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BEFORE THE

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UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

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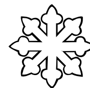

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FINAL REPORT PRODUCED BY THE PRESIDENT'S COMMISSION TO STRENGTHEN SOCIAL SECURITY

THURSDAY, OCTOBER 3, 2002

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:05 a.m., Hon. Max Baucus (chairman of the committee) presiding.

Also present: Senators Grassley and Kyl.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will come to order.

Today we are going to consider the recommendations of the President's Commission to Strengthen Social Security.

Before going any further, I wish to express my disappointment that Treasury Secretary O'Neill has not agreed to testify. As the managing trustee of the Social Security Trust Funds, Secretary O'Neill plays a very unique role. But, unfortunately, the Secretary has declined our invitation to be here today.

At this point, we have no choice but to proceed without the benefit of the Secretary's testimony. That said, let me turn to the issue at hand.

Social Security represents a solemn commitment from one generation to another. Social Security is the major source of income for most of the elderly. About two-thirds of aged Social Security beneficiaries receive more than half of their income from Social Security. For about 20 percent, Social Security is the only source of income. Without Social Security, more than half of elderly women would be living in poverty.

Social Security provides more than just retirement benefits. Disabled workers and their dependents account for 15 percent of total benefits paid. Almost 30 percent of today's 20-year-olds will become disabled before reaching age 67, and in 2001 the insurance value of Social Security benefits for a young disabled worker with a spouse and two children is about $353,000.

Survivors of deceased workers account for another 15 percent of Social Security's total benefits. An estimated 97 percent of young children and their parents are ensured for survivor's benefits through Social Security. Social Security's survivors protection is equivalent to $403,000.

So a strong Social Security program is absolutely critical for seniors, for the disabled, and for survivors. We cannot compromise our commitment.

At the same time, we must all recognize that over the long term Social Security's finances need to be improved. As it now stands, the Social Security trustees estimate that the Social Security Trust Fund will become exhausted in the year 2041.

At that point, there would still be a lot of payroll tax money coming in each year, but the revenues would not be enough to pay full benefits. For example, in 2041 there would only be enough revenue coming in to pay about 73 percent of promised benefits.

So it is clear that we need to do something to shore up Social Security's finances. At this point, there are several alternative approaches.

One, is embodied in the work of the President's Commission. Specifically, the President has proposed to establish voluntary private personal savings accounts for workers. Some amount of the workers' payroll taxes would be diverted into the private accounts instead of going into the Social Security Trust Fund. This is usually referred to as partial privatization of Social Security.

The President set up a commission to flesh out his proposal, and the commission came up with three specific options. We are here today to discuss and evaluate those options in the hope that it will help us move the debate forward.

Having said that, I have very serious concerns about these options proposed by the Commission. With all due respect, both the President's proposal and the Commission's report take us down the wrong track.

Let me be more specific by addressing some of the details of the options that the President's Commission has proposed. For one thing, although these plans are advertised as voluntary, the retiree who chooses not to participate would nevertheless have his or her Social Security benefits cut deeply, a strange form of voluntaryism.

Second, for most of the workers who do choose to participate, their total retirement income, including money from their private accounts, would be significantly less than under current law, not more. The decline would be even worse if the stock market fell like it has over the past 3 years.

Third, the proposal would cut traditional Social Security benefits deeply for disabled individuals, even though their private accounts could not be accessed until they reached retirement age.

Fourth, all of the proposals would exhaust the Social Security Trust Fund earlier than under current law. For example, under Option 1, the trust funds would be exhausted by about 2033 rather than 2041, as under current law.

On a related point, the Commission prefers to use an alternative measure of the year that Social Security's finances reach a dangerous point. That is to say, it would be reached in 2017.

Yet, even using this measure, under all three of the Commission's options, Social Security would hit the danger spot earlier than under current law. For example, under the Commission's Option 2, this point would be reached in the year 2011.

And, finally, even with these flaws, all of the Commission's options would still require trillions of dollars of general revenues from the Treasury in order to work. However, the general fund of the Treasury is likely to be in deficit for a long time into the future, so it is completely unclear where this money will come from.

Putting all this together, I am concerned that the Commission's proposal for partial privatization would make the Social Security system worse, not better.

Others, obviously, may disagree. That is why we are holding this hearing, to see if we can get a better understanding of the Commission's proposals and the effect that they would have on the health of the Social Security system. We look forward to the testimony of our witnesses.

I will now turn to my colleague, Senator Grassley.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA

Senator GRASSLEY. Thank you, Mr. Chairman, for holding this hearing. It is very important any time we can have a discussion of Social Security, because there is so much ignorance about the future of Social Security. That is why I not only compliment you for this hearing, and hopefully many more hearings, and compliment President Bush for setting up the Commission.

But that is not surprising, because I also complimented President Clinton for leading a national discussion on the future of Social Security, which I think he did in about 1997, 1998, in that period of time, to have I think what was supposed to be a 2-year discussion of it.

President Clinton even led four town meetings on the issue himself, and he encouraged members of Congress to hold town meetings in our respective States. I had big turn-outs for those that I did. I may not have done that if it had not been for President Clinton making the suggestion and wanting to make a national debate and have education on Social Security. So, I am glad that President Bush proceeds forward with it.

It is probably not surprising that any suggestions of any commission is disliked, or there is fault found with the various suggestions. First of all, it is easy to find fault if there is a great deal of ignorance about the subject.

It is easy, in this political environment, to demagogue any suggestions about Social Security because it is really easy to scare senior citizens, more so than any other segment of the population. And, particularly, because women live longer than men, there are more women out there and there is a certain amount of insecurity among women about this issue that do not have partners and it is easy to really get them nervous.

I am appalled at the number of people that come up to me at my town meeting, and even if they consider me a friend, they would just say, "leave my Social Security alone." I kind of try to put them at ease by saying you do not have anything to worry about. At least, if you are 70 years old today you do not have anything to worry about.

But I try to let them know that they are in a powerful position in the political spectrum of America. I say, if you knew how power-

ful your voice was in Washington and how much members of Congress fear you, you would be laughing at us instead of really showing disgust towards us that we might do something about Social Security.

So it gives me an opportunity to say to those people, you do not have anything to worry about with your Social Security. But do you want your grandchildren to have Social Security? If Congress does not do something, that something is a big "something" out there that can be done, all sorts of different things that can be done, none of them very easy.

But if we do not do something, your grandchildren are not going to have Social Security, at least as you know it. As the Chairman said, 73 percent cash flow after another 20 or 30 years. Do you not want your grandchildren to have Social Security? That is what this debate is all about, is making sure that, 75 years down the road, or maybe even just 30 years down the road, everybody has got the same good thing that people have had since 1936.

I try to explain that if we do not do something, where, if you live 7 years beyond 65, if you are an average person, you are going to draw out everything that has been paid in for you and the interest on it. Then you have got everything kind of free after that point.

But for people who are 30 years old today, unless they are very low income people when they retire, they are not going to get out what they paid in. There are ways of doing it by increasing taxes, cutting benefits, doing some of both, or by the use the miracle of compound interest to make sure that it is out there so that Social Security people, in the year 2050, can have what Social Security people in the year 2002 have. But if we do not do anything, it is not going to happen.

That is how I kind of approach it to try to get people to think. But it is very difficult in an issue that can be demagogued so easily, to get people to think. That is why I think it is very important that President Clinton set this Commission up, President Bush continued the Commission or set up a new one, and get a debate out there.

I really hope that this becomes very much a part of the 2004 presidential debate. I think, until there is a clear mandate from an educated public on this issue, Congress is not going to do anything.

Now, there are some members of Congress, more apt to be members of the political party than my political party, but we probably even have some in our political party. But how often do I hear colleagues say, well, if we just do something to grow the economy, like 4 percent, it will take care of the problem. We will not have a problem. But how often has our economy grown, for a long period of time, at 4 percent? It has not done it since the 1960's. It grew at 1.5 percent through the late 1960's, 1970's, and early 1980's.

So there is not any easy answer. Somebody that is in a position like Senator Baucus is today, I have been, the people that succeed us, if we do not do something about this, somebody is going to have to bite the bullet. I want to encourage public discussion, at least to the biting of the bullet.

Thank you. I have a statement I want to put in the record.

[The prepared statement of Senator Grassley appears in the appendix.]

The CHAIRMAN. Thank you very much, Senator. I particularly thank you for the constructive tone of your comments. It is true, we have a very difficult problem down the road.

My personal view, is the Commission options are not the right answers. But that sort of begs the deeper question, what is the right answer, and that is something we are going to have to work on very closely on down the road. But thank you very much.

Senator Kyl, do you have a statement?

OPENING STATEMENT OF HON. JON KYL, A U.S. SENATOR FROM ARIZONA

Senator KYL. Thank you, Mr. Chairman. Just a brief comment.

First, let me associate myself with the comments of the distinguished Ranking Member of this committee. With all due respect, I do disagree somewhat with your characterization of the Commission's recommendations. That is part of the discussion we can have. Perhaps that is not a surprise.

The CHAIRMAN. Why did I expect that? [Laughter.]

Senator KYL. But, on a more serious note, I want to specially emphasize the point that Senator Grassley made about scaring our seniors.

The responsible thing to do is to have intelligent people with differing points of views get together and try to make recommendations for fixing a system that we all know will not provide the benefits that we have all promised. Something has to be done. We can disagree about the recommendations, but something has to be done.

The Commission has come out with some good ideas, and I think it is wrong to politically characterize those ideas in a way that is intended to scare our senior citizens. There is nothing more reprehensible, as far as I am concerned, than deliberately scaring our seniors who believe, wrongly, that somehow we are going to take their Social Security benefits away.

We all know that there is nothing that is going to adversely affect the benefits of those who are on Social Security today, or who are about to go on Social Security. The problem is trying to guarantee benefits to the younger citizenry.

I have in the file here, and I will be happy to put some of this in the record, and I will not refer to any names, advertisements that are currently running or that have been running in campaigns that, in my view, are reprehensible because they attempt to scare seniors and they are having the effect of scaring seniors.

They, in part, attempt to do that by mischaracterizing the recommendations of the Commission or mischaracterizing the kind of plan that is being put forth by those who recognize that something has to be done to increase the amount of money going into the plan who do not propose cutting benefits or raising taxes, either one, but who honestly believe, as I do, that there are ways, through compound interest, as Senator Grassley said, enhance the amount of money going into the Social Security fund so that the money will actually be there to keep the promises that we made.

One commercial has a member saying, "Social Security and Medicare are a promise that we have made to our seniors, and I am going to fight anybody who tries to break that promise." Do we

really think anybody is trying to break that promise? That is calculated to scare seniors and it is having that effect.

Another one says, X candidate "wants to take our Social Security and gamble it in the stock market," and that "he wants to turn our Social Security over to Wall Street bankers." These are the kind of things that have perhaps a role to play in a campaign, but we have a responsibility to correct those kinds of misperceptions. Instead, I fear that some of what is happening is to throw gasoline on that fire.

One other one says that certain person's plan is "giving our retirement to Wall Street and would leave seniors without protection from companies like Enron and Worldcom."

Well, nobody is proposing anything like that. But with that kind of political rhetoric, it seems to me we have an obligation not to fan the flames, but to douse them with a dose of reality, which is, very simply, if we do not do something, then we will not be able to keep our commitment to seniors. So those who propose doing something, I think should be patted on the back, not attacked for trying to injure or reduce the benefit of seniors.

I just think, Mr. Chairman, that if we are going to hold a hearing like the one that you have scheduled today, we need to have all sides represented and we need to ensure that the net result of it is to educate and to provide information rather than fanning the flames that I fear will happen in some cases.

The CHAIRMAN. Thank you very much, Senator. That is exactly the point of this hearing, is to discuss the President's options. We have panelists here, as you know, agreed to by the Ranking Member of the committee as to the composition, representing both sides.

It is an honest effort to try to find, what is the effect of the President's options. I cannot think of a better service to the American people than to find out how these options actually affect our people. Thank you very much.

Our first witness is Dr. Olivia Mitchell with the International Foundation of Employee Benefit Plans. She is a Professor of Insurance and Risk Management at the Wharton School of the University of Pennsylvania. She is a former Commissioner of the President's Commission to Strengthen Social Security, and she is from Philadelphia.

Dr. Mitchell, we are honored to have you here.

STATEMENT OF DR. OLIVIA S. MITCHELL, INTERNATIONAL FOUNDATION OF EMPLOYEE BENEFIT PLANS, PROFESSOR OF INSURANCE AND RISK MANAGEMENT, THE WHARTON SCHOOL OF THE UNIVERSITY OF PENNSYLVANIA AND FORMER COMMISSIONER, PRESIDENT'S COMMISSION TO STRENGTHEN SOCIAL SECURITY, PHILADELPHIA, PA

Dr. MITCHELL. Good morning. Thank you very much.

Chairman Baucus and other members of the committee, I thank you for this opportunity to address the Senate Committee on Finance. On behalf of the President's Committee to Strengthen Social Security, I would like to commend you for your attention to the challenges that face all of us.

My name is Olivia Mitchell. I am a professor of Risk Management and Insurance at the Wharton School at the University of

Pennsylvania. I served as co-chair for the panel appointed by the Clinton administration to propose reforms for Social Security. That was called the Social Security Advisory Council.

Most recently, I served as one of eight Democratic members of a 16-member bipartisan Commission to Strengthen Social Security, a group that reported out last December under the leadership of Senator Daniel Patrick Moynihan and co-chairman Richard Parsons.

I would like to begin by saying a few words about the Commission. When I was invited to join this group, I felt it essential that we embody the integrity and bipartisanship needed to strengthen Social Security. Our Commission, as you know, was charged with improving the long-term sustainability of the program without changing benefits for those near or in retirement, without raising payroll taxes, and while establishing new voluntary saving opportunities through personal accounts.

I am delighted that our Commission was able to satisfy these charges by presenting a range of three proposals that, in our view, enhance progressivity, reduce systemic risk, and allow freedom of choice in a way that this system has never before permitted.

Mr. Chairman, some might argue that one could reform Social Security without personal accounts. Indeed, Social Security financing might be temporarily enhanced without personal accounts simply by shifting mounting costs onto future generations.

But as an economist, I find this a fundamentally unsatisfactory approach, and I think it is not a politically viable one, either. Indeed, there probably is no perfect solution. Instead, meeting the challenges of Social Security via personal accounts seems to me, and seemed to the Commission, to be a preferable path to the less appealing alternatives.

In the end, however, the main reasons to create personal accounts are positive, not negative. One benefit of a properly designed Social Security personal account can be a permanently sustainable Social Security system, another can be higher benefits than the existing system can pay.

Yet, others are possibly greater national saving, greater individual control, inheritance rights, new protections for divorced and widowed women, and as co-Chairman Moynihan pointed out, the first opportunity for millions of Americans to accumulate wealth.

I would like to ask my assistant to show Figure 1. This is replicated in the testimony which you have before you. Figure 1 identifies the fiscal challenges facing the Social Security program. What this shows, the red line, is a cost rate under current schedule benefits, which is ever increasing, and the income rate that is the payroll tax revenue that is expected by Social Security, quite a bit lower.

This figure shows that system solvency is part of a much bigger problem. That is, you could, in theory, achieve solvency simply by raising the level of interest credited to the Social Security Trust Fund. This number is set fairly arbitrarily anyway, and you could do it with a stroke of the pen. Or you could do it by raising payroll taxes today, even if that money were used to finance expenditures, for example, additional tax cuts, finance a war, and so forth.

But this is the critical point. Such measures would do nothing to address the fundamental underlying problem of Social Security, which is that it maintains and embodies an unsustainable cost growth rate relative to the size of the economy. We cannot take credit for solving Social Security simply by shifting costs ever forward onto future taxpayers.

As my colleague former Congressman Tim Penny urged at one of our Commission hearings, we simply must get these lines to cross again. The system must return to at least cash flow balance, not only now but for the future as well. So, our Commission, accordingly, rated all of the proposals according to how much progress they make toward this goal.

In addition to the fiscal issues, the Commission looked very closely at the treatment of individual Americans under the current system and we found many reasons for concern.

One issue is, as Senator Grassley mentioned earlier, there is worsening treatment of young Americans going forward. A boy born, for example, in the year 2000, if he remained single all his life and earned an average income, could expect only a 0.86 percent annual real return from Social Security. A girl would anticipate a return of only 1.25 percent on her payroll taxes, and a dual-earner couple, 1.88 percent return.

Now, rates of return are not the only way to judge Social Security and its system's equity, but it is clear that plummeting rates of return threaten not only the program's efficacy, but also its support.

We also were very concerned that the system fails to redistribute income to those who need it most. For example, the system redistributes money from those with shorter lifetimes to those with longer lifetimes, from single individuals to traditional one-earner married couples. This works against system progressivity.

So what we proposed in our reforms was to enhance the safety net for vulnerable populations, particularly women and widows, and to make the system sustainable so that everyone would find the system less risky.

In the Commission report, we go through in great detail aspects of our reform proposals. I would like, today, just to focus on Model 2 in the interest of time.

When constructing Model 2, the Commission pointed out that the current wage indexed formula is inherently unsustainable within the demographics of our Nation. We concluded that the entire imbalance in Social Security could be accounted for by growth in initial benefits above and beyond inflation.

So Model 2 contains a provision that would gradually increase defined benefits for low-wage earners and surviving spouses, would also add benefits that many critics have neglected to mention.

Let me emphasize, this model—in fact, all three of our models—provide benefits above what today's retirees are receiving. There are no benefit cuts anywhere in this story.

This plan also provides individuals with an opportunity to invest 4 percent of their wages into personal accounts, with a cap of $1,000. The account would be set up so that participants would have a higher expected benefit than from traditional Social Secu-

rity, providing that the personal account accumulates at faster than a 2 percent real rate of return.

And if I could just have Figure 2 up. Figure 2 shows the extent to which the proposed Model 2 would enhance individual benefits if they opted for the personal accounts. During the discussion, we can get into particular comparisons.

The Commission also devoted substantial attention to plan design. In fact, we modeled our plan, our proposal along the lines of the Federal Government Employees Thrift Saving Plan.

I emphasize, the TSP is not a privatized system. It is, instead, an effective and safe means of saving and investing that benefits countless Federal employees.

In terms of financing, I will just conclude, the Commission took very seriously its charge.

The CHAIRMAN. Doctor, if you want to take a couple of more minutes, that is fine, if you have more to say.

Dr. MITCHELL. Thank you.

The Commission took very seriously its charge to enhance fiscal sustainability. If I could ask for Figure 3, please. We do not know exactly how many people would opt for the voluntary accounts under the different models we proposed.

This would depend on a national educational campaign. Structuring the personal account properly would ensure, however, that the accounts accelerate progress toward the system's permanent sustainability. The figure illustrates this can be done. The two lines cross.

In the handout, I show the scoring of the alternative plans. Figure 4 in my handout, which I do not have on a chart, illustrates that, in present value terms, Model 2 requires $0.9 trillion. In other words, it requires less than $1 trillion over the 75-year evaluation period, or about one-half of 1 percent of GDP in years where additional investments are required.

The Commission concluded that this amount was comparatively small and would not pose major economic or budget concerns, particularly compared to the alternative of doing nothing.

The Commission recommended a year of discussion on Social Security before legislative action is taken. I commend the Senate Finance Committee for furthering this discussion today.

We on the Commission are, accordingly, quite pleased that others have come up with constructive suggestions for shoring up Social Security. Throughout our deliberations, we met with interested individuals from both sides of the aisle and we repeatedly sought input from all quarters.

Some opponents of personal accounts testified before us and promised to send us specific plans that could be scored, like our plans were, by the Office of the Chief Actuary of Social Security. We, however, never received any such plans.

I would urge this committee, therefore, in fielding testimony on the Commission proposals or any others, to pose two questions for Social Security experts. First, what is your proposal for making Social Security permanently sustainable? Two, are you willing to subject your proposal to the Chief Actuary's Office for evaluation in the same way we did?

We at the Commission find no fault with those who may have other ideas on how to shore up Social Security, but in order to assess them proponents must put their plans forward for the same independent evaluation to which we subjected our reports.

I have been told that some critics of the Commission's work proposed taking personal accounts off the table as a condition for moving forward on Social Security reform.

But, Mr. Chairman, I am concerned that if personal accounts are off the table and if the Commission's ideas for sustaining the basic system are off the table, quite frankly, there is nothing left on the table.

The Commission's proposals, we believe, offer reforms that are——

The CHAIRMAN. Doctor, I am going to have to ask you to summarize, if you could, please.

Dr. MITCHELL. I will. I am finishing.

The CHAIRMAN. Thank you. Thank you.

Dr. MITCHELL. The Commission's proposals, we believe, offer reforms that are affordable, reduce risk, enhance progressivity, and offer workers the chance to build retirement wealth.

Finally, our plans do not touch benefits for anyone over the age of 55, and they propose raising expected benefits for future retirees.

Let me end by expressing my thanks for the opportunity to testify before this distinguished committee and to express hope that you and your advisors will expect and receive a set of proposals that can be scored by the neutral actuaries.

Thank you very much.

[The prepared statement of Dr. Mitchell appears in the appendix.]

The CHAIRMAN. Well, thank you very much, Dr. Mitchell.

One of the witnesses later to testify is Mr. Bixby. He is the executive director of the Concord Coalition, which many of us have heard a lot about. He describes in his testimony the Concord Coalition as "a nonpartisan, grassroots organization dedicated to strengthening the Nation's long-term economic prospects through sound and sustainable fiscal policy."

I am going to read you a couple of comments he makes in his prepared testimony, and I would just like your response, please.

Basically, he says that "the most basic question to ask of any reform plan is whether or not, if implemented, Social Security would still run out of money." He goes on to say that "none of the Commission's plans meet this standard. Ignoring new general revenue transfers, they all go bankrupt by the year 2030."

He says the same point another way: "The bottom line, however, is that the Commission's plans do not pay for themselves or put Social Security on a sustainable basis."

Your comments?

Dr. MITCHELL. I think it is important to understand the size of the problem we face. As the earlier graph indicated, if we do nothing the lines continue to move apart, we face an insolvent system in the long run.

The Office of the Actuaries, the neutral office, estimates that in current dollars the deficit is around $20 trillion, or in present value

dollars it is about $5 trillion. That is greater than the size of the national debt that the American people hold several times over.

We need to clearly bring the lines together. There have to be cost reductions or revenue increases one way or another, and no reasonable viewer of the problem would suggest otherwise.

Our approach saves the system money vis-a-vis the current hole that we face. Model 2 of the Commission proposes reducing revenue needs by about 45 or 50 percent, and Model 3 would reduce revenue needs by about one-third.

So, really, the question is, what is your benchmark? The benchmark is, we face a terrible problem. The sooner we start to act, the better.

The CHAIRMAN. The question is, where is all this general revenue transfer going to come from? As you know, we do not have near the surpluses, total budget surpluses, now that were projected a little over a year ago. A lot of it depends on the performance of the economy.

Right now, I suspect most people are not terribly sanguine, at least about the near-term performance of our Nation's economy, which implies that probably next year actual Federal revenues are going to be a little lower than anticipated, probably, in the near future.

So, how in the world are we going to solve the sustainability with requiring such massive transfers when we do not have the big surpluses that we once had that was always right there?

Dr. MITCHELL. The way to think about the problem, is the following. In order to fill the gap in Social Security, some funding will have to come from somewhere. It is a question of how much and when, but it is not a question of whether.

So the way we look at it, for example, in Model 2, the proposal would phase in the reforms over a period of time. That was necessary in order to completely hold harmless current retirees and near retirees, which we defined as anybody 55 years of age and older.

So the phase-in would begin, when we designed the program, in 2004. The surplus would be sufficient to finance the reform in the program until 2010. The reason that is important, is that would ensure that the Social Security surplus would actually be saved in personal accounts rather than be spent through other means as it has been in the past.

The new transition investment would be required over a period of roughly 2025 to 2054. In that span of time, who knows? The economy will probably be growing again. I have great faith in Congress and the economic system to re-find its feet. So, there will be a transitional investment period.

But let me remind you, this is investment. This is not simple expenditure. There is a pay-back that then follows thereafter. At the end of the 75-year period, there will be something on the order of $5 trillion of assets which will be the result of that investment period.

The CHAIRMAN. What do you say, though, to American citizens, say, roughly 55 and a little bit younger, for whom retirement is not too far down the road who will receive a reduction in benefits when they retire if they do not participate in the partial privatization?

What do you say to them? They are going to receive, under these plans, a reduction in benefits.

Dr. MITCHELL. I guess I would like to set the record straight. The Commission report, which I am sure you have seen—it is available on the web—makes it very clear. There are no benefit cuts vis-a-vis what today's retirees are receiving at all. So we should, as Mr. Kyl pointed out, make very clear to retirees that there are no benefit cuts.

The CHAIRMAN. But that assumes general revenue transfers. If there are no general revenue transfers, which is difficult at this point, there are still going to be cuts for those under 55 when they retire.

Dr. MITCHELL. The current system is one where scheduled benefits cannot be paid. If you would not mind putting up Figure 1 again. We know that as the system moves into the future, there will be insufficient money to pay scheduled benefits.

Benefits, as Mr. Kyl and Mr. Grassley said, will have to be reduced on the order of 30 percent, perhaps more, at the end of the period. So what we are trying to do is avoid those benefit cuts by structuring the system in such a way that there is investment up front, benefits will be at least as high if not higher—in fact, we expect them to be higher—for all retirees.

So people in retirement have nothing to worry about. People 55 and older have nothing to worry about. As this system phases in, benefits will be higher than what can be paid under current projected tax revenues.

The CHAIRMAN. I have one more question. How can benefits be higher for those under 55 to the degree to which other people investment in partial privatization? That is, take the 2 percent, 4 percent, or whatnot, leaving less money going into the trust fund?

How can they, with less money going into the trust fund, receive the same benefits as those who do not participate in the partial privatization?

Dr. MITCHELL. The way that we have structured the plan—and of course the Congress is free to imagine a different plan—was this would be phased in over a period of time. The benefits that will be received by future retirees will be price indexed.

In other words, they will never be at all below current benefit levels. They will be protected in real purchasing power terms. So, that is one piece of the answer.

Another thing to recognize is that our proposals actually enhance benefits for people in the low wage, low earner categories. We proposed improving the benefits for people who were lifetime, low-wage earners, making sure that they would be at least 20 percent above the poverty line.

I should emphasize, the current Social Security system has big holes in the safety net. There are people that can work their entire lifetimes and not even earn a poverty line benefit under Social Security. We consider that inadequate and something that should be fixed.

The CHAIRMAN. I appreciate your testimony. I just do not think the numbers add up the way that you are saying here.

Dr. MITCHELL. I should emphasize, all of our numbers were scored by the Chief Actuary.

The CHAIRMAN. I understand. I understand. But there are other assumptions which you are not stating.

Senator Grassley?

Senator GRASSLEY. The exchange we just had emphasizes what I said before, that we need years—well, not years. You cannot have too many years. But at least a long period of time—of public understanding of this. The questions that Senator Baucus asked would be questions I get, so that is why we need this National debate. I thank you for contributing to it.

The last question that Senator Baucus just asked, I as going to ask, so I will go to my second, and last, question to you.

That is, in your testimony you highlight the fact that the Commission adopted the goal of making Social Security "not only solvent, but permanently sustainable." I would like to have you explain what you mean by that and tell us why the Commission believed it was so important to adopt this goal. Also, are you aware of any other plan that meets the same rigorous standing of permanent sustainability set by the Commission.

Before you answer those two questions, that reminds me that we get criticism of commissions making recommendations. We get criticisms of a few members of Congress putting proposals in that have personal accounts. Everybody in Congress knows that, beyond the year 2015 or 2018, there is a negative cash flow. They know, beyond the year 2040, that it is going to pay 75 percent of benefits.

They know you cannot wait until you get down there to do something about it. Yet, nobody is proposing tax increases. Nobody is proposing benefit cuts, or a combination thereof. We should not be bad-mouthing ideas that are on the table. We can disagree with them, but we ought to invite as many proposals on the table. It is about time that everybody gets proposals on the table.

I would like to have you answer my two questions.

Dr. MITCHELL. Yes, sir.

First of all, I am not aware of any other plans that take the same critical benchmarks that we have proposed and laid out and scores them accordingly. We would strongly encourage everyone to do that.

Going back to the more general question, when the Commission started looking at the various options before it, it is very clear that there are quick fixes that will not solve the problem in the long term. In other words, one proposal might be, let us raise taxes today and then we can make the lines cross by simply raising taxes.

The problem with such a proposal is that there is no guarantee that the money would actually be saved in the trust fund. It was our belief that that money would have to be taken off the table and put in the individual accounts in order to ensure that the money would be there for retirement.

But the broader issue is one of fiscal sustainability. Some people have proposed fixes that make the system look sustainable over the 75-year actuarial window. I would add parenthetically, this is the window that the actuaries have been encouraged to use over time. That may look good today, but as time rolls forward and one more bad year replaces a good year, then what you have is the system would again fall into actuarial imbalance. This is what has hap-

pened in the past, that a temporary fix does not really make the system live within its means in the long run.

So it was our intention to go back to Franklin Delano Roosevelt's model, that the system ought to be living within its payroll tax revenue structure. It was Roosevelt's view that this would be the best way to protect the system for the long run, so this is what we attempted to do to make the two lines cross that it was cash flow solvent and to make the system sustainable in the long run on its own feet.

Senator GRASSLEY. Well, I am glad to hear that. I am glad to know that there is a forerunning to what you said, Franklin Delano Roosevelt. It seems to me that, 65 years later, we ought to have 100 percent support in Congress for what President Franklin Delano Roosevelt said.

I am done, thank you.

The CHAIRMAN. Senator Kyl?

Senator KYL. Thank you. I want to thank you, Dr. Mitchell, for your testimony and for the constructive suggestions that the Commission has made. As you say, somebody has to come up with an idea. I think your ideas merit a great deal of attention and offer the fundamental basis for permanent reform.

Let us get to the question that the Chairman asked, because I think it represents a fundamental point of divergence here in the debate. The Chairman said, "How are we going to afford massive transfers from the general fund? The dollars are not there."

Could you inform the committee what the source of repayment to the Social Security Trust Fund is?

Dr. MITCHELL. The way we structured the reform proposals, we would be able to finance the personal accounts and continued benefits for retirees through the surplus up through 2010, basically. At that point, the trust fund itself would be drawn down, just as it would be if you did not do anything, in order to meet benefit payments.

As I said earlier, a transition investment would be required. It was the Commission's judgment that this would be less than half a percent of GDP in those years when it was required in order to finance the continuation of benefits, and then the payback would occur after that.

Now, where would the revenue come from? Well, the revenue would come from wherever Congress deems that it would have to come from anyway. It is just that we would only require either half or a third of what we would need anyway. It could come from income taxes, it could come from raising debt, it could come from reducing other expenditures that Congress is currently committed to. That is a Congressional decision. That was not the Commission's decision.

Senator KYL. Congress and past administrations have spent the excess money in the Social Security Trust Fund, or used it to pay down debt. If the Social Security Trust Fund is ever going to be made whole, therefore, the American people will have to do so through some funding through the general fund. Is that not true?

Dr. MITCHELL. You are absolutely correct. In the past, every time the surplus has gotten positive the other government expenditures

have increased or various other means have been taken in order to actually make sure that the funds are spent.

It is our focus, and it was our hope, that in order to preserve the money the most effective way would be to convert them into personal accounts so that they would be, essentially, off the books of the government and in individuals' hands.

Senator KYL. So it is a bit of a misconception to suggest that we cannot use the general fund for the purpose of stabilizing Social Security, when in fact that is where the revenue would have to come from to repay the trust fund in any event.

Dr. MITCHELL. That is absolutely true. If we were going to keep the current system, at some point, if benefits would be maintained as scheduled, revenue would have to be come up with from some other source. It was not our Commission's, I think, prerogative or responsibility to say where it would come from.

Senator KYL. No.

Dr. MITCHELL. It was our job to identify what it would cost, and how much less it would cost under our proposal.

Senator KYL. Exactly. One of the, I think, misconceptions, at least early on when the Commission's report came out, was that somehow it represented some kind of a rubber stamping of a specific proposal of the Bush administration. If that is correct, confirm it. If it is not correct, would you tell us what the situation really was?

And, by the way, am I correct that this was a bipartisan Commission? I do not mean to put you on the spot, but if you would like to identify your political affiliation, maybe that would be useful as well.

Dr. MITCHELL. Absolutely. I am a registered Democrat. When I was asked to join the Commission, I remember talking to the executive director and saying, well, I would be happy to help. I think this is the most important domestic issue we can work on. But do you know I am a Democrat? He said, oh, we know everything about you.

The CHAIRMAN. That is not very encouraging. [Laughter.]

Dr. MITCHELL. But absolutely. It was a bipartisan Commission. I do not want to say which ideas came from where because it really was a group working as a whole. But one of the things that I think the Democrats contributed to it, was this very progressive flavor.

On the other hand, there were a number of Republicans who stood very firm and said, if we can bring people out of poverty, if we were to implement the system today we could bring 800,000 people out of poverty among the elderly population—this is a number that was generated by the Office of the Actuary, this seems to me to be a very progressive, sensible thing to do. If you can do that while strengthening the system and building personal accounts and raising benefits, it seems to me to be the right path.

Senator KYL. Now, if we have a second round, I would like to get more into that issue. Since so much of this debate ends up being in little sound bites, frequently by people that are not experts, Dr. Mitchell, let me just ask you, yes or no, if you can answer the following questions. Would the Commission's proposals cut benefits for anyone today?

Dr. MITCHELL. No, sir.

Senator KYL. Would they raise the retirement age?
Dr. MITCHELL. No, sir.
Senator KYL. Would they raise the payroll tax?
Dr. MITCHELL. No, sir.
Senator KYL. Would they cut the COLA?
Dr. MITCHELL. No, sir.
Senator KYL. Would they result in benefits that are lower in the future than they are today?
Dr. MITCHELL. No, sir.
Senator KYL. And, in your opinion, would they lead to insolvency?
Dr. MITCHELL. No, sir.
Senator KYL. I think that those answers demonstrate that the plan that has been put forward is a responsible, constructive proposal that does not have a lot of the negative down sides that have been attributed to it.

We can debate about what positive proposals can be put forth, but I agree with you that those who criticize your plan need to, in effect, put their money where their mouth is, to submit their plans to the same rigorous analysis that you submitted your plans to, and then we can have a valid basis for comparison.

Again, I thank you for your testimony. If we can have a second round, I do want to get into that second point that you raised about the benefits to certain groups of people that are going to suffer under the program that exists today.

The CHAIRMAN. Thank you very much, Senator. Thank you, Dr. Mitchell, very much.
Dr. MITCHELL. Thank you.
Senator KYL. Mr. Chairman, are we going to have a second round?
The CHAIRMAN. I had not planned on one.
Senator KYL. I respect the Chairman's need to move the hearing on. Might I then just——
The CHAIRMAN. I say that because we have got a vote coming up at 11:30, and we have a lot of witnesses.
Senator KYL. We do have a vote at 11:30. You are right.
The CHAIRMAN. Yes.
Senator KYL. Perhaps we could submit a couple of questions for the record.
The CHAIRMAN. Certainly. Absolutely.
Senator KYL. I will do that then at this point. Thank you.
The CHAIRMAN. Thank you very much.
Senator KYL. Thank you, Dr. Mitchell.
The CHAIRMAN. Thank you, Dr. Mitchell.
Dr. MITCHELL. Thank you.
[The questions appear in the appendix.]
The CHAIRMAN. Our next panel consist of Mr. Peter Orszag, who is a Senior Fellow at the Brookings Institute; Mr. Andrew Biggs, Social Security analyst for the CATO Institute; and Dr. Robert Greenstein, executive director for the Center on Budget and Policy Priorities here in Washington, DC.
Dr. Orszag?

STATEMENT OF DR. PETER R. ORSZAG, JOSEPH A. PECHMAN SENIOR FELLOW, BROOKINGS INSTITUTE, WASHINGTON, DC

Dr. ORSZAG. Thank you, Mr. Chairman.

In my brief oral statement, I would like to just touch upon three aspects of the Commission's plans that may provide insight into how they operate.

Let us take Model 2, as the earlier witness had discussed. The first component of Model 2 is a set of changes to the benefit structure under Social Security that would result in a dramatic reduction over time in the replacement rate from Social Security. That is, the percentage of previous wages that are replaced by Social Security traditional benefits in retirement.

Under current law, average earners in 2025 and thereafter would get back in Social Security benefits about 37 percent of their previous wages. Under Model 2, that traditional component of Social Security would wither on the vine. It would fall over time, reaching about 22 percent by the end of the 75-year projection period.

In addition, those benefit changes would apply to the disabled. Now, I want to talk about the disabled for a moment. The Commission, near the end of its report, noted that it did not intend these benefit adjustments to apply to the disabled.

But, in scoring the proposals and evaluating their financial effects, the assumption was that those changes would apply in full to the disabled. Every single penny of those reductions were counted in making those lines cross and in making the numbers add up.

In addition, it is very important to remember that all of the improvement in actuarial solvency under Model 2 comes from these benefit changes. The individual accounts do not contribute to actuarial solvency under Model 2. All of the improvement comes from these benefit changes.

Without the individual accounts, Model 2 is permanently solvent and the system is playing a much smaller role in replacing previous wages for retirees. So, that is the first component of Model 2.

The second component is a set of voluntary individual accounts that are carved out of that scaled-back Social Security system. Now, the unusual thing here is that those accounts are subsidized.

What do I mean by subsidized? When a dollar is diverted into the individual account, a liability is simultaneously created. So you take a dollar of your payroll revenue, divert it into your individual account. At the same time, the trust fund will say you owe me a dollar back.

That dollar that you owe back grows at an interest rate, and then is paid back when you retire through further reductions in your traditional Social Security benefits above and beyond the ones I already described.

The key thing is, under Model 2, the interest rate at which that liability accrues is 2 percent after inflation. The trust fund, however, earns 3 percent after inflation. What that means, is that a dollar that is diverted into an individual account is effectively earning 2 percent for the trust fund, and if it had not been diverted it would be earning 3 percent. That means that the accounts are subsidized.

What that means, is even over the entire lifetime of a worker, on a permanent basis, the individual accounts make Social Security solvency worse. You can see the combination of that subsidy and the normal cash flow problem that we associate with the transition to individual accounts in the actuarial effects of Model 2.

After the traditional benefit changes, Model 2 has a positive actuarial balance. The introduction of individual accounts without the general revenues yet, just the introduction of the individual accounts, causes a deterioration in that actuarial balance and you wind up with a deficit that is over 1 percent of payroll, after the traditional benefit changes, but with the individual accounts. One percent of payroll is more than half of the actuarial imbalance that exists without any changes.

So to fill that hole, the third component of the plan is a set of general revenue transfers that, if all workers participated in the accounts, would amount to $2.2 trillion in present value. That is two-thirds of the amount that is required under the fiscally reckless course of just paying scheduled benefits out of the rest of the budget, which no one is suggesting should be done.

In my opinion, a reduction required revenue of one-third, is not good enough. It is a huge magic asterisk in the plan where you just assume that money is given from the rest of the budget to Social Security, more than $2 trillion.

And if the disabled were protected from the cuts that I talked about in the first component, that number, instead of being $2.2 trillion, would be $2.8 trillion in present value.

Now, the earlier witness, and also Mr. Biggs' written testimony, talks about a $0.9 trillion number. Why did I say $2.2 trillion? The short answer is, the $0.9 trillion is the increase off of the scheduled benefit baseline that would be required in some years. It is not the aggregate level of general revenue transfers that would be required under Model 2.

I talk about that in some more detail on some comments of Mr. Biggs' testimony that I wrote up last night.

In sum, I have quotations in my written testimony from the executive director of the Commission saying a key question with regard to general revenue transfers is, how are you going to pay for them? The money has to come from somewhere.

The fact of the matter is, the Commission did not identify where these trillions of dollars would come from. That is the mother of magic asterisks. It is very easy to make a plan add up if you can just assume trillions of dollars from the rest of the budget without identifying where that money comes from.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you, Dr. Orszag.

[The prepared statement of Dr. Orszag appears in the appendix.]

The CHAIRMAN. Dr. Biggs?

STATEMENT OF DR. ANDREW BIGGS, SOCIAL SECURITY ANALYST, THE CATO INSTITUTE, WASHINGTON, DC

Dr. BIGGS. Mr. Chairman and members of the committee, thank you for inviting me to offer testimony regarding the reform proposals of the President's Commission to Strengthen Social Security.

My name is Andrew Biggs and I am a Social Security analyst at The CATO Institute here in Washington. During 2001, I was a staff member to the President's Commission. While I am supportive of the Commission's goals and recommendations, the opinions expressed today are my own.

My oral testimony will concentrate on important objections to the Commission's proposal made in a recent study co-authored by Peter Orszag of Brookings and Peter Diamond of MIT.

In particular, I wish to address the much-publicized charges of benefit cuts in the Commission's Model 2, the second of the three Commission reform proposals and the one that has generated the greatest public debate.

A press release summarizing the Diamond-Orszag study stated that the Commission's proposals "would substantially reduce benefits for future retirees and the disabled, while requiring multi-trillion dollar transfers from the rest of the budget to finance private retirement accounts." The press release flatly states that benefits will be reduced 41 percent for those who retire in 2066.

The essential problem with Diamond-Orszag's charges of benefit cuts is, simply put, they use the wrong definition of benefits and the wrong definition of cuts.

Under their definition, benefits paid by personal accounts are not counted, while cuts are measured versus what the current system promises, not what it can actually afford to pay.

The charts included in the back of my testimony illustrate. Chart 1 compares the annual retirement benefits promised to a low-wage worker by the current program to the traditional benefit paid by the government under the Commission's Model 2.

Model 2 would pay a low-wage worker retiring in 2075 a traditional benefit 35 percent less than he is promised by the current program. This is the basis of charges of large benefit cuts.

The problem with Chart 1, is it compares what the Commission proposal would pay to the benefits the current program only promises, but cannot pay.

In testimony to the House Budget Committee, GAO Director David Walker said that such comparisons are "unfair, unbalanced, and, in my opinion, inappropriate." I should note here in my oral testimony, as I do in my written testimony, that David Walker's comments applied only to the baseline to this comparison of benefits and not to the Diamond-Orszag study as a whole.

Former Senators Bob Kerrey and Warren Rudman recently characterized such benefit comparisons as a shell game, while the Congressional Research Service wrote that they "can be misleading."

Chart 2 corrects for this problem and compares the traditional benefits paid under Commission Model 2 to the benefits the current program can actually pay. In most years, Model 2 would increase benefits to a low-wage retiree. But even this comparison does not tell the whole story, since Chart 2 omits the benefits that will be paid by the personal account.

Chart 3 compares the total retirement benefits a low-wage worker could expect under Commission Model 2 to those the current program could afford to pay. In almost all cases, Model 2 would pay large benefit increases. A low-wage worker retiring in 2052, for in-

stance, can expect total retirement benefits of 40 percent higher under Model 2 than under the current system.

