds. You cannot pay Social Security benefits with bonds. You have got to pay them with cash. And so, therefore, from a macroeconomic standpoint eventually we are going to have to pay the bonds off.

Mr. MCCRERY. Absolutely. But if we are running an overall surplus at the Federal level at the time we have to redeem those bonds in the Social Security Trust Fund, we do not have to raise taxes. We can simply redeem less of the publicly held debt, and redeem more of the internal debt in the Social Security Trust Fund.

Mr. WALKER. And I agreed with that.

Mr. MCCRERY. And that points up one, I think, very good facet of the President's proposal on Social Security. He does propose to use a good portion of the expected surplus to buy down the publicly held debt from now through 2013 and beyond. And that gives us the flexibility—if we adhere to that, it gives us the flexibility when payroll tax revenues are insufficient to meet the demands of the Social Security payout to simply transfer from redeeming publicly held debt to redeeming debt in the trust fund without raising taxes. So I think the President's plan is a good one in that respect.

Mr. WALKER. We are on record saying that that is a very positive element of the President's plan—paying down debt held by the public.

Mr. MCCRERY. Now, you note in your testimony, that comparing reform options to current law is not an appropriate benchmark. What is an appropriate benchmark?

Mr. WALKER. I think you have to look at two different elements. You have to look at promised benefits and funded benefits. I have seen people out there doing comparisons where they will end up comparing a reform proposal to current promised benefits, but there is a 2.19 percent payroll tax financing gap on promised benefits. We do not have the revenues to meet promised benefits. Therefore, you cannot just consider promised benefits, you also have to consider funded benefits when you are comparing various reform proposals.

Mr. MCCRERY. Thank you.

Chairman SHAW. Mr. Cardin.

Mr. CARDIN. Thank you, Mr. Chairman. I would like to follow up on some of Mr. McCrery's questioning, because I do think the President's outline or proposal does have the trust fund more like a trust fund, to the extent that there are investments of funds in equities. That makes them more like a trust fund because it is going to be less paying down of public debt to the extent that moneys are invested in equities. And second, the returns are going to be producing more revenue that ultimately will be to the benefit of the United States Treasury.

Mr. WALKER. I agree. That element is more like a real trust fund. It would result in incremental rates of return above and beyond Treasury bonds.

Mr. CARDIN. And I would just like to underscore the point that the Chairman made, and I guess you are making also, and that is one of the ways to evaluate is to what extent does it provide a reasonable return on investment; that Democrats and Republicans all agree that what we need to do is get a better rate of return in the Social Security system. And I assume the reason you list that here is for us to evaluate recommendations or plans as to how well it fares on providing a better rate of return for the Social Security system?

Mr. WALKER. Right. I think there are two ways: Rate of return for the Social Security system, and rate of return for the individual beneficiaries who are paying taxes.

Mr. CARDIN. That is true, and the Chairman pointed out the 99-to-0 vote in the U.S. Senate. And I just want to underscore the point that Mr. Levin made and that is there is total agreement that we do not want direct investment by government officials. That is not the President's proposal. The President's proposal is to have those investments made through a private entity; through protection in law on the entity that selects how investments are made. And you have also indicated that as a criteria to review proposals by to what extent does the proposal limit the potential for political-motivated investment decisions. I assume that is one of the reasons you listed that there.

Mr. WALKER. That is correct. We have crossed that bridge before in connection with the Federal Thrift Savings plan, although clearly one has to recognize that the magnitude of the dollars here are a lot higher and the number of people affected are a lot greater.

Mr. CARDIN. I assume there is always a risk here—whatever plan, even with private accounts, that are set up through a Federal structure. There is also a concern that we set it up in a way that minimizes that risk.

Mr. WALKER. Absolutely.

Mr. CARDIN. You also indicate as one of the standards to what extent does the proposal increase national savings. And I just really want to underscore the point that Mr. Portman made. It may well be that our legislation is not one that will be directly linked to Social Security changes, and we can fully appreciate that. But it seems to me that related proposals that try to increase a private retirement savings are consistent with what we are trying to do on Social Security; that is, to provide for a stronger retirement security for Americans; yes, by strengthening Social Security, but also by looking at why we have not done better as a nation on private savings; why we have not done better as a nation for private retirement. And, yes, the direct proposal might help us in that regard. But there will also, I hope, be efforts made to combine other proposals to look at existing mechanisms in place for private savings and retirement that can help strengthen this Nation's retirement security.

Mr. WALKER. I think that is very important, Congressman. When I look at retirement security, I think there are a couple of elements: one, to make sure that Americans have an adequate stream of income throughout retirement; and second, to make sure they have access to affordable health care. To deal with that, you have to look at Social Security, private pensions, personal savings, Medicare, employer-provided health care, and individual health care arrangements, among other things.

Mr. CARDIN. And the last question I have for you—I am very impressed by your written and oral presentations here and your commitment of objectivity in evaluating proposals. We need that. And we need to be able to bridge a way to come forward I hope with a bipartisan recommendation for Social Security.

My concern is that you have said in evaluating at least a verbal presentation of a proposal, but Dr. Feldstein, that based upon his assumptions or based upon—how do you determine how realistic those assumptions are?

Mr. WALKER. We can take a shot at that. And I imagine that we might be asked to take a shot at that. One of his assumptions is the rate of return with regard to equity investments. And there are a lot of other people that are talking about rates of return for equity investments like the President. The President had to make an assumption as to what he was assuming the incremental rate of return would be on his proposed equity investment by the trust fund. I can look and verify this, but I think both may have used something close to a 7-percent real rate of return. I will look to try to verify that.

Mr. CARDIN. Let me make just one suggestion to you. It may be helpful to us in evaluations as to how risky assumptions are. Some proposals have very little at stake on sums that are pretty well known. Transferring some of the surplus directly into the trust fund is a known quantity. There are no assumptions there. Whereas, other proposals have much more risky outcomes because assumptions are not as certain. And I think it would be useful for this Subcommittee if you could help us in saying how safe or how much risk there is involved in the assumptions that are used in order to achieve our objectives.

In 1983, we missed. We did not get where we thought we would get. And I hope in 1999 we are more accurate in reaching what we need to do in Social Security.

Mr. WALKER. I think there are two ways we can help on that: One is the structure of the proposed reform. What are the risks, for example, that the government will assume from contingent liabilities? And then, second, what are the risks associated with the underlying assumptions that relate to reform? And I think it is very relevant for us to help the Congress look at those.

Mr. CARDIN. Thank you.

Chairman SHAW. Thank you. Mr. Matsui.

Mr. MATSUI. Thank you, Mr. Chairman.

Mr. Walker, I just wanted to ask one more question. It was prompted, actually, by Mr. Cardin's question. Do you know how much revenue loss is attendant to the Feldstein plan, using the 2.3–2.2 percent, whatever it is—tax credit of income up to about $74,500 over the next 15 years, should it come into play?

Mr. WALKER. I do not, but I can provide it for the record.

[The following was subsequently received:]

In response to the questions about Martin Feldstein's Social Security reform proposal, Rep. Matsui has asked that GAO instead examine the proposal put forth by Chairmen Archer and Shaw because the latter proposal is under discussion in the House. GAO is preparing a report in response to Rep. Matsui's new question that will be available late in the year.

Mr. MATSUI. OK, the reason I ask that is because you are saying you are basing your conclusions on a number of assumptions. So I would have to assume that you know what the revenue loss will be over 15 years or 5 years or 10 years. I was under the impression it was somewhere in the range of $4.8 trillion, but maybe that number is out of sight. I thought it was, like, for the first 10 years about $1.8 trillion, and then for some reason it just really bounces up. But I am surprised you do not know that number. You will have to forgive me by making that observation, because you have basically said this is sustainable based upon the assumption——

Mr. WALKER. The overall assumptions, that is correct.

Mr. MATSUI. A number of assumptions. But then, if you have not really costed it out, I do not know how you can even reach that conclusion. I am somewhat perplexed by that.

Mr. WALKER. Well, our people——

Mr. MATSUI. I would expect that we have a little more concreteness in the analysis, particularly, the Comptroller General. I mean, it seems to me that you cannot reach a conclusion and not know that basic number about how much revenue loss there will be.

Mr. WALKER. As you can imagine, Congressman, there are about 3,200 people who work at the GAO, and we have had a lot of people do a lot of analysis of this. I would be happy to provide that number for the record.

Mr. MATSUI. Well, well, no. Let me say this——

Mr. WALKER. I just do not recall it off the top of my head.

Mr. MATSUI [continuing]. Your response is very legitimate.

Mr. WALKER. Surely.

Mr. MATSUI. On the other hand——

Mr. WALKER. Yes.

Mr. MATSUI. You were appearing before a congressional Committee to address what you, yourself, admit was probably the most important policy issue we are going to be deciding over the next—maybe our entire careers. And here you kind of just threw out, that based upon these assumptions, it is sustainable. And I am just really kind of perplexed by that. I would just expect a little bit more out of a professional as you are in that kind of a situation.

Mr. WALKER. Yes.

Mr. MATSUI. Well, let me finish.

Chairman SHAW. If the gentleman would yield, though. I think what you are saying is very, very unfair.

Mr. MATSUI. It is not unfair.

Chairman SHAW. That is about as professional an opinion I could possibly hear, and, also, it is coming from about the most neutral corner you can possibly find to say, assuming these things are true, then it is sustainable.

Mr. MATSUI. Yes, but, you do not which——

Chairman SHAW. It is not being an advocate. It is not being an advocate for——

Mr. MATSUI. If I can take back my time—we do not know exactly—you do not even know what these assumptions are. That is what my problem is. I thought you did know that number.

Mr. WALKER. No, no, Congressman, in fairness——

Mr. MATSUI. That is a followup suggestion.

Mr. WALKER [continuing]. In fairness, Congressman, we know a lot more than you are giving us credit for.

Mr. MATSUI. Well, what is that number?

Mr. WALKER. I do not recall off the top of my head, but then, again, do you recall what the number is for the amount of Social Security obligations right now?

Mr. MATSUI. Well, no, but I am not making a conclusion.

Mr. WALKER. The fact of the matter is that the Social Security actuaries and the CBO calculate the exact numbers. Our staff is closely coordinating with them. The fact of the matter is the President's proposals have assumptions in them, too. And that is one of the things that we all have to recognize here is a lot of these proposals are based upon assumptions. And I think it is very relevant, Congressman——

Mr. MATSUI. Mr. Walker——

Mr. WALKER. Can I finish, Congressman, for a second?

Mr. MATSUI. Well, let me——

Mr. WALKER. I think it is very relevant, Congressman, for us to look at the validity of those assumptions and to help you understand the risks, and we will do that.

Mr. MATSUI. And let me say this, Mr. Walker: I appreciate what you just said. On the other hand, I have to say that you gave the impression that based upon these assumptions, this is sustainable. But you did not know what these assumptions were. And I just do not know how you can come before this Subcommittee, and actually reach that conclusion. Now, if you would have just basically said, look, we are doing a study on this, and we do not know exactly whether it is sustainable or not, that is a very, very legitimate answer. And then I could not trust it any further. But you basically concluded that this was a sustainable proposal based upon assumptions. And all you raised was that economic growth would continue where you will continue to have a surplus. But it seems to me it is pretty obvious that you should know what the revenue loss would be——

Mr. WALKER. With all due respect, Congressman, what I did not know was the exact number of 2.3 percent times the projected taxable wage base of younger workers for the next 15 years. That is what I said I did not know. I know what the assumptions are for the President's projected budget surplus. I have seen what the numbers are for the CBO. I just did not know what 2.3 percent times of that wage base was.

Mr. MATSUI. I think, as Mr. Levin said, because you have some preconceived notions coming before this Subcommittee, it would just make us feel a little bit more comfortable if there was just a little bit more caution in your observation.

Chairman SHAW. I would like to make this final observation, if I could. To begin with, this is not a hearing on the Feldstein proposal. And I think if you think that the Republicans are going to be introducing a plan that is going to be a carbon copy of the Feldstein proposal, I think that, based upon your comments, that you will be delighted with what we might introduce. I also say that this witness has simply said that his only exposure to the Feldstein plan is an hour spent with Mr. Feldstein, and he is neither an advocate of the Feldstein plan, nor is he an expert on the Feldstein plan. And I think that this line of questioning has been tremendously unfair and below the dignity of this Subcommittee.

Mr. Walker, thank you very, very much.

Mr. WALKER. Thank you. I appreciate it.

Chairman SHAW. I appreciate your being with us again today.

Now, I would like to introduce the next witness from the Social Security Administration, Mr. Stephen C. Goss, Deputy Chief Actuary for Long-Range Actuarial Estimates.

Mr. Goss, as other witnesses, we have your full text of your testimony, and we will submit that for the record. And you may proceed and summarize as you see fit.

TESTIMONY OF STEPHEN C. GOSS, DEPUTY CHIEF ACTUARY, OFFICE OF THE ACTUARY, SOCIAL SECURITY ADMINISTRATION

Mr. GOSS. Mr. Chairman, Members of the Subcommittee, thank you very much for the invitation to come here and speak to you today about the work we do at the Office of the Chief Actuary at the Social Security Administration in assessing the financing and the financial status of the Social Security system into the future.

There are two primary functions that we serve at the Social Security Administration in the Office of the Chief Actuary. And the first one of those is related to the statutory legal requirement of the board of trustees to report annually to the Congress on the status of the Social Security system. Two different financial estimates are required in that law. One is an assessment of the financial status of the system over the next five fiscal years; and the other is referred to as a statement of the actuarial status of the program, and it is not further defined in law. Over time, though, the actuarial status of the program has evolved into meaning an assessment of the financing of the system over a 75-year period.

The other primary function that we fulfill at the Office of the Chief Actuary at the Social Security Administration is to provide estimates and analysis of potential legislative proposals that are developed by Members of Congress and by the administration. To the best of our ability, we provide objective and thorough analysis on these proposals that will be useful to policymakers, who are the ones that will ultimately make the decisions, as you do, in terms of where we will be going in the future with this program.

I will turn, momentarily, to the current financial status of the program. As you all are well familiar, the program provides monthly benefits currently to over 44 million Americans and the primary financing for this, for these benefits, is based on payroll taxes from about 150,000,000 working Americans. Currently, we are operating with annual surpluses to Social Security. The total tax revenue is exceeding the cost of the program, and as a result our trust funds are growing in magnitude.

There are three principal dates that are often referred to in terms of the financing of Social Security. The first one that was discussed at some length with the prior witness, David Walker, is 2013; the year in which the tax revenue to the system will first be insufficient to be able to pay for the cost of the system. Therefore, there will be a necessity to be withdrawing some money from the trust funds.

A second date that is sometimes referred is the year 2021, which under the intermediate assumptions of the 1998 Trustees' Report, would be the first year in which the combination of taxes and interest on the existing trust funds would be insufficient to pay for the cost of the program.

The third date, and I would suggest from the point of view of the work that we do related to the financing and the solvency of the Social Security system, is perhaps the most important date of these three, is the year 2032, the date in which the combination of taxes and money available from the trust funds will be insufficient to pay the benefits to the system. This is one of the very few points that I can think of where I would disagree on a technical point with David Walker.

As of the year 2032, when the trust funds will be exhausted and will no longer be available to be able to augment the tax income to the Social Security system to allow us to pay benefits in full, on a timely basis, there will be continuing tax revenue coming into the system under our current intermediate projects that would be equivalent to about 71 percent of the cost of the system. This is, I think, a useful measure in giving some sense of how far it is we have to go to put the system back into proper financial balance.

What are criteria for evaluating options for reform of the Social Security system? You are all familiar with the very great complexity of this system. The fact is that it has been over six decades in evolution. It reflects the collective judgment of policymakers like yourselves and of several prior generations in evolving a very complex and important system for providing income to people when they have a loss of income because of retirement, disability, or death of a worker in the family.

There are two primary considerations for evolving a plan for Social Security. One is the relationship between equity and adequacy that David Walker spoke to and also addressed in describing the benefit structure.

The other is the nature really the nature of the financing and the financial status of the Social Security Trust Funds under the particular plan. The work that we do in the Office of the Chief Actuary relates very largely to the latter of these, to assessing the financial status of the trust funds under the program.

As you are familiar, we are at this point in time in pretty good shape for Social Security financing—to 2013 by everybody's assessment, and out to even 2032 from the point of view of the solvency of the trust funds under our intermediate assumptions.

For that reason, I will focus in the remaining moments here on some concepts of the long-range financial status of the program and some of the measures that we think of when we try to evaluate these concepts.

The fundamental criterion for the solvency of the Social Security system has to be the ability to pay benefits in full on a timely basis. When we reach the point of trust fund exhaustion, that means we will not be able, under current law, to pay benefits fully on a timely basis. The taxes will be insufficient, and the trust fund will be exhausted.

The most commonly cited single value or measure of the status of the trust fund is the term referred to as the actuarial balance, which is a representation of the summarized present value of the system's income relative to the summarized present value of the system's outlays over the next 75-year period. Currently, the number that we are all familiar with is that this actuarial balance is a negative 2.19 percent of payroll. As a negative, we sometimes refer to it as actuarial deficit. One possible way of interpreting this 2.19 percent deficit is that if we were, starting today, to raise the payroll tax rate from its current level of 12.4 percent up to about 14.6 percent, raise it by 2.2 percent of the payroll, that would be sufficient to put the system in balance and make benefits payable over the next 75 years. And I would hasten to add that this 2.2 is really only intended to be a marker and not any indication by any of our forefathers that this should be the way that should be pursued for putting Social Security back into balance. Any combination of benefit changes or revenue changes that will, in total, result in the same amount of money equivalent to a 2.2-percent increase in the payroll tax that will be sufficient to put the system in balance.

