A LEGACY TO OUR CHILDREN: UNDERSTANDING INTERGENERATIONAL ECONOMIC ISSUES

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COMMITTEE ON THE BUDGET

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A Legacy to Our Children: Understanding Intergenerational Economic Issues

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THURSDAY, JULY 27, 2000

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

The committee met, pursuant to notice, at 10:02 a.m., in room 210, Cannon House Office Building, Hon. John R. Kasich (chairman of the committee) presiding.

Members present: Representatives Kasich, Chambliss, Smith of Michigan, Hoekstra, Gutknecht, Sununu, Knollenberg, Fletcher, Price, Moran, Lucas, Holt, and Baldwin.

Chairman KASICH. Let us go ahead and get started. The purpose of this hearing is to focus on how the Federal Government distributes resources among the generations. Understanding our current situation is the first step in setting priorities for the future, Mr. Crippen.

Two of the biggest programs affecting both the current and future generations, obviously, are Social Security and Medicare.

The programs have, without question, dramatically improved the lives of our Nation's seniors, providing real retirement security for nearly 40 million Americans and helping to lift seniors out of poverty. But, of course, it has come at a very high cost. Today, the Federal Government spends $7 on seniors for every $1 on children. It is a very interesting statistic. In other words, for every dollar we spend on kids today, we spend $7 on senior citizens.

Over the next 75 years, benefits paid out will exceed payroll taxes and premiums coming into these programs by dramatic amounts. And the numbers are really almost too hard to appreciate. Social Security will be in the hole by $133 trillion. Medicare A and Medicare Part B will be in the hole by about $204 trillion. That adds up to a $337-trillion shortfall. These costs will impose a huge burden on future generations, and eliminating these cash shortfalls would require increasing payroll taxes by two-thirds over the next 30 years. Why is it happening? Part of the reason, demographics. The baby boomers will start retiring in about 10 years, and the ratio of workers to beneficiaries will fall.

In 1960, there were five workers paying for each Social Security beneficiary. Today, the ratio is 3.4 to 1, and in 30 years it will be 2 to 1. In addition, spending per beneficiary in these programs is growing faster than the rate of inflation. There are, obviously, proposals to address this issue. I have one. Congressmen Kolbe and Stenholm, Kerrey, Breaux-Thomas for Medicare, all of these folks have weighed into this issue. But all of the proposals require that we act sooner, rather than later. The latest figure shows a $4.6-trillion budget surplus over the next 10 years, and it is an historic opportunity. The question is can we leverage these surpluses to develop the kinds of reforms that will make these programs stronger and better for the future?

I suppose when you take a look at these kinds of numbers, $337 trillion worth of shortfall, it is pretty hard for anybody to even begin to consider them. I think it is important we begin to look at this. Because if we don't get started sooner, the problems get even more devastating later, and it gives us an opportunity to get started on them.

So, Dan, we have a vote on the floor. I am thinking maybe, we have got so many committees marking up today, but I don't really want to have you—I want to make sure we vote, and come right back and hear from you, whatever members we can get back here. And why don't we just take a break right now because I want to hear all of the testimony. And I also would, on the record, like to extend my deepest sympathies to you and to your family over the loss of your wife. But we are glad you are back on the Hill. I just want to tell you that publicly. Thanks for being back, Dan.

We will just recess, and vote and return.

[Recess.]

Chairman KASICH. OK. Let us get started.

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

Mr. CRIPPEN. Thank you, Mr. Chairman, Mr. Spratt, members of the committee.

Let me begin by recognizing the difficult schedule we have today and the more limited time of some of your panelists. I am available all day, so please feel free to interrupt me if it proves convenient for the committee or for other witnesses.

Mr. Chairman, I take as one of CBO's roles assisting in getting the questions right. That is not to say that CBO is always right or even that it always has an answer. But I suggest, Mr. Chairman, it would be rare to obtain the right answer when positing the wrong question.

I believe there is a growing consensus among economists on the appropriate questions concerning programs that span generations, specifically Federal programs that support retirees. But before I present what I believe to be the right questions, I want to state what I believe to be the wrong question, namely, the status or solvency of trust funds. This hearing was billed as considering the sustainability of Government entitlement programs. Mr. Chairman, balances in trust funds by themselves have nothing to do with sustainability. We mislead and confuse ourselves and others when we cite improvements in solvency as improvements in our collective ability to pay obligations in the future.

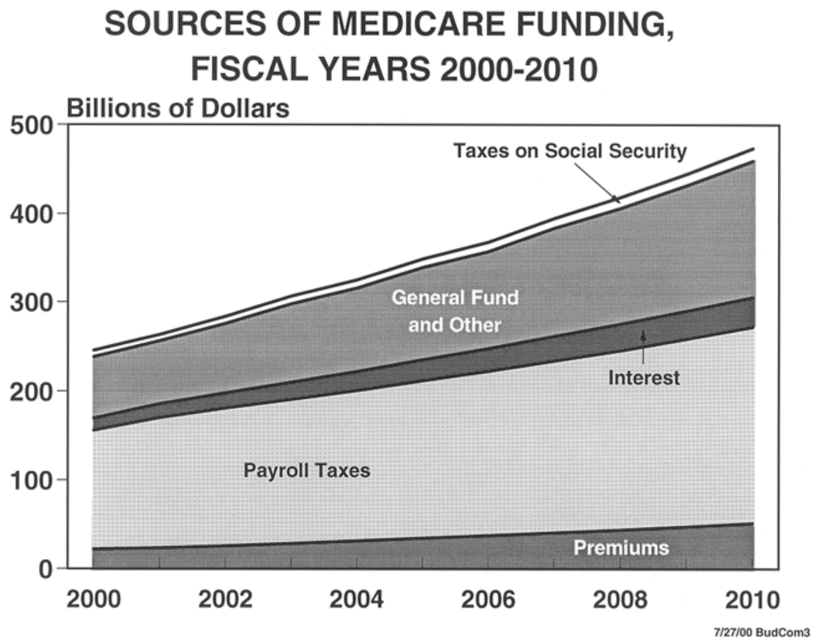
Unfortunately, the confusion is widespread. This poster is representative of——

Chairman KASICH. Mr. Crippen, would you say that in English. I understood what you meant, but there isn't anybody else in the room, except for Kotlikoff back there that understood what you just said. Say it in plain terms, would you?

Mr. CRIPPEN. Well, I'll be as plain as I can be. Trust funds don't matter for the issue of sustainability. They are an accounting mechanism, and I will cite others who believe that and say other words that may make it clearer than I can. But the balance in the trust funds has little to do with our ability to pay future obligations.

Chairman KASICH. I think that was pretty clear there.

Mr. CRIPPEN. As I said, this poster just shows you the reporting after the last Trustees report. The reporters equated solvency, or increased trust fund balances, with a rosier future. It may turn out to be true, but not for any of the reasons cited in these articles, save one, and I will get to that in a minute.



Let me give one example of the potential danger in our accounting, and then, by contrast, pose what I believe to be the more relevant questions. Sometime in the not-too-distant future, around 2015, Social Security expenditures will exceed payroll taxes. At that point, general funds, in the form of interest credited to the trust funds, will be drawn down to pay benefits. Later on, U.S. Government debt credited to the Social Security trust funds will be redeemed for cash to cover any shortfall.

But all of that raises the question, how does the cash get generated to cover benefits in excess of payroll taxes? It must come from the rest of Government and taxpayers by cutting other programs, increasing borrowing or raising taxes—the same result as if there were no bonds credited to the funds or, indeed, if there were no trust funds at all.

I repeat, the economic and budgetary result is the same with or without trust funds. As the President said in his fiscal year 2000 budget: "* * * the trust fund balances are claims on the Treasury that, when redeemed, will have to be financed by raising taxes, borrowing from the public, or reducing benefits. The existence of large trust fund balances, therefore, does not by itself have any impact on the Government's ability to pay benefits." That point, Mr. Chairman, is not well-understood.

So if the trust funds are inappropriate for answering questions about sustainability, what is appropriate? I would argue, as have others I will cite this morning, that the size of the economy and the amount of those resources consumed by the elderly are most relevant to the issue of sustainability. Clearly, there are other very legitimate questions, particularly about distribution of the benefits, that this analysis does not address; rather, this approach analyzes the overall funding. As such, it would apply to virtually any distribution of the benefits you choose.

In the end, Mr. Chairman, it is the economy that acts as our intergenerational trust fund, not just for Social Security, but for all other transfer payments to retirees. It is largely the resources produced after we retire that we will be consuming in Federal benefits—mostly resources produced by our children and transferred to us to satisfy our claims.

Before the committee supposes that I have jumped off an ideological cliff, let me assure you that this is not a fringe notion, nor does it favor one kind of reform over another. It simply states that the size of the economy defines and constrains our ability to pay beneficiaries.

Dr. Alice Rivlin, in a speech last year on this topic said, and I quote, "I believe, however, that focusing too narrowly on the Social Security funding question, in isolation from the more fundamental economic challenge of an aging population, risks muddling the problem and perhaps picking a wrong answer."

"In any given future year," she went on to say, "say, 2050, a larger proportion of older people will be competing with the workforce and the rest of the population for shares of GDP in that year. Whatever is produced in 2050 will have to suffice for all claimants. Societies cannot consume more than they produce for long, nor can consumer goods feasibly be stockpiled."

Dr. Rivlin went on to say that the most important and urgent question—I would argue, Mr. Chairman, the right question—is, and I again quote, "What can we do now to increase future GDP so that there are more goods and services to be distributed among the claimants in future years?"

She went on to say, "Some solutions contribute to higher growth and some do not. It is important to choose a pro-growth solution and choose it soon."

Similarly, Alan Blinder and Frank Newman, in an op-ed article in the Wall Street Journal earlier this year said, "Unlike pension funds, Social Security does not own independent assets that can be sold. Rather, retired Americans can consume more of our gross domestic product only if other segments of society, including working people and children, consume less. And the harsh reality is that the workforce of the future will have to support a larger number of retirees. Just how heavy that burden will be depends on several factors, including the level of retirement benefits and the rate of population growth. But one factor stands out particularly important, the rate of productivity growth."

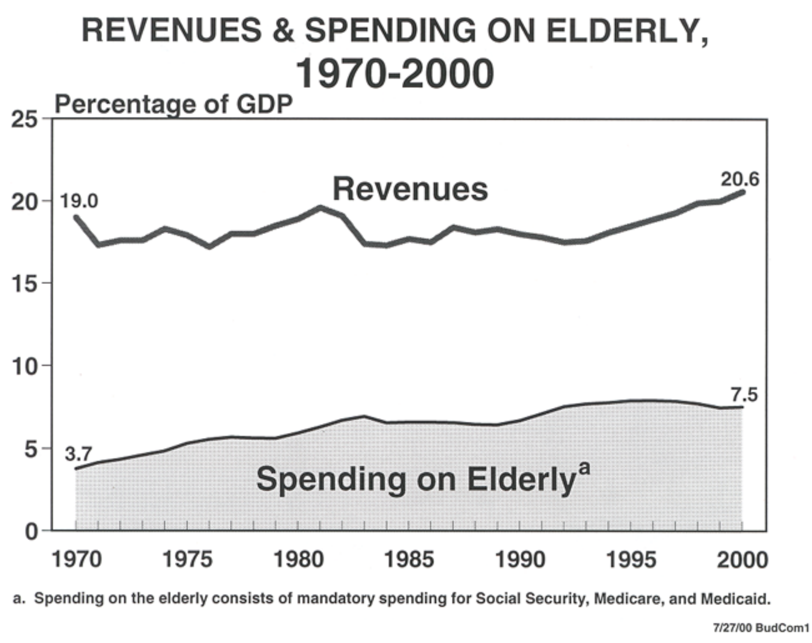
Again, that was Alan Blinder and Frank Newman earlier this year in the Wall Street Journal.

Thankfully, there is, I believe, one calculation that takes those factors into account: the percent of the economy devoted to Federal spending for the elderly. The numerator is obviously obligations to retirees, as defined by existing law, and the denominator is the size of the economy, the result of both the size of the workforce and its productivity.

These next two charts, one the record for the last 30 years and one our projections for the next 30, plot the portion of the economy dedicated to Federal spending on the elderly. We have also added to both charts the actual and projected amounts of total Federal revenues as a percent of GDP.

Chairman KASICH. I just want everybody in the room to know, particularly my colleagues on the Democratic side, I didn't want to have this hearing today for any purpose that was related to politics. I just want everybody to take a look at these numbers, and we are going to have other people that are probably going to have other points of view. But the purpose of this is really, I think my party, in a large way is as unable to deal with these as the other party. And in some respects, I feel like I am back in 1989 again saying we need to balance the budget. Now I don't think I would say that, but I want to warn about this—frankly, this problem is as serious or more than what we faced 10 years ago. So I just would like everybody to be able to kind of see these charts.

Go ahead, Dan. I am sorry.



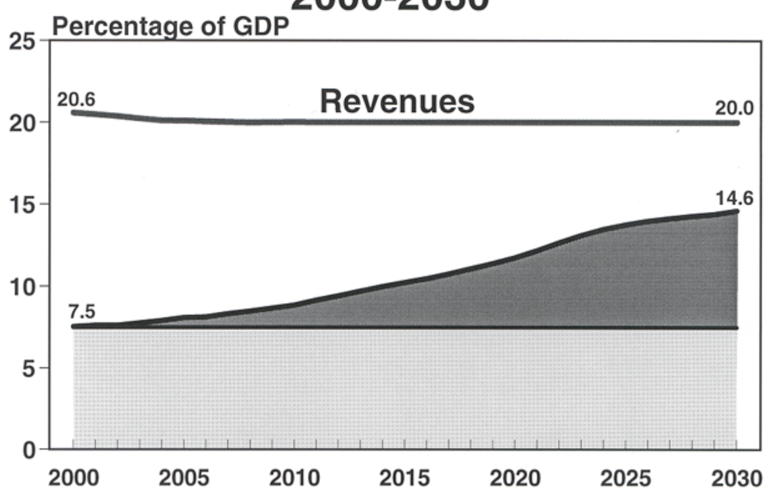
Mr. CRIPPEN. The next two charts show the record of the past 30 years and our projections for the next 30 years. As I said, we have added the revenue projections as a percent of GDP as well, just to be illustrative.

For the past 30 years, this measure has been creeping up, largely because of increased costs of Medicare and because of growing numbers of retirees. Thus, because the ratio grew, costs were shifted from the elderly to the working population—the burden on the workforce increased.

Over the next 30 years, the portion of the economy dedicated to Federal programs for the elderly will virtually double from 7 percent to 14 percent. A substantial part of the increase is due, Mr. Chairman, as you already said, to the increase in the retired population—the baby boomers—with little growth in the underlying workforce.

A large portion of the increase is also due to ever-increasing Medicare costs for each retiree. The result is that the burden on the workforce and future generations will rise dramatically. Put another way, as we have talked before, to eliminate the shift of burdens to the future, my generation, essentially, needs to pay twice—once for our parents and once for ourselves.

REVENUES & SPENDING ON ELDERLY,[a] 2000-2030



a. Spending on the elderly consists of mandatory spending for Social Security, Medicare, and Medicaid.

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We are currently contributing more than our parents require—hence, the Social Security surpluses.

In order for that surplus to contribute to future funding of these programs, it must, I repeat, must add to national savings. Simply running a surplus in the Social Security trust funds or otherwise adding to the trust fund balances does nothing to aid future financing, does nothing to grow the economy. That is why trust fund accounting, by itself, has nothing to do with the ability to meet future obligations. But saving Social Security surpluses by running total budget surpluses of the same amount or more should enhance economic growth and make future benefits more affordable.

The calculation of spending on the elderly as a percent of GDP illustrates the policy dilemma.

There are only two moving parts—the level of benefits and the size of the economy. If you want to change this outlook, say, to lower future burdens, the economy needs to grow faster or benefits need to grow more slowly, neither of which is directly related to solvency or trust fund balances.

But assume, for a moment, that these charts are about right; what are the implications of our projections for spending on the elderly? With revenues at a constant 20-plus percent of GDP, programs for the elderly will eventually consume much of the Federal budget, leaving little room for anything else. I should note Federal revenues have averaged under 18 percent of GDP for the last 55 years, and the current level is near the historic high of 20.9 percent, reached in 1944.

How can we reduce future burdens? We need to increase productivity, and one way to do it is to save more as a Nation. As our grandparents and parents told us, forgoing consumption today and saving instead will make us better off in the future by enhancing productivity. There may be other policies that enhance productivity. We could also expand our workforce by changing immigration policy. In short, Mr. Chairman, we need to exhibit behavior and pursue Government policies that will grow the economy.

Can we grow our way out of this problem? Not within the construct of current programs. Social Security is pegged to replacing a portion of real wages, so as the economy grows, so will future Social Security obligations, although there is a significant lag that would improve this picture. Likewise, Medicare, as currently structured, will likely increase even more rapidly than the economy. But make no mistake, a growing economy will make it easier for our kids to support us in retirement, as Blinder and Newman observed.

If we can't grow all the way out of the problem, we—meaning my generation—would have to accept some reduction in our benefits to ease the burden on future generations. For example, as you have proposed, Mr. Chairman, if in calculating an individual's Social Security benefits, the current indexation for real wages were changed to indexation for consumer prices, the growth in average benefits would be less than the growth in the economy. That would restrain the growth of the ratio on the second chart considerably. Obviously, the policy implication of such a change is the conversion of some notion of wage replacement to one of preservation of purchasing power—retirees would be guaranteed some level of consumption.

Mr. Chairman, let me quickly summarize what I've tried to present here today:

First, I want to note that it is my generation, my kids, and my grandkids, not my parents, who would be affected by anything I have discussed today.

Second, the existence of trust funds, and whatever balances might be in them, are largely irrelevant to the country's ability to pay future obligations. That is not to say the financing of the program, the current excess of taxes over expenditures, is irrelevant, but those surpluses are a result of the operation of the program and the operation of the rest of the Government, not a result of the existence of trust funds. Rather, the most important factor is economic growth—the future size of the economy. Unless we begin to recognize this, as Dr. Rivlin said, we are likely to take actions that will make the outlook worse, not better.

Mr. Chairman, if we don't have the right question, we are unlikely to get the right answer.

Thank you.

[The prepared statement of Dan Crippen follows:]

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

Mr. Chairman, Congressman Spratt, and members of the committee, I appreciate this opportunity to appear before you today to discuss the budgetary implications of an aging population.

My testimony focuses on several major themes:

- Financing the nation's current promises to the elderly will require a major reallocation of society's resources once the baby-boom generation has retired.
- A strong and growing economy will make fulfilling pledges to Social Security and Medicare recipients easier, but it is not the entire solution.
- Although government trust funds arguably have some value as an accounting mechanism, their projected solvency does not by itself ensure that economic resources are available to cover program costs.

THE CURRENT OUTLOOK

Earlier this month, the Congressional Budget Office (CBO) projected that under current policies, the Federal Government would accumulate total surpluses of about $4.6 trillion to $5.8 trillion over the next 10 years (see Table 1). The off-budget surpluses, which are basically the Social Security surpluses, total $2.4 trillion over the decade; the on-budget surpluses amount to $2.2 trillion to $3.4 trillion, depending on the assumptions about discretionary spending. Two important caveats apply to those projections:

- Demographic and economic forces already in place are expected to erode the surpluses, renewing the Federal Government's fiscal imbalance of previous years. According to CBO's long-term budget projections published in December 1999, Federal deficits will return in about three decades under current policies and eventually cause the Federal debt and its corresponding interest costs to escalate as a percentage of national income.
- Deficits will reappear earlier if the government spends more or taxes less than CBO projects under current policies. Significant pressures are already building to cut taxes, increase Medicare spending, and boost discretionary spending.

TABLE 1.—THE BUDGET OUTLOOK UNDER CURRENT POLICIES

[By fiscal year, in billions of dollars]

	Actual 1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Total, 2001–2005	Total, 2001–2010
Discretionary Spending Grows at the Rate of Inflation After 2000 [1]														
On-Budget Surplus	1	84	102	126	143	154	169	222	260	288	332	377	695	2,173
Off-Budget Surplus	124	149	165	186	202	215	232	247	263	278	293	307	1,001	2,388
Total Surplus	124	232	268	312	345	369	402	469	523	565	625	685	1,696	4,561
Total Surplus as a Percentage of GDP	1.4	2.4	2.6	2.9	3.0	3.1	3.2	3.6	3.9	4.0	4.2	4.4	n.a.	n.a.
Discretionary Spending Is Frozen at the Level Enacted for 2000 [1]														
On-Budget Surplus	1	84	116	157	195	231	270	346	410	466	541	618	969	3,349
Off-Budget Surplus	124	149	166	187	202	216	233	248	263	279	294	309	1,003	2,395
Total Surplus	124	232	281	344	397	447	503	594	673	745	834	927	1,971	5,744
Total Surplus as a Percentage of GDP	1.4	2.4	2.7	3.2	3.5	3.8	4.1	4.6	5.0	5.3	5.6	6.0	n.a.	n.a.
Discretionary Spending Equals CBO's Estimates of the Statutory Caps Through 2002 and Grows at the Rate of Inflation Thereafter														
On-Budget Surplus	1	84	163	219	245	263	290	348	393	433	488	545	1,179	3,387
Off-Budget Surplus	124	149	165	186	202	215	232	247	263	278	293	307	1,001	2,388
Total Surplus	124	232	329	405	446	478	522	595	655	711	781	853	2,180	5,774
Total Surplus as a Percentage of GDP	1.4	2.4	3.2	3.7	3.9	4.0	4.2	4.6	4.8	5.0	5.3	5.5	n.a.	n.a.

SOURCE: Congressional Budget Office.
NOTE: n.a. = not applicable.

[1] After adjustment for advance appropriations.

The projected long-range fiscal shortfall is associated with three phenomena: the aging and eventual retirement of the baby-boom generation; increased life expectancy, which will lengthen the time people spend in retirement; and escalating per capita medical costs. Under the intermediate assumptions of the Social Security trustees, from 2000 to 2030 the number of elderly people in the United States will nearly double while the number of people ages 20 to 64 will grow by about 16 percent.

With demographic trends such as those, Federal programs for the elderly will consume sharply increasing shares of national income and the Federal budget. According to the Social Security and Medicare trustees, spending for Social Security and Medicare as a percentage of gross domestic product (GDP) will rise from about 6.5 percent in 2000 to almost 11 percent in 2030. Using similar projections, CBO expects that in 2030, those programs will constitute more than half of total Federal spending excluding interest, compared with 39 percent in 1999. In addition, the Medicaid program will experience severe budgetary pressures in meeting the needs that low-income elderly people will have for long-term care.

But those projections, as unfavorable as they may seem, may be too optimistic for at least two reasons. First, the Medicare trustees' projections assume that the growth rate of Medicare costs per enrollee will gradually slow to equal the growth of average wages. No policy currently in place would accomplish that end, and little historical evidence would suggest that the slowdown could occur on its own. When CBO updates its long-range projections, the middle-cost assumption will be that costs per enrollee will continue to climb more quickly than wages. Moreover, pressures are growing to increase Medicare spending through a new prescription drug benefit, increased payment rates for providers, or both. For example (as shown in Table 2), in the Mid-Session Review, the President has proposed specific initiatives in those areas, which CBO estimates would cost $427 billion in direct spending over the next 10 years, with Medicare alone accounting for three-quarters of that. (The President also has proposed to move Medicare's Hospital Insurance Trust Fund off-budget, which I will address later in this statement.)

Second, the intermediate assumptions about demographic and economic trends could prove to be too favorable. Under the high-cost assumptions of the Medicare trustees and the assumption that Supplementary Medical Insurance spending equals the same proportion of Hospital Insurance outlays as projected under the intermediate assumptions, Social Security and Medicare outlays would exceed 15 percent of GDP in 2030.

TABLE 2.—ESTIMATED EFFECT ON DIRECT SPENDING OF CHANGES IN THE PRESIDENT'S HEALTH INSURANCE PROPOSALS

[Billions of dollars]

	10-year cost
Medicare	
CBO's Estimate of February Proposals [1]	$67.3
Changes in Mid-Session Review:	
Expand prescription drug benefit [2]	167.6
Drop policies to reduce payment rates	34.9
Add policies to increase payment rates	40.5
CBO's Estimate of Mid-Session Review Proposals	310.4
Medicaid and SCHIP	
CBO's Estimate of February Proposals [1]	98.2
Changes in Mid-Session Review:	
Expand prescription drug benefit [2]	14.6
Other changes and interactions [3]	3.6
CBO's Estimate of Mid-Session Review Proposals	116.4
Total (Medicare, Medicaid, and SCHIP)	
CBO's Estimate of February Proposals [1]	165.6
Changes in Mid-Session Review:	
Expand prescription drug benefit [2]	182.2
All other changes	79.0
CBO's Estimate of Mid-Session Review Proposals	426.8

SOURCE: Congressional Budget Office.

NOTE: SCHIP = State Children's Health Insurance Program.

[1] CBO's estimate of the February budget proposals reflects the estimate of the Medicare prescription drug benefit as revised in testimony presented before the Subcommittee on Health of the House Committee on Ways and Means on May 11, 2000.

[2] Consistent with the estimates in the Administration's Mid-Session Review, this estimate assumes that subsidies for low-income beneficiaries will cover all of their costs each year in excess of the initial coverage limit but less than the annual out-of-pocket cap. If the President's proposal does not include coverage of those costs, CBO estimates that the change in direct-spending outlays from expanding the prescription drug benefit would be $163.3 billion over 10 years for Medicare, $1.5 billion for Medicaid, and $164.8 billion in total. CBO has made minor technical changes to its estimating methods since preparing estimates of the February budget proposals. Those changes account for a very small portion of the estimated cost of expanding the prescription drug benefit.

[3] Includes the effects of dropping the school lunch initiative (because it was enacted), freezing allotments for disproportionate share hospitals, and interactions with Medicare provisions and with a proposal to change rules regarding the treatment of income for veterans in nursing homes.

Some analysts have argued that focusing on the resources directed toward the elderly ignores an important offsetting factor—the drop in children's share of the population. That is, while the elderly population is projected to climb from 12.4 percent of the total population to 19.7 percent over the next 30 years, the portion represented by children will fall from 28.6 percent to 24.7 percent. The combined share for the two groups will change only from 41 percent to 44 percent. But for the outlook for the Federal budget, the combined share is misleading because Federal spending for an elderly person is roughly seven to eight and one-half times that for a child. Although state and local governments spend much more on children than on the elderly, that support is at a much lower level than Federal spending for the elderly (see Tables 3, 4, and 5).

Today's children are the taxpayers of the future, so they will be the ones called upon to pay for the increasing portion of the Federal budget that will be devoted to programs for the elderly. However, significant wage growth is assumed in most projections, so today's children will be more affluent and may be able and willing to share an increasing portion of their income with the generations that preceded them.

PREPARING FOR THE FUTURE

The resources required to finance the government's obligations are drawn from the overall economy when the obligations are liquidated. That is, in 2030, as in any year, pledges to the elderly as well as other Federal priorities—such as national defense, assistance to State and local education agencies, public health services, and transportation projects—will require the government to draw on economic resources available at that time. Whether a program receives earmarked revenues and is accounted for through a government trust fund or relies upon annual appropriations does not alter that fact. Whatever the Federal Government is required to spend, it must acquire those resources through taxes, borrowing, sales of assets, or some combination of those.

TABLE 3.—ESTIMATED FEDERAL SPENDING FOR THE ELDERLY UNDER SELECTED PROGRAMS, 1971–2010

[By fiscal year, in billions of dollars]

	1971	1980	1990	2000	Projected 2010
Mandatory Programs					
Social Security [1]	29	85	196	307	471
Federal Civilian Retirement	2	8	21	33	50
Military Retirement	1	2	7	14	21
Annuitants' Health Benefits	(3)	1	2	4	9
Special Benefits for Coal Miners and Black Lung	(3)	1	1	1	1
Supplemental Security Income	1	2	4	6	10
Veterans' Compensation and Pensions	1	4	7	9	14
Medicare	8	29	96	189	377
Medicaid	2	5	14	33	73
Food Stamps [2]	(3)	1	1	1	1
Total	44	137	349	597	1,026
Discretionary Programs					
Housing	(3)	2	4	7	10
Veterans' Medical Care	1	3	6	9	13
Administration on Aging Programs	(3)	1	1	1	1
Low Income Home Energy Assistance Program	n.a.	(3)	(3)	(3)	1
Total	1	6	11	18	24
Total					
All Federal Spending on People 65 and Over	46	144	360	615	1,050

TABLE 3.—ESTIMATED FEDERAL SPENDING FOR THE ELDERLY UNDER SELECTED PROGRAMS, 1971–2010—Continued

[By fiscal year, in billions of dollars]

	1971	1980	1990	2000	Projected 2010
Memorandum:					
Federal Spending on People 65 and Over					
As a percentage of the budget	21.7	24.3	28.7	34.8	42.8
As a percentage of gross domestic product	4.2	5.3	6.3	6.4	7.1
Per elderly person (In 2000 dollars)	8,896	11,839	15,192	17,688	21,122

SOURCE: Congressional Budget Office.

[1] Includes Tier 1 of Railroad Retirement.

[2] Includes the Federal share of states' administrative costs and nutrition assistance to Puerto Rico.

[3] Less than $500 million; n.a. = not applicable.

One way to prepare for the budgetary pressures expected in the 21st century would be to save more as a nation. By implementing policies that promote capital accumulation, the nation could boost both its productive capacity and its wealth and essentially help prefund future consumption. But adding to the supply of capital requires less current consumption in exchange for more national saving and investment. One approach to increasing national saving is for the Federal Government to run annual budget surpluses, so long as the policies creating the surpluses do not come at the expense of private saving. Strategies to encourage private saving might also help pay for future consumption.

Economic growth would expand the capacity to fund future Social Security benefits and other Federal commitments, and a larger economy could ease the transfer of additional resources to retirees. Strong growth swells revenues, which, if used for debt reduction, would reduce interest costs and improve the overall outlook for government budgets. Yet despite those benefits, growth will not eliminate the imbalances of the current Social Security program. The reason is that economic growth generally increases real (adjusted for inflation) wages, and under the current benefit formula, higher wages subsequently translate into higher Social Security benefits, although with a substantial lag. Therefore, although the nation might be wealthier, it would still face a sharp increase in the budgetary resources necessary to pay for the Social Security and health care costs of the baby-boom generation during retirement.

The sharp rise in the share of national income directed toward programs for the elderly could be mitigated directly by curtailing promised benefits. If the benefits provided to the elderly are to be reduced relative to those promised under current law, it is desirable that such changes be announced well in advance so that people who will be affected can change their plans accordingly.

GOVERNMENT TRUST FUND ACCOUNTING

Some analysts suggest that government trust fund programs offer a mechanism for accumulating public savings. They point to the Social Security trust funds as an example. However, government trust fund accounting often can be misleading. Simply because surpluses are recorded in a particular government account does not necessarily mean that the government is actually contributing to national savings. The overall budget deficit or surplus better indicates the Federal Government's potential contribution to savings.

TABLE 4.—FEDERAL SPENDING FOR CHILDREN UNDER SELECTED PROGRAMS IN 2000 AND 2010

[By fiscal year, in billions of dollars]

	Estimated 2000	Projected 2010
Mandatory Programs		
Medicaid	23	52
Family Support [1]	16	21
Earned Income Tax Credit (Outlay portion only)	14	17
Social Security and Railroad Retirement	13	20
Child Nutrition	9	14
Food Stamps	9	13
Foster Care and Adoption Assistance	5	10
Supplemental Security Income	5	10

TABLE 4.—FEDERAL SPENDING FOR CHILDREN UNDER SELECTED PROGRAMS IN 2000 AND 2010—Continued

[By fiscal year, in billions of dollars]

	Estimated 2000	Projected 2010
State Children's Health Insurance Program	2	5
Social Services Block Grant	1	1
Child Tax Credit (Outlay portion only)	1	([2])
Medicare	([2])	([2])
Total	99	163
Discretionary Programs		
Elementary and Secondary Education	20	27
Housing Assistance [3]	10	14
Other Health and Human Development Programs [4]	9	12
Nutrition Programs [5]	4	5
Community Services, Development, and Other Block Grants	2	3
Youth Employment and Training [6]	2	3
Low Income Home Energy Assistance Program	1	1
Department of the Interior (Indian Affairs) [7]	1	1
Juvenile Justice	([2])	1
Refugee and Entrant Assistance	([2])	([2])
Other	([2])	([2])
Total	50	66
Total		
All Federal Spending on Children	148	229
Memorandum:		
Federal Spending on Children		
As a percentage of the budget	8.4	9.4
As a percentage of the gross domestic product	1.5	1.5
Per child (In 2000 dollars)	2,106	2,541

SOURCE: Congressional Budget Office.

[1] Family support programs include Temporary Assistance for Needy Families, Family Support, Emergency Assistance, Child Care Entitlements to States, Children's Research and Technical Assistance, and Child Support Enforcement.

[2] Less than $500 million. These numbers do not include payments to adults, even when adults receive the payments because of the presence of children.

[3] Includes Federal assisted-housing dollars based on data from the American Housing Survey. Housing assistance includes low-rent public and Indian housing, Section 8 low-income housing aid, Section 236 interest-reduction payments, Section 101 rent supplements, and Section 235 homeownership assistance.

[4] Includes services provided to children by community and migrant health centers; some programs of the Centers for Disease Control and Prevention and the Substance Abuse and Mental Health Services Administration, such as immunization programs and programs for children with serious emotional disturbances; spending on the National Institute on Child Development; services for children through the Indian Health Service, and various programs and aid administered through the Department of Health and Human Services, including Healthy Start, perinatal facilities, pediatric emergency medical service, Ryan White Title IIIB and IV programs, family planning, child welfare and child abuse programs, programs for runaway and homeless youth, programs involving children with developmental disabilities, and Head Start.

[5] Includes the Special Supplemental Nutrition Program for Women, Infants, and Children; the Commodity Supplemental Food Program; food aid provided by the Federal Emergency Management Agency; and the Emergency Food Assistance Program.

[6] Includes Job Training Partnership Act programs such as youth training grants, youth opportunity grants, and Job Corps.

[7] Includes services to Indian children, the elderly, and families; Indian housing assistance; Indian Affairs schools; and other educational services funded through the Department of the Interior for the Bureau of Indian Affairs.

TABLE 5.—FEDERAL SPENDING ON CHILDREN AND THEIR PARENTS UNDER SELECTED PROGRAMS IN 2000 AND 2010

[By fiscal year, in billions of dollars]

	Estimated 2000	Projected 2010
Mandatory Programs		
Medicaid	31	69
Family Support [1]	23	29
Earned Income Tax Credit (Outlay portion only)	25	30
Social Security and Railroad Retirement	15	22
Child Nutrition	9	14
Food Stamps	9	13
Foster Care and Adoption Assistance	5	10
Supplemental Security Income	5	10
State Children's Health Insurance Program	2	5
Social Services Block Grant	1	1
Child Tax Credit (Outlay portion only)	1	([2])

TABLE 5.—FEDERAL SPENDING ON CHILDREN AND THEIR PARENTS UNDER SELECTED PROGRAMS IN 2000 AND 2010—Continued

[By fiscal year, in billions of dollars]

	Estimated 2000	Projected 2010
Medicare	(2)	(2)
Total	126	203
Discretionary Programs		
Elementary and Secondary Education	20	27
Housing Assistance [3]	10	14
Other Health and Human Development Programs [4]	9	12
Nutrition Programs [5]	4	5
Community Services, Development, and Other Block Grants	2	3
Youth Employment and Training [6]	2	3
Low Income Home Energy Assistance Program	1	1
Department of the Interior (Indian Affairs) [7]	1	1
Juvenile Justice	(2)	1
Refugee and Entrant Assistance	(2)	(2)
Other	(2)	(2)
Total	50	66
Total		
All Federal Spending on Children and Their Parents	175	269
Memorandum:		
Federal Spending on Children and Their Parents:		
As a percentage of the budget	9.9	11.0
As a percentage of the gross domestic product	1.8	1.8
Per child (In 2000 dollars)	2,491	2,986

SOURCE: Congressional Budget Office.