In fact, a new analysis by Social Security's independent actuaries released yesterday shows that, even if the current program received the same general revenue transfers contained in Model 2, low-wage workers retiring in 2075 could expect benefits 30 percent higher under the Commission than under the current program. Dollar-for-dollar, the Commission proposal pays higher benefits than the current system.

In sum, the Commission plans cut benefits only compared to a Social Security program that, quite literally, does not exist. But these comparisons are, to repeat David Walker's words, "unfair, unbalanced, and inappropriate."

Compared to the Social Security that does exist, that must by law cut benefits by 25 percent when the trust fund is exhausted in 2041, Commission proposals substantially raise benefits and low-wage workers receive the largest increases.

I do not except these comparisons to convince die-hard critics of personal retirement accounts. In that case, personal account critics should put forward their own proposals so that true apples-to-apples comparisons can be made. To date, almost none of them have been willing to put their own plans on the table.

I submit to you that, for all their charges of decreased benefits and increased costs in the Commission's plans, reform proposals lacking private investment would pay even lower benefits at even higher costs. The silence from the other side of the debate is, understandably, deafening.

The best way to defeat the Commission's proposals is to put forward a better one. It is telling that most personal account opponents appear reluctant in the extreme to do so.

Once viable alternatives to account-based plans are put forward, the political and legislative processes can produce choices and compromises between these outlooks and progress towards strengthening Social Security can be made.

Thank you for the opportunity to testify. I hope that my views may be helpful to you in your consideration of Social Security.

The CHAIRMAN. Thank you very much, Dr. Biggs.

[The prepared statement of Dr. Biggs appears in the appendix.]

The CHAIRMAN. Mr. Greenstein?

STATEMENT OF ROBERT GREENSTEIN, EXECUTIVE DIRECTOR, CENTER ON BUDGET AND POLICY PRIORITIES, WASHINGTON, DC

Mr. GREENSTEIN. Thank you, Mr. Chairman.

I am not going to respond to the comments Dr. Biggs just made in his testimony, but I do want to underscore a point Dr. Orszag made, that in various respects it does misrepresent the Diamond-Orszag study. Dr. Orszag, I think, has submitted for the record a clarification of all of the places where that is the case.

Mr. Chairman, my testimony today is going to center on issues relating to the financing of the Commission plans and their relationship to the rest of the budget. Two of the three Commission plans succeed in restoring Social Security solvency.

The question is, how do they do that? It is not because of the individual accounts. As the Commission report itself acknowledges, the private accounts by themselves would worsen Social Security's balance over the next 75 years and would worsen Social Security's financial condition on a permanent basis, not just during a transition period.

The private accounts would have that affect because, under the Commission plans, they would be subsidized with revenue from the Social Security trust funds, and those subsidies would be a permanent part of the new financing structure.

Social Security trust funds would lose more in revenue due to the private accounts than they would gain as a result of the reductions in traditional Social Security benefits that would be tied to participate in the accounts

The result would be a permanent worsening of the trust funds' condition. How then do the Commission plans manage to restore solvency? The answer is, they are able to do so only through massive infusions of general revenue from the rest of the budget.

In the absence of those general revenue infusions, the actuaries' analyses show that the plans would actually hasten the date of insolvency in Social Security.

How big are the general revenue transfers? As the Diamond-Orszag demonstrates, under Model 2 the general revenue transfers that would be needed would be two-thirds as large as the entire Social Security shortfall over the next 75 years, and under Model 3, three-fifths as large as the entire shortfall.

Transfers of that nature can only be described as massive, a term that I note is also used in Mr. Bixby's testimony.

Moreover, those figures may understate the magnitude of the transfers because of how they deal with disabled beneficiaries. These figures assume that deep cuts in traditional Social Security benefits that are part of Models 2 and 3 would be visited upon disabled Social Security beneficiaries, yet those who become disabled at a relatively young age and are out of the workforce would have little opportunity to build income from private accounts to offset these substantial reductions in the traditional Social Security benefits.

Now, the assumption that these benefit changes would apply to the disabled is made by the Commission itself in its report when it describes the financing of its plans, and it is made by the actuaries when they estimated the solvency of the Commission plans. Without these reductions in disability benefits, which are very large, the plans do not succeed in restoring solvency.

The Commission treatment of this issue in its report is curious. It counts the savings from these large reductions in disability benefits to make its numbers add up, yet until two pages from the end of its 150-page report the Commission is silent about this issue and never mentions, until page 149, that its proposed reductions in traditional Social Security benefits would apply in full to disability benefits unless a change in its plans is made.

At that point, two pages from the end of the report, the Commission acknowledges this would cause hardship to the disabled and disavows the application of these reductions to disability benefits,

and asserts that it is not proposing that those reductions apply to disability insurance.

So the Commission has it both ways. Either it is proposing that the benefit reductions do apply to the disabled, in which case it can count those savings, but serious hardship ensues to disabled people, or it is not proposing that the benefit reductions apply to the disabled, in which case the relevant savings cannot be counted and solvency is not restored.

Instead, the Commission claims that it is not recommending these benefit cuts be applied to the disabled, while at the same time counting the savings that would result from doing exactly that.

Now, the most critical question is, and you asked this to Dr. Mitchell, where would the money for these large transfers come from? There are no surpluses left outside of Social Security over the next 10 years. There are no surpluses outside of Social Security in the long term, as the long-term CBO and GAO projections show.

So there is no money available for these very big transfers, other than through major budget cuts elsewhere in the budget, major tax increases, or substantial deficit financing.

Where the money for these transfers would come from is very unclear. Policymakers would face three choices in finding the trillions of dollars needed: deep cuts in the rest of the budget, large tax increases, larger deficits in future decades.

The Commission report does not address those questions. It simply assumes that large general revenue transfers would be made, without providing any indication of where the money would come from.

As Dr. Orszag has noted, if the Commission plan were enacted those transfers would represent a magic asterisk of historic importance.

Mr. Chairman, as you know, at our center we do a lot of analysis of the budget. We looked at what it would take to come up with the amount that would be needed that is assumed for the transfers under Plan 2. For technical reasons I will not take the time to go into now, this is a conservative estimate that understates what you would need over the next several decades.

The amount that you would have to get for these transfers is the equivalent of what you would save if you either, A) eliminated all entitlement and discretionary veterans programs, veterans hospitals, veterans health, veterans disability compensation, veterans pensions, or B) you eliminated military retirement and disability benefits, all farm price supports, or C) you cut all transportation, agricultural, natural park, and environmental programs by 50 percent. That is the magnitude of what you have to do to come up with the amounts of the general revenue transfers.

So let me close with a plea. I would hope that policymakers of both parties, whether they do or do not favor partial conversion of Social Security to private accounts, would adopt the basic principle from here on.

If general revenue transfers are to be part of proposals to restore long-term solvency to Social Security and the non-Social Security is still projected to be in deficit so there is no money there to transfer, then the transfers should be paid for.

Henceforth, Social Security plans should not simply assume transfers without financing them. They should specify where the money would be gotten and how it would be achieved to make these transfers.

The final point I would make, is there is one other real risk, I think, to the rest of the budget here. Imagine what would happen if the Commission plans were in effect already. Say they took effect two or 3 years ago, and the stock market plunged, as it has in recent months, wiping out a significant share of the assets in personal accounts that the public had been told were a basic part of the Social Security system and an alternative to the old, traditional Social Security benefits.

I think the risks are high, that the political pressure is on Congress to take some action to fill in the gaps and make up for those losses in the private accounts, particularly in an election years, would be tremendous. That would represent yet another risk to the rest of the budget. Thank you.

The CHAIRMAN. Thank you, Mr. Greenstein. That is a very thoughtful statement.

[The prepared statement of Mr. Greenstein appears in the appendix.]

The CHAIRMAN. Is it true that the proposals would still require massive transfers, as you have mentioned, but that if nothing is done there would be also massive transfers required, and probably even greater than would be the case under these three proposals?

If that is true, and I think it is true, is it also true that the reason why, under the proposals, the massive transfer might be a little less massive, because of benefit cuts or other changes made—and you can identify what they are—that allow us those massive transfers to be a little bit massive? I will ask, first, Mr. Greenstein that question.

Mr. GREENSTEIN. I do not think anyone responsible favors sitting around doing nothing until the trust fund runs out of money.

The CHAIRMAN. I agree. I agree.

Mr. GREENSTEIN. Of course, under that scenario, if you wanted to maintain the current level of promised benefits, you would need even bigger transfers.

What I think is very disturbing is a practice on the part of some who favor the Commission plans to simply act as thought that level of transfers, which heretofore most responsible analysts, whether they are for or against partial privatization, have condemned as being an irresponsible course of action, doing nothing, assuming we will fill the whole thing with transfers. I testified against that before this committee in 1998 when we had big budget surpluses projected.

To somehow make that a new baseline and say, no matter how big the transfers, if they are smaller than what you would do if you did the irresponsible "do nothing" and let everything run, that somehow we have saved money, I mean, particularly given the choices Congress has made in recent years and the other changes in the budgetary situation over a variety of factors, economic, technical, and so forth where there are no surpluses left outside Social Security, as I said, I just think talking about any kind of transfers. It can be——

The CHAIRMAN. That is my question. If you would answer my question, please. My question is, why, under the three options, is it less?

Mr. GREENSTEIN. Why is it less? Well, the principal reason is the substantial reductions in the traditional Social Security benefits under Plans 2 and 3. I mean, if you switch from wage indexing to price indexing, over time that is a very, very large reduction compared to the scheduled benefits in what would be paid out. So, that takes a significant amount of pressure.

The CHAIRMAN. If I could have Dr. Orszag also address the same question.

Dr. ORSZAG. Yes. If I could just add, the general revenue transfers here are required only because of the individual account component under Model 2. So, in the absence of the individual account component, there are no general revenue transfers that would be required under Model 2. The system would be in actuarial balance.

So the size of the transfers reflects the size of the diversion of revenue into the individual accounts, and then the backfill that is required from the general revenue in order to make up the difference to the trust fund. That is one point.

The other thing I just want to emphasize, is a lot of the comparisons that are made here shuck and jive, use different baselines without telling you what they are doing. So, let me just be very clear.

Almost all of the comparisons that the Commission puts forward will compare the financing side to scheduled benefits and say, oh, look, we are saving money relative to that hugely expensive system. Then on the benefit side, they will compare to payable benefits, which are much lower. They will not really tell you when they are doing which comparison.

Under payable benefits, there are no general revenue transfers, which means that Model 2 is much more expensive. Under scheduled benefits, yes, you save a little bit on the general revenue transfers, but you also have benefit reductions relative to that baseline. It is very important to do all of the comparisons against a consistent baseline. There are many instances in the Commission report in which that is not the case.

The CHAIRMAN. Could you also address this question about, sort of having your cake and eating it too, with respect to disability benefits? I mean, is that accurate? It sounds like, on the one hand, yes, there are cuts. On the other hand, there are not cuts. Is that a fair characterization?

Dr. ORSZAG. My read of the Commission report is that they do not advocate those as a policy measure. But in all of the numbers, those are counted. Those account for about 15 percent or so of the savings that are generated by moving to price indexing. If you wanted to hold the disabled harmless, you would need that extra money, about a half a trillion dollars, in order to hold them harmless.

I would just note, the disabled will not have access to their individual accounts. So the Commission often likes to talk about, oh, you have to add the individual account income in. The disabled will not have individual accounts because, in many cases, they will not have much time to have built up an individual account.

But, even if you had a disabled worker who had somehow built up a big balance, the Commission would prevent that worker from drawing on the individual account before retirement anyway. So for disabled workers, all that is happening is the reduction in traditional benefits relative to those that are scheduled under current law.

The CHAIRMAN. Dr. Biggs, do you agree that the Commission's report does not advocate cutting disability benefits, but in their conclusions they take disability cuts into consideration? That is, to make the numbers work, disability benefits are cut?

Dr. BIGGS. I would submit to you that I do not think there would have been a superior way for them to handle the issue.

The CHAIRMAN. I am not asking that question. I am just asking, do you agree that, although they did not advocate disability cuts, to make the numbers work the disability benefits are indeed cut? That is the only question I am asking.

Dr. BIGGS. Clearly, the Commission did not advocate applying the changes to the benefit formula that they advocate for retirement to the disabled. They specifically say they do not do that.

The question is, how do you score something along those lines? I would refer back to a Social Security reform panel appointed by the Senate Finance Committee in the 1970's that included Peter Diamond, who is Peter's co-author.

In that panel, which advocated price indexing for many of the same reasons that the Commission did, they said the same thing the Commission does: we will leave the treatment of the disabled to another commission of experts on disability. When they scored the savings from their plan, they did precisely the same thing that the Commission did. They looked at the system as a whole and they did not make any assumptions about how disability will be treated.

I think that is the right thing to do. If the Commission had said, as I think Peter would advocate, we need to throw in extra general revenue in order to make no changes in the disability program, that would have been taken as an implicit recommendation of policy, that is what we should do.

The CHAIRMAN. All I am saying is, first of all, two wrongs do not make a right. I am just asking the basic question, do you think the numbers add up, are disability benefits cut? I think the answer is yes.

Dr. BIGGS. I would disagree that they do it to make the numbers add up.

The CHAIRMAN. But, still, to reach the conclusions and the numbers, the totals, that is what they have done. I do not want to get in a huge debate here on the finer points, but there are two witnesses who do, frankly, say positively that, to make the numbers add up, they have to assume disability benefit cuts.

Dr. BIGGS. If you were to assume different changes or different benefits paid to disabled individuals, if you were to assume higher benefits than benefits scheduled under current law, the general revenue needs for Plan 2 would, indeed, be higher. That is correct.

The question is, should the Commission have treated the issue in a different way? I would submit to you, they should not have.

I would submit to you that other people have treated it in a similar way.

Dr. ORSZAG. Can I make a quick comment?

The CHAIRMAN. Very quick. Time is running out.

Dr. ORSZAG. Just very quickly.

The CHAIRMAN. Time is out.

Dr. ORSZAG. I do not agree that that is the only way to handle the problem. In other situations, whether it is a Medicare prescription drug, or a contingency fund for military affairs, you set aside money without defining precisely what you are going to do in that area in order to sort of make some provisions for dealing with a problem that you know is there.

Just with very brief reference with regard to the panel on which Professor Diamond served, I would just note, disability costs at that point were much lower than they are today. The huge run-up that we have seen in DI beneficiaries had not occurred. Professor Diamond recognizes that that was an oversight, but it was the less important one at the time.

Mr. GREENSTEIN. Could I just very quickly say, there are two incontrovertible facts that I think you have just established in the question and answers. Are the savings from applying those benefit reductions to disability benefits included in the figures in the report when they do their numbers? The answer is yes. Do the numbers achieve actuarial balance if you do not count those savings? The answer is no.

The third point is, if you wanted to take the, at best, questionable step that Dr. Biggs defended, count the savings, but say you are not for taking the action that produces the savings, you would think that the Commission would at least have been up front about it and said something about it before page 149 in a 151-page report.

The CHAIRMAN. Well, I have gone way over my time.

Senator Kyl?

Senator KYL. Mr. Chairman, it seems to me that when you asked for a yes or no answer on that, it is a little bit like the lawyer asking the question, have you stopped beating your wife. What you really want to say is, but I never did.

I think the point here that has been confirmed, is there was not a recommendation on how to deal with disability. If you say yes or no, you are going to get a different answer, and a wrong answer, than if you give an opportunity for an explanation, which is that the issue was deferred.

But I want to get back to one of the questions that I asked Dr. Mitchell having to do with the personal accounts. If you accept the proposition that somehow you have to enhance revenue to the program, which is an obvious premise given the fact that revenue does not meet the requirements for payment of benefits, then it seems to me that you have got to somehow begin putting savings into Social Security.

There are three ways to do that. You can do it through the personal accounts, through a collective investment of the Social Security trust fund as some have proposed, or in some way trying to advance funds through the existing trust fund investment structure.

I would like to ask Dr. Biggs this question. Why do you think that it is better to accomplish this through personal accounts as opposed to either the collective investment or relying on the government to save the money through the current structure?

Dr. BIGGS. At the economic level, you could pre-fund Social Security equally in all of the three ways. Each way would, in theory, add to national saving which would increase productivity in the future and make it easier for future workers to support the larger populations of retirees.

The question is, which is the best method by which to do so? The current trust fund structure, which is largely set up in the reforms of 1983, of deliberately running surpluses in order to build up assets in the fund, many people on both sides of the personal accounts debate agree that that has not effectively pre-funded Social Security for the future.

The GAO even did a study back in the late 1990's. They essentially said, we would have to be kidding ourselves to say we are doing extra savings this way. We are essentially producing the payroll tax surpluses which are disguising deficits elsewhere in the budget. That, I would submit to you, is exactly the same situation we have today.

Senator KYL. There is no lock box.

Dr. BIGGS. That is correct.

Now, certainly you could advocate having the government centrally invest money in the stock market in order go build up private assets. That was a plan advocate by the Clinton administration at various times, and various members of Congress have advocated it as well.

This has been quite a bone of contention. The standard argument which has been pushed very hard by Federal Reserve Chairman Alan Greenspan is that, inevitably, over time the protections against political manipulation would break down, so you would have some incentive to politicize it.

So, personal accounts are seen as another option, a way to build up savings today in order to pay benefits tomorrow, but do it in a way that cannot be raided by the government on one hand to pay for current programs, and it cannot be politicized on the other hand like centralized government investment would. So, personal accounts at the economic level are seen as the most effective way of pre-funding future benefits.

Senator KYL. Now, by “personal accounts,” are you talking about, every day, having my mother go down and buy a stock or sell a stock?

Dr. BIGGS. Not at all.

Senator KYL. I think that is a misconception here. Would you describe what you mean by personal accounts?

Dr. BIGGS. The plans, as laid out by the Commission, will be modeled after the Federal Thrift Saving Plan, which millions of Federal employees use. Instead of having to pick and choose individual stocks, people would invest in broad index funds, which are very widely diversified and have very, very low administrative costs.

This is an especially important piece. You would have millions of new investors, people who have not invested before, entering into

savings. By making it very simple and very diversified, you eliminate the possibility of getting cold calls in the middle of the night from a stock broker, or having very high administrative costs.

This way of doing it really ensures diversification. Over the long term, diversified investments, even in the stock market, have never lost money. That is the safety of diversified long-term investment.

Senator KYL. And a final question to you. When some talk about privatizing Social Security versus personal accounts, granted, different words have different meanings to different people, but would you characterize the difference between those concepts as it applies to what the Commission recommended to hear?

Dr. BIGGS. There is obviously a lot of controversy over the word "privatization," or the "P word" as we use it. Certainly, The CATO Institute has used it in the past. We think today it is not the best shorthand for the idea of personal accounts.

The analogy I would use, I think, would probably be that many of your colleagues who once called themselves liberals now call themselves progressives, for the reason they felt that the label "liberal" did not express what they were standing for, that it had negative connotations to it.

Privatization, as a word, has been given negative connotations, such that we would eliminate or reduce the safety net, that we would not honor benefits to current retirees, that we would shut the system down. That is clearly untrue under the Commission's plans.

The Commission's plan would strengthen the safety net so that we would have fewer seniors in poverty than we would under the current program. It would still be a mandatory savings program. You could not pick and investment stocks, you could not day trade.

So I think privatization, as a shorthand meaning private investment, may have been accurate at one point, but it is conveying ideas to people that I think have been designed to scare them.

Senator KYL. As opposed to having a personal account, which is invested pursuant to a plan, but over which you do not have day-to-day control.

Dr. BIGGS. That is correct.

Senator KYL. Thank you, Mr. Chairman.

The CHAIRMAN. We have just a little time here. here is a vote coming up. I guess the basic question Senator Kyl asked, is why is privatization the best alternative. You have talked, Dr. Biggs, about pre-funding.

I would just like to ask that the other two witnesses, since they have not had a chance to comment, are there other ways to deal with this? I am not prejudging private accounts as being wrong.

I just do know what the financial and actuarial effect is with the proposals with respect to current beneficiaries and other beneficiaries up to, say, at least age 55. That does have a certain effect, adverse effect, on a lot of beneficiaries.

So my question is, are there other ways, in addition to the basic three options proposed by the Commission, that you might be thinking of in trying to address the basic question, if not this, what might it be? That is a fair question. The Commission did not address other options, it just addressed the basic three privatization personal account options.

So, what other ways might a future Commission come up with?

Senator KYL. Mr. Chairman, can I just interrupt? You made a statement that I am not sure, when the transcript is read, you will want to be in there. You said the Commission did not look at any other options. Did you really mean to suggest that?

The CHAIRMAN. Not in a serious way.

Senator KYL. All right. That will be one of my questions for the record, has the Commission looked at other options in a serious way.

The CHAIRMAN. Just not in a serious way, in my judgment.

All right. The other two.

Dr. ORSZAG. Sure. Senator, I have with me a document from the Social Security Advisory Board which has a series of options that have been examined in other contexts for restoring Social Security solvency. We all recognize that there is a long-term imbalance.

I think, in broad outlines, the approach that I would prefer relative to the Commission's approach—the Commission's approach relies exclusively on benefit reductions in order to reach solvency.

The approach that I would prefer is a mixture of general revenue infusions that are paid for, for example—just as an example—I would support freezing the estate tax at 2008 levels and dedicating that revenue to Social Security. Right there is a quarter of the 75-year imbalance, and it is paid for. Relative to eliminating the estate tax, I am willing to keep it at the scheduled 2008 levels.

Chairman Greenspan has advocated, just in testimony a few weeks ago, adoption of a different new Bureau of Labor Statistics measure of consumer price inflation, the so-called CCPIU, which more accurately reflects underlying price trends in the economy. I think that is also worthy of serious consideration.

The point is, there are a series of things that have been looked at in the past that people could get together and reach agreement on. But in order to get there, you cannot start with people who are just going to always advocate carve out individual accounts. You cannot take off the table ways of identifying resources from the rest of the budget that could grease the wheels of a reform.

The CHAIRMAN. Mr. Greenstein?

Mr. GREENSTEIN. I very much agree with what Peter has just said. An interesting note on this question of the better way of measuring inflation, which Chairman Greenspan recently strongly urged that Congress move to, a proposal of that nature is actually found in the Social Security plan that Congressmen Stenholm and Colby introduced.

Analysts generally agree, if you go to a better measure of inflation you go to it for everything in the Federal Government that uses the CPI, whether it be Social Security, SSI, elements of the Tax Code, anything that uses the CPI. If we are over-measuring inflation, we should measure it right.

In their plan, they note that that produces government-wide a substantial amount of savings that rise as the years go by, and one could consider dedicating some portion—not all of that—to Social Security as part of a larger plan that also makes changes on the benefit and the tax sides.

With regard to the question of pre-funding, let me take the three options. With regard to a lock box, we talked about it a lot. But,

as you may recall, there were various proposals. Senator Domenici had a proposal, Senator Abraham had a proposal, Senator Conrad had a proposal.

None of them were ever passed. They were proposals that would erect fire walls that made it much harder—not infallible, but harder—to override the walls around the lock box. None of those ever passed, so they were not really fully tried.

Second, there are some real advantages to collective investment, allowing, through an independent board, a portion of the trust fund surpluses to be invested. One of them, and I mentioned in my testimony the risk, that if the stock market fell you could get a run on Congress of people whose individual accounts had gone down in value saying, dip into the Federal budget and make us whole. An advantage the trust fund offers, is it lets you smooth out over the generations and it eases, I think—does not eliminate, but it eases—that political risk.

The concern, as Dr. Biggs noted, is the question of would there be political interference. I think, and there is very good work that Reischauer, former head of CBO, and Henry Aaron, have done on this. It is eminently feasible to set up an independent board that is insulated from the political pressures. But there is an issue on that.

So what I would suggest there, is we try it as a pilot project with a limited amount of money. If there is any hint of political interference, Congress ends the pilot. The amount of money involved is sufficiently small. There cannot possibly be a risk to the economy. If it turns out to work and we really can do it so that we insulate ourselves from political interference, we can build on it.

A final point about pre-funding, not so much Social Security, but the broader theme of building national saving. I would recommend consideration of something else. That is, you secured the inclusion, Mr. Chairman, in last year's tax bill of the saver's credit. I think you are the author, as I understand, of the saver's credit. I know the saver's credit was limited. Given the constraints, you extracted the maximum you could. It was a very important provision. Preliminary indications are, it is being used.

If the saver's credit could be enlarged and made refundable, that is a way to build national savings, so long as it is paid for. So I would recommend—and I know this is controversial—taking some of the very high upper income elements of the tax cut that are not in effect yet, freezing them, and shifting the money into a different tax cut, broadening the saver's credit. That would have two benefits.

Number one, it would move money from consumption, which is where a lot of the tax cut that is not in effect yet would otherwise go, into savings because people would not be able to simply withdraw money from the accounts the saver's credit sets up before retirement.

Second, to the degree that we will need to, and I think we probably will need to make some moderate benefit changes/reductions compared to schedule benefits as part of restoring Social Security solvency, if we can build up these add-on accounts through your saver's credit in an expanded form, that helps offset those effects.

So these are some ideas to look at in the context of both Social Security solvency, pre-funding, and building national saving.

The CHAIRMAN. Well, thank you all very much. I have got to move on to the next panel. There is a vote going on already. But this has been a good, provocative discussion here, and I thank all of you very, very much. Thank you.

The next panel is Ms. Esther "Tess" Canja, immediate past president of AARP; Hon. Barbara Kennelly, president and CEO of The National Committee to Preserve Social Security and Medicare; Mr. Bob Bixby, who has been referred to several times already, who is executive director of The Concord Coalition; and Marty Ford, co-chair of the Social Security Task Force, Consortium for Citizens with Disabilities.

There is a vote on now. I will stay as long as I can, and will have to come back. Let us begin with you right away, Ms. Canja. Why do you not proceed?

STATEMENT OF ESTHER "TESS" CANJA, IMMEDIATE PAST PRESIDENT, AARP, WASHINGTON, DC

Ms. CANJA. Thank you very much. Good morning, Chairman Baucus and Senator Kyl.

I am Tess Canja, immediate past president of AARP. AARP appreciates this opportunity to testify about Social Security solvency.

Social Security's income protection for Americans of all ages is unmatched. It is the primary income source for the overwhelming majority of older Americans and keeps nearly half of them out of poverty.

The program also provides insurance protection against disability and death for nearly all working Americans and their families, and once benefits begin, they are indexed annually for inflation and they are guaranteed for a lifetime.

Social Security is the only component of retirement income that cannot be jeopardized by misfortune, eroded by inflation, or depleted by a long life. Although Social Security is in sound financial health for the foreseeable future, some changes will be necessary and interest has grown in diversifying Social Security's investments, either on behalf of the trust funds or through individual accounts.

Now, individual accounts can be an important component for an overall national retirement income policy, provided that they are not financed with existing payroll taxes. AARP believes that individual account should supplement, not replace, any of Social Security's defined benefits promised.

Accounts that are financed with payroll tax dollars, so-called carve-outs, would worsen the system's long-term financing and exposure workers to unnecessary risk. Carve-outs would gradually move the program from a guaranteed benefit toward a non-guaranteed individual savings plan.

Social Security's base of income protection would become less stable and less predictable. Indeed, the distinction between Social Security, pensions, and savings would be blurred and the different purpose of each would be lost.

Social Security provides a secure foundation and individuals should be encouraged to save, invest, and take on risks in addition

to that foundation. In fact, in the past two decades, trillions of dollars have moved into individual retirement arrangements such as IRAs and 401(k) plans. AARP believes we should work to increase access to such existing retirement savings vehicles, but not at the expense of Social Security.

Critics often state that low-income workers such as members of a minority group and/or women would be better served by individual investment accounts. They are wrong. Women who live longer are protected by Social Security's lifetime guarantee and annual cost of living adjustments. While larger numbers of African American workers die before reaching retirement age, they and their families receive valuable survivor benefits. Those who become disabled also qualify for benefits.

Hispanic workers and beneficiaries have much to lose as well. The Hispanic population, disproportionately younger than other ethnic groups, would be hard hit by having to pay for benefits under the old system while funding a new system for themselves. Hispanic elders tend to be longer-lived. They are advantaged by Social Security's lifetime benefit guarantee and annual inflation adjustment.

Carve-out proponents contend that individual accounts will yield higher returns. However, the projected rates of return are not adjusted for risk and assume a worker has a steady steam of contributions over a working life.

Yet, many workers have periods of unemployment or reduced earnings, and all investors remain at the mercy of greater volatility, particularly as they approach retirement.

Proponents also contend that individual accounts will promote national savings. But, as the Congressional Budget Office and others note, simply moving funds into individual accounts does not necessarily increase national savings. To increase the overall savings, we need more savings, not simply a shift in savings.

There are many ways to strengthen Social Security, but carve-outs are not the answer. AARP believes we should find a bipartisan solution for Social Security that maintains the program's role of secure income protection for current and future generations, and that fits into the overall framework of retirement security.

Social Security has been, and should continue to be, the foundation of our Nation's commitment to providing income protection for workers and their families when a worker retires, dies, or becomes disabled. Thank you.

The CHAIRMAN. Thank you very much.

[The prepared statement of Ms. Canja appears in the appendix.]

The CHAIRMAN. Ms. Kennelly, why do you not proceed? If you could maybe shorten slightly, then I will run off and vote.

STATEMENT OF HON. BARBARA KENNELLY, PRESIDENT AND CEO, THE NATIONAL COMMITTEE TO PRESERVE SOCIAL SECURITY AND MEDICARE, WASHINGTON, DC

Ms. KENNELLY. All right. Thank you, Chairman Baucus. Thank you for the opportunity to appear before you, and thank you for holding this timely and very important hearing.

The President's Commission presented a real opportunity to move the Nation toward Social Security reform. Unfortunately, the

Commission was not a success. The President placed too many preconditions on its work, several of which contradicted Social Security's fundamental mission.

The preconditions precluded solutions and, not surprisingly, the Commission faltered. It produced three controversial options, each of which failed to meet most of the President's own basic tenets.

Based on an analysis of the Social Security Administration's chief actuary, none of the plans produced long-term solvency, as we have been talking about this morning, without large infusions of general revenues for which no source was specified.

The plans reduce defined benefits below current baselines, reduces most workers' projected overall retirement income, and lack important details about how private accounts would operate.

Finally, all three plans sharply reduce not only retiree benefits, but survivor and disability benefits as well. The President directed the Commission to propose plans that strengthen Social Security and increase its fiscal sustainability. The administration also appropriately instructed the Commission to hold harmless those at or near retirement.

Like President Reagan's model for the 1983 Greenspan Commission, this should have been direction enough. Yet, the President also required the Commission to come up with a final recommendation that would allow today's workers to divert at least a portion of their payroll taxes to risk-bearing private personal accounts.

The President instructed the Commission to introduce privatization, which is a radical departure from the current insurance model. Privatization siphons precious resources from the insurance pools and exposes a great share of retirement income to market risk.

Off limits was any discussion of increasing revenues. With revenues off the table and pressures on to address private accounts, transition costs, as well as solvency, the Commission was handed an impossible task. Its efforts, despite the talents of the 16 distinguished members, ended in failure.

Social Security's chief actuary has found that, because of the transition costs, Commission plans would boost the unified deficit from $1.2 trillion to $1.5 trillion. All three plans carve reductions as great as 43 percent in the guaranteed benefit for those retiring in 2075.

Under Plan 2, which we also talked a great deal about this morning, program expenses exceed tax revenues by as early as 2026. Recently projected annual deficits throw serious doubt on the availability of general revenues over the next decade to cover this accelerated shortfall.

What I thought was such an irony as I read the report, is that Social Security privatization's transitional costs will compete with other domestic social spending, yet the Commission did not seem to act as if this might be a problem.

The final report contains a number of assertions that are either misleading, or possibly false. For example, the final report says that the current system places African Americans at a disadvantage, when we all know that African Americans comprise 12 percent of the population, yet 17 percent of those receiving disability

payments and 21 percent of children receiving benefits are African American.

The report also contends that privatization plans would provide a net improvement for women, while suggesting that the current system has not served women well. I can only tell you that two-thirds of women over age 65 depend on Social Security for at least half their income, and one-third for 90 percent of their income.

Privatization is inherently problematic for women, as they tend to spend more years outside the workforce, earn less on the dollar, and are less likely to have another source of retirement.

The Commission does propose some positive changes intended to address longstanding equities for women. These changes, which I did agree with, are undermined by dramatically lower replacement rates due to other benefit cuts in the plans. What happens, is the plans just give women a slightly larger share of a much smaller pie.

According to the National Women's Law Center, under Plan 2 a surviving wife would see her survivor benefits cut by 10 percent if she earned the same salary as her husband, and cut be a third if she earned less.

Despite the administration's instructing Commissioners to preserve Social Security's disability and survivor programs, all three plans assume benefit cuts. If the Commission had adhered to the mandates, the cuts in other areas would have been even larger. The concept of rates of return on an individual investment, or the concept of an individual getting one's money's worth is something that I really have trouble with. It is incompatible with Social Security, structured as an insurance policy.

The CHAIRMAN. Thank you very much, Ms. Kennelly, and for also being very accommodating in reading your testimony very quickly.

[The prepared statement of Ms. Kennelly appears in the appendix.]

The CHAIRMAN. We will recess, subject to the call of the chair. I will probably be back in about 10 minutes.

[Whereupon, at 11:48 a.m. the hearing was recessed.]

[12:03 p.m.]

The CHAIRMAN. The hearing will come back to order.

Mr. Bixby, it is your turn.

STATEMENT OF ROBERT BIXBY, EXECUTIVE DIRECTOR, THE CONCORD COALITION, WASHINGTON, DC

Mr. BIXBY. Thank you, Senator Baucus. Thank you for inviting me to discuss the final report of the President's Commission. I am here representing The Concord Coalition, which, as you have noted, is a grassroots organization dedicated to strengthening the Nation's long-term economic prospects, and your former colleagues, Warren Rudman, Republican, and Bob Kerrey, Democrat and former member of this committee, are the co-chairmen.

My testimony is divided into three sections. I will shorten it, but the three questions to address are whether Social Security reform is necessary, what are the viable reform options, and what are the main achievements and shortcomings of the Commission's report?

Well, is Social Security reform necessary? I think probably everybody in the room would agree that at some point, in some fashion,

it is. Changing demographics simply make the current pay-as-you-go system fiscally unsustainable and, I would argue, generationally inequitable over the long term.

Let me pose a hypothetical question which is based on one that Senators Kerrey and Rudman asked in a recent op-ed. Suppose that one of your colleagues introduced legislation called the Social Security Do Nothing Act. Under this bill, promised retirement benefits would be cut by 16 percent for today's 30-year-olds, 29 percent for today's 20-year-olds, and by 35 percent for today's newborns. Alternatively, payroll taxes could suddenly go up by 34 percent in 2041.

How many of you would rush to endorse this bill? None, I suspect. Yet, those are the grim choices under what could be called the "Do Nothing" plan.

What is remarkable is not that reform plans engender so much heated debate, but that the "Do Nothing" plan engenders so little outrage. Worse yet is the fact that no one will have to endure the scrutiny and ridicule of specifically advocating these absurd consequences, because the "Do Nothing" plan has already been enacted. It is current law.

So the question facing you is the same one that faced the Commission, and all of us, really. It is, what should be done to undo the consequences of the "Do Nothing" plan?

Now, I would underscore what other witnesses have said, that the Social Security challenge is, first and foremost, a cost challenge. But that is not the only challenge. There are also the issues of benefit adequacy and individual equity.

In recent years, much attention has been given to various ways to try to pre-fund more of the system, because I think most people agree that would be a good thing to do while we have got a surplus. The options are a budgetary lock box and an independent board to manage trust fund investments and personally owned accounts. Those have gotten a lot of discussion so far.

I would like to make this point, that ideological factors often cloud the debate over these options. The real issue, is which is most likely to result in genuine savings? At least, that is the real issue as far as The Concord Coalition is concerned. What legal, political, and fiscal incentives best ensure that resources are actually set aside or reallocated from the present to the future?

Now, let me turn to the main accomplishments and shortcomings of the Commission's report. First, it is important to note that they have not been presented, and I do not think we should consider them, as a take-it-or-leave-it proposition. I think of it more as a work in progress. In fact, the administration has not even told us which of the various models it prefers, if any.

So at this point, I think a good thing to do is to look at what they are proposing, offer constructive suggestions, keeping in mind that some change must come.

Let me summarize what, from The Concord Coalition's perspective, are the main accomplishments or achievements. Really, by that I mean the things that could most help us come to a credible Social Security reform plan.

First and foremost, the Commission recognized that reform must pursue fiscal sustainability. We can argue about whether or not it was achieved, but I think that should be a goal for all of us.

Two, the Commission explained the flaws of trust fund accounting. One of the problems—and this is something The Concord Coalition has talked about for years—is that if you just look at what it takes to achieve trust fund solvency, it really understates the size of the problem, because you could do almost anything.

That is primarily a bookkeeping problem. But we really need to concentrate on the funding problem and where real resources are going to come to pay the benefits, not on trust fund solvency.

Three, the Commission advocated advance funding and increased savings. I think that is something there is a wide consensus about. Again, people can disagree about the objective, but the savings must be genuine here in order to help pre-fund benefits and help grow the economy.

Next, the Commission raised the possibility of an add-on contribution of personal accounts. I think that is a good way to fund personal accounts. At least, it is something that ought to be on the table. It does not have some of the drawbacks that the carve-out approach does.

The Commission did not deduct cost savings. Ultimately, we need cost savings in the system, as Bob Greenstein mentioned. Price indexing and longevity indexing are good options.

Could I take a moment, Mr. Chairman, just to respond to the criticism that is in my testimony that you already have mentioned?

The CHAIRMAN. Briefly. Right.

Mr. BIXBY. That is, I just want to stress that that should be taken in context, that we do have concerns about the funding of the three models. We have even more concerns about just letting general law, current law, go on auto pilot. I just wanted to make sure that we were clear about that.

The CHAIRMAN. Correct. All right. Thank you. Thank you very much.

[The prepared statement of Mr. Bixby appears in the appendix.]

The CHAIRMAN. Ms. Ford?

STATEMENT OF MARTY FORD, CO-CHAIR, SOCIAL SECURITY TASK FORCE, CONSORTIUM FOR CITIZENS WITH DISABILITIES, WASHINGTON, DC

Ms. FORD. Chairman Baucus, thank you for this opportunity to testify. People with disabilities have a major stake in this debate. The Title 2 Old Age, Survivors and Disability Insurance programs are insurance programs, not investment programs, designed to reduce risks from certain life events.

They insure against poverty in retirement years, they insure against disabilities limiting persons' ability to work, and they insure dependents and survivors of workers who become disabled, retire, or die.

In fact, more than one-third of all Social Security benefit payments are made to 17 million people who are not retirees. People with disabilities benefit from all three parts of the Title 2 program, not just the DI program.

They include disabled workers and their dependents who do benefit from the DI program, but also retirees with disabilities, dependents of retirees, who include disabled adult children, and disabled survivors, including disabled adult children and disabled widows and widowers.

Their benefits come from the retirement program, the survivors program, or the disability insurance program. Benefits are based on the same formulas as for retirees, and beneficiaries move between the three programs depending on their work history, their age, and their category of eligibility, such as disabled adult child.

The average benefit for disabled workers in 2000 was $755 a month, and the average benefit for disabled adult children was $498 a month. Eighteen percent of disability insurance beneficiaries are living in poverty. Without Title 2 benefits, that figure would climb to 55 percent.

The insurance aspect of the programs is essential to the protection of people with disabilities. The programs provide benefits to multiple beneficiaries across generations and under coverage earned by a single wage earner's contributions.

Partially or fully privatizing current or projected Social Security trust funds would shift risks that are currently insured by the Federal Government back to the individual.

Social Security is a system that works. Therefore, we look at reform proposals to see whether they preserve the insurance nature of the programs, maintain a benefit formula that does not result in deeper poverty, protect against inflation, protect disabled adult children and other family members with disabilities, protect the DI program from increased pressures caused by raising the retirement age, adequately consider the impact on people with disabilities, ensure solvency of the trust fund, and prevent substantial costs from affecting the rest of the Federal budget.

Where individual accounts are established, we also consider whether they provide adequate benefits at retirement age, include protection if annuities or disability insurance must be purchased, and minimize risks and address capacity to manage accounts.

On the whole, we believe that the Commission's recommendations fall far short of addressing these critical issues for people with disabilities. As described in more detail in my statement and as heard earlier this morning, the Commission's proposals would create substantial problems for people with disabilities, including deep cuts in benefits. We believe that the Commission's plans cannot be supported.

While Commission members believed that their mandate did not encompass the DI program, nevertheless their proposals rely on cuts in disability benefits throughout all three components of the OASDI programs.

Furthermore, the Commission suggested that a comprehensive retirement system should provide improved poverty protection either through SSI or some combination of Social Security and SSI.

We believe that SSI should not be considered as a way to make up for reduced Social Security benefits. The Commission's work is designed to "create wealth for all Americans." Yet, the Commission seems willing to solve problems it creates for people with disabilities by relegating them to a program that has limits on earnings

and resources which would ensure that they live in poverty. The asset depletion necessary for many to qualify for SSI violates the basic tenets of the Commission's work.

We urge you, we urge Congress, to request a beneficiary impact statement from SSA on every major proposal under serious consideration.

With a potential impact on millions of people of all ages, it is simply not enough to address only the budgetary or economic impact of change. The people impact must also be studied and well understood before any change is initiated.

Again, I thank the committee for considering our viewpoints on these critical issues. People with disabilities and their families will be vitally interested in the Finance Committee's work. We pledge to work with you to ensure that disability issues remain an important consideration in reform analysis and solution development.

Thank you.

[The prepared statement of Ms. Ford appears in the appendix.]

The CHAIRMAN. Thank you, Ms. Ford. I take it that it is your view that the Commission's numbers required disability benefit cuts, that disability benefit cuts were needed to pay for the conclusions that the Commission reached.

Ms. FORD. That is my understanding.

The CHAIRMAN. All right.

I would like to just kind of go down the table here and get brief thoughts on what some of the answers—and the viable answers—might be for addressing the Social Security system.

My personal view is that the Commission's recommendations are not going to fly, and we have to come up with some other alternative. It is just a question of when and what those alternatives might be, recognizing that this is a very difficult challenge ahead of us.

But if I might start with you, Ms. Canja. I will not hold you to anything here, but just some of the thoughts that might come to your mind as we honestly begin to solve the problem.

Ms. CANJA. There is a whole menu of ways of reforming Social Security, many different kinds of things that could be done, and they all can add up to exactly what is needed. AARP has been engaged for several years now in trying to educate our members on these options for Social Security, and we are still doing that.

We are looking at options such as more broadly investing the trusts funds to include government-backed debt instruments, including newly hired, Federal and State employees who are not covered, into Social Security, and maybe a modest increase in the wage cap. So, there are all of these. We heard more today of other possibilities. If we have a very good debate on it and we can come to some bipartisan agreement, I think we can have a reform package that will be accepted by everyone.