There is one additional measure. There are actually many others that we could talk about. But there is one additional measure that I would like to mention—that was discussed somewhat with the prior witness—and that goes beyond the actuarial balance for the current 75-year period. With this measure we look at the extent that there is stability in the actuarial balance in the future. We measure the extent to which stability will occur by looking at something referred to as the "trust fund ratio," which is simply the ratio of the amount of money we have in the trust funds at a given moment in time as compared to what annual benefits are. At this point in time, we are approaching a point where we have about 2 years of benefits held in our trust funds. What is critical is that this ratio, the percentage of benefits held in the trust funds is fairly constant toward the end of the period. If this is the case, then we will be in a position where our actuarial balances will not be moving toward negative. They will be fairly stable in the future. So a very, very reasonable way to look for stability in the trust fund financing is whether or not these trust funds, as a percentage of annual outgo, are fairly stable at the end of the period. This, by the way, does not require that the tax income is equal to the outgo at that time. If, indeed, there are funds on hand that are generating interest sufficient to not only maintain the level of the trust funds, but also help pay for some of the benefits at that time, then it is possible to have the tax income fall somewhat short of the cost of the program.

This concludes the remarks that I would like to pass on to you at this point and would very much enjoy hearing any questions you might have.

[The prepared statement follows:]

Statement of Stephen C. Goss, Deputy Chief Actuary, Office of the Actuary, Social Security Administration

Mr. Chairman and members of the Subcommittee, thank you the opportunity to describe the work of the Office of the Chief Actuary in assessing the financial status of the Social Security program.

The Social Security Act requires that the Board of Trustees report annually to the Congress providing the expected operations and status of the Old-Age and Survivors Insurance (OASI) and Disability Insurance (DI) Trust Funds for the next 5 fiscal years and "a statement of the actuarial status of the Trust Funds." The Office of the Chief Actuary works with the trustees in the development of this annual report of the financial status, under present law, of the program.

In addition, the Office of the Chief Actuary provides to the Administration and to the Congress estimates of the financial effects on the Social Security (OASDI) program of potential or proposed legislation. The mission of the Office of the Chief Actuary is to provide objective analysis that will permit policymakers to make informed decisions about the future of the Social Security program.

Current Financial Status of The Social Security Program

The Social Security program currently provides monthly benefits to about 44 million individuals. The primary source of financing is a payroll tax on the nearly 150 million workers in covered employment. Tax revenue currently exceeds the cost of the program, so the trust funds are growing. Trust funds are currently almost twice the size of the annual cost of the program, and growing.

Based on the intermediate assumptions of the 1998 Trustees Report, tax income to the OASDI program is expected to exceed cost until 2013. The combined OASI and DI trust funds are expected to continue growing until 2021. The combined trust funds are then expected to decline until they are exhausted in 2032.

At the point of trust fund exhaustion in 2032, continuing tax income is expected to be equal to 72 percent of the cost of the program.

Criteria for Evaluating Options for Social Security Reform

The Social Security program is a complex system developed over more than 6 decades to provide monthly benefits that offer what has been referred to as a "floor of protection" against loss of income due to retirement, death, or disability. The program provides a blend between individual equity and social adequacy that has evolved through the judgement of several generations of policymakers.

Both Annual Trustees Reports and estimates by the Office of the Chief Actuary for legislative proposals focus primarily on the financial status of the OASDI program. Because current program financing is expected to be adequate for the full payment of benefits on a timely basis for over 30 years, I will describe the criteria used for evaluating the "actuarial status" of Social Security over the long run.

The actuarial status of the OASDI program is evaluated over a 75-year, long-range projection period. This period provides a view of the adequacy of financing over the entire lifetime of virtually all current participants in the program, from the oldest beneficiaries to the youngest workers. This period also provides the opportunity to view the full, mature financial effects of legislative proposals that may take decades to become fully implemented.

The most fundamental criterion for evaluating the financial status of the OASDI program is its ability to pay full benefits in a timely manner. The inability to do so is indicated by expected exhaustion of the trust funds within the 75-year period.

Perhaps the most commonly used measure of long-range solvency of the OASDI program is the actuarial balance. This measure indicates the size of the difference between expected financing and cost for the program over the 75-year period, on a summarized present-value basis. An actuarial balance of zero indicates that financing over the 75-year period is equal to the expected cost of the program, with enough left over for a trust fund balance at the end of the period equal to the annual cost of the program.

The actuarial balance is expressed as a percentage of taxable payroll over the 75-year period. Under the intermediate assumptions of the 1998 Trustees report, the estimated actuarial balance is −2.19 percent of taxable payroll. Because this balance is negative, it is referred to as an actuarial deficit. This actuarial deficit indicates that long-range Social Security solvency could be restored by an immediate increase in the combined payroll tax rate of about 2.2 percentage points, from 12.4 to 14.6 percent of taxable earnings, or by any other combination of revenue increases and benefit reductions with the same long-range financial effect.

An additional important measure for evaluating the actuarial status of Social Security is the stability of the financing at the end of the 75-year period. Financial stability is achieved at the end of the period if total program income is sufficient to meet the costs of the program and to maintain stable trust fund reserves. Stability of trust fund reserves means that the trust fund balance expressed as a percentage of the annual cost of the program (the "trust fund ratio") is essentially constant.

The Office of the Chief Actuary will continue to work with the Administration and the Congress, as policymakers develop and consider various options for addressing the long-range financing issues facing the Social Security program.

I will be happy to answer any questions.

Chairman SHAW. Thank you, Mr. Goss.

We have two votes that are on the floor. It is the intention of the Chair to continue this hearing through the lunch hour as not to unduly inconvenience any of our witnesses—either you, Mr. Goss, or the panel that is going to come after you. We will stand in recess just long enough to conclude our voting, and then we shall return.

[Recess.]

Chairman SHAW. Mr. Goss, the President, in his recommendation on Social Security, took 62 percent of the surplus and ran it back through the Social Security Trust Fund, then I believe he took 20 percent of that and invested it in equities; and then the funds that came out the other end that were not invested in equities, which is 80 percent of the 62 percent, he then used to retire publicly owned debt—I say publicly owned—to mean debt owned by other than the Federal Government or the trust fund. Now, let me ask you this question: What did that do from an actuarial standpoint to the life of the trust fund?

Mr. GOSS. From an actuarial standpoint, the money that would be specified to be transferred to the trust funds. Our understanding of the way in which that transfer would occur is that it would be specified as a percentage of taxable payroll in the law so that the money would absolutely be transferred to the trust funds. And as you say, 20 percent, actually 21 percent, of it—of the transfer each year would be invested in equities up to a maximum of about 15 percent of the total trust fund assets being held in equities.

From the point of the view of the trust fund, the additional money that would be transferred to the Social Security Trust Fund——

Chairman SHAW. This includes the Treasury bills?

Mr. GOSS. Pardon?

Chairman SHAW. That includes the Treasury bills?

Mr. GOSS. Including the Treasury notes, absolutely. The additional money transferred to the trust fund, which I think has been widely described as totaling about $2.8 trillion dollars over the 15-year period, would be added into the trust funds in our calculation and would augment the trust funds both in the bonds and in the stock reserves, and those amounts of money would be presumed to be available when needed for benefits in the future.

Chairman SHAW. In the form of Treasury bills?

Mr. GOSS. About 85 percent of the trust fund, once we got out to the year 2015, would be in the form of the special issue Treasury bonds, and the other 15 percent would be presumed to be held in equities.

Chairman SHAW. So that extended the life of the trust fund to what—2045?

Mr. GOSS. In total with the purchase and holding of stock included, our estimate is that the trust fund exhaustion date would be extended to the year 2055.

Chairman SHAW. Now, that money, if you go back and look at the way the unified budget is structured, it could certainly be argued that that money has already been through the trust fund once. What if you were to take that money that came out of the other side and ran it through again? And then my next question is going to be, and then again? And then again? And then again? Would you push that 2045 and keep pushing that even though you are using the same money because you are putting more and more Treasury bills in the Social Security Trust Fund, is that not correct?

Mr. GOSS. Our view is that a crediting to the trust fund of money for which bonds are purchased does, indeed, represent a commitment of the Federal Government to provide revenue to the trust funds at a future point when they are needed. And so I would agree with you that by making a transfer that would purchase these bonds we would, indeed, be creating a commitment to provide the revenue in the future, and we would look at that as having improved the actuarial status of the trust funds. The one further point that I guess I would say——

Chairman SHAW. So, if it was a good idea to run it through once, it is a good idea to run it through 3 or 4 times, 5 times, 10 times, 20 times. I mean, you can keep running this money through and inflate the trust fund, and then at the end you will still have the money left to retire some of the debt. And you have created a fiction, and that fiction is that the trust fund is out there with assets ready to take care of people when they retire without being a future call on the taxpayers or requiring any further revenue.

Mr. GOSS. If I may just add, Mr. Chairman, as I think you all know, our view on the President's proposals, or proposals that are developed by Members of Congress, is not to judge any of them as to whether or not——

Chairman SHAW. No, no. I am not asking you to judge it. I am asking you strictly from an actuarial standpoint—just strictly from the question—I mean, the more Treasury bills you put in the trust fund, the greater—the further that line is going to be drawn out as to when the trust fund is going to run out of Treasury bills, because Treasury bills is all that is in there disregarding the fact that the President's plan puts a few stocks in there.

Mr. GOSS. It is true in the assessment that we make that to the extent that there are more Treasury bills available to the fund that that will, indeed, advance the exhaustion date. The only remark that I would suggest, and I am, by no means, here as an apologist for the administration or any other entity——

Chairman SHAW. No, I am not getting into that. I understand, and the Social Security Administration—your office has been very helpful to this Subcommittee, and I am in no way suggesting that your answers would be in any way skewed. So do not worry about that.

Mr. GOSS. If I could, Mr. Chairman, just reiterate the point that you made earlier about the President's plan, keeping in mind that we are not terribly familiar with the budget aspects of this, more with the actuarial aspects, but it is my understanding, as you stated, that the rationale for having the transfers occur is to have publicly held debt reduced by some amount along the lines of the amount of the transfers to Social Security. However, if, as you suggest, this were done a second or a third time, there would not be any further reduction in publicly held debt.

Chairman SHAW. Wait a minute now. Let us back up, because I missed a bit there. Let us just get away from the President's plan, even though there is going to be great similarity in what I am talking about. We run 62 percent of the surplus through the trust fund. Period. We do not buy equities or anything else. We have extended the life of the trust fund, actuarially.

Mr. GOSS. Absolutely.

Chairman SHAW. And when it comes out the other end if we run it through again, we are going to do that again, and again, and again, and again. So you can, in effect, use those same dollars, and if you run it through enough times, you can run the life of the trust fund out to 2000 whatever you want. 2075. 2100. I mean, if you redundantly push that money through and keep writing more and more Treasury bills, obviously you are putting more paper into the trust fund, and you are extending the life of the trust fund. But you really have not changed the year in which we are going to have to seek additional revenue to take care of the claims, is not that correct?

Mr. GOSS. That is true, Mr. Chairman.

Chairman SHAW. So in my example, you have not changed that year 2013? That 2013 is still out there, and it is still a date of reckoning on which the Congress is going to have to make a tough decision, either raise FICA, hopefully there would be surplus that they could use, or raise taxes. I mean, some way there has got to be some dollars brought into the government—additional dollars made available that do not come out of the trust fund that would be paid to beneficiaries under the Social Security Act.

Mr. GOSS. That is absolutely true. The distinction that I think is reasonable to make in this case, though, as to where the trust fund does have these bonds as opposed to having no trust fund—having the trust fund being exhausted—is that there would be a commitment of—indicating what the source of revenue would be that would be providing the benefits in that period. If there were no trust fund or the trust fund were exhausted, then we would be left up in the air as to whether we should——

Chairman SHAW. What is wrong with the trust fund that concerns me most. I mean, if a lawyer takes his trust fund and goes and pays his mortgage or buys himself a speedboat or something of that nature, and puts an IOU in the trust fund, and then the examiners come along, and he says, well, geez, there is plenty in there. See those IOUs? But the day of reckoning is coming, and that is the problem that we have. And that is the problem we are wrestling with. And that is the problem we are stuck with, where we have to find real cash in order to take care of the retirees of the future.

One of the things in Mr. Walker's presentation that I thought was particularly scary was where he was showing the number of workers that were there to support each retiree. And it is getting down close to two workers per retiree, which is totally unacceptable and unaffordable, particularly for low-income people. And that is—that is what I am so concerned about. And that is what I think we really need to concentrate on. Mr. Cardin?

Mr. CARDIN. Thank you, Mr. Chairman.

Mr. Goss, first, let me thank you for your help to those Members of Congress who have been asking for information on how to deal with the Social Security system. You have been very helpful, very objective, and I think that is extremely important that we have that type of resource available to us. The Chairman's comments about what impact would it be if we put more special notes or more government notes into the Social Security system—I think we gave a very accurate reply. But, as you pointed out, there is also the budget of the Nation. And if you try to run more of the special notes into the Social Security system, you will be running afoul of our budget system. The President's proposal takes 62 percent of a surplus that would otherwise be available for government spending; could be available for tax cuts; could be available for any host of reasons, but the President's proposal, as I understand it, pays down the publicly held debt, and gives the Social Security Trust Fund additional assets that you correctly analyze under an actuary system of extending the life of the Social Security—ability to pay its benefits, current obligations.

The second point I would like to make is that the President's proposal also has a better return for the Social Security Trust Fund. And that is real dollars in the extent that that would extend the 2013 date; that there would be additional funds available as a result of a better rate of return to the system. I am correct on that, as I see you nodding. I am curious that if we all did what we said we would like to do, and that is make this a real trust fund, a real trust fund with real assets that invests like fiduciaries would invest. And if we transfer this 62 percent into the Social Security Trust Fund, as the President has suggested; and we then allow the trustees to do what any other trustee of any other pension plan could do and invest, as the trustees believe is best; and the trust invested about 60 percent to 65 percent of its assets in equities, which is what is happening in the real world out there. And the remainders were invested in some types of fixed-rate returns, but better than what they are doing on government bonds, which is the lowest rate of return. I am curious as to how you would evaluate that in regards to the 75-year solvency. It seems to me that we would be much further along, and following much more the practice of the private sector which many Members of Congress have been urging that we do. So I just appreciate your assessment as to what impact that would have on the—our goals of achieving a 75-year solvency?

Mr. GOSS. Thank you very much, Representative Cardin. In the analysis that we have done in the past, for instance, for the Advisory Council, where they had a plan that would, in fact, have 40 percent of the trust funds invested in stock, we utilized an assumption that was developed within discussions with the Advisory Council members, presuming that stocks would have a seven percent real yield, which is about the average of what stocks have realized so far this century. Using that in conjunction with the assumed yield on the government bonds for the other 60 percent, I believe that the roughly 2.2 percent long-range deficit for the system was reduced by about 0.9 percent of payroll. It was reduced by not quite half. If, as you suggest, we were to go to 60 or 70 percent in stocks, presuming that we would be able to achieve the same yield over and above the price of bonds, and in addition, put the other 30 to 40 percent in corporate bonds, which we believe according to the Ibbotson data is indicated to be about one-half a percentage point higher yield than the government bonds, you would probably eliminate something on the order of two-thirds of the long-range deficit of Social Security.

Mr. CARDIN. And then, if you transfer the 62 percent of the surplus into the trust fund, you get another seven or 8 years, do you not? And then, of course, you have more assets to invest so that has another impact. It seems to me that you are going to be very close if not exceed the 75-year solvency if you were to combine the President's transfer of the surplus into the fund, and then invest like any other pension fund—whether it is a State of Maryland pension fund, or State of California pension fund, or a private company pension fund—if you were to invest in a similar manner, you could deal with the problems.

I just mentioned that because—I am not making that as a suggestion; I am not making that as a proposal, because, obviously, the Social Security Trust Fund is very delicate, and we need to deal with it in a special way. But there are many here who are saying, why do not we just make this like a trust fund? And it seems to me that if we did, we would solve a large part of the problem that is out there; if we just allowed the trustees to do what any other trustee of a pension plan could do, a large part of the problem would be solved in real dollars, as the Chairman likes to mention. This would be real money coming in, because of a better rate of return.

I thank the Chairman.

Chairman SHAW. Oh, Mr. Collins.

Mr. COLLINS. Mr. Goss, do you have deductions from your income that go into Social Security?

Mr. GOSS. I am sorry, Representative?

Mr. COLLINS. Do you have deductions from your income that are paid into Social Security? Are you a member of the Social Security system?

Mr. GOSS. As a Federal employee, for better or for worse of fairly longstanding, I am still, at this point, under the Civil Service Retirement System, so my earnings at SSA are not under the current Social Security system.

Mr. COLLINS. You do not have. You do not participate in the Social Security system?

Mr. GOSS. That is correct.

Mr. COLLINS. You opted not to. Are you part of the program that did not have to go into it?

Mr. GOSS. That is correct.

Mr. COLLINS. So you have a different type of retirement system? You are a part of a retirement system?

Mr. GOSS. I am—as a Federal employee hired before 1983, I participate in the CSRS.

Mr. COLLINS. You belong to the Federal Employees Retirement system?

Mr. GOSS. I participate in CSRS.

Mr. COLLINS. OK, that is all I have.

Chairman SHAW. Thank you, sir. We appreciate your being with us, and we will be looking forward to working with you as this whole thing begins to evolve.

Our next panel is Dallas Salisbury, the president and chief executive officer, Employee Benefit Research Institute; a former staffer of this Subcommittee, Dr. William Primus, who is Director for Income Security, Center for Budget and Policy Priorities; and Louis Enoff, Enoff Associates, Limited, from Maryland. He is a former Acting Commissioner of the Social Security Administration.

We welcome you, gentlemen. Again, your whole testimony is made a part of the record. And you may proceed and summarize as you see fit.

STATEMENT OF DALLAS L. SALISBURY, PRESIDENT AND CHIEF EXECUTIVE OFFICER, EMPLOYEE BENEFIT RESEARCH INSTITUTE

Mr. SALISBURY. Thank you, Mr. Chairman and Members of the Subcommittee.

I appreciate this opportunity to discuss Social Security's goals and criteria for assessing reforms. Social Security, as has been underlined by other witnesses, plays a critical role in providing income to the retired population, the disabled and survivors. The primary goals of Social Security have been reviewed by previous witnesses. I would stress one among them: a benefit that grows in real value by passing on productivity increases and lifestyle increases to retirees, with a benefit formula that targeted replacement of final income as opposed to a constant level of purchasing power. I stress this because of the point raised by Mr. Goss that with a "benefit reduction to about 72 percent, current payroll taxes would, in fact, cover all benefits." In my testimony's chart one, I showed what the benefits would be that would be covered by that, and simply note with interest that it would provide a continuous increase in purchasing power relative to today's retirees. So it gets back to the issue of what is a cut.