[1] Family support programs include Temporary Assistance for Needy Families, Family Support, Emergency Assistance, Child Care Entitlements to States, Children's Research and Technical Assistance, and Child Support Enforcement.

[2] Less than $0.5 billion. These numbers include payments to adults when adults receive the payments because of the presence of children.

[3] Includes Federal assisted-housing dollars based on data from the American Housing Survey. Housing assistance includes low-rent public and Indian housing, Section 8 low-income housing aid, Section 236 interest-reduction payments, Section 101 rent supplements, and Section 235 homeownership assistance.

[4] Includes services provided to children by community and migrant health centers; some programs of the Centers for Disease Control and Prevention and the Substance Abuse and Mental Health Services Administration, such as immunization programs and programs for children with serious emotional disturbances; spending on the National Institute on Child Development; services for children through the Indian Health Service; and various programs and aid administered through the Department of Health and Human Services, including Healthy Start, perinatal facilities, pediatric emergency medical service, Ryan White Title IIIB and IV programs, family planning, child welfare and child abuse programs, programs for runaway and homeless youth, programs involving children with developmental disabilities, and Head Start.

[5] Includes the Special Supplemental Nutrition Program for Women, Infants, and Children; the Commodity Supplemental Food Program; food aid provided by the Federal Emergency Management Agency; and the Emergency Food Assistance Program.

[6] Includes Job Training Partnership Act programs such as youth training grants, youth opportunity grants, and Job Corps.

[7] Includes services to children, the elderly, and families; Indian Housing assistance; Indian Affairs schools; and other educational services funded through the Department of the Interior for the Bureau of Indian Affairs.

The Federal budget contains more than 150 trust funds. They vary widely in size and purpose, but the best known ones fall into two categories: major benefit programs (such as Social Security, Medicare, unemployment insurance, and retirement programs for Federal employees) and infrastructure programs (notably, the Highway and the Airport and Airway Trust Funds). The Federal Government's trust funds, including those for Social Security, are not trust funds in the same sense as private trust funds but rather are accounting mechanisms. They record the income from earmarked taxes and transfers from the general fund; spending for benefit payments, purchases, grants, and administrative expenses; and the interest that accrues on the difference. Private trust funds such as pension plans, by contrast, preserve assets for future use. Government trust funds do not necessarily do that because surpluses in a trust fund may be offset by higher spending or lower taxes elsewhere in the budget. Moreover, even the nature of the government's trust funds is different since the Federal Government can unilaterally establish the terms for benefits and contributions.

Simply stated, the government has a deficit when it spends more money than it takes in and a surplus when the reverse is true. Any change that affects outlays or revenues, regardless of whether it concerns trust fund or Federal fund activities, alters the measured deficit or surplus and therefore the potential contribution to national savings. Nevertheless, people often attempt to portray the true deficit or surplus as excluding trust funds. Such attempts ignore the fact that trust fund revenues and outlays are an integral part of the Federal Government's tax and spending policy and the fact that decisions affecting trust funds generally are not made in isolation. They also overlook the extent to which trust fund surpluses reflect the effects of transfers within the budget rather than genuine surpluses of earmarked taxes over spending.

From 1983 to 1997, the government's accounts—including trust funds—added $1.4 trillion in holdings of government securities, while the debt held by the public grew by $2.6 trillion as total Federal revenues lagged well behind spending. Currently, the government's trust funds are credited with $1.9 trillion in government securities, but the publicly held debt stands at $3.6 trillion. Thus, even though surpluses generated by Social Security and other government trust funds may have helped reduce overall borrowing from the public, the government remains a net borrower.

Ultimately, the government's ability to pay future commitments, whether they are Social Security benefits or some other payments, depends on the total financial resources of the economy—not on the balances attributed to the trust funds. As the President has stated, "[T]he existence of large trust fund balances * * * does not, by itself, have any impact on the government's ability to pay any benefits." Trust fund balances indicate that the government may provide funding in the future for certain programs, but they do not have direct economic significance. The government can prefund future obligations—that is, make it easier to meet them—by taking actions that enhance economic growth. Reducing debt held by the public is one of the most effective means of increasing saving and investment. Thus, the economy is the true "trust fund" because it forms the pool from which future consumption—public and private will come.

PROPOSED ACCOUNTING CHANGES AND INTRABUDGETARY TRANSACTIONS

Notwithstanding the limitations of government trust funds, proposals abound that would use trust fund accounting to achieve various policies. For example, the President's Mid-Session Review contains two proposals for the budgetary treatment of Medicare's Hospital Insurance trust fund. One would transfer additional funds from the general fund of the Treasury to the trust fund; the other would place the receipts and outlays of that fund off-budget.

TRANSFERRING ADDITIONAL FUNDS TO THE HOSPITAL INSURANCE TRUST FUND

The Administration proposes to assign an extra $115 billion to the Hospital Insurance trust fund over the next 10 years: $31 billion in 2001, $14 billion in 2002, and $70 billion between 2008 and 2010, over and above the income the fund would ordinarily receive. Those transfers are described in the Mid-Session Review as "interest savings resulting from devoting the Medicare surplus to debt reduction"—although, under current law, the trust fund is already credited with interest earnings on the surplus it generates.

Since the transferred amounts would not be needed immediately to pay benefits, they would add to the trust fund and make it appear more "solvent." But, as illustrated earlier, the solvency of a trust fund is not a meaningful measure of the government's ability to meet its future obligations because the fund's balances are really just claims against future tax collections. Under current policies, as the population ages, payroll tax collections will become inadequate to finance Medicare, which will have to be funded through general revenues and, perhaps, through proceeds from borrowing. That will be true whether or not trust fund balances exist on paper.

By themselves, changes in trust fund balances through legislated transfers would affect neither the size of the economy nor the resources available to the government in the future. There is some risk, however, that larger trust fund balances could obscure the long-term fiscal threat posed by the aging of the population and deter needed reforms by giving lawmakers and the public a false sense of security.

TAKING THE HOSPITAL INSURANCE TRUST FUND OFF-BUDGET

The Administration also proposes to change the budget categorization of the Hospital Insurance trust fund so that its receipts and outlays would be off-budget, like those of the Social Security trust funds. That change is intended to ensure that the Hospital Insurance trust fund's surpluses over the next 10 years "are not used for other purposes and therefore will be used to reduce the debt," according to the Mid-Session Review. That proposed accounting change would have no direct effect on the economy or the overall budget. It would reduce on-budget surpluses while correspondingly increasing off-budget surpluses, but it would not, by itself, reduce the debt or change the government's financial position.

However, if the Congress and the President agreed to avoid on-budget deficits in future years, that accounting change might make the surpluses generated by the Hospital Insurance program (and any additional transfers from the general fund) less vulnerable to proposals to increase spending or reduce taxes. But even if the accounting change made expanding on-budget programs and cutting taxes more difficult, the President's proposed transfers to the trust fund might still lessen the public debt reduction that would have taken place otherwise. The reason is that the enhanced fund balances might make it easier to liberalize Medicare benefits and deter programmatic reforms.

CONCLUSION

The current strong economy and growing budget surpluses encourage optimism about the nation's future, but they should not breed complacency about maintaining budgetary discipline. The aging of the population will bring about major structural shifts in the amount of resources directed toward the elderly. By increasing national savings and capital accumulation that will contribute to growth, the budget surpluses offer one course of action that may make it easier for workers of the future to bear that heightened burden.

It is critically important to consider the impact that legislative action may have on economic growth and on the burden that future taxpayers will have to bear. The challenge before the nation is to find the appropriate balance between benefit levels that are both affordable and adequate to meet the needs of the elderly and an overall fiscal policy that will help create an economy strong enough to sustain those benefits.

Chairman KASICH. Well, obviously, you say the economy would have to grow faster, but yet we—let me ask you this question: Do you think that the economic growth we have been seeing, with the higher productivity, which is brought about by higher productivity, do you think it can be sustained, in your judgment? Have we actually seen a break-through in terms of productivity based on the development of all of the new technology?

Mr. CRIPPEN. There seems to be an increase that is closer to historic rates of productivity increases. So, in that sense, it is comforting to say this might go on. It is still not clear. A number of weeks ago, we hosted a conference, at the request of your counterparts in the Senate, on the new economy and where the productivity is coming from. And there is no consensus, exactly, on what is happening.

One point of view, Dr. Gordon's, is that we are getting most of the productivity increases out of making computing equipment—not in using it, but in making it. If he were right, for example, then there might not be as pervasive a productivity increase as would appear to be the case now.

Chairman KASICH. And now the Napster has gone down.

Mr. CRIPPEN. I know.

Chairman KASICH. We are really in trouble.

Mr. CRIPPEN. That means you got off-line, I assume, last night.

Chairman KASICH. I ain't telling. [Laughter.]

Mr. CRIPPEN. I noticed that. It would be wrong.

So we have adopted in our forecasts some increase in productivity over the last 12 to 18 months, as we have changed our economic estimates as well. But our long-term forecasts are still below what we are currently experiencing. So we are not complete converts yet, in our forecasting, to showing a new economy at permanently higher productivity levels. But we have upped our forecast of productivity growth by about 0.6 percentage points over the next 10 years.

So we are hopeful that some of this increase is permanent and obviously have put that in our projections.

Chairman KASICH. It just kind of occurs to me, a lighter moment here is it would be interesting to see, on the next vice presidential questionnaire, when exactly did you stop downloading Napster. Anyway——

Mr. CRIPPEN. It will get there eventually.

Chairman KASICH. The answers to the Social Security problem really aren't that difficult, are they, if you have—they are really not that difficult, are they, if you can figure out a way to generate a significant boost in return on the Social Security taxes plus, over time, you slow the growth in the benefits to keep pace with inflation rather than higher than inflation; is that correct?

Mr. CRIPPEN. Well, just increasing the rate of return on Social Security contributions won't do you a lot of good in and of itself. Again, those increased returns have to be due to increased national savings. If we are simply swapping one dollar for another, debt for equity, it doesn't matter how you view it, just increasing the rate of return to the trust funds makes the trust funds look better, but it doesn't grow the economy. And, again, that is why I am arguing that we should not focus or at least diminish our focus on the trust funds and, rather, look at what I think is the more relevant question—are the actions we are taking growing the economy? Whether or not the trust funds have improved or worsened is irrelevant. The point is, is the economy made better by the proposal of reform that you are positing?

Chairman KASICH. But if the problem with Social Security is being driven by demographics, number one, the fact that more retired, fewer working, and the problem that the benefits themselves are being funded at a level that is higher than replacement level, higher than the rate of inflation, then even if this economy were to grow, I don't know if it could grow much—I mean, it depends who the Fed chairman is—but let us assume it grew a little bit faster, you still are going to have a rising percentage of the economy being eaten up by Social Security, for example. In other words, the point I want to make is, if you do nothing about the benefits, then you can't fix this.

Mr. CRIPPEN. That is why I was saying, I think, Mr. Chairman—trying to say, at least, in my opening statement—that if you define the problem as an ever-growing share of the economy going to the elderly, and therefore probably squeezing all other things, and if your policy goal is to lower the 14-plus percent to something less, growing the economy will help because there is a considerable lag in the benefits as we grow the economy, but it can't solve the entire problem because you are chasing your own tail.

So, in order to lower that number significantly, you will have to do something with benefits.

Chairman KASICH. Let us move on to Mr. Smith. But I wanted to just make the point to you that I think it is possible, with very modest projections, to not only create the private accounts, which would generate a higher rate of return and maybe the debate gets to be who invests this money—I hope that is where it ends up because that means you won a fundamental debate about the need to allow people to put some money in the private economy. But you don't have to slash the benefits, really. You just have to slow the growth in those benefits, and the people would benefit more. I mean, their total amount of take from Social Security would be greater than the current system, even though the current system can't meet this obligation.

I think the problem with Medicare is a lot more severe, and the Medicare problem is more severe, isn't it?

Mr. CRIPPEN. Yes.

Chairman KASICH. Do you want to just do 30 seconds on that?

Mr. CRIPPEN. Well, about half of the increase you see here is accounted for by Social Security and the other half, Medicare, and even then most of these long-term projections are based on assumptions about Medicare that are probably way too low. For example, the Medicare actuaries, which most of us use for our projections, assume that at some point in the not-too-distant future—I think it is around 2010—the cost of Medicare, the increases in Medicare, will only mirror those in the economy—Medicare can only grow as fast as the economy. But that has not been the case almost since it was instituted. So that assumption is probably very low, and spending on the elderly, which our figure portrays as 14.6 percent of GDP in 2030, will be higher because Medicare spending is going to be higher than we currently project.

Chairman KASICH. So it is likely that for every dollar we spend on children which, in a sense—and I hate to get into this debate, but I think maybe Democrats have some, or the economists that argue that investing in, you know, for example, higher education, I happen to think they are probably right on this, although the higher education programs are so screwed up from the standpoint of out-of-control costs, but certainly investments in higher education, which gives you greater skills, is going to contribute to higher productivity.

But if, in fact, that ratio of 7 to 1 grows to 8 to 1 or 9 to 1 or 10 to 1, then you are feeding consumption, while you are not encouraging investment. Would that be correct?

Mr. CRIPPEN. Yes.

Chairman KASICH. Mr. Smith. Go ahead, Nick.

Mr. SMITH of Michigan. Mr. Chairman, thank you very much.

Just a tremendously important hearing, disappointed that there aren't more members. Maybe it represents the fact that it is still somewhat a third rail. There is a reluctance, when we talk about the huge challenge that faces us with both Social Security and Medicare, to deal with that problem. It is easier to put it off, and that is what we have been doing.

Dan, what is included when you talk about senior spending? Is there anything in addition to Social Security, Medicare and Medicaid?

Mr. CRIPPEN. No. Although we have compiled some estimates of other things that you might put into that category, of programs for veterans, for example.

Mr. SMITH of Michigan. Veterans' programs, extra tax benefits, that isn't included.

Mr. CRIPPEN. Those are not included.

Mr. SMITH of Michigan. How about GDP, what is included in GDP? Is the inflated—I use that word uneconomically—is the inflated value of equities, especially the tech stocks and Nasdaq included as part of GDP?

Mr. CRIPPEN. The effects that rising equity values have had on the economy are included in the base, which we then grow by our assumption over time. So I think the answer is yes.

Mr. SMITH of Michigan. So, in my mind, you would have an inflated evaluation of GDP then if you are including the increased value of those stocks, rather than real production in this country.

Mr. CRIPPEN. There are arguments, let me say, on both sides; that, yes, the equity values may be too high, and therefore if they decreased precipitously, it would hurt economic growth. As we were talking with the chairman, we may have our productivity numbers too low as well.* But what——

Mr. SMITH of Michigan. Do you support Alan Greenspan's contention that we should be providing the Bureau of Economic Analysis over in the Department of Commerce, more funding to deal with these more complicated problems of developing GDP?

Mr. CRIPPEN. Data are certainly a continuing problem.

A number of the past administrations have recognized that and tried to increase funding without success. We rely exclusively on other folks to generate data. We don't collect data.

Mr. SMITH of Michigan. So is that a yes?

Mr. CRIPPEN. Yes.

Mr. SMITH of Michigan. And, Mr. Chairman, as you know, I introduced my first Social Security 7 years ago when I first came to Congress, introduced the first bill 5 years ago that was scored by the Social Security actuaries to keep Social Security solvent, so they scored that, and then each session I have introduced a new bill. And, Mr. Chairman, most of those plans that are proposed set aside 2 percent of taxable payroll in terms of investment, and I call for 2.5 percent. It eventually grows to 8 percent. But in terms of solving the problem without reducing benefits for senior citizens or increasing taxes, it would take closer to 7 percent, rather than 2 percent of payroll, with a kind of investment that is going to return someplace around 8 percent in real terms to still solve the program. And if you go that high, then the transition costs are almost unsolvable. And so it is a huge challenge.

And the good news is that we are more conscious of this than we have ever been. We have got two presidential candidates that are at least approaching some of the solutions, and yet we have still got a Congress that is looking at this new-found wealth of extra surplus revenues as justification to increased spending. And so, politically, the decision continues to be extremely difficult, it seems to me.

In your evaluations of the benefits to seniors, did you include or project prescription drugs as part of that projection?

Mr. CRIPPEN. No. This is our current baseline, if you will, which does not have prescription drug benefits reflected in it.

Mr. SMITH of Michigan. In terms of the economic consequences of putting this kind of burden on future workers, if we were to solve the problem like we have in '77 and again in '83 by increasing taxes and decreasing benefits, the consequences on the economy, if we simply rely on increased payroll taxes that we project are going to approach 40 percent by the year 2040, 40-percent payroll taxes to solve the problem of senior benefits, what kind of effect is that going to have on the economy?

*While the effects of rising equity values are incorporated in CBO's projections, the actual measurement of GDP does not include a valuation of the equities market.

Mr. CRIPPEN. Well, those kinds of payroll taxes would presumably seriously deter work effort and hurt economic growth—if not in the generation on which you imposed them, certainly on succeeding generations. So such taxes would continue to push the burden onto the workforce and into the future.

Mr. SMITH of Michigan. And when you suggest chasing our tail by an expanding economy—in the short run, bringing more Social Security funding in, but in the long run resulting in higher benefits because of what the chairman suggested, in terms of our benefits being indexed to wage inflation rather than straight inflation, what is the lag time? Do you have an idea of the lag time?

Mr. CRIPPEN. Well, it occurs over cohorts, if you will, or generations. The lag, however, produces a benefit equal to about 1 percent of payroll for a 1 percentage point increase in real wages. So the lag is a fairly significant part of the benefit increases in these out years—maybe 30 or 40 years from now. So it is significant.

Mr. SMITH of Michigan. But still, it eventually catches up with us.

Mr. CRIPPEN. Yes.*

Mr. SMITH of Michigan. And, Mr. Chairman, what we are also I don't think building into a very serious situation is the futurist projections of longevity. With our new technology and the gene technology now evolving, our futurists in our Social Security Task Force were guessing that within the next 20 years anybody that wanted to live to be 100 years old would be able to do that, and they would be able to live to be 120 years old within the next 40 years. And we are not even considering that kind of medical technology that is going to really add to the longevity of people.

So savings and investment and getting a real investment return of the money and some of the surpluses is just critical if we are going to solve the problem.

Chairman KASICH. Mr. Sununu.

Mr. SUNUNU. Thank you.

One of the things that strikes me in the chart on the right, and in the chart we have and some of the notes prepared for this hearing is the degree to which benefit payments, in particular I believe this is a graph of Social Security payments, which is the largest transfer of benefits to the elderly, grow at a rate much higher than the rate of inflation. And I think that the general perception of Members of Congress and the public, for that matter, is that the cost of living adjustment is intended to keep pace with inflation, so that benefits grow, and you don't have an erosion of purchasing power for those who are dependent on Social Security.

Could you describe why Social Security benefits or the total payments through the Social Security system are projected to grow dramatically higher than inflation.

Chairman KASICH. John, let me—there is a motion to instruct on the floor that has to do with military retirees, which I think you will want to——

Mr. SUNUNU. How much time do we have left?

Chairman KASICH. We have about 6 minutes, I think.

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*After about 30 years, the beneficial effects of the more rapid wage growth levels out. It still improves the outlook for Social Security, but the improvement no longer increases after several years.

Mr. SUNUNU. I will try to finish my questioning in just 3 or 4 minutes, and then we can let Mr. Crippen——

Chairman KASICH. That is fine. We can run over.

Mr. CRIPPEN. I will think about it.

Mr. SUNUNU. I will try and finish in 2 minutes, so you can answer, and we can free you from your bonds here.

Why is it the benefits grow so much higher than the rate of inflation?

Mr. CRIPPEN. Well, there are two reasons, but largely, in this chart, the reason you see the benefits growing is because of the baby-boom generation's retirement. We are going to double the number of retirees, roughly double, from between 2000 and 2030. So even if the per capita benefits weren't growing any more than inflation, clearly, you would have an increasing amount going to the elderly.

Mr. SUNUNU. But do the per capita benefits grow at a rate higher than CPI as well?

Mr. CRIPPEN. No, not after the initial benefit calculation. The initial benefit is currently based on wages, adjusted for wage inflation. So it is a wage-replacement concept. After that initial benefit calculation, benefits are then indexed to CPI or to price increases. So the initial benefit uses——

Mr. SUNUNU. That would mean that an individual's benefit would grow at inflation, but the system's per-capita benefit would grow at a higher rate than inflation, correct?

Mr. CRIPPEN. Right.

Mr. SUNUNU. Terrific. Second, a brief question about cash balances. There are projections now for surpluses on budget and off budget, very significant. CBO just increased its estimates. It seems to me that the surpluses will exceed the amount of outstanding debt coming due and force the Government to start accumulating very significant cash balances. What will the Federal Government do with the excess cash as it is accumulated?

Mr. CRIPPEN. We don't know, and we don't make an assumption about what it is invested in. But we do make an assumption that it will earn some rate of return.

Mr. SUNUNU. Are there any statutory limits right now to what the Treasury can do with the cash balances?

Mr. CRIPPEN. Not that I am aware of.

Mr. SUNUNU. Could they purchase equities in the public markets?

Mr. CRIPPEN. I don't know the answer to that.

Mr. SUNUNU. What is the projection for cash balances right now at the end of this fiscal year, fiscal year 2000?

Mr. CRIPPEN. At the end of this fiscal year, over the last couple of years, about $40 billion. That is partially a cash and debt management——

Chairman KASICH. We are about out of time, John. We better—we can come back and finish this. We will just take a few minutes, and then we will have Pete du Pont and the next group get up. We will be right back.

Mr. SUNUNU. I am happy to follow-up in writing, unless you have additional questions, so that Mr. Crippen doesn't have to stay, and we don't have to detain him.

Chairman KASICH. That would be fine.

Mr. SUNUNU. Thank you, Mr. Chairman.

[Recess.]

Chairman KASICH. OK. This has just been the most bizarre. I swear to you, you have a hearing like this, and the committee will come to order, and we are going to have my long-time friend, I think this is the first time Tim has ever testified before this committee. He is a great, great buddy of mine. And, of course, Pete du Pont, who is in really a class of his own. He is a terrific man, and I have admired him for many years.

We have got so many things going on, all of these votes on the floor, committee meetings, but I would like to get started and get this stuff on the record. And, Pete, you know, I think that sometimes you have got this iceberg out there, and you have got to start talking about it before the ship hits it. So this stuff will get on the record. Some members will come, and let us just go through this stuff.

So I think the first person we want to have testify is Mr. du Pont; is that right? Let us let Mr. du Pont go first. You are on, sir.

STATEMENTS OF HON. PETE DU PONT, FORMER GOVERNOR, STATE OF DELAWARE; HON. TIM PENNY, FORMER MINNESOTA MEMBER, U.S. HOUSE OF REPRESENTATIVES; HENRY J. AARON, SENIOR FELLOW, THE BROOKINGS INSTITUTION

STATEMENT OF PETE DU PONT

Mr. DU PONT. Thank you, Mr. Chairman. And it is good to be with former Congressman Penny and Henry Aaron. Henry and I have debated this issue many times over the last 5 years. And I was just saying to him that I think we can take credit for the fact that when we started talking about it, nobody much cared, and now it is the central issue in a presidential campaign, and I think Henry and I have done well in elevating the debate that far.

Mr. Chairman and committee members, thank you for the opportunity to say a few words this morning about how we might meet the demographic challenges of the U.S. Social Security system.

I think maybe the place to start is the Organization for Economic Cooperation and Development, OECD. Their website has a map that shows the fertility rate of the world's nations, nation-by-nation. A fertility rate of 2.1 children per woman is required to maintain a constant population in the long run. And of all of the OECD countries, only Ireland, Mexico and Turkey meet or exceed 2.1. In other words, the population increase is starting to decline. In the United States, the fertility rate last year was 2.06 children per woman.

At the same time, people are living longer in every developed country. U.S. life expectancy in 1940 was 61 years for a male and 66 years for a female. Last year, it was 74 for a male and 80 years for a female. There are going to be fewer and fewer of us, and we are going to live longer and longer, and this demographic trap is the problem that Social Security is facing.

There is going to be major trouble for developed nations, with pay-as-you-go Social Security systems, of which the United States is one, as they face these demographic challenges. Fewer babies are being born. They grow up to be workers paying payroll taxes, and at the same time people are living and drawing retirement accounts longer and longer.

There is no question that the pay-as-you-go Social Security system is unsustainable in the long run. Fourteen years ago, in 1986, one poll found that 46 percent of Americans doubted that Social Security would be there and that 68 percent were not confident about the future of the Social Security system. So even then it was clear that things could not go on as they are for a long while.

I recount these events of 14 years ago to emphasize the conditions that make Social Security reform imperative have not gone away, and we cannot put off for another 14 years what we should have been working on 14 years ago because the cash flow in the Social Security system turns negative in about 2015.

In 1986, I actually proposed a solution to the problem of demographics in the retirement system in our country called a financial security program, and it involved giving Americans the options of contributing part of their payroll taxes to private retirement accounts. That fell pretty much on deaf ears then, but it's certainly very much in the news today.

In short, the problems inherent in the Social Security system and their solutions are nothing new. The problems have been there for a long while, the solutions have been on the table for a long while. The only things that have changed is that the American people now seem interested in hearing about alternative solutions to meet the challenge.

Some very respected economists have helped raise this awareness. Eugene Steuerle of the Urban Institute wrote in 1994, and I quote, "The next few years should be viewed as a crucial period of opportunity during which the Nation should be readying itself for the demands of the future. We should not be lulled into inaction by the relative retiree-to-worker ratios in the near time, while a potent demographic challenge looms right around the corner."

Federal Reserve Chairman Alan Greenspan said in 1996, "It is becoming conventional wisdom that the Social Security system, as currently constructed, will not be fully viable after the baby boom generation starts to retire in about 15 years." And I was looking over Professor Kotlikoff's testimony, which he is going to give later on, and he is going to present you some data in very stark terms about those numbers.

The plight of Social Security is not a partisan matter. Senator Bob Kerrey of Nebraska said, "Each day we let go by means tougher tax increases or benefit cuts for future workers and retirees."

Senator Moynihan, "Social Security, as now constituted, is a social insurance program that will disappear before our eyes if we do not reform it now."

So my message to this committee this morning is that the moment to act is now. The time to act has come. The American people are interested, as they have not been interested before, and the proposals on the table give us a number of alternatives for meeting the challenge.

It seems to me that letting workers put a percentage of their Social Security payroll tax into personal retirement accounts to be invested in real assets, continues to be the best approach. Indeed, 5 of the 13 members of President Clinton's 1994 Advisory Council on Social Security favored that approach.

A number of approaches have been suggested by Members of Congress of both parties. You are familiar with them. The idea of personal retirement accounts is both current and bipartisan. Senator Robb has such a bill, Senator John Breaux has such a bill. And he said, and I think this is an interesting point with which I agree, he said, "I believe we have moved the debate past the argument of whether there should be private investment to how private investment should be done."

Now, Mr. Chairman, some witnesses may tell you today that the problem is a small one, requiring a minor adjustment to the benefits paid here or the taxes levied there. They are mistaken. The demographic destiny of our current retirement system presents a massive challenge to our economy, to our families and to the Congress. You cannot save Social Security with some makeshift fixes in an effort to get beyond the baby boom retirements. You must make a choice, and you must make it soon. Either we can make it possible for people to fund their retirement income during their working years, or we can anticipate a ruinous intergenerational conflict that will balkanize America and limit opportunity for everyone.

Thank you, Mr. Chairman.

[The prepared statement of Pete du Pont follows:]

PREPARED STATEMENT OF HON. PETE DU PONT, FORMER GOVERNOR OF DELAWARE AND POLICY CHAIRMAN OF THE NATIONAL CENTER FOR POLICY ANALYSIS

Mr. Chairman, members of the committee, thank you for the opportunity to testify this morning on how we might meet the demographic challenges of the U.S. Social Security System.

The Organization for Economic Cooperation and Development's Web site has a map that shows—in color—the fertility rates nation by nation. A fertility rate of 2.1 children per woman is required to maintain a constant population in the long run. Blue indicates nations with fertility rates below 2.1—and a sea of blue spreads across the map, from the United States and Canada through Europe and Asia and on to Japan and down to Australia. Of all the OECD countries, only Ireland, Mexico, and Turkey meet or exceed 2.1. The U.S. fertility rate of 2.06 last year was one of the highest among developed nations.

At the same time, people are living longer in every developed country. The U.S. life expectancy at birth in 1940 was 61.4 years for a male and 65.7 years for a female. Last year it was 73.7 years for a male and 79.5 years for a female.

What these demographic statistics add up to is impending major trouble for developed nations with pay-as-you-go Social Security systems, of which the U.S. is one. Fewer babies are being born to grow up to be workers paying payroll taxes; at the same time people are living and drawing retirement benefits longer and longer. As the population ages, it becomes increasingly difficult to pay the benefits of the many who are retired out of payroll taxes collected from fewer current workers.

It is no secret that our pay-as-you-go Social Security system is unsustainable in the long run. Nor is that something only recently discovered. Fourteen years ago, in 1986, one poll found that 46 percent of Americans doubted that Social Security would be around when they retired, and another found that 68 percent were not confident about the future of Social Security. Even then it was evident that taxing today's workers to pay benefits to today's retirees could not continue indefinitely when the ratio of workers to retirees was shrinking.

I recount these events of 14 years ago to emphasize that the conditions that make Social Security reform imperative have not gone away, and that we can put it off another 14 years only at our peril. Indeed, cash flow in the system turns negative in another dozen years, about 2015. Today, a majority of young people doubt that Social Security will be around when they retire. The ratio of workers to retirees, which thanks to the baby boomers has remained steady over the past two decades, is about to begin a sharp decline. The Social Security system has piled up 14 more years of unfunded liabilities since 1986—unfunded liabilities that threaten to destroy our retirement system, our tax system, and our economy.

In 1986, I proposed a solution to the problem, what I called the Financial Security Program, which would protect Social Security by giving Americans the options of contributing part of their payroll taxes to private retirement accounts. These accounts would be invested in the market and would finance part of a person's retirement benefit, thus reducing the burden borne by the Social Security system. I pointed out that the cost of transition from a pay-as-you-go system to a funded system to save Social Security would be costly then, and more costly later, but would spare future generations from having to choose between much higher payroll tax rates or deep cuts in Social Security benefits. I also suggested extending the full faith and credit of the U.S. government to Social Security benefits to protect retirees.

In short, the problems inherent in the Social Security system, and their solutions, are nothing new. The only thing that has changed is the American people are more aware of the problem and more amenable to a long-term approach that actually saves Social Security instead of delaying the inevitable wreck for unborn generations to deal with.

Some respected economists have helped raise this awareness. For example, Eugene Steuerle of the Urban Institute wrote in 1994 regarding Social Security, "The next few years should be viewed as a crucial period of opportunity during which the nation should be readying itself for the demands of the future. We should not be lulled into inaction by the relative retiree-to-worker ratios in the near term, while a potent demographic challenge looms right around the corner." And Federal Reserve Chairman Alan Greenspan said in a 1996 speech, "It is becoming conventional wisdom that the Social Security system, as currently constructed, will not be fully viable after the so-called baby boom generation starts to retire in about 15 years."

The plight of Social Security is not a partisan matter, and Members of Congress from both sides of the aisle have also helped increase public awareness. For example, in introducing the Senate Bipartisan Social Security Relief Act of 1999, Senator Bob Kerrey, a Democrat, said, "Each day we let go by means tougher tax increases or benefit cuts for future workers and retirees." And Senator Daniel Patrick Moynihan, also a Democrat, recently said that Social Security as now constituted "is a social insurance program that will disappear before our eyes if we do not reform it now."

So this is the moment to act, to make the changes needed to save and preserve our retirement system.

Letting workers put a percentage of their Social Security payroll tax into personal retirement accounts to be invested in real assets continues to be, in my opinion, the best approach. Five of the 13 members of President Clinton's 1994-1996 Advisory Council on Social Security also favored letting individuals invest part of their Social Security taxes directly in the financial markets. As these accounts grow, and the magic of compounding increases them still further, the payroll tax revenues needed to fund benefits will decrease. Several proposals based on this approach have been made by Members of Congress of both parties, and some have already offered bills that address not only the mechanism for setting up the personal retirement accounts but also the transition costs involved in meeting current commitments to retirees and future retirees.

Nor is the idea of personal retirement accounts a partisan matter. For example, here is what Senator Charles Robb, Democrat of Virginia, said about the bipartisan reform bill mentioned earlier. "Creating individual retirement savings accounts ensures today's Social Security surplus is set aside for today's workers who will become tomorrow's retirees."

Another Democratic sponsor, Senator John Breaux of Louisiana, said, "I believe we have moved the debate past the argument of whether there should be private investment to how private investment should be done. There is a growing consensus that we can strengthen the safety net provided by Social Security, while at the same time providing Americans with more investment opportunities and retirement choices."

Mr. Chairman, some witnesses may tell you today that the problem is but a small one, requiring a minor adjustment to the benefits paid here, on the taxes levied there. But they are mistaken: the demographic destiny of our current retirement system presents a massive challenge to our economy, our families, and to the Congress.

We cannot save Social Security with some makeshift fixes in an effort to get us beyond the baby boom retirements. The United Nations Population Division projects that by 2050, 22 percent of the world's population, 33 percent of the population of developed nations, and 28 percent of the U.S. population will be over age 60. Further, the Population Division projects that the world's population may be decreasing by the end of the 21st century.

The significance of this demographic information about the world and the United States, it seems to me, is that we must make a choice and make it soon. Either we can make it possible for people to fund their retirement income during their working years, or we can anticipate a ruinous intergenerational conflict that will balkanize America and limit opportunity for everyone.

Thank you.

Chairman KASICH. Thank you very much, Governor.

Mr. Penny, welcome.

STATEMENT OF TIM PENNY

Mr. PENNY. Thank you. It is good to be here. I testify today in my role as co-chairman of the Committee for Responsible Federal Budget. This is an organization that has now been around for 19 years. It is a bipartisan, nonprofit educational organization. My co-chairman is a fellow Minnesotan, Bill Frenzel, who served our State for 2 decades here in the U.S. Congress, and was at one time the ranking Republican on this committee.

Over the years, our board membership has included every former House and Senate Budget Committee chairman, every former House and Senate ranking committee member, every former CBO director and most of the former OMB directors. So it is sort of a haven for us budget wonks when we leave elective office.

My testimony today is going to be based on two initiatives that our group has been involved with over the last few years. The first is The Graying of America Project. I think most members of this committee have received copies of this in your office. We concluded this project in January of this year. It is an exhaustive research project sort of analyzing some of the various statistics that Mr. du Pont just shared with you, and I have several charts from the study that will be displayed at the front of the room, and I will discuss the information in those charts briefly.