We are concerned about whether the package includes individual savings accounts, but in addition to Social Security, not as part of Social Security. In fact, this is something that we are strongly urging our members to really invest in, to do the savings so we can achieve, more national savings.

The CHAIRMAN. Ms. Kennelly?

Ms. KENNELLY. Yes, Mr. Chairman. Our committee does not belong to the "Do Nothing" group, like Mr. Bixby spoke of. I agree with him that we have to watch out for that. That list that Peter Orszag held up this morning as he was testifying, we all have that list. We all know if you take bits and pieces of that list, you could reach solvency.

My problem with the Commission, is its report is holding hostage this whole discussion on solvency. The other problem I have, is I truly believe in the insurance model of Social Security.

This morning, one of the witnesses talked about Roosevelt. What Roosevelt said when he introduced this program, is that it was really insurance against the accidents and vicissitudes of life. That is what this insurance concept is, that we have shared risk. So, my committee is more than willing to be involved in the discussion on bringing together numerous options.

My other, and final, point is, we cannot wait too long. You and I both know, we were in Congress in 1983. We had to vote on the last reform, and it was tough because we waited so long. That is when the age went up. That is when students lost their benefit. That is when we taxed Social Security. We do not want to have that happen again.

So I think most of us are more than willing to be involved in the debate, put together a number of ideas, get a pool of money to help with the whole solution of solvency. But let us not just talk about this privatization, because it is apples and oranges.

The CHAIRMAN. All right.

Mr. Bixby?

Mr. BIXBY. Well, I think, two big comments here. The two things we need to do, is reduce the long-term costs of the system to make it fiscally affordable, while at the same time maintaining an adequate benefit level, which is not an easy thing to do, but that is the trick.

That is where the combination of a phased-in benefit, defined benefit reduction, like the price indexing switch or the longevity indexing that the Commission proposed, I think, are good ideas and I suspect would be something that The Concord Coalition would support.

If you just keep it clean, a lot of tiny little benefit cuts here and there adding up, I think, gets very confusing. Nobody knows what is going on, and I do not think the public would rally behind any support.

The other component is to start advance funding more of the system. There you get back to the three options. Do you just credit more bonds to the trust fund, try to have them invested collectively or in individual accounts?

I think the individual accounts are more likely to result in genuine savings to be able to pay to fund the benefits for people in the future, which is the bottom line. I do not think it is an ideological question about choice or market returns, or stuff like that. The question is, how do we pre-fund benefits?

The CHAIRMAN. I am going to have to ask you to be brief, if you could.

Mr. BIXBY. It is not just constantly raising taxes. The last point is, the question is, do you do the carve-out approach or the add-on approach? They each have different pluses and minuses.

The CHAIRMAN. All right.

Ms. Ford?

Ms. FORD. Thank you. I would make two points. First, while the Commission was bipartisan, all of the members were committed to private accounts before the Commission met. Therefore, I do not think that the Commission actually represented all points of view. I think we do have to get all approaches on the table, as discussed earlier, get all of the pieces of that list on the table to look at.

Second, I want to emphasize again the need for beneficiary impact statements. I know that over the last few years in some of the major reform proposals that have been put forward, there were also serious impacts on people with disabilities, and in some cases the proponents of those proposals did not even realize the impact that their own proposals would have.

I think it is very important that we not keep looking only at the economics of it, but also look at who is affected by each particular proposal, and how are they affected.

The CHAIRMAN. That was a good contribution. I appreciate that suggestion.

Ms. FORD. Thank you.

The CHAIRMAN. Regrettably, we do not have any more time left. I thank all of you very, very much. My personal view is, as Ms. Kennelly mentioned, back in 1983, where a commission was put together, it was clearly perceived as bipartisan, not only in name but in spirit, headed by Alan Greenspan.

Senator Patrick Moynihan was on that commission, and several others. It was put together, and when they deliberated and when they met, it was clear to me anyway that they were looking for an honest, good-faith solution. They did come up with one, and both political parties, both ends of Pennsylvania Avenue, joined hands together. Neither politicized it.

Unfortunately, at that time—or fortunately—the situation was dire. We had to move very quickly. Frankly, we have a little more luxury now, but that is a blessing and it is a curse. The blessing is that we have more time, but the curse is that too many people are just going to wait.

But it is up to us. It is up to the American people, it is up to Congress. It is up to us to collectively do the best we can, as early as we can, so that we can find a good-faith solution.

Thank you very much. We appreciate it.

The hearing is adjourned.

[Whereupon, at 12:23 p.m. the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

STATEMENT BY SENATOR MAX BAUCUS SOCIAL SECURITY HEARING

Today, we are going to consider the recommendations of the President's Commission to Strengthen Social Security. Before going any further, I wish to express my disappointment that Treasury Secretary O'Neill has not agreed to testify. As the Managing Trustee of the Social Security Trust Funds, Secretary O'Neill plays a unique role. Thus, we worked hard to accommodate his schedule. We originally planned to hold this hearing on July 31, but agreed to reschedule it because Secretary O'Neill was expected to be out of the country at that time.

We then tried to find a date in September when Secretary O'Neill could testify. In fact, we told Secretary O'Neill that we would hold the hearing on any date in September that he would be available. Unfortunately, Secretary O'Neill has declined our invitations. At this point, we have no choice but to proceed without the benefit of the Secretary's testimony. That said, let me turn to the issue at hand.

Social Security represents a solemn commitment from one generation to the next. Social Security is the major source of income for most of the elderly. About two-thirds of aged Social Security beneficiaries receive at least half of their income from Social Security. For about 20 percent, Social Security is the only source of income.

Without Social Security, more than half of elderly women would be living in poverty. And Social Security provides more than just retirement benefits. Disabled workers and their dependents account for 15 percent of total benefits paid. Almost three in ten of today's 20 Year-olds will become disabled before reaching age 67. And in 2001, the insurance value of Social Security benefits for a young disabled worker with a spouse and two children is about a $353,000.

Survivors of deceased workers account for another 15 percent of Social Security's total benefits. An estimated 97 percent of young children and their parents are insured for survivors benefits through Social Security. And Social Security survivor's protection is equivalent to a $403,000 life insurance policy. Therefore a strong Social Security program is absolutely critical, for seniors, for the disabled, and for those who survive.

We cannot compromise our commitment. At the same time, we all must recognize that, over the long term, Social Security's finances need to be improved. As it now stands, the Social Security Trustees estimate that the Social Security Trust Fund will become exhausted in 2041. At that point, there will still be a lot of payroll tax money coming in each year. But the revenues will not be enough to pay full benefits. For example, in 2041, there will only be enough revenue coming in to pay about 73% of promised benefits. So it is clear that we need to do something to shore up Social Security's finances.

At this point, there are several alternative approaches. One is embodied in the work of the President's Commission. Specifically, the President has proposed to establish voluntary private personal savings accounts for workers. Some amount of the worker's payroll taxes would be diverted into the private accounts instead of going into the Social Security Trust Fund. This is usually referred to as "partial privatization" of Social Security. The President set up a Commission to flesh out his proposal, and the Commission came up with three specific options. We are here today to discuss and evaluate those proposals, in the hope that it will help us move the debate forward.

Having said that, I have very serious concerns about the options proposed by the Commission. With all due respect, both the President's proposal and the Commission's report take us down the wrong track. Let me be more specific, by addressing some of the details of the options that the President's Commission has proposed.

For one thing, although these plans are advertised as voluntary, a retiree who chooses not to participate would have his or her Social Security benefits cut deeply anyway. In Montana, we would not call such a system voluntary.

Second, for many of the workers who do choose to participate, their total retirement income, including money from their private accounts, would be significantly less than under current law, not more. And the decline would be even worse if the stock market fell like it has over the past three years.

Third, the proposal would cut traditional Social Security benefits deeply for disabled individuals, even though their private accounts could not be accessed until they reached retirement age.

Fourth, the proposals would all make the Social Security Trust Fund exhaust earlier than under current law, not later. For example under option 1, the Trust Funds would exhaust in about 2033 rather than in 2041 as under current law.

The Commission prefers to use an alternative measure of the year that Social Security's finances reach a dangerous point. They say that this point will be reached in 2017. Yet, even using this measure, under all three of the Commission's options, Social Security would hit the danger spot earlier than under current law. For example, under the Commission's option 2, this point would be reached in 2011.

Finally, even with these flaws, all of the Commission's options would require trillions of dollars of general revenues from the Treasury in order to work. However, the general fund of the Treasury is likely to be in deficit for a long time into the future, so it is completely unclear where this money will come from. All in all, I am concerned that the Commission's proposals for partial privatization would make the Social Security system worse, not better.

Others, obviously, may disagree. That is why we are holding this hearing, to see if we can get a better understanding of the Commission's proposals, and the effect that they would have on the health of the Social Security system. I look forward to the testimony of our witnesses.

Statement of Andrew G. Biggs, Ph.D.
Social Security Analyst, The Cato Institute

Testimony before the Senate Finance Committee
Hearing on the Final Report Produced by
The President's Commission to Strengthen Social Security
October 3, 2002

Mr. Chairman and members of the Committee, thank you for inviting me to offer testimony regarding the reform proposals of the President's Commission to Strengthen Social Security.

My name is Andrew Biggs, and I am a Social Security analyst at the Cato Institute. During 2001 I was a staff member to the President's Commission and worked with the Commission members and other staff on reports and proposals in question. While I am broadly supportive of the Commission's goals and proposals, I should add that the opinions expressed today are my own.

Details of the Commission's reform models can be found in its final report, as well as in a shorter analysis I conducted for the Cato Institute and a recent working paper for the National Bureau of Economic Research by two Commission members.[1]

The Commission was appointed with a mandate to "provide bipartisan recommendations to the President for modernizing and restoring fiscal soundness to the Social Security System,"[2] with provisos that modernization should: protect retirees and near-retirees from changes to their benefits; dedicate the entire Social Security surplus to Social Security; not increase payroll taxes or allow the government to invest Social Security funds in the stock market; preserve Social Security's disability and survivors' components; and include voluntary personal retirement accounts to augment the Social Security safety net.

My testimony today will focus on Commission Model 2, which has been the subject of the greatest debate in the public sphere. The Commissioners' first step with

Model 2 was to determine the rate of benefit growth the current program could afford to pay each cohort of future retirees without raising taxes, regardless of whether personal accounts were introduced. This affordable rate of benefit growth turned out to be slightly above the rate of inflation. The Commission instituted this affordable benefit growth rate by replacing the current program's formula of "wage indexing" with a formula of "price indexing." (See below for further comment.) The excess affordable benefit growth was targeted toward improving the safety net and poverty protections for low-wage workers and widows. *Under Commission Model 2, however, all workers and retirees aged 55 and older would be exempt from any changes to their Social Security benefits.*

Having established a benefit formula that would bring Social Security back to long-term solvency without tax increases, the Commission introduced personal retirement accounts. Accounts could help make up for the reduction in traditional benefit growth through their higher-returning investments; give workers a true property right to their benefits, which they lack under current law; more effectively prefund future benefits than the current trust fund financing mechanism; and aid groups disadvantaged by aspects of the current program, such as African Americans, divorced women, and single workers and dual-earner couples.

Commission Model 2 would improve the long-term unified budget cash flow by over $16 trillion (in $2001), equivalent to a lump sum today of $2.2 trillion. Thus Model 2 provides increased budgetary flexibility to address national security, health care, and the many other issues sure to face the government over the next 75 years.

The remainder of my testimony will concentrate on several important objections to the Commission's proposals made in a recent study co-authored by Peter Orszag of the Brookings Institution and Peter Diamond of the Massachusetts Institute of Technology.[3] This focus is testament to the authors' reputations as economists and the influence the study has had on the public debate over Social Security since it was released in June. Nevertheless, I am concerned that their study does not tell the full story, and by itself could give a false impression regarding the challenges we face over Social Security and the role the Commission's proposals could play in addressing those challenges.

In my testimony, I will make several references to recommendations from the Consultant Panel on Social Security, which was appointed in April 1975 at the request of the Senate Finance Committee to recommend revisions to Social Security's financing structure. Professor Diamond served on the Consultant Panel, and in several significant ways the Panel's recommendations mirror those of the President's Commission.[4]

Benefit Cuts

I first wish to address charges of "benefit cuts" in the Commission proposals. Consider the following passage from a press release summarizing the findings of the Diamond-Orszag study:

> The proposals that President Bush's Social Security Commission issued in December would substantially reduce benefits for future retirees and the disabled while requiring multi-trillion dollar transfers from the rest of the budget to finance private retirement accounts.

The press release goes on to state that, "Benefits would be reduced 41 percent for those born in 2001 who retire at age 65 in 2066."[5]

These charges are initially compelling. After all, if a Social Security proposal both pays less and costs more than the current program, what is the point of making the change? This is the question that many opponents of personal accounts would like the public to ask itself, particularly in this year in which Social Security reform is a highly-charged election issue.

Winston Churchill was reputedly once asked the question, "How is your wife?" The former British Prime Minister reportedly answered with a second question: "Compared to what?"

It is not recorded precisely how the Prime Minister's wife reacted to this comment, yet these charges of benefit cuts and large general revenue transfers must be subjected to the same counter-question put forward by Mr. Churchill: "Compared to what?" The answer, I submit, is not compared to the present Social Security program.

The following arguments may seem excessively technical and arcane. Yet they have a direct impact on the Social Security debate taking place not only here in Congress, but outside the beltway as well.

For example, last week the head of the North Carolina Democratic Party wrote that under the Commission's proposals, "the guaranteed monthly benefits for the average retiree would fall by 46 percent, or $374, from $814 to $440 per month."[6] This statement, which is wholly and unequivocally false, is based on a misunderstanding of the arguments presented in the Diamond-Orszag paper.

It is unlikely that the Democratic Party chair intended to make such a blatant misstatement, and I am sure that Peter Orszag and Professor Diamond do not intend for such errors to be made. But unless participants in the debate clearly understand the distinctions I am going to make, an informed and accurate debate regarding the choices facing us on Social Security will be difficult to achieve.

The essential problem with Diamond and Orszag's charges of "benefit cuts" is that, simply put, they mis-define "benefits" and mis-define "cuts." Benefits paid by personal accounts are not counted as true benefits, while cuts are measured versus what the current system *promises*, not what it can and would pay under current law.

The following charts illustrate.

Chart 1 compares the annual retirement benefits promised to a low-wage worker[7] by the current program (solid line) to the traditional benefit paid by the government under the Commission's Model 2 (dashed line). While the Commission proposal would pay higher traditional benefits in the short term, beginning in 2031 the current program promises a significantly higher government-paid benefit. This is the basis of charges of large "benefit cuts" that you have heard repeated so often. By 2075, the "cut" for a low-wage worker reaches 35 percent, for an average-wage worker 46 percent.

The comparison in Chart 1 is less than fully informative, though, because it compares the Commission proposal to the benefits Social Security *promises*, not what Social Security would actually *pay*.[8] By law, when the trust fund runs out in 2041, benefits would be reduced to the level that payroll tax revenues alone could pay. This will amount to an across-the-board benefit cut of 25 percent or more.

In testimony to the House Budget Committee the day following the release of the Diamond-Orszag study, GAO director David Walker made pointed reference to this issue:

> There's a lot of people that want to compare Social Security reform proposals just to promised benefits. That is fundamentally flawed and unfair because all of promised benefits are not funded. There is a huge shortfall between what's been promised and what's been funded, and you've got to figure out how you're going to close that shortfall. So, any analyses, including the [Diamond-Orszag] one released yesterday, that compare the benefit cuts based upon promised benefits solely rather than funded and promised, is unfair, unbalanced, in my opinion inappropriate.[9]

Former Senators Bob Kerrey (D-NE) and Warren Rudman (R-NH) went as far as to characterize such comparisons as a "shell game," writing recently that while

> It is certainly fair to criticize reform plans on policy grounds. But it is fundamentally unfair to judge them against a standard that assumes the current system can deliver everything it promises. It can't. Today's Social Security system promises far more in future benefits than it can possibly deliver. The relevant comparison for any reform plan is with what current law can deliver, not what it promises.[10]

Likewise, the Congressional Research Service writes that

> Comparing a proposal's projected benefits to those resulting from the rules of current law can be misleading, since the full amount of benefits promised under current law would not be payable under the trustees' projections. For example, a proposal that is shown to result in benefits that are 10 percent or 20 percent lower than under current law may at first glance appear politically unattractive, but may appear less so if compared to the 27 percent reduction in benefits that would have to occur ... if policymakers were to take no action.[11]

These points are important to remember throughout the debate.

Correcting for this problem, Chart 2 compares the traditional benefits paid by the government under Model 2 to the benefits the current program can actually pay.[12] In most years the Commission's Model 2 would pay a low-wage retiree a higher traditional benefit than the current program can afford to pay.

But even this comparison does not tell the whole story. Chart 2 assumes that the worker holds a personal account. Such a worker would accept a traditional benefit up to 24 percent lower than a worker without an account. Yet Chart 2 does not include the benefits paid by the account.[13]

Chart 3 compares the total retirement benefits a low-wage worker could expect under Commission Model 2 to those the current program could afford to pay.[14] In almost all cases Commission Model 2 would pay a low-wage account holder

substantially higher expected benefits than the current program can afford to pay. A low-wage worker retiring in 2052, for instance, can expect total retirement benefits 47 percent higher than Social Security can afford to pay.

However, some would call this an unfair comparison, arguing that Commission Model 2 receives general revenue transfers with a present value of $0.9 trillion while the current program receives no extra funding.

Chart 4 compares the total retirement benefits a low-wage worker could expect under Commission Model 2 to those the current program could pay with similar general revenue transfers. Simply put, Chart 4 shows what the current system could afford to pay if we boosted the current $1 trillion balance of the trust fund by another $900 billion. The current program would remain solvent for 9 additional years, from 2041 until 2050, but after that would again be forced to cut benefits by more than 25 percent. A low-wage worker retiring in 2052 could expect total retirement benefits from Commission Model 2 46 percent higher than from the current program, even with similar general revenue transfers.

Chart 5 shows that Model 2 generally would increase benefits for a low-wage worker, even compared to a current program that faced no financing shortfall and could pay full benefits without any increase in taxes. A worker retiring in 2052, for instance, could expect total benefits some 7 percent higher under Model 2 than those promised by the current program.

An average-wage worker retiring in mid-century would receive around 94 percent of promised benefits (and around 28 percent more than the current program can afford). A high-wage worker would receive less, collecting around 89 percent of promised benefits, though 23 percent more than the current program can afford to pay. All workers, however, would be spared the 50 percent increase in payroll tax rates necessary in 2041 to finance the benefits the current system promises, but cannot pay.

To repeat, the entire basis of charges of large benefit cuts under the Commission proposals is, in the opinion of GAO head David Walker, "fundamentally flawed and unfair." People from both sides of the debate should remember this when considering these claims.

A Note on "Risk Adjustment"

Most charges of "benefit cuts" do not even count income from personal accounts as true benefits, though this is rarely made clear in non-technical writings. But even when Diamond and Orszag do count the benefits from personal accounts, they use a method of "risk adjusting" which reduces them by one-third or more compared to the standard methodology used by Social Security's actuaries.[15]

In practice, "risk adjusting" means that Diamond and Orszag assume that personal accounts would invest solely in government bonds (earning 3 percent returns after inflation), rather than the mixed portfolio of stocks, corporate and government bonds assumed by Social Security's actuaries (returning 4.6 percent). This risk adjustment reduces monthly benefits substantially; for a low-wage worker retiring in 2042, "risk adjustment" reduces the account balance by 36 percent.

Three points are worth making regarding risk adjustment.

First, whatever its merits, risk adjustment is not standard policy of Social Security's independent actuaries, nor is it standard practice among actuaries in general. Any equity investment necessarily involves risk, and economists and actuaries should and do explore the best ways to express the risks of equity investment. Even some members of the Commission favored risk adjusting. Nevertheless, general actuarial practice[16] as well as the specific policies of Social Security's actuaries is to focus on the expected value of the investment portfolio chosen, not to risk adjust all equity and corporate bond investments to the government bond rate of return. Diamond and Orszag have in other contexts criticized the Commission for veering from the actuaries' standard methodology,[17] yet risk adjusting investment returns is simply not how the Office of the Chief Actuary conducts its analysis.

In the actuaries' analysis, "Workers are assumed to maintain personal-account portfolios that would have an average distribution of 50 percent in equity, 30 percent in corporate bonds, and 20 percent in U.S. Treasury long-term bonds." Equities are assumed to return 6.5 percent after inflation, corporate bonds 3.5 percent, and government bonds 3 percent, for an annual portfolio return of 4.6 percent net of inflation and administrative costs. The benefit levels discussed in this testimony and in

the Commission's own report are based on these return assumptions, which the actuaries make in consultation with outside experts.

Social Security's actuaries presented two variations on the assumed account yield. A "high yield" portfolio assumes that equities return 7.1 percent annually, their long-term historical average or, alternately, that workers invest a higher proportion of their portfolio in equities. The "low yield" portfolio assumes 100 percent investment in government bonds or, alternately, the risk adjustment utilized by Diamond and Orszag.

The actuaries judged the intermediate yield assumptions utilized in this presentation to be the most likely. Following that, "the high yield is assumed to be more likely to occur than the low yield."[18] In other words, the risk-adjusted return utilized by Diamond and Orszag is, in the view of Social Security's actuaries, the least likely outcome of the three.

Second, while Diamond and Orszag have discussed issues of risk in prior analyses of Social Security, their analysis of the Commission proposals appears to be the first instance in which explicit risk-adjustment of investment returns was insisted upon.

In a prior paper on then-Governor Bush's proposal for personal accounts, Peter Orszag did not explicitly risk-adjust account returns.[19] Likewise, the final report of a recent panel chaired by Professor Diamond argued that

> Diversifying the planned portfolio for Social Security would increase the expected rate of return on the Trust Fund. Thus *it would improve the intermediate-cost actuarial evaluation of Social Security* that is based on expected returns.[20]

Yet if proposals for the government to invest the trust fund in the stock market were scored on Diamond and Orszag's risk-adjusted basis, this would be wholly untrue: even if the trust fund diversified from bonds to stocks, it would be *treated* as if still held only bonds and thus actuarial balance would be unaffected.

Diamond and Orszag's risk adjustment renders any private investment, whether undertaken centrally by government or de-centrally by individual workers, superfluous to enhancing the solvency of the Social Security program. This would be a radical departure from mainstream Social Security analysis over the past decade or so.

Third, if benefits from personal accounts are to be adjusted for risk, benefits from the current program should be similarly risk-adjusted. This concept applies in two ways. First, the current program is insolvent over the long-term, promising future retirees benefits 50 percent higher than can be paid under current law financing. Hence, there is not simply a risk but a *certainty* that current tax or benefit schedules will be altered. Assuming that legislated tax rates are not changed, the common sense "risk adjusted" benefit baseline would be what the current program can afford to pay – that is, the payable level of benefits utilized for analysis by the Commission. By this standard, the comprehensive Commission Models pay substantially higher benefits to all retirees than the current program, with low-wage individuals receiving the largest increases.

Moreover, benefit promises under the current program are clearly not as secure as explicit government obligations such as Treasury bonds. A worker with a personal account holding bonds backed by the full faith and credit of the government would unquestionably have a stronger claim on future government resources than a worker promised the same sum under the current Social Security program, which grants individuals no legal right to their benefits and which, as the 1977 and 1983 reforms attest, can change the rules of the game at relatively short notice. Risk adjusting current program benefits could involve estimating the risk of the current system and adjusting promised benefit levels downward until risk was comparable to that of government bonds.[21]

Subsidies to personal accounts

Under Commission Model 2, workers opting for personal accounts give up their traditional benefits equal to their account contributions compounded at a 2 percent real interest rate, called the "offset interest rate."[22] Diamond and Orszag argue that "Model 2 subsidizes the accounts by charging an interest rate projected to be one percent below the [3 percent real interest] rate on Treasury bonds." The traditional program, they argue, loses money on the deal and reform therefore subsidizes personal account holders at the expense of non-account holding taxpayers and retirees.

This argument relies on a confusion between the interest rate earned by the Social Security trust fund – which is set in legislation, and can be changed at any time –

and the (generally lower) rate of return Social Security pays to individuals. In this context, several points are worth making:

1. Account holders *as a group* do not receive a subsidy under Commission Model 2. If a worker choosing an account gives up less traditional benefits than his account contributions would have "bought" him from the current program, he has effectively been subsidized. On average, future retirees will receive an approximately 2 percent real return from Social Security, the same as the offset interest rate under Model 2. At a 2 percent offset interest rate, most workers would give up traditional benefits worth roughly what their account contributions would have bought them. At an offset interest rate of 3 percent, which Diamond and Orszag imply would eliminate the "subsidy," most workers would give up substantially *more* in traditional benefits than their account contributions would have bought from the current program.[23] Hence, there is no overall subsidy to the individuals holding accounts.

Illustration: A worker earns a 2 percent return under the current program, entitling him to $1,000 per month in retirement. If he put *all* his payroll taxes into an account (not just part, as under the Commission plans) subject to an offset interest rate of 2 percent, he would give up all his traditional benefits -- $1,000 per month. At a 3 percent offset interest rate, he would not only have to give up the entire $1,000 per month but pay an *additional* $200 per month back to the government. In short, Diamond and Orszag argue that to eliminate Model 2's account "subsidies" account holders should owe the traditional system *more* than they would have received from it, a highly counterintuitive argument.

2. Subsidies *within* the group of account holders tend to flow toward lower-wage individuals. An account-holder entitled to a current-program return exceeding the 2 percent offset interest rate gives up *less* in traditional benefits than his account contributions would have bought him in the current system. In effect, he receives a subsidy. An account holder entitled to a current-program return below the 2 percent offset interest rate effectively pays an "exit tax": he must give up *more* traditional benefits than his account contributions would have bought him.

While future retirees will receive approximately 2 percent returns *on average*, low-wage workers tend to be entitled to returns above 2 percent and high-wage workers to returns below 2 percent. Hence, while account holders as a group do not receive a subsidy, within the group low-wage account holders effectively receive a subsidy from high-wage account holders.[24]

3. Diamond and Orszag's contention that 100 percent of eligible workers would opt for accounts means we would be "subsidizing ourselves." Even if we accept that a general subsidy to account holders exists, Diamond and Orszag argue that participation under Commission Model 2 would be 100 percent (not 67 percent as assumed by the Commission and Social Security's actuaries).[25] If every eligible worker would become an account holder, what exists is a general tax subsidy to personal account holders with, as point 2 shows, the largest subsidies relative to wages flowing to low-wage workers.

4. Charges of "subsidies" assume the trust fund can effectively save cash today to pay benefits tomorrow. Many believe this not to be the case. Many argue that Social Security surpluses have historically been used to hide deficits elsewhere in the budget, enabling the non-Social Security portion of the government to tax less or spend more than in otherwise would have. If this is the case – and many on both sides of the personal accounts debate believe it is[26] – then Social Security funds are effectively subsidizing the rest of the budget, not being saved to pay future retirement benefits. Saving Social Security funds in accounts that cannot be "raided" to pay for other programs simply reduces these subsidies to the rest of the budget and ensures that funds dedicated to Social Security can, in a meaningful economic sense, help pay benefits in the future.

It is true, of course, that a worker holding a personal account could increase his total benefits simply by investing in guaranteed, risk-free government bonds. What that shows is that today's workers effectively subsidize the system, since they receive lower returns than their contributions would earn in Social Security's trust fund and could earn higher returns with ownership and absolute security by holding even the safest, lowest-returning private investments. That says very little for the value-for-money the current Social Security program renders to the public.

Price Indexing

The Commission's recommendation in Model to move from the "wage indexation" to the "price indexation" of initial Social Security benefits has generated controversy, at lies at the root of charges of "benefit cuts." At present, the initial benefits received by each annual cohort of new retirees rises by the rate of wage growth. If wage growth were 2 percent, for instance, an average-wage worker retiring in any given year should receive benefits 2 percent higher in real terms than an average-wage worker retiring the previous year. Under price indexing, the two retirees would receive the same benefit from the government, adjusted for inflation.[27] (Total benefits under Model 2 would continue to rise, however, due to rising personal account balances.)[28]

Wage indexing's principal merit is that it maintains replacement rates over time, such that Social Security benefits would comprise a relatively constant share of a worker's retirement income. But wage indexing has several downsides as well.

The first, of course, is dramatically rising costs. The math is simple: today, the average benefit paid by Social Security equals roughly 36 percent of the average wage; since there are 3.4 workers per retiree, the required tax rate is approximately 10.6 percent (36/3.4=10.6). As the payroll tax rate is 12.4 percent, Social Security is currently running surpluses. When the worker-to-retiree ratio falls to 2-to-1, the cost to each worker to maintain that 36 percent replacement rate rises from 10.6 percent to around 18 percent of each worker's wages (36/2 = 18). Under a wage-indexed benefit formula, rising costs are simply inescapable.

Wage indexing means that in 2075 a maximum-wage earner will be entitled to a monthly retirement benefit of $3,250 (in today's dollars), yet the program will require a 19.8 percent payroll tax rate to pay such benefits. Is such a growth in both taxes and benefits truly necessary? As chairman of the 1978–79 Advisory Council on Social Security, Henry Aaron of the Brookings Institution argued for price indexing on just such a basis:

> As per capita income rises, the case for increasing the amount of mandatory "saving" for retirement and disability through Social Security is far weaker than was the rationale for establishing a basic floor of retirement and disability protection at about the levels that exist today.[29]

The policy was not adopted, however.

Second, wage indexing means that increased economic growth can do very little to ease the burden of Social Security's financing. If economic growth increases then wages and payroll tax receipts rise as well. But since Social Security's benefits are also linked to wages, after a short delay the amount it must pay out rises too. Hence, even if economic growth doubled, Social Security would still begin running payroll tax deficits and eventually become insolvent.[30]

Price indexing would avoid these rising costs, principally because price indexing closely approximates the level of benefits that the current Social Security program is able to pay over the next 75 years. (In fact, Social Security could pay somewhat higher benefits; under Model 2, as noted above, the residual is dedicated to improving the Social Security safety net.)

Indeed, Peter Diamond argued as a member of the Consultant Panel that it was both "fair and necessary"[31] to price index future benefit levels, since "Future generations of workers should not be committed in advance to materially rising tax rates."[32] The wage indexing formula, as noted above, commits future workers to an over 50 percent increase in system costs relative to their wages. Under price indexing, Diamond and the Panel argued, "Workers would receive more equitable benefits in relation to their contributions."[33]

Diamond also noted, correctly, that price indexing "is not a benefit reduction for those already retired. Nor is it a reduction in the purchasing power of benefits for any generation of retired people compared with corresponding people of previous generations."[34] A glance at the Commission's report shows rising real benefit levels for all future retirees.

When President Carter was seen to be favoring wage indexing over a price-indexed approach, Diamond and the other panel members chided him for fiscal and generational irresponsibility:

> President Carter would be displeased with his predecessors if he were currently faced with the choice of cutting Social Security benefits for present recipients or raising the same amount of revenue as would be raised by an increase in the payroll tax rate of five percentage points. Yet that is precisely what the best

> current estimates say he is proposing to do to some future President.... *It appears to us that correction of overindexing by choice of a price indexing method would be greatly superior [to wage indexing]....* Use of the price indexing method would eliminate the need for a tax rise when the percentage of retirees increases sharply early next century... While the price indexing method implies protection from inflation and a growth in benefits with the real growth of the economy, *the wage indexing method calls for a much larger growth in benefits for future retirees at a time when the country may not be able to afford it.* Use of the price indexing method would permit moderate tax and benefit increases to aid those recipients with greatest need as perceptions of those needs arise.[35]

The same charges could be made today against those who wish to saddle future taxpayers with economic burdens they themselves are unwilling to bear today.[36]

The price indexing method as advocated by Professor Diamond was somewhat different from that proposed by the Commission. Diamond's iteration would, if instituted at the same time as the Commission's method, pay somewhat higher total benefits over time (at a somewhat higher cost, of course). On the other hand, according the Social Security's actuaries, the alterations this method of price indexing makes to Social Security's benefit formula would "gradually reduce, and eventually eliminate, the progressivity of the current benefit formula.[37] As a whole, Model 2 clearly *increases* Social Security's progressivity.[38]

The most important difference, however, is based on time: the Consultant Panel of which Diamond was a member would have fully implemented their version of price indexing by 1988, reducing benefits for workers retired *today*. The Commission, by contrast, would not begin price indexing benefits until 2009, protecting all workers aged 55 and over from any changes. Moreover, unlike the Commission's Models, the Consultant Panel's proposal contained no provisions for higher-returning personal accounts with which to make up for reductions in promised traditional benefits.

Diamond and others argue that they favored price indexing in the 1970s because the short and long-term financing problems facing Social Security at the time were much greater than those at present. But price indexing, which is extremely slow to take effect, would have done little to avert short-term insolvency, which was addressed largely through increases in the payroll tax rate and wage ceiling.

Over the long term, the double indexing for inflation introduced in the 1972 amendments would have produced runaway growth of benefits. Clearly promised benefit levels would not be produced.

The question facing Diamond then, as facing us today, is what is the appropriate level of benefits that Social Security should pay – the higher but more expensive level entailed by wage indexing, or the lower but less expensive level produced by price indexing? Diamond rejected the wage indexed benefit formula that Social Security now contains and argued that a price-indexed formula was more appropriate.

Today, Diamond and Orszag argue that maintaining constant replacement rates through wage indexing is "crucial."[39] Yet as part of the Consultant Panel, Diamond explicitly rejected the idea that replacement rates should be the sole criterion for appropriate benefit levels: "The merit of seeking a benefit formula that undertakes to maintain the present distribution of replacement ratios is a source of doubt to this Panel." [40] The Panel elaborated:

> [T]he effects of any particular formula should be studied in terms of what the formula accomplishes in each of two related but distinct measure, these being (a) the purchasing power of the benefit, and (b) the relationship of retirement benefit to income covered for Social Security just before retirement, i.e., the 'replacement ratio.' Discussion of Social Security benefit structure has concentrated heavily upon the second of these as the criterion of reasonableness. But we believe it is just as important to discover whether the proposed formula succeeds in granting nearly equal purchasing power to comparable workers who retire at different times. [41]

For lower-wage individuals, total benefits paid under Commission Model 2 would largely maintain current law replacement rates. For higher-wage individuals, greater emphasis is placed on maintaining real purchasing power at a reasonable cost to the workers supporting the program. By the standard set by Diamond as a member of the Consultant Panel, Commission Model 2 would be more successful than maintaining the current program's benefit formula, as most critics of the Commission propose.[42]

Disability Benefits

Diamond and Orszag, as well as many other commentators, have been harshly critical of the Commission's treatment of Social Security's Disability Insurance program,

which provides benefits to workers who through illness or injury are unable to continue to work. They say:

> The same benefit formula that is used for retirement benefits is also used for disability benefits. Thus the switch to price indexation means that a worker becoming entitled to disability benefits in 2020 would have disability benefits reduced by 10.7 percent; a worker becoming entitled in 2040 would have disability benefits reduced by 26.4 percent; and a worker becoming entitled in 2075 would have disability benefits reduced by 47.5 percent. Yet, many disabled workers would have little opportunity to accumulate substantial balances in their individual accounts to offset these benefit reductions – and in any case, they would not be allowed access to their individual account balances prior to retirement age.[43]

To their credit, Diamond and Orszag recognize that "the Commission apparently does not support the dramatic implications of its proposals for disability benefits."

This does not, however, stop them from condemning the Commission's handling of disability benefits:

> Nevertheless, the Commission still counts every penny of decreased disability benefits in its actuarial scoring. While the Commission was willing to assume substantial general revenue infusions to subsidize individual accounts, it was unwilling to use general revenue or other means to protect the disabled and young survivors from the traditional benefit reductions called for under Models 2 and 3.[44]

These charges have been repeated throughout the Social Security reform debate.

Diamond and Orszag's charges would have greater resonance, however, if there had been a superior way for the Commission to handle disability benefits and if Diamond himself had not treated disability benefits in precisely the same way as a member of the Consultant Panel on Social Security.

To be clear, the Commission made <u>no</u> specific recommendations regarding the long-term financing of Social Security's disability program. As the Commissioners' stated:

> The Commission's short life span has not allowed time for the careful deliberation necessary to develop sound reform plans for the disability program. Because of the complexity and sensitivity of the issues involved, we recommend that the President address the DI program through a separate policy development process.[45]

The Commission noted that, "in the absence of fully developed proposals, the calculations carried out for the Commission and included in this report assume that defined benefits will be changed in similar ways for the two programs." However,

> *This should not be taken as a Commission recommendation for policy implementation....* the Commission recognizes that changes in Social Security's defined benefit structure and the role of personal accounts may have different implications for DI and OASI beneficiaries. The Commission urges the Congress to consider the full range of options available for addressing these implications.[46]

In other words, while the Commissioners anticipated that additional steps would be taken to address the DI program, in the absence of such recommendations the Commission's proposals were *scored* as if the changes made to Social Security's benefit formula were to be equally applied to the disability (and survivors) elements of the program.

This is clearly an imperfect step. Were legislation based on the Commission models to provide higher disability benefits than as scored by the actuaries, it would come at a greater cost and therefore produce smaller savings relative to maintaining the current program.

Nevertheless, it is difficult to imagine a superior solution. Diamond and Orszag faulted the Commission, saying, "it dedicated no revenue to financing a more modest reduction in disability benefits."[47] But any such dedication of additional revenues to the disability program would clearly (and mistakenly) be *interpreted* as a specific policy recommendation, just as the Commission's failure to dedicate additional revenues has been mistakenly interpreted.

The Commission itself had neither the time nor the expertise to tackle the considerable financing and policy difficulties facing the disability program.[48] Rather than pretend to have solved the disability program's problems through hastily considered changes or to paper them over through increased general revenue transfer that imply that DI needs only money and not reform, the Commission chose to leave disability reform to a later group of specialists.

Significantly, as a member of the Consultant Panel on Social Security, Professor Diamond adopted precisely the same treatment of disability benefits as the Commission:

> This Panel has concentrated on benefits for retirements, and therefore recommends a separate exploration of redesign of survivor and disability benefit programs by a selected group of authorities.[49]

The Consultant Panel presented its cost estimates for the Social Security program as a whole – including Disability Insurance – rather than restricting its scoring to the retirement element of the program. In addition, the Consultant Panel – like the President's Commission – did not dedicate additional revenues to the disability program.

Moreover, reductions in promised disability benefits under the Consultant Panel's recommendations would have been substantially *larger* than under the Commission proposals, as price indexing would already have been in place for twenty years.

By all appearances, this is an instance of the pot calling the kettle black. Yet both the pot and the kettle did the right thing. A working group focusing on retirement issues could not adequately address the more complex policy questions involved with disability reform. Dedicating additional revenue to the disability program would inevitably be interpreted as a policy recommendation, whatever the group members might have said.

The non-partisan Social Security Advisory Board declared that, "the issues facing the disability programs cannot be resolved without making fundamental changes."[50] The Commission did not, and did not claim to, make recommendations for those fundamental changes. Nor, however, did it recommend the nefarious "cuts" that so many commentators have attributed to it.

Conclusion

Let me conclude by pointing out that Social Security reform incorporating personal accounts is not painless, it is not a free lunch, it is not something for nothing. And the Commission never claimed that it was. Personal accounts would, however, pay higher benefits at lower cost than alternatives lacking private market investment,

making reform *less* painful than it otherwise will be. And the continued public appeal of personal accounts – a July poll by Zogby International found 68 percent of likely voters continuing to support voluntary accounts, despite a falling stock market and relentless attacks by political opponents – can make public acceptance of reform easier to achieve.

As I argued, Commission Models cut benefits only when compared to a mythical Social Security program that faces no financing shortfall. To their credit, Diamond and Orszag acknowledge the current program's financing shortfalls, noting that

> Some combination of a reduction in benefits, an increase in revenue, and an increase in the rate of return earned on the reserves of the Social Security Trust Fund is required to bring the system back into balance. Since it is unlikely that a reform plan would restore long-term solvency solely through payroll tax increases, transfers from the rest of the budget, and/or the investment of Social Security reserves in financial instruments that yield a higher rate of return than Treasury bonds, restoring long-term balance to Social Security will likely involve some reduction in "replacement rates." A fundamental issue is whether the balance among the possible elements of a reform plan is appropriate.[51]

Yet nowhere in their study do they even hint at what the proper balance among reform elements is, nor how they would address Social Security's long-term funding problems.[52]

What would be most helpful to the reform debate would be for the considerable talents of Drs. Diamond and Orszag, as well as the many other able critics of personal accounts, to be dedicated to formulating model legislation so that a true apples-to-apples comparison between legitimate reform proposals could be made.

The best way to defeat the Commission's proposals is to put forward a better one. It is telling that most personal account opponents appear reluctant in the extreme to do so. At present, the so-called "secret plan" for Social Security is not, as some allege, the Commission's proposals but the alternatives to them. Once viable alternatives to account-based plans are put forward, the political and legislative process can produce choices and compromises between these outlooks and progress toward strengthening Social Security can be made.

Thank you for the opportunity to testify, and I hope that my views may be helpful in your consideration of Social Security reform.

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[1] See "Strengthening Social Security and Creating Personal Wealth for All Americans," Report of the President's Commission, December 2001; available at hereafter referred to as "CSSS Final Report." See also "Perspectives on the President's Commission to Strengthen Social Security," Cato Institute Social Security Paper No. 27, August 2002; and John F. Cogan and Olivia S. Mitchell, "The Role of Economic Policy in Social Security Reform: Perspectives from the President's Commission," National Bureau of Economic Research Working Paper No. 9166, September 2002.

[2] Executive Order 13210, President's Commission to Strengthen Social Security, May 2, 2001.

[3] Citations here are from Peter A. Diamond and Peter R. Orszag, "An Assessment of the Proposals of the President's Commission to Strengthen Social Security," Brookings Working Paper, June 18, 2002, hereafter referred to as "Diamond-Orszag." Other versions have been released as well, though the fundamental arguments do not change.

[4] William Hsiao (Chairman), Peter Diamond, James Hickman, and Ernest Moorhead, "Report of the Consultant Panel on Social Security to the Congressional Research Service," August 1976, p. 23. Hereafter referred to as "Consultant Panel Report."

[5] "Social Security Commission Plans Would Entail Substantial Benefit Reductions And Large Subsidies For Private Accounts," press release, Center on Budget and Policy Priorities, June 18, 2002

[6] Barbara Allen, "Simple Arithmetic," letter to the *Winston-Salem Journal*, September 24, 2002.

[7] Benefits are illustrated with a low-wage worker for two reasons: first, low-wage workers and their families are in most in danger of poverty if the current program becomes insolvent. Second, two of the Commission reform models (2 and 3) contain progressive personal accounts giving relatively larger contributions to lower-wage workers. High-wage workers with relatively smaller accounts would not see the same improvements in benefits relative to the current program; nevertheless, these illustrations show the power of prefunding future benefits with market assets earning higher rates of return than the current program.