In addition, we have talked today about the criteria for reform—whether or not a reform supports the basic goals of the system of providing retirement income; of the redistributive nature of the program; and of long-term financial stability. Whether the reform fully utilizes the present administrative and recordkeeping structure which has relative cost efficiencies; determining whether the reform proposal changes outcomes in terms of tax levels, benefits, income levels, and life income streams; whether the reform proposal reduces risk in the system or increases risk, which goes to the points of Mr. Cardin, that in most private pension funds there have been very wide variations or return, and as the Pension Benefit Guaranty Corporation painfully knows, there have been some pension funds that have gone out of business because their return assumptions were never met; determining whether the reform proposal strengthens, weakens or has no effect on the existing system; and whether the affected public would support the fundamental reform.

We have developed a comprehensive model to attempt to look at some of these issues. That model allows us to look, for example, at issues of equity market investment against various assumptions and on a more dynamic income basis than so-called static assumptions that are traditionally used by actuaries.

One of the assessments we tried to look at was an issue of if one simply took the projected FICA surplus, or in a second case, the projected FICA surplus plus the interest earnings and did that as an investment into the equity markets, whether collectively or through individual accounts. Using a static model that has been used by most estimators, just using this deterministic approach in the FICA surplus would still leave a 75-year deficit of eight-tenths of 1 percent.

If one invested the FICA surplus plus, the credited interest earnings on a static basis, it would produce at actually a 75-year surplus of 0.46 percent.

Regrettably, the world is not deterministic. Markets go up. Markets go down. Economies ebb and flow. And using the dynamic portion of this model, more similar to what is used by Wall Street firms to assess financial risk, we find that using this the FICA surplus only is more likely to create a deficit of 0.97 percent, and even using that plus interest income, a dynamic surplus of minus 0.7 percent.

I would note that we looked at this, as the charts three and four underlined, as to cases where scenarios would produce positive returns and in approximately 15 percent of the scenarios, those would be positive instead of negatives.

Last, collective investment, I would note, which is what these estimates did look at do not include some of the administrative costs or startup costs that would be attributable to individual accounts or annuitization costs, so we have actually provided a slightly more optimistic picture than would otherwise be the case.

Administratively, I would also note that the current Social Security Administration, with its approximate cost of $10 per participant, per year, that $9.30 of that cost is actually the cost of paying the annuities. Only 70 cents is for the basic administration of the ongoing system. So some of the comparisons to date—most assessments of using individual accounts do not factor in that annuitization issue.

In concluding, Mr. Chairman, I would simply note that we have included in our testimony as well an analysis of the implications for private employer plans and proposals such as the administration's USA proposal and would be happy in the future to do a specific analysis using the model for all Members of the Subcommittee. Thank you.

[The prepared statement follows:]

Statement of Dallas L. Salisbury, President and Chief Executive Officer, Employee Benefit Research Institute

The views expressed in this statement are solely those of the author and should not be attributed to the Employee Benefit Research Institute, or the EBRI Education and Research Fund, its officers, trustees, sponsors, or staff, or to the EBRI–ERF American Savings Education Council. The Employee Benefit Research Institute is a nonprofit, nonpartisan public policy research organization that does not lobby or take positions on legislative proposals.

Mr. Chairman and Members of the Committee. I appreciate this opportunity to discuss Social Security's goals and criteria for assessing reforms.

I appear today as President of the Employee Benefit Research Institute (EBRI), a non-profit research organization located here in Washington DC. EBRI does not lobby or advocate specific actions, but has worked for over 20 years to provide objective data and analysis that allows policy proposals to be evaluated.

Our first book on Social Security was published in 1982,[1] and we have conducted much work[2] since then that has documented the critical role Social Security plays in providing income to the retired population, as well as to the disabled and survivors. The primary goals of Social Security have been to provide:

- A foundation of income for all Americans—which it has done.
- A nearly adequate income for the lowest-income Americans—which it does.
- Income protection against the "risk" of living much longer than one plans, or the actuarial tables suggest, by paying a life annuity that is indexed for inflation—which it does.
- Dignity for retirees, by having the income paid through a government transfer rather than requiring family members to ask other family members for direct assistance.
- A level of taxation that permits a pay-as-you go program with a small reserve.
- A benefit that grows in real value by passing on productivity increases and lifestyle increases to retirees with a benefit formula that targets replacement of final income, as opposed to a constant level of purchasing power. (This increase in real purchasing power is shown in Chart 1. The chart also shows that increases in real purchasing power would remain, even if benefits were cut to allow for full funding under the present level of the FICA tax.)

Chart 1:

Projected Future Annual Social Security Benefits for Retirees (Various Years)

Year	NRA 98$ Promise	With FICA Frozen	Age 65 98$ Promise	With FICA Frozen
1998	$16,124	$16,124	$16,124	$16,124
2050	$28,717	$19,240	$24,697	$16,547
2060	$31,314	$20,980	$26,931	$18,043
2065	$32,700	$21,909	$28,124	$18,843
2070	$34,145	$22,877	$29,367	$19,676
2075	$32,655	$21,878	$30,666	$20,546

Many reform proposals now being discussed would change these goals to some degree. The criteria for assessing reforms should be to:

- Determine whether a reform proposal supports these goals, or changes them, and whether proposed changes are acceptable.
- Determine whether the reform fully utilizes the present administrative and recordkeeping structure, and if not, whether the reform proposal is feasible for implementation.
- Determine whether the reform proposal changes outcomes in terms of tax levels, benefit/income levels, and life income streams.
- Determine whether the reform proposal reduces risk in the system or increases risks.
- Determine whether the reform proposal strengthens, weakens, or has no affect on the existing system.
- Determine whether the affected public supports any fundamental reforms.

Our 1997 book, "Assessing Social Security Reform Alternatives,"[3] contains a first chapter which provides a detailed list of sub-questions in each of these areas. Our just-released 1999 book, "Beyond Ideology: Are Individual Social Security Accounts Feasible?"[4] applies this methodology to individual account proposals.

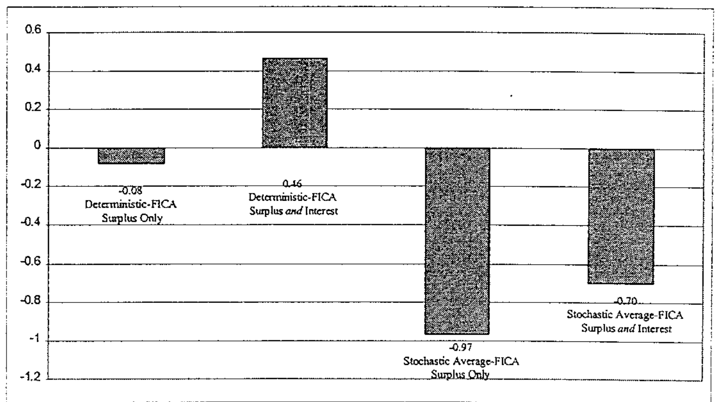
Also, the EBRI–SSASIM2 model that we have developed allows comparisons making use of analytic methods that are more complete and dynamic than what is being used by many advocates. Our model allows for the use of equity market return assumptions that are consistent with economic growth assumptions, and utilizes a thousand economic scenarios that introduce a full range of possible economic outcomes, as opposed to doing static straight-line projections. Our model uses earnings projections that reflect actual lifetime income patterns (based upon Bureau of Labor Statistics data), as opposed to the "unisex flat earnings for typical households" used by most analyses. This permits assessment of effects on more than just the "average" worker, and allows more accurate measurement of "rates of return" on individual accounts. Our model allows analysis of alternative forms of transition costs, and alternative payment periods for these costs (40 year versus 70 years, etc.).

Equity Investment of the Annual FICA Surplus

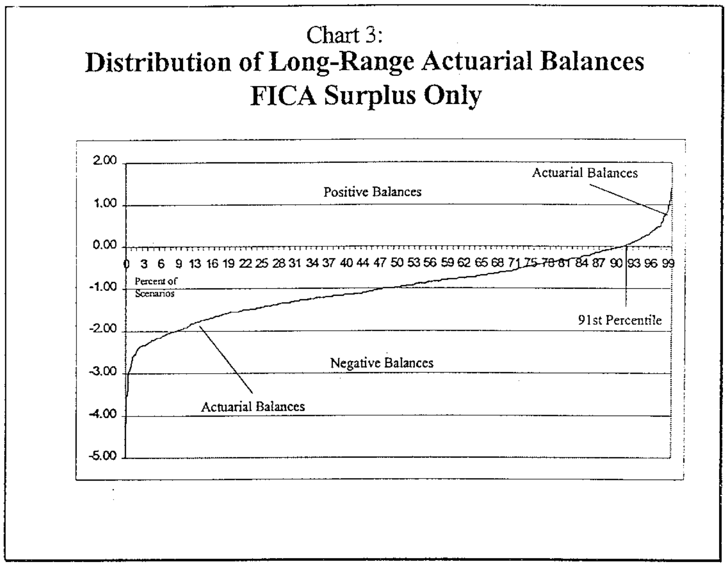
One use of the EBRI model is to assess the program finance outcome of investing the annual FICA surplus—the annual amount of FICA taxes above the costs of the program for a particular year—into the equity markets or into individual accounts for workers. We modeled (first) the collective investment in equities of just the FICA surplus, and (second) the FICA surplus plus interest payments on the existing trust fund balance (which would remain in special-issue U.S. Treasury bonds). Using the actuarial assumptions from the1998 Social Security Trustees Report, when the model is in deterministic mode, the FICA-surplus-only investment has a 75-year actuarial balance of −0.08 percent of taxable payroll; but if the FICA surplus plus the interest from the bond investment is added, the actuarial balance becomes positive at 0.46 percent of taxable payroll (see Chart 2).

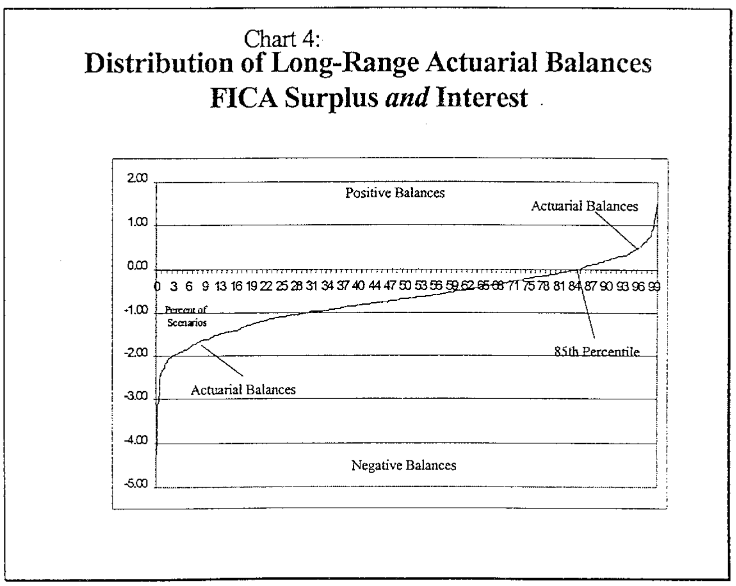
Chart 2:

Long-Range Actuarial Balance of Investing Annual FICA Surplus in Equities



But the real world is not deterministic, it is dynamic. Therefore, the model was also run in stochastic (or random) mode to evaluate what would happen if the future were allowed to have ups and downs in the economy, as it has in the past. In this mode, both levels of investment yielded an average negative 75-year actuarial balance of −0.97 percent of taxable payroll for FICA surplus only, and −0.70 percent of taxable payroll for FICA surplus plus interest. When examining the various scenarios, 91 percent of the scenarios resulted in a negative 75-year actuarial balance for the FICA-surplus-only case, while 85 percent of the scenarios had a negative 75-year actuarial balance for the FICA-surplus-plus-interest case (see Charts 3 and 4).





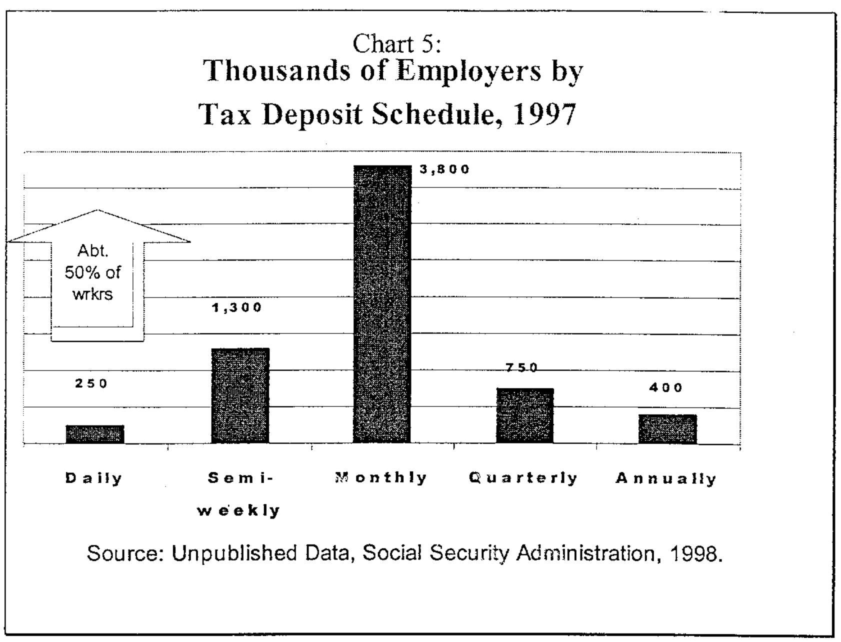
This would be a best-case scenario because all of the surplus would be placed into equities, whereas if individuals were allowed to invest in individual accounts as they saw fit, some of the surplus would be invested in bonds. Furthermore, in our modeling we forced the equity percentage to increase by more than the annual FICA tax surplus regardless of the performance of equities over the 12-year period. This is realistic, since over 12 years it is highly improbable that bonds would outperform equities. In addition, once the program began to have expenses greater than revenue, funds were drawn down in a manner that left the equity percentage the same. Therefore, the investment in equities had a chance for long-term returns. Lastly, collective investment does not account for all the additional start-up and administrative costs that would result from creating individual Social Security accounts, and these costs would be significant.

Regarding administration, our analysis finds that a system of personal accounts would involve a number of distinct operations:

- First, employer deduction of payroll taxes and transmittal to a third party, with ultimate transmittal of records on whom each dollar belongs to.
- Second, receipt of the funds by a trust company or financial intermediary.
- Third, receipt of full information on the employee and the amount of money that went to the financial intermediary.
- Fourth, notice to the recordkeeper and the financial intermediary of how the money is to be invested.
- Fifth, either investment by the intermediary or the transmittal to an investment manager.
- Sixth, regular reporting on investment results to the recordkeeper so that account balances can be maintained.
- Seventh, a system for servicing the worker's account and providing information on the account, the investments, and details on choice.
- Eighth, education of the worker on the personal account system, what "investments" are, what a bond, a stock, and cash are, and on what actions they can or must take regarding his or her individual account.
- Ninth, a system for communicating ultimate annuity options and then paying the annuities. Each of these steps involves costs, with most estimates provided to date leaving out many of these costs, or providing ranges based upon frequency of choice designed into the system. Those studies make clear that the more responsive the system, the more expensive.

ADMINISTRATIVE CONCLUSIONS

A system of personal accounts that applies to all who now pay Social Security taxes can only function at reasonable administrative cost if it takes full advantage of the present system of payroll tax deposits. Over 5 million employers still file all records on paper, and many make deposits only once each year (see Chart 5). Other approaches could be implemented but only at much higher cost to employers, workers, and the government.



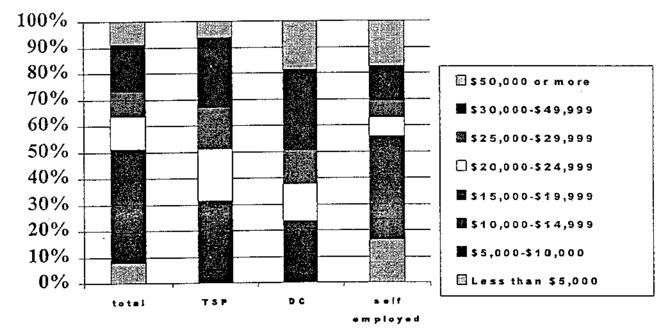
An individual accounts system that seeks to use the income tax system would be more difficult to make universal and would be more difficult to enforce, as it would be tied to over 140 million individuals rather than six million employers, as is currently the case.

Basing an individual accounts system on Federal Thrift Plan (TSP) or private 401(k) plans as a model is not an accurate comparison, since the covered populations are very different (see Chart 6) and thus the costs of recordkeeping and administration also would be very different. This is most true of wage levels, and thus the expected amount of annual contributions per account. Again, using the TSP or 401(k) model for individual Social Security accounts would involve much higher costs for employers, workers, and the government than is incurred under the present Social Security program.

Chart 6:

Distribution of Annual Earnings: Total Workers vs. DC Participants

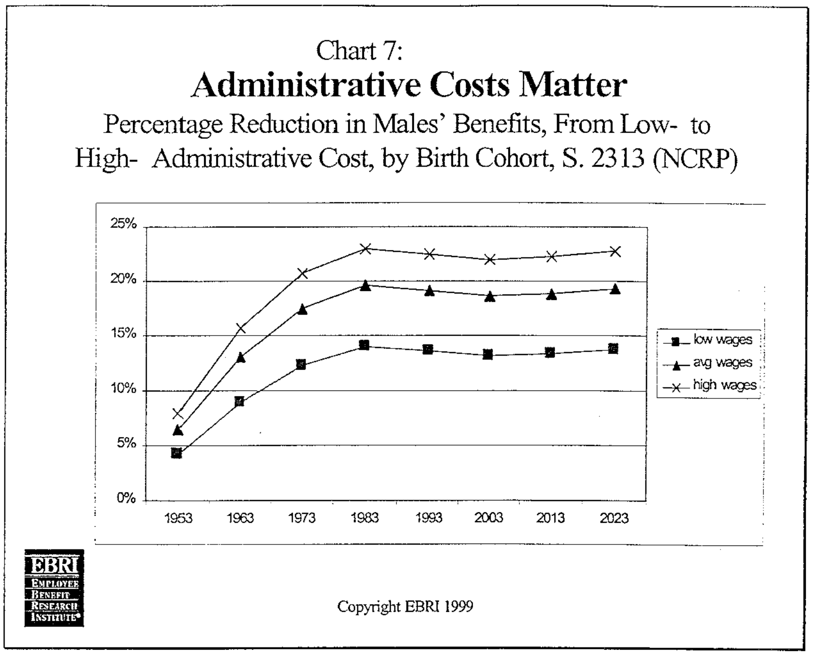
Excluding self-employed and govt employees



Source: unpublished tabs of Apr. 93 CPS supplement and 1990 Survey of TSP Participants

A major cost of any retirement program is the ultimate cost of paying benefits. Only with an ultimate annuity form of payment can a personal account be compared to the present system in terms of economic security. Social Security currently spends over 90 percent of its total administrative expense on annuitization and benefit payments.