The second aspect of my testimony today will be to discuss with you an exercise that we conducted in eight localities around the United States, where we pulled together groups—on the Federal budget, on Federal tax policy, on demographic trends, and asked them to make some hard choices and to help us sort through policy options that Congress would soon face regarding these various budget decisions.

These exercises were co-sponsored by American Express Financial Advisors. We had participation from Democratic and Republican House members at virtually every stop along the way and had somewhere between, I believe we had somewhere between 60 and 120 participants, and in one case a couple hundred participants in these sessions. We broke them into roundtable discussions and made sure that there was a diversity at each table; in other words, to sort of force the kind of compromise and consensus that would be required here in Congress in order to sort through the options and come up with policy recommendations.

So I will conclude with an aggregate number of respondents from these groups and what sorts of recommendations they would make relating to the demographic pressures that are facing our retirement programs in the years ahead.

I want to start with the chart that is on display. It shows from 1940 through 2050, both actual and projected workforce participation rates. This gives you some sense of the segment of the population—the under-20 crowd represented in green, the over-65 cohort represented in yellow, and how that relates to the center, those between 20 and 64, who are of working-age population and essentially paying the bulk of the taxes, virtually all of the taxes to support those on either side of the spectrum.

As you can see, the size of the working population, as compared to the, for lack of a better term, dependent population, has been increasing and will continue to increase significantly as we move into the new century.

The second chart that I would like you to review has to do with the amount of time that the average American worker stays in the workforce. This chart, as well, gives you, in the center, the number of years that men and women are likely to be working. And then at the far right, from my perspective, it demonstrates the average number of years that they will be in retirement phase. And as you can see, the number of working years is declining. This is comparing 1940 to 1995 actual statistics; whereas, the length of those retirement years has dramatically increased. It is a good news/bad news scenario. It is great that we are now living much longer and enjoying another phase in our lives. But it is also a phase in our lives where we are drawing on public resources, to a great extent, through both the Social Security and Medicare programs. And that longevity issue will continue to plague these retirement programs in the years ahead.

The third chart that I want to share with you has to do with the worker-to-retiree ratio. Flowing from the earlier charts, it should be no surprise that today we have about 3.5 workers per each retiree. But by the year 2030, we will be down to two workers for every retiree. Hard to sustain a pay-as-you-go system, which our Social Security system is when we have that sort of a declining worker-to-retiree ratio.

It suggests that we would need to do a variety of things in order to make these programs sustainable in the longer term. Obviously, we could look for ways to increase the workforce. Expanding immigration is a possibility, although there are limits in that regard. We could, of course, reduce the number of beneficiaries by extending the retirement age. We could reduce benefit payments, so that the amount paid into the system would not need to be increased or payroll taxes would not need to be increased. However, another option would be to simply increase payroll taxes or to borrow money or we could cut other programs in the Government to provide the differential. But none of these are attractive or easy options.

All of these options, however, were options that we shared with the focus groups in our exercise with hard choices, and I will get to the response of those groups at the end of my testimony.

The fourth chart has to do with the median age of the U.S. population. And as you would expect, flowing from the statistics in the earlier charts, here as well we are seeing an aging population according to this chart.

A parallel trend is that our workforce is becoming more diverse. And that is depicted in the next chart that Wayne will place on the board. This one might be a little harder to read. In fact, I can't even read it from here. But it exhibits that as years go by, a larger share of the workforce is projected to be nonwhite and Hispanic and that as we approach the year 2030 and beyond, we will have essentially a retirement population that is white, and a much, much larger segment of the working population that is nonwhite or Hispanic.

I think it raises some interesting policy implications as we continue to tax, through the payroll tax system, virtually every dollar earned by working Americans in order to support a largely white and less diverse retired population. And I think the implications of that could play out politically and complicate the policy debate in years ahead.

And the final chart that I want to share with you simply indicates where we are going in terms of retirement population in America. We now have about 14 percent of Americans who are retired. That will grow to over 20 percent by the year 2030. In a sense, we will be a Nation of Floridas within 3 decades.

So with this as background information, we challenged these groups of average citizens in eight locales around the United States to share with us their recommendations, their policy prescription. It was interesting to me to see the responses because it didn't track with what you often see in opinion polls. And I think it bears out that, given adequate information, that Americans are capable of coming to different judgments than they might by simply being asked: Would you cut Medicare? Would you raise taxes? Those answers are relatively simple—less simple when you have the policy briefing as a background.

Our response to size of Government found that 60 percent of our exercise groups were determined to hold the size of Government at about 19 percent of GDP. This conforms with trends that you can see over the past several decades in which we have risen above 19 percent of GDP as the size of Government only to see, in ensuing years, the size of Government retract once again. It indicates that American voters over time are resistant to tax levels that take more than 19 percent of GDP out of their pocketbooks, and that was reaffirmed by the focus groups that we met with around the Nation.

Seventy-three percent of our participant groups voted for unified budget surpluses, followed by balanced budgets as the norm for fiscal policy decision making. So there was a sense of fiscal restraint exhibited by these groups.

Seventy-six percent of the roundtable groups that we met with supported some form of individual account as part of Social Security reform. These audiences were well-informed and did understand the tension between political risk and financial risk if partial privatization were adopted. They understood that the entire amount of payroll tax withholding is also, including the employer's share, is also part of employee compensation. They discussed and understood the financial risk associated with individual investments, and they understood the political risk that future Congresses and future presidents could modify promised benefits or raise taxes to fund current benefit promises.

Knowing all of that, most groups, again, chose to balance political and economic risk and did support some degree of individual accounts as part of a Social Security reform plan.

There was no clear consensus on Medicare reform. However, interestingly, 44 percent of our exercise groups voted for incremental reforms, which is to say they favored constraining provided benefits, increasing eligibility age and encouraging more beneficiaries to enroll in managed care. Thirty-six percent voted for some kind of defined benefit contribution program or voucher program. There were no other options discussed by these groups that commanded more than 12-percent support.

The bottom line is I think the American people are perfectly capable of understanding the crunch that Government faces as our population ages and becomes more diverse. They do not want Government to grow hugely to meet those challenges. They do want to be able to meet the needs of our children and others in the population, while at the same time meeting the legitimate needs of our elderly. There seemed to be a strong sense of fiscal responsibility in these groups and that debt reduction, in their view, ought to be a near-term priority. They seemed to understand the relationship between debt reduction, overall national saving rates, and the way that would play out in terms of our economic performance.

Today's surpluses, Mr. Chairman, cannot be used to pay benefits in the year 2010, when Medicare will likely spend more than its dedicated receipts or in 2015 when Social Security is projected to go negative on a cash-flow basis. The taxes Government collects in future years must be augmented by future borrowing or benefit promises must be revised or future leaders must eliminate other functions of the Government to make money available for these retirement programs. These are demographic challenges that will only grow more serious as time goes by, and delay will make solving the problem much more difficult.

Frankly, in this election cycle, it may not be a bad thing to delay any far-reaching prescriptions for solutions in these programs and to allow this to be played out in the presidential and congressional debate during this election cycle. In the meantime, as we wait for this election, it might be best to do no harm and to allow current surpluses to be used for debt reduction.

We do, at our committee, applaud your committee for holding these hearings. There is not anything wrong with too much education on an issue like this. And so we do applaud you for trying to keep this issue on the front burner and out there in the public domain because it is an issue that must be better understood by the American public. And our sense, after holding these eight sessions around the country, is that armed with the information that they need, Americans are willing to make rather far-reaching and significant changes in these programs so as to avoid unnecessary burdens on future taxpayers.

Thank you for your time and for your efforts to advance the education of the public on these issues.

[The prepared statement of Tim Penny follows:]

PREPARED STATEMENT OF HON. TIM PENNY, FORMER MEMBER OF CONGRESS AND COCHAIRMAN, COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET

Mr. Chairman, Mr. Spratt, members of the committee, I am very pleased to be here—some might say back home—to talk with you about the impact that intergenerational issues will have on public policy in the years ahead.

I am here today as cochairman of the Committee for a Responsible Federal Budget. I cochair the Committee with Bill Frenzel who was the Ranking Republican on your Committee until he retired from Congress in January 1991. Our group believes that the baby boom generation's retirement—and intergenerational issues driven by changing demographics—will dominate the public policy debates for decades to come, unless the United States finds itself embroiled in major foreign conflict(s).

For 5 years, the Committee for a Federal Budget focused our time and resources on two projects designed to examine the intergenerational issues that are the focus of this hearing:

Building a Better Future—The Graying of America produced a two-part report and Chart Book. We provided copies of those materials to your staff. The Graying project began out of concern that political leaders tend to consider individual programs and policies as if each existed in a vacuum. But various aspects of spending and tax policy must fit together like a jigsaw puzzle. Policy-makers must take into account trade-offs between and among individual programs and the impact of spending decisions on tax policies. Changes at the Federal level affect other levels of government and the private sector. Current policy choices affect future economic and social conditions. Unless policy makers keep all these separate pieces in view, choices they make in one area may foreclose desirable options in others. Changing demographics make the problems we face much more urgent than they otherwise would be. Medicare, Social Security and the tax system generally are viewed as sources of the long-term problem and they must contribute to the solution. Ignoring the interrelationships among these issues and their collective impact of the Federal budget and the overall economy is folly.

Much of the information, and many of the opinions, I shall share with you today developed out of the Graying of America project.

Building a Better Future: An Exercise in Hard Choices was a joint venture between the Committee for a Responsible Federal Budget and American Express Financial Advisors. That project produced eight programs. Each included briefings on the issues by well-known experts followed by the Exercise in Hard Choices. To complete the Exercise, audience participants are divided into groups of eight to ten. We assign people to groups to ensure diversity within each, i.e., different ages, political party affiliations, political leaning (conservative, liberal, moderate) professional and educational backgrounds, etc. Each group goes through a book, not unlike your budget mark-up books. Each group makes decisions collectively. They decide on the appropriate size of government relative to GDP; adopt a fiscal discipline (i.e., maintain budget balance, "save" by using surpluses to retire debt until the baby boomers retire, or stabilize the ratio of debt to GDP); then they consider alternative approaches to reform retirement income policies and programs, Medicare policies and programs, and all other programs; next they consider tax options; lastly, they decide how short-term budget surpluses best should be used. At the end of the day, groups share their results with one another.

We have provided your staff copies of the Exercise, Background Materials and Final Report from the Exercise project. It is interesting to note that the eight meetings occurred in seven states and the District of Columbia. Democratic and Republican Members of Congress participated (frequently in the same meeting). The Exercises were held in urban, rural and suburban areas, the populations of which were all over the political spectrum.

The Board of Directors of the Committee for a Responsible Federal Budget believes that these two projects produced information not to be found elsewhere. (Our board includes three former Chairmen of your Committee and Bill Gradison who also served as Ranking Member. Over time, every former Budget Committee Chairman and Ranking Member—all former CBO Directors and almost all former OMB Directors have served on our Board.)

Pollsters may think they know how Americans feel about future retirement policy, health care policy, tax policy, etc. But public opinion polls can't produce a meaningful feedback on such complex issues. I don't care how many phone calls the pollsters make, people need more information and more time than they are likely to get in any telephone canvass in order to provide meaningful information. Similarly, focus group results may not prove dispositive because they tend to tell you that 75 percent of individuals support option "a", 20 percent support option "b" and 5 percent are undecided. By contrast, the Exercise does not report individual preferences. We report consensus preferences of diverse groups mirroring congressional constituencies. This kind of feedback is likely to reflect the kinds of compromises that can pass Congress and command consensus support in the court of public opinion.

So what have we learned from these two projects?

First, American voters understand the demographic changes that already are underway in our society.

They know that the labor force rapidly is shrinking relative to the retired population. Faced with facts, they can understand very easily the impact such change will have on tax burdens for workers and entitlement benefits for the elderly. When shown how small changes now can make huge impacts to ease the crunch a few years hence, citizens have hard time understanding why Washington has not acted to address the problems. Having completed an Exercise, however, voters begin to understand the difficulty facing their elected representatives—to find compromises that can command support among competing constituencies with different values and different priorities.

LESSONS LEARNED—THE GRAYING OF AMERICA PROJECT

- Dependency ratios add the number of young people and the number of retirees and compare to the number of workers. In this calculation, ratio or workers continues to shrink well into the 21st century. This suggests that the burden to support a burgeoning elderly population could impact on society's ability to meet children's needs—even more than is the case today.
- Labor Force participation. Women entering the workforce enabled much of the economic and productivity growth in the last quarter century. But there probably is not much room further to expand the numbers of women in the workforce beyond current levels. One possible approach to increase future economic growth and productivity would be to increase immigration—but that could create other political problems.
- Longer life Expectancies—Shorter Working Lives. People are going to work later in life, retiring earlier and living longer. One way to ease the crunch would be to encourage people to remain in the workforce longer.
- The Number of Workers per Beneficiary of Federal entitlement programs drops precipitously and by 2030 falls to about 2:1. If we cannot increase the workforce, we must either reduce the number of beneficiaries or the per capita payments to beneficiaries must decline—else the tax burden on workers must rise very substantially.
- The median age of the population is increasing. 1940–1980, the median age of the U.S. population was 28–30. In 2020–2050, the median age will be 38–39 years old. People in their late thirties are more likely to have college age children than those in their late twenties or early thirties. College is increasingly expensive. This serves to underscore the importance of dependency ratios. Future workers could feel squeezed between the demands of their parents and grandparents and the desire to provide their children with increasingly important post-secondary and tertiary educational opportunities.
- Changing racial and ethnic trends. There are two parallel changes occurring in the U.S. population. We are getting older and we are becoming more diverse. As diversity occurs first among the young. By 2040, a majority of the U.S. labor force could be non-White or Hispanic. At the same time, the vast majority of retirees will be White.

On average, non-Whites and Hispanics are much less well off than Whites in the U.S. population. Whites have higher average incomes and education; they enjoy better health care and live longer; they live in better housing and in almost every other measurable way do better than their non-White and Hispanic counterparts.

Unless we act now to improve the condition of non-Whites and Hispanics, is it reasonable to expect that they will be happy to shoulder increased burdens in the future to support a largely White retired population who (in general) have enjoyed better lives than the majority of workers?

- Americans over 65 will increase from 11 percent in 1980, and 13 percent today, to 17 percent in 2020 and 20 percent by 2030. That will require dramatic increases in productivity so that a smaller percent of the population can produce sufficient goods and services to meet the needs of a huge retired population, and satisfy the needs of workers and their children at the same time.

Alice Rivlin reminds us that dollar bills don't taste very good. That is short hand for the fact that the dollar value of tax financed retirement and elderly health care benefits is not nearly as important as purchasing power and the availability of goods and services to satisfy demand.

This is why savings, investment and productivity growth are the key to solving the demographically driven problems we will face in future years. Growth will not solve all problems but without growth the country cannot expect to meet the demands we know lie ahead.

Government cannot pass a law to grow the economy or increase productivity. Economists disagree about many policies to promote growth. But economists virtually universally agree that increased saving is needed to fuel increased growth. The US is a very low saving country. The Federal Government has gone from record deficits to record surpluses—and applied the majority of current surpluses to debt reduction. That change in fiscal policy has done more to increase net saving available for productive private investment than any other alternative policy could have done. It should surprise no one that the economy and productivity have grown very rapidly coincident with that change in fiscal policy.

Going forward, government policies must continue to foster and encourage savings investment and growth else nothing else you do likely will effectively address the challenges we face as the baby boom generation ages.

FEEDBACK—THE EXERCISE IN HARD CHOICES

- 60 percent of Exercise groups chose to hold government expenditure to about 19 percent of GDP. Put another way, the majority of our audiences would solve the challenges we face without raising taxes.
- 73 percent of participant groups voted for unified budget or temporary surpluses followed by balanced budgets as the norm for fiscal policy decision-making.

43 percent would run budget surpluses more or less equal to Social Security surpluses then maintain unified budget balance after Social Security goes negative on a cash flow basis.

35 percent would balance the unified budget permanently.

- 76 percent favor some form of individual account as part of Social Security Reform. Our audiences understood the tension between political risk and financial risk. They understood that the entire amount of payroll tax withholding (including the "employer share") is part of employee compensation. Groups discussed and understood the financial risk associated with individual investments. They understood the political risk that future Congresses and future Presidents could modify promised benefits—or raise taxes to fund current benefit promises. Most chose to balance political and economic risk.

The largest percentage of groups would scale back tax financed benefits to achieve solvency in the traditional system and increase payroll taxes to fund personal accounts. The Gramlich Commission option that represented this choice in the Exercise would have a federally appointed board manage investments in individual accounts. Our audiences were less enthusiastic about that aspect of the proposal than they were about the mix of sustainable tax-financed guaranteed benefits and earnings from individual accounts.

- There was no consensus on Medicare Reform. 44 percent of Exercise groups voted for "Incremental Reforms" (constraining provided payments, increasing the eligibility age, and encouraging more beneficiaries to enroll in managed care). 36 percent voted for a Defined Contribution (voucher) program. No other option commanded more than 12 percent support.
- Many if not most audiences would have been happier had there been a separate, explicit option to cut benefits more for middle and upper income—and protect low-income retirees—in both Social Security and Medicare reform.
- To meet fiscal policy goals 52 percent of Exercise audiences voted to cut Medicaid by 10 percent; 48 percent voted to cut nondefense discretionary spending 10 percent; 43 percent would cut "other entitlements" 10 percent; 39 percent voted to cut defense.
- 89 percent of all exercise groups voted to save the surpluses and reduce debt. 4 percent would cut taxes; 2 percent would cut taxes and increase spending; none would use surpluses just to increase spending.

Of course, this was before surplus projections grew into the trillions.

CONCLUSIONS

The American people are perfectly capable of understanding the crunch government faces as the population ages and becomes more diverse. They do not want to grow government hugely to meet those challenges. They do want to be able to meet the needs of children and others in the population—and meet the legitimate claims of the elderly.

Americans understand the need to save and invest for the future. They do not understand nearly as well that saving is consumption delayed. And government programs to increase saving for education, home purchase, retirement, etc., may simply shift saving from other accounts or purposes. The single most effective "program" government can adopt to increase savings is the one we have adopted almost de facto in recent years—run surpluses and reduce debt held by the public.

Debt reduction has the added benefit that it reduces claims on future Federal budgets for interest costs. However, debt reduction alone cannot solve the problems we face. And extending the actuarial solvency of trust funds does nothing to address the challenges we face, unless we also reduce future benefit claims or increase future taxes.

Today's surpluses cannot be used to pay benefits in 2010, when Medicare likely will spend more than dedicated receipts—or in 2015 when Social Security is projected to go negative on a cash flow basis. The taxes government collects in future years must be augmented by future borrowing or benefit promises must be revised or future leaders must eliminate whole functions from the Federal Government.

The demographic challenges we face are so great that those are the only options. Delay makes the problem harder to solve. But delay may be inevitable. It seems inconceivable that this Congress and the incumbent President could pass legislation to address these challenges in the few legislative days you have left. And delay until after the election may not be a bad thing. That would give the electorate an opportunity to be heard on the two major party's and the Presidential candidates' very different views of the future and recommended policy directions. In the meantime, we hope that your first priority will be to do no harm.

We applaud your committee for holding these hearings. There is no such thing as too much education on these issues. Congress and the American people will need all the information and wisdom we can gather when our political leaders do turn to issues such as Social Security reform, Medicare reform and tax reform. Thank you for taking time today to help forward that education process.

Chairman KASICH. Mr. Aaron.

STATEMENT OF HENRY J. AARON

Mr. AARON. Thank you very much, Mr. Chairman, for inviting me to appear here today, and I am honored to appear with Governor du Pont and former Congressman Penny.

Governor du Pont referred to a comment made by Gene Steuerle in 1994 regarding the importance of moving expeditiously to deal with the obligations we are going to be facing in the future. He suggested, I believe, that we had not done much since 1994 in that direction. I think that is not true.

In 1994, as you know better probably than anybody else in this room, official projections of the Congressional Budget Office, foresaw ever growing deficits stretching out into the indefinite future. The 1995 projection was for a deficit of $450 billion by 2005. In July of the year 2000, the CBO's projection for the budget in the year 2005 is plus $550 billion. That is a swing of $1 trillion in 1 year of additional national saving. Credit for that achievement goes to you, and other members of this Congress and to the White House. There is enough credit here to share on a bipartisan basis.

The idea that we have not done anything in the last few years to prepare ourselves for the obligations we are going to face in the future is not correct. We are doing the right thing by building national saving, which can increase our productive capacity and enable us to meet whatever we decide are our obligations to the elderly in the future.

Now, my testimony is divided into four parts. I am going to refer briefly to one part, and at somewhat greater length to a second part and omit the other two parts altogether. I will just name them.

The first section deals with the projections of the financial condition of Social Security and Medicare. In the service of those remarks, I would draw your attention to Table 1 of my testimony. The purpose of this chart is to illustrate the rather considerable variability over time in the projections that we make. I am going to focus on Medicare.

Ten years ago we foresaw a long-term Medicare deficit, measured as a percent of payroll, of over 3 percentage points. Three years ago, in 1997, we foresaw a deficit of over 4 percentage points of payroll. As a result of the strong economy and legislation enacted in 1997, the Balanced Budget Act of 1997, we currently project the long-run deficit in Medicare of 1.2 percent, less than one-third as large as what we projected just 3 years ago. The point of this is that a combination of significant, but not really radical, legislation and a stronger economy than we anticipated just 3 years ago, compounded out for 75 years, has completely transformed the character of the financial problem that we see in Medicare. Rather than having an enormous hill to climb, there remains a problem, but one that I think successive Congresses will be able to deal with.

The simple fact is, when one goes out into very long-term projections, the likelihood that the numbers we are currently projecting will actually be realized diminishes sharply. We do not know how to make accurate forecasts over very long time periods. Just with respect to the budget, there is a trillion-dollar error over the last 5 years. And I might add that error is purged of all effects of policy change. The trillion-dollar error results exclusively from changed forecasting methods and economic assumptions.

If we can make mistakes of that magnitude looking just a few years ahead, we should, I think, understand that the projections we make in the very distant future are highly uncertain. It doesn't mean they are wrong, and it doesn't mean they are biased, and it doesn't mean we should ignore them. But I think it does mean we should be careful about undertaking radical action that will have immediate effects on today's population based on projections of the quite distant future.

I think we can all agree Social Security and Medicare currently are running large cash flow surpluses. We could all agree that they face significant projected long-term deficits, and I think we can all agree that current action to deal with those long-term deficits is in order. We probably won't agree on what the character of those actions should be.

The second section of my testimony deals with the arithmetic of transferring payroll taxes from Social Security to individual accounts along the lines that Governor Bush has proposed. I am not going to spend any time on that. I ask that it be part of my printed testimony.

The next section presents what I think is a persuasive argument for why it does, indeed, make sense to transfer general revenues, both to Social Security and to Medicare. And, indeed, the testimony has implications for what the size of those general revenue transfers should be. But I would like to spend the rest of my time on a question that I gather was raised by Mr. Crippen and I know has been of concern to many Members of Congress. That question is whether the Social Security trust fund is real or somehow imaginary.

Many analysts have claimed that Social Security and Medicare reserves are just accounting mechanisms, that the trust funds hold only paper assets. They sometimes claim that the accumulation of large trust fund balances does not do anything to improve Government's ability to meet future benefits. This view, I believe, is simply and flatly wrong, and I would like to explain why.

One has to start, I think, by acknowledging that Government accounting conventions contain many arbitrary rules, and that if different conventions had been adopted, budget accounts would look rather different from the way they do right now. Professor Larry Kotlikoff, from whom you are going to hear presently, has contributed greatly to our understanding of these anomalies by pointing out these problems in a series of articles that have appeared in economics journals, and you may hear more about that today.

But the issue here is not whether Government accounts are logically consistent constructs. The issue, rather, is whether a policy of collecting more in taxes earmarked for Social Security than is paid in Social Security benefits today contributes to the Nation's and the Government's capacity to meet future benefit obligations. The answer to both of those questions, I believe, is yes, and the issue isn't even close.

The first step is to recognize that the direct effects on private investment of adding $1 billion to Social Security reserves or to individual accounts are identical, as shown in Table 6 in my testimony. Given Government spending and revenues outside Social Security, a $1 billion cash flow surplus in Social Security and a $1 billion addition to private saving directly add to funds available for private investment in exactly the same way and in exactly the same amount. In each case, the return to the Nation is $1 billion multiplied by the private marginal productivity of capital.

That table demonstrates that the answer to the first question I posed—does the accumulation of Social Security reserves increase the Nation's capacity to pay pensions in the future, the Nation's capacity?—is a clear and unambiguous yes. The accumulation of reserves also shifts the asset position of the Federal Government. The accumulation of a billion dollars in Social Security reserves means that future taxpayers will be spared $1 billion in taxes to pay for any given future level of benefits. Pay more taxes today, and we have to pay fewer taxes in the future.

To be sure, some form of financial transaction is going to be necessary——

Chairman KASICH. Mr. Aaron, can I ask you just a question on that point?

Mr. AARON. Yes, please.

Chairman KASICH. Does that presume that it is not then spent?

Mr. AARON. I am taking the rest of Government operations as given. So that what we are doing is we are adding——

Chairman KASICH. In other words, if we are running a surplus in Social Security, you are presuming that money is being used to retire debt.

Mr. AARON. Correct.

Chairman KASICH. Not being used to spend.

Mr. AARON. That is correct. In effect, what I am saying is that I think the position——

Chairman KASICH. Whether you save here or save there, it is savings.

Mr. AARON. I am taking the position, I think, that members in both parties in Congress and both presidential candidates have embraced, which is you should treat Social Security reserves, in effect, as a locked box. Balance the rest of the budget, do what one thinks is wise there.

Chairman KASICH. You are not betting any money on that, are you, that that is going to happen?

Mr. AARON. I think the chances are not bad. I trust you, Mr. Kasich, and I trust——

Chairman KASICH. Well, Henry, I have got to, you know, just like having a name like Henry Aaron, I have just got to say, you know, if you ask me, "Say it ain't so," I couldn't tell you that. We will spend a big chunk of it. But go ahead. We already have. But go ahead.

Mr. AARON. I think what has been happening is that you have been spending a chunk of the projected surpluses in the non-Social Security budget. Whether we are going to dip into the Social Security reserves to use those to justify tax cuts or spending increases, I think there would be a very hard case that a Member of Congress would have to make to get that through Congress today.

Let me turn to the paper assets point. The statement that Social Security reserves are only paper assets is true at an insignificant level and is false in substance. Neither Social Security nor private financial savers, including individuals and pension funds, hold real assets in their accounts. Both hold IOUs, paper promises of some private or public entity to pay interest or dividends. In each case, the assets are only as good as the willingness of someone to redeem the assets or to buy them before maturity. In each case, any future need to cash in reserves to meet current obligations would reduce national saving. The only difference between the reserves of Social Security and those of private savers is that Social Security reserves consist entirely of gilt-edged Federal securities guaranteed as to principal and interest by the Federal Government because Federal law restricts Social Security trustees to invest only in those assets.

Private savers, in contrast, can invest in assets that carry higher yields because the companies issuing them face some risk of bankruptcy. Social Security reserves are as real as the reserves of any private pension fund, personal brokerage account or corporate reserves.

The view that the trust fund assets are not real confuses two distinct questions: whether trust fund accumulation adds to national saving, investment, and the capacity to pay future pension benefits and whether Government budget operations on accounts other than Social Security add to national saving, investment, and capacity to pay future benefits.

As noted, the additions to Social Security reserves add to national saving and the capacity of the Government to meet future pension obligations in precisely the same sense that additions to private savings accounts add to national saving and the capacity of savers to meet their debts.

The concluding section of my testimony deals with some comments on the proposed repeal of 1993 legislation, which subjected an increased portion of Social Security benefits to personal income tax. It argues that the repeal of that legislation at this time would be unwise.

Thank you very much, Mr. Chairman.

[The prepared statement of Henry J. Aaron follows:]

PREPARED STATEMENT OF HENRY J. AARON, BRUCE AND VIRGINIA MACLAURY SENIOR FELLOW, THE BROOKINGS INSTITUTION

Mr. Chairman, thank you for the invitation to testify today on entitlement reform. This topic raises so many issues that the limits of time demand that one be selective.

I should like to start with some observations with which I think everyone on this committee and all those sitting before you agree.

- First, current long-run projections indicate that neither Social Security nor Medicare will have enough revenue under current law to pay for all the benefits promised under current law. Each faces a long-term financing problem, and the sooner Congress acts to deal with those problems the better.
- Second, the long-run projections of both programs have improved in recent years—dramatically in the case of Medicare and significantly, but less dramatically in the case of Social Security.
- Third, both programs are now running sizeable cash flow surpluses and these surpluses are currently projected to continue throughout the forthcoming decade and beyond. Social Security has sufficient revenues to pay all currently promised benefits for the next thirty-seven years, Medicare for about the next twenty-five. These facts mean that talk of "crisis" is hyperbolic nonsense. But they do not contradict the existence of a projected, long-run financing problem or excuse Congress and the next president from moving expeditiously to solve it.
- Fourth, whether one favors or opposes the diversion of part of the current payroll tax to underwrite the creation of individual savings accounts, reducing revenues flowing to Social Security will increase the size of the cuts in Social Security benefits necessary to restore balance in that program. This is a matter of simple arithmetic. We may disagree on the likelihood that balances accumulated in such individual accounts will compensate workers for the cuts in Social Security benefits. That is an issue to which I shall return presently.

I should also like to comment on two other matters. The first is the claim that Social Security and Medicare reserves are just accounting mechanisms, that all it holds are "paper" assets, and that the existence of large trust fund balances does not have any impact on the Government's ability to pay benefits. This view is simply wrong, and I shall explain why. The final issue that I shall address in my testimony is the legislative proposal, now under discussion, to repeal the 1993 legislation mandating couples with taxable incomes above $44,000 and single persons with incomes above $34,000 to include 85 percent of their Social Security benefits in taxable incomes, revenues from which are now deposited in the Medicare Trust Fund. I shall explain why repeal of this tax has no analytic justification.

THE FINANCIAL CONDITION OF SOCIAL SECURITY AND MEDICARE

The long-run financial projections for both Social Security and Medicare indicate that the programs face sizeable projected long-term deficits. This fact is well-known. What is less well known is that these projections have been quite volatile and that further sizeable adjustments can be expected. Table 1 illustrates both the existence of financial problems and the volatility of projections. The projected long-run deficit in Medicare is now 72 percent smaller than it was just 3 years ago. The Balanced Budget Act of 1997 explains most of the change, but the projected Medicare deficit today would be more than twice as large as it is, were it not for other changes. The improvement in the financial status of Social Security is less dramatic, but still significant—the projected long-term deficit is 15 percent smaller than it was 3 years ago.

Even more striking has been the inaccuracy in projections of balance in the fund in specific years. I have picked the year 2000 to illustrate the problem. Just 3 years ago, Medicare was projected to run a $32 billion deficit in 2000. It fact, it will run a $28 billion surplus, a $60 billion swing in just 3 years. The Social Security surplus is also about $60 billion larger than projected just 3 years ago, and without significant legislative change. These errors illustrate that even very skilled professionals fail to make accurate projections, even in the near term balance of these two programs. These projections also illustrate that both programs are now collecting much more than they are spending and that results are better than anticipated just a few years ago. To label this situation a crisis makes little sense.

As one looks into the more distant future, the uncertainty of projections increases. The reason is that long-term projections depend on extrapolations of assumed growth rates. Small errors in assumptions regarding compound growth rates cumulate into massive errors after periods as long as the seventy-five year projection periods used for Social Security and Medicare. If real wages were to grow half a percent a year faster than assumed by the actuaries—a rate that is below the actual record of the last 3 years—real earnings seventy-five years hence would be 45 percent higher than the current projections assume and the projected deficits in Social Security and Medicare would be 27 percent and 14 percent smaller, respectively, than current official projections indicate. On the other hand, sharper decreases in mortality rates than now assumed could result in significantly larger deficits than current projections indicate. The simple fact is that we do not know how to make accurate forecasts, over very long periods, of any of the variables on which Social Security and Medicare projections depend—birth rates, death rates, productivity growth, disability rates, immigration rates, real interest rates, the rate and character of advance in medical science, or the evolution of institutions to hold down medical costs. If you doubt me, I invite you to examine previous projections of each of these variables contained in past Trustees Reports. Current projections may be too optimistic. They may be too pessimistic. But they will assuredly be wrong—despite the best efforts of some of the most competent and dedicated professionals working in the pension and health insurance fields.

This fact does not mean that they are biased or that we should ignore long-term projections. They are based on reasonable, if unreliable, assumptions regarding key variables that lie well within the rather wide range of estimates of responsible analysts. The projections are signals that problems may well lie in the future. Given the length of pension promises and the need for gradualism in modifying those promises, we should gradually introduce changes when long-run projections indicate that problems probably lie ahead. It would be imprudent in the extreme to make abrupt changes based on long-term financial projections, particularly when—as now—financial balances are currently favorable and expected to remain that way. But it would also be imprudent to ignore the warning signals and do nothing now. We should act promptly to phase in changes to close projected long-term deficits. And we should recognize that as more information becomes available, we may undo those changes or we may do more.

THE SIMPLE ARITHMETIC OF DIVERTING PAYROLL TAXES TO INDIVIDUAL ACCOUNTS

Many people favor the creation of individual accounts as a partial or complete substitute for Social Security. Some propose to fund these accounts out of general revenues. When some part of the pensions based on these individual accounts is used to reduce Social Security benefits, this approach can indirectly reduce the projected long-term deficit in Social Security. This is the approach used, for example, in the Archer/Shaw bill.

Other so-called “carve-out” plans, such as those of Senator Kerry and Governor Bush, would divert part of the current payroll tax from the Social Security system. Their plans would carve out part of the payroll tax, which would then be directed to individual accounts. They would cut Social Security benefits enough to restore projected long-term balance.

- The first point to recognize is that by subtracting revenues from the Social Security system, these plans force larger cuts than would otherwise be necessary to restore financial balance in that system. On the other hand, pensioners would have the balances in their individual accounts with which they could (or, in some plans, would have to) buy annuities.

This trade raises several practical questions:

- Will the individual-account-based pensions fully compensate pensioners for the Social Security cuts?
- Will the individual-account-based pensions be inflation protected?
- Will individual account holders be required to convert their accounts into annuities? If not, what happens to those who are imprudent or unlucky, exhaust their accounts, and find themselves dependent on much-reduced Social Security benefits.

THE BUSH PLAN AS ILLUSTRATION

As far as Governor Bush’s proposal is concerned, I have no idea about how he would answer the second and third questions because his statements so far have been confined to broad principles and do not address many of the difficult technical questions with which, to their credit Senator Kerry and Representatives Archer and

Shaw have grappled. But some simple arithmetic suffices to answer the first of these questions "What will be the effect of the proposal on retirement income?" Tables 2, 3, and 4, from a report[1] by Alan Blinder, Alicia Munnell, Peter Orszag and me, provide the answer.

AVERAGE BENEFIT CUTS

- If one were to use benefit cuts to close the gap, proportional cuts relative to current law in Social Security benefits of 41 percent for all workers would restore long-term financial balance (Table 2).

We derived this conclusion from the following basic arithmetic. The cost of the benefits that Governor Bush does not promise to leave unchanged is 9.2 percent of taxable payroll. The current deficit is 1.89 percent of payroll. If one diverts to individual accounts 2 percentage points of the payroll tax starting in 2002, the size of the deficit rises to 3.8 percent of payroll—3.8/9.2 = 0.41.