[8] Diamond and Orszag argue that their use of the single baseline of promised ("scheduled") benefits "conforms to the approach to evaluating Social Security reforms adopted by the Greenspan Commission in 1983 and the Advisory Council in 1994-1996, both of which used the scheduled benefit formula as the baseline despite projected long-term deficits in Social Security." It is worth noting, however, that the Greenspan Commission report contained (surprisingly) little in the way of individual benefit projections. The report of the 1994-96 Advisory Council, like the Final Report of the President's Commission, contained in its actuarial tables data both for what the program promises ("Present Law") and what under current law financing it could actually pay ("Present Law Payable"). Providing information both on what Social Security promises and on what it can actually pay allows readers to understand how much a reform proposal improved on what it started with – a system that must make deep across the board benefit cuts beginning in 2041.

[9] Testimony of David Walker, General Accounting Office, before the House Budget Committee, June 19, 2002. In fairness, Walker's comments applied only to the scheduled benefits baseline utilized by Diamond and Orszag. Walker did not condemn the paper as a whole, only the basis of their charge of benefits cuts.

[10] Bob Kerrey and Warren Rudman, "Social Security Shell Game," *The Washington* Post, August 12, 2002, Page A15.

[11] David Koitz, Geoffrey Kollmann and Dawn Nuschler, "Social Security: What Happens to Future Benefit Levels Under Various Reform Options," Domestic Social Policy Division, Congressional Research Service, August 20, 2001, p. 13.

[12] The current law baselines tells us what will happen in the absence of action, so that we might best weigh the various courses of action available to us today and in the future. Some have noted

comments by Federal Reserve Board Chairman Greenspan that such a sudden reduction in benefits is politically unrealistic, since some action would surely be taken to avoid it. (See "Saving for Retirement," Remarks before the 2002 National Summit on Retirement Savings, February 28, 2002.) Greenspan's observation is unquestionably true, but the laws of politics cannot justify defiance of the laws of mathematics. If we assume that full promised benefits are to be paid beyond the trust fund exhaustion date of 2041, we must similarly assume the tax increases necessary to fund those benefits; the simplest assumption is an increase in the payroll tax rate in 2041 from the 12.4 percent contained in current law to the 17.8 percent required to pay scheduled benefits.

[13] Some argue for showing only the government-paid portion of the total Social Security benefit, describing it as "guaranteed." In fact, Social Security benefits are not guaranteed in a legal sense, as the Supreme Court ruled in Flemming v. Nestor (1960). Neither are currently scheduled benefits guaranteed in a financial sense, since the current program promises benefits up to 50 percent greater than the tax rates mandated in law can sustain. Were a worker to invest his account in government bonds, his account assets would be both legally and financially more guaranteed than scheduled (or even payable) benefits from the current program.

[14] Workers are assumed to purchase annuities at retirement paying a fixed monthly benefit indexed annually for increases in the Consumer Price Index. Workers who chose variable annuities would receive benefits 4–9 percent higher than those with fixed annuities, assuming that the annuity is invested in the default portfolio of 50 percent stocks, 50 percent bonds. It is also assumed that the worker is married. Single workers would receive benefits approximately 10 percent higher, as they would not be required to purchase joint-and-survivors annuities providing spousal coverage.

[15] Diamond and Orszag cite recommendations from the Congressional Budget Office and the Office of Management and Budget that the Railroad Retirement Fund "risk adjust" its investments in equities. Certainly, had the Commission been allowed to borrow policy views from other organizations rather than submitting their proposals to the scoring rules of Social Security's actuaries, its conclusions would have been buttressed. Nevertheless, the Commission abided by SSA's scoring guidelines, as do Diamond and Orszag in other aspects of their analysis.

[16] The American Academy of Actuaries recommends a similar process focusing on expected returns, with due cognizance of historical variations, rather than Diamond and Orszag's practice of risk adjusting all investments to the government bond rate of return. See Pension Practice Council of the American Academy of Actuaries, "Practice Note: Selecting and Documenting Investment Return Assumptions," May 2001. Available at www.actuary.org.

[17] For instance, Diamond and Orszag criticize the Commission for stressing sustainable rather than mere 75-year solvency, which is the standard most often used by Social Security's actuaries, despite the fact that all sides agree that a sustainable system would be preferable and that sustainability is clearly a higher standard than mere 75-year solvency. See, for instance, Peter A. Diamond and Peter R. Orszag "A Response To The Executive Director Of The President's Commission To Strengthen Social Security," Center on Budget and Policy Priorities, July 15, 2002.

[18] Stephen C. Goss, Chief Actuary, Alice H. Wade, Deputy Chief Actuary, Memorandum: "Estimates of Financial Effects for Three Models Developed by the President's Commission to Strengthen Social Security," January 31, 2002, p.18

[19] Henry J. Aaron, Alan S. Blinder, Alicia H. Munnell, and Peter R. Orszag, "Governor Bush's Individual Account Proposal: Implications for Retirement Benefits," The Century Foundation Issue Brief no.11, June 2000.

[20] "Evaluating Issues in Privatizing Social Security: Report of the Panel on Privatization of Social Security," National Academy of Social Insurance, November 1998, p. 10. Emphasis added.

[21] The difference between the risk-adjusted current program benefit and the benefit offered by an account holding government bonds would be the amount a rational individual would pay in order to have the greater security that an explicit legal asset provides. On a simpler basis, a worker who would be owed,

say, $1,000 per month at retirement could be asked how much less he would accept in order to have a benefit based on government bonds, which would give him a legal asset backed by the full faith and credit of the government.

[22] Under Model 1 the "offset interest rate" equals 3.5 percent; under Model 3, 2.5 percent.

[23] Moreover, even at a 3 percent offset rate the current program's actuarial balance would decline, due the fact that the fixed 75-year actuarial scoring period would count the "loss" to the trust fund through account diversions taking place within the scoring period but ignore the "gain" from benefit offsets taking place outside of it.

[24] To illustrate, an average-wage dual-earning couple retiring in 2029 is projected to receive a 2 percent real annual return from Social Security. This couple would be held relatively harmless either way. A low-wage dual earner couple, by contrast, is projected to receive a 3.1 percent average return from the current program, but in choosing an account they give up traditional benefits only as if they were earning a two percent return and hence are subsidized. A high-wage couple is entitled to a 1.4 percent return from the current program, but must give up traditional benefits at a 2 percent rate, effectively penalizing them.

A note on progressivity: Diamond and Orszag argue that the alleged subsidy in Model 2 favors high-wage over low-wage workers: "A lower earner choosing to divert revenue into an account would receive a smaller subsidy than would a higher earner, so that the subsidies represent a regressive feature of the Commission plans." (Diamond-Orszag, p. 12) However, the authors' use of the word "regressive" is wholly contrary to its general application. Under the current Social Security program, for instance, high-wage workers receive larger monthly benefits than do low-wage workers. Does this make Social Security regressive? Of course not, because low-wage workers receive higher benefits relative to what they contribute. Based upon Diamond and Orszag's definition of progressivity, the current Social Security system itself would be regressive.

Under the Commission's Model 2 a low-wage worker holds an account – and therefore receives a "subsidy" – four times higher relative to his income than a maximum-wage worker. For workers retiring in 2052, for instance, a personal account would increase a low-wage worker's total benefit by 48.5 percent, versus a 32 percent increase for a maximum-wage worker. Moreover, as noted above, subsidies under Model 2 flow not from the system as a whole to account holders but from account holders earning low returns under the current program to account holders earning higher returns under the current program. To the extent the current benefit formula is progressive, the individual subsidies inherent to the offset interest rate maintain that progressivity.

[25] Diamond-Orszag, p. 29. Higher participation increases the costs of Model 2 during the 75-year valuation period because the assets accumulated in accounts as of the 76th year (and traditional benefits foregone by account holders at that point) are not counted.

[26] For instance, in 1988 – under budget conditions similar to those of today – Henry Aaron of the Brookings Institution argued that, "the current policy is to borrow the OASDHI surplus to finance a deficit in the rest of the budget. As a result the payroll tax, ostensibly earmarked for retirement, survivors, disability, and hospital insurance, is being used increasingly to pay for other government expenditures, such as defense and interest on the public debt." Henry Aaron, Barry Bosworth and Gary Burtless, *Can America Afford to Grow Old?* (Washington: The Brookings Institution, 1988), pp. 11, 7.

[27] Following retirement, benefits for both retirees would continue to increase along with the Consumer Price Index, as under current law.

[28] Lifetime benefits from the government would also rise, since future retirees will live longer.

[29] Aaron and his coauthors argued that:

> At the levels of real income prevailing in the 1930s (or perhaps even in the 1950s), it can well be argued that it was appropriate, indeed, highly desirable—perhaps even necessary for the preservation of our society—that government should, by law, have guaranteed to the aged and disabled and their dependents replacement incomes sufficient to avoid severe hardship, and to

> have required workers (and their employers) to finance this system with a kind of "forced saving" through payroll tax contributions. But as real incomes continue to rise, it is not easy to justify the requirement that workers and their employers "save" through payroll tax contributions to finance ever higher replacement incomes, far above those needed to avoid hardship. Perhaps not all workers will want to save that much, or to save in the particular time pattern and form detailed by present law.
>
> Future Congresses will be better equipped than today's Congress to determine the appropriate level of and composition of benefits for future generations... Congress might elect to give more to certain groups of beneficiaries than to others, or to provide protection against new risks that now are uncovered. But precisely because we cannot now forecast what form those desirable adjustments might take, we feel the commitment to large increase in benefits and taxes implied under current law will deprive subsequent Congresses, who will be better informed about future needs and preferences, of needed flexibility to tailor Social Security to the needs and tastes of the generations to come.

Statement of Henry Aaron, Gardner Ackely, Mary Falvey, John Porter, and J. W. Van Gorkom, *Social Security Financing and Benefits, Report of the 1979 Advisory Council* (Washington: Government Printing Office, 1979), pp. 212–15.

[30] See Andrew G. Biggs, "Social Security: Is It 'A Crisis That Doesn't Exist'?", Cato Institute Social Security Paper No. 21, October 5, 2000.

[31] Consultant Panel Report, p. 23. As the panel's report pointed out: "The wage-indexing method provides a sharp tilt in favor of workers retiring in the future. The increases in benefits for workers already retired are limited to increases in the rise in the Consumer Price Index. Yet workers who retire five years later will receive increments due to both price changes and increases in real wages. This difference in retirement benefits can be substantial" (p.9).

[32] Consultant Panel Report, p. 2

[33] Consultant Panel Report, p. 4

[34] Consultant Panel Report, p. 4

[35] William Hsiao, Peter Diamond, James Hickman, and Ernest Moorhead, letter to the *New York Times*, May 29, 1977, sec. 4, p. 14. Emphasis added.

[36] Other current opponents of the Commission's position then took a similar view. Henry Aaron of the Brookings Institution concurred with Diamond, arguing that price indexing "would leave more options open for spending the productivity dividend of economic growth. Congress could still raise pensions in the future, but it could also decide that other programs such as housing, health insurance, or defense have greater claims on available funds." See "Propping up Social Security," *Business Week*, July 19, 1976, p. 34.

[37] Stephen C. Goss, Deputy Chief Actually, Social Security Administration, "Long-Range OASDI Financial Effects of a Proposal to CPI-Index Benefits Across Generations," Memo to Harry C. Ballantyne, Chief Actuary, May 3, 1999

[38] Under current law, a low wage retiree in 2022 would receive benefits equal to 46 percent of those received by a high wage retiree. Under Model 2, that figure would increase substantially to 56 percent.

[39] Diamond-Orszag, p. 6

[40] Consultant Panel Report, p. 23.

[41] Consultant Panel Report, p. 21.

[42] The current wage indexing formula would promise far higher benefits to future workers with identical wages to a worker today. For instance, a $20,000 per year worker would retire today with

monthly benefits of about $877, equal to 53 percent of his pre-retirement earnings. By 2050, the same worker earning the same $20,000 (in today's dollars) would be entitled to $1091 monthly, equal to 64 percent of his pre-retirement earnings. In other words, the 2050 retiree would receive 25 percent higher benefits simply due to the passage of time, even if he paid precisely the same taxes. Moreover, under the current benefit formula, future increases in benefits will be greatest for the highest earners. For instance, a worker earning $10,000 today already receives the maximum 90 percent replacement rate on much of his wages. A similar worker making $10,000 (in 2002 dollars) in 2031 will receive a 25 percent real benefit increase, and in 2071 a 58 percent increase versus today. By contrast, higher income workers today have much of their wages covered under the upper bend points offering lower replacement rates. Over time, wage indexing pushes more of these wages into the bend points offering higher replacement rates. For instance, a $100,000 worker retiring at 65 in 2001 can expect to receive about $330,000 in lifetime retirement benefits. By 2031, lifetime benefits increase by 51 percent to $499,000, and by 2071 increase by 120 percent to $725,000, under today's (unsustainable) benefit formula. See Andrew G. Biggs, "Perspectives on the President's Commission to Strengthen Social Security," Cato Institute Social Security Paper No. 27, August 2002, pp. 26-27.

[43] Diamond-Orszag, p. 8

[44] Diamond-Orszag, p.43

[45] CSSS Final Report, p. 149

[46] CSSS Interim Report, August 2001, p. 138; emphasis in original. Available at www.csss.gov.

[47] Diamond-Orszag, pp. 9-10. Emphasis in original.

[48] As the Commission's Final Report pointed out, "While both OASI and DI face financial shortfalls due to demographic changes, other factors affect the DI program that are more complex and may require a unique set of solutions. It has been decades since a comprehensive review of the DI program has occurred. There are indications that the standards used to determine disability vary across geographic regions and across different levels of the adjudicative process, which raises questions about the overall consistency and fairness of the program for claimants. In addition, fundamental questions exist as to whether the program adequately reflects Congressional intent and current thinking on disability policy. Technology, the economy, and social attitudes about disability have changed dramatically in the past 50 years. The law has only begun to respond to these changes." CSSS Final Report, p. 149.

[49] Consultant Panel Report, p. 38

[50] Social Security Advisory Board, "Charting the Future of Social Security's Disability Programs: The Need for Fundamental Change," January 2001, p. 11.

[51] Diamond-Orszag, p. 8-9

[52] Peter Diamond has suggested the following steps to address Social Security's funding problems: force newly-hired state and local workers to enter the system; raise the maximum wage subject to payroll taxes; increase taxes on benefits and eliminate the current tax exemption for low-income retirees; index benefits for life expectancy to about half the degree done in Plan 3 (critics call this an increase in the retirement age, though technically it is not); and phase in payroll tax increases to cover the remainder of the deficit. "Will Voluntary Personal Accounts Save Social Security?" American Enterprise Institute Seminar Series in Tax Policy, April 5, 2002. The impact of these steps on individual benefits and annual system cash flows is not clear, as they have not been combined in a comprehensive way so that they might be actuarially scored.

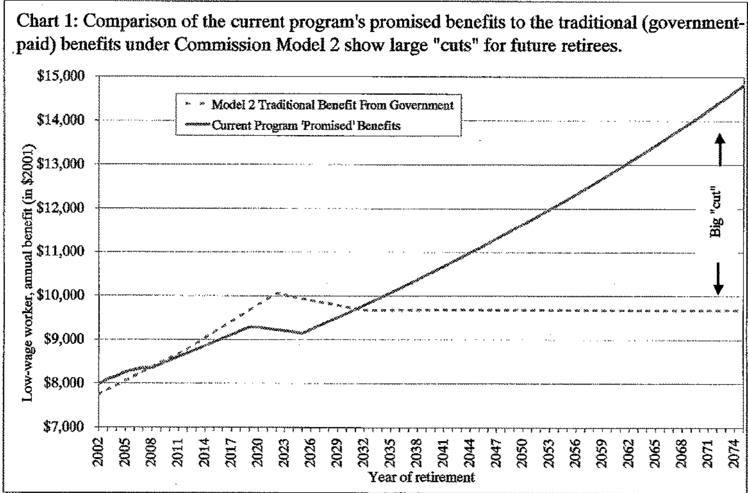

Chart 1: Comparison of the current program's promised benefits to the traditional (government-paid) benefits under Commission Model 2 show large "cuts" for future retirees.

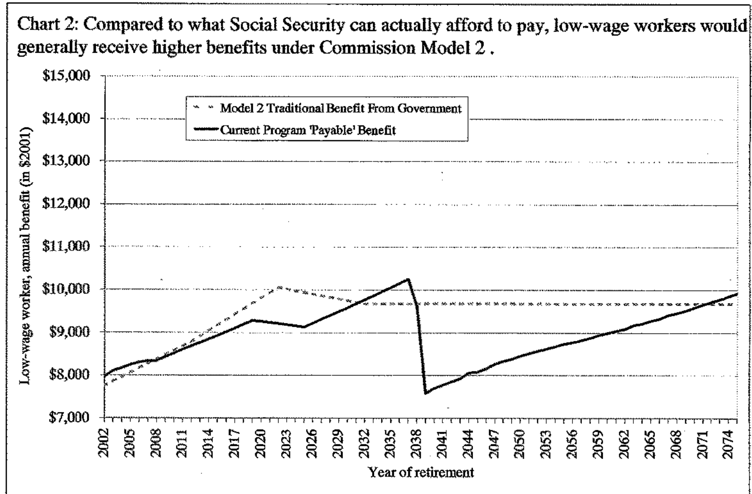

Chart 2: Compared to what Social Security can actually afford to pay, low-wage workers would generally receive higher benefits under Commission Model 2 .

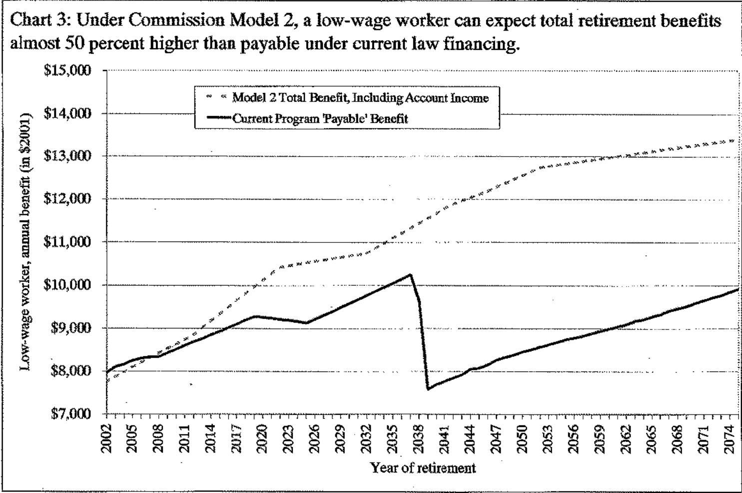
Chart 3: Under Commission Model 2, a low-wage worker can expect total retirement benefits almost 50 percent higher than payable under current law financing.
Model 2 Total Benefit, Including Account Income
Current Program 'Payable' Benefit
Low-wage worker, annual benefit (in $2001)
$15,000
$14,000
$13,000
$12,000
$11,000
$10,000
$9,000
$8,000
$7,000
2002 2005 2008 2011 2014 2017 2020 2023 2026 2029 2032 2035 2038 2041 2044 2047 2050 2053 2056 2059 2062 2065 2068 2071 2074
Year of retirement

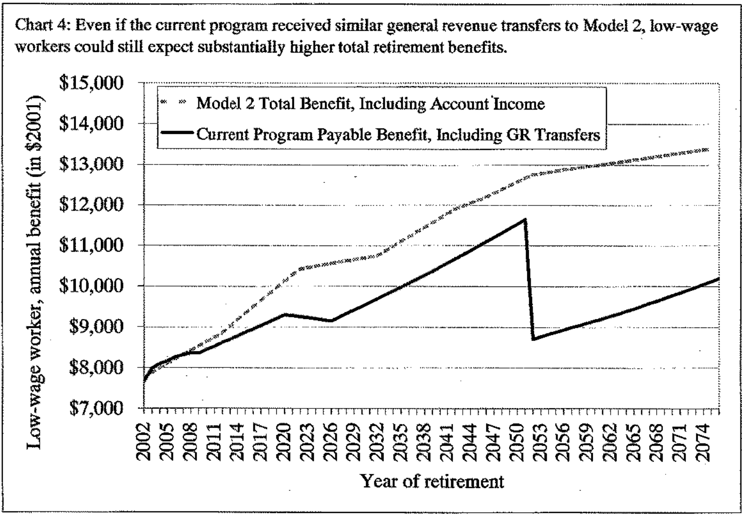
Chart 4: Even if the current program received similar general revenue transfers to Model 2, low-wage workers could still expect substantially higher total retirement benefits.
Model 2 Total Benefit, Including Account Income
Current Program Payable Benefit, Including GR Transfers
Low-wage worker, annual benefit (in $2001)
$15,000
$14,000
$13,000
$12,000
$11,000
$10,000
$9,000
$8,000
$7,000
2002 2005 2008 2011 2014 2017 2020 2023 2026 2029 2032 2035 2038 2041 2044 2047 2050 2053 2056 2059 2062 2065 2068 2071 2074
Year of retirement

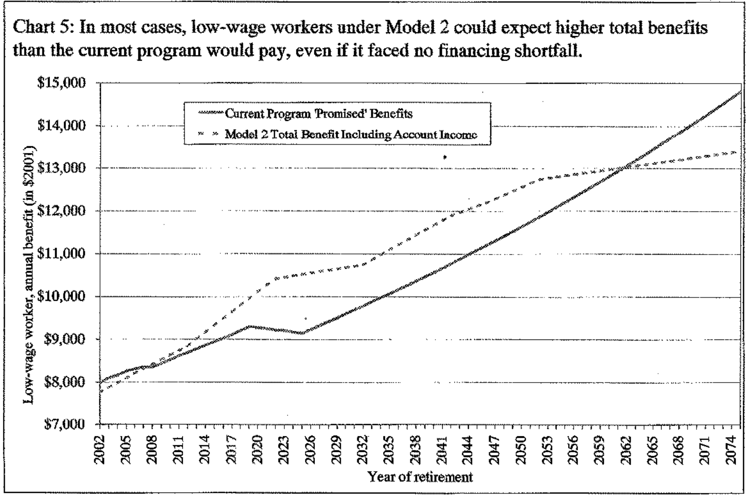
Chart 5: In most cases, low-wage workers under Model 2 could expect higher total benefits than the current program would pay, even if it faced no financing shortfall.
Current Program 'Promised' Benefits
Model 2 Total Benefit Including Account Income
Low-wage worker, annual benefit (in $2001)
$15,000
$14,000
$13,000
$12,000
$11,000
$10,000
$9,000
$8,000
$7,000
2002
2005
2008
2011
2014
2017
2020
2023
2026
2029
2032
2035
2038
2041
2044
2047
2050
2053
2056
2059
2062
2065
2068
2071
2074
Year of retirement

Written Questions for Andrew Biggs

Senator Kyl

1. Given that the discussion of the disability program that took place during your panel was very brief, do you have any additional thoughts on the question of whether the Commission's treatment of the disability program is in some way disingenuous and to the accusations that the proposal would cut benefits for the disabled? Do you have any additional thoughts on the suggestion made at the hearing that the treatment of the disability program in the report was employed for the purpose of "making the numbers work out"?

Response to written question from Senator Kyl with regard to Oct. 3, 2002 hearing of the Senate Finance Committee

Andrew G. Biggs
Social Security Analyst
The Cato Institute
Washington, D.C.

As I pointed out in my written testimony to the Committee, the President's Commission's treatment of disability benefits under their reform proposals has been subject to substantial outside criticism.

With reference to this criticism several points are worth making:

First, the Commission's proposals do not "cut" disability benefits, in the sense that future beneficiaries would receive lower benefits in real terms than do current beneficiaries. For all beneficiaries, disabled and retired alike, the real inflation-adjusted monthly benefits paid by Social Security would continue to increase over time. No future retired or disabled individual would have a lower real standard of living than a comparable individual today.

Second, the Commission's proposals do not cut disability benefits versus what the current program is capable of paying over the long term. In fact, the Commission's proposal to "price index" the Social Security benefit formula (in the Commission's Model 2) closely approximates the rate of benefit growth the current program is capable of paying, *regardless* of whether personal accounts are introduced. Compared to doing nothing – which the dearth of reform proposals from opponents of personal accounts suggests is the de facto current policy alternative – the Commission's reform models clearly would not reduce benefits.

Third, the Commission itself stressed that while the proposals would be *scored* as if their proposed changes to the benefit formula for retirement benefits applied equally to disability benefits, the proposals themselves included no recommendations for changes to disability benefits. The Commission never claimed that estimates of the budgetary effects of their proposals did not assume the uniform treatment of retirement and disability benefits, nor that alternate plans for the disability program could not potentially increase costs. Hence, charges of inconsistency are baseless.

Moreover, the Commission's scoring of its proposals with regard to disability benefits is identical to that of a previous reform panel that included Professor Diamond – co-author, with my fellow witness Peter Orszag, of a study harshly critical of the Commission's handling of disability benefits. This is not to cast aspersions on Professor Diamond or the panel he served on, but merely to point out that the Commission's treatment of disability benefits is hardly unprecedented.

Charges that the Commission's treatment of disability insurance was designed for the purpose of "making the numbers work out" ignores several key facts. First, the calculation of such "numbers" was conducted not by the Commission but by Social Security's own independent actuaries, under the rules and standards the Office of the Chief Actuary applies to other reform proposals. Second, if the Commission were inclined to manipulate the numbers for its own benefit, there would have been substantially more fruitful avenues to take. For instance,

unlike many reform proposals that aim only for solvency over a 75-year actuarial scoring period, the Commission aimed to make Social Security solvent and sustainable *permanently*. Given that Social Security's actuarial deficit over 75 years is less than one-half that of it's permanent deficit, had the Commission held itself to the standards of some other analysts the "numbers" could have been made substantially more attractive than as portrayed in the Commission's report and accompanying actuarial analysis.

As the Commission pointed out, the disability program's problems go beyond the structural/demographic issues plaguing the retirement portion of Social Security. The Commission recommended that a separate panel, made up of experts on the Disability Insurance program, be commissioned to explore options to keep DI solvent and sustainable over the long term.

Senate Finance Committee

October 3, 2002

The Final Report of the President's Commission to Strengthen Social Security

Statement of Robert L. Bixby
Executive Director, The Concord Coalition

Chairman Baucus, Senator Grassley, and members of the Committee, thank you for inviting me to discuss the final report of the President's Commission to Strengthen Social Security. I am here representing the Concord Coalition, a nonpartisan grassroots organization dedicated to strengthening the nation's long-term economic prospects through sound and sustainable fiscal policy.

Concord's co-chairs are former senators, Warren B. Rudman (R-NH) and Bob Kerrey (D-NE). They, along with Concord's President former Commerce Secretary Peter G. Peterson and our nationwide membership, have consistently urged Washington policymakers to produce a credible plan for dealing with Social Security's long-term challenges in a fiscally responsible and generationally equitable manner. Given this objective, The Concord Coalition welcomed the appointment of the President's Commission.

My testimony today will address three questions:

- Is Social Security reform necessary?
- What are the viable reform options?
- What are the main achievements and shortcomings of the Commission's report?

I. Is Social Security reform necessary?

Absolutely. Changing demographics make the current pay-as-you-go system fiscally unsustainable and generationally inequitable over the long-term. Social Security reform is on the political agenda not because President Bush wants to change the law but because the law must be changed.

In just six years the baby boomers begin to receive their first Social Security checks. From that moment on, the number of workers whose wages are taxed, relative to the number of beneficiaries who receive the proceeds of the tax, will sharply decline. Here are the facts:

- In 1960 there were 5 workers for each Social Security beneficiary. Today the ratio is 3.3 workers for each beneficiary. As the huge baby boom generation retires the ratio will fall to 2 to 1.

- This dynamic has a profound effect on the system's fiscal sustainability. Social Security will generate ample surpluses for the next few years. But in 2009, the year after the first baby boomers qualify for benefits, the annual cash surplus will begin to shrink, and by 2017 Social Security's cash flow will turn negative.

- From 2017 through 2041 Social Security will need to draw upon interest income and eventually liquidation of its trust fund assets—special issue Treasury bonds—to pay benefits. In 2041, the trust fund will be depleted, leaving Social Security with enough annual income to pay just 74 percent of benefits.

- Redeeming Social Security's trust fund assets will have an impact on the rest of the budget because these "assets" are liabilities to the Treasury. To come up with the money for Social Security, Treasury will have to cut other spending, raise taxes, use any surpluses that may exist, or borrow from the public.

- Between 2017 and 2041, the year of projected trust fund insolvency, the system faces a cumulative cash deficit of more than $5 trillion in today's dollars. By 2041 the annual cash deficit will reach $360 billion in today's dollars — an amount roughly the size of this year's entire national defense budget.

- Closing the gap in 2041 would require a Social Security tax hike of 34 percent or a 27 percent cut in benefits.

- Over the trustees' 75-year horizon Social Security's cash deficit of $22 trillion in today's dollars far outweighs the cash surplus of roughly $1 trillion through 2017.

- As a percentage of the economy Social Security will grow by 50 percent from 4.46 percent today to 6.70 percent in 2041.

- More importantly, this growth in Social Security's cost will take place in the context of rising costs for other entitlements. The combined cost of Social Security, Medicare, and Medicaid will grow from less than 10 percent of the economy today to nearly 17 percent by 2050. And this assumes no additions to the current programs such as a Medicare prescription drug benefit. By comparison, all of government this year equals 19.5 percent of GDP, and revenues equal about 19 percent.

- This trend leads to one of three outcomes: large tax hikes, resurgent and unsustainable deficits, or the withering away of the rest of government — allowing spending on the poor, on infrastructure, and on defense to steadily decline decade after decade. No one believes that the federal government's sole function should be to transfer income to retirees at the expense of all other government functions. But that is the inevitable consequence of adhering to two widely held-and entirely contradictory-goals: limiting the size of government and leaving senior benefits on autopilot.

Suppose that one of your colleagues introduced legislation called "The Social Security Do Nothing Act." Under this bill, promised retirement benefits would be cut by 16 percent for today's 30-year olds, by 29 percent for today's 20-year olds, and by 35 percent for today's newborns. Alternatively, payroll taxes would suddenly go up by 34 percent in 2041. How many of you would rush to endorse this bill? None, I suspect. And yet, these are the grim choices under the Do Nothing Plan.

What is remarkable is not that reform plans engender such heated debate, but that the Do Nothing Plan engenders so little outrage. Worse yet is the fact that no one will have to endure the scrutiny and ridicule of specifically advocating the Do Nothing Plan in order for its absurd consequences to take effect. The Do Nothing Plan has already been enacted. It is current law.

The question facing you is the same one that faced the Commission — what should be done to undo the Do Nothing Plan? Ultimately it is you, our elected leaders, who must answer this question.

Now is the time to begin preparing for the aging of America by designing a retirement system that is both more secure for the old and less burdensome for the young. Demographic and economic circumstances will never again be so favorable for Social Security reform. However, the window of opportunity is rapidly closing.

To put it in more personal terms, consider the table below which looks at where four different generations will be at various times in their lives relative to Social Security's current outlook. What may sound like a distant and abstract problem becomes more immediate and relevant when we consider that today's 28-year old will qualify for full retirement benefits in 2041 — the year of projected trust fund insolvency — and that the system will begin to run growing annual cash deficits even before today's newborn enters the workforce.

Ages of Persons in Four Generations at Significant Dates for the Social Security Program				
2002	2017[1]	**2041[2]**	2050[3]	2076[4]
90 years old	105 years old			
60 years old	75 years old	**99 years old**	108 years old	
30 years old	45 years old	**69 years old**	78 years old	104 years old
Newborn	15 years old	**39 years old**	48 years old	74 years old

1. In 2017, Social Security's dedicated revenues will no longer cover all of its expenses. At this point Social Security will become a net drain on the budget as it begins to draw upon its claims on general revenues. The pay-as-you-go tax rate will be 13.07 — up from 10.84 today. Including Medicare Part A, the payroll tax cost rate will be 16.37.

2. In 2041, all of the assets in the Social Security trust fund will be exhausted, leaving the program able to pay only 74 percent of promised benefits. The pay-as-you-go tax rate will be 17.76 percent of taxable payroll. Including Medicare Part A, the tax rate will be 24.05.

3. In 2050, the Congressional Budget Office estimates that the cost of Social Security, Medicare and Medicaid combined will consume nearly 17 percent of GDP, almost all total federal revenues assuming that taxes remain at about 19 percent of GDP. The pay-as-you-go tax rate will be 17.92 percent of taxable payroll. Including Medicare Part A, the tax rate will be 25.08.

4. 2076 is the last year of official 75-year projection. By then the program will be able to pay just 68 percent of that year's promised benefits. The pay-as-you-go tax rate will be 19.84 percent of taxable payroll. Including Medicare Part A, the tax rate will be 30.62.

***

The table above underscores an important point: Social Security reform is a much more critical issue for today's young than today's elderly. The current system is more than adequate to meet its obligations to those who are already retired. However, the system can't possibly afford all of the benefits it promises to today's workers. Those with the greatest stake in this debate are therefore the so-called Gen X'ers and younger, and it is this segment of the population most overlooked in the Social Security reform debate. It is a big mistake.

Public opinion surveys have indicated declining confidence in Social Security over the past 25 years. Many younger workers are beginning to discount Social Security entirely in their retirement planning. This decline in public confidence is itself a major problem for a system that depends critically on everyone's approval and trust. Social Security is a generational compact in which each generation's welfare depends directly upon the willingness of the next generation to participate. If the next generation grows disaffected, the survival of the system is thrown into question.

II. What are the viable options for reform?

The Social Security challenge is first and foremost a cost challenge. Any responsible reform plan must start with measures that reduce the projected growth in benefits and makes the system fiscally sustainable over the next 75 years and beyond.

But reducing Social Security's cost is not the only challenge. There are also the issues of benefit adequacy and individual equity. Reform must ensure that future retirees have adequate benefits. It must also ensure that workers do not pay an ever-rising payroll tax burden in return for ever-diminishing paybacks on contributions. Reform needs to raise the return on Social Security contributions.

This is why The Concord Coalition believes that, along with measures to reduce its long-term cost, greater funding is an essential part of Social Security reform. To make a difference, however, the funding must be genuine. It isn't enough to simply credit more Treasury bonds to the trust funds or to redirect existing payroll contributions into marketable securities, with or without personal accounts.

Without ***new*** savings, without ***real*** funding, a plan cannot increase the productivity of tomorrow's workers, and thus becomes a zero-sum game of pushing liabilities from one pocket to another or from one generation to another. It cannot be supposed that funding more of Social Security's benefits is a way to avoid the hard choices. *It is the hard choice.*

In recent years, much attention has been given to various methods of advance funding future benefits. Suggestions include:

- a budgetary "lockbox" for the Social Security surplus
- an independent board to mange trust fund investments
- personally owned accounts

While ideological factors often cloud the debate over these options, the real issue is which is most likely to result in genuine savings. What legal, political and fiscal incentives best ensure that resources are actually reallocated from the present to the future?

Lockboxes

The main drawback of trying to prefund through a trust fund lockbox is that the trust funds are a matter of intergovernmental bookkeeping. When the Social Security trust funds run a surplus, the money is lent to the Treasury, which immediately spends it. In return, the trust funds are credited with interest –earning Treasury bonds. These transactions are entirely internal to government and are designed to keep track of formal budget authority. They give Social Security a lien on future taxpayers but they do not create real economic resources that can pay future benefits.

It is true that over the past few years political leaders buoyed by huge surplus projections reached a tacit agreement to increase savings through debt reduction by keeping the budget balanced excluding Social Security's trust fund receipts. Devoting the Social Security surplus to debt reduction is a fiscally responsible goal but it is easier said than done - as events over the past year have made clear. Regardless of intent, and despite any bookkeeping devices such as a lockbox, the government can only save the Social Security surplus if it continues, year after year, to take in more money than it needs to pay all of its other bills without dipping into the Social Security trust funds. This has only happened twice from 1983 to the present, and is not projected to happen again for many years.

Success of the lockbox concept is therefore critically dependent on the willingness of future political leaders to maintain a level of fiscal discipline that is not currently discernable.

Investment by an independent board

To get around the porous nature of trust fund lockboxes, some have proposed to set up a Social Security reserve fund administered by an independent trustee and invested in marketable securities. This mechanism would probably provide a more reliable method than the lockbox for promoting savings but here too, there are important questions. What would prevent the federal government from borrowing against its own Social Security investments? When all is said and done, government would still own the reserve, and whatever government owns it can contrive to spend. Moreover, the public would have no particular incentive to ensure that the savings are genuine because Social Security's defined benefit promise is not contingent on the system's fundedness.

Personally owned accounts

A third method of prefunding is to establish a system in which some portion of workers' payroll tax contributions are saved and invested in personally owned accounts. The advantage of this method is that it would provide a lockbox no politician could pick. The current system provides a *statutory* right to benefits that Congress can cut at some future date. Personally owned accounts would offer workers ownership of constitutionally protected property which could be passed on to their heirs — something the current system does not allow. The funds would be put beyond the reach of government. Congress could not double-count personal account assets in the budget. And if it tried to shut down the flow of funds into personal accounts, voters would have a huge incentive to object.

The transition cost

Transitioning out of the current pay-as-you-go system into a partially funded system, with or without personally owned accounts, inevitably requires some group of workers to pay for the pre-funding of the new system while at the same time maintaining funding for those still receiving benefits under the old system. There is no avoiding this cost. Workers will thus have to save more, retirees will have to receive less, or both.

The fundamental issue is not whether the system should be public or private, but the extent to which it should be unfunded or funded. Unfunded personally owned accounts would neither add to national savings nor reduce the burden of today's system on future generations, even if they earn a higher rate of return than the current pay-as-you-go system. The fiscal and economic effects of debt-funded personal accounts are no different from the effects debt-funded trust funds. Both avoid the real challenge, which is to ensure that adequate resources are set aside to meet the cost of future benefits.

Investment in higher return assets might provide a way to mitigate the extent of benefit cuts or tax increases that might otherwise be required. However, no conceivable rate of return on investments, standing alone, would be enough to fund currently projected benefits at today's contribution rate. Indeed, this proposition is confirmed by the Commission's Model One, which does nothing more than dedicate 2 percent of the current payroll tax to personal accounts. As the report states, under this approach, "Workers, retirees and taxpayers continue to face uncertainty because a large financing gap remains requiring future benefit changes or substantial new revenues."

Finally, it should be emphasized that despite the vitriolic rhetoric often surrounding Social Security reform, a widespread consensus exists that any viable plan will probably include some combination of benefit cuts, increased contributions, higher returns and general revenues. Each involves trade-offs and each comes with a fiscal and political price, regardless of whether it aims to prop up the existing pay-as-you-go system or aims at transitioning to a partially prefunded system.

III. What are the achievements and shortcomings of the Commission's Report

The Commission's suggested reform plans have not been presented to the public or to Congress as take-it-or-leave-it propositions. Indeed, the Administration itself has not said which of the three model plans it prefers, if any. In assessing the Commission's report, therefore, one need not accept or reject its proposals in whole. At this point, a better approach is to make constructive suggestions for improvement — keeping in mind that change must come and that there are no magic bullets.

Report's main achievements

- **The Commission recognized that reform must pursue fiscal sustainability**

The Commission rejected the "free lunch" approach to reform. One finding of the Commission's final report states: "There are many paths to fiscal sustainability. All of them require some combination of changing the rate of benefit growth or committing additional revenues generated by taxation or by the proceeds of investment."

The Commission further observed, "Social Security's fiscal problems exist independently of the debate over whether personal accounts should be part of a reformed system. With or without personal accounts, policymakers must answer a fundamental question: how much of the nation's output should be spent on government support of senior citizens? Those who believe that the share devoted to the elderly should continue to consume a larger and larger share of the nation's output have a responsibility to identify where the money will come from. Those who believe that growth in spending should be restrained have a responsibility to explain how exactly they would change Social Security's benefit structure to achieve this."

This is very sound advice to guide the reform debate.

- **The Commission explained the flaws of trust fund accounting**

It is often said that Social Security's problems are far off in the future because the program can pay full benefits until 2041. The Commission appropriately rejected this notion and explained that the fiscal and economic consequence of Social Security's fiscal shortfall will begin to show up long before its official insolvency date of 2041.

Trust fund solvency says nothing about fiscal sustainability. The trust funds are a matter of intergovernmental bookkeeping. Their assets consist of Treasury IOUs that can only be redeemed if Congress raises taxes, cuts other spending, uses surpluses if any exist, or borrows from the public. Thus, their existence, alone, does not ease the burden of paying future benefits. If trust fund solvency were all that mattered, Congress could instantly credit the trust funds with sufficient paper assets to keep them solvent for any length of time imaginable.

A related argument based on trust fund accounting is that a tax hike of merely 1.87 percent of payroll is all that is needed to restore Social Security to long-term solvency. This claim is based on the program's actuarial balance, which averages projected trust-fund surpluses and trust-fund deficits over the next seventy-five years. In 2002, Social Security's actuarial balance was a shortfall of 1.87 percent of payroll. In theory, this is the amount that Congress would have to raise FICA taxes or cut Social Security benefits, starting immediately, in order to keep the trust funds solvent until 2076.

On the surface, a tax hike of 1.87 percent of payroll sounds small, but it is equivalent to a roughly 10 percent increase in everyone's personal income taxes. More importantly, the solution is not permanent: It assumes that the horizon for trust-fund solvency will forever remain fixed at seventy-five years from today. In other words, it assumes that while we would require the trust funds to be in balance over a full seventy-five years, our children will be satisfied with forty years and our grandchildren will be satisfied with an empty cupboard. Correcting this "cliff effect" is a necessary element of credible reform.

But there is a more fundamental problem. As noted above, any trust-fund surplus is immediately lent to Treasury, leaving Congress free to spend the money it is supposedly saving. For the 1.87 percent solution to ease Social Security's burden on the economy, legislators would have to allow the program's extra interest-earning assets to accumulate unspent for decades — a proposition that seems unlikely and in any event cannot be guaranteed.

Fiscally, what really matters is Social Security's operating balance — that is, the annual difference between its outlays and its dedicated tax revenues. Trust fund accounting sidesteps the real issue, which is not how to meet some official solvency test, but how to ensure Social Security's fiscal sustainability and generational fairness.

- **The Commission advocated advanced funding and increased savings**

The Commission report aptly states, "Advance funding raises national savings, increasing the nation's capital stock and productive capacity and reducing Social security's financial burden on future generations....To ensure that Social Security's financing burdens are equitably shared, it is imperative that a portion of these revenues be devoted to advance funding. The resulting increases in national saving will raise the country's capital stock, and therefore boost our productivity and output. In essence, increased national savings increases the size of the economic pie that is available for everyone, old and young alike, to consume in the future."

- **The Commission raised the possibility of "add-on" contributions to personal accounts**

One approach to funding personal accounts is to add new mandatory contributions on top of the existing payroll tax (i.e., an "add-on" plan). Model Three in the Commission's report provides for a small voluntary add-on to help fund personal accounts. While the overall design of Model Three is rather confusing and its funding inadequate, the idea of an explicit add-on contribution is worth exploring further.