Most analyses to date of individual accounts do not include an estimate of this cost. As shown on Chart 7, administrative cost can substantially reduce benefit levels. Even without annuity cost, a recent analysis by the CATO Institute suggested costs of $55 to $115 per worker per year for just the cost of account administration and funds investment. This did not include any expense for (1) education, or (2) compliance. The CATO analysis notes that any frequent reporting to workers, frequent investment changes, loans, or other features could substantially increase costs. A recent report from the Heritage Foundation notes that the system could make use of Electronic Funds Transfers to hold down employer costs, and suggested credit bureaus as the model for individual Social Security account administration. Most employers in the United States currently report their payroll taxes on paper, and the static records of credit bureaus have little of the dynamic nature of a personal investment account.

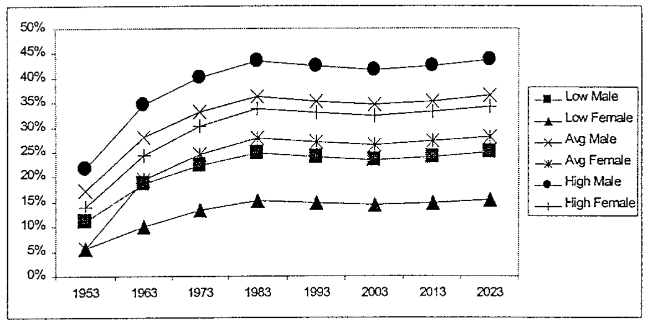


BENEFIT EFFECTS OF INDIVIDUAL ACCOUNTS

When assessing reform proposals against the current Social Security system, it is important to note that an individual account provides a *proportional* benefit, meaning an equal percentage of pay contribution at each income level. As a result, the redistribution in the current system, or the "non-proportional" delivery of benefits, is not reinforced by individual accounts. This is shown graphically in Chart 8, as the higher an individual's income, the higher the proportion of total benefits that derive from the individual account.

Chart 8:

Percentage of Benefits From Average-Cost IA by Birth Cohort, S. 2313 (NCRP)



USA ACCOUNTS IMPACT ON EMPLOYER PLANS

Whenever public or private employers want to create a retirement program, they must make a number of decisions. Since most employers have more than one retirement plan, part of the reason for careful analysis is to avoid causing harm to other programs. Depending on how it is designed, a Universal Savings Account (USA) could be designed to avoid adverse consequences for employer plans, or it could potentially cause nondiscrimination problems for a significant percentage of employer plans. It is premature to predict what the eventual outcome of these "testing problems" may be on a plan-specific basis; however, most sponsors would need to consider a redesign—perhaps a drastic one—of their plans, and undoubtedly some plan sponsors would seriously consider the elimination of their plans. Termination of plans could reduce retirement savings, the opposite of the intended result of USA account creation. The primary employer design factors for retirement programs are as follows:

Possible USA Features	Option I	Option II
1. Employer Contributions	Taxable Now	Tax Deferred
2. Worker Contributions	Taxable Now	Tax Deferred
3. Investment Earnings	Taxable Now	Tax Deferred
4. Matching Contributions	Amount of Match (50%; 100%).	Amount of Contribution Matched (x% of pay or some flat amount)
5. Timing of Contributions	End of Year	Each Pay Period
6. Investment Options	One/Few	Many

The characteristics in bold are the most common in employer-sponsored individual account plans today. To the degree that a new mandatory universal government program were *less generous* employer plans, one would expect that employees would continue to participate in the employer plan. For example, if the employer's 401(k) plan offers no match but includes payroll deduction each pay period and several investment options, while the government plan offers no match, few investment options, and a contribution once each year, the worker would likely remain in the employer plan.

However, to the extent that a new mandatory universal government program were *more generous* than employer plans, one would expect that employees would stop or reduce their participation in the employer plan. For example, if the employer plan offers no match, payroll deduction each pay period and several investment options, while the government plan offers a 50 percent match up to $600 in worker contributions, few investment options, and a contribution once each year, the worker would likely drop out of the employer plan and move funds to the government plan in order to get the match.

To the extent that the new plan has the worker's contribution come out of taxable income, so that taxes are not deferred, then the balance shifts back in favor of the employer plan, all other things being equal. For example, if an employer has no matching contribution, a government program with a match could affect participation in the employer plan.

Why Would It Matter if Workers Reduce Their Participation In Employer Plans?

The tax laws that apply to employer plans are extensive and complex. Most relevant here are the "nondiscrimination rules," which, put simply, "test" 401(k) plans for relatively equal deferrals (expressed as a percentage of compensation) between lower-paid and higher-paid workers. In general, for "highly compensated employees" (known as HCEs, or those paid $80,000 a year or more) to contribute to a retirement plan, the "non-highly compensated employees" (NHCEs, or those paid less than $80,000 a year) also must do so.[5] Further, what the HCEs can contribute to the plan is a direct function of what the NHCEs contribute. This means that if the lower-paid workers choose not to participate or contribute, the higher-paid workers would be substantially frozen out—and there would be no reason for the employer to sponsor the retirement plan.

As a matter of public policy, Congress could also make this issue irrelevant by *repeal* of the nondiscrimination rules that apply specifically to 401(k) plans.[6] If this happened, the level of participation by the NHCE group would not matter to the HCE group. But since repeal is unlikely, we provide analysis.

The Clinton administration, it must be noted, has been meeting with many groups in an effort to complete the design of its USA program in a form that would not have an adverse impact on employer plans. It is our hope that this good-faith effort by the administration will lead to design decisions that minimize or avoid any adverse impact on employer-based plans.[7] This analysis is provided to assist in those efforts. For example, a USA-type plan design that:

- Provides an automatic (non-matched) employer/government contribution that is tax-deferred (the same as in a 401(k) plan);
- Requires employee contributions to be taken from taxable income (while 401(k) contributions are tax-deferred); and
- Provides no matching contribution;

would clearly provide a set of limited incentives which would be insufficient to cause employees to leave an employer plan, and most employees would consider themselves to be better off contributing to the employer plan (where available) than to the government plan.

Were there to be a government-provided match, however, then workers in an employer plan with no match might be better off in the USA, depending on the level of the match and whether the match contribution is treated as taxable income or is tax-deferred.

For a number of design and administrative reasons, the Clinton administration is unlikely to propose what was mentioned in the State of the Union Message and described through examples in a White House fact sheet. However, we have used that plan for this analysis to show how much of a difference plan design can make and why the administration is wise to work hard on the design issue.

USA Analysis

Recently the Employee Benefit Research Institute and the Investment Company Institute have completed a two-year study of the 401(k) market[8] which has yielded detailed individual participant records (including demographic information and contribution behavior) from more than 27,000 plans. Due to strict confidentiality standards, no information on the plan sponsor's identity was included. However, the database does break out source of contributions (e.g., employee before-tax, employee after-tax, employer matching, qualified non-elective contributions (QNECs), etc.) and we are currently working on a set of computer algorithms to classify each plan by the types of incentives provided to employees at various contribution levels (e.g., a

2 percent QNEC plus 100 percent match for the first 3 percent of compensation and a 50 percent match for the next 3 percent of compensation).

When completed, this analysis will provide unique insight into how participating employees at various compensation levels may be expected to react to various formulae adopted by the employer. It will also provide the basic framework for sensitivity analysis into the likely impact of modifications in the 415(c) and/or 402(g) limits.

Given the political timeline, we do not have the luxury of completing the pattern recognition algorithms necessary to identify the contribution formulae of 27,000 plans. However, we have taken a random sample of 6,700 plans to provide some initial insights into this policy. While this is just a small fraction of the year-end 1996 information we have collected, we believe it is still much more comprehensive than any other research database in existence.[9]

It is important to note that for the preliminary analysis we are substituting the participant-specific average employer match for the marginal match.[10] The analysis conducted by Yakoboski and VanDerhei (1996) and Kusko, Poterba and Wilcox (1994) both demonstrate the need to consider the incentive effects of the employer's matching formulae. Our final analysis of this proposal will provide a general framework for each plan in which the total participant's contribution is modeled as follows: [11]

Total contribution = employee deferral + employer match + QNEC, where:

- Employee deferral will be subject to Internal Revenue Service Sections 402(g) and 415(c), and potential ADP/ACP restrictions,
- Employer match will attempt to replicate the contribution formula in place for plan x in year t (e.g., 100 percent match on employee contributions up to the first 3 percent of employee compensation plus 50 percent match on additional employee contributions up to the next 3 percent of employee compensation),[12] and
- QNECs are determined as the amount of employer contribution that is provided regardless of employee deferral (e.g., 2 percent of compensation).

This substitution of variables would be expected to bias the results if we were attempting to analyze contribution behavior at the margin for the types of formulae seen in actual 401(k) plans where there is expected to be a significant decrease in contribution incentives after approximately the first 6 percent of compensation and a complete ban on deferrals after the first $10,000.[13] However, as long as our analysis reflects only the relatively small level of employee contributions discussed thus far (i.e., no more than $600 per year), this substitution is not likely to be significant.

For purposes of passing a nondiscrimination test unique to 401(k) plans (the so-called ADP tests), it is of utmost importance that non-highly compensated employees choose to participate in the sponsor's plan. It is logical to assume that if any employee with limited investible funds finds an alternative arrangement with a higher match rate that they may choose to reallocate some or all of their future contributions from the 401(k) plan to the USA plan. To what extent is this likely to happen in the existing plan population? Our findings are summarized below.

Methodology

The analysis consisted of the following steps:

A representative random sample of approximately 6,700 401(k) plans was taken from the EBRI/ICI 401(k) database in which there was sufficient information to determine employee deferral percentages and employer match rates for at least 90 percent of the participants in the plan.

Average match rates for each participant with the requisite information were computed.

Each participant was categorized as to whether they were a highly compensated employee (HCE) or non-highly compensated employee (NHCE).

Each participant was categorized as being "at risk" or not. We defined a participant to be in the former category if the employer average match rate was less than 50 percent.[14]

Average deferral percentages were computed for each plan for the HCEs (ADP_H) and the NHCEs (ADP_N).

Each plan was tested to see if it passed the basic ADP test: $ADP_H \leq ADPN * 1.25$.

Each plan was tested to see if it passed the alternative ADP test: $ADP_H \leq \min(ADP_N * 2, ADPN + 2\%)$.

Any plan that did not pass either of the above two tests was excluded from further analysis.[15]

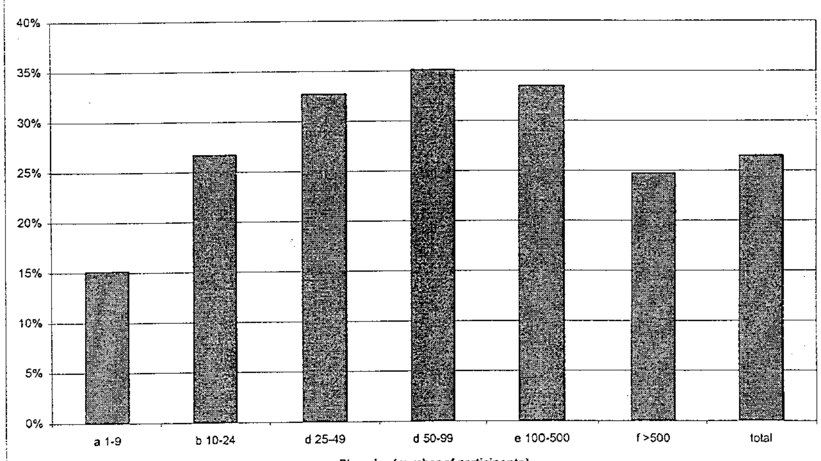
At this stage of the analysis, there are several potential methods of modeling the likely impact from a competing plan with matching contributions. Two methods were chosen to illustrate the importance of behavioral assumptions in quantifying the likely impact.[16]

• *Method One: Assume any NHCE that is "at risk" drops out of the employer's 401(k) plan while HCEs continue their current contribution.*

This "all or nothing" response to a governmental competing matching plans could be justified on several grounds. First, HCEs may not be eligible to benefit from a government match due to potential constraints on adjusted gross income (AGI). Second, it is highly unlikely that employees with salaries of at least $80,000 would leave the employer plan for a 50 percent match on only $600 (at most 0.75 percent of compensation).

The ADPs are recomputed and the percentage of plans that would be in violation of both the basic and alternative tests (assuming no corrective measures were taken) are tabulated and shown in Chart 9.

Chart 9: Percentage of 1996 401(k) Plans "At Risk" for ADP Compliance Under 50% Match, Assuming Complete Migration for NHCEs and None for HCEs, by Plan Size

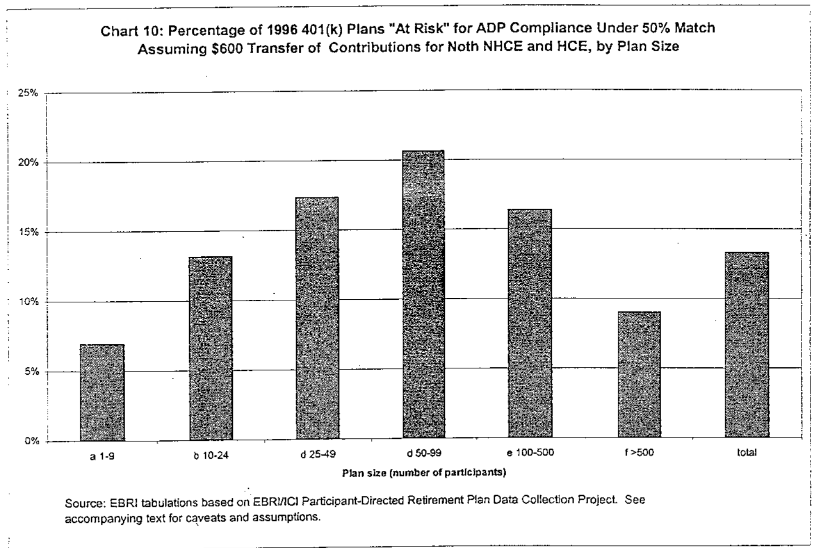


Source: EBRI tabulations based on EBRI/ICI Participant-Directed Retirement Plan Data Collection Project. See accompanying text for caveats and assumptions.

• *Method Two: Allow the substitution to be quantified.*

Given that a significant percentage of NHCEs are deferring more than $600, a problem with method one is that if a NHCE were already putting in $1,000 for a 25 percent match with the employer's current plan, why not assume that they would put in $600 to a 50 percent match for the government's plan and leave the other $400 in the employer's 401(k) plan? This method subtracts $600 (or the participant's current deferral, if less) from each participant and recomputes their ADP's.

The percentage of plans that would be in violation of both the basic and alternative ADP tests (assuming no corrective measures were taken) are tabulated and shown in Chart 10. It should be noted that this estimate of the number of plans impacted would need to be re-estimated if AGI thresholds were imposed for eligibility in the government's matching program.



Preliminary results

Chart 9 illustrates the estimated percentage of 401(k) plans that would be in violation of the ADP tests assuming any NHCE that is "at risk" drops out of the employer's 401(k) plan while HCEs continue their current contribution. Overall, 26 percent of all private 401(k) plans are expected to be impacted under this assumption. The percentage of plans is obviously a function of plan size, with only 15 percent of plans with 1–9 participants being impacted, increasing to 35 percent of the plans with 50–99 participants. The impact decreases for larger plans; slightly less than 25 percent of the plans with more than 500 participants were estimated to be impacted.[17]

Chart 10 illustrates the estimated percentage of 401(k) plans that would be in violation of the ADP tests assuming all employees with a match rate of less than 50 percent transfer up to $600 of their contributions from the employer's 401(k) plan to the government's plan. The estimated impact is obviously much smaller, since some NHCEs that are assumed to be making zero contributions in method one would still have some contributions in method two (leading to a higher ADP≤N and all HCEs considered to be "at risk" in the second method would have a smaller deferral than in method one (leading to a smaller ADP≤H).

Approximately 13 percent of all 401(k) plans are estimated to be impacted under method two. This varies from a low of 7 percent for plans with less than 10 participants, to a high of 21 percent for plans with 50–99 participants.

In terms of the number of participants impacted, the plans estimated to be impacted under method one covered 9.7 million participants at the end of 1996 (approximately 26 percent of the universe). Method two suggests that the impacted plans had 3.9 million participants at the end of 1996 (approximately 11 percent of all 401(k) participants).

I have made available to the Committee our studies completed to date, and offer our assistance in carrying out additional studies. I have also attached to this statement a set of slides intended to add detail to some of the points contained in my statement, including the results of a 1998 survey of small employers to determine attitudes on personal accounts.

I thank the Committee for this opportunity to appear before you today and wish you the best as you seek to assure future retirement income security.

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[1] Social Security: Perspectives on Preserving the System, ISBN 0–86643–028–8

[2] For example, "Retirement in the 21st Century..Ready or Not" (1994, ISBN 0–86643–081–4), which deals with the preparation of the baby boom for retirement.

[3] ISBN7125.A783

[4] ISBN 0–86643–092–X

[5] Technically, it is possible for plan sponsors to also use non-elective contributions to satisfy these tests as long as these contributions satisfy special vesting and withdrawal restrictions.