PHASED BENEFIT CUTS

The foregoing estimate assumes that benefits are cut abruptly and equally for all workers who are covered, even briefly, under the new individual account system. Such a policy would be unfair, however. Older workers would have little time to build up individual account balances and would suffer major reductions in their pensions. Younger workers would fare better because their individual accounts would have more years to build up.

Accordingly, we calculated a phased-in reduction in Social Security cuts, so that the change in the combined Social Security benefit and individual-account-based-pensions would be the same for workers of all ages. Table 3 shows the cuts in Social Security benefits for the average earner.

- Under this more realistic schedule, Social Security benefits would have to be cut 25 percent for 55-year-old workers and 54 percent for workers age 30 or younger.

OVERALL EFFECT

Table 4 shows the combined effect of the Social Security benefit cut and the partly offsetting pension that could be financed by the individual account.

- Total benefits are cut 20 percent relative to current law for the average single earner who earns the average rate on individual accounts assumed by the Bush advisers.

RISK

Average earners who happened to experience the lowest rate of return actually observed over a thirty-five year historical period (1947-1981) would have earned less in their individual accounts and would experience an overall reduction of 38 percent relative to current law. Average earners who received the highest rate of return actually observed over a thirty-five year historical period (1965-1999) would have earned more on their individual accounts and would have no cut in benefits relative to current law.

HIGH AND LOW EARNERS

All of the foregoing statements apply only to average single earners. Table 5 shows the effects of the partial shift to individual accounts on married earners and on workers who have above- or below-average earnings. Married workers experience larger cuts in their combined benefits because their Social Security benefits—and hence their benefit cuts—are larger absolutely than those of single workers, yet their individual accounts will be the same. Low earners experience larger cuts in their combined benefits because the Social Security benefit formula favors low earners while individual accounts do not. Under the Bush plan, cuts in combined Social Security and individual account benefits for married, low-earners who receive lower-than-average returns on their individual accounts could approach 50 percent.

CAN THE DISABLED, CURRENT RETIREES, AND OLDER WORKERS BE PROTECTED?

Despite claims in the Bush plan that the disabled, current retirees, and those near retirement would be spared all benefit cuts, it is difficult to believe that Congress—or, indeed, Mr. Bush on fuller consideration—would decide to cut retirement

[1] *Governor Bush's Individual Account Proposal: Implications for Retirement Benefits,* Issue Brief No. 11, The Century Foundation, *www.tcf.org* or *www.socsec.org*.

benefits for younger workers by 50 percent or even more and leave the disabled, older workers, and current retirees wholly insulated from benefit reductions. I believe that few elected officials would think it fair to subject some Americans to large benefits cuts yet spare others from any cuts at all.

CAN GENERAL REVENUES SOFTEN THE BLOW?

Benefit cuts would be smaller than I have indicated if a plan transfers general revenues to the Social Security fund. Based on revenue and expenditure projections based on current law, official projections indicate that there will be sufficient general fund revenues to support sizeable transfers—$2.2 trillion over the next decade alone, according to the most recent CBO projections.

However, these projections misstate the budget situation for several reasons. First, as this committee knows well, this projection assumes that growth of discretionary spending will not exceed inflation. Neither party has shown a willingness to live within such tight constraints. Neither Republicans nor Democrats, as groups, have recently shown a willingness to hold discretionary spending growth as low as the rate of inflation.

Second, both parties have agreed that cash flow surpluses in Social Security should not be used to justify spending increases or tax cuts. The logic is that these reserves (and more) will be needed to pay for future benefits. Yet the same logic applies to Medicare reserves and to balances accumulating in the Civil Service Retirement System, both of which are now counted toward the projected budget surpluses. Both should be removed. Doing so would reduce the projected surpluses by approximately $500 billion over the next decade, reducing the projected surpluses to $1.7 trillion. Adjusting the AMT for inflation and various other tax extenders will reduce revenues by about $150 billion over the next decade, leaving a projected surplus of about $1.55 trillion. As it happens $1.55 trillion exactly matches the cost of the tax cut that Governor George W. Bush has proposed, as estimated by the Joint Committee on Taxation, plus added interest costs that would be generated by the tax cut.

- In short, if the candidate for president who supports individual accounts is elected, his other policies are adopted, and one uses plausible budget projections, there would be no funds to transfer to Social Security, unless the deficit financing pays for the transfers.

Martin Feldstein has argued that establishing individual accounts would boost national saving and that the corporate profits taxes generated by a larger capital stock could be transferred to Social Security to reduce the size of benefit cuts that would otherwise be necessary. The claim that individual accounts would boost national saving is without foundation, however. As indicated, the general revenue transfers would have to be financed by borrowing from the public; and each dollar of payroll taxes transferred to individual accounts would force the government either to borrow $1 more or pay down the Federal debt $1 less for each dollar deposited in individual accounts, a wash transaction that would not tend to boost saving at all.

If, on the other hand, large tax cuts are not enacted, the general fund is likely to generate some surpluses—although not as large as current CBO or OMB projections would lead one to think—and resources would be available to support general revenue transfers to Social Security.

WHY GENERAL REVENUE TRANSFERS MAKE SENSE

General revenue transfers to Social Security do make sense. The program's unfunded liability is more properly viewed as an obligation of the American people as a whole than of future workers based on their earnings.

Early Social Security beneficiaries received benefits worth far more than the payroll taxes they and their employers paid. Money to pay these extra benefits came from the payroll tax collections of still-active workers. The period when cumulative benefits to new retirees will be worth more than the payroll taxes paid by them and their employers is coming to an end. Current retirees and those who will retire in the future will, on the average, receive benefits worth no more than the taxes they have paid, cumulated at a modest real rate of return. Thus, Social Security will not be generating new unfunded liabilities for future retirees.

Whether or not one thinks that the payment of comparatively generous benefits to early Social Security retirees was a good or a bad idea, that action cannot now be undone. The reserves not accumulated to support benefits of future retirees is an obligation that we must meet, one way or another. The question is: who should meet it? Under current law, the cost of paying for this unfunded liability falls on workers, in proportion to their earnings. The rationale for this policy is difficult to comprehend. They will be receiving in benefits no more than they and their employers will be paying in taxes. The unfunded liability, like the national debt, should be recognized as a general obligation of the American people. To be sure, workers are a large part of the American people and their earnings are a large part of the overall tax base. But I know no one who would suggest financing the pay-down of the national debt or interest payments on that debt exclusively from the payroll tax, and there is no good reason for distinguishing Social Security's unfunded liability from general obligations of the Federal Government.

SOCIAL SECURITY TRUST FUND—PHONY OR REAL?

Some analysts have claimed that Social Security and Medicare reserves are just accounting mechanisms, that the Trust Funds only hold "paper" assets. They sometimes claim that the accumulation of large trust fund balances does nothing to improve the Government's ability to pay future benefits. This view is simply wrong.

One should begin by acknowledging that government accounting provisions contain many arbitrary conventions and that if different conventions had been adopted, budget accounts would look different from the way they do now. Professor Laurence Kotlikoff, among others, has contributed greatly to our understanding of these anomalies by pointing out these problems in a series of articles in economics journals. But the issue here is not whether government accounts are logically consistent constructs. The issue is whether a policy of collecting more in taxes earmarked for Social Security than is paid in Social Security benefits contributes to the nation's and the government's capacity to meet future benefit obligations. The answer to both questions is "yes," and the issue is not even close.

The first step is to recognize that the direct effects on private investment of adding $1 billion to Social Security reserves or to individual accounts are identical, as shown in Table 6. Given government spending and revenues outside Social Security, a $1 billion cash flow surplus in Social Security and $1 billion of private saving directly add to funds available for private investment in exactly the same way and in the same amount. In each case, the return to the nation is $1 billion multiplied by the private, marginal productivity of capital. Table 6 demonstrates that the answer to the first question I posed—does the accumulation of Social Security reserves increase the nation's capacity to pay pensions in the future—is a clear and unambiguous "yes."

The accumulation of reserves also shifts the asset position of the Federal Government. The accumulation of $1 billion in Social Security reserves means that future taxpayers will be spared $1 billion in taxes to pay for any given level of future benefits. By paying more in taxes today, we shall have to pay less taxes in the future. To be sure, some form of financial transaction will be necessary to pay for those future benefits, but that is true everywhere and always when savers cash in assets to pay for something they want to buy. Private savers must reduce future saving or increase borrowing when they cash in assets they have accumulated. The Social Security Administration will have to do the same.

The statement that Social Security reserves are only "paper assets" is true at an insignificant level that has no significance, and is false in substance. Neither Social Security nor private financial savers, including individuals and pension funds, hold "real" assets in their accounts. Both hold IOUs—paper promises of some private or public entity to pay interest or dividends. In each case, the assets are only as good as the willingness of someone to redeem the assets or buy them before maturity. In each case, any future need to cash in reserves to meet current obligations would reduce national saving. The only difference between reserves of Social Security and those of private savers is that Social Security's reserves consist entirely of "gild-edged" Federal securities, because Federal law restricts Social Security trustees to invest only in securities guaranteed as to principal and interest by the Federal Government, while private savers can invest in assets in private securities, which carry higher yields because the companies issuing them face some risk of bankruptcy. Social Security reserves are as real as the reserves of any private pension fund, personal brokerage account, or corporate reserves.

This view that Trust fund assets are not real confuses two distinct questions: whether trust fund accumulation adds to national saving, investment, and the capacity to pay future pension benefits; and whether government budget operations on accounts other than Social Security add to national saving, investment, and the capacity to pay future benefits. As noted, additions to Social Security reserves add to national saving and the capacity of the government to meet future pension obligations in precisely the same sense that additions to private savings accounts add to national saving and the capacity of savers to meet their debts.

On the other hand, simultaneous deficits in the non-Social Security budget can subtract from national saving. From fiscal year 1983 through fiscal year 1999, Social

Security ran surpluses—thereby adding to national saving—but deficits in the rest of government operations subtracted from national saving. From 1983 through 1997, the deficits on non-Social Security accounts exceeded Social Security surpluses so that the Federal Government as a whole ran deficits, thereby reducing national saving. In 1998 the Social Security surpluses exceeded the deficit on the rest of government operations. And starting in 1999 the Federal Government began to run surpluses both in Social Security and in the rest of government operations. In no case, however, does the fact that non-Social Security operations of government are in deficit contradict the fact that additions to Social Security reserves add to national saving, productive capacity, and the government's balance sheet, thereby increasing the capacity of Federal Government and of the nation to meet future pension obligations.

TAXATION OF SOCIAL SECURITY BENEFITS

In 1983, President Reagan signed into law a bill under which only half of Social Security benefits would be included in income subject to tax and only to the extent that couples' incomes exceeded $32,000 and single persons' income exceeded $25,000. The revenues were to be transferred to the OASDI trust funds. In 1993, President Clinton signed into law a provision that 85 percent of Social Security benefits would be included in income subject to tax, but only to the extent that couples' incomes exceeded $44,000 and single filers' incomes exceeded $34,000. The revenues were to be transferred to the Medicare trust fund. There would be no income thresholds below which Social Security income would be exempt.

The rules applied to taxing Social Security are patterned on, but are more lenient than, those applied to taxation of contributory private pensions. Pensioners are required to include private pensions in income subject to tax pensions only to the extent that they represent the repayment of contributions out of previously taxed income. If the same rules were applied to Social Security, workers would be required to include in income subject to tax all Social Security benefits in excess of a portion equal to their own payroll tax payments, but the rest of benefits would be subject to tax.

In 1979, I chaired the Advisory Council on Social Security which reported that if that rule were applied to workers retiring at that time, less than 15 percent of benefits would be excluded from income subject to tax for any worker and the percentage would be lower for most workers. That meant that 85 percent or more of Social Security benefits should be included in income subject to tax if they were to be treated in the same way as contributory private pensions.

Even after the 1993 legislation, Social Security benefits are treated more favorably than are contributory private pensions. On grounds of tax policy, there is no basis for repealing the tax enacted in 1993. It is needed for the proper definition of an income tax base. To be sure, there is no particular reason for allocating revenue from the taxation of Social Security benefits to either the Social Security or the Medicare trust fund any more than there is justification for transferring revenues from taxing private pensions to private pension funds. But, as I have noted, there is a good case for general revenue transfers to Social Security; and the same logic applies to Medicare. Since both programs face projected long-term deficits and since the current tax treatment of Social Security is still more favorable than that of contributory private pensions, I believe that there is no analytical justification for reducing this tax at this time.

TABLE 1

Projection year	Social Security		Medicare	
	75 Year balance (percent of payroll)	Balance in 2000 (billions of dollars)	75 Year balance (percent of payroll)	Balance in 2000 (billions of dollars)
1990	–0.91	+150 (est.)	–3.26	–23.9
1995	–2.17	+95.7	–3.62	–16.9
1997	–2.23	+91.7	–4.32	–37.9
2000	–1.89	+153.8	–1.21	–22.3

Source: Trustees Reports, selected years.

TABLE 2.—THE SIMPLE ARITHMETIC OF THE BUSH PLAN

	Percent of taxable payroll
Current law 75-year cost of Social Security	15.4

TABLE 2.—THE SIMPLE ARITHMETIC OF THE BUSH PLAN—Continued

	Percent of taxable payroll
Less "protected benefits"	–6.2
= Unprotected benefits (available for cuts)	9.2
Projected long-term imbalance	1.89

Source: Social Security Trustees Reports and calculations of Henry Aaron, Alan Blinder, Alicia Munnell, and Peter Orszag.

TABLE 3.—SOCIAL SECURITY BENEFIT REDUCTIONS

[Phased-in to reflect time to accumulate accounts]

Age in 2002	Reduction relative to current law
55	–25%
50	–29%
45	–33%
40	–39%
35	–46%
30	–54%
25	–54%

Source: Social Security Trustees Reports and calculations of Henry Aaron, Alan Blinder, Alicia Munnell, and Peter Orszag.

TABLE 4.—COMBINED RETIREMENT BENEFIT

[Including individual account]

	30-year-old single average earner ($31,685 in 2000)
Current-law benefit	$15,877
Minus: 54% reduction	–$8,510
Plus: Average individual account	+$5,305
Total	$12,672
Change relative to current law	–$3,205 (–20%)

Source: Social Security Trustees Reports and calculations of Henry Aaron, Alan Blinder, Alicia Munnell, and Peter Orszag.

TABLE 5.—COMBINED RETIREMENT BENEFIT

[Including individual account for workers age 30 or younger]

	Single	Married
Low earner	–29%	–38%
Average earner	–20%	–33%
High earner	–3%	–22%

Source: Social Security Trustees Reports and calculations of Henry Aaron, Alan Blinder, Alicia Munnell, and Peter Orszag.

TABLE 6.—WHAT HAPPENS WHEN WE SAVE $1 BILLION?

Private saving		Addition to Social Security reserves	
Private savers save	+$1 billion	Social Security reserves rise	+$1 billion
		Social Security trustees buy additional government bonds.	+$1 billion
		Government sells fewer bonds to private sector	+$1 billion
Private saving available for private investment	+$1 billion	Private saving available for private investment rises.	+$1 billion
U.S.-owned capital stock grows	+$1 billion	U.S.-owned capital stock grows	+$1 billion

In either case the return equals $1 billion times private rate of return.

Chairman KASICH. Mr. Aaron, I am going to have Pete du Pont respond to you, but I would agree with you that if we took Social Security surplus and we use it to pay down debt, in fact, part of the argument now is we should not only take the off-budget surplus and use it to pay down debt, but to take as much of the on-budget surplus as we can, these dramatically-improved forecasts, and use it to pay down debt because it gets us ahead of the game.

The problem is though that if you have a $4.6-trillion surplus over the next 10 years, and your projections are for a $337-trillion shortfall in both Social Security and Medicare combined, then the $4.6 trillion compared to the $337 trillion obviously gets dramatically overwhelmed, correct?

Mr. AARON. Actually, no, it isn't correct. And the reason it is not correct is that you are referring to periods of radically different duration to some of those numbers.

Chairman KASICH. No, that is correct.

Mr. AARON. In fact, were you to transfer instantly, this afternoon, $2.9 trillion of general revenues to the Social Security trust fund, the system would be in actuarial balance over the next 75 years.

Chairman KASICH. Right. But the actuarial balance is based on the notion that somehow we are going to honor these IOUs.

Mr. AARON. I could not imagine the United States Government reneging on its debt, and I hope you can't either.

Chairman KASICH. Let me ask you this question: How do you think that is going to happen?

Mr. AARON. How do I think what is going to happen?

Chairman KASICH. How are you going to honor those IOUs? Where are you going to get the money from?

Mr. AARON. The same way we have always honored them. The Government has never reneged on its public debt once.

Chairman KASICH. We have never had the demographic challenge that we have now. I mean, how would we do it? Tell me how you would do it.

Mr. AARON. The public debt, even if you use the gross debt, not the debt in the hands of the public, has been declining in recent years as a share of our GDP. And debt in the hands of the public is now lower than it has been in probably 2 or 3 decades. The projections are that debt in the hands of the public will continue to diminish. What that means is that by paying down the debt today and even conceivably building up positive assets, publicly-held assets, we are preparing ourselves to meet the very costs that you describe in the future.

Pensions are transfers from the active population to the inactive population. From the 40 years from 2000 until 2040, the number of people that each active worker will have to feed goes up 6 percent, not the huge numbers that you hear thrown around. In fact, as the elderly increase as a share of the population, children as a percent of the population go down, and labor force participation is projected to increase. So the actual burden that workers are going to be carrying to support the inactive population goes up, but it goes up relatively modestly. And if we save now and increase productive capacity, we can meet those obligations.

Chairman KASICH. Well, but Mr. Penny just testified that Medicare will not be collecting enough revenues to meet the demands in 10 years. Social Security will not be collecting enough revenue in 14 years to meet the demands.

Mr. AARON. Actually, Medicare can pay all its bills for 25 years, Social Security for 37 years. Even cash flow surpluses remain positive a little longer than Mr. Penny indicated. And in both cases there are reserves which could be used to support benefits. Medicare now has a larger window of financial solvency than it has had at any time since it was enacted.

Chairman KASICH. Well, that is the issue of solvency.

Mr. AARON. Yes.

Chairman KASICH. Solvency isn't the issue. The issue is when the bills come due, how do you pay them? Do you pay them by raising taxes? Do you pay them by raiding other programs? How do you pay your bills when they come due? You won't have enough money to pay them, so where do you get the money from?

Mr. AARON. As with the purchase of a house or sending our children to college——

Chairman KASICH. Go in debt.

Mr. AARON. Planning, prudent planning is to start saving early.

Chairman KASICH. Right.

Mr. AARON. Then when the expense comes, you have the income from those assets to help you meet those costs.

Chairman KASICH. This is only 10 years away for Medicare and only 15/14 years away for Social Security.

Mr. AARON. Oh, it is actually sooner than that. The baby boomers start retiring in 2008.

Chairman KASICH. Right. So we won't have enough money. So what is all of this prudent planning? You are going to have, I mean, it would be like my barber, who is trying to set some money aside to pay for his daughter's education, and then she announces she is going to a school that costs $35,000 a year. He can't pay for it. I mean, in other words, what is coming over the wall is so big that the kind of action we would have to take today wouldn't be enough to keep the waves from coming over the wall. I mean, we are putting up two sandbags, and we have got the "Perfect Storm" coming our way.

Let me ask Mr. du Pont to make a comment on this and Mr. Penny.

Mr. DU PONT. Well, Mr. Chairman, I can't disagree with Mr. Aaron's comment that a dollar is a dollar, and a dollar surplus in Social Security helps you just as a dollar of saving in the private sector helps you. That is certainly true. But as a I said in my testimony, this is not a small problem. When the baby boom generation retires, we are going to double the number of people who get Social Security benefits. We are going to double from where we are today. I don't see how $2.9 billion transferred this afternoon——

Mr. AARON. Trillion.

Mr. DU PONT. Trillion dollars, transferred this afternoon can solve a doubling of the retirement population. I mean, the arithmetic isn't there. If you cut off how far you go out in time, you can always make it look a little bit better. I mean, you can say if you cut it off at 10 years, well, we are fine; if you cut it off at 20 years, well, we are not in much trouble. But if you look at the number of people who are working, who are entitled to benefits, and as that number is going to double over time, there is a problem, and I don't think $2.9 trillion will simply wash that away.

Mr. AARON. This isn't a matter of opinion. This number comes courtesy of Stephen Goss, who is the deputy chief actuary. They have a continuing calculation that is done as part of the long-term projections. It is the direct analog of all of the projections that we commonly use.

Chairman KASICH. This is all about actuarial soundness. That is a presumption that somehow my two young girls are going to be chained to a machine about 22 hours a day to have to pay those bonds. That is the problem with your actuarial soundness.

Mr. AARON. No, it isn't. With due respect, sir, that is not correct.

Chairman KASICH. Sure, it is correct.

Mr. AARON. It isn't. I don't believe so.

Chairman KASICH. You have fewer workers, you have dramatically fewer workers, dramatically more beneficiaries, you have the benefits growing by faster than the rate of inflation. I mean, the numbers are pretty simple. I don't know who this guy is, but I know that——

Mr. AARON. He is the guy that produces the projections we all rely on.

Chairman KASICH. Well, he makes the projections to say that somehow this program is actuarially sound. That is based on the presumption you are going to take—that these IOUs are ultimately going to count for something.

Mr. Penny, do you want to make a comment?

Mr. PENNY. Well, I thought you were going to respond.

Mr. AARON. No, go ahead.

Mr. PENNY. The point that you keep stressing, Mr. Chairman, is to remind us that this is a pay-as-you-go proposition. And payroll tax collections will be insufficient to meet annual benefits in the Medicare program by 2010, in the Social Security program by 2015. Once you reach a point where we have to begin relying on reserves, you have to come up with the cash. And Mr. Aaron continues to insist that somehow because these are assets that have the full faith of the Federal Government behind them that they are not any different than any other sort of investment, and therefore we can count on it, ignores the fact that in order to honor these IOUs in the trust fund we have to make some other adjustment in the budget at that time. It is not money in the bank that we can simply grab hold of.

There is something to be said about paying down debt in the near term, which will ease our interest payments on an annual basis, and you could then have those interest savings in the budget in year 2011, 2012, 2013, to honor some of our trust fund obligations, but it won't be enough. Even if you pay off the debt, those interest savings are not enough, in an ongoing basis, to pay all of the promised benefits in this system. So something else will have to give.

And with the declining worker-to-retiree ratio, there are only three options available to us: One is to borrow once again and begin increasing our debt, having spent a decade or more paying down our debt; the other is to cut dramatically the other programs of Government so as to make money available for a general fund transfer into the Social Security and Medicare systems; or the third is to burden future taxpayers with higher payroll taxes. These are explicit choices that will need to be made unless some miracle happens, whether it is higher immigration rates that expand dramatically our workforce, whether it is some other growth in our economy that just continues unabated for the next 2 decades, but that is betting on the come, and I don't think that is prudent public policy.

Chairman KASICH. Just one other question for Mr. Aaron. When you talk about Mr. Goss, you are talking about actuary soundness; is that correct? That is his argument——

Mr. AARON. He is an actuary, yes.

Chairman KASICH. That the bonds actually will be honored.

Mr. AARON. I am, indeed——

Chairman KASICH. That is the basis.

Mr. AARON. But I have never heard any elected official suggest otherwise.

Chairman KASICH. Well, you are going to hear one here. I am not convinced of it. I am not convinced that—the reason they will not be able to be honored is because you are going to have a generational war if you don't deal with this problem up front, which is the purpose of this hearing. We are not going to boost people's payroll taxes by 30 or 40 percent, and we are not going to slash—you are going to have a problem, going to end up having to slash benefits if we don't deal with it, and create private accounts and figure out how to generate more revenue.

The fact is this problem is the most vexing problem facing this country, but there is even one more problem, and that is the rest of the world is facing the same problem. And then it is going to be great difficulty being able to come up with the capital to even borrow the money to finance not only this, but also the operation of our economy.

I can tell you that in the transportation trust fund, we, in fact, did write off bonds that were deposited. We did not honor them in the agreement we did on the transportation bill. We, in fact, cancelled out IOUs to the Government. And we want to avoid that. We don't want to get into that position. But, Mr. Aaron, if the argument is because there is an IOU in there, everything is going to be hunky-dory, I have been around politics 25 years. This is a sunami coming our way. But I think some of what you say I agree with, in terms of saving here means you get ahead of the program.

Mr. AARON. May I ask you a question, Mr. Chairman?

Chairman KASICH. Sure.

Mr. AARON. Bond obligations to the Social Security trust fund are obligations of the Treasury Department in the same sense as are the bond obligations of the Treasury Department held, say, by Chase Manhattan Bank. Are you telling me that you think that the Government would renege on bonds that underwrite promises to $45 million beneficiaries before they would renege on bonds to the Chase Manhattan Bank?

Chairman KASICH. I know that New York City went bankrupt and that the Government had to bail them out. I know there have been a lot of times when—I know about the S&L crisis, where people lost much, much, much money. The point is, Mr. Aaron, I don't think we can allow ourselves to get to that position. But the notion that everything is great——

Mr. AARON. I am not suggesting that.

Mr. PENNY. If I could ask, Dr. Aaron, a related question. Accepting your premise that these bonds are as secure as any instrument, more so because the faith of the Federal Government stands behind them, and we have never reneged on any debt in the past, would you also grant that in order to make good on our promise, we have basically only three options: to transfer out of the general fund monies into the Social Security system, which may then require us to dramatically reduce spending in the general fund for other purposes; to raise payroll taxes on future workers to replenish, to make sure that the fund has enough money to honor obligations; or to borrow money in the future to make the system whole?

Mr. AARON. Currently, these bonds can be sold only to the Treasury Department. Under those circumstances, the three options you describe are the only ones available.

However, if the Social Security fund held bonds that could be marketed to the public, then there would be no need for Treasury borrowing, higher payroll taxes or cuts in other spending.

Chairman KASICH. You mean if you borrow more money.

Look, I think that the question here is we don't know what is going to happen. Hopefully, and I think we will, at some point we will deal with this, but I never know what the Government is ultimately going to do or what elected officials are ultimately going to do when the crisis comes. You remember the Pepper Commission, they did a variety of things. It was involved in cutting benefits. I don't think that the debate is really ultimately going to be what do we do with these bonds? Do we honor them? There will be some way to get through that period if we let this thing roll. And I think Mr. Penny is on to it. There are only two or three things that can happen. And my only point of the hearing is let us be aware of this, and let us begin to deal with this thing sooner, rather than later. Because I believe that if we deal with it sooner, Mr. Aaron, what we need to do is a lot simpler than if we deal with it later.

Mr. AARON. Amen.

Chairman KASICH. And that is my point.

Mr. AARON. Amen.

Chairman KASICH. The only thing I get concerned about with some of the testimony is everything is fine. I get that sense from the two sides. One side says everything is trouble, the sky is falling, and then there is the other side of this which is, well, you know, we can grow out of this. Everything will kind of work itself out. I think that both sides need to say, look, the sky isn't going to fall, and the other side needs to say we have got a problem, we ought to get about it as soon as we possibly can.

Mr. AARON. What you have said almost exactly echoes the first bullet in my testimony, which says we have got a long-run problem, and the sooner we deal with it the better.

Chairman KASICH. Thank you, Mr. Aaron.

Mr. Smith is recognized.

Mr. SMITH of Michigan. Bearing out, Mr. Chairman, what you suggested, we really don't renege on the debt. But what happened in 1977, what happened again in 1983, when push came to shove on available money, we reduced benefits and we increased taxes. And so you don't say we are not going to pay our debt, and that is the danger that we are facing if we continue to put off this problem in the future. And I am disappointed, Mr. Aaron, at your suggestion or at least the implication that the problem isn't that big. And your suggestion of putting $2.5 trillion into the trust fund now is not consistent with the figures that we have received from the actuaries at the Social Security Administration or Chairman Alan Greenspan, who has suggested, at one time, $9 trillion unfunded liability and at one time $10 trillion unfunded liability. And if you add to that approximately $3.2 trillion unfunded liability for Medicare and Medicaid for seniors, then I think the problem is significant.

The words "unfunded liability" and "$9 trillion for Social Security," means, to me, that if you took that money now and put it in a savings account, then the problem would be solved. If you pay out the money that is needed over the next 75 years for Social Security, the shortfall, what revenue is coming in from the Social Security taxes are going to be short of the benefits that are now promised, then it is $120 trillion over the next 75 years. The problem, I think, is significant.

And then there was sort of the suggestion that, look, everybody has agreed we are now taking the extra surplus from Social Security and paying down part of the debt, the debt held by the public. That is not what has been happening.

Mr. AARON. It is what has been happening. Furthermore, Mr. Smith, our output over the next 75 years will be approximately $7 quadrillion. So an obligation of $120 trillion, although a large number, is less than 2 percent of the total.

Mr. SMITH of Michigan. For the last 40 years—pardon?

Mr. AARON. It is what has been happening.

Mr. SMITH of Michigan. No, sir. No, sir. For the last 40 years, we have used that Social Security surplus for other spending. Where we came close for the first time in the last 40 years, 30-some years—close to 40—was last year at $700 million, .7 billion dollars. But if you put the cost of the overexpenditure of the Postal Service, then we still spent part of the Social Security surplus last year. This is going to be the first year that we are putting the Social Security surplus in a lock box. And if we go ahead with this Railroad Retirement bill that is going to cost $21 billion, if we continue with even half of the increased spending that the President has suggested in his budget that he sent to us for next year, we are going to spend part of that Social Security surplus again this year.

So I am very nervous about the suggestion that we simply might somehow be disciplined in spending, and I agree with the chairman that the tendency is to spend it.

Let me ask the three of you a question in terms of getting some real investments from some of these surplus monies. And, let us see, two-thirds of you were in Congress. Mr. Aaron, you didn't serve in this chamber.

Mr. AARON. Regrettably, no.

Mr. SMITH of Michigan. Well, you have looked at the thrift savings account. The thrift savings account is essentially a Government-type board making decisions on investments. Is it possible to set a private investment account that would ultimately be in the name of the worker, so that he or she would have some entitlement to that money—in case they died before they were 62, it would go into their estate?

Is it possible to set the kind of parameters of limiting to some kind of safe investments—indexed funds or whatever—that we could have the kind of safe parameters for those investments or even having a Government board, like the thrift savings account, invest it, but having that money in the name of the individual worker, so that they would have the entitlement to those funds, like we do in the thrift savings account?

Let me maybe get your reactions, starting with you, Governor, on this balance that Republicans and Democrats seem to be arguing about, where Republicans say, look, it has got to be privately-owned personal investments; a lot of the Democrats are saying, well, look Government should do the investing. But it seems to me that a reasonable compromise there is maybe there could even be a Government board investing it, but it would be in the name of that individual worker, so that the Supreme Court on two decisions now that says there is no entitlement for Social Security can at least start to be countered by having part of that money and part of that investment in the name of individuals.

Pete and then——

Mr. DU PONT. Well, certainly, you could structure it that way. The real solution to this enormous unfunded liability that is facing us in the Social Security system is a market account that allows people to get a better return on their Social Security contributions, which ultimately will take the pressure off the existing trust fund. Yes, you could design an investment account in which the individual had unrestricted investment choices, and I don't know anybody who is in favor of that, in terms of letting you invest in the latest dot com or art or speculative securities. You could then move to the next step and say, well, we will have an account that simply can go into one of ten or fifteen Government-approved investment vehicles, and that has been tried in many countries around the world and worked extremely well. Or you could take the next step, which you just suggested, Congressman, of letting a Government board make the investment in your name.

Mr. SMITH of Michigan. Well, I really, to make the record clear, I am not suggesting that. I am just throwing that out.

Mr. DU PONT. Exactly.

Mr. SMITH of Michigan. I am very nervous about Government having that much control over that much investment.

Mr. DU PONT. Certainly, it could be done. The risk, of course, of having Government oversee investments is that the investments aren't made on a market basis. There tends to be a little political investing done, and that is not often good for the beneficiaries of the investment. But, technically, it could easily be done. Any one of those alternatives could be accomplished very simply.

Mr. SMITH of Michigan. Tim.

Chairman KASICH. Pete du Pont has to get on a plane in about—he has to leave here to get a plane in about 10 minutes. Could we just direct a few questions to Mr. du Pont, and then we can come back.

Mr. Moran is recognized. You have a question for Mr. du Pont.

Mr. MORAN. Thank you, Mr. Chairman.

Let me bring up another alternative that is invariably part of this context, of course. And that is the fact that as we see this change in demographics, we also have to recognize that there is a change in the health, the longevity of the population. We have a much healthier population. And I think it is almost criminal that so many people are retiring so early, so healthy, and not contributing to this economy and society, and we are having to go overseas to bring in workers, which is fine with me, and I think it is essential. But, gosh, we are losing a whole lot of human resources because people are retiring too damn early because we are making it too damn easy.

Now, I think we ought to raise the retirement age significantly, but incrementally. The big problem, though, in doing that is that that is unfair to people who work all of their lives in functions that require brawn, that require the use of your back, and your arms, and the human body just can't sustain that kind of work. Now, we are making a transition, where far more people are relying upon their brains, and automation and computer technology. So that is helping.

But could we not devise a system where people could retire from those back-breaking jobs earlier, using some combination of disability insurance and retirement insurance, so that we could relieve the burden on the trust fund and act in a rational manner with regard to the vast majority of people who can certainly afford a much higher retirement age? The work that has been done on that seems to me pretty sketchy. And yet I don't know why that it is not possible to figure something out that would enable us to use a whole lot more of the resources that you find down in Florida on the golf courses instead of contributing to our economy in productive ways.

Now, Pete can answer that, and I would be more than happy to have some response from the rest of the panel, as well.

Mr. DU PONT. My answer will be brief. I am not familiar with any research, Congressman, that has been done on that either. One way, of course, to keep the talents of the people, in your language, who are in Florida, keeping those talents in the economy, is to remove the earnings limitation, which——

Mr. MORAN. Well, we are doing that.

Mr. DU PONT [continuing]. Which is being done. I am not sure what your suggestion is regarding people who do physical work, as opposed to mental work. But I would think that the Congress should be cautious in creating two classes of beneficiaries, if that is what you are suggesting. That begins to raise a lot of equity issues that I think would prove very difficult.

Mr. MORAN. Let me just respond. See, I think that you can show some physical inability to continue doing the work that you have traditionally performed. It takes a more flexible disability insurance policy. But that may be a way to be fair and also rational and fiscally responsible. I just don't know what work has been done, and it just seems to me it is not that outlandish an idea. Because we have got to raise the retirement age, but we are going to be stuck with—we are going to be hit with all of these anecdotal examples, which are absolutely true, that there is a whole lot of people out there where you just can't expect them to working, you know, loading things on trucks and so on or even working in a lot of heavy industrial manufacturing jobs much beyond 65.

Now, Henry, I think has——

Mr. AARON. The key age really is 62. I agree with you, and I would frame it just the way you did. But the key age in Social Security is not 65, it is 62. That is when you become eligible first for benefits.

There is research on the effect of reducing benefits on people's willingness to work. And let us be clear, raising the age of full benefits is a benefit cut. That is all it is, and strictly speaking has nothing to do with "the retirement age."

Available research indicates that cutting benefits has a very small effect on labor supply. Raising the age of initial entitlement would have a much larger effect on labor supply, and that is precisely where the problem you are raising comes into play. The people who are retiring at age 62 include, to a disproportionate degree, those people who have been doing heavy labor and just can't get out fast enough.