In general, the Commission chose the other prominent approach to funding personal accounts — a "carve-out" that redirects a portion of the existing payroll tax. The two approaches differ in the trade-off they make between two objectives:

- A pure carve-out approach guarantees that no extra compulsory contributions of any kind will be added to the Social Security system. But there is an unavoidable trade-off in not requiring any new contributions. While it is possible for a carve-out plan to give workers bigger benefits than the current system can afford, it is not possible for it to give workers bigger benefits than the current system promises. The Commission's models confirm this.

- The add-on approach meets a different objective. Increased funding can make it possible for every worker to be at least as well off in total benefit dollars in retirement under the new system as under the old. In effect, an add-on can fund the unfunded promises of the current system. The much better benefit adequacy possible with an add-on option is not without a cost—namely, the extra contributions required of all workers.

No reform plan can fund currently promised benefits at the current contribution rate — and still abide by honest accounting and prudent assumptions. Is it worth paying a bit more to achieve superior results? In the end, after all the shell games are played out, this is the central choice the American public must confront.

- **The Commission distinguished between what current law promises and what it can afford**

Because the current system is substantially under financed, the proper comparison for any reform plan is between the benefits payable under a reformed system and the benefits payable under the Do Nothing plan. Some have argued that the Commission's plans would result in deep benefit cuts when compared to the current system in a hypothetically solvent condition. This is neither fair, nor realistic. No realistic reform plan looks good when compared to the false hypothetical of a perfectly solvent system. It is fundamentally unfair to judge any reform plan against a standard that assumes the current system can deliver everything it promises. It can't. Today's Social Security system promises far more in future benefits than it can possibly deliver.

Moreover, in assessing the adequacy of benefits under a reformed system that includes personal accounts it must be kept in mind that a person's retirement income would come from *both* sources—a basic level of benefits from the defined benefit portion and the additional benefit financed from the lifetime accumulation of the personally owned account. In comparing benefit levels the entire benefit of a reformed system must be included.

- **The Commission did not duck the need for cost savings**

Perhaps the Commission's most positive contribution to the debate is its clear statement that current-law benefits are unsustainable and will have to be reduced in the future. The Commission acknowledged that meaningful reform will require meaningful trade-offs. Two of the Commission's cost-saving proposals in particular—price indexing (Model Two) and longevity indexing (Model Three) — merit serious consideration.

(1) Price indexing: Under current law, initial benefit awards are indexed to wages—that is, the wage history on which benefits are based is updated at the time of retirement to reflect the rise in the economy's overall wage level over the course of the beneficiary's working career. In effect, wage indexing ensures that the living standard of retirees keeps pace with society's overall living standard. Re-indexing initial benefit awards to prices merely ensures that the absolute purchasing power of retirees keeps up with inflation. Note that this reform effects only initial benefit awards; current benefits are already price indexed.

The reform has two advantages: its simplicity and its large savings. If real wages are growing 1 percent per year faster than inflation, price indexing will result in a roughly 35 percent cut in initial benefits relative to current law for the first cohort to spend a complete career under the new regime. Under this assumption, the savings would be roughly sufficient to close Social Security's long-term cash deficit.

Under current law, closing Social Security's deficit would require an enormous acceleration in productivity growth. Yes, higher productivity would result in higher wages and this would boost payroll tax revenue. But higher wages would also result in higher benefits, and this would largely cancel out the gain. With price indexing,

however, benefits would shrink dramatically and indefinitely relative to taxable payroll and GDP—and the faster wages grow, the more benefits would shrink as a share of the economy.

This dynamic, of course, means that the living standards of retirees will diverge from those of the working population. To the extent that we view Social Security as a pure floor of projection, this does not pose a public policy problem. To the extent that we view it as an income replacement program, it does. This is why wage-indexing makes most sense as part of an overall reform that also incorporates funded benefits like personal accounts. The price indexed pay-as-you-go benefit would ensure that the absolute living standard of each new generation of retirees matches the living standard of the previous generation. The funded benefits would help ensure that the relative living standard of retirees is not eroded. The rate of return to a funded system, after all, is the rate of return to capital—and historically, this has been faster than the rate of growth in wages.

This is precisely what the UK is doing. In a series of reforms beginning in the 1980s, Great Britain's venerable Basic State Pension was price indexed while access to funded pensions, including occupational plans and personal accounts, was expanded. As a result, the UK is now the only industrial country that faces little or no long–term cost challenge due to the aging of its population. While the UK reform was initiated by the conservative government of Margaret Thatcher, it has been endorsed by Labour under Tony Blair.

(2) Longevity indexing. Social Security retirement benefits are paid in the form of a defined benefit annuity. An annuity purchased with a defined contribution personal account balance would naturally take into account expectations about future longevity. The more years the annuity provider expects to have to pay benefits, the smaller the annual benefit a given account balance would buy. The current Social Security system makes no such adjustment. The benefit annuity it promises is set by a formula that yields the same result no matter how fast and far life expectancy rises. Cutting benefits by a fixed percentage may balance the system for a while. But unless reform also adjusts benefits for ongoing gains in life expectancy, the system will drift out of balance again.

The impact of rising longevity on Social Security's long-term cost is large. Over the next 75 years, the Trustees project that life expectancy at 65 will rise from 17.4 to 21.7 years, or by 25 percent. Over the long run, this 25 percent rise in life expectancy will translate into a roughly equivalent percentage rise in total benefits. The Trustees' projection, moreover, assumes that longevity will increase more slowly in the future than it has in the past. If the historical trend continues, the impact on Social Security costs will be even greater.

There are two ways to index Social Security to longevity. The minimum eligibility age for benefits could itself be indexed—that is, the early retirement age could be raised in tandem with average life expectancy. Or else—and this is the approach the Commission took—annual benefits could be reduced so as to offset the greater number of years that will be spent collecting those benefits. This is the equivalent of indexing the so-called normal retirement age, the age at which full or unreduced benefits are payable.

There is a logic to longevity indexing that reaches beyond the need for programmatic cost savings. Americans live longer and healthier lives than we did a generation ago—yet we retire earlier. Over the postwar era, more than all of the nation's "longevity dividend" has gone into extra years of retirement, none into extra years of work. That may have seemed affordable back when the baby boom was in the workforce, but it won't be when the boomers retire.

At least two countries have recognized the importance of longevity indexing for stabilizing the long-term cost of pay-as-you go systems. In the 1990s, major public pension reforms in Italy and Sweden included provisions for longevity indexing. Germany and a number of other countries are considering this reform.

Report's main shortcomings

While The Concord Coalition agrees with many of the Commission's findings, particularly those regarding fiscal sustainability and advance funding, we do not endorse any of the three reform plans as proposed by the Commission. Model Two comes the closest to meeting the goal of fiscal sustainability, but its 4 percent "carve out" structure would put a substantial near-term drain on the budget, particularly in the absence of surpluses, and its need for large scale general revenue financing calls into question it's integrity over the long-term. For the numbers to add-up, the defined benefit cuts would need to be phased in sooner. Without additional contributions, the plan cannot afford to grandfather (as it does) every worker over 55. Alternatively, the plan could fill the gap with new revenues, for instance through a modest personal accounts add-on along the lines included in Model three.

In the spirit of constructive criticism we offer the following observations:

- **The Commission's plans are not adequately funded**

The most basic question to ask of any reform plan is whether or not, if implemented, Social Security would still run out of money. None of the Commission's plans meet this standard. Ignoring new general revenue transfers, they all go bankrupt by 2030.

In Model One, after bankruptcy Social Security's cash deficits widen into the indefinite future. As the report agrees, Model One comes nowhere near sustainability (indeed, it is only a slight improvement over current law). Its primary purpose in the report may be simply to illustrate the arithmetic of personal accounts.

Models Two and Three both technically remain solvent throughout the valuation period (i.e., the next 75 years) but only because they authorize the transfer from Treasury of whatever sum might be needed on an annual basis to prevent the trust fund ratio from falling beneath 100 percent. In addition, Plan 3 includes a special schedule of general revenue transfers that are set in advance. All of this comes on top of the draw down of existing trust fund assets.

It is true, as the Commission report asserts, that over the next 75 years both plans reduce Social Security's long-term general revenue requirement relative to current law. Under

current law, Social Security's cumulative cash deficit from 2001 to 2075 is projected (according to the 2001 Trustees report) to be $22.7 trillion. In Plan 2, it is projected to be $7.0 trillion; in Plan 3, $9.8 trillion. All figures are in constant 2001 dollars. The relative advantage of the reform Plans over current law is similar if we take into account timing by discounting deficits to present value. The corresponding PV figures are $5.1 trillion (current law), $2.8 trillion (Plan 2), and $3.3 trillion (Plan 3). The same is true if we calculate the figures net -- that is, if we include years where Social Security is running a cash surplus. Here the PV figures are $4.2, $2.2, and $2.8 trillion, respectively.

The bottom line, however, is that the Commission's plans don't pay for themselves or put Social Security on a sustainable basis. Plan 3 obviously does not. Under this plan, Social Security is still running a cash deficit at the end of the period. Unless new tax revenue is raised to liquidate the transition debt, it will be a permanent and growing burden throughout the indefinite future. Plan 2 ultimately results in a growing cash surplus. But even here, it is not clear that the surplus is large enough or growing fast enough to pay off the transition debt.

There is another important issue regarding funding that needs to be reconsidered -- namely, the Commission's provision for open-ended general revenue transfers. Yes, if all goes according to expectations, Plans 2 and 3 improve the outlook relative to current law. But what if things don't? The Plans will still have short-circuited trust-fund discipline – even as they render the system permanently "solvent." Experience with the Medicare part B trust fund, which has an open pipeline to the Treasury for 75 percent of program costs, should be enough to make policymakers avoid any similar arrangement with Social Security.

Keep in mind that we're not talking about just a few years of additional borrowing. In the case of Model Two, the borrowing would commence in 2025 and last all the way to 2054 (29 years); in the case of Model Three, it would commence in 2034 and last all the way to 2065 (31 years). And keep in mind as well that all of this borrowing will start just after Social Security has already consumed all of its trust-fund assets—a liquidation which will itself burn a big whole in the federal budget. In fact, under either option, the deficit impact on the federal budget will begin immediately and last until the 2040s, that is, for nearly half a century. In addition to all this, moreover, Model Three calls for a further and explicit drain on the federal budget in the form of a permanent and unborrowed "annual general revenue transfer" (equal to nearly one percent of worker payroll).

The report implies that this long and massive borrowing, which it calls "temporary transition financing," is affordable because Social Security will be able to pay it back out of cash surpluses in the distant future. But even assuming the future unfolds exactly according to the report's projections, the question must be asked: Are these surpluses big enough? The report does not answer this question.

Apparently, the Commission assumed that any finite negative number in the medium-term future would be overwhelmed by a growing positive number in the long-term future. However, the negative number will be compounding at an interest rate that exceeds both

the growth rate of GDP and the growth rate of the later surpluses. In the report, the Commission emphasizes the "magic" of compound interest. But this magic, when you're talking about debts rather than assets, quickly becomes a nightmare.

- **A personal account system should be mandatory**

Given that Americans like the idea of choice, voluntary participation may be a political selling point. While the Commission was directed by the President to develop a voluntary plan, The Concord Coalition believes that mandatory participation is necessary to boost national savings, maintain progressivity within the system, and ensure that workers build meaningful assets in their personally owned accounts. To date, voluntary savings incentives such as 401(k) plans and Individual Retirement Accounts (IRAs) have met with mixed results. This experience is evidence that participation in any new system must be mandatory to ensure that personal savings will actually increase.

In a more fundamental sense, moreover, mandatory participation is basic to the concept of Social Security as a universal system of social insurance. Government has a legitimate interest in seeing that people do not under-save during their working lives and become reliant on safety net programs in old age. Moving toward personal ownership need not and should not mean "privatizing" Social Security.

This voluntary requirement hugely complicates and confuses the Commission's report. It forces the report to present each reform-package option as a spectrum of results between two extreme outcomes (everyone choosing to opt in versus everyone choosing to opt out). The report then shows that retirees will fare well under reform—but only if they choose to opt in. This presents an unresolved paradox. If the Commission were sure of its projections, why would anyone be allowed the "choice" to opt out and be a loser?

Before enacting a system of voluntary accounts it is important to ask: Do we really want Americans to sort themselves into two vast interest groups—one making a cosmic economic and policy bet going one way, and the other making a bet going the other way? Furthermore, why is "choice" important in a compulsory floor-of-protection plan whose primary function is to protect people against poor choices?

Social insurance should not be a crapshoot. In the Commission's framework, voluntary accounts allow people to "choose" to bet on an outcome (defined benefits doing better than personal accounts) which the Commission is meanwhile assuring everyone cannot happen. The question must be asked: If, for the sake of choice, Group A is allowed to experience outcomes much worse than for Group B, then why does our system of compulsory contributions maintain a much higher floor-of-protection for group B? If what we are forcing Group A to save is sufficient, then what we are forcing Group B to save is excessive. Why not reduce the required contribution, force everyone to invest at Group B's rate of return, ensure that everyone has a benefit outcome like Group A's, and then leave everyone free to do what they want with the extra money outside of Social Security?

None of this is to suggest that personal accounts don't have a role to play in Social Security reform. But the best argument in their favor is that given any menu of contribution hikes and defined-benefit cuts, a personal accounts component will certainly maximize future benefits while minimizing the risk of improper or improvident fiscal accounting; it will probably boost national savings and increase public confidence in the system; and it may even improve the odds that voters will embrace reform. None of these arguments suggest that accounts must be voluntary to be successful. Just the opposite.

IV. Conclusion: Generational responsibility requires that prompt action be taken.

The rationale for reforming Social Security now has nothing to do with today's retirees or those who are about to retire. For them, there is no crisis. What's at stake is the retirement security of future generations — those who have many working years ahead, or who have yet to enter the workforce. For them, doing nothing is the worst option. The issue is what makes sense for the world of 2035, not what made sense in the world of 1935.

The longer reform is delayed, the worse the problems inherent in the current system will become and the more difficult they will be to remedy. Delay risks losing the opportunity to act while the baby boom generation is still in its peak earning years, and the trust fund is running an ample cash surplus. Squandering this opportunity would be an act of generational irresponsibility.

We should stop playing political shell games with this issue. If we do not have the political will to solve the Social Security problem now, there is no hope of doing so when the baby boomers start collecting benefits — not just for Social Security but for Medicare and Medicaid as well. The problems facing our health care programs are much more daunting and difficult than Social Security. These three programs together are expected to double as a share of the economy within 30 years, putting unthinkable pressure on tax rates, the economy and the budget.

Not acting is itself a choice — one that has grim consequences for today's midlife adults and even bigger ones for their children. Politicians of both parties should get behind specific reform plans or be held accountable for supporting the consequences of the Do Nothing Plan.

APPENDIX A

"The Social Security Shell Game," by former Senators Bob Kerrey (D-NE) and Warren B. Rudman (R-NH), *Washington Post,* August 12, 2002.

The Washington Post
August 12, 2002, A 15

Wall Street's slump and the disappearing budget surplus are shaping this year's campaign rhetoric on Social Security reform. It's easy to see why. These events have taken two cherished free-lunch options off the table. Politicians can no longer claim that investment returns from a never-ending bull market or general revenue transfers from perpetual budget surpluses will save them from making hard choices.

This development should spark a more realistic debate on genuine reform options. But the clear danger is that without a free lunch to promise, politicians will fall back on an equally bad option: the Do Nothing Plan. Voters shouldn't let that happen. In just six years the baby boomers will begin receiving Social Security checks. Then, the number of workers whose wages are taxed, relative to the number of beneficiaries who receive the proceeds of the tax, will begin to decline sharply. Before Tiger Woods turns 50, the number of beneficiaries will grow by at least two-thirds, while the number of workers will barely budge. Doing nothing means deep benefit cuts or steep payroll tax increases for future generations, which is why the Social Security trustees warn that prompt action is essential.

Suppose that a member of Congress introduced legislation called "the Social Security Do Nothing Act." Under this bill, promised retirement benefits would be cut by 16 percent for today's 30-year-olds, by 29 percent for today's 20-year olds and by 35 percent for today's newborns. Alternatively, payroll taxes would go up by roughly 40 percent in 2041. How many politicians would rush to endorse this bill? And yet these are the choices under the Do Nothing Plan.

Today's political heat is primarily aimed at three reform plans produced by the president's Commission to Strengthen Social Security. Critics argue that the commission's plans would result in deep benefit cuts, fiscally irresponsible general revenue transfers and undue risk, when compared with the current system in a hypothetically solvent condition.

It is certainly fair to criticize reform plans on policy grounds. But it is fundamentally unfair to judge them against a standard that assumes the current system can deliver everything it promises. It can't. Today's Social Security system promises far more in future benefits than it can possibly deliver. The relevant comparison for any reform plan is with what current law can deliver, not what it promises.

No realistic reform plan looks good when compared with the false hypothetical of a perfectly solvent system. Reformers have the burden of saying what changes they would make to a system that is popular but unsustainable. Critics can sit back and take pot shots at politically painful options without having to say what they would do instead.

We have a simple suggestion to improve the dialogue. Critics of the commission's proposals should come up with their own plans for shoring up Social Security. They should be specific about the benefit cuts and tax increases they recommend and the amount of general revenues that would be required. A real debate then could take place -- not one between the commission's plans and an impossible ideal but between the commission's plans and the plans of its critics.

The public should ask: How does each plan affect total benefits, total taxes and different beneficiaries -- the retired, disabled and survivors? How will each plan affect national savings? What are the risks? Do the plans provide the resources to pay for promised benefits, or do they just balance the fund on paper? Do they make Social Security permanently sustainable?

We should stop playing political shell games with this issue. If we do not have the political will to solve the Social Security problem now, we can't hope to do so when the baby boomers start collecting benefits -- not just for Social Security but for Medicare and Medicaid as well. The problems facing our health care programs are much more daunting than Social Security. These three programs together are expected to double as a share of the economy within 30 years, putting unthinkable pressure on tax rates, the economy and the budget.

Not acting is itself a choice -- one that has grim consequences for today's midlife adults and even bigger ones for their children. Politicians of both parties should get behind specific reform plans or be held accountable for supporting the consequences of the Do Nothing Plan.

Bob Kerrey, a former Democratic senator from Nebraska, and Warren B. Rudman, a former Republican senator from New Hampshire, are co-chairs of the Concord Coalition.

APPENDIX B

Reform Criteria

In assessing whether Social Security reform proposals face up to the real issues or merely conceal or shift problems under the pretense of solving them, The Concord Coalition suggests that reform plans be evaluated using the following criteria:

Does it improve net national savings? Given demographic trends, the economy in the future will be called upon to transfer a rising share of real resources from workers to retirees. These resources will be much easier to find in a healthy growing economy than in a stagnant one. The best way to achieve economic growth and increase real income in the future is to increase savings today. Savings provide the capital to finance investments, which will enhance productivity and increase the amount of goods and services each worker can produce. Without new savings reform is a zero-sum game.

Does it focus on fiscal sustainability rather than trust fund solvency? Trust fund solvency is the wrong goal because it is unrelated to the cost of future benefits or to the manner in which sufficient resources will be found to afford this cost. For example, the trust funds could be made perpetually "solvent" by granting them additional Treasury bonds, or by crediting them with higher interest on the existing bonds. Such actions would improve trust fund solvency, but they would not make the program any more affordable for future workers. Fiscally, what really matters is Social Security's operating balance — that is, the annual difference between its outlays and its dedicated tax revenues. Trust fund accounting sidesteps the real issue, which is not how to meet some official solvency test, but how to ensure Social Security's fiscal sustainability and generational fairness.

Does it rely on a hike in the FICA tax? Hiking payroll taxes to meet benefit obligations is neither an economically sound nor generationally equitable option and will fall most heavily on the middle class. Younger Americans in particular may be skeptical of any plan that purports to improve their retirement security by increasing their tax burden and by further lowering the return on their contributions.

Does it rely on new debt? Paying for promised benefits or the transition to a more funded Social Security system by issuing new debt defeats the whole purpose of reform. To the extent that plans rely on debt financing, they will not boost net savings. And without new savings, any gain for the Social Security system must come at the expense of the rest of the budget, the economy, and future generations. Resort to borrowing is ultimately a tax increase for our kids.

Does it rely on outside financing? Unrelated tax hikes and spending cuts may never be enacted, or if enacted, may easily be neutralized by other measures. Unless the American public sees a direct link between sacrifice and reward, the sacrifice is unlikely to happen.

Does it use prudent assumptions? There must be no fiscal alchemy. The success of the plan must not depend upon large perpetual budget surpluses or lofty rates of return on privately owned accounts. All projections regarding private accounts should be based on long-term historical averages, a prudent mix of equity and debt, and realistic estimates of new administrative costs.

Does it maintain the system's progressivity? While individual equity ("moneysworth") is important, so too is social adequacy. Social Security's current benefit formula is designed so that benefits replace a higher share of wages for low-earning workers than for high-earning ones. Under any reform plan, total benefits, including benefits from personal accounts, should remain as progressive as they are today.

Does it protect participants against undue risk? Under the current system, workers face the risk that future Congresses will default on today's unfunded pay-as-you-go benefit promises. While reducing this "political risk," reform should be careful to minimize other kinds of risk, such as investment risk, inflation risk, and longevity risk — i.e., the risk of outliving ones assets.

Does it keep Social Security mandatory and preserve a full range of insurance protection? The government has a legitimate interest in seeing that people do not under-save during their working lives and become reliant on the safety net in retirement. Moving toward personal ownership need not and should not mean "privatizing" Social Security. Any new personal accounts should be a mandatory part of the system. Moreover, Social Security does more than write checks to retirees. It also pays benefits to disabled workers, widows, widowers, and surviving children. A reformed system must continue to provide these important insurance protections.

Answers to Written Questions for Robert Bixby from Senator Jon Kyle

Hearing on October 3, 2002

"The Final Report of President Bush's Commission to Strengthen Social Security"

Question

During the hearing, your testimony was cited as being critical of certain aspects of the Commission proposals' financing. Just to make clear your position for the Committee, if you had to choose between one of the Commission proposals being adopted and continuing with the present course of the current system, which would you choose? And of the Commission proposals, which do you believe represents the greatest improvements over the current system?

Answer

I was delighted to have the opportunity to testify before the Senate Finance Committee on October 3 regarding the recommendations of the President's Commission to Strengthen Social Security.

The Concord Coalition believes that few challenges facing Congress and the nation are more critical than putting America's most important social program on a fiscally sustainable and generationally equitable basis. As I stressed in my testimony, the current Social Security system, left unreformed, will either overburden tomorrow's workers or betray tomorrow's retirees. Reform must reduce Social Security's long-term cost while also raising returns on contributions and ensuring adequate benefits. I commend you and the Committee for engaging this difficult but vital task.

In your written follow up to my testimony, you posed the following question: If I had to choose between current law and one of the Commission's three reform options, which of the three would I choose? Naturally, none of us will ever actually have to make this choice. The Commission's options, of course, are not legislative proposals. They are simply meant to illustrate how a second tier of funded personal accounts might be integrated into Social Security. While the Concord Coalition believes that there is much merit in the Commission's overall approach to reform, it does not believe that any of its specific reform illustrations represent satisfactory solutions.

That said, I believe that the Commission's Model 2 is, on balance, superior to the other options. It leans less heavily on general revenue, it closes Social Security's long-term cash deficit, which none of the other options do, and its main cost-saving provision—price indexing—is simple, fair, and easy to understand and explain. I elaborated on all of these advantages in my original testimony.

Model 1 is not even in the running. It does nothing to reduce Social Security's long-term cost to workers and taxpayers. To the extent that the personal accounts improve returns on contributions, it is a matter of pure financial arbitrage. Since the personal-account carve out is entirely debt-financed, it will not result in net new savings—and without new savings, it cannot leave society as a whole better off.

Model 3 does reduce Social Security's long-term cost burden. Two of its specific provisions, moreover, merit serious consideration: longevity indexing and the personal accounts "add-on." Indexing Social Security benefits to longevity simply acknowledges the obvious: Work spans must begin to rise along with life spans and health spans. Over the postwar era, more than all of the nation's "longevity dividend" has gone into extra years of retirement, none into extra years of work. While this may have seemed affordable with the baby boom in the workforce, it won't be when the boomers retire.

As for the add-on, it offers an honest and transparent way to ensure the adequacy of future benefits. In practice, most personal account carve outs, including all three of the Commission's options, rely on large general revenue subsidies to substitute for the lost FICA and mitigate the benefit cuts. With an add-on, Social Security can pay more generous benefits without recourse to budgetary shell games. The Concord Coalition does not necessarily advocate an add-on. What it insists is that it is impossible to have it both ways: no cuts in total benefits and no new contributions.

The problem with Model 3 is that the numbers don't add up. Model 3 cuts future benefits so much less than Model 2 that, despite the add-on, it still ends up requiring a larger infusion of general revenue over the next seventy-five years: $9.8 trillion versus $7.0 trillion in today's dollars. What's more, this hemorrhage from the rest of the budget will continue indefinitely. While Model 2 eventually restores Social Security to cash surplus, Model 3 never does. It thus fails the most basic test of fiscal sustainability.

As I've said, Model 2 is the preferable option, but that does not make it a satisfactory solution. I want to single out three problems—not just because they are the most serious, but because they recur in the Commission's other options as well.

- ***Problem One: The personal accounts are voluntary.*** The Commission's projections show that retirees will receive larger total benefits under reform than under current law—but only if they choose to opt in. This raises concerns that I strongly urge you to consider. If the Commission is correct that a system with personal accounts can pay larger total benefits than a system without one—and it is—why should anyone be allowed the "choice" to opt out and be a loser? Indeed, why is "choice" important at all in a compulsory program whose primary function is to protect people against poor choices? Society has an interest in ensuring that people do not under-save during their working lives and become free riders on the means-tested safety net in old age. The best way to do so is to make the personal accounts mandatory.

- ***Problem Two: Social Security's lien on general revenue is open-ended.*** Under both Models 2 and 3, Social Security would be authorized to borrow from Treasury *whatever* sum might be needed on an annual basis to prevent its trust-fund ratio from falling beneath 100 percent. If the future unfolds exactly as expected, Social Security's total drain on general revenue under Models 2 and 3 would be less than it would be under current law, assuming that the trust fund is authorized to borrow to prevent bankruptcy under current law just as it would be under reform. But what if the future doesn't unfold as expected? What if spending comes in high or revenues low—and the need to borrow rises beyond the projections?

  Under today's rules, Congress would be compelled to take corrective action to avert bankruptcy, as it did in 1977 and 1983. Although trust-fund accounting does not accomplish genuine savings, it does serve a useful function—as a backstop against runaway spending. By giving the trust fund an open-ended lien on Treasury, the Commission's proposals would short-circuit this discipline. Henceforth, Social Security would be permanently "solvent," no matter what happens to the economy and whether or not any of the Commission's projected cost savings materializes.

- ***Problem Three: The transition debt may become a permanent burden on future generations.*** The additional borrowing authorized under Models 2 and 3 may never be paid pack. In the case of Model 2, the borrowing would commence in 2025 and last all the way to 2054 (29 years); in the case of Model 3, it would commence in 2034 and last all the way to 2065 (31 years). Keep in mind that this borrowing will start after Social Security consumes all of its trust-fund assets—a liquidation which will itself burn a big whole in the federal budget. In fact, under either option, the deficit impact on the federal budget will begin immediately and last until the 2040s, that is, for nearly half a century. In addition to all this, moreover, Model 3 calls for a further and explicit drain on the federal budget in the form of a permanent and unborrowed "annual general revenue transfer."

  The Commission's report implies that this long and massive borrowing, which it calls "temporary transition financing," is affordable because Social Security will be able to pay it back out of cash surpluses in the distant future. But even assuming the future unfolds exactly according to the report's projections, the question must be asked: Are these surpluses big enough? Under Model 3, the answer is clearly no. Social Security will still be running a cash deficit at the end of the projection period. Unless new tax revenue is raised to liquidate the transition debt, it will be a permanent and growing burden throughout the indefinite future. Although Model 2 ultimately results in a growing cash surplus, it is neither large enough nor growing fast enough to pay off the transition debt.

While I have reservations about the Commission's three illustrative models, I want to reiterate something I said in my prepared testimony: the Commission's work should not be viewed as a take-it-or-leave-it proposition. Its illustrative models are best viewed as the beginning, not the end, of a long overdue debate on the specifics of a meaningful reform plan. The sooner Congress and the Administration undertake this task the better. The Commission deserves real praise for moving the debate in the right direction. The Concord Coalition substantially agreed with the Commission's assessment of the magnitude and nature of the challenge. It also welcomed the Commission's clear explanation of the limitations of trust-fund accounting, its acknowledgment that reform must include reductions in pay-as-you-go benefits; and it insistence on the importance of funded savings. These elements of the Commission's report provide sound guideposts for the legislative debates to come.

Again, thank you for giving me the opportunity to elaborate on my views.

Robert Bixby
Executive Director
The Concord Coalition

November 12, 2002

TESTIMONY

BEFORE THE

SENATE COMMITTEE ON FINANCE

ON

SOCIAL SECURITY SOLVENCY

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AARP appreciates the opportunity to present its views regarding proposals to strengthen Social Security over the long-term. Concern about Social Security's long-term financial health has prompted a variety of solvency recommendations from legislators, presidential commissions, and policy analysts. In addition to solvency measures, many recommendations include proposals to establish individual accounts either instead of or in addition to Social Security's basic guaranteed benefit. Improving Social Security's long-term financial health is essential. We believe it must be accomplished in a prudent and bipartisan manner that both maintains the program's critical income protections for current and future beneficiaries and fits into the overall framework of retirement security, which includes policies supporting broaden pension coverage and more opportunities for older workers. Any changes must also command the support of the public.

Social Security's income protection for Americans of all ages is unmatched. It is the primary income source for the overwhelming majority of older Americans, and Social Security keeps nearly half of older Americans out of poverty. The program also provides insurance protection against disability and death for nearly all working Americans and their families. Once benefits begin, they are indexed annually for inflation and are guaranteed for a lifetime. Social Security remains the most dependable of the four pillars of a secure retirement. (The remaining three pillars are savings and pensions, earnings, and health insurance.)

According to the 2002 trustees' report, Social Security has sufficient assets to continue paying full benefits on time until 2041 and over seventy percent of benefits for decades thereafter. Some changes to Social Security will be necessary to enable the program to continue as the solid

foundation of retirement income security. The sooner modifications become law, the more modest they can be and the longer those affected will have to adjust their plans.

Historically, Social Security financing shortfalls have been corrected through a balance of benefit reductions and revenue increases. Examples of benefit cuts include increasing the age for collecting full retirement benefits, modifying the benefit formula, and delaying or reducing cost of living adjustments. Additional Social Security revenue could be generated by, for example, requiring the participation of all newly hired state and local workers not covered by Social Security or by a modest increase in the level of wages subject to the payroll tax.

Since many traditional solvency options lack widespread popular support, interest has grown in diversifying Social Security's investments --either collectively or through individual accounts. This approach could lessen the degree of benefit cuts or payroll tax increases needed to restore long-term solvency provided individual accounts were not financed with current payroll tax revenue.

By law, Social Security can invest only in special interest Treasury securities and certain government-backed debt instruments. Some would increase the potential return on trust fund investments by broadening the range of permissible trust fund investments to include other government-backed securities. Others prefer to let Social Security, similar to the practice for pension plans, hire professional money managers to invest a portion of the trust funds in a more diversified portfolio, including stocks and bonds. Collective investment in the private market could increase the return to the trust funds and spread the risk among workers and across

generations. Collective investment would also have much lower administrative and management compared to individual investment accounts for 150 million workers.

Opponents argue that broader trust fund investments could interject politics into the investment decision-making process, could interfere with economic and market performance, and potentially place too much government oversight in the corporate boardroom. AARP believes greater diversification can be accomplished, by fiduciaries on behalf of the trust funds, without such negative consequences. In particular, AARP supports investment of Social Security reserves in other government-backed securities.

AARP also believes that individual retirement savings accounts can and should be an important component of an overall national retirement income policy. However, AARP believes individual accounts should supplement, not supplant, Social Security's defined benefit promise. Substituting individual accounts for all or part of Social Security would worsen Social Security's solvency and shift to the individual a larger portion of risk, thus jeopardizing the nation's near 70-year commitment to assure retirement, disability, and survivor benefits for eligible workers and their families.

Individual investment accounts financed with current payroll tax dollars ("carve-outs"), such as those recommended by the President's Commission to Strengthen Social Security, worsen Social Security's long-term financial outlook by diverting revenue needed to pay currently- promised benefits into individual accounts. The greater the percentage of payroll tax dollars siphoned off,

the larger the loss to the trust funds. A further decline in Social Security's long-term financial outlook would hasten the need for benefit reductions and/or higher taxes to restore solvency.

Individual accounts that substitute, in whole or in part, for Social Security would gradually move the program from a defined benefit plan toward a non-guaranteed, defined contribution, or individual savings plan. Social Security's base of income protection --augmented by pensions and private savings (and possibly earnings)--would become less predictable. Indeed, the distinction between Social Security and the pension and savings pillar of retirement income would be blurred, and the different purpose of each could be lost. Currently, the systems are complementary, with the guaranteed lifetime benefit of Social Security providing a secure foundation for individuals to invest and take on risk elsewhere. Over the past two decades, the private sector has seen trillions of dollars moved into individual retirement arrangements, either through IRA's or pension plans such as 401(k) plans. In fact, all individuals currently have a tax-favored personal retirement account vehicle available to them. We should work to increase access to and use of such accounts, but not at the expense of Social Security. Adding to current retirement savings is necessary especially for lower wage workers if we are to improve overall retirement security.

Individual investment accounts financed within Social Security would not only reduce Social Security's guaranteed lifetime benefit, but it could weaken the special protection for low earners provided by Social Security's progressive benefit formula. Social Security benefits represent a larger portion of low-wage workers' pre-retirement earnings than for average and high earners. If workers contribute the same percentage of payroll taxes to individual accounts, then higher

earners would have more to invest, with potentially greater returns. Yet, the size of the Social Security trust funds would be smaller and less revenue would be available to support the progressive benefit structure.

Many low-income workers are members of ethnic minority groups and/or women. Each group would face additional problems if Social Security individual investment accounts are financed with existing payroll tax dollars. Social Security is critical to women's financial security because they live longer and depend on benefits for a larger share of their retirement income. Women benefit from Social Security's lifetime guarantee, which, unlike investment accounts, cannot be outlived. Moreover, Social Security benefits are adjusted annually for inflation in order to help keep pace with the rising costs of goods and services. This adjustment helps prevent beneficiaries from becoming poorer when they are older and more likely to have higher medical costs and fewer assets. Both the lifetime guarantee and annual inflation adjustments are rarely available with individual investment accounts.

Social Security's critics have often asserted that minority populations would benefit from having a portion of their payroll tax dollars diverted to individual investment accounts rather than remaining in the trust funds to help finance a guaranteed Social Security benefit. They are wrong. The critics are quick to point out that some African American workers die before reaching retirement age, but conveniently overlook the value of disability and survivor benefits for them and their families. African Americans represent 12 percent of the population, but make up 18 percent of workers receiving Social Security disability benefits; their children represent

21 percent of those who receive benefits as the child of a disabled worker. In addition, a large percentage of low-income minority populations benefit from Social Security's progressive benefit formula.

Hispanic workers and beneficiaries have much to lose as well. Since the Hispanic population is disproportionately younger than other ethnic groups, they would be hard hit by having to pay for benefits under the old system while funding a new system for themselves. Additionally, Hispanic elders tend to be longer lived than other beneficiaries and are advantaged by the fact that Social Security is guaranteed for life and adjusted annually for inflation.

Carve-out individual accounts also jeopardize Social Security's disability protection. Approximately 6.7 million people receive disability benefits as a worker or a dependent. Young workers who become disabled could receive a smaller lifetime benefit for themselves and their dependents since they might not have enough time to build up their accounts and cannot contribute once they withdraw from the labor force. Some comprehensive individual account proposals, such as those suggested by the President's Commission to Strengthen Social Security, claim to preserve the disability program but do not maintain the same level of benefits provided under current law.

In addition to weakening Social Security's protections for vulnerable groups, individual accounts pose additional problems. The high rates of return supporters promise may be lower than expected. As the Congressional Budget Office (CBO) points out, rates of return analyses overlook differences in risk. Corporate stocks can yield a higher return than government bonds,

but they carry a higher risk. On a risk adjusted basis, investing in government bond provides the same return as investing in corporate stock. Furthermore, this "money's worth" analysis overlooks the fact that in a pay-as-you-go system, the first generation of retirees always receives a higher return compared to future generations. This does not reflect any inefficiency on Social Security's part; rather it reflects the nature of a pay-as-you-go system. Raising the rate of return for current generations of workers can be done only by lowering the returns for future generations. ("Social Security: A Primer," Congressional Budget Office, p.58)

Rate of return analyses assume a worker has a steady stream of contributions over a working life. However, many workers have periods of unemployment or reduced earnings. Social Security protects these workers by providing "dropout years." (The Social Security benefit formula assumes a forty-year work history, but calculates the worker's benefit on the thirty-five highest earning years, thus allowing five "drop-out" years). Additionally, investors remain at the mercy of stock or bond price volatility, particularly as they approach retirement (as illustrated by the most recent "adjustment" in the market). Some analysts question whether the projected value of a portfolio will materialize when the boomers reach retirement. At that point, a large group of retirees may begin to sell their assets, and public and private retirement programs may also need to sell holdings to finance their benefit commitments. Some have speculated that this simultaneous unloading of assets could drive down the value of the investments in workers' accounts.

Individual account supporters insist that these vehicles will promote additional retirement savings. CBO points out that the impact on national savings depends on the details of the proposal and on how the government and individuals respond. When individuals save more, they must forego current consumption, not reallocate their existing assets. If individuals save more, government action elsewhere could offset this, thereby leaving the national savings rate unchanged.

To help future generations attain a more financially secure retirement, many have proposed establishing supplemental individual savings accounts at the same time that we work toward securing Social Security's long-term solvency. These accounts could be in addition to or an extension of individual retirement accounts, 401(k) plans and other savings opportunities already available and could be targeted to low- and moderate-income workers who find it most difficult to save. Others suggest that in order to make saving easy, everyone be provided access to supplemental accounts through payroll deductions. AARP supports such an "add-on" approach. These supplemental accounts could have various designs. Ideally, such accounts would include professional management, be easy and inexpensive to administer, and offer workers incentives to save.

Since many low-income workers have little, if any, discretionary income, added incentives may be necessary to attract them to participate in supplemental retirement accounts. For example, the recently enacted tax credit for lower wage workers - which in effect works as a government match for some - could be expanded.

Americans of all ages should become better informed about the Social Security system so they can participate in the debate about its role in their future. AARP is committed to contributing to this public information effort. The program has been, and should continue to be, an important part of our nation's commitment to providing income protection for workers and their families against the financial difficulties many would face as a result of a wage earner's retirement, death or disability.

Maintaining Social Security's long-term solvency and improving the overall retirement income of future generations are vital to our nation's economic well-being. Fortunately, we have the opportunity to engage in a meaningful national dialogue that will lead toward informed judgment and consensus about the best way to strengthen the program for the long term.

The Association looks forward to participating on a bipartisan basis with our nation's elected officials to achieve a solution to strengthen Social Security for the future. This solution should maintain the program's guiding social insurance principles, ensure benefit adequacy, and achieve solvency in a fair and timely manner. Social Security must continue its role as the foundation of lifetime income security for tomorrow's beneficiaries.

Written Questions for Esther Canja

Senator Kyl

1. You criticized the Commission proposals but did not yourself offer a comprehensive proposal to attain permanent sustainability for Social Security that lacks the flaws you ascribe to the Commission proposals. What is your specific proposal to make Social Security permanently sustainable? Are you willing to provide such a proposal for analysis by the Social Security actuaries using standards as stringent as those applied to the Commission's proposals? In answering, please do not simply outline concepts but provide a specific program analogous to those put forward by the President's Commission. Do you believe that those who have not offered a superior program for making Social Security permanently sustainable are in a credible position to criticize the commission's work?

2. Your testimony criticizes the mix of revenue requirements and benefit levels in the Commission proposals. Please describe the mix of revenues and benefit levels that you believe are appropriate, and provide a specific proposal to achieve this.

Responses to written questions for Esther Canja:

Although the subject of the Finance Committee hearing was the report of the President's Commission to Strengthen Social Security, AARP's testimony focused more generally on the issue of individual "carve out" accounts. We oppose carve out accounts because they would worsen the program's long-term financial outlook, reduce the revenue available to pay promised benefits, and expose individuals to unnecessary risk in the most secure portion of their retirement income stream. Our testimony specifically refers to the commission twice (1) stating that the commission's proposals were "carve outs", and (2) noting that the commission's proposals claim to preserve the disability program but do not maintain the same level of benefits.

During the question and answer period, we indicated our support for three changes to Social Security that would move the program closer to long-term solvency. They are: adding newly hired workers in state and local governments that do not participate in Social Security; raising the amount of wages on which payroll taxes are collected so as to more closely approximate the percentage of wages nationwide originally covered by Social Security; and diversifying trust fund investments to include, for example, other government-backed securities. We would be willing to look at other revenue and benefit options as part of an overall solvency package. AARP will continue to educate our members and the general public on Social Security solvency options as well as other options to improve retirement income security. A full and open debate is essential prior to any changes to one of our nation's most important programs.

CONSORTIUM
for
CITIZENS
with
DISABILITIES

Hearing on the Final Report of the President's Commission to Strengthen Social Security
Senate Finance Committee
October 3, 2002

Testimony of

Marty Ford
Co-Chair
Social Security Task Force
Consortium for Citizens with Disabilities

ON BEHALF OF:
Advancing Independence: Modernizing Medicare and Medicaid (AIMMM)
American Association on Mental Retardation
American Congress of Community Supports and Employment Services
American Network of Community Options and Resources
Association for Persons in Supported Employment
Bazelon Center for Mental Health Law
Brain Injury Association of America
Inter/National Association of Business, Industry and Rehabilitation
International Association of Psychosocial Rehabilitation Services
NAMI—National Alliance for the Mentally Ill
National Association of Developmental Disabilities Councils
National Council for Community Behavioral Healthcare
National Industries for the Blind
National Organization of Social Security Claimants' Representatives
Paralyzed Veterans of America
Research Institute for Independent Living
The Arc of the United States
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Chairman Baucus, Senator Grassley, and Members of the Committee, thank you for this opportunity to discuss the Final Report of the President's Commission to Strengthen Social Security, *Strengthening Social Security and Creating Personal Wealth for All Americans*, from the perspective of people with disabilities.

I am Marty Ford, Director of Legal Advocacy for The Arc of the United States, a national organization of and for people with mental retardation and related developmental disabilities and their families. I am here today in my capacity as a co-chair of the Social Security Task Force of the Consortium for Citizens with Disabilities.