[6] While the analysis below focuses exclusively on the ADP tests, a complete analysis of the public policy implications would require similar analysis on employee after-tax and employer matching contributions as well as the multiple use test and the potential for 401(k) sponsors to adopt the newly implemented safe harbors. See Chapter 11 of Allen, Melone, Rosenbloom and VanDerhei (1997) for an explanation.

[7] It is important to note that we are referring exclusively to private 401(k) plans in the analysis below and that Section 403(b), Section 457 and public plans may or may not have similar consequences based on this proposal.

[8] See VanDerhei, et. al. (1999). Analysis of account balances and loan information was provided in addition to asset allocation information.

[9] Both Yakoboski and VanDerhei (1996) and Clark and Schieber (1998) had a large number of participants but what matters in this type of analysis is that a sufficient number of plans be available to determine the distribution of match rates by salary.

[10] This variable has been used extensively in the academic literature on an aggregate basis; however, our data provides more powerful analysis since we are able to look at the average match for a particular individual and observe their specific deferrals.

[11] We will also control for the impact of both before-tax and after-tax employee contributions. Note this is likely to be extremely important if the final government plan design involves after-tax employee contributions.

[12] N.B.: some plans involve a more complex function, possibly incorporating the sponsor's profits.

[13] For purposes of the 1996 data used in this analysis, the 402(g) limit was $9,500.

[14] See Internal Revenue Code Section 414(q) for a definition. Technically, the simplified definition of HCEs implemented by the Small Business Job Protection Act of 1996 had not taken effect as of year end 1996 however we used the new definition to be more relevant for predictions of impact on plans in the post 1996 environment. Moreover, no information on the 5% owner classification is available in this database.

[15] This accounted for less than 1 percent of all plans in the sample. Technically, 401(k) plans now have the flexibility to use the ADP generated by NHCEs in the previous year to test whether the current year's ADP for HCEs is too high. This modification was not included in the current analysis since the database is temporarily limited to 1996 contribution information.

[16] A third method will be attempted as soon as the database is expanded to include information on eligible employees that choose not to contribute. Although the two methods used in these illustrations produce conservative estimates of the impact, they are not precise in that we are currently unable to observe non-participant eligibles that drag the ADP for NHCEs down further than HCEs.

[17] Technically, the smaller plans are more likely to have no HCEs among their participants and therefore relatively immune to the impact of a competing governmental plan on their ADP test. This influence gives way to the fact that larger plans appear to have more generous matches and thus are less likely to have NHCEs considered to be "at risk."

[The attachments are being retained in the Committee files.]

Chairman SHAW. Thank you.
Wendell.

STATEMENT OF WENDELL PRIMUS, DIRECTOR OF INCOME SECURITY, CENTER ON BUDGET AND POLICY PRIORITIES

Mr. PRIMUS. Mr. Chairman, I appreciate very much your invitation to testify.

My understanding of the overall budgetary framework you are considering is as follows: continue to abide by the discretionary caps through the year 2002 in holding nondefense discretionary spending below inflation after 2002; enacting substantial tax cuts which match the size of the on-budget surplus; and then using much of the Social Security surplus to establish individual accounts. If this actually became law, there is a large risk that the outcome would be large budget deficits, little reduction in the debt burden, severe reductions in nondefense discretionary spending, and significant new spending on the elderly.

These discretionary cuts are unrealistic. There is little evidence to suggest that the appropriation bills can pass Congress and be enacted that actually live within those limits. Look at the 1999 appropriations process. The caps were considerably less tight, and yet substantial funding had to be designated as emergency. Or look at the bill the Senate passed several weeks ago increasing military pay and pensions. The reality is that the discretionary caps will be increased; the only questions are when and by what amount.

These unrealistic discretionary cuts are then turned into permanent tax cuts under the budget resolutions. By the year 2007, the annual cost of the tax cuts exceeds the amount of the on-budget surplus. The tax cuts are paid for by furthering reductions in nondefense discretionary spending. And after the year 2009, the problem becomes greater. CBO baseline projections indicate that the non-Social Security surplus stops growing. But the cost of the tax cuts will likely to continue to grow, and the result is the tax cuts would result in a return of deficits in the non-Social Security budget.

A similar result occurs in the Social Security off-budget accounts. The Social Security plans now under consideration would establish individual accounts without reducing Social Security benefits. These plans require large amounts of additional funding, which cannot come from the non-Social Security Surplus, because they have been used for tax cuts. The funding must come from the Social Security surplus. However, very soon, the cost of these individual accounts would exceed the entirety of the Social Security surplus. At that time, this framework would require new taxes or even deeper cuts in the rest of government or deficit spending. Individual accounts are essentially a new entitlement program.

At a time when we have not fully funded the promises we have made to the elderly under the current Social Security program, and when we face large financing gaps in Medicare and unmet needs in other areas, why should we enact a Feldstein-type plan which would make new promises to the elderly and direct substantial new resources to retirement pensions without increasing government revenues to defray these added costs.

The plan poses as a free lunch entailing no pain or tough choices. One criterion which should be used to assess Social Security plans is whether they boost national savings. I think the congressional plans fall short here. Tax cuts will primarily increase current consumption. Another criterion should be whether the plan provides adequate benefits that are equitably distributed and represent a fair return. Individual account plans generally result in a less progressive distribution of benefits that Social Security today.

One frequently hears the argument that individual accounts yield much higher rates of return than Social Security. This is not correct. A recent Center paper, by Peter Orszag, summarizes an important set of papers by three economists, some of whom are sympathetic to individual accounts. The major finding of their work is that it is advanced funding that increases rates of return, not individual accounts. Advanced funding will raise rates of return, whether it occurs through individual accounts or Social Security.

Another criterion is protection against risk. The Feldstein plan does provide ample protection against risk, because it guarantees participants their Social Security benefits. However, the plan is likely to undermine political support for Social Security as we know it today. Because people would seem to be paying substantial payroll taxes and getting little back from it, Social Security would appear to much of the middle class and more affluent segments of the population to be a bad deal.

A tax—I could not agree more with Mr. Walker—a tax or an integration factor of 75 to 90 percent, I believe is politically unsustainable. How can you give the American public an account, which they manage, and which public officials say is theirs, and then take almost all of it back when they retire?

Another key question is whether 75-year solvency has been restored and maintained. The President's plan receives high marks for its emphasis on reducing the public debt. However, in my opinion, both plans—the Feldstein plan and the administration's—fall short on the fiscal discipline.

Under the Feldstein plan promises to the elderly are increased. There are massive infusions of general revenues. There are no structure reforms, and revenues are not explicitly increased. In addition, the publicly held debt would not be reduced very much.

Let me say, in conclusion, Mr. Chairman, you consistently argued during the welfare debate that the States were doing the right thing and that the Federal Government should take its cue from what the States were doing. I believe in your new role, Mr. Chairman, you should continue to follow your own advice and have the Federal Government adopt two policies that the States are doing on a regular basis, and that is investing a considerable portion of their pension funds, the Social Security funds in equities.

And second, the States do manage and have learned how to set aside their pension funds and not spend or give them away in tax cuts.

The Federal Government should be able to do the same thing. We should not need the mechanism of individual accounts to partially advance fund our Social Security system. Thank you.

[The prepared statement follows:]

Statement of Wendell Primus, Director of Income Security, Center on Budget and Policy Priorities

Mr. Chairman and Members of the Subcommittee on Social Security:

I very much appreciate your invitation to testify on the subject of the overall budget framework and Social Security program's goals and criteria for assessing reform proposals. My name is Wendell Primus and I am Director of Income Security at the Center on Budget and Policy Priorities. The Center is a nonpartisan, nonprofit policy organization that conducts research and analysis on a wide range of issues affecting low-and moderate-income families. We are primarily funded by foundations and receive no federal funding.

THE OVERALL BUDGETARY AND SOCIAL SECURITY FRAMEWORK OF CONGRESSIONAL PLANS

My understanding of the overall budgetary and Social Security framework assumed under the House and Senate budget resolutions is as follows:

- Continuing to abide by the discretionary caps through 2002 and holding non-defense discretionary spending in most years after 2002 below the 2002 inflation-adjusted level (although modestly above a freeze level),
- Enacting substantial net tax cuts of $778 billion over 10 years, which would nearly equal the estimated size of the on-budget surplus over this period, and
- Using much of the Social Security surplus to establish individual account plans and employing a variant of the Feldstein approach.

I would like to comment briefly on the feasibility and economic ramifications of this framework, discuss criteria for how to judge Social Security reform and compare alternative Social Security plans under those criteria and conclude with a few thoughts on an alternative framework.

UNDERSTANDING THE ECONOMIC AND BUDGETARY IMPLICATIONS OF THIS FRAMEWORK

What we have learned over the past several weeks about the Senate and House budget resolutions is cause for serious concern from a fiscal discipline point of view. If this framework were enacted, there is a large risk that the eventual outcome would be a return of large budget deficits, little reduction in the debt burden we would pass on to our children and grandchildren, severe reductions in non-defense discretionary spending, large tax cuts that grow in size over time, and significant new spending on the elderly. Policymakers are promising more than can be delivered within the available budgetary resources, especially once we get a few years past the end of the 10-year budget window in FY 2009 and the baby boom generation begins to retire in large numbers.

UNREALISTIC DISCRETIONARY BUDGET CUTS:

The budgets the Senate and House Budget Committees have approved would require radical shrinkage over time in some parts of the federal government. Not only would the budget plans maintain the stringent caps the 1997 budget agreement placed on discretionary (i.e., non-entitlement) spending for years through 2002—which themselves would require sizeable reductions in discretionary spending in the next several years—but the budgets call for large additional reductions in non-defense discretionary programs in the years after that.

- The Senate and House budget resolutions include approximately $200 billion in additional reductions in discretionary programs between 2003 and 2009, on top of the reductions that would result from enforcing the caps through 2002 and holding discretionary spending in fiscal years 2003 through 2009 to the fiscal year 2002 cap level, adjusted for inflation. These additional reductions in discretionary programs provide room for larger tax cuts than could otherwise be accommodated.
- The cuts the House Budget resolution contains in non-defense discretionary programs are so large that by 2009, overall non-defense discretionary spending would be 29 percent below its FY 1999 level, adjusted for inflation.[1] These deep cuts would occur although non-defense discretionary spending already constitutes as small or smaller a share of the Gross Domestic Product than in any year since 1962. Discretionary cuts of this magnitude are unrealistic.

One fact that I find astonishing is if discretionary spending is allowed to grow just enough to preserve the same inflation-adjusted amount of resources available to discretionary programs as is available to these programs this year, not including the emergency spending in fiscal year 1999, discretionary spending would use up *$824 billion—or 88 percent—of the non-Social Security surplus.* In other words, all of the projected non-Social Security surplus is due to assumed reductions in discretionary programs.

The CBO baseline projections assume that policymakers will keep spending within the discretionary caps.[2] There is, however, little evidence to suggest that appropriations bills can pass Congress and be enacted that actually live within those limits. Look at the 1999 appropriations process. The caps were considerably less tight

[1] The FY 1999 level used here as a point of reference excludes emergency spending. If emergency spending were included, the dimensions of the discretionary cuts in the budget resolution would seem deeper.

[2] More precisely, the CBO projections assume that discretionary spending will fit within the caps for as long as they are in place. After 2002, when the caps are no longer in place, the projections assume that discretionary spending will grow with inflation.

and yet substantial funding had to be designated as "emergency." In addition, the bill the Senate passed several weeks ago on military pay and pensions increases both discretionary spending and entitlement costs. According to CBO, the legislation increases discretionary spending by $40.8 billion over the next 10 years, with the costs rising each year. The costs reach $6.5 billion a year by 2009 and would continue to rise for a number of years after that. This requires Congress and the President to agree to make even deeper cuts in other discretionary programs (possibly including other defense programs). Including entitlements and revenues, the bill's total cost is $55 billion over 10 years.

The reality is that the discretionary caps will be increased. The only questions are when Congress will adjust the caps and by what amount.

Tax Cuts Should Wait Until Social Security and Medicare Programs Have Been Strengthened

The proposed House and Senate budget resolutions include tax cuts designed to absorb most of the on-budget (non-Social Security) surplus for the next ten years. To follow the path of the anticipated surplus, the tax cuts start relatively small and grow substantially over time. The proposed resolutions include tax cuts costing $142 billion over the first five years, with the cost rising to $636 billion in the second five-year period.

In fact, *by 2007 the annual cost of the proposed tax cuts exceeds the amount of the on-budget surplus the Congressional Budget Office estimates will be available.*[3] *The additional tax reduction is "paid for" by further reductions in non-defense discretionary spending, beyond those that result from adhering in years after 2002 to the cap for FY 2002, adjusted only for inflation.*

Looking beyond 2009, the problem becomes still greater. Three factors suggest these tax cuts will become unaffordable after 2009 and would almost certainly bring back deficits in the non-Social Security budget.

• CBO baseline projections indicate that the non-Social Security surplus stops growing and begins to shrink during the five years after 2009.[4] Once the surplus stops mounting and begins to contract, there will be a smaller non-Social Security surplus each year to support a tax cut.

• But the cost of the tax cut is likely to continue growing substantially after 2009. The size of the tax cut in the Senate resolution grows from $32 billion in 2003 to $177 billion in 2009, an annual average increase in cost of more than $24 billion a year. Between 2008 and 2009, the cost grows by $26.5 billion.[5] If this incremental growth were to continue in the years beyond 2009, the cost of the tax cut would rise from $636 billion in 2005–2009 to $1.25 trillion in the five years from 2010 to 2014.

Even if growth in the tax cut could be held down to the rate of growth in GDP in years following 2009—which is unlikely because it would require reductions in tax relief at that time—the cost of the tax cut in the five years from 2010 to 2014 would still exceed $1 trillion. (See Figure 1.)

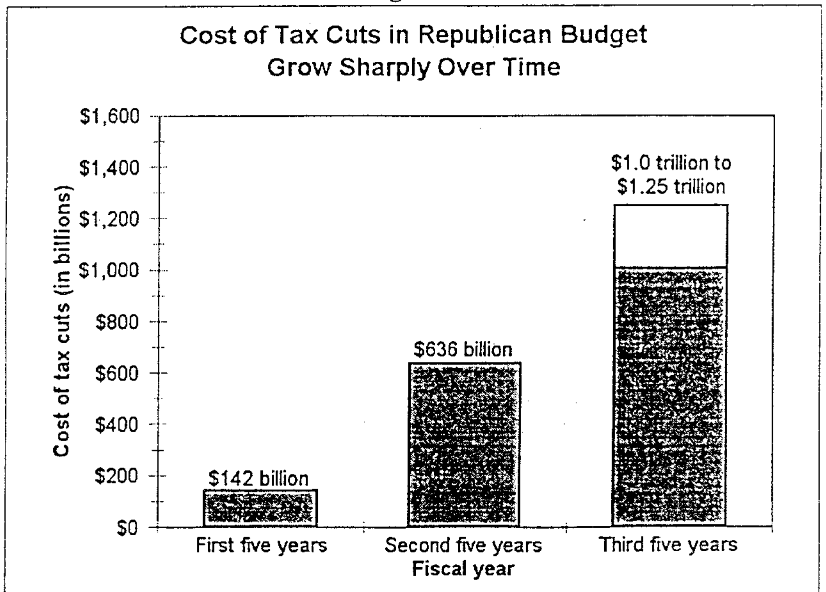
• With the size of the non-Social Security surpluses beginning to decline and the cost of the tax cut continuing to grow, the only way to avoid a re-emergence of on-budget deficits would be to make cuts in programs on top of those that would made by 2009. Such cuts, which could entail eliminating a sizable share of what remained in non-defense discretionary spending, are not likely to be achievable. As a result, the tax cuts in the House and Senate budget resolutions would likely result in a return of deficits in the non-Social Security budget.

[3] These figures are based on CBO's "capped baseline," which assumes that discretionary spending will increase with inflation after the current caps expire in 2002. This is the standard baseline that CBO and OMB use to estimate the extent to which the budget will be in deficit or surplus.

[4] The CBO baseline goes through 2009. The CBO capped baseline was extended to 2014 for purposes of this analysis by applying the growth rates in the CBO long-term forecast. The projections show that annual surpluses in the non-Social Security budget begin to decline after 2012. Policy changes could shift by one or a few years the specific year in which these surpluses begin to shrink, but such shrinkage is virtually certain to occur some time shortly after the baby boom generation begins to retire.

[5] In the Senate budget resolution, the size of the tax cut grows by an average of $24.2 billion a year between 2003 and 2009, while in House version the average annual growth is $24.6 billion. In the House version, the cost grows from $30.7 billion in 2003 to $178 billion in 2009, and growth between 2008 and 2009 is $24.8 billion.

Figure 1



Source: CBPP calculations based on the Senate Budget Committee's Chairman's Mark of the Budget

The projected surpluses present policymakers with a once-in-a-generation choice. You can spend those surpluses by cutting taxes or raising government spending and thus boosting current consumption. Or you can save those surpluses by paying down the debt held by the public, by strengthening Social Security and Medicare, and raising national saving, investment and long-term economic growth.

Tax Cuts Should Wait Because of the Economic Uncertainty Surrounding These Budget Projections

Furthermore, if Congress and the President pass legislation this year that is projected to result in balance or modest surpluses in the non-Social Security budget but the economy subsequently weakens and grows more slowly than CBO has forecast, the non-Social Security budget will likely slide back into deficit during the next ten years. The resulting deficits could be substantial. CBO estimates that a downturn of the size of the recession of the early 1990s, which was not a severe recession as recessions go, would increase the budget deficit (or reduce surpluses) by approximately $85 billion a year just after the recession hits bottom.

CBO cautions that its surplus forecasts could be off by even larger amounts if revenues grow more slowly than forecast. Analysts do not fully understand why revenues have grown more rapidly than projected in recent years, and they do not know the extent to which the factors that have caused this unexpected revenue growth are temporary or permanent. Revenue growth in future years could be significantly lower or higher than CBO currently projects. If it is significantly lower (and legislation using most of the non-Social Security surpluses currently projected has been enacted), deficits in the non-Social Security budget are likely to return.