Mr. MORAN. And need Social Security all the more than the average.

Mr. AARON. But I must say I share Governor du Pont's concern about designing this. I have thought about exactly this question for a long time. I know a number of other people have. We can't come up with a good answer. How you would produce an administratable program that would provide some kind of soft condition for disability benefits, really. And, unfortunately, the more you get into the disability program and look at the way it works, the less confident you are. I won't even say that they can administer it the way it is, and this kind of additional complexity would be troublesome. I wish we could. I wish I had a more upbeat answer.

Chairman KASICH. Gil, any questions for Pete du Pont?

Mr. GUTKNECHT. Yes, just real briefly.

First of all, I want to say that I attach myself largely to the comments of my colleague from Virginia. It just strikes me that, you know, we are living longer, we are healthier, and at some point we have to address the idea. And I think I speak, as a baby boomer—I was born in 1951—which, coincidentally, I am told there were more kids born in 1951 than any other year. This is a generational fairness issue. My parents are both alive. I don't want to pull the rug out from under them. But on the other hand, I don't want to saddle my kids with a burden that they won't be able to pay.

I don't expect to retire when I am 65. I really don't expect to retire when I am 67. I am not going to ask any personal question about your particular ages, but whether you expect to retire at 67. I think many of my generation does not expect to retire, as we know it today, at some magic age.

I do want to raise a quote, and I am going to go to Governor du Pont. Winston Churchill observed once that Americans always do the right thing, once we have exhausted every other alternative. It does seem that we have to be forced by some crisis to take action, and that is, indeed, unfortunate. I am interested in this issue, in fact, fascinated by it, for a variety of reasons—as I mentioned, because I was born in 1951. But, also, when I was in the State legislature, and I am not sure if former Congressman Penny served on the Legislative Commission on Pensions and Retirement in the State legislature or not. I know that our colleague Colin Peterson did and I did.

I am curious, and the reason I get to this, Governor du Pont, when you were governor of Delaware, you clearly had to deal with pension issues in the State. How did you depoliticize those? And I guess what we had in Minnesota I think was very effective. We had a commission. It was bipartisan. It was five members of the House, five members of the Senate, and we literally worked out some of these retirement issues, which sometimes could be very thorny, but those were worked out. We had our own set of actuaries. All of these things were done. And as a result, starting in 1978, when we had a pension fund problem in the State of Minnesota which was we had unfunded liabilities all around, and they began to lay out a plan, and they stayed with the plan. And the Pension Commission I think was very effective.

And I have really felt for a long time—I am getting to a question, I guess—but I felt for a long time what happens with this big issue, and this is a huge issue, and we thank you, even though we may have slight differences in terms of where we should go and how big the problem is, it clearly is a big problem, and it is something that the Congress needs to concentrate on. But the problem is we have the Budget Committee who once in a while takes a bite at this, and we have the Ways and Means Committee that once in a while takes a bite at this, we have the Government Reform Committee which sometimes takes a bite at it. It seems to me we need to have more of a permanent congressional commission.

And I am just curious, Governor, did you have something like that in the State of Delaware? And do you think there might be a way we could set up some kind of a permanent commission that would begin to chart a course and would somehow hold the Congress accountable for staying on that course?

Mr. DU PONT. A twofold answer, Congressman. First, from my years not as governor, but my years in this body—I was an inmate here for some time—the idea of making one committee responsible for dealing with this, rather than the six or seven or eight that are responsible is a good idea, to get more focus. Because as I testified, this is a massive problem. This is not a problem to be nibbled at around the edges of eight committees.

As for Delaware's experience, there was good news and bad news. The good news was that we did not have a pension crisis in my 8 years in office. The bad news was we had so many other crises, that if we had had a pension crisis, that would have made it absolutely intolerable. We had so many fiscal problems dealing from near bankruptcy of the State to sagging revenues to ballooning expenditures, I mean we had the whole 9 yards.

But the answer has to be to find a way to take some pressure off of the Social Security trust fund by increasing the amount of resources that go to beneficiaries outside that, and that is why the market-based accounts offer such a good opportunity.

Mr. GUTKNECHT. Well, I happen to agree with you. And I think whether we are talking about retirement age, whatever we are talking about, you know, the system that was created in the thirties fit the times back in the thirties. But the workforce has changed, a lot of things have changed. Life expectancy has changed, and I think it really is time for us to modernize and update the retirement system.

Mr. DU PONT. There was nothing wrong with Social Security in 1935. It has served millions of people extremely well in the years since. But the demographics have dramatically changed since 1935, and that is what needs to be addressed by the Congress.

Mr. Chairman, I apologize for having to leave. But I trust my two colleagues will provide you enough ammunition to keep you going for sometime. And I thank you for allowing me to testify.

Chairman KASICH. Thank you, Mr. du Pont. Other questions for the panel?

Mr. AARON. May I respond to the question about jurisdiction?

Chairman KASICH. You sure can.

Mr. AARON. I think it is an important issue, and it is devilishly difficult, as you well know. No committee wants to give up jurisdiction, and that is one of the sources of the problem.

In the case of tax policy, one solution that has been adopted is to have a staff that is shared jointly by the House and the Senate to do tax analytic work. I wonder whether, and I may be foolish to suggest something without thinking through its full implications, but I wonder whether something analogous to that in the field of social insurance might serve the Congress well.

Mr. GUTKNECHT. Well, that is exactly what we had in Minnesota. We had this commission, and it was a joint commission between the House and the Senate. They had professional staff. They had their own set of actuaries. And many of the problems that we had relative to particular pension questions were worked out, ironed out in that commission, and pretty much accepted by the rest of the body.

The problem here, of course, is we have got everybody—if everybody is in charge, nobody is in charge. And because of the political nature sometimes of these issues, and they are easily misunderstood, easily misconstrued, and easily demagogued politically, it makes it almost impossible for us to take any kind of action. And, clearly, it is time.

And I did appreciate your comments, Tim, that if you give the American people the facts, they can sort this out much better than we sometimes think they can. And I think if we have a rational discussion about where we are and where we need to go, I think the American people will go with us. I think sometimes we worry far too much about this, in terms of politics, but it does seem to me that we need some commission or committee that helps to work these things out and begins to chart a course.

I don't share the chairman's view that we are all headed—I don't see this as a sunami. I do see this as a serious problem, but I do think it is solvable if we make modest changes now. I hope we don't wait until that wall is upon us.

I yield back my time, Mr. Chairman.

Chairman KASICH. Mr. Moran.

Mr. MORAN. The other question I wanted to ask, in addition to trying to find some differential in benefit structure so that we can raise the retirement age, and it will work from a policy and a political standpoint, is means testing.

We have a bill that is coming up on the floor this afternoon, and basically it is a means testing bill—at least the Democratic substitute is, that says that a couple can earn up to $100,000 and not have to pay any more than—tax on 50 percent of their income. Over $100,000, you would pay on 85 percent of your income, and it is $80,000 for single, up from 35 and 45 respectively, roughly. But that is going to fail, and we are going to go back to the 50 percent that we had, and of course repeal one of the elements of that 1997 Balanced Budget Act that both of you were strong proponents of and, in fact, Henry has alluded to.

What is your point of view on the legislation before us today?

Mr. AARON. I would oppose repeal. This is a question of income tax policy. In the case of contributory private pensions, the pensioner is entitled to receive back in pension, without tax, all contributions that came out of taxed income. All of the rest of the pension is subject to tax.

In 1979, I chaired the Advisory Council on Social Security that recommended partial taxation of benefits. And in order to do that, staff estimated the lowest fraction of benefits—that should be included in taxable income under this principle, so that everybody, except for the last person, would get a better deal out of the recommendation that we advanced than under the rules applied to contributory private pensions. It was to include 85 percent of Social Security benefits without a floor and without a 50-percent range in the tax base. It may come as no great surprise that that recommendation was not received with great enthusiasm by the Congress. But it is the correct policy if you are going to have consistent taxation of pension income.

There is a question of whether one wants to cut tax revenues now, and I realize there is a partisan divide on that issue. But if we wish to cut taxes, I think the way to do so is by cutting rates for everybody, not by adopting a rule that makes even more overly generous than the current rule the definition of income for one class of beneficiaries. Be clear that the current rule treats Social Security under the income tax more favorably than it would be treated if it were taxed as other contributory pensions are taxed.

Mr. PENNY. I could quickly answer this by saying, since I voted for the 1983 Social Security reforms and the 1993 increase in the threshold of taxation, that I would be hard-pressed now to say roll those back. And I think the arguments that Dr. Aaron has laid out are valid arguments. I would also draw to your attention two other documents that would, I think, provide some perspective on this question. One is a fax alert that was sent out by another organization which I am involved with, the Concord Coalition—I am on the board of directors—and a recent fax alert, dated July 20th of this year, speaks to this very issue and suggests that reduction in this tax would be inequitable, as this is a tax that essentially applies only to seniors who are relatively well off. The higher rate, the 85-percent threshold, only applies to those earning $34,000 or more, as an individual, and $44,000 or more as a couple. And some degree of taxation of that income I think is warranted in those income categories.

There is another report by CBO that looks at the relative tax burden of young and old, and the relative benefit programs for the young and the old. And I think that also suggests that especially among the better-off seniors, there is some reason to think that they ought to put more back into Government coffers in reflection of the fact that our Government programs are now tilted heavily in favor of the retirement population. So, again, those better off clearly could be expected to return some portion of their income to the Government to help finance these senior programs.

Mr. MORAN. Thanks.

Chairman KASICH. Dave.

Mr. PRICE. Thank you, Mr. Chairman. Tim, we want to welcome you back. It is good to see you here today and Dr. Aaron as well. We appreciate your testimony.

Let me start, Tim, with the answer you just gave Representative Moran, and I apologize for being in and out of this hearing today. We have just come from a memorial service, which made me unable to hear all of your testimony. So I hope I am not repeating questions others have asked.

If you move to the analysis you just gave of the proposal before us today to a political or public opinion assessment, much like you testified, I wonder what you would say about that. Because, as you know, we were faced last year with a trillion-dollar tax cut all in one piece, and public opinion was not particularly receptive to that, given the uncertainty of surplus projections, and given the trade-off in terms of debt reduction and other national priorities.

Now, as you know, the majority party in the House has adopted a very different strategy, which is to split that trillion-dollar tax cut into smaller morsels and to try to pass them one at a time. The total amount of the tax cuts we have had before us thus far are well over $700 billion over the decade, and future tax cuts are proposed, and of course there are interest losses and so forth. So I gather you are not terribly sympathetic with that strategy, whether you do it in the aggregate or in pieces.

I want to ask you, though, specifically about public opinion because I think the shift in strategy is dictated by an assumption that the public opinion battle is tougher when you are dealing with these more focused tax breaks.

What do you find in your own discussions around the country; have they raised this issue? You talked a great deal about how the public is willing to make those budget trade-offs and those budget sacrifices. You have some pretty impressive evidence about how seriously people take our country's fiscal situation. Do you have any evidence about where the public comes down when the issue is posed, though, as the current strategy of the majority would pose it?

Mr. PENNY. The workshops that we conducted around the country predated this legislative session, and so they are a bit dated in that respect.

What I can tell you is that, in the eight sessions we conducted with anywhere between 60 and a couple hundred people in attendance, we broke them into the tables for discussion, made sure that there was diversity at each table in terms of age, and ethnicity, and political persuasion, and profession, so that, very much like Congress, people of differing views were forced to come to terms with one another.

And so, in that sense, what we felt we got out of these sessions was sort of an informed poll. And what we heard from the vast majority of the participants was a strong desire for fiscal responsibility, a strong inclination to use current or near-term surpluses to pay down debt. And as I recall, when the question of tax cuts for any future projected surplus was brought into the discussion, we had I think fewer than 4 percent of our respondents that thought that tax cuts ought to be a priority item for Congresses in the near term.

So, again, I can only tell you what came out of these roundtable discussions that we sponsored in eight locations around the Nation. But there clearly was a disinclination to buy into any sort of a tax-cut scenario, and I think that was based on their understanding that while we may have some near-term good news, in terms of the economy and surplus revenues in the Federal coffers, that we still have these daunting challenges right out there on the horizon that require a certain caution in the near term, and that applies to the tax-cut agenda.

Mr. PRICE. Of course, as you stress, this is an informed poll, and it assumes that people do have good information about the trade-offs they, in fact, face. And that, of course, places a burden on Members of Congress and others who understand these issues and who have to deal with them to make certain that public interpretation is made.

Mr. PENNY. That is right. And obviously the exercise we went through, which involved half a day of presentations to give people a context for their ultimate decisions, is not necessarily the way this will play out in a campaign environment.

Mr. PRICE. Let me quickly, Dr. Aaron, ask you a question. I know we have limited time here, and again forgive me if you have already dealt with this. Maybe this amounts to a request to slice your testimony a somewhat different way because I am sure you did touch on these subjects.

I know you come to this hearing and the subjects you have testified on today with a great concern to increase national savings, to help older Americans in future years avoid total dependence on the regular Social Security program for their retirement income, to shore up other sources of retirement income, but you end up with an unfavorable comparison, I gather, between privatization or partial privatization of Social Security versus the design of a supplemental retirement savings program, perhaps much like the President has proposed—this kind of private savings plan inside or supplementary to Social Security.

I wonder if you could, in shorthand, tell us how you compare those two options. What are the relative advantages or disadvantages of approaching the agreed-upon need in those two ways?

Mr. AARON. Let us start with Social Security. This is not, in fact, a very generous system. A full-time average wage worker retiring at age 62 will receive a pension slightly above the U.S. poverty threshold. The function of social insurance is to provide assured basic income, income that isn't going to vary, that will be there till you die.

It strikes me that a system of approximately the size of the one we now have, that provides benefits roughly of this order of magnitude, perhaps starting at a later age, is one we want to keep because it does provide assured basic income, and the simple fact is that no private account system can provide an equal degree of insurance—assurance. They are subject to financial market risk during the accumulation phase, and unless they are converted into indexed annuities at pension phase, they are subject to inflation risk, and if you will, the danger you might live too long and outlive your assets.

So I think the starting point is that, of course, we have a projected long-term deficit, and I fully agree with the chairman and others that we should move expeditiously to try and close that deficit through a combination of instruments that would leave the system in a condition similar to the current system.

Having said that, there are large numbers of Americans, all too many, who don't save at all in other forms. They may own their own homes, they have their Social Security and that is just about it, and I think that is regrettable. It is important to encourage saving for people who now don't find it the fashionable thing to do, who are bombarded by advertisements to consume now, and do, and even go into debt. It is important to make saving chic. It will help them meet lifetime objectives, sending children to college, buying houses, meeting illnesses, being ready for unemployment, being able to take care of a serious illness, that now will lay them low financially or that they will find simply impossible to do.

And for that reason I think using the tax system to encourage additional private saving, along the lines of accounts that would be tilted toward those who now don't save enough, which mean low- and lower middle-income households. It would serve a very important public objective, and I would hope that Congress would view such savings devices sympathetically.

I would add that I think it would be a bad mistake to condition those savings—to make those savings available only for retirement income. The motivations I have described are that if you are a low-income household, the true fact is Social Security does provide what financial advisers would characterize as an adequate replacement rate, ratio of benefits to earnings. But these folks don't have the cash on hand to deal with lifetime wants and crises before retirement. So the direction I think should be to promote saving. If people want to keep it till retirement, fine, if they want to withdraw funds under the kinds of rules under which we now allow withdrawals from 401(k) plans, IRAs, SEPs, the whole alphabetical zoo of saving instruments we now have, those rules ought to carry over to this plan as well, and I think it would be a great step ahead.

Mr. PRICE. How do you think this kind of savings for the households that you are wanting to target could best be incentivized? And, of course, in your answer I would appreciate your taking account of what you think, at this point, we could afford.

Mr. AARON. Well, I agree with the chairman that the true fact is that, confronted with on-budget surpluses of the magnitudes we now confront, whether this year or next year or the year after, we are going to see some increases in spending, and we are going to see some tax cuts.

What form should they take? It seems to me that one form that the use of some tax reductions could take would be as incentives to individuals who set up savings accounts and make some contribution on their own, a kind structurally similar to 401(k) plan. I call it a tax cut with a benign string attached. The benign string attached is this: we are giving you a tax cut, but you can't consume it right now. You are going to have to build it up for a while, and you will have it available when the need strikes later in your life. That seems to me to be a tax cut that would merit very serious consideration.

Mr. PRICE. Thank you. Thank you, Mr. Chairman.

Chairman KASICH. I want to thank both of you for being here.

Henry, one question. Would you be for lowering or eliminating the tax on long-term held capital gains?

Mr. AARON. No, I would not. I have gone through the evidence on this question pretty carefully. The evidence that it would boost national savings isn't there. On the contrary, it is more likely to lower saving, given other tax rates. And it is, in fact, a tax cut that is very heavily skewed toward a very small percentage of the wealthiest people in the United States—a feature, I might add gratuitously, that it shares with repeal of the estate tax.

Chairman KASICH. I understand.

I want to thank you guys for being here, both of you, very, very much. Senator Kerrey has arrived, and we want to make sure he gets up and delivers his testimony. He is a very important man. [Laughter.]

He is now on the short list, they tell me. I sure hope you are not breathing heavy over that.

Mr. PENNY. Mr. Chairman, if I might, before we call forward the illustrious Senator from Nebraska, in response to Congressman Smith's question, though he is no longer in the room, I would simply refer the committee to Pages 9 and 10 of my testimony, my written testimony, where I speak to the issue of individual accounts, and I would ask that someone bring that segment of my testimony to Mr. Smith's attention, so that he can get a response to the question he posed.

Chairman KASICH. Terrific. Thank you. Thank you, gentlemen.

Well, I want to welcome the Senator from Nebraska. I had an opportunity to take a look at a little of his testimony, and we will let him run through it. I can see him. There we go.

Senator Kerrey, has had a long distinguished career, a successful businessman, a Senator and now moving on to be president of a university, if he is truly going to retire from politics.

So, Bob, it is all yours.

STATEMENT OF HON. J. ROBERT KERREY, A UNITED STATES SENATOR FROM THE STATE OF NEBRASKA

Senator KERREY. Thank you, Mr. Chairman and members of the committee.

I appreciate the opportunity to testify. I have written this testimony, and I may not get through all of it, but I will begin as if I am, and if not, if I feel like ad libbing, I will ask later to be made a part of the record.

I do think this hearing provides us with an opportunity, certainly it has provided me with an opportunity, to reflect about how we should set our priorities for the future and what kind of legacy we want to leave to our children. We are lucky, in many ways, to be having this discussion about spending priorities and intergenerational equity during a time of large projected surpluses.

These surpluses provide legislators with a great deal more flexibility in choosing among priorities and in determining our legacy to future generations. Until recently, we were not so lucky. For more than 30 years, the budget projection reports in the Congressional Budget Office and the Office of Management and Budget were a source of growing despair to the American people. As each year went by, CBO and OMB would present worse news—larger deficits, larger national debt levels, larger net interest payments. And as the Government's appetite for debt expanded, fewer and fewer dollars were available for private investment.

In the beginning, Mr. Chairman, as you may recall, experts were saying that the deficits were good for us because they were stimulating economic growth and were creating jobs. But over time, the voices of experts opposed to large deficits grew louder. They argued that deficits caused inflation, increased the cost of private capital, mortgaged away our future just at the time when we needed to be preparing for the retirement of the large baby boom generation. As the opinions of the experts shifted, so did public opinion.

During the 1980s and 1990s, the Federal deficit became public enemy number one. Great efforts were made to understand it, to propose solutions to reduce it, to explain how much better life would be without it. During election season, the airways were filled with promises and plans to get rid of the deficit and pay off the national debt. Editorial page writers reached deep into their creative reservoir to coin new phrases and create new metaphors to describe the problem. Books were published, nonprofit organizations were created, constitutional amendments were called for. There was even a new political party created simply on account of the deficit.

In the 1990's, at great political risk, we finally started action to control the size of the deficits and control the national debt. We voted and passed three budget acts in 1990, 1993, 1997. Unfortunately, we didn't pass Penny-Kasich, Kerrey-Brown, which would have made it even better. These three acts have radically altered the fiscal condition of the Federal Government, and now the debate in Congress is about how the public's hard-earned tax dollars should be spent.

The enactment of these three budget acts—particularly the 1993 and 1997 budget acts—coupled with impressive gains in private-sector productivity and economic growth, led to a remarkable reversal of our deficit and debt trends. We celebrated our first unified budget surplus of $70 billion in 1998. And over the next 10 years, if we maintain current spending and revenue policies, CBO projects an eye-popping unified budget surplus of $4.5 trillion. I am proud that we are able to celebrate the fruits of our fiscal restraint.

But today, Mr. Chairman and members of the committee, I would like to call your attention to what I would call one of the unintended consequences of our fiscal responsibility. Not only have we allowed total Federal spending to dip below 20 percent of GDP—levels that we have not seen since the 1970's—but very seldom has it been commented upon that we are also on course to have spending levels drop to 15.6 percent of GDP by 2010—spending levels we haven't seen since the 1950's. At the same time as total spending is declining as a percent of GDP, Mr. Chairman, the makeup of our Federal spending is continuing to shift in very significant and, in my view, troubling ways. An increasingly larger proportion of our spending, even after net interest is reduced, is being used for mandatory spending programs compared to discretionary spending programs. These numbers have very important implications for the measurement of intergenerational equity.

And now that we have constrained spending and eliminated our budget deficits, the budget debate has shifted to questions about how to spend the surplus on debt reduction, tax cuts, new discretionary spending programs, fixing Social Security, creating a new Medicare prescription drug benefit. I favor all of these things, to varying degrees, and enjoy participating in this debate, as I suspect most of you do as well.

Mr. Chairman and members of the committee, the trick is to find the right balance among these initiatives. And in finding the right balance, I believe one of the most important criterion in determining how to use these surpluses should be measuring intergenerational equity. Not only do we need to assess the amount of money we invest on our seniors versus our children, but we also need to assess the trends of mandatory versus discretionary spending.

Let me start my own assessment of Federal spending on children and seniors. Today, the Federal Government spends substantially more on seniors over the age of 65 than it does on children under the age of 18. In 2000, the Federal Government spent roughly $17,000 per person on programs for the elderly, compared with $2,500 per person on programs for children. This means, at the Federal level, we are spending seven times as much on people over the age of 65 as on children under the age of 18.

Mr. Chairman, even when we consider that States are the primary funders of primary and secondary education, the combined level of State and Federal spending still shows a dramatic and growing contrast in spending on the old versus the young. At the State and Federal level, we are still spending 2.5 times the amount of money on people over the age of 65 as on children under the age of 18.

Given these discomforting facts, it might seem logical that most of our current proposals for spending surplus dollars would be for investments in our children. But instead, the Congress—and especially the Senate—has been proposing, and working and voting as well to spend a major portion of the surplus on the most politically organized voting bloc in the Nation—Americans over the age of 65.

In the Senate, Mr. Chairman, we have either acted on or are expected to act on the following proposals, which directly benefit seniors only. We eliminated the earnings test on Social Security, which has a price tag over the next 10 years of $23 billion. There is an offset after that, but over the next 10 years, we will take $23 billion out of the payroll taxes of Americans to pay for that new law.

We voted to allow military retirees who do not like Medicare to opt out of Medicare and into TriCare or the Federal Employee Health Benefit Program. That has a 10-year price tag of $90 billion.

We are proposing to create a new universal Medicare prescription drug benefit, which has a price tag of about $300 billion over 10.

We are discussing Medicare give-backs, which has a 10-year price tag of about $40 billion.

And we voted once, and we will probably vote again after we get back, to increase the Federal income tax exemption provided to Social Security beneficiaries, which has a 10-year price tag of $125 billion.

Mr. Chairman, if Congress acts on all of these popular provisions, we will be spending for seniors over the next 10 years, we will have an increase in spending of $578 billion, an amount that is equivalent to this year's entire discretionary spending budget.

At the same time as we are proposing these things, voting in favor of and enacting legislation to improve benefits and tax cuts for seniors, we will be lucky to get legislation passed that spends an additional $10 billion on children under the age of 18.

The principal reason, Mr. Chairman, as you know very well, is not simply because seniors are better organized voters and children are not. We also have to look at how most programs for seniors are funded versus programs for children. As the members of this committee are well aware, most programs for seniors are funded through mandatory entitlement spending. Whereas, spending increases in these programs are not subject to the annual appropriations process and are protected by automatic cost of living COLAs each year, spending programs that primarily benefit our children are discretionary. And that means, as you know well, they are subject to the annual appropriations process. There are no automatic spending increases for these programs, and instead, most programs for children are held victim to politics and spending caps.

As a result, the proportion of Federal Government spending on mandatory versus discretionary spending has undergone a dramatic and relevant shift of this debate. Back in 1965, when I graduated from the University of Nebraska, the Federal Government spent the equivalent of 6 percent of GDP on mandatory entitlement programs, like Social Security, and 12 percent of GDP on discretionary funding items, like national defense, education and public infrastructure.

Put another way, Mr. Chairman, 35 years ago, one-third of our budget funded entitlement programs and two-thirds of our budget funded discretionary programs. But today, the situation has completely reversed. Today, we spend about two-thirds of our budget on entitlement programs and net interest payments and only one-third of our program on discretionary spending programs.

I am particularly troubled, Mr. Chairman, by the decline in spending on discretionary initiatives. Although our tight discretionary spending caps were a useful tool in the past for eliminating deficits and lowering debt, they are not so useful today in helping us assess the discretionary budget needs of the Nation. And, today, appropriated spending is contained through spending caps, in my view, that are too tight for today's economic reality.

Mr. Chairman, downward pressure on discretionary spending will become worse during the retirement of the baby boom generation, when the needs of programs on the mandatory spending side will increase dramatically. Mr. Chairman, the coming demographic shift of workers per retirees is not a "pig in a python" problem, as described by some commentators whose economics are usually better than their metaphors. The ratio of workers needed to support each beneficiary does not increase after the baby boomers have become eligible for benefits. It remains the same.

And, Mr. Chairman, here are the hard numbers. You cannot run away from these numbers. This is what we are going to face starting in 10 years. The number of seniors drawing on Medicare and Social Security will double from 39 million to 77 million, and the number of workers is projected to grow only slightly from 137 million to 145 million. Worse, if we continue to underinvest in the education and training of our youth, we will have no choice, but to continue what I consider to be a terrible process. I voted for it before, and I probably will again, of using H–1B visas to solve the problem of shortage of skilled labor.

One of the least-understood concepts regarding Social Security and Medicare, Mr. Chairman, is that neither of these programs is a contributory system with dedicated accounts for each individual. Both are intergenerational contracts, and we are saying again they are intergenerational contracts. The generations in the workforce agree to be taxed on behalf of eligible beneficiaries in exchange for the understanding they will receive the same benefit when eligible. Both programs are forms of social insurance. They are not welfare, but both are also transfer payment programs. We tax one group of individual people and transfer that money to another group.

The proportion of spending on seniors and the proportion of mandatory spending will most surely increase as the baby boomers become more eligible for transfer payments. Unless we want to raise taxes substantially or accrue massive amounts of debt, much of the squeeze will be felt by our discretionary spending program. The spiral of underinvestment in our children and in the workforce will continue. Our Government will become more and more like an ATM machine.

So what should we do about this problem? Well, Mr. Chairman and members of the committee, I recommend a two-step approach. Step one is to honestly assess whether we can cut our way out of this problem. Do you think public opinion will permit future Congresses to vote for reductions in the growth of Medicare or Social Security or the long-term care portion of Medicare? At the moment, my answer is a resounding no. Indeed, as I said earlier, we are currently heading in the opposite direction. There is no indication, Mr. Chairman, that the political will is there to do anything other than to spend more, not less, than we are currently forecast to spend.

Thus, I reached a conclusion that Step 2 is to consider whether it is time for us to rewrite the entire social contract, and to do that you have to answer the question do the economic and social changes that have occurred since 1935 and 1965 justify a different kind of safety net? Mr. Chairman and members of the committee, I believe they do. I believe we need to rewrite and modernize the contract between Americans and the Federal Government in regards to retirement income and to health care. We should begin by transforming the Social Security program, so that annual contributions lead all American workers, regardless of their income, to accumulate wealth by participating in the growth of the American economy. Whether the investments are made in low-risk instruments such as Government bonds or higher-risk stock funds, it is a mathematical certainty, Mr. Chairman, that 50 years from now a new generation of American workers could be heading toward retirement with the security that comes with the ownership of wealth if we rewrite now the contract to allow them to do so.

Not only should we reform Social Security to allow workers to personally invest a portion of their payroll taxes, but we should also make sure those account contributions are progressive so that low- and moderate-income workers can save even more for their retirements. At the same time, it is important to make the traditional Social Security benefit formula even more progressive so that protections against poverty are stronger for our low-income seniors.

Finally, it is important to change the laws so that we can keep the promise to all 270 million current and future beneficiaries. And that will mean reforming the program to restore its solvency over the long term.

Mr. Chairman, in addition to reforming Social Security, we should end the idea of being uninsured in this Nation by rewriting the Federal law so that eligibility for health insurance occurs simply as a result of being a citizen or a legal resident. Currently, under Federal law, you are eligible for subsidies if you can prove that you are 65 and you paid in for 40 quarters. You are eligible for a subsidy if you prove that you are poor enough and promise to stay poor under the Medicaid program.

If, like me, you get lucky to get blown up in a war, you are eligible for a subsidy as a consequence of being service-connected disabled through the Veterans' Administration. If you work for the Government at the local level, at the State level, at the Federal level, you are also eligible for subsidies. What that means is that all of us who under law are eligible have a claim on the income of all other Americans. And, unfortunately, that claim also reaches out to about 40 million Americans, 20 million of whom, I would guess, simply cannot afford to buy health insurance, though their taxes are being collected to subsidize everybody else who is eligible. I left one out, Mr. Chairman, the Federal income tax deduction, which is an odd formula that says that the higher your income the greater the subsidy we are going to provide you.

Mr. Chairman, I think we should end all of those programs, have a single system of eligibility—if you are an American, if you are a legal resident. And we should provide subsidies for the purchase of health insurance only for those who need assistance.

Mr. Chairman, in 1969, I needed assistance, and thank God I live in a great country like this that would have a law written so that I had my health care needs taken care of. But today it embarrasses me that there are Americans out there with incomes far lower than mine subsidizing me, while they have no claim on my income to provide them assistance. They are law-abiding, they are in the workforce, they are struggling to raise their families. I have been with them, Mr. Chairman. I have met with mothers and fathers who have children who, as a result of an accident or because of a birth defect, had their legs or arms amputated. They come to me for some assistance because I am in a similar condition, and we have to seek charity to provide them with assistance because they are uninsured.

It is, in my view, it makes no economic sense, nor does it make moral sense for the richest Nation on Earth to have this differentiated and fractionized system of eligibility.

Now, to be clear, Mr. Chairman and members of the committee, enacting a Federal law that guarantees health insurance does not mean we have to have socialized medicine. It worked for me in 1969 when I was in the Philadelphia Naval Hospital. I would not argue for it for all Americans. There will be times when only the Government can deliver. But, in general, in my view, it is better for the market to be making these decisions. You can still have 80 percent of it controlled by the marketplace.

And, Mr. Chairman, I don't believe we will face the problem of growing mandatory spending until we create on the Social Security side that says that every single American is going to have the opportunity to accumulate a sufficient amount of wealth, so they don't need to be subsidized in other areas. If you look at the long-term costs, especially of the health care program that we have, and you just scratch your head of whether it is acute care or long-term care, which is in many ways worse, and you say, how are we going to be able to finance that? And if you finance it only with taxes, Mr. Chairman, we are going to find, sooner rather than later, that our budget is entirely an ATM machine.

Mr. Chairman, one last suggestion. With budget projections showing that Federal spending will fall to 16.6 percent of GDP by 2010, given our willingness to vote additional monies for people over the age of 65, I would urge my colleagues to consider whether or not we should set a goal of putting aside a portion of the surpluses, perhaps an amount equivalent to one-half or 1 percent of GDP—it isn't that large—by 2010 for additional discretionary investments, investments that will improve the lives of our children, both in the near and long term—investments in education, in research and development, in science and technology, all of the things that my parents did when we had a Nation that was investing in its future rather than merely worrying about how to entitle the present.

Mr. Chairman, again, and members of the committee, I want to thank you for this opportunity to testify. I want to, in particular, Mr. Chairman, thank you for your leadership over the years. You have been a truth teller on the budget, a real leader on the budget. If Penny-Kasich had passed over here and Kerrey-Brown had passed over in the Senate, we might have eliminated the deficit an awful lot earlier. Now, that is the good news. You probably wouldn't be chairman if that would have happened. I am not sure that the election of the 1994 would have had the same outcome. But I appreciate very much your leadership, and I have enjoyed our friendship.

[The prepared statement of Senator Kerrey follows:]

PREPARED STATEMENT OF HON. J. ROBERT KERREY, A UNITED STATES SENATOR FROM THE STATE OF NEBRASKA

I want to thank the distinguished chairman and ranking member for providing this opportunity to come before the committee to talk about inter-generational issues related to Federal budget spending. I appreciate your ongoing interest in inter-generational equity issues related to entitlement and discretionary spending. This hearing provides an important opportunity to talk about the spending priorities we should be setting for the future and the legacy we want to leave to our children.

We are lucky to be having this discussion about spending priorities and inter-generational equity during a time of large projected surpluses. These large projected surpluses provide legislators with a great deal more flexibility in choosing among priorities and in determining our legacy to future generations.

Until recently, we were not so lucky. For more than thirty years, the budget projection reports from the Congressional Budget Office (CBO) and the Office of Management and Budget (OMB) were a source of growing despair for the American people. As each year went by, CBO and OMB would present worse news: larger deficits, larger national debt levels, and larger net interest payments. As the government's appetite for debt expanded, fewer and fewer dollars were available for private investment.

In the beginning, experts explained that deficits were a good thing because they stimulated economic growth and created jobs. Over time, however, the voices of experts opposed to large deficits grew louder; they argued that deficits caused inflation, increased the cost of private capital, mortgaged away our future—just at the time when we needed to be preparing for the retirement of the large Baby Boom generation. As the opinions of the experts shifted, so did public opinion.

During the 1980's and 1990's, the Federal deficit became public enemy number one. Great efforts were made to understand it, to propose solutions to reduce it, and to explain how much better life would be without it. During election season, the airwaves were filled with promises and plans to get rid of the deficit and pay off the national debt. Editorial page writers reached deep into their creative reservoir to coin new phrases and create new metaphors to describe the problem. Books were published. Non-profit organizations were created. Constitutional amendments were called for. There was even a new political party created on account of the deficit.

In the 1990's—and at great political risk—we finally started taking action to control the size of the deficits and the growth of the national debt. I am proud to have participated in and voted for three budget acts—in 1990, 1993, and 1997—which have radically altered the fiscal condition of the Federal Government and the debate about how the public's hard-earned tax dollars should be spent.

The enactment of these three budget acts—particularly the 1993 and 1997 budget acts—coupled with impressive gains in private sector productivity and economic growth led to a remarkable reversal of our deficit and debt trends. Deficits started shrinking in 1994. We celebrated our first unified budget surplus of $70 billion in 1998. Over the next 10 years, if we maintain current spending and revenue policies, CBO projects an eye-popping unified budget surplus of $4.5 trillion. I am proud that we are able to celebrate the fruits of our fiscal restraint because we had the sheer will and political courage to put ourselves on a spending diet.