The Consortium for Citizens with Disabilities is a working coalition of national consumer, advocacy, provider, and professional organizations working together with and on behalf of the 54 million children and adults with disabilities and their families living in the United States. The CCD Task Force on Social Security focuses on disability policy issues and concerns in the Supplemental Security Income program (Title XVI) and the disability programs in the Old Age, Survivors, and Disability Insurance programs (Title II) of the Social Security Act.

For more than 60 years, the Social Security program has been an extremely successful domestic government program, providing economic protections for people of all ages. It works because it speaks to a universal need to address family uncertainties brought on by death, disability, and old age. The Social Security system has evolved to meet the changing needs of our society and will have to change again in order to meet changing circumstances in the future. However, we believe any changes must preserve and strengthen the principles underlying the program: universality, shared risk, protection against poverty, entitlement, guaranteed benefits, and coverage to multiple beneficiaries across generations. We believe that the three proposals put forward by the President's Commission violate these principles.

People With Disabilities Have A Major Stake In Social Security Reform

The Title II Old Age, Survivors, and Disability Insurance (OASDI) programs are insurance programs designed to reduce risk from certain specific or potential life events for the individual. They provide a basic safety net by insuring against poverty in retirement years; insuring against disability limiting a person's ability to work; and insuring dependents and survivors of workers who become disabled, retire, or die. While retirement years can be anticipated, disability can affect any individual and family unexpectedly at any time. According to the Social Security Administration, a twenty-year-old today has a 1 in 6 chance of dying before reaching retirement age and a 3 in 10 chance of becoming disabled before reaching retirement age.

People with disabilities benefit from all three programs in Title II under several categories of assistance. Those categories and the source of their benefit payments include:

- disabled workers and their dependents, including disabled adult children, draw benefits from the disability insurance program;
- retirees with disabilities draw retirement benefits;
- disabled dependents of retirees, including disabled adult children, draw their benefits from the retirement program; and
- disabled survivors, including disabled adult children and disabled widow(er)s, draw their benefits from the survivors program.

More than one-third of all Social Security benefit payments are made to 17 million people who are non-retirees, including over 5 million disabled workers, over 1.6 million dependents of disabled workers, over 200,000 disabled widow(er)s, and nearly 730,000 disabled adult children covered by the survivors, retirement, and disability programs. Other non-retirees include non-disabled survivors and dependents. For the average wage earner with a family, the Social Security Administration (SSA) has estimated that OASDI insurance benefits are equivalent to a $300,000 life insurance policy or a $200,000 disability insurance policy.

Beneficiaries with disabilities depend on Social Security for a significant proportion of their income. The *National Organization on Disability / Harris 2000 Survey of Americans with Disabilities* revealed significant data on employment of people with disabilities. Of those aged 18 to 64, people with disabilities are much less likely to be employed (either full-time or part-time) than people without disabilities (32 percent versus 81 percent respectively). The capacity of beneficiaries with disabilities to work and to save for the future and the reality of their higher rates of poverty must be taken into consideration in any efforts to change the Title II programs. While the Commission acknowledged the inability of workers with disabilities to contribute to their private accounts, the Commission's proposals make no accommodations for this concern.

The CCD Task Force has developed a list of criteria against which we analyze the major components of various reform proposals. In reviewing various proposals, or their components, we look at whether the proposal:

- Maintains the OASDI programs as insurance programs;
- Ensures solvency of the Social Security Trust Funds and prevents substantial transition costs from affecting the rest of the federal budget;
- Ensures a benefit formula that does not force more people with disabilities into greater poverty;
- Provides protection against inflation;
- Protects disabled adult children and other family members with disabilities;
- Protects the disability insurance program from increased pressures caused by raising the retirement age; and
- Adequately considers the impact on people with disabilities.

Where individual accounts are established, we also consider whether the proposal:

- Provides adequate benefits at retirement age;
- Includes protection if annuities and/or disability insurance must be purchased; and
- Minimizes risk and addresses capacity to manage accounts.

Effects of Proposals in *Strengthening Social Security and Creating Personal Wealth for All Americans*

The CCD Social Security Task Force took great interest in the deliberations of the President's Commission to Strengthen Social Security. We submitted information for the record, met with staff, and requested to testify at the public hearing. We were disappointed that the Commission members believed that the Commission's mandate did not encompass the disability program and, therefore, we were not given an opportunity to testify publicly on the record. We did take advantage of the opportunity to meet "off the record" with several of the Commission members prior to their final deliberations. Nevertheless, the Commission discussed the disability program on several pages at the end of the final report, including comments about substantive statutory and policy matters.

In addressing the Commission's proposals, we find substantial problems in the following areas:

1. **Maintaining Old Age, Survivors, and Disability Insurance as Insurance Programs** -- The nature of the OASDI programs as insurance against poverty (for survivors; during retirement; or due to disability) is essential to the protection of people with disabilities. The programs are unique in providing benefits to multiple beneficiaries and across multiple generations under coverage earned by a single wage earner's contributions. Proposals that partially or fully eliminate the current sharing of risk through social insurance and replace it with the risks of private investment will be harmful to people with disabilities who must rely on the OASDI programs for life's essentials, such as food, clothing, and shelter.

For purposes of this discussion, we view "privatization" to mean the conversion of Trust Fund dollars or current or future payroll tax receipts (that would go into the Social Security Trust Funds) into funds for private accounts. Whether it is total or partial, this conversion or privatization of Social Security Trust Fund dollars shifts the risks, either fully or partially, that are currently insured against in Title II from the federal government back to the individual. We do not use the term privatization to include proposals for the federal government to invest a portion of the trust funds in the private market. Those proposals contemplate shared investment with no shift of the risks from the government to the individual.

Combining privatization with benefits cuts , as the Commission's proposals do, could have a devastating impact on people with disabilities and their families as they try to plan for the future. Through benefit cuts and otherwise, the basic safety nets of retirement, survivors, and disability insurance would be substantially limited and individuals, including those with limited

decision-making capacity due to cognitive or other disabilities, would be exposed to the fluctuations of the financial markets.

2. **Solvency of the Social Security Trust Funds and Impact on the Federal Budget --** Solvency plans which are likely to produce substantial pressure on the rest of the federal budget in the future could have negative impact on people with disabilities, ultimately reducing the other services and supports upon which they also must rely. Plans which spend the current or projected Social Security trust fund surpluses on building private accounts would be harmful because the resulting deficits in the Trust Funds would endanger the continued payment of benefits. Plans which create private accounts from non-Social Security sources must be viewed in the context of the total budget and weighed against other priorities, such as preserving Medicare. Since we are currently facing deficits again, it is hard to imagine the source of the funds necessary to make up the Trust Fund losses from the establishment of private accounts in the Commission's plans. The Commission's plans would place substantial pressure on the rest of the federal budget for decades into the future.

3. **Transition Costs** – The Commission's plans try to address the very high transition costs associated with privatization through deep cuts in the current program. These cuts will negatively affect people with disabilities who draw benefits from all three parts of Title II. In addition, while the Commission admitted that it did not address the Disability Insurance program issues, all of the proposed changes, including benefits cuts, would apply equally to people with disabilities. Such cuts are proposed even though the Commission acknowledged that many people with disabilities are significantly limited in their ability to contribute to those accounts for themselves and their families.

4. **Specific Plans** -- Each of the Commission's three proposals would have a negative impact on people with disabilities through the interaction of several features, as follows:

Plan 1: Individuals could elect to direct 2 percentage points of their payroll taxes (FICA) to an individual account. At retirement, a benefit offset would occur, i.e., funds in the account would cause a reduction in Social Security benefits. Retirees would not receive both their Social Security benefit and the total value of their accounts. According to the report, if the rate of return exceeded 3.5 percent per year, the retiree would be able to keep the excess. If the rate did not exceed 3.5 percent, the retiree would be worse off. Trust Fund revenues would be used to fund the accounts, which would dramatically worsen the Social Security deficit over the next several decades.

Plan 2: Individuals could elect to direct 4 percentage points of their payroll taxes (FICA) to an individual account, capped at $1,000. This cap would be reached once a worker had earned $25,000 in wages. A benefit offset also would occur -- one that is more generous to retirees than Plan 1 but less beneficial to Social Security. Retirees would be able to keep any difference between what their account actually earned and a 2 percent rate of return.

This plan includes benefit changes and reductions for all future beneficiaries, not just those with an account:

- Indexing the benefit formula by price growth rather than wage growth. This would significantly reduce benefits for future beneficiaries, including those with disabilities.
- The report indicates that benefits for low-wage workers would be increased.
- The plan also calls for a benefit increase for surviving spouses; however, because these benefits are tied to the basic formula which would be reduced under this plan, spouse's benefits also would be reduced.

The benefit reductions alone would restore solvency to the Social Security system. But if payroll taxes are diverted to individual accounts, the system would be insolvent and would require general revenue transfers or long-term loans.

Plan 3: Individuals could elect to have an account but would be required to contribute an additional one percent of their pay to establish an account. The new contribution would be matched by monies taken from the Trust Funds equal to 2.5 percent of their pay, capped at $1,000. There would be a benefit offset slightly less generous than under Plan 2 – retirees would be able to keep any difference between what their account actually earned and a 2.5% rate of return.

Like Plan 2, this plan includes benefit reductions for all future beneficiaries:

- The benefit formula would be adjusted to reflect increasing life expectancy, which is equivalent to increasing the retirement age. This would gradually but significantly reduce benefits for new beneficiaries and increase pressure on the Disability Insurance program.
- Benefits for middle and high earners would be reduced by adjusting the part of the benefit formula that applies to workers earning more than about $43,000. This would affect not only the retirees, but also all of their dependents and survivors. It would also affect the benefits of disabled workers who had been middle and high income earners.
- Benefits would be reduced for early retirees.

There is a benefit increase for low-wage earners, but lower than under Plan 2. The same increase for surviving spouses is included.

Like the other two plans, additional revenues or borrowing would be required, but this plan requires both loans and transfers from general revenues to make the system solvent. The source of general revenues is not identified other than that "Congress would be able to choose from a variety of sources for making such revenues available to the Social Security system".

5. **Additional Concerns** -- The Commission's proposals also raise some concerns in areas that are not readily apparent, as follows:

Disabled Adult Child Benefits -- An individual who is eligible as a disabled adult child (DAC) has a severe disability with onset prior to age 22. Cash benefits based on DAC eligibility will not begin until a parent who is a covered worker becomes disabled, retires, or dies. Once the parent has become disabled, retired, or died, the disabled adult child receives benefits as a dependent of the parent. The DAC benefit is based on the parent's benefit amount (up to 50 percent of the parent's benefit while the parent is living and up to 75 percent of the parent's benefit when the parent dies). Often the DAC benefit is greater than the maximum allowable SSI benefit. The disabled adult child will be eligible for Medicare after a 24 month waiting period. As mentioned above, beneficiaries who receive DAC benefits draw benefits from the retirement, survivors, and disability programs, depending on their parents' benefit status, with the majority coming from the survivors program. Changes made to the benefit formula which affect the parents' benefit will automatically affect the disabled adult child's benefit. The Commission's plans do not address the impact on beneficiaries with DAC benefits.

Adequate benefits at retirement age – The Commission did acknowledge that changes in defined benefits to OASI beneficiaries also would be applied to DI beneficiaries, i.e., reductions in benefits, given the "close integration" between the programs. While the Commission recognized that people with disabilities would be limited in their ability to contribute to personal accounts, no recommendation is made regarding the loss of income from the benefit cuts other than that the personal accounts would not be available until retirement.

Include protections in annuities – For disabled adult children who may live for decades beyond their parents, the parents' personal accounts in the Commission's plans would not make up for the loss of a guaranteed benefit for the life of the disabled adult child. Annuities purchased with the amount in the parents' personal accounts would be unlikely to provide enough income to the retiree, a surviving spouse, and then a disabled adult child for life. This would be a significant loss of Social Security's social insurance coverage that the Commission does not address.

Risks in account management -- The increased risk associated with retirement that depends upon individual account earnings is an issue for everyone. In addition, the capacity of an individual to manage these accounts profitably is similarly an issue and involves many factors including education, money management skills, and risk-taking. The risks and management issues become a much more significant concern for people with cognitive impairments, such as mental retardation or mental illness, which create substantial barriers to making wise and profitable decisions over a lifetime. In many cases, the person may be unable to make any financially significant decisions. In addition, management of individual accounts that will have a significant impact on the quality of retirement years is not a responsibility that should be shifted to representative payees. Individual accounts remove the shared-risk protection of social insurance and place these individuals at substantial personal risk.

Other DI program issues -- The Commission notes that, due to demographic changes, DI program outlays are projected to exceed DI tax revenues much sooner than in the OASI program. It discusses "other factors" that "are more complex and may require a unique set of solutions". However, the Commission's application of its proposals to all beneficiaries with disabilities, would ensure that these other issues will be even harder to resolve.

The Commission also raises two issues: (1) that standards used to determine disability vary across geographic regions and across different levels of the adjudicative process, and (2) that "fundamental questions" exist whether the law has responded adequately to helping DI applicants and beneficiaries participate in the workforce. We believe that these questions are separate and apart from the concerns about whether the programs continue to be adequate social insurance programs. The quality and nature of the disability determination process and the response of the law to changes in technology and the economy are issues that are continually addressed by the Congress and SSA. The "solutions" for these issues will continue to evolve over time as the system responds to change. These issues should not serve as an excuse to ignore the very real needs of people with disabilities who must rely on Social Security's social insurance system.

6. **Supplemental Security Income** -- The Commission also discussed the role of SSI in Social Security retirement reform and indicated that "a comprehensive retirement security system should provide improved poverty protection for the aged, either through SSI or some combination of Social Security and SSI". We believe that SSI should not be considered as a way to make up for reduced Social Security benefits; OASDI is an insurance program based on wages while SSI is a needs-based program funded through general revenues. Most importantly, in a set of proposals designed to "create personal wealth for all Americans", the Commission would solve some of the problems it creates for people with disabilities by relegating them to a program that, with its limits on earnings and resources, would ensure that they live in poverty. Asset depletion necessary for many beneficiaries with disabilities to qualify for SSI violates the basic tenets of the Commission's work. Nevertheless, the Commission "recommends that Social Security reform plans should also encompass reforms in SSI policy, to improve retirement incomes for those persons who might not otherwise attain poverty-level income in old age".

On the whole, we believe that the Commission's recommendations fall far short of addressing important questions about coverage for people with disabilities. Indeed, some would endanger the security of people with disabilities. We believe that these proposed plans cannot be supported.

We strongly recommend that Congress only consider proposals that: maintain the basic structure of the current system based on workers' payroll taxes; preserve the social insurance nature of the disability, survivors, and retirement programs; guarantee benefits with inflation adjustments; and preserve the Social Security trust funds to meet the needs of current and future beneficiaries. Certainly changes will be necessary within the basic structure to bring the trust

funds into long-term solvency. However, those changes must not be so drastic as to undermine or dismantle the basic structure of the program.

The disability community urges Congress to request a **beneficiary impact statement** from SSA on every major proposal, or component of a proposal, under serious consideration. In a program with such impact on millions of people of all ages, it is simply not enough to address only the budgetary impact of change; the people impact must also be studied and well understood before any change is initiated. For people with disabilities, their very lives depend on such analyses.

Again, I thank the Committee for considering our viewpoints on these critical issues. People with disabilities and their families will be vitally interested in the Finance Committee's work. The CCD Task Force on Social Security pledges to work with you to ensure that disability issues remain an important consideration in reform analysis and solution development.

ON BEHALF OF:
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Statement of Senator Chuck Grassley
Finance Committee Hearing
Report of the President's Commission on Social Security
October 3, 2002

Mr. Chairman, I would like thank you for holding this hearing. I'm especially glad to see that Dr. Olivia Mitchell, a member of the President's Commission, is here to testify.

Today, there are 46 million people collecting Social Security benefits. These benefits are funded by payroll taxes collected from 152 million working Americans. Because there are more than three workers for each beneficiary, Social Security is running a surplus. This surplus is invested in government bonds.

Once the 78 million baby boomers retire, however, there will be only two workers for each beneficiary and Social Security will begin running deficits. At that point, Social Security will have to redeem its government bonds to pay benefits.

Redeeming these bonds will cost the government more than $13 trillion over the next thirty-nine years. That means higher income taxes, less spending on other programs, or more government debt. Even if the government can afford to redeem all of these bonds, once they are gone, benefits will have to be reduced 30%, or the payroll tax will have to be increased 50%.

We cannot continue to ignore this problem. That's why I strongly supported President Bush's decision to create a bipartisan commission on Social Security. The Commission was assigned the task of developing a plan to protect current beneficiaries while eliminating the Social Security deficit and avoiding higher payroll taxes.

Since the Commission issued its final report this past December, it has been the subject of much criticism. Most of this criticism has been focused on two issues: "transition costs" and "benefit cuts."

According to the critics, the options developed by the Commission would require "massive" amounts of additional revenue and result in "dramatic" benefit cuts. I would suggest that these criticisms, when taken together, are categorically false.

According to the Social Security Administration, over the next 75 years, the benefits scheduled to be paid will exceed the taxes scheduled to be collected by $129 Trillion. The argument that the President's Commission, or any other commission, could design a plan that costs more <u>and</u> pays less than current law defies all reason. Hopefully, today's hearing will shed some light on this matter.

Finally, I would note that while much time and effort has been given to criticizing the Commission's proposals, very little thought has been given to the alternatives. But, I look forward to the day we hold a hearing on any plan developed by the Commission's critics. Thank you, Mr. Chairman.

Testimony of Robert Greenstein
Executive Director, Center on Budget and Policy Priorities

Before the
Senate Finance Committee

October 3, 2002

I appreciate the invitation to testify here today. I am Robert Greenstein, executive director of the Center on Budget and Policy Priorities, a nonprofit policy institute here in Washington, D.C. Several years ago, I also had the privilege of serving on the Bipartisan Commission on Entitlement and Tax Reform, chaired by two individuals who were members of this Committee at the time, Senators Kerrey and Danforth.

As you know, the President's Commission to Strengthen Social Security completed work last December and proposed three Social Security plans. One of these plans (Model 1) would not restore long-term balance to Social Security. I focus on the other two plans today.

My comments will center primarily on issues related to the financing of these plans and their relationship to the rest of the budget. Because the financing of the plans rests upon massive general revenue transfers despite the presence of budget deficits outside Social Security as far as the eye can see — and fails to provide any way for the rest of the budget to come up with the revenues that are to be transferred — my assessment of the financing of the plans is necessarily a critical one. Before addressing these matters, however, I would like to discuss an area where I believe the Commission's report makes an important contribution to the Social Security debate.

The "Free Lunch" Fallacy

In recent years, some proponents of partly converting Social Security to private accounts have sought to portray such accounts as a painless way to restore Social Security solvency without having to institute any reductions in Social Security benefits, increases in payroll taxes, or budget cuts or tax increases elsewhere in the budget. Some have presented private accounts as a direct alternative to benefit cuts or payroll tax increases and have essentially described individual accounts as a third way that entails no painful sacrifices. In this portrayal, there are three approaches to restoring Social Security solvency — benefit cuts, payroll tax increases, and private accounts.

Careful analysts, whether or not they favor partially replacing Social Security with private accounts, have long recognized that such "free lunch" claims regarding private accounts are inaccurate and misleading. Nevertheless, such claims concerning private accounts have continued to be made.

The Commission's proposals should help put a halt to such claims. Both of the Commission plans that restore solvency are able to do so only through a combination of: 1) large reductions in traditional Social Security benefits, as compared to the benefits scheduled under the current-law benefit structure (benefit reductions that are sufficiently large that, for millions of

beneficiaries, the combined benefits from Social Security and private accounts would be below the benefits payable under the current-law benefit structure); and 2) extremely large general revenue transfers that would entail hefty budget cuts or tax increases or large-scale deficit financing. Given that a Presidential commission composed entirely of advocates of private accounts was unable after months of deliberation to find a way to restore solvency without these large benefit changes and general revenue transfers, I hope that we will see an end to spurious claims that private accounts are a panacea that can restore long-term solvency without other painful actions. As is true elsewhere in life, there is no "free lunch." The Commission report should be helpful in demonstrating that.

In this vein, I also would like to commend several members of this Committee who, along with Reps. Stenholm and Kolbe in the House, have put forth private-account proposals that do not shrink from hard choices or seek to hide or camouflage the choices they have made. I do not favor those plans, but I respect the fiscal and intellectual integrity on which they are based.

The Financing of the Commission Plans

Two of the three Commission plans succeed in restoring Social Security solvency, according to the estimates of the Social Security actuaries. *How* they restore solvency warrants close examination.

As Peter Diamond of M.I.T., widely regarded as one of the world's leading experts on retirement systems, and Peter Orszag of Brookings, a fellow panelist at today's hearing, have shown in their magisterial analysis of the Commission plans, the private accounts that would be established under the Commission proposals would make no contribution to restoring Social Security solvency. To the contrary, as the Commission report acknowledges, the private accounts themselves would worsen Social Security's balance over the next 75 years.[1] The accounts would have an adverse effect on Social Security's financial condition on a permanent basis, rather than just during a "transition period."

The private accounts would have this effect for a basic reason: under the Commission plans, these accounts would be subsidized with revenue from the Social Security Trust Funds, and these subsidies would be a permanent part of the new financing structure. As a result, the Social Security Trust Funds would lose more in revenue due to the private accounts than they would gain as a result of the reductions in Social Security benefits that would be tied to participation in the private accounts. The result would be a permanent worsening of the Trust Fund's financial condition.

How then do the Commission plans succeed in restoring solvency? They are able to do so through rather massive infusions of general revenue from the rest of the budget. Indeed, in the absence of these general revenue transfers, the Commission plans actually would hasten the date of Social Security insolvency, despite the large reductions in traditional Social Security

[1] President's Commission to Strengthen Social Security, "Strengthening Social Security and Creating Personal Wealth to All Americans," p.127.

benefits they contain. For example, in the absence of general revenue transfers, Model 2 would hasten the date of insolvency by 13 years.

The Magnitude of the General Revenue Transfers

As Diamond and Orszag have demonstrated, the general revenue transfers that would be required under Model 2 would be *two-thirds as large as the entire Social Security shortfall over the next 75 years*. (This estimate assumes all eligible workers would participate in the plan's private accounts, as it would be to their advantage to do given the subsidies that would be provided to the accounts.) The transfers that would be required under the Commission plan known as Model 3 would be *three-fifths as large* as the entire Social Security shortfall. (This estimate for Model 3 assumes that two-thirds of eligible workers would participate in the private accounts under that plan; this is a reasonable participation estimate for Model 3, since participants would have to contribute some of their own money to participate in the plan's private accounts.) Transfers of this nature can only be described as massive.

The Problem of Disability Benefits

Moreover, these figures may significantly understate the magnitude of the transfers that would be needed. These figures assume that the deep cuts in traditional Social Security benefits that are part of Models 2 and 3 would be visited upon disabled Social Security beneficiaries. Yet those who become disabled at a relatively young age would have participated in the private accounts for only a short number of years and hence would receive little income from these accounts to offset the large loss of traditional Social Security benefits. Furthermore, under Models 2 and 3, no one — including disabled beneficiaries — would be able to receive any income from their private accounts until they reached retirement age.

I raise this issue here because the figures cited above for the magnitude of the general revenue transfers assume that the reductions in traditional Social Security benefits would apply in full to the disabled. That assumption is made because it is what the Commission assumes in its report when it describes the financing of the plans. It consequently also is what the Social Security actuaries assumed when they estimated the costs of the Commission plans and assessed whether those plans would restore solvency. Without these substantial reductions in disability benefits, either the Commission plans would fail to restore Social Security solvency or the general revenue transfers would have to be even larger.

The reductions in Social Security disability benefits would be large. Those who began to receive Social Security disability benefits in 2060 would be subject to a 39 percent reduction in these benefits under Model 2 (compared to the current-law benefit structure) and a 23 percent reduction under Model 3. Moreover, the reductions would grow deeper for each new cohort of disabled individuals. Those beginning to receive disability benefits in 2075 would be subject to a 48 percent reduction in Social Security disability benefits under Model 2 and a 29 percent reduction under Model 3.

Adding to the problems that these deep reductions in disability benefits would entail, these benefit reductions would disproportionately affect minority workers, since the proportion

of workers who are disabled is significantly higher among African-Americans than among the rest of the population. (These same reductions in benefits also would apply to young children of deceased workers. African-Americans would be disproportionately affected by those benefit reductions as well.)

Unfortunately, the Commission's treatment of this problem was less than straightforward. Throughout its report, the Commission counted the savings from these large reductions in disability benefits to help make its numbers add up. Until two pages from the end of its 151-page report, however, the Commission was silent about this important matter, failing to explain that its proposed reductions in traditional Social Security benefits would apply in full to Social Security disability benefits unless a change in the plans were made. Only at the end of its voluminous report did the Commission acknowledge that these reductions in traditional Social Security benefits would apply to disability benefits and that the disabled individuals affected would not have had the same opportunities as retirees to build private account balances. In essence, at the end of its report, the Commission acknowledged that application of these benefit changes to the disabled could cause significant hardship and accompanied this acknowledgement with a statement that disavowed the application of these benefit changes to Disability Insurance and asserted it was *not* proposing that these benefit reductions apply to DI.

The Commission cannot, however, have it both ways. Either it *is* proposing that these benefit reductions apply to disabled beneficiaries — in which case, hardship would ensue but the resulting savings could be used to help restore Social Security solvency — or it is *not* proposing that the benefit reductions apply, in which case the savings would not be realized and cannot be counted. Instead, the Commission has tried to claim that it is not recommending that these benefit reductions be applied to disabled beneficiaries, while still counting the substantial savings that would result from doing exactly that.

If these benefit changes do *not* apply to the disabled, the general revenue transfers would have to be even larger than the figures cited above (if Social Security solvency is to be achieved). Diamond and Orszag calculate that in this circumstance, the transfers under Model 2 would equal *four-fifths* of the 75-year Social Security shortfall that the actuaries currently project. Under Model 3, the transfers would equal 70 percent of the Social Security shortfall.

Where Would the Money for the Transfers Come From?

This raises the question of where the large amounts to be transferred would be found. This is a crucial question, as surpluses outside Social Security no longer remain. No money is available for such transfers, unless action is taken to secure such funds through major cuts elsewhere in the budget or substantial tax increases.

Nor is this lack of surplus revenues available for transfer a short-term problem only. To the contrary, long-term budget projections that have been issued by the General Accounting Office and the Congressional Budget Office, as well as the long-term projections made by independent analysts, show very large *long-term* budget shortfalls outside Social Security. The retirement of the baby-boom generation will lead to substantial increases in costs for Medicare and the long-term-care component of Medicaid, while the aging of the population will slow labor-force growth and hence the growth of the economy. Recent estimates suggest that the

long-term budgetary shortfall outside Social Security is at least *twice as large* as the long-term Social Security shortfall itself.

In short, no funds are available in the budget to make the very large transfers the Commission plan entails. Where the funds would be found is entirely unclear. Policymakers would essentially face three choices in finding the trillions of dollars to transfer to the private accounts. They could impose deep cuts on the rest of the budget. They could impose large tax increases. Or they could run even larger deficits outside Social Security than those currently projected, with such deficits continuing for decades.

In one of its less admirable aspects, the Commission report ducks these questions. It simply assumes that these large general revenue transfers will be made, while providing no indication of how or where the money for the transfers could be secured. If the Commission proposals were enacted, the general revenue transfers it would require would represent a "magic asterisk" of historic proportions.

By assuming such large transfers and then failing to pay for them, the Commission report itself becomes a "free lunch" proposal of sorts after all. Looked at another way, the large, unspecified transfers included in the Commission plans essentially mask the adverse financial impact that the subsidized private accounts the Commission has proposed would have on Social Security solvency.

I would hope that policymakers of both parties — whether or not they favor partial conversion of Social Security to private accounts — would adopt a basic principle from now on for Social Security reform: If general revenue transfers are to be part of proposals to restore long-term Social Security solvency and the non-Social Security budget is projected to be in deficit, the transfers should be "paid for." Henceforth, Social Security plans should not simply assume such transfers without financing them. Plans should specify the changes that would be made elsewhere in the budget to produce the revenue that would be transferred.

Two Risk Factors Could Aggravate the Financing of the Commission Plans

Finally, two risk factors that could add to the financing problems of the Commission plans. First, for the reasons just described, there is a possibility that the assumed transfers would not fully materialize. If they did not, Social Security benefits could have to be reduced to a greater degree to adapt the system to the available level of funds.

The second risk is a risk to the rest of the budget. Imagine what would happen if one of the Commission plans were in effect and the stock market plunged as it has in recent months, wiping out a significant share of the assets in the accounts. If balances plummeted in accounts that had been presented to the public as being a key part of the Social Security system and a substitute for a significant share of their Social Security benefits, the political pressures on the federal government to make up for these losses could be tremendous. One can see how this easily could become a political football, with possible bidding wars erupting in election years. The threats to the rest of the budget to produce even larger transfers could be substantial.

Written Questions for Robert Greenstein

Senator Kyl

1. You criticized the Commission proposals but did not yourself offer a comprehensive proposal to attain permanent sustainability for Social Security that lacks the flaws you ascribe to the Commission proposals. What is your specific proposal to make Social Security permanently sustainable? Are you willing to provide such a proposal for analysis by the Social Security actuaries using standards as stringent as those applied to the Commission's proposals? In answering, please do not simply outline concepts but provide a specific program analogous to those put forward by the President's Commission. Do you believe that those who have not offered a superior program for making Social Security permanently sustainable are in a credible position to criticize the commission's work?

2. Your testimony criticizes the mix of revenue requirements and benefit levels in the Commission proposals. Please describe the mix of revenues and benefit levels that you believe are appropriate, and provide a specific proposal to achieve this.

Responses to Questions from Senator Kyl

1. As you note, I have not myself designed a detailed plan for restoring Social Security solvency. Doing so is a difficult task without the type of extensive staff support the Commission had.

Having said that, I have repeatedly observed that restoring solvency should entail a combination of changes in scheduled benefits and increases in Social Security revenues, coupled with some reasonable level of transfer from the rest of the budget that is paid for with appropriate offsetting changes in the rest of the budget. As I mentioned at the hearing, one way to finance a general revenue transfer would be to retain the estate tax at the parameters it will reach later in this decade (rather than repealing it), and to dedicate the remaining estate tax revenue to the Social Security Trust Fund. I am also very interested in the idea of changing the inflation measure used for Social Security COLAs, as well as for the indexation of other programs and of tax code provisions that are adjusted by the CPI, from the current official CPI to the improved, alternative Consumer Price Index that the Bureau of Labor Statistics recently began issuing. Broadening Social Security coverage of state and local workers is another meritorious proposal.

The strongest set of proposals I have seen for restoring Social Security solvency is the set published by Henry Aaron and Robert Reischauer in their excellent book, *Countdown to Reform: The Great Social Security Debate*. Aaron and Reischauer provide a menu of options that, in total, would produce about 50 percent more in savings than is needed to restore 75-year solvency. While I do not favor every option on their list, a strong plan that restores solvency can be put together by drawing upon this list and other proposals such as the aforementioned CPI change. I certainly agree that all solvency plans should be submitted to the Social Security actuaries.

Finally, I must dissent from the notion that one cannot credibly criticize the Commission's plans unless one has designed an alternative plan. The logical implication of this notion is that analysts and Members of Congress cannot credibly offer critical analyses of pending policy proposals in a range of fields until they have developed specific, detailed proposals of their own on the same issues. Policy debates never have been — and should not be — limited in such a fashion. The credibility of a critique of the Commission's proposals, or of any other policy proposal for that matter, should rest on the quality and rigor of the critique, not on whether the analyst in question has designed an alternative detailed policy proposal of his or her own.

2. My answer to this question is covered by my answer to the previous question.

National Committee to
Preserve Social Security
and Medicare

Statement of

The Honorable Barbara B. Kennelly
President and CEO of the
National Committee to
Preserve Social Security
and Medicare

Submitted to

Committee on Finance
U.S. Senate

Regarding

The President's Commission to Strengthen Social Security

October 3, 2002

10 G Street, NE, Suite 600 • Washington, DC 20002-4215 • 202 216-0420
www.ncpssm.org

Chairman Baucus, Senator Grassley and members of the Committee. I appreciate the opportunity to testify before the Senate Finance Committee on the Final Report of the President's Commission to Strengthen Social Security. Thank you for holding this timely and important hearing.

For nearly 70 years, Social Security has guaranteed working families some income should the family wage earner die, retire, or become disabled. Social Security provides benefits in a manner that is both progressive and fair. No other wage replacement program, public or private, offers the protections of the Social Security Old Age, Survivors and Disability Insurance program. While Social Security has sufficient revenues to cover currently promised benefits for the next 39 years, incoming revenues beyond that point are projected to cover only about 72 percent of currently scheduled benefits.

The president's commission presented a real opportunity to move the nation toward long-range Social Security reform. Unfortunately, the commission was not a success. The president placed too many preconditions on its work, several of which contradicted Social Security's fundamental mission. Preconditions precluded solutions. Not surprisingly, the commission faltered. It produced three, highly controversial options, each of which failed to meet most of the president's own basic tenets.

Based on analysis provided earlier this year by the Social Security Administration's chief actuary, none of the plans produce long-term program solvency without massive infusions of general revenue, for which no source is specified. All three plans sharply reduce defined benefits below current baselines. All three plans reduce projected overall retirement income for most workers. All three plans lack important details on how the proposed private accounts programs would actually

operate. Finally, in addition to retirement benefits, all three plans would sharply reduce not only retiree benefits survivor and disability benefits as well.

The president directed the commission to propose Social Security reform plans that strengthen Social Security and increase its fiscal sustainability. The administration also appropriately instructed the commission to hold harmless those at or near retirement. This should have been direction enough.

Yet the president chose to require that the commission's final recommendation would allow today's workers to divert at least a portion of their payroll taxes to risk-bearing private, personal accounts. With no debate on the merits, the president thus ordered the commission to introduce privatization, a radical departure from the current insurance model. Privatization siphons precious resources from the insurance pool as it exposes a greater share of retirement income to market risk.

Off limits was any discussion of increasing revenues; this mandate that precluded the commission from considering a number of alternatives to benefit cuts, including a proposal to restore the taxable wage base to historic levels by raising the cap to cover about 90 percent of covered wages. The commission could have been instructed to consider a package of any number of small changes, most of which have been discussed at length by experts over the past decade. But with revenues off the table and pressure on to address private accounts transition costs as well as solvency, the commission was handed an impossible task. Thus, the commission's efforts, despite the obvious talents and accomplishments of its 16 distinguished members, ended in failure.

The commissioners fashioned all three plans so that those opting for the accounts take an "actuarially equivalent" reduction in their guaranteed insurance benefits. Plan 1 further threatens defined benefits by failing to achieve solvency. Plan 2 and

Plan 3 pay for incentives to entice individuals to opt for the accounts through additionally cutting the defined benefit. Plans 2 and 3 threaten still further cuts by relying on currently unavailable general fund revenues to achieve solvency. Ironically, these general funds, according to Dr. Peter Orszag, if applied directly to the existing program with no private accounts, would be sufficient to close as much as two-thirds of the current solvency gap without cutting benefits.

Social Security's chief actuary has found that, because of the transition costs commission plans boost the unified deficit by $1.2 trillion to $1.5 trillion in the period between 2003 and 2012. All three plans call for reductions as great as 43 percent in the guaranteed benefit for those retiring in 2075. Under Plan 2, program expenses exceed tax revenues by as early as 2006, thus projected annual deficits over the next decade raise serious questions about the availability of general revenue to cover the costs, even for those currently receiving benefits. The irony here is described by Dr. Carroll Estes in her new book, *Social Policy and Aging,* when she observes, "The Social Security privatization transitional costs will compete with (if not foreclose) on other domestic social spending; yet they either are not described at all or are not described as any kind of problem by privatization advocates."[1]

The final report contains a number of assertions that are either misleading or false. For example, the final report states, in spite of the facts, that the current system places African-Americans at a disadvantage. Although African-Americans comprise 12 percent of the population, they represent 17 percent of those receiving disability insurance benefits and 22 percent of the children receiving survivor benefits. African-Americans also benefit disproportionately from Social Security's progressive structure.

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[1] Sage Publications, 2001, p. 116.

The report also contends that its privatization plans would provide a net improvement for women, while suggesting that the current system has not served women well. But two-thirds of women over age 65 depend on Social Security for at least half of their income, and one-third for at least 90 percent of their income. Privatization is inherently problematic for women, as they tend to spend more years outside the work force, earn less on the dollar than do men for the same work, and are less likely to have any other sources of retirement income.

The commission does propose some positive changes intended to address long-standing inequities for women in the current system that do, in fact, exist. Still these improvements are undermined by dramatically lower replacement rates due to other benefit cuts contained in the plans. The plan just gives them a slightly larger share of a much smaller pie. According to the National Women's Law Center, a couple with relatively equal earnings under Plan 2 would still see a 10 percent cut in survivor benefits, even with the proposal to give widows a greater share of benefits in place. A surviving spouse from a household with less-equal earnings could experience cuts as high as a third of total promised benefits under this plan.

The commission left unresolved many crucial implementation issues. It did not address the age at which the decision would have to be made to opt for the voluntary accounts, although wages are subject to FICA no matter the age of the worker. Nor did the commission address whether the decision would be a one-time choice. Under certain circumstances, the commission allowed for lump-sum withdrawals from the accounts, but it did not clearly define the terms requiring that the remaining combined annuity and guaranteed benefit leave the individual "safely above the poverty line." The commission also assumed 0.3 percent for administrative costs on the private accounts. This assumption demands greater scrutiny given the experience of such plans in other countries.

Despite the administration's instruction to the commissioners to "preserve" Social Security's disability and survivor programs, all three plans assume benefit cuts as high as 47 percent to these vital programs. If commissioners had adhered to the mandate, the cuts recommended for retirement benefits would have been far deeper. The concept of rates of return on an individual's investment or the concept of an individual getting one's "money's worth" is incompatible with the structure of Social Security as insurance. And this is immediately apparent when severe disability or death of a family wage earner strikes a young household.

The administration also sought to limit discussion by selectively appointing to the commission only individuals who already had expressed support for privatization. By contrast, President Reagan's 1983 Greenspan Commission included noted scholars, members of Congress, seniors' advocates, corporate leaders and representatives of organized labor—all of whom were given little instruction beyond a mandate to recommend changes necessary to preserve the program. Many of the decisions were difficult but necessary at the time because our government had waited until only four months of solvency remained in the program. Today, we have adequate time before program revenues fall short of promised benefits.

The true value of the commission's report is that it exposes privatization's fundamental failings. How telling it is that pollsters are advising pro-privatization candidates to avoid using the term "privatization" this fall. In distancing themselves from the term, they will not succeed in changing the debate. Still, the administration continues to voice support for personal accounts plans. I believe that the issue is not dead but merely in hibernation, to be revived after the mid-term elections.

Privatization sounds appealing in concept, but is fatal in reality. The devil is in the details. The mission of the National Committee is to see that all American citizens truly understand the ramifications of privatization. When presented with the fine print, the American public will never abide the benefit cuts and risk that privatization demands.

Chairman Baucus, I know you are a leader in the fight in the Senate against Social Security privatization, and we are truly grateful. I appreciate the opportunity to appear before you today. I look forward to any questions the distinguished members of this committee may have.

November 13, 2002

Honorable Max Baucus
Chairman
Committee on Finance
United States Senate
Washington, DC 20510

Dear Chairman Baucus:

Thank you for the opportunity to respond to Senator Kyl's questions in writing. I was pleased to see you at the October 3 hearing of the Senate Finance Committee.

Although Senator Kyl has submitted two lines of inquiry, his first, regarding proposals of the National Committee, poses several specific questions. Attached you will find our responses.

We hope this information will be helpful to you and to Senator Kyl in your efforts. Again, we appreciated the opportunity to respond and we look forward to continued dialogue with you on these matters of vital importance to all Americans.

Sincerely,

Barbara B. Kennelly
President and CEO

Q. You criticized the Commission proposal but did not yourself offer a comprehensive proposal to attain permanent sustainability for Social Security that lacks the flaws you ascribe to the Commission proposals. What is your specific proposal to make Social Security permanently sustainable? Are you willing to provide such a proposal for analysis by the Social Security actuaries using standards as stringent as those applied to the Commission's proposals? In answering, please do not simply outline concepts but provide a specific program analogous to those put forward by the Commission.

A. My testimony was focused on the three proposals of the President's Commission to Strengthen Social Security, as requested in our invitation to the hearing. Toward that end, my testimony speaks to the evidence that none of the commission's plans meet the tests put forward in the President's own mandate to the commission for achieving long-term sustainability. The commission was specifically charged by the president to do this.

As mentioned in my testimony, the debate surrounding Social Security solvency has become excessively politicized. We are very concerned that in this environment, it would be difficult for any specific plans to be considered objectively. That is why we have called upon the president to begin the process anew. We urge the administration to establish a more inclusive process modeled after President Reagan's leadership in the early 1980's.

Q. Do you believe that those who have not offered a superior program for making Social Security permanently sustainable are in a credible position to criticize the commission's work?

A. I do not believe that having a specific plan is an appropriate litmus test to determine one's credibility to discuss proposals to reform Social Security. My responsibility to our organization's membership demands that we provide timely analysis and reaction to any proposals that may affect current or future generations of retirees.

I welcome your efforts to seek dialogue with us regarding regarding our views. I have tremendous appreciation for your need to gather information that helps in making such decisions. Toward that end I look forward to working with you and your colleagues on the Committee to foster that dialogue.

Q. Your testimony criticizes the mix of revenue requirements and benefit levels in the commission proposals. Please describe the mix of revenues and benefit levels that you believe are appropriate, and provide a specific proposal to achieve this

A. Based on the latest report of the Social Security Trustees efforts must be made over the long-term to raise new revenues for the program. However, we do not believe that this necessarily requires new or increased taxes. In my response to a similar question posed by Chairman Baucus at the hearing, I responded that a number of commissions have weighed a wide range of possible options over the years, and many options have been thoroughly researched and discussed. Given the current climate of the debate, we would urge a renewed national discussion to review all options. Such discussions should begin with a focus on the merits of our present approach to Social Security as it compares to private accounts proposals such as those advanced by the recent president's commission.

We also believe that current benefit levels should not be reduced. If anything, consideration must be given to improve benefit levels in some areas, particularly for certain widows and surviving spouses. While Social Security provides an important base of income for those eligible, average benefit levels continue to hover around the federal poverty line. As you know, women in particular depend on this benefit level, as about half of all women in retirement who live alone rely on Social Security for at least seventy percent of their income and nearly a third rely on Social Security as their sole source of income.

Statement of Dr. Olivia S. Mitchell
International Foundation of Employee Benefit Plans
Professor of Insurance & Risk Management
The Wharton School of the University of Pennsylvania

Testimony before the Senate Finance Committee
Hearing on the Final Report of the President's Commission to Strengthen Social Security
October 3, 2002

Chairman Baucus and Senator Grassley, I thank you for this opportunity to address the Senate Committee on Finance. On behalf of the President's Commission to Strengthen Social Security, I would like to commend you for your attention to the challenges facing Social Security.