A drop in the stock market also would result in lower-than-expected revenue collections, since less capital gains tax would be collected. That, too, could push the non-Social Security budget back into deficit.

CBO this year devoted a full chapter of its annual report on the budget and the economy to the uncertainty of its budget projections. CBO warned that "considerable uncertainty" surrounds its budget estimates "because the U.S. economy and the federal budget are highly complex and are affected by many economic and technical factors that are difficult to predict. Consequently, actual budget outcomes almost certainly will differ from the baseline projections..."[6] CBO reported that if its esti-

[6] Congressional Budget Office, *The Economic and Budget Outlook: Fiscal years 2000–2009,* January 1999, p. 81.

mate of the surplus for 2004 proves to be off by the average amount that CBO projections made five years in advance have proven wrong over the past decade, the surplus forecast for 2004 could be too high or too low by $300 billion.

A much more prudent course would be to wait several years before enacting any substantial tax cuts to see if on-budget surpluses of the magnitude now projected actually appear, to determine if our unusually long-lasting economic recovery continues to last (the probability is high that a recession will occur sometime between now and 2009), and to determine the levels of a realistic set of discretionary caps needed to enact the 13 appropriations bills.

Feldstein type Plans Increase Spending on the Elderly, Undermine Social Security as We Know It and Are Not Adequately Financed

The Social Security plans now emerging in Republican leadership circles appear to envision using the bulk of the Social Security surpluses to fund individual accounts. The Social Security proposal that I understand Chairman Shaw to be developing, as well as the plan Senator Phil Gramm has crafted, would establish individual accounts apparently without reducing Social Security benefits. Such plans require large amounts of additional funding for a number of decades. Under the proposed budget resolutions, these new funds could not come from the non-Social Security surplus, since the vast majority of that surplus would be used for tax cuts. This leaves only one source for funding these accounts—the Social Security surpluses. However, after about 2012, the Social Security surplus is projected to stop growing each year and start to decline, while the cost of funding these individual accounts would continue to increase. As a result, sometime in the five-year period from 2010 to 2014, the cost of individual accounts equal to two percent of Social Security wages would exceed the entirety of the Social Security surpluses. At that time, this plan would require new taxes, even deeper cuts in the rest of government or deficit spending. Individual accounts are essentially a large new entitlement program.

At a time when we have not fully funded the promises we have made to the elderly under the current Social Security program, and when we face large financing gaps in Medicare and unmet needs in other areas, the Feldstein plan would make new promises to the elderly and direct substantial new resources to retirement pensions without increasing government revenues to defray these added costs. The plan poses as a “free lunch” entailing no pain or tough choices. In reality, the plan would be likely to put programs funded through general revenues at a substantial disadvantage and to sacrifice the needs of younger generations to increase benefits directed to the elderly, especially the more affluent elderly.

The plan also would weaken the progressive nature of the current benefit structure, widening the nation’s already-large income disparities. In addition, it would establish a hybrid private account/Social Security benefit structure not likely to be politically sustainable over time. The plan would set in motion a dynamic that could lead eventually to the dismantling of much or all of Social Security as we know it today.

SUMMARY OF ECONOMIC AND BUDGETARY IMPLICATIONS OF CONGRESSIONAL BUDGET RESOLUTIONS

The emerging Republican budget and Social Security proposals risk exacerbating the serious fiscal problems the nation faces when the baby-boom generation retires. Since the tax cuts would use up the on-budget surplus while most of the Social Security surplus was used for individual accounts, there would be little debt reduction. As a result, these proposals would squander a historic opportunity to reduce sharply or eliminate the debt held by the public, and future generations would be burdened with obligations to continue making large interest payments on the debt far into the next century. Even if deficit spending is avoided during the next 10 years, the likelihood is high that in the next five-year budget window, our public debt would again increase.

- On-budget surpluses would head back to deficits because currently projected on-budget surpluses stop growing after 2012 while the tax cuts would continue to mount.
- Off-budget surpluses head back to large deficits at approximately the same time because the cost of individual accounts would exceed the Social Security surpluses.
- Aggravating these problems, interest payments would still be around $200 billion a year because there would have been little debt reduction over the previous ten years.

CBO already projects fiscal difficulty when the boomers retire, with deficits returning sometime between 2020 and 2030 and climbing to record levels. Moreover, those projections assume that all the surpluses are used solely for debt reduction.

Under the tax cut and individual account proposals just discussed, deficits would return much sooner and climb much higher.

In addition, these budget proposals would require cuts of stunning depth in non-defense discretionary programs. Due to the magnitude of these cuts, some programs that constitute public investments and hold promise of improving productivity—and hence economic growth—could face the knife, as could many programs to aid the most vulnerable members of society. Of course, cuts of such magnitude might not be made given their political difficulty. But then the overall fiscal picture becomes even grimmer, given the costs of the tax cuts and the individual accounts.

The course these proposals chart is a troubling one. It constitutes a high-risk undertaking that is not consistent with building a sounder fiscal structure in preparation for the budgetary storms that lie ahead. It also would be likely to lead over time to some radical changes in the role and functions of the federal government.

Key Criteria by Which Social Security Reform Proposals Should be Judged

In their book *Countdown to Reform*, Henry Aaron and Robert Reischauer discuss four criteria for assessing Social Security reform. I think these four criteria provide a sound basis for such assessments. I also would add a fifth criterion—restoring and maintaining program solvency in a fiscally disciplined manner.

Boosting National Savings and Economic Growth—the Congressional plans fall short here. The on-budget surpluses would be devoted to tax cuts that will primarily increase current consumption. Devoting a portion of the on-budget surpluses to the Medicare trust fund and using those funds to reduce the publicly held debt, as well as devoting a portion of the surplus to Universal Savings Accounts that are saved rather than consumed, would increase national savings more than using these surpluses for tax cuts. If Congress in its wisdom rejects placing more monies in Medicare or the Universal Savings Accounts, it would be better to place these surpluses in the Social Security trust fund and use them for debt repayment than to use them for tax cuts.

Adequate Benefits that are Equitably Distributed and Represent a Fair Return—Individual account plans generally result in a less progressive distribution of benefits than Social Security does. For example, Aaron and Reischauer's analysis of the Feldstein plan finds it would boost government-funded retirement income several times as much for more-affluent workers than for low and moderately-paid workers.

One frequently hears the argument that diverting resources to individual accounts helps everyone, because such accounts yield much higher rates of return than Social Security. This is not correct. A recent Center paper by Peter Orszag summarizes and puts into layman's terms a recent and important set of papers by economists John Geanakopolos, Olivia Mitchell and Stephen Zeldes. The major finding of the papers by these three economists is that it is advance funding that increases rates of return, not individual accounts. Advance funding will raise rates of return whether it is provided through individual accounts or through Social Security.

The provision of funding that exceeds what is needed to pay current benefits, often termed "partial advance funding" when referring to Social Security, raises the rate of return on contributions because such funding can be invested at the market rate of interest; by definition, none of it is needed to pay current benefits. Since the market rate of return is higher than the rate of return on existing Social Security contributions, and since each dollar of additional funding can earn the market rate of return, additional funding secures a higher rate of return than existing contributions do. This higher rate of return can be captured by channeling the additional funding through *either* the trust fund or individual accounts.

A corollary of this point is that creating individual accounts out of existing Social Security payroll tax contributions, without any additional advance funding, does not raise the rate of return. If individual accounts are created out of existing funding, the benefits that current workers and retirees have accrued under Social Security must still be paid. That drives the overall rate of return back toward its current level under Social Security. It is the additional funding, not the individual accounts themselves, that is crucial to producing the higher rate of return.

As Geanakopolos, Mitchell, and Zeldes show, the statement that individual accounts yield much higher rates than Social Security is incorrect. Such a statement is based on an invalid rate-of-return comparison. That Geanakopolos, Mitchell, and Zeldes are correct is borne out by the work of the Social Security actuaries in analyzing the three very different plans advanced by Members of the 1994–1996 Advisory Council on Social Security. The three plans adopted very different approaches to individual accounts from no individual accounts (under the Maintain Benefits plan) to relatively large individual accounts (under the Personal Security Accounts plan). But despite the sharply different treatment of individual accounts in the three proposals, their estimated rates of return are *very similar*. Consider, for example, an average two-earner couple born in 1997. According to projections made by the Social Security actuaries and published in the Advisory Council report, the real rate of return for such a couple would be:

- Between 2.2 and 2.7 percent per year under the Maintain Benefits plan, depending on the share of the Social Security Trust Fund invested in equities;
- 2.2 percent per year under the Individual Accounts plan; and
- 2.6 percent per year under the Personal Security Accounts plan.

In summary, the simple argument that individual accounts necessarily provide higher rates of return than Social Security is not valid. This argument rests on computations that either mistakenly count the cost of Social Security benefits that must be paid to current retirees as costs only under Social Security and not under a system of individual accounts or inappropriately compare the return on *additional* funding for individual accounts to the return on existing contributions to Social Security (or commit both errors).

Analytically sound comparisons also should reflect risk and administrative costs. Individuals generally dislike risk; a much riskier asset with a slightly higher rate of return is not necessarily preferable to a much safer asset with a slightly lower rate of return. Administrative costs are also important; all else being equal, higher administrative costs reduce the net rate of return an individual receives. When these factors are taken into account, the supposed advantage of individual accounts in providing higher rates of return diminishes further and may even be reversed, given the higher administrative costs associated with individual accounts than with Social Security.

PROTECTION AGAINST RISK

On one level, the Feldstein plan does provide ample protection against risk because it guarantees all participants a benefit as large as the Social Security benefits promised under current law. However, the plan is likely to undermine political support for the Social Security program as we know it today. Because people would seem to be paying substantial payroll taxes to Social Security and getting little back from it, Social Security would likely appear to much of the middle class and more affluent segments of the population to be a bad deal. It would seem to provide them a very poor rate of return compared to what there private accounts were paying. These disparate rates of return would partly reflect the fact that the Social Security trusts funds would bear all of the burden of financing the benefits of workers who had already retired or worked for many years before the individual accounts were established. The trust funds also would bear all of the burden of providing more adequate benefits to low-income retirees, low-earning spouses and divorced women, and covering widows, the disabled and the children of disabled and deceased workers. Although not obvious to many workers, a sizeable portion of the Social Security payroll tax is essentially an insurance premium for the disability and life insurance protection that Social Security provides. The private accounts, by contrast, would bear *none* of these burdens, which would enable them to appear a better deal to the average worker.

Also a clawback or a tax or an integration factor (whatever it is called) of 75 percent to 90 percent is politically unsustainable. It is unlikely that you can give the American people accounts which they manage and which public officials say are theirs and then take almost all of the accounts back when they retire. Lowering the "clawback" percentage, however would require deeper cuts in Social Security benefits, increased transfers from the rest of government to Social Security, or deficit-financing. Finally, as discussed earlier, a Feldstein-type plan poses substantial risks for the rest of government and for fiscal integrity.

Administrative Efficiency

The Feldstein plan would be complex and costly to administer. How costly would depend upon details of the plan. A recent study of the administrative costs of privately managed individual accounts in the United Kingdom shows that more than 40 percent of the their value is consumed by administrative fees and annuitization and other costs, a figure that is significantly higher than has been acknowledged thus far in the debate in the United States. What this experience in the U.K. vividly illustrates is that if individual accounts are created in the United States, a decentralized, privately managed approach (as distinguished a Thrift Saving Plan-type approach) could carry a variety of dangers.

Restoring and Maintaining Program Solvency in a Fiscally Disciplined Manner

A key question in assessing reform is whether 75-year solvency has been restored and whether it is maintained. The President's plan receives high marks for its emphasis on reducing the public debt.

Lowering interest burdens is one of the best things we can do for younger generations. It increases our ability to meet our Social Security promises. The interest savings alone from this proposal (as a percentage of GDP) would more than offset the increase in Social Security costs that will occur under current law over the first half of the next century. The Administration's plan also envisions that the half of the shortfall not closed by general-fund transfers be closed, in whole or in large part, through more traditional methods. The President has called for the specific changes to be identified and agreed upon through bipartisan negotiations. To reinforce this strategy, the Administration wants to "Save Social Security First"; it proposes that the increased discretionary spending and the USA accounts contained in its budget proposal not be created until Social Security solvency is restored.

In my opinion, both plans—the Administration's (insofar as specifics have been provided) and the Feldstein type approach—fall short on the fiscal discipline test. Under the Administration's approach, the massive infusion of general funds, if not tied to structural reforms in Social Security, might encourage policy-makers to avoid the needed structural reforms in Social Security (i.e. reductions in benefits and increases in revenues). Indeed, the crediting the Administration has proposed coupled with a higher level of trust fund investments in equities than the Administration has proposed could make the Social Security program solvent over 75 years without any structural changes. In my view, the transfers the Administration proposes need to be conditioned upon making the structural changes to close the full 75-year financing gap.

However, the Feldstein type plans fails the fiscal discipline test to a much greater extent. Promises to the elderly would be increased and there would be massive infusions of general revenues. There are no structural reforms and revenues are not explicitly increased. As I have argued earlier, this will cause severe fiscal pressures down the road. In addition, as a result of the combination of a Feldstein-type plan and the proposed tax cut the publicly held debt would not be reduced very much and therefore the interest burden on our younger generations would remain high. Finally, while it is assumed that a portion will be invested in equities, the manner in which this is done (compared to investment of the trust fund in equities) is likely to be costly and inefficient, especially if the individual accounts are privately managed.

A Brief Description of a Fiscally Disciplined Alternative Framework

Let me briefly describe an alternative framework:

- Recognize reality and adjust the discretionary caps for fiscal year 2000 upward so that the 13 appropriation bills can be enacted.
- Transfer to Social Security or Medicare some portion of any remaining on-budget surpluses, which would result in further reductions in the publicly held debt.
- Delay enactment of any substantial tax cuts or substantial new spending for the out-years until the Medicare and Social Security programs have been strengthened and there is a better sense of how much of the on-budget surplus safely can be used for tax reductions.
- In addition to any transfers from the on-budget surplus, further transfer to the Social Security trust fund are appropriate to the extent that Congress is unwilling to grant the authority to invest up to 50 percent of the Social Security reserves in equities (a smaller percentage than state and local pension funds invest in equities) under the management of an independent board. To the extent that such authority is not granted, general revenue transfers to compensate the trust fund for this lost income are appropriate. This policy (or better yet the actual investment of 50 percent of the trust fund in equities) would close slightly more than 50 percent of the 75-year financing gap. (This proposal is described in more detail in testimony I provided earlier this year to the Senate Special Committee on Aging.)
- Close the remainder of the solvency gap by other structural changes in the Social Security program.
- Reduce the publicly held debt to zero by walling off the Social Security surpluses in a manner that precludes their being used for new tax reductions or spending increases. These surpluses should be used solely for Social Security solvency and debt repayment. A properly designed lock-box (that automatically adjusts for changing budget estimates due to economic and technical changes in estimates) employing a revised pay-as-you-go rule would be the most appropriate mechanism for accomplishing this. This pay-as-you-go rule should be enforced with a both a sequester

and a 60-vote point of order. The bill announced yesterday by this Chairman is a significant improvement to the lock-box mechanisms being discussed on the Senate side. We would, however, suggest allowing a majority rather than a super-majority vote to waive the points of order that the bill establishes during recessions and wars.

In conclusion, Mr. Chairman, you consistently argued during the welfare debate that the states were doing the right thing and the federal government should take its cue from what the states were doing. I believe, Mr. Chairman, that in this Social Security debate, the federal government should adopt two policies from the states. One is that 50 to 60 percent of state pension funds are invested collectively in equities. Second, if states have learned how to set aside their pension funds and not spend or give them away in tax cuts, the federal government should be able to do that as well.

Chairman SHAW. Wendell, I thank you for your compliment, but I learned a long time ago, with great respect to you, sir, beware of liberals bearing gifts. [Laughter.]

Mr. Enoff.

STATEMENT OF LOUIS D. ENOFF, ENOFF ASSOCIATES, SYKESVILLE, MARYLAND; AND FORMER ACTING COMMISSIONER, SOCIAL SECURITY ADMINISTRATION

Mr. ENOFF. Thank you very much, Mr. Chairman. Mr. Chairman, Mr. Matsui, Mr. Collins, Mr. Cardin, it is a pleasure to be back here, and I thank you for the opportunity to be here. And I thank you for continuing to pursue this issue, because I think a lot has been accomplished in the discussions over the last couple of years, I will say.

In my written statement, I have listed 12 principles that I outlined in 1997. And these are principles that I believe should be used in coming up with the answer to Social Security reform. They are principles that have been developed in my 30 years of experience, working with the Social Security Administration in the U.S., and that have been confirmed in the 5 years that I have been working in many foreign countries on Social Security reform issues.

I have been privileged to work in 18 countries, and to study reforms in several others. And I will say that there is much to be learned from other countries, even though the situations are different. There is much to be learned—both good and bad—from the experiences, and I think we should take that into account.

As I said in my written statement, and I will say again, the present Social Security program has served our Nation well in the 60 years that it has been in existence.

However, I believe the time has come for basic changes in the program to reflect the economic, social, and political situation in our time, and to take us into and through the next century. I think we should look at this as if we have the opportunity to design the program from its very inception, and I think even those who would say we should stick with the current program would say that starting today they would not design the program as it currently is. I would just like to briefly summarize those 12 points. You have heard most of these in various parts of the testimony already this morning.

First, make sure that the reform has broad, bipartisan support.

Second, protect current beneficiaries and those near retirement.

Third, take extra care to protect long-term, low-income workers and to give them the opportunity to have a say in their own retirement.

Fourth, regulate carefully, but allow some flexibility.

Fifth, educate the public not only about the reforms, but about the current program, and why it is being changed. There is not enough known about the current program.

Sixth, give priority to the long-term security of American workers, not to short-term fixes that take us through the next 10 years or whatever.

Seventh, honestly discuss the cost of reform and what it would take to fix the current program. And I think that was brought out earlier in testimony.

Eighth, give workers a say in their retirement investment. And I want to say that that is why I think individual accounts are important. I think that young people want to have some say. I think that will have to be restricted in some ways. And I will be glad to elaborate on that. But I think people want to have a say, and I think when they have that say, experience shows that people will put more into those accounts and save more. And that leads to another point. We should—whatever we do in reforming the program, we should try to increase the savings rate in this country.