Today, however, I want to call your attention to what could be called the "unintended consequences" of our fiscal responsibility. Not only have we allowed total Federal spending to dip below 20 percent of GDP (levels not seen since the mid-1970's), but we are also on course to let spending drop to 15.6 percent of GDP by 2010. We have not seen spending levels this low since the 1950's. At the same time as total spending is declining as a percentage of GDP, the make up of our Federal spending is continuing to shift in significant ways. An increasingly larger proportion of our spending is used for mandatory spending programs compared to discretionary spending programs. These numbers have important implications for the measurement of inter-generational equity.

Now that we have constrained spending and eliminated our budget deficits, the budget debate has shifted to questions about how to spend the surplus: on debt reduction, on tax cuts, on new discretionary spending programs, on fixing Social Security, or on creating a new Medicare prescription drug benefit?

I favor all of these things to varying degrees, as I suspect most of you do. The trick is to find the right balance among these initiatives. In finding the right balance, I believe one of the most important criterion in determining how to use these surpluses should be measuring inter-generational equity. Not only do we need to assess the amount of money we invest on our seniors versus our children, but we also need to assess the trends of mandatory versus discretionary spending.

Let me start with my own assessment of Federal spending on children and seniors. Today, the Federal Government spends substantially more on seniors over the age of 65 than it does on children under the age of 18. For example, in 2000, the Federal Government spent roughly $17,000 per person on programs for the elderly, compared with only $2,500 per person on programs for children. This means that at the Federal level, we are spending seven times as much on people over the age of 65 as on children under the age of 18.

Even when we consider that states are the primary funders of primary and secondary education, the combined level of State and Federal spending still shows a dramatic contrast in spending on the old versus the young. At the state and Federal level, we are still spending 2.5 times the amount of money on people over the age of 65 as on children under the age of 18.

Given these discomforting facts, it might seem logical that most of the current proposals for spending surplus dollars would be for investments in our children. Instead, this Congress has been proposing and voting to spend a major portion of the surpluses on the most politically organized voting bloc in the nation—those over the age of 65.

In the Senate alone, we have either acted on, or are expected to act on, the following proposals which directly benefit seniors only:

- Eliminating the Social Security earnings test for workers over the age of 65 (10-year price tag: $23 billion)
- Allowing military retirees to opt out of Medicare and into TriCare or FEHBP (10-year price tag: $90 billion)
- Creating a new universal Medicare prescription drug benefit for seniors (10-year price tag: $300 billion)
- Medicare provider “give-backs” package (10-year price tag: $40 billion)
- Increasing the Federal income tax exemption provided to Social Security beneficiaries (10-year price tag: $125 billion)

If Congress actually enacted all of these popular provisions into law, spending for seniors over the next 10 years would increase by $578 billion—an amount equivalent to this year’s entire discretionary spending budget.

At the same time as we are proposing, voting in favor of, and enacting legislation to improve benefits and tax cuts for seniors, we will be lucky to get legislation passed that will spend only an additional $10 billion on children under the age of 18.

Why? The answer is not simply because seniors are politically organized voters and children are not. We also have to look at how most programs for seniors are funded versus programs for children. As the members of this Committee are well aware, most programs for seniors are funded through mandatory/entitlement spending. Spending increases in these programs are not subject to the annual appropriations process and are protected by automatic cost-of-living-adjustments (COLA) each year.

The spending programs that primarily benefit our children, on the other hand, are discretionary, which means they are subject to the annual appropriations process. There are no automatic spending increases when it comes to programs for our kids. Instead, most programs for kids are held victim to politics and spending caps.

As a result, the proportion of Federal Government spending on mandatory versus discretionary spending has undergone a dramatic shift. Back in 1965, the Federal Government spent the equivalent of 6 percent of GDP on mandatory entitlement programs like Social Security and 12 percent of GDP on discretionary funding items like national defense, education, and public infrastructure. Put another way: 35 years ago, one-third of our budget funded entitlement programs and two-thirds of our budget funded discretionary spending programs.

The situation has now reversed. Today, we spend about two-thirds of our budget on entitlement programs and net interest payments and only one-third of our budget on discretionary spending programs.

I am particularly troubled by the decline in spending on discretionary spending initiatives. Although our tight discretionary spending budget caps were a useful tool in the past for eliminating deficits and lowering debt, they are not useful today in helping us assess the discretionary budget needs of the nation. Today, appropriated spending is contained through spending caps that are too tight for today’s economic reality. We are left with a discretionary budget that bears little relationship to the needs of the nation and that leaves us little flexibility to solve some of the big problems that still need to be addressed: health care access for the uninsured, education, and research and development in the areas of science and technology.

The downward pressure on discretionary spending will become worse during the retirement of the Baby Boom generation—when the needs of programs on the mandatory spending side will increase dramatically. The coming demographic shift toward more retirees and fewer workers is NOT a "pig in a python" problem as described by some commentators whose economics are usually better than their metaphors. The ratio of workers needed to support each beneficiary does not increase after the baby boomers have become eligible for benefits. It remains the same.

In 10 years, the unprecedented demographic shift toward more retirees will begin. The number of seniors drawing on Medicare and Social Security will nearly double from 39 million to 77 million. The number of workers will grow only slightly from 137 to 145 million. Worse, if we continue to under-invest in the education and training of our youth, we will have no choice but to continue the terrible process of using H–1B visas to solve the problem of a shortage of skilled labor.

One of the least understood concepts regarding Social Security and Medicare is that neither is a contributory system with dedicated accounts for each individual. Both are inter-generational contracts. The generations in the work force agree to be taxed on behalf of eligible beneficiaries in exchange for the understanding that they will receive the same benefit when eligible. Both programs are forms of social insurance—not welfare—but both are also transfer payment programs. We tax one group of people and transfer the money to another.

The proportion of spending on seniors—and the proportion of mandatory spending—will most surely increase as the baby boomers become eligible for transfer payments. Unless we want to raise taxes substantially or accrue massive amounts of debt, much of the squeeze will be felt by our discretionary spending programs. The spiral of under-investment in our children and in the future work force will continue. Our government will become more and more like an ATM machine.

What should we do about this situation?

I recommend a two step approach. Step one is to honestly assess whether we can "cut our way out of this problem." Do you think public opinion will permit future Congresses to vote for reduction in the growth of Medicare, Social Security, and the long-term care portion of Medicaid? At the moment my answer is a resounding "no." Indeed, as I said earlier, we are currently heading in the opposite direction.

Step number two is to consider whether it is time for us to rewrite the social contract. The central question is this: Do the economic and social changes that have occurred since 1965 justify a different kind of safety net? I believe they do. I believe we need to rewrite and modernize the contract between Americans and the Federal Government in regards to retirement income and health care.

We should transform the Social Security program so that annual contributions lead all American workers—regardless of income—to accumulate wealth by participating in the growth of the American economy. Whether the investments are made in low risk instruments such as government bonds or in higher risk stock funds, it is a mathematical certainty that fifty years from now a generation of American workers could be heading toward retirement with the security that comes with the ownership of wealth—if we rewrite the contract to allow them to do so.

Not only should we reform Social Security to allow workers to personally invest a portion of their payroll taxes, but we should also make sure those account contributions are progressive so that low and moderate income workers can save even more for their retirements. At the same time, it is important to make the traditional Social Security benefit formula even more progressive so that protections against poverty are even stronger for our low income seniors. Finally, it is important to change the law so that we can keep the promise to all 270 million current and future beneficiaries—and that will mean reforming the program to restore its solvency over the long-term.

In addition to reforming Social Security, we should end the idea of being uninsured in this nation by rewriting our Federal laws so that eligibility for health insurance occurs simply as a result of being a citizen or a legal resident. We should fold existing programs—Medicare, Medicaid, VA benefits, FEHBP, and the income tax deduction—into a single system. And we should subsidize the purchase of health insurance only for those who need assistance. Enacting a Federal law that guarantees health insurance does not mean we should have socialized medicine. Personally, I favor using the private markets as much as possible—although there will be situations in which only the government can provide health care efficiently.

One final suggestion. With budget projections showing that total Federal spending will fall to 15.6 percent of GDP by 2010, I urge my colleagues to consider setting a goal of putting aside a portion of the surpluses—perhaps an amount equivalent to one-half to 1 percent of GDP—for additional discretionary investments. Investments that will improve the lives of our children both in the near future and over the long term—investments in education, research and development, and science and technology.

Mr. Chairman, Congressman Spratt and other members of the committee: I again thank you for the opportunity to testify on the very important issue of intergenerational equity. Given the length of my response I suspect this may be the last such invitation I receive.

Chairman KASICH. Thanks, Bob. It is amazing testimony. It is on the record. And I think part of the problem is that people don't really want to look at these things right now. They think it is so far away. And the tragedy of it, as I know you are aware, if you don't get on it soon, the power of things like compound interest is minimized. I am convinced that we need to create not only private accounts for Social Security, but I think we need to create private accounts for Medicare as well, where the Government would ensure against catastrophic illness, but that the private accounts could accumulate money that could be used for other kinds of medical care and perhaps an ability to have a seamless transition into long-term care.

But, Bob, when do you think that we could actually get about doing some of these things?

Senator KERREY. I don't know. I mean, as to the question you are raising with your suggestion to have private accounts both for Social Security and for Medicare, one of the problems, Mr. Chairman, is oftentimes what happens is the private accounts get debated all by themselves, as if that is all I am proposing or all that you are proposing.

There is a purpose in both proposals, and the purpose is to enable somebody, whether you are making $5 an hour or $500 an hour, to accumulate wealth and become wealthy. And one of the interesting things there is it may take that moment when people who write and report on this thing to understand that there is a huge difference between income and wealth. I can have $500,000 worth of income every single year. If I spend it all, I don't have any wealth to show for it. At the same time, I can make $5 or $6 an hour, if I save a little bit, and my poster child over the years who is Oseola McCarty from Hattiesberg, Mississippi, who was a washer woman for almost 60 years, and when she finally quit working, she called Southern Mississippi University up to offer them a gift. They thought it was a doily or a coffee can she had decorated or something, it turned out to be a couple of hundred thousand dollars cash. When they asked her how she accumulated $200,000 cash on income that was under $10,000 a year, she said it was simple. I just used the power of compounding interest rates. Well, on that basis, I would have voted for her to be chairman of the Federal Reserve.

Chairman KASICH. It is like the book, "The Millionaire Who Lives Next Door."

Senator KERREY. The goal here is to say, I don't care how much money you make, you have value. You are worth something. The market may say you are only worth $6 an hour or $7 or $8 or whatever, but we can change the law to enable you to accumulate wealth.

Mr. Chairman, it may take us going, and rather than allowing the press to do it or our opponents to do it, it may take us going to people who are over the age of 65 and asking them, so the country can hear, especially those who have only Social Security income, and say to them, you are 70 years old now, let me describe this program. And they will say, my gosh, I wish that had been in law when I was young and working because they know what makes them secure is wealth. They don't feel secure as a result of getting $600 a month from Social Security.

So it may take a real muscular public education effort because right now, boy, I think the jaws of consent are closed. There is just too much misunderstanding and too much disinformation that is put out. In our line of work, Mr. Chairman, and you have seen as well an awful lot of money spent that is essentially lying to the American people about what Social Security is. So if you have that on top of sort of a tendency not to want to know the truth to begin with, why it is not accidental that people don't understand it.

Finally, I say I do think that we have a tendency to underestimate the willingness of people over 65 to participate in this. This is the greatest generation ever. You give them the truth, in my view, they will take the truth, they care about their kids, they care about their grandkids, they want them to have a better future. If you BS them, that is a different thing. But if you tell them the truth, in my view, and if you call out greatness in them, I think they will take the challenge.

Chairman KASICH. Bob, in an era where it seems as though people are isolating themselves more every day, in a time when we have great economic prosperity, but it seems as though the gated community and the high walls are the direction that we are going—you know, I want to take care of me—how do we begin to, and maybe you have touched on it. Maybe the greatest generation one more time needs to contribute to the country, but how do we get people to look beyond the self-interests in this country, particularly in light of everybody yelling, and screaming, and shouting, and politicizing everything because that is always all about me. It is about reelection, it is about whatever is good for me, how do we even begin to start this kind of a dialogue? How do we get this where people can think in a broader way? I mean, you are a poet. I wouldn't ask this question to most people, but you are a poetic man.

Senator KERREY. I think you have got to start just quietly talking straight to a person and say, look, you and I both know that our worst instinct is when all we care about is ourself. And I get in the most trouble when I am selfish. If all I am worried about is me, I am unhappy. That is not how happiness is found. Happiness is found when you fall in love with someone, when you care about somebody more than you do yourself, when you have children, when you do something for somebody else. And if you want to be remembered, if you want to have somebody stand on your grave, as they most assuredly will, because nobody gets of this deal alive, if you want to have somebody stand on your grave and weep because you are a hero, you have got to act like it.

We celebrate D-Day and we celebrate those men landing on the beaches of Normandy, well, those were not selfish kids. And by the way, they didn't ask for Veterans benefits when they went over. They didn't say, wait a minute, I am not going to go over there unless you let me have a VA hospital. I mean, we gave that to them because we saw them as heroes, and I think you have just got to, you just quietly, and if that doesn't work, you have got to come and try to shame people into understanding this Nation didn't become great as a consequence of starting out with selfish human beings.

Chairman KASICH. Well, here you have a situation, curious situation, where both our friend, Tim Penny, went face-to-face with a race for the United States Senate, a race I personally believe he would have won; Bob Kerrey comes face-to-face with whether he runs for reelection, and he says, no, I don't think I need to do that. And yet we, all of us, look at this problem, and we know that it needs real leadership. Maybe I could ask you to reflect on your decision. Did you have a sense that you could do more to move these issues out of here? How did you reach the conclusion not to continue to fight on these kinds of issues?

I know that Mr. Penny made the decision really based on family considerations, yet he is here today, and going about this in another way. What was your decision process?

Senator KERREY. Well, first, Mr. Chairman, God bless them, Nebraskans gave me permission to work on these issues. I campaigned on it in 1994. I asked their permission and told them much of what I have said today, except I have learned a lot more since then about the problem.

And, secondly, I believe in going back to private life. You can see things, hear things, feel things that you just can't here, not because we are—just because, in any job, you get focused on what you are doing, and it is hard to get away from it.

And, thirdly, I got an opportunity to do something else that I am excited about—to work directly with kids in education, so I said yes to it.

And I don't think, lastly, that I can be as influential. I mean, there is nothing quite like being in the arena, having the platform to talk. I would love to, and intend to try to find something. Maybe when we are down in Texas together at George Bush's library, we can talk about doing something together because I would love to try to create a public space, where the public could understand the issue better.

I thought the President was going to be doing that with Social Security, and unfortunately he didn't. I will never forget out at Georgetown he was introduced out there by a young woman who understood the program. It was his first Town Hall meeting that he had in this year-long discussion on Social Security. And she said, I got my first paycheck, and I went home, and I said to my mother, who is this FICA person and why are they taking so much money away from me? And then she went on to explain what FICA was. She understood it. And then she made a mistake, and she said I have been contributing to that, and I don't get a very good return on my investment. And the President didn't correct her, and should have.

What he should have said is, no, we are taxing you now at levels higher than ever before. I have talked to many people who say, well, I am paying—I paid in all of my life and I am just getting it—young people are taxed today at levels that we have never taxed them before on the payroll tax side to pay for benefits that we have raised over time, and boy do I know this one. My benefits from military retirement started in 1969, and I watched on in absolute sort of a combination of horror and delight as Congress in

1970, 1971, and 1972 voted 20-percent increases, and then had to put a COLA through in law, 1973. I thought, oh, my gosh, I dropped back down to 4 percent. And then guess what? Inflation took care of that. In 1978, 1979, 1980, 1981, it was 17/18, it was a huge increase.

So we need some way to have a public debate, so that people like Congressman Sununu, who are still here, have permission to talk about this and do the right thing. Because otherwise right now, it seems to me, that, as I said, the jaws of consent are closed. We need to pry them open somehow so that political representatives who are still in the game have permission to at least honestly assess what they want to do. Let the left and right have a debate at that point, and it will be a healthy debate, but it will not be healthy as long as it is dominated by the political fear that currently dominates it.

Chairman KASICH. Well, the 7-to-1 statistic is just staggering to me; that for every dollar we spend on children we spend $7 on our seniors. You know, Bob, maybe most things in life are really about experience. I have two little twin daughters 6 months old now——

Senator KERREY. Congratulations.

Chairman KASICH. And they are very healthy, and we have been very blessed.

Senator KERREY. I knew you when you didn't, and you are a better man.

Chairman KASICH. You are right. I am. I am. But here is the interesting thing. I had an opportunity. I kind of sometimes think maybe the good Lord sent me to this place, but my little girl had a virus early in her life, RSV. It was sweeping Ohio and a lot of the Midwest, and she ended up in the Children's Hospital for a couple of days. And I went down there, and I looked, slept on the floor one night, and after you are sleeping there long enough, they really don't care who you are. They just, you know, could you just get out of my way. And I watched the nurses. And I listened to the nurses talk about, it wasn't about being overworked, it was about the fear of the fact that they could not properly attend to children.

Our program of reimbursing physicians is based on Medicare recipients. You get graduate medical education based on how many Medicare recipients you have in the hospital. There are no senior citizens in the stand-alone Children's Hospitals. So what a lot of the Children's Hospitals have done is to associate with the adult hospitals, which means, again, that the tail begins to wag the dog. There is a network of hospitals that stand alone and serve only children. We need $285 million to make sure that these hospitals can be reimbursed for the training of physicians.

And you know, Bob, this has been a near impossibility. Out of a $100 billion HHS budget, they somehow have difficulty finding $285 million for children. I don't know how—maybe your suggestion of setting aside a certain amount of dollars. We have seen fit to dramatically increase the budget of the Pentagon by $25/$30 billion in 1 year, yet it seems to be so hard, in this society, to carve out some things for our children.

Senator KERREY. I think if you did it in a real thoughtful fashion, I think you could come up with a package that the Republicans and the Democrats both would support. But I think unless you do, the problem is, John, it won't get done. Because we will vote—the mandatory stuff is easy to vote for.

Chairman KASICH. Yes.

Senator KERREY. And you vote for it once——

Chairman KASICH. Or you don't vote for it, and then it is automatic. I think we are going to get the money for the Children's Hospitals, and I hope you will help. But it is an interesting, but it is in subtle ways that are difficult to——

Senator KERREY. No, you are right.

Chairman KASICH. To determine, to assess.

Senator KERREY. And by the way, I have been leading the effort on the Senate side on that very issue, Children's Hospital. So I hope we can succeed and get something done this year.

Chairman KASICH. The 7 to 1 is interesting because when you look at all of the charts, we realize that it is the children who build this economy over time. And if they are shortchanged, then this economy is hurt and hurt dramatically.

Senator KERREY. I have no idea how you voted on that H-1B issue, but I have seen you talk very eloquently about what it means to be middle class in America today. That is a vote that, I mean, I will vote for it. But I heard Chairman Goodling, before the Web-Based Education Commission, say exactly—he described exactly how I feel. He said, it was the worst vote I ever cast. He said, I know I am going to have to do it again, but it is essentially a vote that says we failed—we failed.

Chairman KASICH. Maybe we will start our own party, huh? Let me recognize the gentleman from New Hampshire, Mr. Sununu.

Mr. SUNUNU. Thank you, Mr. Chairman. Thank you for being here, Mr. Kerrey.

You talked a little bit about your disappointment, that it is not the best environment to talk about these issues, or sometimes we feel it is not the best environment, the most receptive environment. But I happen to be a bit more of an optimist, and I sense that people, as you described the greatest generation, they are willing to take up their burden, they are willing to take on a tough issue, and people really are further out in front of this issue than we give them credit for. And I think that is largely due to the groundbreaking work that you have done, and my own Senator Gregg, and Pat Moynihan, and others in the Senate, and Jim Kolbe, and Charlie Stenholm here in the House, and Chairman Kasich. So I think the public is ready. We are more ready than we give them credit for.

I guess I have a two-pronged question here: One, if you don't feel that the debate is as advanced as it ought to be, what else can or should we do, as legislators, other than just talk honestly and substantively about these issues to better prepare the public for legislation on this issue?

And question two would be, well, why not just move? Why not just move a legislative vehicle? Why not just take up the legislation and use that as a focal point for engaging both policy makers and the public in debate?

Senator KERREY. Well, first of all, I share your optimism about the American people's view, which leads me to say I would love to do a markup. Senator Gregg, your distinguished Senator, and I have worked together on this. And what we have tried to do is we have tried to resolve our own relatively small conflicts to produce a single piece of legislation. And I would love to see a markup on it because I think, in fact, it would pass the Senate. I think we could enact it on the Senate floor if we were able to get it done.

As to the second part of your statement and question having to do with what can we do, I do think that there is just an awful lot of work that needs to be done to help people understand both what Social Security is and what it isn't, and to help them understand what it could become, and to do something, and I was taught—I was in the Navy, but I went to a number of Army schools and one of them was called Army Ranger School. And I led a mission one night under instruction, and the instructor said, you know, you did a good job, except you were missing one thing. And I said, what is that? And he said you are missing a sense of urgency, and your men know it. They know that you lack the sense of urgency, and so they are all sort of slacking and taking it easy, and you are not as successful as you—and I think we have to create that sense of urgency that says if you do it today, here are the good things that happen. And the longer you wait, the harder this thing gets. And guess who pays the price for it? Guess who pays the biggest price? It is lower wage, lower income people that are going to pay the biggest price of all.

So part of what we need to do is simultaneously educate and create a real positive urgency. This isn't about eating spinach. This is about helping people accumulate wealth that right now don't think they have any chance of it.

Chairman KASICH. Bob, don't you also think, though, that, you know, we talk about the Penny-Kasich bill—by the way, I want you to know I named my dog after Tim Penny. My dog now is named Penny Kasich. [Laughter.]

But, Bob, isn't it interesting, I would say that that was the first successful shot fired in the war. I mean, you have to be able to go to the floor and get your brains beat out and be willing to a bunch of times before people really start to notice. I mean, in "1776," I don't remember the movie all that well, but they used to say, "Would you sit down, John. Will you shut up." And isn't that what really we need? We need votes, we need people raising cane, and right now——

Senator KERREY. I think you do. But, John, you need a lot of sort of calm education simultaneously with getting people turned onto the idea that this could change their lives in a positive way, in a very positive way. I mean, it can be quite exciting to think about we have 3.8 million babies will be born in the United States of America in the year 2000. Think about helping them accumulate wealth. What happens if all of them hit 50 years of age and say to Henry Aaron, you are wrong about the estate tax. I want to get rid of it because I have got an estate over $650,000, which we could do.

Chairman KASICH. There is no way you are getting picked, Bob. [Laughter.]

Mr. SUNUNU. There are brief questions about particular issues that have been raised in this debate that I have some concerns about. And I just wanted to get your reaction, as someone who has probably thought more than I about these points.

One is the thought raised that among the reforms or changes to Social Security that might strengthen the system would be to bring those currently not covered under Social Security into the system—a lot of State and local employees, public safety employees, that aren't part of the Social Security system. And people say, well, let us bring them into the system because it would be good for them and good for Social Security. I have got real questions about the "good for them part" because I haven't seen a lot of the letters written by these employees to their State, local or Federal officials saying please allow me to pay 12.5 percent per year and participate in Social Security.

And I have questions about the "good for Social Security part" because what that seems to mean to me would be, well, it is a way to bring more revenues into this system that is insolvent.

I want to bias your answer. Somehow I don't think I have. But what is your thought about that option for reform?

Senator KERREY. Well, I have been squarely on both sides of that issue, so that you know. Moynihan and I had it in our first proposal, and I agreed to it because we needed the money, not because I thought it was necessarily——

Mr. SUNUNU. I was unaware of that.

Senator KERREY. And we did not put it in our second proposal, in part, because of the mix of people who were then looking to get on the bill included people whose States didn't require it. If I am able to step back from the thing, it is a little difficult to make the case that I should force somebody to buy into a system that I think is so badly flawed that needs to be, you know, give them a chance to pay 12.4 percent to buy into a system that I am not particularly crazy about.

Mr. SUNUNU. In my limited discussions with public safety employees or State employees, it is my experience that most of them are covered by private or public—quasi-public pension systems that are solvent and well managed. Again, I am not aware of any that have looked at what they have in the way of private pensions and said, we would like to participate.

Do you know of any that——

Senator KERREY. No. That is also a good measure. You are exactly right. That is another good measure. Believe me, if the State employees of California wanted to get into the Social Security system, I believe they could find a way to get it done. The last time I checked it is a pretty good congressional delegation in the House. So my guess is if they really wanted to get into that system, they could somehow manage to get it done.

Mr. SUNUNU. One final question about modeling. In the discussion about personal retirement accounts and an evaluation of the opportunities created by such accounts, inevitably you need to try to model those accounts. You make assumptions about the mix in your portfolio, you make an assumption about how much you are contributing, you make an assumption about rate of return and all kinds of other things.

There are a number of plans that have been put out there, and I assume yours is one, which have been structured in such a way as to use these accounts to strengthen the system. But one of the other witnesses today has put together a model that looks at these accounts and suggests that they are doomed to fail.

It would seem to me that it is a little bit dangerous to try to put together these kinds of portfolio models that try to empirically prove the success or failure of the personal accounts——

Senator KERREY. That is true.

Mr. SUNUNU [continuing]. Before we even get into the crafting of legislation. Could you talk a little bit more about a point you made about wealth and income? It seems to me that a good portion of the value of a personal account isn't necessarily found in a quantitative analysis, but more in a personal or moral analysis of empowerment of the individual and wealth creation at the individual level.

Senator KERREY. You have touched on a number of things in your question, so let me know if I don't answer them, whichever ones are your priorities.

But I believe strongly all of the administrative stuff, those are usually objections raised by people that if you could solve the problem that they have got, they are still going to oppose the plan. They are basically ankle biters, you know, looking for some reason to inflict a little bit of pain on a proposal knowing that they are going to be against it no matter what.

The administrative problems are easy to solve. I mean, for gosh sakes, the payroll tax is a very complicated system to administer. For anybody that has been in business out there and has tried to figure out how to get the forms filled out and that—I figure that is why God allowed us to invent software. That is an easy problem to solve.

Arthur Levitt once gave a speech when this thing got hot a couple of years ago, the head of the SEC, people are not educated enough, and they are not going to be able to figure it out. And I wrote him a letter back saying, look, if you can't regulate it, let us put it on the banking system. We will just take it away from the stock market and see what your clients think about that.

And as far as being educated enough, the kid that bags my groceries at HiV has got a 401(k) account, and every time I go through there, he is talking to me about stocks and bonds. He knows more about it than Arthur Levitt does. So the American people are educated enough to be able to figure this thing out, in my view.

I think it is terribly important to just almost brush aside those administrative folks, and maybe just say, look, go talk to somebody that runs annuities. We can keep the administrative costs low, we can keep the risk at an acceptable level, we can do all of that sort of stuff. But if we can solve that problem, will you join us in trying to help create wealth for everyone? And in that regard, I say to you, Congressman, I do think it is important to recognize that people with lower incomes, if you put 2 percent on them, they are simply not going to be able to generate enough. I am not a mathematician so I don't know why. But for some reason, you need to get somewhere north of $700 or $800 a year annual contributions in order to accumulate wealth impressively.

Well, the way I figure it, whoever vacuumed this rug last night is worth as much as I am, even though the market may say I am worth $130,000 and he or she is worth $20-. But 2 percent of that

$20- only generates $400 a year. So I think you have got to figure out a way, and we call ours the Breaux kicker, the one that John Breaux, and I and Judd Gregg have introduced, that enables everybody to get up to that $7- or $800 level—makes it relatively easy. And we are talking to people who have some ideological problem. The Heritage has been working with us trying to get it better.

And we also open accounts early. Because the variable that is most important is the number of years you contribute. You can jog, you can eat Grape Nuts, you can do high colonics, you can do whatever you want to get healthy, but you don't get those years back. And if you are 55, you cannot make this thing work. And even if you are 45, it is tough to make it work. If you are 35, you have got to contribute a lot more than you do at 25. And the best way to do it so to get them opened at birth. And, again, we have been working at Heritage. I know there are some ideological problems with that.

I think you can make it an earned entitlement, so that it is not giving money away. But you have got to get those accounts opened early, and you have got to just force the debate into helping people accumulate wealth and just say, do you think it would be good for somebody making $7 an hour to hit age 60 and have real wealth in their hands? And if they answer the question yes, you say, join me in figuring out how to get it done. Because it is absolutely mathematically certain that it can be done.

Mr. SUNUNU. Thank you.

Thank you, Mr. Chairman.

Mr. HOEKSTRA. The Senator is also——

Senator KERREY. We have got to go take a nap. We have had three votes this week. [Laughter.]

Mr. HOEKSTRA. The Senator is also awfully good on this issue. I only had a chance to catch the tail end of your testimony and then the questioning by Congressman Sununu. I would just like to say it is refreshing, and I hope that you guys reach out to the House and work in putting together some partnerships.

Senator KERREY. We will try.

Mr. HOEKSTRA. Because I think you are providing some very fresh thinking to the issue. On these kinds of issues, that is exactly where you need to be. You need to step back, think about it in a fresh way. We might be surprised with the kinds of coalitions that we could put together to actually get some things done. You have piqued my interest into what you are doing on the Senate side.

Senator KERREY. Thank you.

Mr. HOEKSTRA. Thank you very much.

And, John, thanks for calling over and saying, "Hey, Pete, you have got to get over here. There is some stuff over here you can learn."

Mr. CHAMBLISS. I don't have a question. I just want to make a comment, and that is, Senator Kerrey, I am sorry I had to be away and didn't have a chance to listen to you. But I have followed you on this issue, as well as many other issues, over the 6 years that I have been here, and I have great admiration for you. And I am just sorry really, in one way, that guys like you and John Kasich are leaving our institution because you bring fresh ideas and not just common sense, but just plain good sense to some complicated issues, and this being one of them.

And it is unfortunate, from my perspective, that we don't have strong leadership coming out of the administration on this issue. I think it was a perfect opportunity over the last couple of years to have something laid on the table when guys like you, and John and others were willing to pick up the ball and run with it, and I think the Congress was in the mood to maybe get something done. It is going to take a long period of time to really accomplish a good positive end result. But I just want to commend you for your boldness, your thoughtfulness on this idea, and I hope that folks like you, as well as John, will continue on the outside to keep beating up on us here on the inside until we get something done because I have got a couple of grandchildren that I sure want to see fall into that category that you are talking about, whether they are making $7 an hour or $700 an hour, I mean, it is just critical for them 60 years from now that we do something now.

Thank you for your service.

Senator KERREY. Thank you.

Chairman KASICH. Bob, I make a prediction. I think the Social Security solution is relatively simple. Because if you create the accounts and get it done quickly, most people are winners. Almost everybody wins. And the younger you are, the bigger the winner you are.

You are going to have to do something with benefits, but I think you can actually write them in such a way that they keep up with inflation and not more. And that is why the 7-to-1 statistic is so important because people are going to say you are going to hurt these people as they become seniors. And with a 7-to-1 advantage, seniors over children, maybe it helps to put some perspective on this.

I think that the Medicare problem and the long-term care problem is very—is so much tougher. Because with Social Security, there is a win. You can sell this as a winner. Like you say, there is a great wealth there. Health care is going to be trickier because the nature of our tax code, the nature of the way in which the benefits, the health benefits are arrived, and we all I think know that health care has to become more market-oriented, while protecting people against catastrophic. To me, that is going to be the great challenge. But I kind of look at Social Security as a very short putt. Most people know what the problem is, and maybe we can get it done in a relatively short period of time.

Senator KERREY. And I see it as two sides of the same coin. I suggested in my testimony, if you start off by saying you are going to change Social Security so it becomes a source of wealth, and by the way I say to my Democratic friends, many of whom have spent a long time and are great passionate and articulate defenders and helpers of people who are poor, that you don't make somebody not poor by increasing the minimum wage or expanding the EITC or some other device like that. That doesn't make them nonpoor. That gives them a little more income, but it is not the same thing. And if you really do care about the rich getting richer and the poor getting poorer, you are not going to solve that problem by having an estate tax or by putting other barriers in between people and wealth.

You are going to solve that problem by helping everybody accumulate wealth. And if they accumulate wealth, John, I think the second problem gets fixed. But you have got to be willing to come in and tear up that contract and say, well, what we had in 1965 for health care was a system that was based upon the economic reality at the time, which was you worked for 45 years in the same job—I graduated from high school in 1961, and three-fourths of my class went right in the workforce, and they were making more money than I did for quite a while. And they did a little time in the service, they came back. The job supported a family.

Today, it is 6 or 7 years, and you are on to something else. So what we needed then was something to take care of you when you hit 65 because that was the economic reality then. It is not the economic reality now. And if you are going to have the right trade, technology and immigration policies, in my view, you have got to have a safety net that starts off by saying you get health care by being an American or legal resident, and then fold Medicare, Medicaid, the VA, the income tax deduction, all of it, into a single system of eligibility and say, Bob Kerrey, if you need it in 1969 right after you got blown up in the war, God bless you. We are going to provide it for you. If something else happens to you, and your genes say that you are going to have cancer or something else, which happens—I mean, I don't control 90 percent of the things that happen to me—so if something bad happens to me, we'll provide a subsidy.

But if your income goes up, Bob, and you have the capacity to take care of yourself, we are not going to ask somebody with a lower income to pay higher taxes to take care of you. That is why I think Social Security fixes the second one. But the second one you are exactly right, it is a much, much longer putt. It is more like a hole in one. I am not even sure you are on the putting surface.

Chairman KASICH. I think that is exactly right. But maybe it all kind of, in a funny sort of way, dovetails with what I think is the greatest challenge of the future, and that is whether we can get people to tear down the walls and realize that life is not just about me. And maybe it all kind of fits together.

I want to thank you for your testimony.

Senator KERREY. Thank you. Thanks for your service.

Chairman KASICH. I look forward to spending time with you.

Senator KERREY. And you are a better man now that you have got those babies.

Chairman KASICH. You have got it. All right, Bob.

Senator KERREY. I know your committee knows that.

Chairman KASICH. All right. I am going to bring Larry Kotlikoff, the father of generational accounting, and Alicia Munnell, who has had a long and distinguished career in academia and with the Clinton administration. I want to welcome you both and have you, see if we can get through the first part of your testimony.

At 2:30, I have to defend a Kosovo provision in a Conference Committee. I will go to that. But Saxby will be here to hear you. I have to do that. I have no choice on that.

So if you want to go ahead and testify. What does the committee want to do? Do you want to start the testimony? Why don't we go ahead, and if you can—I hate that we have to do this—but go ahead and summarize where you are.

STATEMENTS OF ALICIA H. MUNNELL, PROFESSOR OF MANAGEMENT STUDIES, BOSTON COLLEGE, AND LAURENCE J. KOTLIKOFF, PROFESSOR OF ECONOMICS, BOSTON UNIVERSITY

STATEMENT OF ALICIA MUNNELL

Ms. MUNNELL. Mr. Chairman and members of the committee, I am delighted to have the opportunity to appear before you today to discuss the question of intergenerational economics. These issues are crucial to framing the debate over Social Security and Medicare. If you say there is a huge problem out there and that the numbers are just staggering, then that forces you to find a very dramatic solution. If you say the problems out there are manageable, then you can solve the problems with moderate changes. What I would like to argue is that the problems are manageable and that dramatic restructuring of either Social Security or Medicare is both unnecessary and undesirable.