My name is Olivia S. Mitchell and I am a Professor of Risk Management and Insurance at the Wharton School of the University of Pennsylvania. I recently served as one of 8 Democratic members of the 16-member bipartisan Commission to strengthen Social Security, a group that reported out last December under the leadership of Senator Daniel Patrick Moynihan and Richard Parsons.

I would like to begin by saying a few words about the Commission. When I was invited to join this group, I felt it essential that we embody the integrity and bipartisanship needed to strengthen Social Security. Our Commission was charged with improving the sustainability of Social Security -- **without changing benefits for those now or near retirement, without raising payroll taxes, and while establishing new savings opportunities through personal accounts.** I am very much gratified that our Commission was able to satisfy these charges by presenting proposals that **enhance progressivity, reduce systemic risk, and allow freedom of choice in a way that the system has heretofore never permitted**. These objectives, we believe, can be achieved, within a reformed and fiscally sustainable system, which promises benefits higher than those currently payable and, in many cases, higher than those expected under current benefit promises. Our proposals were also rigorously scored by the Social Security Chief Actuary, a high standard that we invite other interested parties to meet, by submitting their own plans.

The Commission achieved something that no prior commission has done, namely to produce a consensus report with recommendations to make Social Security **not only solvent but permanently sustainable**. Further, each of the reform models we proposed would **establish personal accounts within the context of the Social Security system.**

Mr. Chairman, some might imagine that one could reform Social Security without personal accounts. Indeed, Social Security financing might be temporarily enhanced without personal accounts, simply by shifting mounting costs onto future generations. But as an economist, I find this a fundamentally unsatisfactory approach, and I would suggest that it might not be a politically sustainable solution either. Indeed, there is probably no "perfect" solution; instead, meeting the challenges of Social Security via personal accounts seems to me, and seemed to the Commission, to be a preferable path to the unappealing alternatives, namely raising taxes, or cutting benefits.

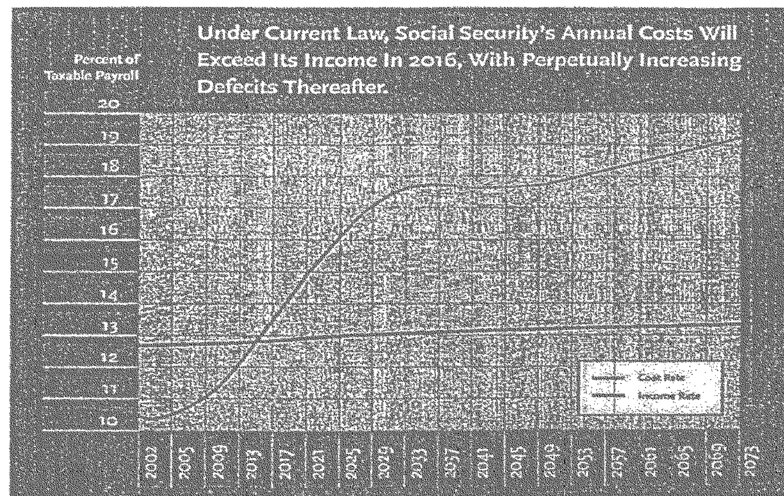
In the end, however, the main reasons to create personal accounts in Social Security are positive, not negative. One benefit of a properly designed Social Security personal accounts systems can be a **permanently sustainable Social Security system**. Another can be **higher benefits than the existing system can pay**. Still others are possibly **greater national saving, greater individual control,**

inheritance rights, new protections for divorced women, and, as Co-Chairman Senator Daniel Patrick Moynihan has emphasized, the first **opportunity for millions of Americans to accumulate wealth.**

Addressing the Challenge of Social Security Sustainability: The Available Choices

The fiscal challenges facing the Social Security program are summarized in the following chart (Figure 1.)

Figure 1.

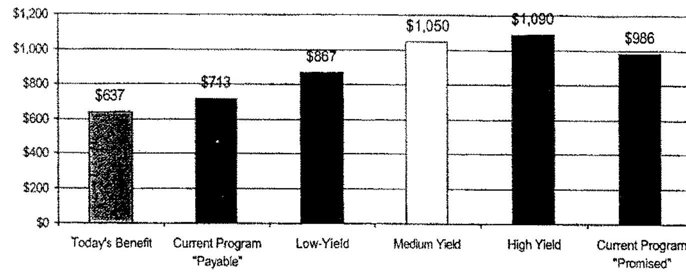


In developing this chart, the Commission worked with the 2001 Trustees' Report estimates, which showed that Social Security's benefit obligations will start to exceed annual cash income in 2016. (This date has shifted to 2017 in the most recent Trustees' Report.) At this point, the federal government will have to allocate additional cash to the Social Security program to cover promised or scheduled benefits. Specifically, Congress will have to allocate not only all projected payroll tax dollars, but also more additional revenues to redeem debt held by the Social Security Trust Fund. The figure shows that, under current law, these costs will escalate very rapidly, and the revenue and cost lines will forever pull further apart.

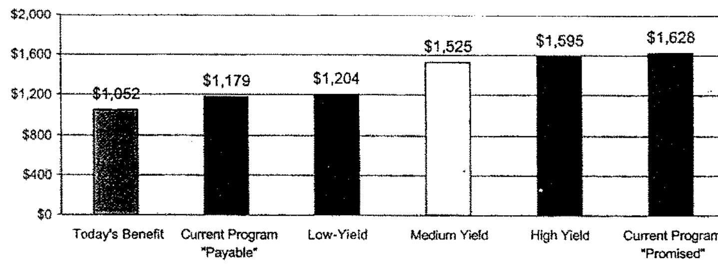
This figure shows that system "solvency" is only one piece of a much more difficult problem. That is, "solvency" might be achieved in theory, simply by raising the level of interest paid to the Social Security Trust Fund. Or it could be achieved by raising payroll taxes today, even if that payroll tax money were used to finance current expenditures (for example, to finance a war or additional income tax cuts). But here is the critical point: such measures would do <u>nothing</u> to address the fundamental underlying problem, which is the program's unsustainable cost growth relative to the size of the economy.

Figure 2: Monthly Social Security Benefits Under Alternative Scenarios (2052, Model 2)
Source: CSSS Final Report (2001)

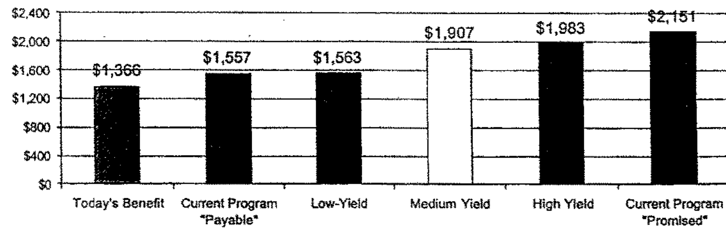
A. Lifetime low-wage earner



B. Lifetime medium-wage earner



C. Lifetime high-wage earner



We cannot take credit for "solving" Social Security by shifting ever-increasing costs onto future taxpayers.

Social Security will not be sustainable – either fiscally or politically – unless in the long run, its annual dedicated income exceeds its payment obligations, *without* relying on appropriations from the rest of the budget. As my colleague, former Congressman Tim Penny urged at one of our Commission hearings, **we must get these lines to cross again.** The system must return at least to cash-flow balance, not only now, but for the future as well. The Commission accordingly rated all proposals according to how much progress they make toward this goal. This was the critical test facing the Commission, and which I believe today faces the Congress of the United States. I would therefore encourage this Committee to subject all proposals to a similar evaluation, as it examines alternative means of shoring up Social Security.

In our Commission report we illustrated the choices facing those who are serious about taking on this challenge. For each of our proposals, we showed the operations of Social Security assuming no participation in personal accounts – as though the personal accounts had not been established – and also assuming, respectively, 2/3 and 100% participation. This is crucial since there is some uncertainty about exactly how many workers under the age of 55 would take up personal accounts. As we point out many times in our report, no one age 55 and over would have benefits affected in any way by these plans.

The analysis of Commission Model 2 (without the accounts) shows that if the system were converted from wage indexing to price indexing, the plan would attain full actuarial balance without raising payroll taxes and without cuts in the real value of benefits. Other approaches lay out alternative options for the Congress: for instance, Model 1 (without the accounts) shows the ramifications of keeping current benefit formulas in place, which would require the allocation of an additional $22 trillion (in 2001 dollars) or $5 trillion (in present value) of on-budget revenues in order to remain solvent. In each case, however, expected benefits will be higher for most workers under the personal account plan than without. In other words, no benefits would be cut relative to current payments, and in most cases benefits would be higher. In fact, long-term low-wage workers would be substantially better off as compared to the benefits that can be financed under the current system.

Helping Social Security Fulfill its Promise to Beneficiaries

In addition to fiscal issues, the Commission looked closely at the treatment of individual Americans under the current Social Security program. **We found many reasons for concern.**

One clear and systemic problem has to do with the **worsening treatment of young Americans.** In our Interim Report, we showed that a boy born in 2000, if he remained single all of his life and earned an average income, could expect only a 0.86% real rate of return from Social Security. A girl would anticipate only a return of 1.25% on her taxes, and a dual-earner married couple, a 1.88% rate of return. While rates of return are not the only relevant measure of the system's equity, it is clear that perpetually plummeting rates of return threaten not only the program's efficacy but also its political support.

Commission members were also concerned about how the **program fails to redistribute income to those who need it most.** For example, the current system redistributes money from those with shorter lifetimes to those with longer lifetimes, and from single individuals to traditional one-earner married couples. Both of these elements work against the progressivity of the existing system.

These issues are complex, and no single prescription addresses them all. We sought, however, to **enhance the safety net for certain vulnerable populations, particularly divorced women** who

currently gain no entitlement to benefits based on their years of marriage, despite being at very high risk of poverty. We also proposed **benefit enhancements for surviving widows and widowers** most at risk for low income in old age.

A Brief Description of the Commission Proposals

I would like to briefly describe key aspects of our Commission's proposals, since others speaking before you today will offer their own interpretations of our plans. I will focus in the interest of time on what we called "Commission Model 2" because it is the one that passes the most rigorous tests of fiscal sustainability. When constructing Model 2, the Commission pointed out that the current wage-indexed benefit formula is inherently unsustainable within the demographics of our nation. We concluded that the ***entire* actuarial imbalance in Social Security over the next 75 years could be accounted for by growth in initial benefits beyond inflation**: in other words, if the benefit formula were indexed to grow with prices rather than wages, the system can be placed on a sustainable course. This would enable the government to maintain actuarial balance while offering benefit growth *above* existing law for low-income earners and for widows.

Model 2 contains a provision that would gradually increase defined benefits for low-wage earners, added benefits that some have neglected to mention. When fully phased in by 2018, the provision would ensure that any individual who worked for a full career at the minimum wage would receive a benefit that is 20% **higher than the poverty line.** Model 2 also would **expand benefits for low-income widows.** This reform plan also provides individual participants with an opportunity to invest 4 percent of their wages into a personal account, up to a maximum of $1000 annually (a figure indexed to wage growth.) The account would be set up so that participants would have higher expected benefits than from traditional Social Security, providing that the personal account accumulates at faster than a 2% real rate of return.

The SSA Actuaries' projections show that this personal account option can provide higher expected total benefits than can be paid under the current system, and in addition, benefits would be enhanced for many taxpayers. The attached chart (Figure 2) show the extent of the increases individuals can expect if they opt for the personal accounts.

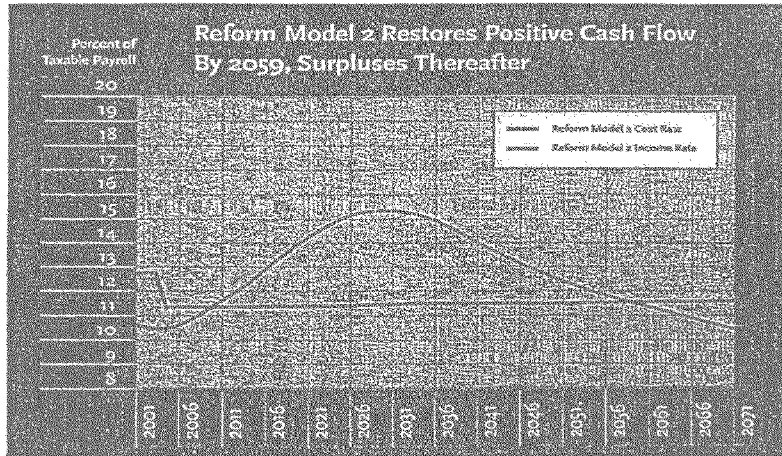
We also devoted substantial attention to plan design, and intentionally we modeled these personal accounts very closely on the federal government employee's Thrift Savings Plan. I emphasize that the TSP is not a "privatized" system, but an effective and safe means of saving and investing that has benefited countless federal employees. In these personal accounts, individuals would have the opportunity to invest in broadly diversified funds – an inflation-indexed Treasury bond fund, a stock fund, and others. There would be no "day trading" or "stock picking."

Financing Results

I should also emphasize that the Commission took seriously its charge to **enhance fiscal sustainability** (see Figure 3). If no one opted for personal accounts, the actuaries project that permanent cash surpluses would begin in 2062 under Model 2's reform. If everyone opted for personal accounts, cash surpluses would begin somewhat earlier, in 2058. While we don't know exactly how many people would opt for the accounts, and this would depend on a national educational campaign, **structuring the personal account properly would ensure that the accounts accelerate progress towards the system's permanent sustainability. Figure 4 illustrates that this can be done very affordably. Of course,** there is an investment required when moving to a funded system, which under Model 2 lasts from 2005 to 2029 and is then balanced by a payback period from 2029 onward. The Commission defined transition costs as

the **net additional general revenue requirement associated with the proposed reform**, for the years when additional resources are needed to cover promised benefits and fund the personal accounts. In present value terms, Model 2 requires $0.9 trillion or about half of one percent of GDP, between now and 2029. (These transition financing requirements are initially quite small, $4 billion in 2010, and grow to a maximum of just over $73 billion in 2016 (in $2001). Thereafter, the amount of new cash requirements for the reformed system would diminish. Starting in 2029, the new system would require less general revenue than the old one on a permanent basis.) The Commission concluded that this amount was comparatively small and would not pose major economic or budget concerns, particularly compared to the alternative of doing nothing.

Figure 3.



In order to fully evaluate the effects of reform, we constructed a rigorous "fiscal sustainability report card" for each of the Commission's reform Models. I would note that we ourselves did not fill in the results on this scorecard – we left that to the independent analysis of the Social Security actuaries, who updated the table on July 9 of this year. I include this table with my testimony (Figure 4). It shows clearly how these models for reform improve significantly upon current law.

Time forbids a similarly detailed discussion of Commission Models 3 and Model 1. But each of these, too, is illustrative of specific philosophical choices that could be made. With my testimony, I would like to enclose a copy of the Executive Summary of the Commission Report, which provides additional details on each of the Commission proposals. This Executive Summary restates the President's principles for strengthening Social Security, reviews some design elements that are common to all three of our reform models, presents the most significant provisions of each model, and summarizes each model's expected benefits and fiscal projections.

FIGURE 4

Table 1. CSSS Summary Results: Fiscal Sustainability--REVISED* 7/9/02

Assuming 2/3 Participation in Individual Accounts	Model 1 1/	Model 2	Model 3	Current Law
1. Expected PRA assets at end of 2075 ($PV trillions)	$1.1	$1.3	$1.6	NA
2. Gain in system assets at end of 2075 (Increase in Trust Fund plus Expected Personal Account Assets; $ PV trillions)	$0.5	$4.8	$5.0	NA
3. Gross reduction in cash flow requirements from general revenue relative to present law (unified budget concept) 2/ 3/				
Reduction in 75-year total (Sum of Ann Amts in $2001 trillions)	$1.8	$15.0	$11.8	NA
Percent reduction versus current law	8.0	68.2	53.4	NA
Reduction in 75-year total ($PV trillions)	-$0.2	$2.3	$1.8	NA
Percent reduction versus current law	-3.5	45.5	35.5	NA
4a. Social Security cashflow with general revenue transfers				
Positive by end of valuation window?	No	Yes	Yes 4/	No
IncomeRate(including GR Trans)-Cost Rate in 2075 (% of payroll)	-4.56	1.41	0.12 4/	-6.05
4b. Social Security cashflow without general revenue 3/				
Positive by end of valuation window?	No	Yes	No	No
IncomeRate(excluding GR Trans)-Cost Rate in 2075 (% of payroll)	-4.56	1.41	-0.75	-6.05
5. Improvement in Actuarial Balance over 75-year period (% of payroll)				
Improvement with general revenue transfer	-0.32	1.99	1.88	0
Improvement without general revenue transfer 3/	-0.32	1.15	0.87 5/	0
6. Transition investment 6/				
a. Reduction in annual OASDI net cash-flow balance (including gen rev transfers) relative to current law. 7/				
$ PV trillions	$1.1	$0.9	$0.4	NA
As % of GDP over years included in calculation	0.36	0.49	0.25	NA
b. Extent to which annual OASDI net cash-flow balance (including gen rev tarnsfers) is negative or more negative than under current law. 8/				
$ PV trillions	$0.7	$0.4	$0.1	NA
As % of GDP over years included in calculation	0.29	0.33	0.10	NA

1/ Model 1 does not include additional transfers for actuarial balance (solvency).
2/ Gross gen rev requirements include only GR required in any year, and excludes excess OASDI cashflow to the GF in any year.
3/ Taxes on benefits and on PA distributions are treated as Social Security revenues, not general revenue.
4/ Includes Model 2 provision for dedicated general revenue transfers.
5/ Improvement in actuarial balance would be +1.50 if new dedicated sources of revenue are included; see text.
6/ Difference between net annual OASDI cash-flow balance (income minus cost) of proposed model versus present law (with borrowing authority).
7/ Assumes current-law OASDI surplus would not be "saved" for Social Security financing
8/ Assumes current-law OASDI surplus would be "saved" for Social Security financing.

* **Values** in 3. Revised on 7/9/02 to fully reflect tax on PA distributions.

Prepared by: OCACT/SSA July 9, 2002

Towards a Productive Discussion on Social Security Choice

The Commission recommended a year of discussion of Social Security before legislative action is taken, and I commend the Senate Finance Committee for furthering this discussion today. We on the Commission are accordingly quite pleased that others have come forward with constructive suggestions for shoring up Social Security. Since the release of the Commission report, we have been sent proposals in the same vein, sponsored by bipartisan teams such as Congressmen Kolbe and Stenholm, as well as Congressmen Clay Shaw, Dick Armey, Jim DeMint and Peter DeFazio.

Throughout our Commission deliberations, we met with interested individuals from both sides of the aisle, and we sought input from all quarters. Some opponents of personal accounts testified before the Commission and promised to send us specific plans for evaluation if we ourselves developed specific plans, but they failed to do so. I would urge this Committee, in fielding testimony on the Commission proposals, or any other proposals, to pose the following questions of Social Security experts:

- What is your proposal for making Social Security permanently sustainable?
- Are you willing to subject your proposal to the Social Security actuaries for evaluation by the same standards applied to those of the President's Commission to Strengthen Social Security?

We at the Commission find no fault with those who may have different ideas on how best to shore up Social Security. Yet to support such plans, proponents must be willing to put them forward for the same independent evaluation to which we subjected our reports. I have been told that critics of the Commission's work propose "taking personal accounts off the table" as a condition for providing proposals for Social Security reform. But Mr. Chairman, if personal accounts are off the table, and if the Commission's plans for sustaining the basic system are off the table, then there is nothing left *on* the table.

The Commission's proposals, we believe, offer reforms that are affordable, reduce risk, enhance progressivity, and offer workers the chance to build retirement wealth.

I, along with the 15 other bipartisan members of the Commission, stand ready to work with you to modify, improve, and develop the best elements of our thinking with the insights you bring from each of your constituencies. I therefore end my remarks by expressing my thanks for the opportunity to testify before this distinguished Committee, and by expressing hope that you and your advisers will propose and have fairly scored a range of reform plans that truly restores confidence in Social security.

I welcome your questions and thank you for your attention.

Executive Summary

Findings

Social Security will be strengthened if modernized to include a system of voluntary personal accounts. Personal accounts improve retirement security by facilitating wealth creation and providing participants with assets that they own and that can be inherited, rather than providing only claims to benefits that remain subject to political negotiation. By allowing investment choice, individuals would be free to pursue higher expected rates of return on their Social Security contributions. Furthermore, strengthening Social Security through personal accounts can add valuable protections for widows, divorced persons, low-income households and other Americans at risk of poverty in old age.

Partial advance funding of Social Security should be a goal of any effort to strengthen the system. Advance funding within Social Security can best be accomplished through personal accounts rather than direct government investment. Personal accounts offer numerous economic benefits, including a likely increase in national saving, as well as an improvement in incentives for labor force participation.

Personal accounts can be administered in an efficient and cost effective manner. This report outlines specific measures that would effectively balance desires for low administrative costs along with consumer choice and efficient financial markets. Accounts should be structured so as to allow inheritability and to strengthen the protection of spouses.

Personal accounts can also contribute towards the fiscal sustainability of the Social Security system. While there are multiple paths to fiscal sustainability that are consistent with the President's principles for Social Security reform, we have chosen to include three reform models in the report that improve the fiscal sustainability of the current system, are costed honestly, and are preferable to the current Social Security system.

Under the current system, benefits to future retirees are scheduled to grow significantly above the level received by today's retirees, even after adjusting for inflation. The cost of paying these benefits will substantially exceed the amount of payroll taxes collected. To bring the Social Security system to a path of fiscal sustainability—an essential task for any reform plan—there are differing approaches. The Commission believes that no matter which approach is taken, personal accounts can increase expected benefits to future participants in the Social Security system.

Each of the three reform plans abides by the President's Principles for reform.

The President's Principles

The President directed the Commission to propose Social Security reform plans that will strengthen Social Security and improve its fiscal sustainability, while meeting several principles:

- Modernization must not change Social Security benefits for retirees or near-retirees.
- The entire Social Security surplus must be dedicated to Social Security only.
- Social Security payroll taxes must not be increased.
- Government must not invest Social Security funds in the stock market.
- Modernization must preserve Social Security's disability and survivors components.
- Modernization must include individually controlled, voluntary personal retirement accounts, which will augment the Social Security safety net.

Unifying Elements of the Three Reform Plans

- The Commission has developed three alternative models for Social Security reform that feature personal accounts as a central component. Under all three reform plans, future retirees can expect to receive benefits that are at least as high as those received by today's retirees, even after adjusting for inflation.
- All three models include a voluntary personal retirement account that would permit participants to build substantial wealth and receive higher expected benefits than those paid to today's retirees. Thus, all of the plans would enhance workers'control over their retirement benefits with accounts that they own and can use to produce retirement income, or pass on to others in the form of an inheritance.
- Because the Commission believes that the benefits currently paid to low-wage workers are too low, it has included a provision in two of the three plans that would enhance the existing Social Security system's progressivity by ***significantly increasing benefits for low-income workers above what the system currently pays***. This provision will raise even more of our low-income elderly – most of whom are women – out of poverty. Two of the three models also boost survivor benefits for below-average income widows and widowers.
- The Commission set a goal of moving the Social Security system toward a fiscally sustain-

able course that reduces pressure on the remainder of the federal budget and can respond to economic and demographic changes in the future. The three reform models outlined here are therefore transparently scored in terms of plan provisions, effects on workers' expected costs and benefits, and effects on Trust Fund operations as well as the unified federal budget. We also identify clearly how large the personal account assets may be expected to grow as the system evolves.

• All three reform models improve the fiscal sustainability of the program, though some move farther than others. Model 1 would require additional revenues in perpetuity in order to pay scheduled Social Security benefits under the plan. Model 3 prescribes an amount of additional revenues needed to pay scheduled benefits under the plan, an amount smaller than that required under Model 1. Model 2 does not require permanent additional funding.

• All three models also require transitional investments to move to a system that includes Personal Accounts. These transitional investments advance fund future benefits, thus substantially reducing the cost on future generations.

• All three models reduce the long-term need for general revenues as compared to the current, unsustainable system. In two of the three plans (Models 2 and 3), the system's cash flow needs are met so that the benefits promised by each plan can be paid as retirees need them.

• All three of the models are expected to increase national saving, though some would do so more than others.

• The Commission concludes that building substantial wealth in personal accounts can be and should be a viable component of strengthening Social Security. We commend our three models to the President, the Members of Congress and to the American public in order to enrich national understanding of the opportunities for moving forward.

Three Reform Models

The three models for Social Security reform devised by the Commission demonstrate how alternative formulations for personal accounts can contribute to a strengthened Social Security system.

Reform Model 1 establishes a voluntary personal account option but does not specify other changes in Social Security's benefit and revenue structure to achieve full long-term sustainability.

• Workers can voluntarily invest 2 percent of their taxable wages in a personal account.

• In exchange, traditional Social Security benefits are offset by the worker's personal account contributions compounded at an interest rate of 3.5 percent above inflation.

• No other changes are made to traditional Social Security.

- Expected benefits to retirees rise while the annual cash deficit of Social Security falls by the end of the valuation period.
- Workers, retirees, and taxpayers continue to face uncertainty because a large financing gap remains requiring future benefit changes or substantial new revenues.
- Additional revenues are needed to keep the trust fund solvent starting in the 2030s.

Reform Model 2 enables future retirees to receive Social Security benefits that are at least as great as today's retirees, even after adjusting for inflation, and increases Social Security benefits paid to low-income workers. Model 2 establishes a voluntary personal account without raising taxes or requiring additional worker contributions. It achieves solvency and balances Social Security revenues and costs.

- Workers can voluntarily redirect 4 percent of their payroll taxes up to $1000 annually to a personal account (the maximum contribution is indexed annually to wage growth). No additional contribution from the worker would be required.
- In exchange for the account, traditional Social Security benefits are offset by the worker's personal account contributions compounded at an interest rate of 2 percent above inflation.
- Workers opting for personal accounts can reasonably expect combined benefits greater than those paid to current retirees; greater than those paid to workers without accounts; and greater than the future benefits payable under the current system should it not be reformed.
- The plan makes Social Security more progressive by establishing a minimum benefit payable to 30-year minimum wage workers of 120 percent of the poverty line. Additional protections against poverty are provided for survivors as well.
- Benefits under the traditional component of Social Security would be price indexed, beginning in 2009.
- Expected benefits payable to a medium earner choosing a personal account and retiring in 2052 would be 59 percent above benefits currently paid to today's retirees. At the end of the 75-year valuation period, the personal account system would hold $12.3 trillion (in today's dollars; $1.3 trillion in present value), much of which would be new saving. This accomplishment would need neither increased taxes nor increased worker contributions over the long term.
- Temporary transfers from general revenue would be needed to keep the Trust Fund solvent between 2025 and 2054.
- This model achieves a positive system cash flow at the end of the 75-year valuation period under all participation rates.

Reform Model 3 establishes a voluntary personal account option that generally enables workers to reach or exceed current-law scheduled benefits and wage replacement ratios. It achieves solvency by adding revenues and by slowing benefit growth less than price indexing.

- Personal accounts are created by a match of part of the payroll tax – 2.5 percent up to $1000 annually (indexed annually for wage growth) – for any worker who contributes an additional 1 percent of wages subject to Social Security payroll taxes.
- The add-on contribution is partially subsidized for workers in a progressive manner by a refundable tax credit.
- In exchange, traditional Social Security benefits are offset by the worker's personal account contributions compounded at an interest rate of 2.5 percent above inflation.
- The plan makes the traditional Social Security system more progressive by establishing a minimum benefit payable to 30-year minimum wage workers of 100 percent of the poverty line (111 percent for a 40-year worker). This minimum benefit would be indexed to wage growth. Additional protections against poverty are provided for survivors as well.
- Benefits under the traditional component of Social Security would be modified by:
    - adjusting the growth rate in benefits for actual future changes in life expectancy,
    - increasing work incentives by decreasing the benefits for early retirement and increasing the benefits for late retirement, and
    - flattening out the benefit formula (reducing the third bend point factor from 15 to 10 percent).
- Benefits payable to workers who opt for personal accounts would be expected to exceed scheduled benefit levels and current replacement rates.
- Benefits payable to workers who do not opt for personal accounts would be over 50 percent higher than those currently paid to today's retirees.
- New sources of dedicated revenue are added in the equivalent amount of 0.6 percent of payroll over the 75-year period, and continuing thereafter.
- Additional temporary transfers from general revenues would be needed to keep the Trust Fund solvent between 2034 and 2063.

Specifications of Commission Reform Models

Personal Accounts	Model 1	Model 2	Model 3
Personal Account Size	2%	4% up to $1000 annually (indexed to wages each year)	1% new contribution plus 2.5% up to $1000 annually (indexed to wages each
Voluntary	Yes	Yes	Yes
Additional contributions required?	This is a generic 2% plan that can be done with or without contributions	None	1% of wages required to participate (subsidized through income tax
Real return that makes person better off with accounts than without (SS defined benefit offset rate)	3.5%	2.0%	2.5%
Accounts owned by participants?	Yes	Yes	Yes
Accounts can be bequeathed to heirs?	Yes	Yes	Yes
Participants can choose from a mix of low-cost, diversified portfolios?	Yes	Yes	Yes
Contributions and account earnings splitting in case of divorce?	Yes	Yes	Yes

Specifications of Commission Reform Models

Traditional Social Security Benefits	Model 1	Model 2	Model 3
New minimum benefit	None	By 2018, a 30-year minimum wage worker is guaranteed benefit equal to 120% of poverty level, inflation indexed.	By 2018, a 30-year minimum wage worker is guaranteed benefit equal to 100% of poverty level (111% for a 40-year worker), then rising with national wage growth.
Widow/Widower benefits	No changes	Increased to 75% of couple benefits (versus 50% to 67% today) for lower wage couples	Increased to 75% of couple benefits (versus 50% to 67% today) for lower wage couples
Changes to growth rate of traditional benefit for future retirees	None specified	Indexed to inflation instead of wages starting for those turning 62 in 2009.	Indexed to gains in average life expectancy (results in average annual growth of 0.5% over inflation)
Additional changes to traditional benefit formula	None specified	None specified	1. Reduce benefit for early retirement and increase benefit for late retirement 2. Gradually decrease bend point factor for highest income bend point from 15% to 10% starting in 2009

Reform Model 1: Increase in Total Benefits for Account Holders Relative to Current Retirees

Retirement Year	Annual Benefit Levels in 2001 Dollars		
	Low-wage Worker	Medium-wage Worker	High-wage Worker
2001	$7,644	$12,624	$16,392
2032	$10,140	$16,944	$22,620
Percent increase over current retiree	32%	34%	38%
2052	$9,624*	$16,476*	$22,428*
Percent increase over current retiree	26%	31%	37%

* Assumes the current system will pay benefits affordable under current law: $8,568, $14,148, and $18,696, for low, average, and high earners respectively. Currently scheduled benefits are $11,832, $19,536, and $25,812 respectively, but the system is projected to be 27.6% underfunded in 2052. Assuming that currently scheduled benefits are met, the total expended benefit with personal accounts would be: $12,888, $21,864 and $29,544 respectively.

Reform Model 2: Increase in Total Benefits for Account Holders Relative to Current Retirees

Retirement Year	Annual Benefit Levels in 2001 Dollars		
	Low-wage Worker	Medium-wage Worker	High-wage Worker
2001	$7,644	$12,624	$16,392
2032	$11,160	$15,444	$19,680
Percent increase over current retiree	46%	22%	20%
2052	$13,608*	$20,016*	$24,684*
Percent increase over current retiree	78%	59%	51%

* Assumes the current system will pay benefits affordable under current law: $8,568, $14,148, and $18,696, for low, average, and high earners respectively. Currently scheduled benefits are $11,832, $19,536, and $25,812 respectively, but the system is projected to be 27.6% underfunded in 2052.

Reform Model 3: Increase in Total Benefits for Account Holders Relative to Current Retirees

Retirement Year	Annual Benefit Levels in 2001 Dollars		
	Low-wage Worker	Medium-wage Worker	High-wage Worker
2001	$7,644	$12,624	$16,392
2032	$10,932	$17,412	$22,620
Percent increase over current retiree	43%	38%	38%
2052	$14,112*	$23,796*	$31,668*
Percent increase over current retiree	85%	88%	93%

* Assumes the current system will pay benefits affordable under current law: $8,568, $14,148, and $18,696, for low, average, and high earners respectively. Currently scheduled benefits are $11,832, $19,536, and $25,812 respectively, but the system is projected to be 27.6% underfunded in 2052.

Summary of Fiscal Sustainability Results Assuming 2/3 Participation in Personal Accounts (PA)

	Model 1	Model 2	Model 3	Current Law
Expected PA assets at end of 2075 ($PV trillions)	$1.1	$1.3	$1.6	N/A
Gain in Social Security 'system' assets at end of 205 (increase in trust fund + expected PA assets; $PV trillions)	$0.5	$4.8	$5.0	N/A
Reductions in Cash Flow Requirements From General Revenue[2,3] Relative to Present Law				
Reduction in 75-year total (sum of annual amounts in $2001 trillions)	$1.7	$14.8	$11.3	$0.0
Percent reduction versus current law (in $2001)	7.7%	68.1%	52.2%	0.0%
Reduction in 75-year total ($PV trillions)	-$0.2	$2.3	$1.7	$0.0
Percent reduction versus current law (in PV)	-3.8%	45.0%	33.9%	0.0%
Social Security Cashflow				
With Dedicated General Revenue				
Positive by end of valuation window?	No	Yes	Yes[4]	No
Income Rate (excluding GR tansfer)–Cost rate in 2075 (% of payroll)	-4.56	1.41	0.12[4]	-6.05
Without Dedicated General Revenue[3]				
Positive by end of valuation window?	No	Yes	No	No
Income Rate (excluding GR tansfer)–Cost rate in 2075 (% of payroll)	-4.56	1.41	-0.75	-6.05

Summary of Fiscal Sustainability Results[1] Assuming 2/3 Participation in Personal Accounts (PA)

	Model 1	Model 2	Model 3	Current Law
Improvement in Actuarial Balance Over 75-year Period				
Improvement with general revenue transfer (% of payroll)	-0.32	1.99	1.88	0
Percent improvement with general revenue transfer	-17%	107%	101%	
Improvement without general revenue transfer (% of payroll)[3]	-0.32	1.15	0.87[5]	0
Percent improvement without general revenue transfer	-17%	62%	47%	
Transition Investment				
Assuming Current Law Surplus Not Used for Financing[6]				
$PV trillions	$1.1	$0.9	$0.4	
As % of GDP over years included in calculation	0.36%	0.49%	0.25%	
Includes Current Law Surplus Available for Financing[7]				
$PV Trillions	$0.7	$0.4	$0.1	N/A
As % of GDP over years included in calculation	0.29%	0.33%	0.10%	N/A

Notes

1 Model 1 does not include additional transfers for balance.
2 Cash flow requirements are defined as general revenue required in any year to maintain solvency in the absence of dedicated revenues.
3 Taxes on benefits and PRA distributions are treated as Social Security revenues, not general revenue.
4 Includes new dedicated sources of revenue; see text.
5 Improvement in actuarial balance would be +1.50 if new dedicated sources of revenue are included; see text.
6 Unified budget concept: difference between income and cost of proposed model versus present law.
7 Reflects extent to which negative balance in any year is more negative than under current law.

Written Questions for Dr. Olivia Mitchell

Senator Baucus

Benefit Calculations and Comparisons

1. Will you compare the Social Security benefits that can be paid under current law in 2022 and 2032 for those retiring at age 65 in 2022 and 2032 for scaled medium and high earners, and for maximum steady earners, to benefits (including traditional Social Security benefits and annuities generated from the proceeds of private investment accounts) that would be received under Model 2?

When answering this question please use a medium risk investment portfolio (i.e 50% invested in equities, 30% invested in corporate bonds, and 20% invested in Treasury securities). Assume a CPI-indexed life annuity. Please make separate comparisons for 1- earner couples, and two-earner couples with equal earnings. Please do **not** compare benefits (including traditional Social Security benefits and annuities generated from the proceeds of private investment accounts) that would be paid under Model 2, to traditional Social Security benefits that would be paid *today* to such individuals who retired at age 65 *today.*

2. Will you compare the benefits (including traditional Social Security benefits and annuities generated from the proceeds of private investment accounts) that would be received under Model 2, to the Social Security benefits that are *scheduled* to be paid under current law in 2052 and 2075 for those retiring at age 65 in 2052 and 2075 for scaled medium and high earners, and for maximum steady earners?

When answering this question please use a medium risk investment portfolio (i.e 50% invested in equities, 30% invested in corporate bonds, and 20% invested in Treasury securities). Assume a CPI-indexed life annuity. Please make separate comparisons for 1- earner couples, and two-earner couples with equal earnings. Please do **not** compare benefits (including traditional Social Security benefits and annuities generated from the proceeds of private investment accounts) that would be paid under Model 2, to traditional Social Security benefits that would be paid *today* to such individuals who retired at age 65 *today.*

3. Finally, will you please then compare the benefits (including traditional Social Security benefits and annuities generated from the proceeds of private investment accounts) that would be received under Model 2, to the Social Security benefits that are *actually payable* under current law in 2052 and 2075 for those retiring at age 65 in 2052 and 2075 for scaled medium and high earners, and for maximum steady earners.

When answering this question please use a medium risk investment portfolio (i.e 50% invested in equities, 30% invested in corporate bonds, and 20% invested in Treasury securities). Assume a CPI-indexed life annuity. Please make separate comparisons for 1- earner couples, and two-earner couples with equal earnings. Please do **not** compare benefits (including traditional Social Security benefits and annuities generated from the proceeds of private investment accounts) that

would be paid under Model 2, to traditional Social Security benefits that would be paid *today* to such individuals who retired at age 65 *today.*

Implications of Adoption of Model 2 on "traditional Social Security" benefits

4. My understanding is that under Model 2 - with either 67% or 100% participation in the private accounts option – the percentage of the retirement income coming from the "traditional" Social Security benefit declines over time relative to total retirement income (i.e. the combined benefit from both the traditional system and the private account). I am concerned that this trend of a decreasing "traditional" benefit and a larger percentage of retirement income coming from the private account means that, beyond the 75 year window (e.g. in 2100 or 2150), assuming no changes to the policy choices embodied in Model 2 of the Commissions plans, the "traditional" benefit will be almost entirely gone (i.e. the "traditional system," on a percentage basis of total retirement income, will be close to zero percent). At that point, the "Social Security" system would look like a government administered system of Individual Retirement Accounts that are not insured (i.e. no FDIC or PBGC support) and are fully exposed to market risk that must be borne solely by the worker.

Although I am speculating many years into the future, is this not a valid concern about the long-run implications of Model 2?

Baseline Comparisons

5. In your written and oral testimony, you repeatedly make comparisons of benefit levels under Commission Model 2 to those that "can be financed under the current system." In evaluating the financing implications of Commission Model 2, however, you repeatedly make comparisons to the costs of financing the benefits that are scheduled under the current benefit formula. (You refer to this scheduled benefit baseline as "current law." Your Figure 1, for example, shows the cost rate for the scheduled benefit baseline, which is identified in the title of that figure as "current law." In the paragraph immediately below Figure 3, your written testimony also uses the term "current law" to refer to the scheduled benefit baseline.) In addition, your financing comparisons assume that a full third of workers would not opt for the individual accounts under Model 2, but your benefit comparisons only show the results for those who have opted for the accounts.

Could you please explain your justification for comparing benefits to one baseline (those that can be financed under the current system) while comparing financing results to another baseline -- current law -- while never comparing both benefits and financing results to a single consistent baseline?

6. Since you provided financing comparisons relative to what you call current law (that is, the scheduled benefit baseline), it would be helpful if you would also provide benefit comparisons relative to that same baseline. Your financing results assume that one-third of workers would not choose the individual accounts.

Will you please provide a comparison of the benefits under Model 2 for medium-earning two-earner and one-earner couples who claim benefits at age 65 in 2012, 2022, 2032, 2042, 2052, and 2075 and who do not choose the individual accounts, relative to the benefit levels under what you call current law (that is, the scheduled benefit baseline)?

7. Your financing results assume that the disabled would experience the same adjustment to benefits as retired workers.

Will you please provide a comparison of the benefit levels under Model 2 for workers who become disabled in the future, as assumed in your financing results, to the benefit levels under what you call current law (that is, the scheduled benefit baseline)?

Summing Constant Dollars

8. In your written testimony and in other presentations you have given in the past, you present figures on the financing costs associated with the current Social Security system that are computed by summing constant (that is, inflation-adjusted) dollars across a 75-year period. The Chief Actuary of the Social Security Administration, Stephen Goss, wrote in a letter to Representative Lindsey Graham on September 26, 2002: "There is no meaningful interpretation of the result from summing constant dollar values from many different years."

Could you please explain to the Committee your reasoning in presenting such figures, when the Chief Actuary has written that they have "no meaningful interpretation"?

Senator Kyl

1. How do you respond to the specific criticisms of the Commission's proposals offered by the Chairman and your fellow witnesses?

2. How do you respond to the assertions made at the hearing that the Commission's treatment of the disability program is in some way disingenuous, and to the accusations that the proposal would cut benefits for the disabled?

3. How do you respond to the suggestion made at the hearing that the treatment of the disability program in the report was employed for the purpose of "making the numbers work out"?

11-6-02

Responses of Olivia S. Mitchell, former Commissioner, Commission to Strengthen Social Security, to Questions from Members of the Senate Committee on Finance

The Commission to Strengthen Social Security submitted its Final Report and concluded its business in December of 2001. The responses offered below represent my own views, based on my service to the Commission, regarding the questions posed by the Senators pursuant to my testimony on October 3, 2002.

Response to Questions of Chairman Baucus:

Questions 1, 2, 3 and 6:

In response to your questions 1, 2, 3, and 6 requesting numerical computations, please refer to the enclosed copies of pages from the January 31, 2002 memorandum of the SSA Chief Actuary (OAC; see attachment 1). Pages 75, 78, 81, and 84 include all of the requested figures for projected benefits under Commission Model 2 (CSSS2).

No single number fully summarizes all aspects of a given policy alternative, nor can any single number indicate which reform might be preferred over another. The Commission sought to provide more information, rather than less, in its deliberations and in its final report. To further public education and reflect a range of perspectives, the Commission provided a wealth of analytical information on all proposed reforms.

This perspective is reflected in the attached tables that indicate benefits for low, medium, high, and maximum wage earners retiring across a wide range of years. Benefit estimates are provided including as well as excluding personal account income, and projections assume low, medium, and high yields on personal retirement accounts during the accumulation and decumulation phases.

Your request invited the presentation of results assuming a fixed annuity, results presented in the Chief Actuary's report on pages 75 and 78 (also attached). I note that such an annuity might not be the preferred choice for all retirees, since many will prefer a portfolio containing some equities. (Further information on this issue may be found in a book I co-wrote with J. Brown, J. Poterba and M. Warshawsky, *The Role of Annuity Markets in Financing Retirement*, MIT Press, 2001).