Tenth point: reform the retirement program by itself, and then look separately at the disability and survivors program for any changes that want to be made.

Eleven, proceed expeditiously to design and carefully to implement. A lot has been said today about implementation. There are some potential pitfalls. But it can be done. I think what has to be done is a decision as to what you want and then some careful looks at how to implement that.

And the final point I would make, try to simplify the program if it is possible. And we have heard many potential proposals that I have a hard time understanding, and I do not claim to be the brightest person on this Earth, but I have spent a lot of my years involved in Social Security programs. And I think it would be nice if the average worker would understand what they are paying for and what they are going to get back and be able to calculate their benefit on their own.

Thank you very much. I would be pleased to try and answer any questions.

[The prepared statement follows:]

Statement of Louis D. Enoff, Enoff Associates, Sykesville, Maryland; and Former Acting Commissioner, Social Security Administration

Mr. Chairman and members of the Sub-committee, thank you for the opportunity to appear before you today and thank you for continuing to pursue this most important topic. When I appeared before this subcommittee in September of 1997, I outlined eleven principles which I believed should be adopted in designing reform of the US Social Security system. These principles were based on my thirty years of experience in various technical and executive positions with the US Social Security Administration and my experience since 1993 studying and working on social security reform in several foreign countries. Looking back on these principles a year and a half later, I find that they are still valid. Actually I have added one principle, to make and even dozen, which was implicit in my original list, but which I now believe should be explicitly stated. That principle which I have placed number twelve in my list is to: *Develop a broad bi-partisan consensus on the basic design of Social Security Reform.* The discussion and debate over the past eighteen months has confirmed and the twelve principles. That discussion and some experience in other countries has convinced me that the broad bi-partisan consensus is needed so that changes made to our Social Security program are changes that will take root and be allowed to develop over a period of years and not be drastically changed by a change in political leadership in either the legislative or executive branches. Social Security programs are vital to the well-being of the citizens in any country, but these are programs which by design take years to fully develop and to deliver promised benefits to future retirees. It is important that carefully designed program changes be allowed to fully develop before they are substantially modified. Constant changes in program design serve to confuse the participants and to prevent projected effects from happening.

I have said before and I will say again, our current Social Security program in the US has served us well over the almost 60 years of its operation. However, it is not designed to take us into and through the next century. Much has changed in the years since this program was designed and it is time for some basic changes in the program These should be carefully thought through and modeled before implementation. And the implementation plans must be carefully considered and implemented. Faulty operation of a social security system can be as critical as faulty design. My personal proposal would be to leave a basic pay-as-you-go defined benefit plan as a first tier and to add to that a funded mandatory defined contribution plan as a second tier. I believe that this approach gives the best of both worlds and allows a separate third tier to supplement the first two tiers on a voluntary basis for individuals. Implementing these changes will require careful and deliberate planning and timing. There is also a need to plan and implement several related programs to encourage older workers to stay in the work force longer and to develop retraining efforts to help workers in some occupations transfer to less physically demanding vocations.

I have listed below the twelve guiding principles which I believe will lead to a highly successful redesign of the US Social Security program. The list is not in priority order. While some principles are more important than others it is difficult to give them an absolute rank. They all work together to complement the whole package.

1. *Give Priority to the Long-term retirement security of American workers.* Short term budget considerations are obviously important. Using so called surpluses to finance some or all of the transition cost to a funded program could provide a tremendous boost to making the needed changes. However, we must look at the long term picture. The needs of workers who are just now entering the work force should be considered. Just tinkering around the edges of the current program to fiscally sustain it for another ten or twenty years is not really dealing with the problem. If anything, a short term fix will only serve to further undermine workers' confidence in the program. Even the most ardent supporters of the current program agree that they would not design the program as it is currently designed if they were starting anew today.

Short term fixes can work for a time, but in the final analysis, tackling the long term issues are what will win the support of the workers. We see this in approaches taken in Sweden, Argentina, Chile, the United Kingdom and some of the recent reforms in Central and Eastern Europe.

2. *Protect current beneficiaries and those near retirement age.* As has generally been stated in those proposals currently being discussed, current beneficiaries should be protected. The age at which those near retirement should be protected can vary a little depending on how much choice is offered to current workers about opting into a new plan. Until agreement is reached on the basics of a reform plan it is probably best not to try and specify at what age levels different options may be available. Decisions about the indexing of benefits should be resolved on the basis of facts and the resulting numbers factored into the calculation of future costs for the program.

Concern for those already retired have stymied some efforts in developing economies and still are a cause for concern with the British system.

3. *Admit that there will be a cost to transition from the currently underfunded program.* There are costs to transitioning from a strictly pay-as-you-go program to one that includes funded individual accounts. There are costs for the transition, building up funds, as well as for creating the necessary administrative structures. Both of these sets of costs will be more than recaptured in time. The question that needs to be addressed is over what period of time these costs should be spread and who should participate in paying for them We should also clearly and carefully point out what the costs would be to try and preserve and fix the existing program.

Transparency is one of the most desirable traits of a social security system. Countries where the government has attempted to hide the true costs of social insurance programs have either seen these programs fail completely or caused such distrust by the workers as to feed the underground economy in an effort to avoid what are seen as unfair contributions.

4. *Work at simplifying the program* The current program started with a rather complex benefit formula which has become more complex over the years. Average workers have a difficult time computing their own benefit even if they have all of their records. Any simplification should serve to build or restore confidence of the workers in the program.

5. *Take extra care to protect long term low income workers from poverty.* The US Social Security program has from its inception provided for a transfer of funds from higher earning workers to lower earning workers. This transfer is accomplished through weighting in the benefit formula. Although this transfer or welfare aspect of the social security program has not always been well understood, I believe that this principle is accepted by the majority of Americans and should be maintained. A flat rate benefit formula would enable this transfer to work even more transparently. However, care must be taken to ensure that these provisions do not result in unintended windfalls for workers who work intermittently or casually only as a convenience rather than out of need.

The level of the basic benefit tier should be carefully determined considering overall economic and social considerations. Minimum requirements for this basic benefit may determine whether the level should be at or near the poverty level or higher to recognize the long term work effort and contribution of the workers. Means tested or taxation of benefit policy could be considered for preventing unintended windfalls.

Some of the experience in developing countries shows that successful programs can be created for the higher income or so-called formal wage sector while ignoring the less organized vocations and the self-employed. We cannot afford to exclude any category of workers from the protection afforded by a sound secure social security system.

6. *Design any reform to try and increase the overall savings rate in the US.* The savings rate in the US is unacceptably low, having fallen even below zero in recent months. The current pay-as-you-go system does not add to the individual savings rate and may in fact detract from it. However, a two tiered system with a funded individual account has great potential to increase the individual savings rate by itself let alone the behavioral change that might cause individuals to save more once they see their individually owned accounts accruing to them or their heirs. One of the most crucial factors here is to increase the savings rate by low income workers. The ERA experience shows that lower level workers are simply unable or unwilling to participate even when tax incentives are offered. In this case an EITC type approach could be used to stimulate more savings activity by lower income workers and help them to begin to build equity for their future. I also think that the idea of earnings sharing should be further explored as a means of alleviating the low income status of older women. Experience in England and many of the Asian countries shows that formal *mandated* savings has actually had a positive effect on overall individual savings.

7. *Give workers some say in the level and investment of their retirement funds.* Many of the current proposals to reform the current system call for an increase in the retirement age. While I believe this is desirable, I think we have more work to do in this area. Despite the current law provisions which call for the normal retirement age to be raised from 65 to 67 over the next few decades, workers continue to retire earlier. While most of these early retirements may be by individual choice, I continue to be concerned that we have not done enough to ensure that workers in physically demanding jobs are able to retire or be retrained at the age when the physical challenge becomes too great to continue with their lifetime vocation. The proposed two tiered system would offer at least some more choice in deciding when to retire. At the same time we need to develop efforts that will encourage workers to work longer.

With regard to the choice of investments for individual accounts, I also think some choices need to be given. While markets have developed substantially over the last 60 years and individual workers are much more generally informed, I do not believe we can simply let each individual workers make their own choices on the open market. Experiences in other countries show that this can be very dangerous and also very costly. Yet, it is possible to develop a controlled set of options so that workers can make an informed choice about where to invest their individual accounts and yet be protected from unscrupulous practices or exorbitant costs.

Some countries have given workers an option to stay in a government sponsored second tier or to opt to the private sector *managed* programs. Where this option has been left open it has sometimes lead to workers moving back and forth between these two options. The number of choices and options needs to be carefully considered so as to avoid this costly back and forth movement. This option has been discontinued in Argentina and they have seen no ill effects.

8. *Develop a comprehensive but reasonable regulatory framework to protect the retirement accounts of workers.* While any person should be free to invest their own money as they see fit, this is a government program designed to guarantee a secure retirement for all workers. Such a *mandatory* savings program requires a higher degree of protection against unscrupulous practices and perhaps even against precipitous market fluctuations. The FERS and FEHBP programs offer some real life experience with market oriented programs that provide for extra regulatory precautions. I believe we can benefit from these experiences as well as the experiences of other countries in designing the initial framework for social security reform The efforts of the workgroup on reform implementation of the Center for Strategic and International Studies also offers some very sound and practical advice. In this area I believe that we should proceed carefully and allow the set of choices to be expanded as we gain experience.

In England and Australia the initial regulations were not tight enough and allowed for several costly experiences. On the other hand, the kind of tight regulation seen in Chile or some other South American countries does not allow for the situation as it exists in the US economic sector.

9. *Educate the public about the principles and projected outcomes of the proposed reforms as well as the principles and projected outcomes of the current program.* Accurate education of the public about the current program is sorely lacking. Too many citizens continue to believe that they pay their FICA into an account that is held for them to draw from upon retirement. Many other myths about the program continue to persist and as mentioned earlier, few existing workers are able to calculate their own social security benefit amount.

I sincerely hope that a broad bi-partisan agreement on Social Security Reform can be reached soon. If it is, there should be included a provision to educate workers about the current program as well as the future program and why the changes were made. If for some reason this broad consensus is not reached soon, I would urge you to develop a bi-partisan education effort that could be carried out in order to try and develop a public consensus on this critical issue.

10. *Proceed expeditiously to Design and carefully to implement.* While we are not in a crisis, time is of the essence. Each day of delay in correcting problems of the current program means additional costs. At the same time, we and other countries have learned that changes implemented incrementally are usually easier to accept and to implement. While there are potential administrative problems in implementing individual accounts, there is no question that it can be done and it can be done successfully.

Experience in the United Kingdom is of particular value in looking at ways to finance and develop the administrative structure for administering individual accounts. Even with the benefit of the experience of other countries we should allow sufficient time to develop the necessary mechanisms. This time lag does not have to stall the reform process, but simply ensure reasonable implementation dates for the various program changes. This time lag will also provide an excellent opportunity for the public education effort discussed earlier.

11. *Design a reform of the Retirement program but consider separately the reform of the Disability and Survivors programs.* The current Social Security Disability program has a number of substantial problems. These problems are relatively small when compared to the magnitude of the problems with the Retirement program and have more to do with administrative issues or return to work incentives than they do with the financing. The Retirement portion of the program should be redesigned on its own and any resulting effects (such as increased retirement age) should be considered for its effect on the disability program along with efforts to enable more persons with disabilities to fully participate in the economy.

Likewise, the Survivors portion of the program is relatively small compared to the Retirement program. While some countries have opted to purchase group insurance from the private sector to meet the needs of families when the worker dies prematurely, these policies are often less than adequate especially for young families. Once a reformed Retirement program has been designed, a careful look at the Survivors program should be taken to ensure that benefits are adequate and any necessary adjustments made. We should not put at risk this vulnerable group of worker dependents.

12. *Ensure that adopted reforms have broad bi-partisan support.* In several countries reforms have been implemented only to be substantially modified with the next change of government. This tends to lead to confusion by workers and a lack of confidence in the system Confidence of workers should be a hallmark of this nations retirement security program.

As I said in my opening remarks, the past 18 months have only convinced me to a greater degree that properly designed reforms can be successfully implemented and well received by the population. No country has a perfect Social Security system and even if they did it would not likely fit into the economic, political, and social setting at this time in the US. I believe we can learn as much or more from the mistakes made by other countries as we can from the successes. The primary concern we must keep in mind is the need to keep the debate honest and straightforward. The public needs to understand the current program and why change is necessary. Then the consensus must develop about how to move our retirement security plans into and through the next century.

Thank you again for the opportunity to be here today. I would be happy to try to answer any questions you may have and to work with you to see a successful solution of this most crucial issue.

Chairman SHAW. Thank you. Mr. Enoff, what restrictions would you put on investments and what restrictions would you put on the investor. I am speaking now not of the worker, but who would you allow the moneys to go to for purposes of investment? And what type of investments would you require?

Mr. ENOFF. I think that at least in the initial stages, there would have to be very strict regulation on who could run a pension scheme. After all, we are mandating here savings by individuals, and I do not have a problem with having some extra regulatory authority over those firms; that they have to meet certain qualifications. And I think we could look at what has been done in other countries to kind of lay out a framework. I think the Federal thrift system has some pretty basically good guidelines that could be used as starters. I think that you would want companies to be involved in this where they would solely be pension investment funds for that purpose to protect those funds. That does not mean they could not have other kinds of activities going on, but they would have to isolate those pension funds. I think there should certainly be regulations that would limit the amount of investment they could have in equities; the amount that they could have, let us say, in foreign investments. There are some prudent-man guidelines that are used in different countries for provident funds and for other kinds of pension funds that we could use as a base. And as I say, for starters, I think we would probably have to limit the number of options that a person might have. But at least, they should have some option.

Chairman SHAW. How broad-based would you require these investments to be?

Mr. ENOFF. When you say, how broad-based, you mean in terms of spreading them across equities and bonds and so forth? I think, and I have spent some time working with the CSIS Working Group on implementation, I think that you might have to have a kind of a joint fund until people buildup a certain amount of equity in order to make it administratively cost effective. And what I am saying there is that a person should buildup certain credits in a combined fund before they could go and chose an individual fund. Because, otherwise, the costs become prohibitive. And I do not think that is a big problem. They have worked that very well in the U.K. system—that part of it. They have had some problems in the U.K. system, so I am not saying we should adopt that wholeheartedly. But they gather the funds into one common account that is invested, and each person that is in that common account gets the same return for that period of time. So it can be done.

Chairman SHAW. Mr. Matsui.

Mr. MATSUI. I think that Mr. Cardin could precede me since he was here a while ago, sir.

Chairman SHAW. Mr. Cardin.

Mr. CARDIN. Thank you, Mr. Chairman. First, I want to thank all three of our witnesses. Mr. Salisbury, I think you raise a very good point, and that is the higher the rate of return, the greater the risk is going to be. And that is going to be the tradeoff. That is the obvious tradeoff, so we need to be very careful whether we have private accounts or we have collective investments to understand that there will be greater risk the more we want on rate of return.

Mr. Enoff, I want to thank you for your service to our country, and I particularly appreciate our working relationship when you were Acting Commissioner. And I think it is impossible for us to do things to make things more simple, but I thank you for the suggestion. Whenever we get involved, it seems to be more complex.

Wendell, I very much appreciate your testimony, because today's hearing is based upon how do we evaluate plans that are brought forward. And the Chairman has been—in his questioning, has been bringing up over and over again that what we do on Social Security has an impact on the overall budget. And I think you really brought that to focus; that we cannot just look at Social Security in a vacuum. We have got to look at the total budget, because we could easily solve the Social Security problem by taking 100 percent of the surplus, just put into Social Security, and I think under any of the projects will come out with dealing with the Social Security issues. But that is not the right thing to do for our Nation, and you point that out.

It is interesting, if you take a look at what we are doing today on the floor of the Congress, the budget itself, the general approach that the administration has taken is to take the Social Security-generated surplus and to pay down the debt, to make it more likely that we can meet our future obligations for Social Security. The Republican proposal appears to be to have that money reserved to be spent for private accounts that would help deal with our ability to meet the Social Security obligations in the future, because of the offsets from the private accounts and the Social Security system. But then the rest of the surplus, the administration has suggested that we use a significant part of that to protect Medicare, which is an existing commitment, and then make some modest improvements on the discretionary spending caps and a modest tax cut. Whereas, the Republicans are suggesting using the rest of it for a large tax cut, with unrealistic spending caps.

So I think if you put that all in context, your concerns are real legitimate concerns of whether we are going to be able to meet the future needs of our Nation. Yes, we might deal with Social Security. We might be able to deal with long-term solvency of Social Security, but at what price? Is the price Medicare? And then we are not doing seniors any favor.

The one part, I guess, I would disagree with your analysis is that seniors are going to be great under this or may come out OK under this because if they do not have Medicare, we do not deal with Medicare, then we are going to have a serious problem for our seniors. And nothing on the table here suggests that we are going to be able to deal with the Medicare concerns. The first witness made it very clear that Social Security is easy compared to the Medicare. Medicare is going to be a much more difficult problem for us to confront. So I guess I really just wanted to make the observations, give you a chance to respond to that. Yes, I want to deal with Social Security. I want to deal with it. I think we can deal with it this year. I think we can protect the current benefits structure. I do not think we need to raise taxes or reduce benefits. We have got to get a better rate of return to the system in a way that protects from manipulation by government investment. I think we can do that. But to just use this surplus, like it is not going to impact our budget in the future, that we can go ahead and just spend it—whether it is on private accounts or whether it is on tax cuts—does present a problem as to whether we will be able to meet our current commitments to our seniors—and Social Security and Medicare, as well as do what is right for all people in this Nation, whether it is education programs; whether it is health care programs; whether it is job training, and the many others issues that we have. I would be glad to give you a moment or two to respond to that.