I would like to make four points: First, the projected increase in Social Security spending due to the aging of the population is neither enormous nor unprecedented. The cost of the program is going to go up by 2.6 percent of GDP between now and the year 2074, 2.6 percent over the 75-year period. We have seen budget changes of that magnitude before. Defense spending went up by 5 percent of GDP when the Cold War began, and it has gone down by 2.6 percent of GDP in the last 10 years.

Social Security financing is not in crisis. Rather, the current projections show a manageable long-run financing gap. If you look over the whole 75 years, revenues are equal to 84 percent of projected benefits. We have enough money to pay full benefits until the year 2037. After that, the trust funds are exhausted, but that doesn't mean the program ends. There is still enough money in place to pay 70 percent of benefits.

Of course, Social Security is not the whole story. You also have spending on Medicare, and that is projected to grow. But incomes are also projected to grow. And if you look at the growth of income and the projected growth in Social Security and Medicare, the increase in cost for these two programs is going to take up only 20 percent of the increase in well-being and the standard of living that we are going to experience in the future. Thus, moderate economic growth should enable future workers both to enjoy rising standards of living and to pay the added costs necessary to sustain current benefits.

So my first point is that we are not facing a crisis and that future costs are manageable. I am not saying there is not a problem. There is a problem in Social Security. There is a problem in Medicare. Both problems should be fixed, and fixing them sooner is much better than fixing them later.

My second point is that the old arguments that Social Security and Medicare spending will crowd out other Government programs have lost their force now that both parties are committed to moving away from the unified budget. The real threat to on-budget programs is massive tax cuts, not Social Security and Medicare. Under the new budget arrangements, the Social Security financing will be completely separate; that is, they will be kept in a lock box.

With Social Security off-budget, Congress will be focusing on the financing of the non-Social Security expenditures and the money to finance those programs. In the next 20 years or so, these programs are threatened far more by the prospect of massive tax cuts than by Social Security. Thus, the answer to future budget pressures is to limit the size of tax cuts, not to dramatically restructure well-functioning programs.

My third point reiterates the thrust of the testimony by Dan Crippen and everyone else who has testified today. The most important economic decision is the level of national saving because everyone in the future—the elderly and workers—will have to be supported out of future GDP. As a practical matter, we cannot stockpile food and clothing today for retirees in 2040. Their food and their clothing will come out of output produced in 2040. Therefore, the key factor determining the welfare of future workers is the size of GDP in 2040. And the key determinant of future GDP is saving and investment today, both in physical capital and in workers.

One argument used by those who support restructuring of Social Security is the desire to increase national saving. This desire happens to be one that I share wholeheartedly. However, increased saving can be accomplished equally well in the existing Social Security trust funds or in personal accounts. The new budget arrangements will make it clear that Social Security surpluses add to national saving. These surplus funds will be used to reduce Federal debt held by the public, freeing up additional resources for private investment.

Since saving can occur either through Government or through personal accounts, restructuring the Social Security system by itself would do nothing to increase the size of the future economy. Under a system of personal accounts, future retirees would have increased private claims on economic output, but these claims would simply be offset by reduced public claims. Therefore, the desire to increase national saving is not a plausible reason to restructure Social Security.

So my first three points argue that there is no need to dramatically restructure Social Security. First, the program is not facing a financial crisis and people can afford future costs; second, the old arguments about programs for the aged crowding out other Government programs is much less relevant in the new budget environment; third, we can increase national saving as easily through Social Security as through personal accounts.

My last point is that replacing all or part of Social Security's current defined benefit package——

Mr. CHAMBLISS [presiding]. Ms. Munnell, I hate to interrupt you, but we have got 4 minutes, and we need to run over and vote. If you all can be patient with us, let us vote, we will be back because we really want to hear you.

Ms. MUNNELL. OK. Go.

Mr. CHAMBLISS. You have already raised some interesting questions.

[Recess.]

Mr. CHAMBLISS. Thank you all for your patience and for letting us interrupt your lunch there.

Ms. MUNNELL. Sorry. All finished.

Mr. CHAMBLISS. No, that is quite all right. You take your time. Other members may be coming back, but we will proceed on.

Ms. MUNNELL. Can I just summarize where I was and finish up my last point?

Mr. CHAMBLISS. Sure. Absolutely.

Ms. MUNNELL. I think this whole issue of intergenerational economics is very important because it determines how you frame the issues of Social Security and Medicare. And basically, if you characterize the problems as enormous, then when you are looking for solutions, you need a dramatic change. If you characterize the problems as manageable, then when you are looking for solutions, you can get moderate changes.

And the first three arguments I tried to make is that the problems are not enormous, they are manageable. People can afford the future costs. And second, a lot of these arguments have been around about the programs for the elderly squeezing out other programs I think have less force now that Social Security is outside the budget. The third point was that people say, well, we really need to restructure Social Security because we need individual accounts so that we can increase national saving. I agree increasing national savings is extremely important. It will determine what the size of GDP in the year 2040 is. But I argue that you can do that under this new budget arrangement equally well through either the trust funds or through individual accounts.

And so that brings me to my last point, and that is that, in my view, replacing all or part of Social Security's current defined benefit plan with personal retirement accounts is risky, it is costly, and most important it is going to hurt the vulnerable in the long run. The whole point of having a Social Security system is to provide workers with a predictable retirement benefit. As people have said, Social Security benefits are quite modest. They are about $800 a month. And all of these proposals for personal accounts involve first cutting back on Social Security benefits. So it involves reducing that $800 to $600 or $500 or $400, and then substituting an individual account that you hope makes up for the additional lost benefit.

And so when Senator Kerrey was talking about building wealth, I think building wealth is fine, but I think it is fine on top of Social Security, on top of that $800, not making part of that $800 unpredictable. In addition to making that $800 unpredictable, personal accounts are costly. But I agree that is a secondary issue. A very important issue, though, is that they expose participants to the temptations of early withdrawal. I am convinced if people think those are their accounts, they are going to have very legitimate needs to wanting to get access before retirement. They are going to have an illness or want to buy a home. And to the extent that they get access before retirement, there will not be enough money available in retirement.

It also brings up this whole issue of the risks associated with annuitization. What do you do with these piles of money once people get to retirement?

More fundamentally, personal accounts are likely to set in motion a process that will end up separating income support from social insurance. And in the U.S. I think separating these two functions will almost certainly produce less redistribution, which will harm future generations of low-wage workers.

So my conclusion is that while intergenerational economic issues are important, they do not suggest that we need to dramatically alter our major social insurance programs. Under the new budget structure, the main threat to other programs is not Social Security, but tax cuts. Moreover, while increasing national savings is important, this can be done just as easily through the trust funds as through personal accounts. In short, there is no compelling reason to replace part of Social Security with personal accounts, and doing so will make tomorrow's elderly worse off, not better off.

Thank you.

[The prepared statement of Alicia Munnell follows:]

PREPARED STATEMENT OF ALICIA H. MUNNELL, PETER F. DRUCKER PROFESSOR OF MANAGEMENT SCIENCES, BOSTON COLLEGE CARROLL SCHOOL OF MANAGEMENT

Mr. Chairman and members of the committee, I am delighted to have the opportunity to appear before you today to discuss intergenerational economic issues. These issues are crucial to framing the debate over the future of Medicare and Social Security. Critics of these programs claim that entitlements are unsustainable and will push the economy to the breaking point. They are wrong. They claim that transfers to the elderly undermine saving, investment, and economic growth. They are wrong. They claim that intergenerational accounts are out of balance and unfair. They are wrong. The critics of these programs exaggerate the size of the problem in order to justify dramatic solutions.

This morning I would like to make four points to document that the situation is not dire, and that dramatic restructuring is both unnecessary and undesirable.

- First, the projected increase in Social Security spending due to the aging of the population is neither enormous nor unprecedented. The cost of the program is projected to rise by 2.6 percent of GDP by 2074. Budget changes equal to 2.6 percent of GDP are not uncommon; defense spending increased by 5 percent of GDP at the start of the cold war and declined by 2.6 percent of GDP between 1989 and 1999. The financing shortfall is manageable and does not require radical change in the program.
- Second, under the new budget arrangements Social Security financing will be completely separate—that is, kept in a "lock box." Eventually, the same treatment may be appropriate for at least part of Medicare. This means that other government programs are no longer in competition with Social Security; they are in competition with tax cuts.
- Third, the most important economic decision is the level of national saving, because everyone in the future—the elderly and workers—will have to be supported out of GDP in the future. The new budget arrangements make it just as easy to save through the Social Security trust funds as in private accounts. Government saving is just as good as private saving.
- Finally, replacing all or part of Social Security's current defined benefit plan with personal retirement accounts is risky, costly, and will hurt the vulnerable. The whole point of having a Social Security system is to provide workers with a predictable retirement benefit. Social Security benefits are quite modest; the average worker retiring at age 62 last year got $805 per month. That modest benefit should be an amount that people can count on and to which they can add income from private pensions and other sources. It should not depend on investment decisions in a volatile stock market.

Let me address each of these issues in order.

I. SOCIAL SECURITY IS NOT FACING A FINANCING CRISIS

Social Security is not facing a financial crisis. Rather, the current projections show a financing gap in the long run unless remedial action is taken, as it almost certainly will be. According to the most recent official projections, between now and 2015 the Social Security system will bring in more tax revenues than it pays out. From 2015 to 2025, adding interest on trust fund assets to tax receipts produces enough revenues to cover benefit payments. After 2025, annual income will fall short of annual benefit payments, but the government can meet the benefit commitments by drawing down trust fund assets until the funds are exhausted in 2037. The exhaustion of the trust funds does not mean the program ends; even if no tax or benefit changes were made, current payroll tax rates and benefit taxation would provide enough money to cover more than 70 percent of benefits thereafter.

Over the next 75 years, Social Security's long-run deficit is projected to equal 1.89 percent of covered payroll earnings. That figure means that if the payroll tax rate were raised immediately by roughly 2 percentage points—1 percentage point each for the employee and the employer—the government would be able to pay the current package of benefits for everyone who reaches retirement age at least through 2075. While such a tax increase is neither necessary nor desirable, it provides a useful way to gauge the size of the problem.[1]

A different pattern of costs emerges when Social Security outlays are projected as a percent of gross domestic product (GDP) rather than as a percent of taxable payrolls. The cost of the program is projected to rise from 4.2 percent of GDP today to 6.7 percent of GDP in 2040, and to only 6.8 percent by the end of the 75-year projection period. The reason why costs as a percent of GDP more or less stabilize while costs as a percent of taxable payrolls keep rising is that taxable payrolls are projected to decline as a share of total compensation due to a continued projected growth in fringe benefits. A 2.6-percent-of-GDP increase in Social Security costs is significant, but hardly qualifies as a "demographic time bomb."

Of course, Social Security is not the whole story when it comes to future retirement costs. Between now and 2040, Medicare spending is projected to rise by 2.4 percentage points of GDP. Medicaid spending, roughly two-thirds of which provides health services to low-income elderly and disabled persons, is also projected to increase by about 2.4 percentage points of GDP over the next four decades. The costs of Supplemental Security Income (SSI) and food stamp benefits for the low-income elderly and disabled may also rise. Finally, private expenditures for long-term care will also grow.

The projected increase in the costs for Social Security in combination with Medicare and the other programs is significant but is not likely to overwhelm future economic growth. If real output per capita grows 1.0 percent annually—as projected by the Social Security Trustees—it will rise 49 percent by 2040. (Note that per capita GDP grew at an annual rate of 2.1 percent during the 1990s.) Of this amount, only about 20 percent would be required to deal with the projected increases in Social Security and Medicare, even if nothing were done to restrain benefit growth.[2] Thus, moderate economic growth would enable future workers both to enjoy rising standards of living and to pay the added taxes necessary to sustain currently projected benefit costs.

II. OTHER GOVERNMENT PROGRAMS ARE NO LONGER IN COMPETITION WITH SOCIAL SECURITY; THEY ARE IN COMPETITION WITH TAX CUTS.

Although future workers' living standards will increase by more than enough to cover higher taxes, critics often claim that spending on the elderly will crowd out other government programs. One projection that they commonly use to argue for cutting back on Social Security and Medicare is that these programs will increase

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[1] Social Security's long-term financing problem is somewhat more complicated than just described. Under current law, the tax rate is fixed while costs are rising, and this pattern produces surpluses now and large deficits in the future. As a result of this profile, under present law, each year the 75-year projection period moves forward, another year with a large deficit is added to the 75-year deficit. Assuming nothing else changes, this phenomenon would increase the 75-year deficit slightly (.08 percent of taxable payroll with today's deficits) each year. Many policymakers believe that the system should not be left with a huge deficit in the 76th year.

[2] If per capita GDP increases by 1 percent per year between now and 2040, it will be 48.9 percent higher in 2040. Over the same period, OASDI, HI, and SMI outlays are projected to rise from 6.52 percent of GDP to 11.44 percent of GDP. Applying the higher rates to the increased per capita GDP implies that taxes in 2040 will be 17 percent of 2000 per capita GDP, or an increase of 10.5 percentage points. Taking the ratio of the 10 percentage point increase in taxes to the 48.9 percentage point increase in per capita GDP reveals that the higher taxes will take up only 20 percent of the project improvement in per capita GDP.

from 32 percent of the budget today to 53 percent in 2040 (CBO 1999). The implication is that government expenditures as a percent of GDP are absolutely fixed, and every dollar going to the elderly means one less dollar for programs in the rest of the budget.

This argument is misleading for a number of reasons. First, expenditures are not fixed by edict; the U.S. simply has a taste for low government outlays. For example, government spending in the U.S. in 1996 amounted to 34 percent of GDP compared to 41 percent for the United Kingdom, 43 percent for Canada, 46 percent in Germany, 50 percent in Belgium and the Netherlands, 52 percent for France, and 63 percent in Sweden (OECD). As the population ages, the U.S. may choose to increase the share of resources going to government programs.

Second, even if the U.S. decides to hold government spending relative to GDP at today's level, government debt held by the public should be eliminated by around 2010, leading to a major drop in projected interest expenditures. During the 1990s, net interest accounted for 14.5 percent of Federal budget outlays. Thus, while Social Security and Medicare expenditures are projected to go up by 21 percentage points (from 32 percent to 52 percent) of Federal Government outlays, net interest outlays should go down roughly 15 percentage points.

Even more important than the elimination of interest expense is the fact that both parties now agree that Social Security financing should be kept completely separate from the rest of the budget. Technically, the Social Security Amendments of 1983 already reversed the reliance on the unified budget first used by Lyndon Johnson and placed the Social Security trust funds "off-budget." The difficulty is that, while Social Security was exempt from most enforcement procedures, budget targets were always stated in terms of the unified budget, and the budget numbers reported by the Administration, Congress, and the press always included the balances in the trust funds. Thus, separating Social Security from the rest of the budget requires changing culture more than changing legal requirements. That is precisely the aim of current congressional efforts to create a "lock box" for Social Security. By ensuring that Congress does not use surpluses in Social Security to cover deficits in the non-Social-Security portion of the budget, Social Security will be completely separate and will not compete with other domestic programs.

With Social Security truly off-budget, Congress will focus on non-Social-Security expenditures and the financing for these programs. For the next 20 years or so, these programs are threatened far more by the prospect of massive tax cuts than by Social Security. Even though the Office of Management and Budget projects that on-budget surpluses will total nearly $1.9 trillion over the next 10 years, the amount available for tax cuts is much smaller, according to an analysis by the Center for Budget and Policy Priorities. Moving the surpluses in the Medicare (HI) trust fund off-limits, as both parties are moving to do, and assuming that Congress maintains current policies for farmers, middle-class taxpayers, and discretionary programs cuts the $1.9 trillion figure in half. In other words, promises of very large tax cuts endanger current programs and any new initiatives.

In short, projections showing that Social Security and Medicare will increase as a proportion of the Federal budget are much less relevant than they used to be in the unified-budget regime. In all likelihood, both Social Security and Medicare (HI) will be completely separate from the rest of the budget and not competing for funds, especially for the next two decades. The real and immediate threat to the on-budget programs is the prospect of massive tax cuts. Thus, the answer is to limit the size of tax cuts not to restructure the Social Security system.

III. THE "LOCK BOX" MAKES IT EASY TO SAVE THROUGH SOCIAL SECURITY TRUST FUNDS

Keeping Social Security totally separate from the rest of the budget has major economic as well as budget implications, since it significantly enhances the ability to save through the trust funds. Government saving is just as good as private saving as a means of increasing future output and enhancing the economic well-being of both future workers and retirees.

One way or another, everyone wants retirees in the future to have adequate retirement incomes. The argument is simply about the best way to provide that income. Assuming that the claims of the elderly will be the same regardless of the approach, it does not matter from an economic perspective whether their claims on the pie in 2040 is in the form of accrued rights under Social Security or in the form of purchasing power gained through the sale of accumulated assets. Given the size of the pie, the question is simply how much the working population in 2040 will have to reduce its own consumption below that justified by current earnings in order to allow the elderly to consume their share. The cost to the working-age population is simply the amount of consumption that workers will have to forego in 2040.

The size of the pie is not fixed, however, but depends to a large extent on saving and investment decisions that are made in the interim. The bigger the capital stock and the better educated the workforce, the larger will be the pie. Most observers believe that we are saving too little and many have concluded that the Social Security system is a good mechanism for increasing national saving. From an economic perspective, it does not matter whether that accumulation occurs in the existing trust funds or in personal accounts.

To date, increasing saving through accumulations in the Social Security trust funds has produced ambiguous results. Critics contend that the existence of Social Security surpluses encourages either taxes to be lower or non-Social-Security spending to be higher than it would have been otherwise. Although little evidence exists to either support or refute this contention, a unified budget and large deficits have blurred the picture until now. But the fiscal outlook has changed; as discussed above, Social Security will become completely separate from the rest of the budget, and large surpluses are accumulating in the non-Social Security portion of the budget. This configuration should make very clear the extent to which Social Security adds to national saving. The accumulations in the trust funds reflect the amount by which Social Security has reduced the Federal debt held by the public. This reduction frees up additional funds for private investment, and the infusion of private investment boosts long-term economic growth, thereby increasing the size of the economic pie.

Is it realistic to believe that real saving can occur through the Social Security trust funds? Comparisons of the Federal Government with the states are always tricky, but states have been successful in this endeavor. They accumulate reserves to fund their pension obligations but generally present their budgets excluding the retirement systems. Their non-retirement budget balance has remained positive, while annual surpluses in their retirement funds have been hovering recently around 1 percent of GDP. Thus, states are clearly adding to national saving through the accumulation of pension reserves. With a commitment to balance the non-Social-Security portion of the budget, the same should be achievable at the Federal level.

Regardless of whether the increase in saving comes through the trust funds or through personal accounts, for the effort to be meaningful the current generation of workers will have to forego some current consumption so that those alive in 2040 will have more. That means that they will in effect pay twice: they already have to reduce their consumption to cover promised benefits for the retired and those about to retire; now they will also have to reduce consumption to build up assets either collectively or individually. This is an inescapable outcome of the decision to increase saving. While increasing national saving now will impose a cost on the current generation, it means that the pie in 2040 will be larger. One study showed that even relatively modest advanced funding, if really saved and invested, could raise future aggregate income—that is, increase the size of the pie—sufficiently to offset the added Social Security costs on future workers due to the aging of the population (Aaron, Bosworth, and Burtless 1989).

IV. PERSONAL SAVINGS ACCOUNTS ARE RISKY, COSTLY, AND HURT THE VULNERABLE

Despite the relative health of the Social Security system, the ability of future generations to bear the projected increase in costs, and the possibility of using the trust funds to increase national saving, proposals abound to replace at least a portion of the current Social Security program with personal accounts. The enthusiasm for personal accounts can be traced to a confluence of events and the lure of higher returns, but they involve enormous risks.

The basic argument against shifting to personal accounts is that it is inconsistent with the goals of the Social Security program; it would put people's basic retirement benefits at risk and make them unpredictable. The whole point of having a Social Security system is to provide workers with a predictable basic retirement income to which they can add income from private pensions and other sources. If it is appropriate for the government to interfere with private sector decisions to ensure a basic level of retirement income, it does not make sense for that basic amount to be uncertain, reflecting one's good luck or investment skills. The late Herb Stein, Chairman of the Council of Economic Advisers under President Nixon, summarized the argument best.

"If there is no social interest in the income people have at retirement, there is no justification for the Social Security tax. If there is such an interest, there is a need for policies that will assure that the intended amount of income is always forthcoming. It is not sufficient to say that some people who are very smart or very lucky in the management of their funds will have high incomes and those who are not will have low incomes and that everything averages out."

In addition to the fundamental philosophical argument, personal accounts raise a host of practical problems, including potential access before retirement, lack of automatic annuitization, and cost:

- Access Before Retirement. Personal accounts create a very real political risk that account holders would pressure Congress for early access to these accounts, albeit for worthy purposes such as medical expenses, education, or home purchase. Although most proposals prohibit such withdrawals, experience with existing Individual Retirement Accounts and employer-sponsored defined contribution plans suggests that holding the line is unlikely. To the extent that Congress acquiesces and allows early access—no matter how worthy the purpose—many retirees will end up with lower, and in some cases inadequate, retirement income.
- Lack of Automatic Annuitization. Another risk is that individuals stand a good chance of outliving their savings, unless the money accumulated in their personal accounts is transformed into annuities. But few people purchase private annuities and costs are high in the private annuity market.[3] Even if costs were not high, the necessity of purchasing an annuity at retirement exposes individuals to interest rate risk; if rates are high when they retire, they will receive a large monthly amount, if rates are low, the amount will be much smaller. Moreover, the private annuity market essentially does not offer full inflation-adjusted benefits. In contrast, by keeping participants together and forcing them to convert their funds into annuities, Social Security avoids adverse selection and is in a good position to provide inflation-adjusted benefits.
- Cost. The 1994-96 Social Security Advisory Council estimated that the administrative costs for an "Individual Retirement Account (IRA)" approach would amount to 100 basis points per year.[4] A 100-basis point annual charge sounds benign, but it would reduce total accumulations by roughly 20 percent over a 40-year work life. Moreover, while the 100-basis-point estimate includes the cost of marketing, tracking, and maintaining the account, it does not include brokerage fees. If the individual does not select an index fund, then transaction costs may be twice as high. Indeed, the United Kingdom, which has a system of personal saving accounts, has experienced considerably higher costs (Orszag, Orszag, and Murthi 1999). Finally, unless prohibited by regulation, these transaction costs involve a flat charge per account that will be considerably more burdensome for low-income participants than for those with higher incomes.

Many advocates of personal accounts have now recognized the very high administrative costs of the IRA approach and have fallen back to recommending defined contribution plans similar to the Federal Thrift Savings Plan (TSP), which the Federal Government provides for more than 2 million employees.[5] In the Federal plan, the accumulated contributions are invested in large pools, and individuals can choose from a limited number of index funds. Costs would be substantially less under this alternative, although it would still double the costs of the current Social Security program. Moreover, for those concerned about government involvement, this approach has the government picking the appropriate equity funds and retaining control of the money. This is not a particular problem in my view, but for those who are concerned about government investment in private sector activities, the TSP approach raises the same issues as investment by the central trust funds.

While personal accounts are merely risky and costly for the average and above average worker, they could end up being disastrous for vulnerable workers in the future. The whole point of shifting funds to personal accounts is to emphasize individual equity—that is, a fair return for the individual saver—rather than adequacy for all. Taking part of what the high earner makes to improve the return for the low earner would be contrary to the spirit of such a plan. To meet this objection,

[3] The reason for the high costs is adverse selection: people who think that they will live for a long time purchase annuities, whereas those with, say, a serious illness keep their cash. Private insurers have to raise premiums to address the adverse selection problem, and this makes the purchase of annuities very expensive for the average person.

[4] In addition to costs, a study by the Employee Benefit Research Institute (Olsen and Salisbury, 1998) raised real questions about the ability, in anything like the near term, to administer a system of individual accounts in a satisfactory way. Unlike the current Social Security program that deals with the reporting of wage credits, a system of personal accounts would involve the transfer of real money. It is only reasonable that participants would care about every dollar, and therefore employer errors in account names and numbers that arise under the current program would create enormous public relations problems under a system of individual accounts.

[5] The TSP was established by the Federal Employees' Retirement System Act of 1986 (FERSA). It is a voluntary savings and investment plan similar to the defined contribution plans offered under section 401(k) of the Internal Revenue Code. Individuals can direct their contributions to a stock fund, a money market fund, or a bond fund, and can shift their investments over time.

many advocates of the defined contribution approach provide either a flat benefit amount or a healthy minimum benefit for low-wage workers. Although such provisions will protect low-income workers in the short term, opponents of these accounts believe that maintaining redistribution within the program is unlikely to be sustainable.

A mixed defined benefit/personal account system with a flat benefit and a defined contribution account is likely to respond very differently to change over time than the existing defined benefit arrangement. For example, suppose that the overall size of Social Security was viewed as too large as the retirement of the baby boom neared. Benefit cuts under the existing program would likely affect all people at all points in the income distribution proportionately; for example, the extension of the normal retirement age from 65 to 67 in 1983 was a form of an across-the-board cut. Congress might even attempt to protect the benefits of workers with low incomes. Cuts under a mixed defined benefit/ personal account system are likely to be very different. People are likely to view the defined contribution component as individual saving and see little gain from cutting it back. The more likely target would be the flat minimum benefit, which goes to both those who need it and those who do not. Higher wage workers are going to find they get very little for their payroll tax dollar from such a residual Social Security program and will withdraw their support. As the minimum is cut repeatedly, it will become inadequate for low-wage workers. In response, pressure is likely to develop to replace the flat benefit with a means-tested program.

Observers sometimes argue that the same economic outcome can be achieved either through means-tested benefits or through social insurance payments that are then taxed back. This conclusion ignores psychological, social, political, and institutional factors. Means-tested and social insurance programs in the United States grow out of different historic traditions, have different impacts on their recipients, and are viewed very differently by the public. Social insurance reflects a long history of people getting together to help themselves. This self-help approach means that individuals have an earned right to benefits, since they receive payments based on contributions from their past earnings. The programs involve no test of need, and program benefits can be supplemented with income from saving or other sources. Means-tested programs in the U.S., on the other hand, grow out of the punitive and paternalistic poor-law tradition, which recognizes only begrudgingly a public responsibility for providing for the impoverished. Means-tested benefits tend to be less adequate than those provided under social insurance programs and have a stigma, which means that many who are eligible never claim their benefits. To the extent that people at the low end of the income distribution are forced to rely on means-tested benefits, they are likely to be worse off than they would be under the existing defined benefit Social Security system.

V. CONCLUSION

Let me conclude. Social Security is not facing a crisis. The long-term financial gap can be closed within the structure of the current program, and the increased costs of Social Security and Medicare combined will take up only 20 percent of the modest projected growth in living standards. Moreover, the old arguments that Social Security and Medicare spending will crowd out other government programs have lost their force now that both political parties are committed to moving away from the unified budget. The real threat to on-budget programs is massive tax cuts, not Social Security and Medicare.

Despite the benign outlook for Social Security, plans abound to dramatically restructure the system. One argument for such restructuring is the desire to increase national saving. I share the concern about the welfare of future workers and believe that we need to make intelligent decisions in order to ensure them the highest standard of living possible. We cannot stockpile food and clothing today for retirees in 2040; their food and clothing will come from output produced in 2040. Assuming that the personal account debate is about the way in which the elderly secure their claims not the amount, the key factor determining the welfare of future non-elderly is the size of GDP in 2040. If GDP is large, future workers will have a lot after they provide for the elderly; if GDP is small, they will have less. The key determinant of future GDP is saving and investment today, both in physical capital and in workers. With the separation of Social Security from the rest of the budget, this saving can be done equally well through the trust funds as through private accounts. Therefore, the desire to increase national saving is not a plausible reason to restructure the Social Security system.

The legitimate arguments for personal retirement accounts rest on questions of individual control and better matching of portfolios to individual risk preference.

Some proponents also believe that personal accounts would be more stable politically over the long run; others think that they might enhance the possibility of getting more funds into the system. The question is whether the possible gains from personal accounts are worth the costs. The answer seems clearly "no." If it is appropriate for the government to interfere with private sector decisions to ensure a basic level of retirement income, it does not make sense for that basic amount to be uncertain, depending on one's investment skills. Personal accounts also are costly, and expose participants to the temptations of early withdrawal and the risks associated with private annuitization at retirement. More fundamentally, separating income support from social insurance in the U.S. will almost certainly produce less redistribution, which will harm future generations of low-wage workers.

Mr. CHAMBLISS. Thank you very much.

Professor Kotlikoff.

STATEMENT OF LAURENCE KOTLIKOFF

Mr. KOTLIKOFF. Thank you, Mr. Chairman.

Mr. Chairman and distinguished members of the House Budget Committee, I am honored by this opportunity to discuss with you U.S. fiscal policy, specifically the burden it is likely to place on our children and grandchildren.

Notwithstanding the rosy fiscal scenarios being floated today by Government agencies, there is an enormous imbalance in the projected tax burden facing current and future generations. Indeed, the most recent generational accounting for the United States, which was done recently by economists at the Congressional Budget Office and the Federal Reserve Bank of Cleveland, but has so far not been published by either agency, indicates that our children will face lifetime net tax rates that are roughly 40 percent greater than those that we face.

Avoiding that outcome would, for example, require an immediate and permanent 31-percent increase in Federal personal and corporate income taxes. Such a policy would mean a $375 billion larger surplus this year. Stated differently, to achieve generational balance such that our children and grandchildren would face the same tax rates as we face, we should be running a surplus this year that is almost three times larger than the one we are actually running.

Now, rather than warn us about the tidal waves of liabilities facing our children, our Government is doing its level best to mislead the American people about our fiscal future. I speak primarily of the Congressional Budget Office's 10-year budget forecast. But the Office of Management and Budget, Social Security trustees, the Medicare trustees, are all deceiving the American public about what will happen once the 77-million strong baby boomers retire. When that happens, we will have 100-percent more old people, but only 15-percent more workers on whom they can lean for financial support.

Now, how can I be so grim about the Government's long-term finances, when the Congressional Budget Office just last week projected surpluses between now and 2010 that accumulates to $5.7 trillion? The answer is that the CBO's surplus projection is predicated on spending assumptions that no one in Congress takes seriously and upon which no responsible adult would risk his child's economic future. Consider CBO's frozen spending projection in which Federal discretionary spending remains fixed in nominal dollars through 2010. Under that scenario, Federal discretionary spending falls by 35 percent as a share of GDP between now and the end of the decade.

The CBO says that it is just doing what Congress tells it to do in making these projections. But that is not what I and other parents are expecting it to do. We expect the CBO and other Government agencies to provide realistic budget estimates, particularly if these estimates are going to be driving the national debate that determines how we treat our children.

How much of the CBO's $5.7-trillion surplus over the next 10 years will disappear if Federal fails magically to decline as a share of GDP to a level not witnessed in the post-war period? The answer is that $2.1 trillion of the $5.7 trillion supposed surplus will disappear. Of the remaining $3.6 trillion, $2.4 trillion is off-budget and supposed to be spent on Social Security and Medicare benefits. So what is left is only $1.2 trillion—a nontrivial sum for sure, but a far cry from the amount needed to cover all of the remaining Social Security and Medicare bills, let alone those from the rest of the Government's operation.

Mr. Chairman, this is the clear message from the generational accounting to which I referred to at the beginning of my remarks. That analysis, which assumes that Federal discretionary spending stays even with the economy, takes into account all of the future Government receipts and expenditures, not just at the Federal level, but also at the State and local level. Hence, it fully incorporates this $1.2-trillion surplus that we can legitimately anticipate over the next decade. But this short-term surplus notwithstanding, there remains a huge imbalance in generational policy whose elimination requires not major tax cuts or major expenditure hikes, but precisely the opposite.

Because time is short, let me summarize the remaining part of my testimony, and I hope I can submit the testimony to the record.

The generational accounting suggests that we need a 31-percent immediate and permanent increase in our income taxes. That is one way you could solve the demographic problem. There are, of course, other ways. I have in this testimony a Table 2 at the back, which shows alternatives. An alternative to raising income taxes by 31 percent would be to raise all taxes—FICA taxes, income taxes, State income taxes, State sales taxes—by 12 percent, immediately and permanently.

You could also cut all transfer payments to unemployment, to welfare, to Social Security, to Medicare and Medicaid by 22 percent. Or you could start from this time path of Government discretionary spending, which stays even with the economy, and you could cut that by one-fifth at all levels of Government, or, if you just focus on the Federal Government, you could cut spending by 66 percent.

Each of these alternatives would be enormously painful. But the longer we wait, the worse the alternatives will get. So, when Dr. Munnell says that we have a moderate problem or a manageable problem, I couldn't disagree more. We have a horrendous problem, and that problem is revealed by generational accounting very clearly. And this generational accounting is being done by the Congressional Budget Office and the Federal Reserve Bank of Cleveland based on the latest CBO projections.

Generational accounting does not truncate its analysis at 75 years. It looks through time at the true long-term, which doesn't stop 75 years from now. When you stop 75 years from now, you ignore the fact that in year 76, and year 77 and so forth, you have absolutely gigantic deficits in the entitlement programs and other parts of the budget. For example, in the Social Security program, you are looking at a deficit in 2076 that is roughly $650 billion measured in today's dollars.

If you just look at Social Security and Medicare and you ignore the whole rest of the Government, and you assume that the trust funds for those programs that currently exist and the surpluses that are scheduled to be accumulated are all spent on the benefits of those programs, you still find out that those programs are short about 40 percent of the resources they need to pay benefits on an ongoing basis; in other words, Social Security and Medicare are 40-percent broke.

Let me conclude by saying that the Government, through its various fiscal agencies, is assuming away our fiscal problems, rather than disclosing and solving them. In so doing, it badly disserves both us and our children. Notwithstanding the rosy fiscal projections, our country has a huge imbalance in its generational policy. Without dramatic and immediate changes in this policy, our children are likely to face lifetime net tax rates that are two-fifths larger than those we face.

There are a variety of steps, all painful, that we can take to achieve a situation of generational balance, in which our children face the same lifetime net tax rates as we face. But getting any of these steps publicly discussed and enacted into law requires providing the Nation with an honest assessment of our long-term fiscal problems.

Toward that end, Congress should establish an independent agency to do generational accounting. This agency would evaluate the generational accounting implications of all major spending and tax bills and make annual reports to Congress about the steps needed to achieve generational balance.

Thank you, Mr. Chairman.

[The prepared statement of Laurence Kotlikoff follows:]

PREPARED STATEMENT OF LAURENCE J. KOTLIKOFF, PROFESSOR OF ECONOMICS, BOSTON UNIVERSITY

Chairman Kasich and distinguished members of the House Budget Committee, I am honored by this opportunity to discuss with you U.S. fiscal policy, specifically the burden it is likely to place on our children and grandchildren. Notwithstanding the rosy fiscal scenarios being floated today by government agencies, there is an enormous imbalance in the projected tax burden facing current and future generations. Indeed, the most recent generational accounting for the U.S., which was done by economists at the Congressional Budget Office and the Federal Reserve Bank of Cleveland, but so-far publicized by neither agency, indicates that our children will face lifetime net tax rates that are roughly 40 percent greater than those we now face.[1] Lifetime net tax rates are calculated by dividing the present value of lifetime tax payments to federal, state, and local government, net of transfer payments received, by the present value of lifetime labor earnings.

Rather than warn us about the tidal wave of liabilities facing our children, our government is doing its very best to mislead the American people about our fiscal

[1] See Gokhale and Kotlikoff (2000), which updates calculations presented in Gokhale and Page, Potter, and Sturrock (2000).

future. I speak primarily of the Congressional Budget Office's 10-year budget forecast. But the Office of Management and Budget, the Social Security Trustees, and the Medicare Trustees are all deceiving the public about what will happen once the 77-million baby boomers retire. When that happens, we'll have 100 percent more elderly, but only 15 percent more workers on which they can lean for financial support.

THE CBO'S $5 TRILLION SURPLUS

How can I be so grim about the government's long-term finances when the Congressional Budget Office, just last week, projected surpluses between now and 2010 that cumulate to $5.7 trillion? The answer is that the CBO's surplus projection is predicated on spending assumptions that no one in Congress takes seriously and upon which no responsible adult would risk his child's economic future. Consider CBO's frozen-spending projection in which Federal discretionary spending remains fixed in nominal dollars through 2010. Under that scenario, Federal discretionary spending falls by 35 percent as a share of GDP between now and the end of the decade! Under CBO's two other scenarios, in which spending is a) capped through 2002 and then grows with inflation and b) grows with inflation starting immediately, the Federal Government is also involved in a supposed disappearing act. Under the caps scenario, discretionary spending relative to GDP falls by 27 percent. Under the inflationary growth scenario, it falls by 16 percent.

Now the CBO is certainly up front about the assumptions underlying its projections. But the public isn't reading its fine print, nor, for that matter, is the press. So the CBO has succeeded in convincing the nation that we are facing huge surpluses and that we can afford major tax cuts, major spending hikes, or both. The counterpart of this, of course, is that the CBO has convinced the public that there is no need to raise taxes, trim benefits, or limit discretionary spending.

The CBO says it's just doing what Congress tells it to do. But that's not what I and other parents are expecting it to do. We expect the CBO and all other government agencies to provide realistic budget estimates, particularly if these estimates are going to drive the national debate that determines how we treat out children.

How much of the frozen scenario's $5.7 10-year unified budget surplus disappears if Federal spending fails magically to decline as a share of output to a level not witnessed in the postwar period? The answer is $2.1 trillion. Of the remaining $3.6 trillion, $2.4 trillion is "off-budget" and supposed to be spent on Social Security and Medicare benefits. So what's left is only $1.2 trillion—a non trivial sum for sure, but a far cry from the amount needed to cover all the remaining Social Security and Medicare bills, let alone those from the rest of the government's operations.

This is the clear message of the generational accounting to which I referred above. That analysis, which assumes that Federal discretionary spending stays even with the economy, takes into account all future government receipts and expenditures. Hence, it fully incorporates the $1.2 trillion surplus that we can legitimately anticipate over the next decade. But this short-term surplus notwithstanding, there remains a huge imbalance in generational policy whose elimination requires not major tax cuts or major expenditure hikes, but precisely the opposite.

To prepare you for the size of the tax hikes or expenditure cuts needed to achieve generational balance, let me first point out the true dimension of the long-term funding shortfall in the Social Security and Medicare programs. And, to make my position more difficult, let me do so under the dubious assumption that all off-budget surpluses will be strictly allocated to pay benefits to those programs' beneficiaries.

SOCIAL SECURITY'S LONG-TERM FUNDING SHORTFALL

Most Americans realize that Social Security and Medicare face significant funding problems. What they don't know is that these problems are three times more severe than the trustees of the Social Security and Medicare programs acknowledge in their annual reports. Consider first Social Security (the OASDI program). According to unpublished estimates by Social Security's actuaries, paying over time the full amount of promised benefits necessitates an immediate and permanent 4.7 percentage point hike in the program's 12.4 percent payroll tax rate. This 38 percent tax hike needed to shore up Social Security's long-term finances is incredibly large particularly since it assumes that all Social Security surpluses will be allocated to paying Social Security benefits. It is also over twice the size of the 1.86 percentage-point OASDI tax increase the 2000 Social Security's Trustees' Report says is needed.

The discrepancy between the two figures reflects the Trustees' Report's truncation of its projection horizon. The Trustees' Report looks out only 75 years, whereas the 38 percent figure considers the entire future. While 75 years may seem like a long-enough horizon, projected Social Security deficits in 76 years and beyond are gigantic. Ignoring the huge deficits in years 76 and thereafter guarantees that successive 75-year projections will look worse because they will replace, in the prevailing 75-year window, surplus or low deficit years with extraordinarily high deficit years. As a result, the 75-year projection that we make, say, in the year 2020 will show a funding shortfall and we will essentially repeat today's debates about how and when to reform the system.

Recall that the Greenspan Commission was charged in 1983 with the task of definitively saving Social Security. The Commission could have and, presumably did, project that Social Security would face a substantial 75-year financing shortfall beginning in 2000 simply because of the inclusion of 17 additional years of very large annual deficits that weren't included in 75-year projection as of 1983. It turns out that about a third of today's 75-year funding shortfall could have been anticipated back in 1983.

Unfortunately, even a 38 percent payroll tax hike would, most likely, not suffice to address Social Security's problems. The 38 percent figure is computed using the actuaries' intermediate economic and demographic assumptions. But the "intermediate" nature of these assumptions is questioned by top economists and demographers. Indeed, Social Security Advisory Board's 1999 Technical Panel recommended changes in the assumed intermediate rates of longevity improvement, real wage growth, and interest on government securities.

The most important of these changes involves projections of lifespan extension. The Technical Panel recommended a 4-year increase in the life expectancy being used in the actuaries' intermediate assumptions. In demographic terms, 4 years is a huge increase. In advocating this increase, the Technical Panel pointed out that the actuaries were assuming it would take Americans fifty years to start living as long as the Japanese currently live. The Social Security Trustees paid some attention to the Technical Panel's recommendation, but not much. They too are under political pressure to make the system look good. Consequently, they chose to increase their life expectancy assumption by only 1 year.

Overly optimistic OASDI forecasting is nothing new. As just indicated, from the perspective of 1983, only about a third of the current 75-year OASDI funding shortfall is due to the truncation of the projection horizon. The remaining two thirds is divided roughly evenly between overoptimistic economic and demographic assumptions and methodological mistakes in forecasting.

Taken together, the Technical Panel's recommended assumptions raise the OASDI tax hike needed to achieve true long-run solvency from 4.7 to almost 6 percentage points. Given the current 12.4 percent OASDI tax rate, this translates into close to a 50 percent tax rise! If one assumes that the Social Security Trust Fund is available to pay benefits, a fair assessment is that the OASDI system has only about 60 percent of the current and future resources it needs to pay benefits through time. Stated differently, Social Security is short 40 percent of the funds it needs if it doesn't want to cut benefits. If the Trust Fund were not available, the system would be 50 percent, rather than 40 percent, broke.

MEDICARE'S LONG-TERM FUNDING IMBALANCE

The Medicare payroll tax rate for hospital insurance (the HI or Part A program) is 2.9 percent. In contrast to the OASDI tax, the Medicare tax is levied on all labor earnings, not simply earnings up to the Social Security covered earnings ceiling. Medicare Part B, the Supplemental Medical Insurance program, currently accounts for two-fifths of total Medicare expenditure. This program is 25-percent-financed by participant premium payments and 75-percent-financed by general revenue.

Like the OASDI Trustees, the Medicare Trustees use a 75-year truncated projection horizon and make the same longevity assumptions. And like the OASDI Trustees, the Medicare Trustees report a major funding shortfall over this period. According to their calculations, eliminating just the HI program's 75-year deficit would require an immediate and permanent 1.46 percentage point increase in the HI payroll tax rate. For reasons that aren't clear, Medicare's Trustees do not specify the income tax hike needed to eliminate the 75-year Medicare Part B funding gap.

In a recent analysis of Medicare's long-term costs, Harvard economist David Cutler and Federal Reserve economist Louise Sheiner extend the Medicare Trustees' projection beyond the 75-year horizon.[2] They also measure, as a percent of total labor income, the future costs of paying for the 75 percent of the SMI program that would not be covered by Medicare participant premiums. Taking these factors into

[2] David M. Cutler and Louise Sheiner, "Generational Aspects of Medicare," The American Economic Review, May 2000.

account, Cutler and Sheiner find that an immediate and permanent 4.1 percentage point increase in the Medicare tax rate is needed to achieve true long-run fiscal solvency in both parts of Medicare. This tax increase is 2.8 times larger than the 1.46 percent higher tax rate advertised by the Medicare Trustees.

MEDICARE'S NEWFOUND OPTIMISM

The Medicare trustees are dramatically more optimistic than they were just 3 years ago. In their 1997 report, the Medicare Trustees projected that spending in 2030, when those in the middle of the baby boom are in the middle of their old age, would equal 7.1 percent of GDP. In 1999, they projected 2030 spending would total only 4.9 percent of GDP. The 2.2 percent of GDP discrepancy between these numbers is enormous when you consider that Medicare expenditures are currently 2.6 percent of GDP. Hence, between 1997 and 1999, the Medicare trustees assumed away an amount of 2030-spending on Medicare, which, when scaled relative to the economy, equals 87 percent of the current program. The trustee's newfound optimism is greater the further out in time one looks. For 2070, the trustees assume away an amount of Medicare spending, which, when scaled by GDP, exceeds the current program!

The fact that the Medicare trustees are making vastly different projections about future expenditures today than they were only 3 years ago means three things. First, the trustees are anchoring much of what they expect Medicare to spend in future years to what it spent in the last couple of years. Second, in extrapolating so strongly the recent slower growth of Medicare spending to the distant future, the trustees are paying little attention to the fact that Medicare growth has slowed in the past, due to new cost-containment policies and other reasons, only to speed up thereafter. Third, Medicare spending projections are highly volatile, and there is no guarantee that the much higher future costs projected in 1997 won't be projected again in a few years.

THE SOCIAL SECURITY SYSTEM'S LONG-TERM FINANCES—A SUMMARY

The current Social Security plus Medicare (OASDHI) payroll tax rate is 15.3 percent. If one adds to this the 6.0 and 4.1 percentage point immediate and permanent tax hikes needed to secure Social Security's and Medicare's finances, one arrives at a payroll tax rate of 25.4 percent. A total of 18.4 percentage points of this 25.4 percent tax rate would be applied only to OASDI covered earnings; the remaining 7.0 percentage points would be applied to all earnings. While the government's share of the additional costs of Medicare Part B could be paid out of general revenues, this calculation illustrates the magnitude of the fiscal burden facing today's and tomorrow's workers from the Social Security System as currently constituted. One should also bear in mind that this 10 percentage-point tax hike will only suffice to correct the Social Security System's long-term imbalances if it is implemented immediately. Any delay will necessitate an even higher tax increase in the future if benefits are to be paid in full.

To sum up, the Social Security System, including Medicare, has only about three fifths of the long-term revenues it needs to pay its bills. If these programs are in trouble, can the rest of our fiscal enterprise bail them out? Finding the answer requires comprehensive generational accounting, to which we now turn.

U.S. GENERATIONAL ACCOUNTS

Table 1 reports generational accounts assuming discretionary spending grows with the economy. The accounts are constructed using a 4-percent real discount rate and assuming a 2.2 percent rate of growth of labor productivity. This discount rate is roughly the current prevailing rate on long-term inflation-indexed U.S. government bonds, and the productivity growth rate is the one currently being projected by the CBO. The accounts are for 1998, but are based on the CBO projections available as of January 2000.

Table 1 shows, for males and females separately, the level and composition of the accounts. Recall that the accounts are present values discounted, in this case, to 1998. As an example, consider the $112,300 account of 25 year-old males in 1998. This amount represents the present value of the net tax payments that 25 year-old males will pay, on average, over the rest of their lives. This figure is an average. It takes into account the fact that some members of this cohort will pay more and others will pay less in net taxes. It is also an actuarial average in that it takes into account that some cohort members will die earlier than others.

Note that the generational accounts for both males and females peak at age 25 and become negative for females at age 50 and for males after age 60. The accounts for those younger than age 25 are smaller because they have a longer time to wait to reach their peak tax-paying years. The accounts are also smaller for those above age 25 because they are closer in time to receiving the bulk of their transfer payments.

THE GENERATIONAL IMBALANCE IN U.S. FISCAL POLICY

Given the assumed trajectory of discretionary spending and the net taxes those now alive are slated to pay, how big is the tab being left for future generations? The answer is 32.3 cents out of every dollar earned. This lifetime tax rate is an average, not a marginal rate. It is also a net rate, because it nets out transfer payments received.

For today's newborns, the lifetime net tax rate under current policy is 22.8 percent. So future generations face a lifetime net tax rate that is 41.6 percent higher than that facing current newborns! In thinking about this generational imbalance, bear in mind that the lifetime net tax rate facing future generations under current policy assumes that all future generations pay this same rate. If, instead, one were to assume that generations born, say, over the next decade are treated the same as current newborns, the net tax rate for generations born in 2010 and beyond would be higher than 32.3 percent.

POLICIES TO ACHIEVE GENERATIONAL BALANCE

Table 2 considers five alternative policies to achieve generational balance—i.e., to equalize the lifetime net tax rates of newborns and future generations. The first involves immediately and permanently raising Federal personal and corporate income taxes by a given percentage. How large would the tax hike have to be? The answer is 31.3 percent!

Given the CBO's projection of $1.198 trillion in income tax revenue for 2000, such a tax hike would mean an additional $375 billion in revenues this year. This, in turn, would mean a $375 billion larger surplus. Since the FY 2000 surplus is likely to run around $200 billion, achieving generational balance means running a surplus that is 2.6 times larger than we are now running. Hence, the current surplus is far too small compared to what is needed to achieve generational balance.

An alternative to raising just Federal income taxes is to raise all federal, state, and local taxes. In this case, an across-the-board tax hike of 12 percent could deliver generational balance. Cutting transfer payments or government purchases are additional options. Cutting all Social Security, Medicare, Medicaid, food stamps, unemployment insurance benefits, welfare benefits, housing support, and other transfer payments by 21.9 percent is another way to eliminate the generational imbalance. Two final options considered in the table are immediately and permanently cutting all government purchases by 21 percent or cutting just Federal purchases by 66.3 percent.

Cutting government purchases to achieve generational balance would leave future generations paying in net taxes the same 22.8 percent share of lifetime earnings as current newborns are expected (under current policy) to pay. In contrast, either raising taxes or cutting transfer payments would mean higher lifetime net tax rates for those now alive. As Table 2 indicates, these alternative policies would leave newborns and all future generations paying roughly 27 cents out of every dollar earned in net taxes. This net tax rate is over 4 cents more per dollar earned than newborns are now forced to pay. The payoff from having newborns as well as everyone else who is currently alive pay more in net taxes, is a reduction in the net tax rate facing future generations by 5 to 6 cents per dollar earned.

WILL THE ECONOMY SAVE US?

One response to this dire fiscal news is that it ignores the economy's growth potential. In particular, it ignores the possibility that an aging society will have more capital per worker, because the number of elderly wealth holders will rise relative to the number of young workers. More capital per worker means higher worker productivity, higher real wages, and the lower return to capital that worries Wall Street. It also means a larger payroll tax base, which would limit the rise in the payroll tax.

This sounds like the silver lining in the clouds, but is it for real? Not necessarily. The fact that the payroll tax will, on balance, rise means that workers will have less after-tax income out of which to save and will arrive at retirement with less wealth than would otherwise be the case. Thus capital deepening is not a foregone conclusion.

My current research with Professor Kent Smetters of the University of Pennsylvania and Dr. Jan Walliser of the International Monetary Fund (Kotlikoff, Smetters, and Walliser, 2000) considers these two conflicting forces. It develops a dynamic general equilibrium life-cycle simulation model to study the demographic transition. Unfortunately, our simulations show extremely small macroeconomic effects over the next three decades. And because the macro feedbacks are so small, they will do nothing to alleviate our short- and medium-term fiscal problems. Over the longer term, the economy's general equilibrium response will actually exacerbate our fiscal difficulties. To be more precise, real wages per effective unit of labor are predicted to remain virtually unchanged over the next three decades and then decline gradually by about 9 percent. For Wall Street, this bad news about real wages is good news about the real return on capital, which stays fixed over the next three decades and then increases slightly.

The absence of capital deepening between now and 2030 and the presence of capital shallowing thereafter is driven by the model's dramatic rise in taxes. Payroll taxes in 2030 are 85 percent higher than in 2000. Average income tax rates are higher as well, by 15 percent higher. Together, these tax hikes raise the average total tax on labor income tax by 50 percent.

CONCLUSION

The government, through its various fiscal agencies, is assuming away our fiscal problems rather than disclosing and solving them. In so doing, it badly disserves both us and our children. Notwithstanding the rosy fiscal projections, our country has a huge imbalance in its generational policy. Without dramatic and immediate changes in this policy our children are likely to face lifetime net tax rates that are two-fifths larger than those we face. There are a variety of steps, all painful, that we can take to achieve a situation of generational balance in which our children face the same lifetime net tax rates as we face. But getting any of those steps publicly discussed and enacted into law requires providing the nation with an honest assessment of our long-term fiscal problems. Toward that end, Congress should establish an independent agency to do generational accounting. This agency would evaluate the generational accounting implications of all major spending and tax bills and make annual reports to Congress about the steps needed to achieve generational balance.

TABLE 1.—THE COMPOSITION OF MALE GENERATIONAL ACCOUNTS

[Present values in thousands of 1998 dollars]

Age in 1998	Tax payments					Transfer receipts			
	Net tax payment	Labor income taxes	Capital income taxes	Payroll taxes	Excise taxes	OASDI	Medicare	Medicaid	Welfare
0	249.7	128.3	61.8	107.3	93.4	45.2	24.0	58.1	13.7
5	256.4	136.3	66.0	114.1	97.4	48.0	35.9	58.9	14.6
10	272.3	147.1	71.8	123.1	102.1	51.7	44.2	60.2	15.8
15	291.4	158.4	77.9	132.8	105.9	55.4	50.5	60.6	17.1
20	318.7	171.2	85.4	143.8	107.5	59.0	51.9	59.9	18.3
25	327.3	174.5	91.6	145.7	102.4	61.2	52.5	55.2	17.8
30	313.7	167.8	98.2	138.1	95.9	64.6	55.2	49.9	16.5
35	279.2	153.9	104.5	124.3	89.4	69.4	63.7	45.0	14.9
40	241.4	137.1	110.0	108.9	83.2	76.4	67.4	40.4	13.5
45	194.2	116.1	113.0	91.2	75.5	85.5	67.9	35.9	12.3
50	129.7	93.0	112.4	71.8	65.6	95.6	75.4	31.0	11.1
55	66.2	65.5	108.4	50.4	56.0	108.1	69.7	26.3	10.0
60	−5.8	38.0	100.5	29.1	46.4	123.1	66.1	21.8	9.0
65	−77.5	16.6	89.5	12.7	37.2	138.5	69.3	17.7	8.0
70	−91.0	6.8	76.3	5.1	28.4	129.7	56.2	14.8	7.0
75	−75.1	3.3	61.3	2.4	20.8	106.5	38.2	12.5	5.7
80	−56.3	1.4	46.1	1.2	14.6	85.7	20.2	9.7	4.0
85	−42.4	.5	33.0	.5	10.1	67.0	9.0	8.0	2.6
90	−25.6	.4	28.5	.4	7.9	51.7	3.1	6.0	2.0

Growth-Adjusted Net Tax Payment of Future Generations: 361.8.
Lifetime Net Tax Rate on Future Generations: 32.3 percent.
Lifetime Net Tax Rate on Newborns: 22.8 percent.
Generational Imbalance: 41.7 percent.

Note: Table assumes a 4 percent real discount rate and 2.2 percent growth rate.

TABLE 1. (continued)—THE COMPOSITION OF FEMALE GENERATIONAL ACCOUNTS

[Present values in thousands of 1998 dollars]

Age in 1998	Tax payments					Transfer receipts			
	Net tax payment	Labor income taxes	Capital income taxes	Payroll taxes	Excise taxes	OASDI	Medicare	Medicaid	Welfare
0	109.6	67.8	21.6	64.1	89.0	42.3	24.6	44.0	22.0
5	104.6	72.1	23.0	68.2	92.7	45.0	38.3	44.7	23.4
10	104.6	77.9	25.1	73.7	97.0	48.7	48.8	46.1	25.6
15	105.4	84.1	27.2	79.6	99.9	52.4	57.9	46.9	28.2
20	113.7	91.0	29.8	86.2	100.9	56.4	61.1	46.9	29.9
25	112.3	91.5	31.8	86.4	96.6	58.9	63.7	45.2	26.2
30	95.6	85.1	33.9	79.9	91.2	61.9	68.0	43.2	21.3
35	65.6	75.6	35.9	70.8	85.7	65.7	78.6	41.1	17.0
40	37.9	66.0	37.9	62.0	79.7	71.4	83.7	39.3	13.3
45	7.9	55.4	39.2	52.1	72.7	78.8	84.7	37.6	10.4
50	−37.7	42.2	39.6	39.6	64.4	87.7	94.1	33.5	8.2
55	−73.9	28.3	39.1	26.6	55.2	99.0	87.5	29.8	6.8
60	−115.0	15.6	37.4	14.7	46.0	112.7	84.0	26.2	5.8
65	−157.6	6.6	34.6	6.1	36.9	124.6	89.3	22.6	5.2
70	−155.9	2.5	30.8	2.2	28.7	116.8	78.7	20.0	4.6
75	−131.8	.9	26.3	.9	21.3	100.0	59.6	17.9	3.8
80	−99.2	.3	21.5	.3	15.3	82.1	36.9	14.5	3.1
85	−70.5	.2	16.9	.1	11.1	63.4	20.6	12.5	2.4
90	−44.4	.1	14.1	.1	8.3	47.3	9.0	8.9	1.8

Growth Adjusted Net Payment of Future Generations: 158.8.

Note: Table assumes a 4 percent real discount rate and 2.2 percent growth rate.

Source: Gokhale and Kotlikoff (2000)

TABLE 2.—ALTERNATIVE POLICIES TO ACHIEVE GENERATIONAL BALANCE*

Policy	Immediate and permanent change in policy instrument	Equalized lifetime net tax rate
Raise all taxes	12.0 percent	27.5 percent
Raise Federal income taxes	31.3 percent	27.3 percent
Cut all transfers	21.9 percent	26.5 percent
Cut all government purchases	21.0 percent	22.8 percent
Cut Federal purchases	66.3 percent	22.8 percent

*Generational imbalance is the percentage difference in lifetime net tax rates of newborns and future generations.

Source: Gokhale and Kotlikoff (2000).

Mr. CHAMBLISS. Thank you, sir. And I appreciate both of you sharing your thoughts with us. We have obviously got to continue this dialogue because we have heard a difference of opinion with respect to where we are going to be 70 years from now.

Professor Munnell, I hear what you are saying with respect to tax cuts, that we have got to be careful. I don't hear you throw in the mix that we need to be careful about how much we increase Government spending, but that is what I am hearing, in effect, from Professor—and I hope I am saying your name right—Kotlikoff.

And with respect to tax cuts, with respect to trying to increase savings, which I agree with you on, with respect to tax cuts and keeping the economy moving to try to triple that surplus that Professor Kotlikoff talked about that we need, don't we need some kind of balance there with respect to tax cuts to keep the economy moving, to keep it going the way it is going? Don't we need tax cuts of some sort there to provide people with more money in their pockets, so they can save, so they can take that money, pay their bills off, put it in savings, whatever they are going to do with it? Don't we need those tax cuts in there? And we can argue over what is moderate and what is too extreme with respect to tax cuts, but I have just got to believe that tax cuts do enhance the growth of the economy.

I just went to the University of Georgia. I didn't go to school in Boston, but that is what they used to teach us; that you keep the economy churning by keeping money churning in the economy. Now, that is not the only thing. But, obviously—and I am a little bit concerned about your honing in on the idea that we have got a more serious problem with trying to keep tax cuts lowered than we do with the long-term problems in Social Security.

Ms. MUNNELL. I will respond quickly, since we have all been at this for a long time today. There are two things that separate Larry's view of the world from mine. The first is what is the appropriate period when you are talking about long-term planning? And all of the numbers I use and all of the numbers that Social Security uses are the next 75 years, as a reasonable planning horizon. Larry says that is not long enough. You really have to look beyond 75 years. And I guess I would just argue that Henry Aaron showed you a table of how much the projections for these programs have changed over the last 4 years, so I question looking beyond 75 years.

The other thing that my colleague here does is he talks in dollar amounts. And so he talks in hundreds of billions or trillions of dollars. And I think it is very important to always express those numbers as a percent of GDP because we are also going to have much bigger GDP in the future. And so if you do those two things—if you take the 75-year planning and talk in percents of GDP, all of the problems of both Social Security and Medicare look much more manageable.

Just in terms of tax cuts, the economy is operating at full capacity now. We don't really need to have any tax cuts to stimulate it. But I would agree with you, we have surpluses and I don't think it should all go for one thing or the other. I would think that some of it should go for a tax cut, some of it should go to help Social Security and Medicare and some should go for other domestic initiatives. So I am not against tax cuts. I think this is a time that you need to be careful that you don't give away money that you are going to need in the future.

Mr. CHAMBLISS. Professor Kotlikoff, you talked about trying to work on increasing our surplus because of, well, you said for several different reasons there. And in looking at that, is not the key there that rather than thinking on the flip side of it, that in order to look where our children are going to be 50 years from now, they are going to be paying 40 percent more in income taxes, why shouldn't we be looking at ways to decrease Government spending?

Now, I realize in your table you show your numbers there about what would happen with respect to Government spending. But if we concentrate on not leveling off Government spending, but simply slowing down Government spending—I read in the Times this morning where, you know, when my crowd came in, in 1995, we were big on trying to reduce Government spending, and yet we have been growing at a faster rate than previous Congresses. And that scares me every time I see that. And if we do put strong emphasis on trying to slow down Government spending at the same time, would we look at our children not paying two-fifths more in taxes than we are paying today?

Mr. KOTLIKOFF. Well, that depends on exactly what you mean by Government spending. If you are talking about discretionary spending at the Federal level, that type of expenditure as a share of GDP is pretty much as low as it has been since 1960 in all categories—foreign aid, defense, nondefense, nonforeign aid, domestic discretionary spending. We have cut that quite a bit. Now, I am not saying that can't be cut more. But to assume, as the CBO is assuming, that it is going to be cut by 35 percent over the next 10 years is not a realistic projection. But it has led to these enormous surplus projections, which has led everybody to say, well, now we can afford to cut taxes and raise spending. The reality is that if discretionary spending doesn't fall as a share of GDP, the only other place to cut expenditures is through the entitlement programs.

Now, I do believe that a privatization of Social Security could dramatically improve the situation as part of——

Mr. CHAMBLISS. Do you think, at the same time, you could reduce entitlement spending of Social——

Mr. KOTLIKOFF. Yes. Let me explain how I would do that. The reform proposal that I have advanced, together with Jeff Sachs, who is a professor at Harvard—a proposal that has been endorsed by 65 academic economists, including three Nobel Prize winners—is to take the existing OAI system, the Old Age Insurance Program of Social Security, and pay off all of the benefits that are obligated under that system. So you take the current retirees, pay them all the benefits we owe them. Take the current workers, and when they retire, you give them their accrued benefits—the benefits they would have accrued as of the time of the reform, which you calculate by filling zeroes in their earnings records. So when they reach retirement, their benefits are lower because of the fact that they have had zeroes filled in their earnings records after the reform.

Through time Social Security retirement benefits are, under this reform, phased out benefits. But, under our proposal, we would leave the survivor and the disability benefits intact. The proposal would take 8 percentage points of the the 12.4-percent payroll tax that we now use to pay for Social Security and put that into a private account, which would be divided 50-50 between husband and wife. The Government would provide a matching contribution on behalf of poor people, so there would be a progressive element. The balances would be invested in a single security, which is a market-weighted global indexed fund of stocks and bonds.

At retirement age, you would have your account balances gradually transformed into inflation-protected pensions so there would be an annuitization process, which would be done on a cohort-by-cohort basis and would be done collectively, so individuals would not be having to go to individual insurance companies and try and get a deal. And they might not get a good deal from the insurance companies they ended up with. So it would be done collectively at very low administrative costs.

So here you have a proposal which is phasing out the old system, but giving everybody all of the benefits they have accrued as of the time of the reform, putting everybody into a new privatized retirement account, where there is progressivity, there is protection of dependents (because nonworking spouses would have an equal size account as working spouses), there is diversified investment in the world marketplace, and there is the same rate of return to all Americans. Finally, there is collective annuitization so that there is no problem of getting taken by the insurance companies at the end of the day when you try to get your money out in the form of an inflation-protected pension.

The only thing I have left out of this story is how you pay the benefits of the old system because we are taking 8 percentage points of the payroll tax and putting that into private accounts. Incidentally, you could call this a tax cut. So if you want to pass a tax cut, this is the way to do it—cut the payroll tax by 8 percentage points and put it into private accounts.

We would pay off the existing accrued OAI benefits through a combination of two things: one is further restraint on discretionary spending, to the extent that is possible, the other, which is the main source of finance, is a Federal retail sales tax, which would mean that older people, middle-age people and young people would collectively be paying off the liability of the old system.

The only group that would be omitted from the obligation of paying off the benefits of the old system would be the poor elderly. They live off of Social Security, and because their benefits are indexed to the price level, if you put on a retail sales tax at the Federal level, the price level would go up, and their benefits would be automatically increased. Hence, the poor elderly would be perfectly insulated, and we would just be asking the rich elderly and the middle-class elderly, as well as everybody else in the economy, to help pay off the benefits of the old system.

This is a plan for ending up 30 years from now with a payroll tax for Social Security retirement benefits that is zero, as opposed to ending up with a payroll tax for Social Security retirement benefits, which could well be going from 8 percentage points of wages to 14 percent or so.

We need to face facts. We have a huge problem. So what I offer is a radical plan. It is also a realistic plan. It is also a fair plan, and it doesn't beat about the bush in terms of being clear that somebody has to pay off the liabilities of the old system. All of the plans that are being discussed by the two presidential candidates, by Members of Congress, and by most of the academics are suggesting that we can privatize Social Security with nobody bearing any pain, any burden. We can just let the capital markets take care of everything. That is hogwash.

Frankly speaking, the economics are very clear. We have to pay off the liability of the old system, and this would be the way to do it. Alicia even agrees with that. [Laughter.]

Ms. MUNNELL. If I saw the problem as large as Larry did, I would want dramatic restructuring too. But I just want to reiterate that when you look over the 75-year period, which I think, in my view, it is a generation, it is a perfectly reasonable planning period, the costs of Social Security, and this is what the trustees' report says, this is what the actuaries say, are going to go from 4.2 percent of GDP to 6.8 percent of GDP. That is up 2.6 percent. As I said, interest is going to go down from 3 to zero percent of GDP. Defense spending has gone down by 2.6 percent of GDP in the 1990's. We have seen 2.6 percent of GDP swings, and we have been able to cope with them.

So I think we can cope with this kind of change and that the existing system works well. I think we should fix the long-run financing problem immediately. I think tolerating deficits is not acceptable. I think we should get the revenues in there or the benefit reductions or whatever we need to do to close the gap to restore financial balance, both because it is cheaper if you do it early and, two, people need to have confidence in the system.

So I see a small problem, so I need a small fix. Larry sees a big problem, he needs a big fix.

Mr. KOTLIKOFF. About a third of our current Social Security problem can be traced back to 1983 and to the fact that the Greenspan Commission, which was charged with fixing Social Security once and for all, only looked out 75 years. Here it is 17 years later, and we have in the current 75-year projection window 17 years of huge deficits that they did not take into account back in 1983 because they didn't look out far enough.

The demographics are quite clear. The nature of this system is quite clear. The fact that it is indexed and scaled to the economy and how it works is quite clear. There is not a huge amount of uncertainty really about the kinds of liabilities that are going to be out there, given the demographic realities. But we are blithely ignoring them.

Moreover, the Social Security trustees are also making what top demographers in the country think are outlandish assumptions about longevity. The top academic demographers appear to think that the intermediate assumptions should have three more years of expected life than the trustees have assumed. I am not an expert on demography, but I know these individuals have done a great deal of high-quality research on the subject.

The technical panel that Social Security convened to study this issue and other issues last year voted to advise the trustees to increase the longevity assumption by 4 years. The trustees increased the longevity assumption by 1 year. So if you take that into account, you see that even over the 75-year horizon, we have a much bigger problem than Alicia is describing.

Mr. CHAMBLISS. Let me just address this to both of you. In 1995, we were looking at a projection that Social Security was going to be broke, depending on who you listened to, 2018 to 2022. The economy gets on a fast track and all of a sudden we are looking at surpluses now both on-budget and off-budget. If we get back into a depressed economy and if all of a sudden these surpluses disappear, does the opinion of either one of you change with respect to we do or we don't have a crisis in Social Security?

Mr. KOTLIKOFF. Let me just say that the generational accounting that I was referring to uses all of the latest numbers which incorporate all of the information about the surpluses. The only assumption that differs from the CBO projections is that the Federal Government doesn't engage in a disappearing act. In other words, the

CBO is assuming that your salary is going to fall by 35 percent compared to other workers over the next 10 years. I don't see that happening. I don't see that happening with military wages. I don't see that they are going to fill Air Force One with 35-percent less gas. I just don't see discretionary spending falling as a share of GDP by 35 percent over 10 years.

So if you don't make that assumption, and you instead assume that Federal discretionary spending will stay even with the economy, you find out that, yes, we are going to be running some short-term surpluses, even under that assumption, but, no, they are not anywhere near large enough to deal with the long-term problems in Medicare, and Medicaid, and Social Security, and other aspects of our fiscal finances. Indeed, if you leave the whole bill to the next generation, you have them facing a 40-percent higher tax bill. That is, all of their tax rates at not just the Federal level, but also State and local levels would be 40-percent higher.

To make matters worse, Congress is talking about compounding the problem by having tax cuts in the short run or spending more on drug benefits to the elderly or other programs for the elderly. That will make the generational accounting situation worse. We are in a critically difficult situation here. We have agencies in this Government that are systematically misleading the American public about the nature of our problems. And the situation is much more grave than has generally been described today.

Chairman Kasich got it exactly right—this is the "Perfect Storm"—the perfect fiscal storm.

Mr. CHAMBLISS. Professor Munnell, we will let you wind us up.

Ms. MUNNELL. I will just answer your question about how if we have downturn, how that would affect the outlook. Most of the improvement in the Social Security trust fund projections have come from events that have already occurred—the good performance of the 1990's. The actuaries have been cautious in incorporating optimistic economic assumptions in their projections. For instance, they assume that productivity growth will increase over the 75 years by 1.5 percent, even though in the late 1990's we have been enjoying 2.5 or a little bit more.

So I don't think a downturn would have a very big affect on the projections at this point.

Mr. CHAMBLISS. Well, let me just say to both of you thank you very much for your patience today and being here. And to both of you let me say that we wish you would submit your statement, if you haven't already. And we thank you for enlightening us, and we look forward to a continuing dialogue on this question. It is fascinating, it is complicated, but it is something that is so important for literally our children and our grandchildren. We use that phrase figuratively too often, but this really does affect our children and our grandchildren. So we appreciate very much your input and your being here today. Thank you.

Ms. MUNNELL. Thank you, Mr. Chairman.

Mr. KOTLIKOFF. Thank you, Mr. Chairman.

Mr. CHAMBLISS. We are concluded.

[Whereupon, at 3:18 p.m., the committee was adjourned.]