Mr. PRIMUS. Well, thank you. You understood the testimony very well, or you probably understood it before I gave it. But I think you have to look at—I mean, governing is essentially about making choices. And what I was trying to say is that if you want individual accounts, you cannot do tax cuts and individual accounts. You have to make a choice. I am not a fond believer. I think we would do better doing it through a collective mechanism. We would get more for our money, and that is the right way to raise the rate of return. But you cannot do all three. I think we learned that in the eighties. I would say all that I was pointing out—your point about Medicare is absolutely correct; that if you did adopt a Feldstein-type approach, setting aside all the details, you are making bigger promises to the elderly in terms of cash retirement security. And my point is that I do not think we should make more cash retirement security promises to our elderly right now. We should fund the promises that we have made, both on Medicare and Social Security. We should not be increasing those promises and the Feldstein—so I am a conservative here, Mr. Chairman. I do not think we should be increasing those promises, and that is basically what happens under a Feldstein-type approach. And I think you can get the higher rate of return by doing it as the States are doing it. And there may be a little problem here and there, but I think, fundamentally, you can protect and isolate collective investment from political interference. And we all agree that right now the best thing we should do is reduce that publicly held debt. If we can get our interest burden down from 3 percent of GDP to zero, we have increased our capacity to meet promises in the future.

Chairman SHAW. I knew we would get you sooner or later, Wendell.

Mr. Collins.

Mr. COLLINS. A new conservative. I am glad I am on higher ground. That is the reason I wear boots to protect my socks. [Laughter.]

Mr. Enoff, it was a pleasure to listen to you, as you suggest that we should take the "KISS" approach, and that is: Keep it simple, stupid. Because I think we do have to keep it simple so that the people that we serve understand exactly what we will be doing and how we are going about as we save the Social Security system itself. And, you know, I try to do a little bit of this at home by telling people, you know, you already have an individual Social Security number. Supposedly, the funds that are deducted from your payroll check in the form of payroll taxes are some way tracked. So I think it would be just a matter of setting up another accounting system or using the current accounting system to actually establish an individual retirement account. And I think people would understand that. And, like you, I think people, too, would see that this is a system that is working. It is building something for me, and should have the flexibility to maybe put a few more dollars into it if they wanted to, not mandated to.

And then you are leading into a retirement program, an actual individual retirement, rather than continuing this episode of trying to convince people that they are under a retirement system today. As an old-age pension program, but, truthfully, it is nothing but a social insurance program. So I really like your approach to that.

Mr. Primus, you are a piece of work. I am going to tell you. You know, I understand where you are coming from on the budget. But maybe we have, and I know we do have a different approach to this thing. It is kind of like I told the President 1 day, we have differences of philosophy; we will just get that over with. But that is not all bad, because, you know, you bring a different idea to talk about than I do. But I do not think that the budget should depend on the Social Security system or the revenues that come from payroll taxes.

That is a whole different matter. And people at home do not think it should—in fact, people at home do not think that this Congress should do anything with their Social Security payroll taxes, but put them into a Social Security account, and make sure that they stay there. And I understand where you are coming from with the fact that, if we reduce taxes, we have the potential of maybe having a deficit again, unless we have the discipline to control spending; and that, too, is what I hear at home. Go back to the 1993 tax hike. I got more postcards mailed into me and given to me that said: Cut spending first. Do not raise taxes.

And I tell you, I think it would be interesting, and I hope we can get to actually see how that tax increase of 1993, where we changed the marginal rates, and we actually, this Congress or that Congress, the 103d Congress increased the liability on Social Security benefits as far as taxes are concerned. I will have to see the number that shows over the next 10 years where we have set aside in the budget resolution some $800 billion that could be used for tax reduction, to see just what those increases of that year that tax bill actually would bring in over the same 10 years comparable to what the relief may be. I think you will see a lot larger figure than what will actually be given back in relief.

You talked about giving the advice to my Chairman here about looking at these State programs. Well, the States do have programs, but they have true pension programs in their 50 States. It is not a social insurance program that each one has. It is a pension program. And the investments are made by investment boards or the pension retirement boards from those States. They are not made by some central government here in Washington. I believe if the State retirement system sent their money up here for Congress to invest, there would be a lot less and a lot fewer people that would want to be a part of that retirement program, based on the track record of some of the things that happened here.

But we appreciate you taking the time today and to come and give us your input and your philosophy and your side of the story. You know, I have got my side of the story, and I am sticking with mine, and I am sure you are going to stick with yours, and hope you have a good day.

Mr. PRIMUS. Can I just briefly respond, Mr. Chairman? I think, Mr. Collins, maybe we are not as far apart as you think. I mean, I also believe the Social Security system should be set aside; and that those payroll taxes should be just used for Social Security purposes. I think, if you want to establish individual accounts, you should do it outside the Social Security system and that those tax revenues should be reserved for Social Security and making future benefit payments in the future.

And I also think that the bill that the Chairman introduced yesterday, or announced yesterday, is a very good step in terms of a lockbox device to make sure that the Social Security revenues are used to pay down the national debt. And, you know, I would not have the escape clause. I do not think you should be using Social Security money to establish the individual account.

And so, if the States can do it, and they can set aside and fully fund—and I am just arguing for more advanced funding right now of our retirement system—if they can fully fund, surely the Federal Government, and all of the wisdom up there on the podium should be able to figure out a way to reserve it and not use it for either spending increases or tax cuts. I think that is what I am advocating. And I do not think there may be as much difference in philosophy as you initially thought.

Mr. COLLINS. I can assure you there is.

Mr. ENOFF. Can I say something in this debate, because Wendell and I agree on advanced funding? But we stop our agreement, I think when we start talking about who ought to be investing that, and I, you know, I think the government should do those things that the individuals cannot do. And that is the way we ought to start this process. And I believe in the social insurance program. And I believe you can have a social insurance program that includes mandatory savings with individual accounts. There is nothing that is wrong with that. But I think it is question of when we started this in 1935, it was impossible to have individual accounts. But we have that opportunity now, and I hope we do not miss the opportunity to begin those individual accounts, and it should come out of somehow a part of the Social Security contribution.

So, I mean, we are not that far apart maybe. Maybe we ought to focus on that, and we could solve the issue. But I think that is the difference. Who is the dependence on, whether we are going to have dependency on our own account or depend on a government account?

Mr. COLLINS. Well, you know, I understand, and we are a whole lot closer together than I am with Mr. Primus over here. But you are talking about using the current payroll tax that is already coming out of every individual worker's paycheck rather than setting up another mandate that would increase the burden on those working people by taking more of their income and giving them as an ear of corn out there to plow harder to put more of theirs in, because many of them could not because of the low income not having the money to put more in. So I think it—we are a whole lot closer than Wendell and you and I are, but I thank you all for coming.

Chairman SHAW. Mr. Matsui.

Mr. MATSUI. Thanks, Mr. Chairman. Lou, I was not here for your testimony, but were you suggesting a carve-out under the 12.4 percent for individual accounts or were you suggesting it was over and above. I did not get it.

Mr. ENOFF. I think a carve-out is a part of the solution. I am not opposed, and I—you have been talking about Feldstein proposal, and I have not seen—I have been out of the country.

Mr. MATSUI. Well, I am not talking about that. I am just——

Mr. ENOFF. OK, yes. I would suggest that there be a carve-out. And there may even at some point, looking at how you fund that—let's face it. We have got to fund the transition from where we are to where we are going. That is the beginning.

Mr. MATSUI. Right. How do we do that because, you know, Bob Rubin says that transitional costs, the unfunded part is $8.5 trillion. I mean, it is pretty big numbers.

Mr. ENOFF. There is an expensive transition cost which you get back in the long run. You get it all back in the long run, because if you are going to increase the amount of return. I mean, I think everybody agrees on that, too. So it is a matter of how do we pay for that transition and who should pay for the transition.

Mr. MATSUI. I am not too sure if I agree with that conclusion. But, you know, that has been one of the problems, but I appreciate your testimony. And Mr. Salisbury, you probably do not remember this, but you did come to Sacramento for a health care conference in the early eighties, and I appreciated that. Well, he does remember everything, I tell you. It is amazing. But thank you for that.

Wendell, let me ask you, you have studied Martin Feldstein's plan I understand, is this correct?

Mr. PRIMUS. That is correct.

Mr. MATSUI. You know it pretty well—about as well as Martin Feldstein knows it I guess.

Mr. PRIMUS. He keeps changing it, but I try to keep up.

Mr. MATSUI. Right. Let me ask you a couple of questions with respect to it. Assuming a 75 percent claw back, is that plan sustainable under the current budget situation we have now?

Mr. PRIMUS. My understanding is that, again, and the actuaries have done this, that a 2-percent plan does not restore solvency to Social Security and would require substantial amounts of funding, and, again, the point of the testimony is if you spend it all on tax cuts, you do not have the moneys left to fund Feldstein even if you wanted to, because it takes about $80 billion or $90 billion a year; and it is a $2.9 billion cost over the first 25 years; and including interest, it is little over $6 trillion over the next 24 or 25 years.

Mr. MATSUI. Yes, I thought my numbers were reasonably accurate—the $4.6 trillion or $4.7 trillion over 15, but thank you for helping me with that. And you know our surplus is only projected out for 15 years or so. So if we do not sustain a surplus beyond that, how does Feldstein fund itself. Do we have any idea?

Mr. PRIMUS. Well, he is——

Mr. MATSUI. I mean, that in perpetuity whereas the surplus is only projected for 15 years. I mean, I am trying to understand that.

Mr. PRIMUS. Right. He is suggesting that it gets funded out of the general fund. And, you know, I think, if you again, if you set your mind to it and tried to just make Feldstein work and set again the whole notion of tax cuts aside, you would have a better chance of trying to make a Feldstein plan work. I do not think—I still think there are problems down the road, because eventually the promises we have already made to our baby boomers, and we start to retire in about 2010, 2013, those deficit projections, which are now surplus projections head south. And there is considerable uncertainty—you know, a whole page of my testimony is devoted to this notion that those surpluses and projections, you know, assume we are not going to have a recession for the next 10 years, for example. I mean, the probability of that happening is not very great. And so we are building in, if the, again, the framework that I see in the House and Senate budget resolutions, I think spell disaster. You cannot do all of them.

Mr. MATSUI. Now, if you take the Feldstein basic plan, and let us say a 90-percent clawback, is that just another way of kind of avoiding government investment, but getting into the equity markets in order to get a greater return; but do you have the problem of the overhead and the fund maintenance problem?

Mr. PRIMUS. Yes, I think the elements of this debate, as we all agree there should be advanced funding, and we want to raise rates of return. Everybody can give lip service to that. The question is what is the best way of increasing the rate of return. Should we do it through a collective mechanism, where we do not have the administrative costs, and so forth, of setting up 150 million accounts. And I guess the point I would want to make, Congressman, is that there is political risk—a lot of people have talked about the political risk of the collective investment. But there is also political risk of individual accounts. That means—I will give you two examples is you never allow access to that individual account before the individual retires. I mean the question is could you, not like what you have done in IRAs and other retirement vehicles, say forever, we are going to protect that individual account, and it can only be used for retirement. That is a political risk of that approach. Another one is can you force them annuitization. I mean, do those plans require—I mean, Feldstein says, my plan requires mandatory annuitization. Well, when your constituent is in a hospice bed and you have said that $100,000 account is yours—or if the stock market is not doing as well—will you have the fortitude to say to that person, no that plan, we could only give you the 6 months of benefits or however long you live. I think those are difficult decisions.

And what I am trying to emphasize is there are political risks both ways.

Mr. MATSUI. Last, Lou, could you tell me—and I am sorry, Mr. Chairman, I just want to follow up—you were saying that maybe you got a transition in terms of these individual accounts, because I guess——

Mr. ENOFF. Yes, sir.

Mr. MATSUI. I guess risk and, you know, sophistication of the——

Mr. ENOFF. No, sir. It is not a——

Mr. MATSUI. Maybe I misunderstood you.

Mr. ENOFF. Just so I am clear. There is a cost to transition from a pay as you go to a funded program, whether you have individual accounts or not.

Mr. MATSUI. No, no, I understand that. But I sensed that you were a little concerned—am I mistaken about this, that you were somewhat concerned about the individual accounts, and you have said you may have to start off by kind of a larger account?

Mr. ENOFF. Sure. Experience.

Mr. MATSUI. Experience.

Mr. ENOFF. And let me—yes, experience in other countries show that you can, in fact, keep those accounts and cause annuitization and that there is not a hew and cry by the population because what is the alternative. If the alternative to the current system as opposed to an individual account, even if I cannot touch it until I retire, it is my account when I retire and it goes to my heirs at that point, as long as that is well understood in advance. But I would like to say, talking about the Feldstein plan, the President's plan, neither of them address the question of getting people to work longer. And this is an issue that I am afraid is going to have to be dealt with. I mean, you look at the demographics that are pointed out everywhere. People are retiring earlier. They are not working longer, despite the fact that you have increased the retirement age to 67. Still, 70 percent of the people who take their Social Security take it before age 65. We need to do something; we need to focus on how to encourage people to work longer. That is not very popular. I realize most of us like to retire probably at 45, but that has got to be a focus of a solution. I think that if you do not deal with that issue, we are going to have people retired for over a third of their adult life. And you cannot build enough money to pay for that unless you substantially raise the amount you are putting in. You cannot get enough of a return, so we probably have to deal with that issue. I know it is not popular, but we are going to have to deal with it. And I suggest that we need to look at ways to help people transition from maybe a physically demanding occupation into one that is less demanding and look at some gradual retirement approaches and activities like that which will encourage people to pay into the system longer than they are collecting out of it. That is the point.

Mr. MATSUI. Well, you know the only way to do that is by having a greater penalty upon early retirement. And obviously, that is not politically sustainable.

Mr. ENOFF. It is not sustainable, and I am not sure we have done enough work to ensure that it does not hurt some people who we do not want to hurt.

Mr. MATSUI. Yes, absolutely.
Mr. ENOFF. And so I think it needs some more work.
Mr. MATSUI. I want to thank all three of you.
Chairman SHAW. Mr. McCrery.
Mr. MCCRERY. No questions.
Chairman SHAW. Well, I want to thank this panel. It was certainly interesting. It is interesting to see how we all start coming together at some points, even though we disagree on the details. The more we study this program, the more you realize it is only about five or six courses of action that are even out there. And the question is just to select one. And the one I think that is least sustainable is doing nothing. So I think we are going to act, and hopefully, it will be in a bipartisan way. Thank you very much for your input.
Mr. ENOFF. Thank you.
Mr. PRIMUS. Thank you.
Chairman SHAW. We are now adjourned.
[Whereupon, at 12:50 p.m., the hearing was adjourned.]
[Submissions for the record follow:]

DAVID B. LOWRY, ATTORNEY AT LAW
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PORTLAND, OREGON 97223

A.L. Singleton, Chief of Staff
US House of Representatives
Committee on Ways & Means
1102 Longworth House Office Bldg
Washington, DC 20515

RE: Social Security Hearing 3/25/99

Dear L.A. Singleton,

I am a lawyer with a Social Security disability law practice. Here are some ideas on how to promote the solvency of the Social Security system.

1. Increase the numbers of working age taxpayers through a change in immigration law. Have the INS recruit citizens the way football coaches recruit players. Have the INS show up on college campuses around the world and recruit new citizens in the top 10% of their graduating classes, just as IBM or ITT would recruit employees. These people will be hard working, taxpaying citizens somewhere and it might as well be here.

I note that some countries are already advertising for American retirees and if others can advertise for our old people, we can certainly seek out their young people.

Let the bright, ambitious teeming masses yearning to come to America do so.

2. Reduce the outlay of Social Security benefits by converting the cash benefit retirees receive into a tax deduction for those with retirement incomes of $100,000 plus from non-Social Security sources. This will cost the IRS a little and save SSA a lot.

Yours truly,

DAVID B. LOWRY

DBL/bs

Statement of Cynthia Wilson, President, Retired Public Employees Association, Inc., Albany, New York

As President of the Retired Public Employees Association, an organization of more than 80,800 New York government retirees and their spouses, I am writing to urge the Committee to make the financial protection of *individuals,* especially those with low and middle-level incomes, one of the major criteria to be used in evaluating Social Security reform proposals.

There are many ways of establishing the financial stability of the system, but there are few ways for the poor to obtain retirement income outside of Social Security. Therefore we recommend the rejection of any proposal

- that would push the already poor deeper into poverty,
- that would decrease the income of those currently self sufficient to inadequate levels,
- that would cut support for the survivors of deceased workers,
- that would cut support for disabled workers and their families,
- that would force an increase in the costs of means-tested programs, such as SSI which would have to be expanded to rescue the victims of reform.

The Social Security system was established and enlarged to assist the less fortunate in our society. It would be tragic if the structure were stabilized at the expense of those who need help the most.

RICHARD WEEDE PHOTOGRAPHY
14935 HIGHLAND VALLEY RD.
ESCONDIDO, CA 92025
March 22, 1999

Committee on Ways and Means
1102 Longworth HOB
Washington, D.C. 20515

Re: Social Security reform

To whomever will listen:

I must first apologize for any missteps as I try to give you my ideas for the reform of Social Security. This is the first time I have ever written to a committee and know nothing about correct protocol. It seems almost presumptuous of me to think that you have not already considered this thought, but on the other hand, how can I rile about the "dumb things" you do or don't do if I don't at least give you some help?

Obviously, this is only a basic outline and will have lots of flaws, but if looked at in a positive manner, you may find a way to implement a similar program. This is not a near term fix, but could certainly solve the S.S. program of the future. Here goes:

As of a certain date, give a $1000 tax refund to the parents of each newborn child. That money would not go directly to the parents, but to one of many pre-approved, well-established mutual funds. (The parents would choose from the list) That money could never be touched until the child reached 55,60,65 or whatever seems reasonable.

The only exception to the "no touch" rule would be when that first "funded child" has a child. At that time they *must* roll over $1000 into a new fund for this next generation child. At this time the tax deduction method would no longer be necessary and the program would fund itself automatically.

I am sure that you know that the $1000 would be worth the better part of a million dollars at retirement age. However, incentives could be added for the parents to add small monthly amounts to the basic investment for the first ten years which would greatly enhance the original investment.

Of course, I realize this would only take care of retirement benefits, but that is what S.S. was meant to be, isn't it?

What happens if the child dies? You can work on that. I can think of a number of scenarios, but they are not as important as the basic concept. There will be other glitches. Think positively and work them out.

Now don't tell me this would disrupt the entire stock market. It might be a real boon.

Respectfully,

RICHARD WEEDE