Part of the Commission's charge was to compare the results of proposed reforms with the consequences of no reform. Accordingly, it is instructive to review the actuarial projections with a full understanding of the assumptions as to the meaning of "current law." As is well known, the growth of scheduled benefits under Social Security is unsustainable under current law. This creates an analytical difficulty in quantifying benefits that could be paid in the absence of legislation to raise taxes significantly. Comparing reform benefit projections with "current law scheduled benefits" is widely acknowledged to be misleading, since this is not an accurate benchmark reflecting the benefits that would be paid under current law, nor does it represent a politically plausible resolution of Social Security's financing shortfalls.

Also, in modeling what is payable under current law ("current law payable"), analysts must again choose between methods of projecting future outcomes, each of which again poses analytical difficulties. A literal application of current law would imply that Social Security retirement benefits would continue to grow at an unsustainable pace until the point of Trust Fund exhaustion, whereupon there would be a sudden need to reduce costs by more than 25%. Many analysts regard this as politically implausible, though it would literally be what would have to occur in the absence of legislative change. Alternatively, the Commission could have designated a different benchmark, namely one that presented benefits payable under current-law financing with a smoothed path of benefit growth. However, doing so would require making a speculative prediction regarding future Congressional willingness to raise payroll taxes. This would be inconsistent with current law, so when the Commission invited the Office of the Chief Actuary to cost reform options, OACT followed long-establish practice showing *current-law payable* and *current-law scheduled* benefits. Additional discussion of this point appears below in my answer to your question 5.

A consequence of using conventional benchmarks is that discontinuities may appear in benefit comparisons for any given year. For instance, in the material generated by the OACT, this would occur in year 2038, the point of Trust Fund exhaustion under 2001 assumptions. It is important to underscore that these discontinuities *exist in the current-law payable baseline*; they are <u>not</u> attributable to the Commission's reform proposals. Thus prior to 2038, the current-law payable baseline grows at an unsustainable pace; thereafter, benefit payments would fall by more than one-quarter due to financing stringencies. Artifacts of such projections surface in the OACT's benefit computations over time. For example on page 81 of the OACT report, under the assumptions employed in my testimony, you will note that a medium-wage couple with equal earnings would be 4.1% below both "current-law payable" and "current-law scheduled" if the couple retired in 2032, but a medium-wage couple retiring in 2042 would receive benefits 38.4% *higher* than "current-law payable." Under lower-return assumptions suggested in your question, these figures would be 8.3% lower in 2032 but 28.8% higher in 2042. Generally, such a couple with a personal account would anticipate higher benefits under the Commission's Model 2 (CSSS2), than what Social Security would be able to pay under current law.

Consequently, the result is that if benefits are projected to grow at an unsustainable pace for the next three decades, benefits in 2032 would appear to be high but shortly thereafter they would have to be reduced suddenly. *It is important to recognize that this projection is an artifact of the "current law payable" baseline's construction, rather than reflecting the Commission's Model 2 reform plan.* The attached tables make it clear that the specific data point of 2032 is a result of the conventional way of crafting current-law baselines. The Commission encouraged analysts to examine benefits across a range of years as the reforms unfold, so as not to draw policy conclusions based on computational artifacts.

Question 4
Each of the Commission's reform proposals maintains expected retirement benefits at or above today's levels. It is therefore inaccurate to charge the Commission with proposing "benefit reductions" or seeking to dismantle the program. It is incorrect to conclude that the Social Security system under the Commission's proposed reforms would "vanish" over time. *Instead,*

the Commission's proposals would strengthen Social Security so it can provide the essential safety net that today's program cannot ensure.

If the Social Security system is to return to a sustainable path, the economy and the tax base must grow at least as fast as future benefit levels. Social Security actuaries project that, under current benefit rules, the cost of maintaining current replacement rates (defined as the ratio of benefits to pre-retirement wages) will rise perpetually as a percentage of the tax base. Put differently, unless Social Security tax rates are raised perpetually, replacement rates for traditional Social Security benefits must fall. I hasten to note that this does *not* imply that traditional benefits must be reduced, or even that their purchasing power must be curtailed. Instead, projections of Commission reforms illustrate that within existing tax rates, future Social Security benefits can rise, even after adjusting for inflation. Consequently it is inaccurate to argue that traditional benefits would be "almost gone" under Model 2 (or under any of our proposals).

It is important to recognize that Congress will have to determine the affordable growth rate for benefits independently of whether the system is modified to permit the establishment of voluntary personal accounts. Personal accounts under CSSS2 would enable participants to receive a higher expected growth rate of benefits than the rate of inflation alone. Yet even for workers who do not elect the accounts, current law will not provide a rate of benefit growth significantly above inflation; indeed replacement rates must decline in the future, unless taxes are raised by over 50%. This is the inexorable mathematics of the existing Social Security system combined with population aging.

A key policy question is how to confront the issue of declining replacement rates under a traditional Social Security system that faces insolvency. Commissioners believed that perpetually raising payroll taxes would be deleterious to Social Security's political support, as well as to the larger economy. By contrast, the Commission felt that enabling Social Security participants to control their personal accounts would be an important reason to support the reform proposals. A major rationale for the CSSS2 plan is that the reformed Social Security system would return to permanent cash surpluses prior to the year 2060. This would present several appealing options for future policymakers. For instance, if Congress believed it valuable to provide for faster benefit growth, the Social Security surpluses available under CSSS2 would be available to finance it. Alternatively, if Congress wished, it could use the surplus to repay the transition transfers, greatly reducing pressure on the rest of the federal budget.

Under existing revenue projections, these options to enhance future benefits would simply not materialize. That is, if Congress allowed benefits to rise at their currently legislated rate but did not raise taxes in tandem, this would face the nation with what many would agree are highly unattractive choices. Future politicians would then likely be forced to choose between substantial tax rate increases or reductions in retirees' benefits in order to preserve system solvency. In turn, this would impose strains on the rest of the federal budget that would be both permanent and perpetually growing. The Commission believed that today's policymakers cannot predict the state of America's economy fifty years hence with extreme precision; hence we deemed it more prudent to provide future generations the needed flexibility of a fiscal surplus, instead of saddling them with fiscal imprudence.

Question 5

The Commission did not perform its own scoring and analysis, instead turning its proposals over for independent evaluation by the Office of the Chief Actuary of the Social Security Administration. We did so in the interest of increasing public information and in maximizing the objectivity of the analysis published with our report. Consequently Commissioners did not select baselines for analysis, though during our deliberations we gained some insight into how and why the actuaries' assumptions are employed. The problem of modeling the behavior of an insolvent system has concerned many bipartisan analysts, including the 1999 Technical Panel of the Social Security Advisory Board. In its report, that group noted:

> Alternative Projections of Benefits Under Current Law. Because current law is vague as to how the full value of current law benefits could be paid when the Trust Funds are exhausted, the Trustees Report should show real annual future benefits under two scenarios. The first scenario would be current law if current benefit levels are maintained and taxes are raised. The second would be current law if current tax rates are maintained and benefits are lowered proportionately so they are just covered by current tax rates.[1]

This bipartisan analytical consensus of SSA, CRS, and GAO is not shared by some who argue against OACT's methodology and instead propose comparing benefits only to the "scheduled benefits" baseline that assumes that taxes are raised. To avoid being misleading, such advocates must make explicit their implied tax increase. For example, some have confused the policy discussion by incorrectly suggesting that Commission proposals might both reduce benefits and require additional tax revenue at the same time. This wrongly implies that a balanced Social Security system would necessarily both cost more and provide lower benefits than the existing imbalanced system. Irrespective of policy preferences, those who care about the future of Social Security should avoid terminology that incorrectly make any solvency-restoring actions appear to be worse than doing nothing.[2]

In its report, the Commission was careful to note when we compared benefits proposed to benefits that the existing system could actually pay. We also indicated when outcomes were compared to the revenues required to keep the current system solvent for 75 years. The Commission did not claim that expected benefits under our proposals would exceed current promises except where, of course, they would, instead usually referencing the more appropriate benchmark of the benefits that would actually be paid under current law.

Commissioners shared your concern about employing self-consistent baselines in making comparisons between alternative approaches. We agreed that simple comparisons between a payable-benefits baseline, a scheduled-benefits baseline, and the Commission proposals only partly fulfill the Committee's needs for direct comparison, given that all of these require

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[1] OACT employed this methodology when analyzing our reform proposals. I would also note that this recommendation is also used by the Congressional Research Service in its analyses and by the General Accounting Office.

[2] Such a mistake can be avoided if analysts are careful to note the Advisory Board Technical Panel's admonition that the scheduled-benefits baseline is a "tax increase" baseline. Relative to this, both CSSS2 and CSSS3 would clearly *reduce* revenue needs, rather than require additional revenues.

different amounts of revenue. I would therefore urge you to take note of a recent effort by Congressmen Kolbe and Stenholm, in which they requested OACT to evaluate what level of benefits the existing system could pay, given the same financing as under CSSS2. That report clearly showed that personal accounts under CSSS2 would boost expected benefits if revenue requirements were equal. I enclose a copy of this release for your information (see attachment 2).

You have also referenced benefit levels for those who do not elect personal accounts. For CSSS2, these are reported in the OACT tables referenced earlier in this memo. For the Committee's information, I have also attached pages 80 and 82 from the actuaries' report which detail the benefits promised under CSSS1 and CSSS3; these tables provide benefit levels anticipated for those with as well as those without personal accounts. Expected benefits are generally less without the accounts than with them, which Commissioners felt motivated the need to establish the personal account option. If 100% participation rates in the accounts are assumed, of course, one should not indicate benefit projections subtractive of the personal account income.

Question 7
The Commission did not develop nor receive estimates for disability benefits from OACT. As the Final Report indicates, the Commission's reform plans were designed to preserve the structure of disability benefits, and indeed we explicitly formulated the personal accounts so as not to change disability benefits under the traditional system. To be specific, in all Commission proposals, contributing to a personal account would not affect one's Social Security disability benefits until conversion to retirement. Under the Commission's proposals, those receiving disability benefits prior to retirement age would receive the full Social Security benefits payable under each approach to traditional Social Security solvency, without regard to any redirection of payroll tax money to a personal account.

As your Committee members know, the level of disability benefits that can be provided under the traditional Social Security system is a function of actions taken to restore the program to solvency and sustainability. Our Commission proposals illustrate a range of options available to Congress, and further they show that benefits for the disabled need not be cut – in fact they can grow in the future at least as fast as inflation within current tax rates. As with retirement benefits, faster rates of benefit growth (such as wage-indexed growth) would require substantial revenue increases. However, the Commission proposals do not reduce disability benefits as a consequence of opting for a personal account, nor would disability benefits be reduced from today's real levels.

During the Commission's deliberations, we met with numerous representatives of advocates of the disabled, including some who testified before the Senate Finance Committee later at the October 3 hearing. All present supported the proposition that retirement and disability benefit formulas should remain linked, rather than be decoupled. OACT's projections for the Commission proposals assume that this recommendation would be followed by the Congress.

Question 8
In all our deliberations and in our written material, Commissioners took the perspective that providing more information rather than less is essential for educational purposes, since any single measure or benchmark offers only a partial perspective on reform. If the Commission had

pre-selected which assumptions or measures the public could have access to, this would limit the public's access to needed information about Social Security finances. Consequently, our goal was to offer a range of different measures of reform plan outcomes.

Examples of our commitment to information dissemination are available throughout the Commission's Final Report (www.ssa.gov). For example, the report presents results assuming 0%, 67%, and 100% participation in the personal accounts, though the actuaries suggested 67% as the most likely participation pattern when we designed the proposals. Commissioners also felt that showing results for 0% and 100% was instructive even though both extremes were unlikely. We hope your Committee and others would value seeing how the system might appear given alternative extreme projections. Similarly, the Commission's Report provides estimates for three alternative yield patterns in the personal accounts (High, Intermediate, and Low). We did this despite the actuaries' view that a Low Yield account would likely lead to lower-than-expected benefits, and "the high yield is assumed to be more likely to occur than the low yield." As noted previously, the Report also presented both current-law payable benefits and current-law scheduled benefit comparisons, in keeping with the tradition of the Trustees who offer alternative presentations for public consideration.

Commissioners felt it better to provide more information rather than less since biases may be introduced when information is curtailed. One good example of this arises in the previously-cited issue of comparing reform proposals with "scheduled benefits". As indicated by the Technical Panel, GAO, and CRS, doing so would be biased, as it would make the benchmark an unsustainable promise. To the same end, the Commission typically provided both inflation-adjusted and present-value figures, where appropriate, in its measures of fiscal effects. Exclusive reliance on either of these figures alone might be problematic. For example, when relating monetary amounts covering long spans of time, present-value discounting may sometimes be more informative than simple inflation-adjustment but this does not mean that present-value analysis is without issues. Discounting can also skew one's perspective in ways that should be avoided. Thus OACT does not show the present value of *future* initial benefit levels, since this would make future benefits appear to be smaller than today's, which would be inaccurate. Moreover, there is no universally agreed-on discount rate to apply to government spending. The Commission's calculations assume a real rate of 3 percent, which implicitly assumes that giving the government access to a dollar today reduces future federal fiscal pressures in 2075 by the amount of the dollar plus 73 years of compounding at a 3% real return per year. Yet this may not result, in which case compounding would incorrectly appear to make a pay-as-you-go system more attractive than a funded system. Accordingly, the Commission thought it most useful to present both sets of figures.

The Commission consistently resisted all assertions that any one particular measure is the "only measure" worthy of attention when comparing reform outcomes. Rather, we felt that sustainability and solvency both are important concepts; replacement rates and rates of return each have their place; present-value dollars and constant dollars are both of interest; and scheduled benefits and payable benefits are both worthy of inspection. Since presenting only a single measure while ignoring others can bias the debate, the Commission elected to offer comprehensive set of performance outcomes, which we felt was a more objective view. I should also remind you that Commissioners had no influence over the specific benefit and financing

results generated by the OACT. Furthermore, Commissioners had no control over, nor direct input into, the OACT memorandum included with our Final Report.

Questions from Senator Kyl

Question 1

At the outset, Commissioners recognized that our group confronted a very complex subject. In order to work together objectively and amicably across party lines, we resolved to put aside political considerations to develop the best possible proposals that met our Commission's charges. In this process, I would like to remind the public of the cooperative spirit and commitment of all Commission members, along with our bipartisan Commission co-chairs, former Senate Finance Committee Chairman Daniel Patrick Moynihan and Richard Parsons. In addition, the entire staff of the OACT maintained a fair, bipartisan, and honest spirit of analysis. In this spirit of cooperation, we also decided to subject all of our proposals to independent and objective scoring by the non-partisan Office of the Social Security Actuary, long recognized as the impartial arbiter in the Social Security debate. This does not mean that Commissioners necessarily concurred with every detail of how OACT performed its analysis; what is key, however, is that we regarded that analysis as objective. We would therefore urge others with reform proposals to similarly subject them to OACT's objective review and analysis.

Three additional comments may be added regarding the Commission's recommendations. First, our proposals would not change benefits at all for people over the age of 55, and they would further not reduce anyone's benefits below today's levels. Indeed in most cases, projected benefits would be higher. It is simply inaccurate to state that Commission proposals would both reduce benefits and require additional revenues. I suspect that average Americans would agree that a reformed system paying higher benefits than currently possible cannot reasonably be charged with "benefit reductions."

Second, Commissioners were asked "how we would pay for" our proposed reforms, as though they would cost more than maintaining solvency in the existing system. This is a misimpression, since taxes would have to rise substantially just to pay current promised benefits. With the nation facing deficits for the unforeseeable future, it is critically important for policymakers to understand that our proposals would require *less* money than the existing system. The scheduled-benefits baseline is a "tax increase" baseline, against which our CSSS2 and CSSS3 plans save, not cost, trillions of dollars.

Third, I would like to restate the gains that would result from adopting a policy course such as outlined in Commission Model 2. Benefits would not be changed for those now in retirement; benefits in the future would be higher than today's; low-income wage earners would expect more even than the current system's unfinanced benefit promises; and Social Security would be made solvent and sustainable without permanent reliance on general revenues. These invaluable gains to the system and to society would be significant and must not be overloooked.

These analytical concerns apply not only to the Commission proposals but also to *any* policy approach seeking to shore up Social Security. Because Social Security is out of long-range balance, any solution will need to move the lines together -- what is promised, and what can be paid for. Those who deem *any* balanced system "undesirable" offer little useful guidance to policymakers. Accordingly, I urge that other groups proposing reforms be asked to work with

OACT to present their findings in an internally consistent manner. For instance, if 100% participation in personal accounts is assumed, benefit projections should only be shown with the account income included. Similarly, disability benefits should be treated consistently, as I will discuss in my responses to your last two questions.

Questions 2 and 3
These queries brings to the fore two important issues: first, the process by which Commission plans were scored; and second, the substance of the Commission proposals with respect to the disabled. I will comment on each in turn.

Procedurally, the Commission did not control the scoring of its proposals. Instead the models were put forward for objective, independent, nonpartisan scoring by the Office of the Chief Actuary of the Social Security Administration. OACT reviewed the language of the Commission report to ensure internal consistency in calculations. The fact that the Commission did not perform its own scoring should put to rest any concern about the potential for manipulation of the data. I hasten to add that none of the Commissioners would have countenanced any manipulation of the results, since the professional and personal reputations of all Commission members were at stake.

Regarding the issue of disability benefits, it is crucial to note that disabled workers would be unaffected by personal accounts under the Commission's proposed reforms. This is consistent with hearings held by the Commission, during which we met with representatives of the disabled including some who testified before the Senate Finance Committee during your October 3, 2002, hearing. The advice we received from them was that retirement and disability benefit formulas should remain linked rather than be decoupled. OACT's projections for the Commission proposals therefore assumed that this recommendation would be followed by the Congress.

In practice, during the disability period, the disabled person would receive his or her full disability benefits payable by the traditional Social Security system, without regard to any prior period of contribution to a personal account. On reaching retirement age, the retiree would receive benefits accrued during the truncated period of contribution to a personal account, in exchange for an offset to his or her traditional benefit. This exchange would result in an increase in benefits even if his or her personal account earned a risk-free Treasury bond rate of return. In sum, traditional disability benefits would not be affected negatively by a personal account option. Some have asked what benefit levels would be paid under the traditional Social Security system, but obviously answering this question depends on the method chosen to balance the traditional system – though not on the personal account itself. Irrespective of the path chosen, future disability benefit growth could keep pace with inflation; hence future benefits would be at least as high as today's levels even after adjusting for inflation, which undercuts the inaccurate rhetoric about disability benefits being "cut" or "reduced." In sum, Congress faces the same choices in designing the appropriate rate of disability benefit growth as it does with retirement benefits, and the Commission proposals simply show a range of options that would be unaffected by personal accounts as we designed them.

Because our personal account proposals would leave disability benefits unaffected, we suggested that Congress might want to convene a separate policy process for coming up with separate

proposals to reform the nation's Disability Insurance program. This recommendation should not be interpreted as an invitation to discard the Commission's proposals or OACT's methodology. Rather, even if a separate policy process on disability were convened, the choices for balancing the traditional disability program largely mirror those facing traditional retirement benefits – from living within projected revenues, to raising taxes in the future. In any event, benefits would not be cut below today's levels, whether for retirees or the disabled, even with adjustments for inflation.

"Social Security Reform and the Final Report of the President's Commission to Strengthen Social Security"

Peter R. Orszag
Joseph A. Pechman Senior Fellow
The Brookings Institution[1]

Testimony before the Senate Finance Committee
October 3, 2002

Mr. Chairman and Members of the Committee, it is an honor to appear before you to discuss the plans put forward by the President's Commission to Strengthen Social Security. My testimony draws heavily on analyses of those plans jointly undertaken with Professor Peter Diamond of MIT.[2] A version of our analysis is attached as an appendix to this testimony.

The President's Commission issued a final report in December 2001 that contained three different proposals to address the long-term imbalance in Social Security. I will focus my attention on Model 2, which is rumored to have been favored by the largest number of commissioners, although our papers also address Model 3 in detail.

Model 2 has three key components: changes to the traditional benefit structure within Social Security; the creation of voluntary individual accounts; and the transfer of revenue from the rest of the budget to Social Security. Each component includes quite problematic elements.

Traditional benefit changes

The first component of Model 2 involves several changes to traditional Social Security benefits. The most important is that for everyone younger than 55 on January 1, 2002, Model

[1] The views expressed here are mine alone and do not necessarily represent those of the staff, trustees, or officers of the Brookings Institution.
[2] The analyses include "Reducing Benefits and Subsidizing Individual Accounts: An Analysis of the Plans Proposed by the President's Commission to Strengthen Social Security," Center on Budget and Policy Priorities and the Century Foundation, June 18, 2002; "Assessing the Plans Proposed by the President's Commission to Strengthen Social Security," *Tax Notes*, July 29, 2002; "An Assessment of the Proposals of the President's Commission to Strengthen Social Security," NBER Working Paper 9097, August 2002; and "Social Security: The Right Fix," *American Prospect*, Volume 13, Issue 17, September 23, 2002.

2 would replace the current system for determining benefits at retirement with a system under which benefits would replace an ever-smaller share of previous wages.

Under current law, Social Security is scheduled to replace slightly more than 36 percent of former earnings for a two-earner couple each with average earnings retiring at age 65 in 2025 or thereafter. Under Model 2, by contrast, the replacement rate from traditional benefits would fall to 30 percent by 2032 and 20 percent by 2075 (see Table 1). The role of traditional Social Security benefits in allowing the elderly to maintain their standard of living in retirement would thus decline sharply in future decades under this proposal.

Table 1: Effect of Price Indexing under Model 2 on Traditional Benefit Replacement Rates for Workers with Medium Earnings Claiming Benefits at Age 65

Age on January 1, 2002	Year in which the worker attains age 65	Replacement rate under current law*	Replacement rate under Model 2*
55	2011	39.4%	39.4%
45	2021	38.5%	35.0%
35	2031	36.6%	30.2%
25	2041	36.6%	27.5%
15	2051	36.6%	25.0%
5	2061	36.6%	22.7%
0	2066	36.6%	21.6%

Source: 2001 Trustees Report and authors' calculations.

* Replacement rates show traditional Social Security benefits as a percentage of previous wages. Under current law, the replacement rates decline modestly between now and 2025 because of the scheduled increase during this period in the "normal retirement age" – that is, the age at which an individual can receive full Social Security benefits. As a result of changes to Social Security enacted in 1983, the normal retirement age is gradually increasing from age 65 to age 67. It reaches age 67 for those workers turning 65 in 2025

Perhaps the most surprising aspect of these benefit changes is that, in evaluating their overall financial effects, the Commission assumed that they would be fully applied to the disabled and other vulnerable beneficiaries. To be sure, the Commission did emphasize that the disability benefit reductions "*should not be taken as a Commission recommendation for policy implementation.*"[3] Nonetheless, it counted all of the savings from the dramatic reductions in benefits for the disabled as part of its solution to restoring long-term balance to Social Security.

[3] *Strengthening Social Security and Creating Personal Wealth for All Americans*, page 149 (italics in original).

As Robert Greenstein discusses in more detail in his testimony, the implications for the disabled are truly devastating. For example, a worker becoming disabled in 2040 would have disability benefits reduced by more than 25 percent under Model 2 relative to the benefits scheduled in current law. Many disabled workers would have little opportunity to accumulate substantial balances in their individual accounts to offset these benefit reductions, since their disability would have forced them out of the workforce and cut off their flow of contributions. Moreover, under the Commission plans, they would not have access to any individual account balances they might possess until they reached retirement age.

It is also important to emphasize that the traditional benefit changes would apply to all workers under age 55, regardless of whether they opted for an individual account. The traditional benefit changes are so substantial that they are sufficient, by themselves and without the introduction of individual accounts, to *more than* eliminate the long-term deficit in Social Security.

Voluntary individual accounts

The second component of the plan introduces individual accounts that, by themselves, would then push Social Security back into deficit. In particular, workers would be given the option of having part of their payroll taxes deposited into individual accounts. If a worker chose to participate in the individual account system, a portion of his or her payroll taxes would be diverted into an individual account. These amounts would accumulate in the account during the worker's career and be available to the worker upon retirement. But since the revenue diverted to this account would reduce the financing available to the traditional Social Security system, a "liability account" would also be created.

The liability account would be designed to track the debt owed back to Social Security because of the diverted funds. Upon retirement, the debt would be repaid by reducing the worker's traditional Social Security benefit. These reductions would be in addition to the traditional benefit changes described earlier.

The individual accounts are subsidized by charging an interest rate on the liability accounts (i.e., on the amounts diverted from the Trust Fund) that is projected to be lower than

the return the Trust Fund earns on its reserves. Since the interest rate charged on the amounts diverted from the Trust Fund would be lower than the interest rate the Trust Fund would have earned on those funds if they had not been diverted, the individual accounts cause a deterioration in Social Security's financial status.

To see this, imagine $100 is diverted from the Trust Fund into an individual account under Model 2. The $100 diverted into the individual account would trigger an entry of $100 in the worker's liability account. Model 2 charges an interest rate on the liability accounts of 2 percent per year (after inflation). If the worker were 40 years away from retirement, the interest charges would cause the $100 entry to grow to $221 (in constant dollars) by the end of the worker's career. If the $100 had been retained by the Trust Fund, however, it would have grown to $326 by the time the worker retired. The difference between the amount in the liability account ($221) and the amount that would have accrued in the Trust Fund ($326) represents a subsidy to the individual account and a loss to the Trust Fund. Such a subsidy arises whenever the interest rate on the liability account is below the interest rate the Trust Fund earns on its reserves.

As a result of these subsidies, the effect of the individual account option, by itself, would be to worsen Social Security's long-term actuarial balance, and to do so on a permanent basis rather than just over a "transition period" horizon. In other words, the Commission's model is purposefully designed so that the Social Security Trust Fund would be expected to lose more in diverted revenue from the individual accounts than it would gain from reduced benefit obligations – that is, the plan is designed to subsidize the individual accounts at the expense of the Trust Fund. If all eligible workers participated in the accounts, the subsidies on the diverted revenue over the next 75 years would amount to more than 0.6 percent of payroll, or more than $1 trillion in present value and about a third of the existing deficit in Social Security.

Note that these subsidy estimates assume that policy-makers will not step in to bail out individual account owners following stock market declines. The pressure that we have recently witnessed to bail out investors in the wake of the recent stock market declines, however, would presumably be even more potent if individual accounts were included as part of Social Security. Indeed, a substantial danger exists that the type of individual accounts

proposed under Model 2 would represent a "tails I win, heads you lose" proposition: If the stock market performed well, the government would not share in any of the upside benefit. But if the stock market performed poorly, there would likely be political pressure to have the government bail out investors – for example, by reducing the interest rate on the liability accounts.

In any case, in addition to the subsidies, substantial revenues would be diverted from the Social Security Trust Fund to individual accounts long before the Trust Fund would receive the associated "debt repayments" from the liability accounts, since the "debts" would not be repaid until workers retired and their traditional Social Security benefits were reduced. This more conventional transition cost would further worsen the actuarial balance over the usual 75-year projection period.

If all eligible workers chose to contribute to the individual accounts created under Model 2,[4] the net effect of the accounts -- including both the diversion of revenue and the subsequent reduction in traditional benefit obligations -- would be a deterioration in Social Security's 75-year balance equal to 1.1 percent of payroll, which is more than half the existing projected deficit (see Table 2).

Table 2: 75-Year Actuarial Effects of Individual Accounts under Model 2

Assuming all eligible workers participate in individual accounts	Percent of 75-year payroll
Actuarial balance with no individual accounts	**+0.01**
+ Impact of individual accounts	-1.08
Actuarial balance with individual accounts but no general revenue transfers	**-1.07**

Source: Memorandum from the Office of the Chief Actuary; President's Commission to Strengthen Social Security, *Strengthening Social Security and Creating Personal Wealth for All Americans*, page 94; and authors' calculations.

[4] As the Office of the Chief Actuary at Social Security has emphasized, predicting the participation rate in individual accounts under the Commission plans is difficult ("The proportion of workers who would voluntarily participate cannot be determined with any degree of certainty"). Nonetheless, the large subsidies provided to the individual accounts under Model 2 could result in very high participation rates. Depending on the precise form of the liability accounts under Model 2, which the Commission has not officially specified, the Office of Chief Actuary at Social Security has suggested that either two-thirds participation or full participation may be the most plausible assumption for this Model. Since the most plausible participation assumption under this plan may be 100 percent, it seems prudent when examining the fiscal implications of the plan and ascertaining the level of fiscal exposure the plan would create for Social Security and the federal budget to evaluate the effects of the plan with full participation. For those interested, our National Bureau of Economic Research working paper also provides the relevant figures under two-thirds participation rates.

After re-establishing long-term solvency through the traditional benefit changes, Model 2's individual accounts would thus throw Social Security back into long-term deficit.

General revenue transfers

To cover the Trust Fund losses that the individual accounts would create, Model 2 would transfer substantial amounts from the general budget to Social Security. The transfers would amount to 1.2 percent of payroll if all eligible workers participated in the individual accounts. Remember that the entire cost of these transfers results from the financing difficulties the individual accounts would create, since Social Security would be in actuarial balance under Model 2 *without* such accounts (due to the large reductions in scheduled Social Security benefits it contains for all beneficiaries, including those who do not opt for the individual accounts).

If the disabled were to be protected from the drastic benefit cuts I have already mentioned, the required transfers would increase to 1.5 percent of payroll (see Table 3). The present value of the transfers, depending on the assumption made with regard to the disabled, would amount to between \$2.2 trillion and \$2.8 trillion.

Table 3: General Revenue Transfers Required under Model 2

	Assuming 100 percent participation
Percent of taxable payroll, 2001-2075	
General revenue transfers to make up for the losses the Trust Fund incurs as a result of the individual accounts	1.23
Including transfers required if the disabled are to be insulated from benefit reductions prior to retirement	1.53
Total cost in present value (2001 dollars)	
Without protection for the disabled	\$2.2 trillion
Including protection for the disabled	\$2.8 trillion
As percent of transfers required to eliminate currently projected 75-year imbalance with no other changes	
Without protection for the disabled	66%
Including protection for the disabled	82%

Source: Memorandum from the Office of the Chief Actuary; President's Commission to Strengthen Social Security, *Strengthening Social Security and Creating Personal Wealth for All Americans*, page 94; and authors' calculations

To put these figures in perspective, note that the projected actuarial imbalance in Social Security over the next 75 years amounts to slightly under 1.9 percent of payroll. The general revenue transfers that would be required under Model 2 if all eligible workers participated in the individual accounts would amount to between two-thirds and four-fifths of what would be required under the fiscally reckless course of paying scheduled benefits simply by transferring funds from the rest of the budget to Social Security.

A claim of long-term balance that is heavily dependent on such substantial, unspecified general revenue transfers raises questions of credibility in addition to fiscal prudence, especially when the Commission makes no recommendations regarding where to find the money to be transferred. Given the current budget outlook, simply assuming the availability of such large transfers is highly problematic.[5]

There is widespread agreement about the problems associated with excessive reliance on general revenue transfers. For example, the Commission's own executive director previously labeled such general revenue transfers one of the "top ten tricks in the Social Security debate." As he explained, some account plans "want to promise the gains from personal accounts, but they don't want to be seen as reducing the benefits that come from the traditional system. So they pull a clever maneuver: They take a portion of the payroll tax and put it in personal accounts, but then they reimburse the Trust Fund by an equivalent amount."[6] Yet the Commission's plan itself reflects such a trick, effectively relying on a huge magic asterisk in the rest of the budget.

Conclusions

Social Security faces a projected long-term imbalance that should be addressed, and reform involves difficult tradeoffs. Nonetheless, my conclusion is that the Commission's plan is fundamentally flawed. It would dramatically reduce the role of traditional Social Security benefits in replacing previous wages upon retirement, and result in devastating reductions for

[5] In a forthcoming paper with Alan Auerbach of Berkeley, William Gale of Brookings, and Samara Potter of the University of Michigan, we estimate the 75-year unified budget fiscal gap as 4.1 percent of GDP if last year's tax cut is made permanent and 3.3 percent of GDP if the tax cut is frozen at its current levels. These figures imply large projected deficits outside Social Security over the next 75 years.

[6] Charles P. Blahous III, *Reforming Social Security* (Praeger Publishers: Washington, 2000), page 142.

disabled beneficiaries. Its individual accounts would not only generate the familiar transition costs but also involve a permanent and significant subsidy from the Trust Fund, and therefore impose costs on the Trust Fund on both a transitional and permanent basis. Finally, it would require substantial general revenue transfers – between two-thirds and fourth-fifths as much, assuming all eligible workers participated in the individual accounts, as the fiscally reckless course of simply transferring funds from the rest of the budget to eliminate the 75-year projected imbalance in Social Security with no other changes.

Such heavy reliance on general revenue transfers is extremely problematic, especially since the Commission did not identify any source for such transfers and since the budget outside Social Security already faces substantial long-term deficits. As the Commission's executive director correctly emphasized during the November 9, 2001 meeting of the Commission, "what general revenues do is increase the revenues that are committed and obligated to the social security program...Now what they do not answer, however, is the question of how that revenue is to be generated. It is an increase in commitments, but not necessarily a specification as to where that money is going to come from. It has to come from somewhere."[7]

[7] Transcript of the November 9, 2001 meeting of the Commission to Strengthen Social Security, page 128, available at http://www.csss.gov/meetings/transcripts.

Assessing the Plans Proposed by the President's Commission to Strengthen Social Security

Peter A. Diamond and Peter R. Orszag[8]
July 2002

Introduction

Social Security is running short-term surpluses but faces a projected long-term deficit. That deficit and a desire by some to introduce individual accounts have sparked interest in reform over the past several years. Indeed, Social Security figured prominently in the 2000 presidential campaign. Following the election, President Bush appointed a commission to restore "financial soundness" to Social Security while introducing voluntary individual accounts. After deliberating for approximately eight months, the Commission issued a final report in December 2001 that contained three different proposals.

One of the three Commission proposals (Model 1) would not restore long-term balance to Social Security and is therefore not considered further here. The other two proposals substantially reduce traditional Social Security benefits in order to improve the system's long-term balance. Both models would restore actuarial balance in the absence of individual accounts. Model 2 does this solely through reductions in scheduled benefits. Model 3 covers roughly one-third of the projected actuarial deficit from new dedicated revenues and reduces scheduled benefits to close the other two-thirds of the deficit. The Commission does not recommend a source for these dedicated revenues.

The models also create individual accounts that, by themselves, would push Social Security back into deficit. A key reason is that the amounts diverted from the Social Security Trust Fund to finance the accounts (plus forgone interest) exceed the amount by which Social Security's benefit obligations eventually would be reduced by the accounts. The

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Commission's Report argues that "Personal accounts can also contribute towards the fiscal sustainability of the Social Security system."[9] As we demonstrate in this paper, however, the accounts created in Models 2 and 3 do not do so. Instead, the individual accounts created under Models 2 and 3 have an ongoing cost to Social Security. In addition to worsening the infinite-horizon balance in Social Security in this way, the individual accounts create a cash-flow problem since revenues are diverted away from Social Security decades before benefits are reduced as a result. This further worsens the actuarial balance over the traditional 75-year projection horizon.

To deal with the deterioration in Social Security's finances generated by the individual accounts, both Model 2 and Model 3 call for significant infusions of general revenue into Social Security for decades. Given the dramatic deterioration in the nation's fiscal outlook, it is unclear how the general revenue infusions would be financed. Projections by the Congressional Budget Office, the General Accounting Office, and independent budget analysts show substantial deficits outside Social Security in both the short term and the long term.[10] In this context, simply assuming the availability of large general revenue transfers, without specifying other changes in the Federal budget to accommodate such transfers, is problematic.

While the Commission was willing to assume substantial general revenue infusions to subsidize individual accounts, it did not use general revenue or other means to protect the disabled or young children of deceased workers from the reductions in traditional Social Security benefits called for under Models 2 and 3. Under Model 2, for example, a worker becoming disabled in 2040 would have disability benefits reduced by more than 25 percent relative to the benefits scheduled in current law. Many disabled workers would have little opportunity to accumulate substantial balances in their individual accounts to offset these benefit reductions since their disability would have forced them out of the workforce and cut off their flow of contributions. Moreover, under the Commission plans, they would not have access to any individual account balances they might possess until they reached retirement

[9] President's Commission to Strengthen Social Security, *Strengthening Social Security and Creating Personal Wealth for All Americans*, page 11.
[10] Congressional Budget Office, *The Long-Term Budget Outlook*, October 2000; General Accounting Office, "Long-Term Fiscal Issues," GAO-02-467T, February 27, 2002; and Alan J. Auerbach, William G. Gale, and Peter R. Orszag, "The Budget Outlook and Options for Fiscal Policy," The Brookings Institution, April 2002.

age. Despite the fact that disabled beneficiaries are, on average, relatively poor and consist disproportionately of members of minority groups, the Commission chose not to provide funding to avoid such benefit reductions.

The Commission recognized this issue and suggested that Congress consider alternatives to their reductions in Social Security disability benefits, but provided no revenue that could be used to do so. Instead, the Commission counted all of the savings from the large reductions in disability benefits to reach its goal of restoring long-term balance to Social Security. Without the savings from these benefit cuts, none of the Commission's plans restore long-term solvency to Social Security (without even larger general revenue infusions than are already assumed under the plans). Protecting the disabled from the scheduled benefit reductions to which they would be subject under Model 2 would require revenue equal to about one-sixth of the projected long-term Social Security deficit under current law.[11]

To examine the effects of the Commission's proposals in more detail, Section I of this paper analyzes the proposed changes in the determination and financing of traditional Social Security benefits. Examining the changes in traditional Social Security benefits is important as a building block to understanding the overall effects of the proposals and is crucially important in understanding the effects for workers who choose not to contribute to the individual accounts. Section II then examines the structure of the individual accounts proposed by the Commission. Section III presents the combined effects of the individual accounts and the proposed changes in traditional Social Security benefits in terms of cash flows, the long-term balance within Social Security, and the combined benefits that workers with different levels of earnings would receive. Section IV offers some conclusions.

I. Changes in Scheduled Benefits

The Commission referred to its three proposals as "reform models." The first proposal contains an individual account plan without any changes in the traditional Social Security system. It would not restore long-term balance to Social Security and is therefore not

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[11] Protecting the disabled would require revenue of about 0.3 percent of payroll over the next 75 years; the Social Security financing shortfall amounts to 1.9 percent of payroll over the same period.

considered further in this paper. The second and third proposals contain changes in the Social Security system that would by themselves restore long-term balance to the program. The plans would also create voluntary individual accounts to replace part of the scaled-back Social Security system.

In assessing the Commission plans, we compare the benefits provided under the plans to the benefits scheduled under current law. The projected cost of the scheduled benefits under current law exceeds the projected revenue available to Social Security. Some combination of reduction in benefits, increase in revenue, or increase in the rate of return earned on the Social Security Trust Fund will be required to bring the system back into balance.[12] The comparisons to scheduled benefits are not intended to imply that reforms to the current system are not necessary. The Box below discusses this issue in more detail.

The Baseline for Benefit Comparisons

In describing proposed benefit changes to Social Security, the first step is to define an appropriate benchmark with which the proposed benefits can be compared. There are many possible benchmarks, and the choice of the benchmark affects how the nature of the proposed changes is communicated to, and understood by, the public.

One possible baseline is "scheduled benefits" – the benefits scheduled to be paid under the current Social Security benefit formula. As is well known, the projected cost of the scheduled benefits under current law exceeds the projected revenue available to Social Security. Nonetheless, comparing the proposed benefit levels and financing requirements to scheduled benefits is the clearest way of describing the proposed changes, since the workings of current law are readily understood and since this type of comparison is the standard method used to evaluate the effects of Social Security changes on Social Security benefits. For example, both the Greenspan Commission in the 1980s and the bipartisan, Congressionally chartered Advisory Council on Social Security in the 1990s employed this approach despite projected long-term deficits in Social Security at those times.

[12] Other ways of contributing to actuarial balance include reducing administrative costs (since they are less than one percent of benefits, however, little can be saved here, and any savings might result in poorer service for beneficiaries), expanding coverage (more than five million state and local workers are not covered by Social Security), and increasing immigration.

In addition, using scheduled benefits as the benchmark in evaluating proposed benefit changes is helpful because a reduction from scheduled benefits represents a reduction in the percentage of a worker's pre-retirement earnings that Social Security (or combined benefits from Social Security and individual accounts) will replace. The current Social Security benefit structure is designed to keep the percentage of a worker's pre-retirement earnings that Social Security replaces roughly constant over time; as a result, a reduction in scheduled benefits causes a reduction in the percentage of earnings that Social Security replaces. In debates over Social Security changes, it is critical to identify changes in the percentage of wages that retirement benefits would replace, since these "replacement rates" affect how people's standards of living are altered when they retire. Finally, no other reasonable standard of comparison is readily available for measuring changes in benefits.

For example, the Commission proposed an alternative baseline of "payable benefits." It defined this baseline as the benefits that could be financed by projected revenues under current law, assuming there would be no effort to address the long-term imbalance in Social Security until the Trust Fund was exhausted. It then assumes no provision of additional revenue to Social Security after the Trust Fund exhaustion date, so that benefits would be cut each year to equal available revenues.

There are two problems with this alternative baseline beyond its complexity. First, the payable benefit baseline is highly implausible politically. As Chairman Greenspan recently emphasized, a pattern of no action for nearly four decades followed by a closing of the imbalance that emerges when the Social Security Trust Fund is exhausted entirely through sharp benefit cuts – which is what the "payable benefits" baseline assumes – simply will not be allowed to occur.[13]

Second, the Commission argues against use of the "scheduled benefit" baseline because "confusion occasionally arises when comparisons are made between two different plans that employ different levels of tax revenue. For example, scheduled benefits for the current system could be provided only if significant tax increases are enacted. It is not an

[13] Alan Greenspan, "Saving for Retirement," Remarks before the 2002 National Summit on Retirement Savings, the Department of Labor, Washington, D.C., February 28, 2002.

equal comparison to assume these tax revenues will materialize for the current system, but not for a specific personal account system."[14] The problem here is that the Commission's plans themselves involve substantial amounts of general revenue transfers. The "payable benefits" baseline, by contrast, involves *no* general revenue transfers and assumes only the revenue available to Social Security under current law. Thus, the Commission's comparison of the benefits under its plans to the "payable benefits" baseline violates its own warning against comparing plans with different levels of assumed tax revenue. Indeed, if one wanted to compare the plans to a baseline with a similar level of assumed general revenue, Models 2 and 3 would be more appropriately compared to the "scheduled benefit" baseline than the "payable benefit" baseline, because the general revenue transfers under Models 2 and 3 are much closer to the level of transfers required to finance scheduled benefits than to the lack of any general revenue transfers that the "payable benefits" baseline assumes.

One possibility given the tradeoffs between the baselines would be to use more than one benchmark for evaluating the proposed benefit levels throughout the analysis. The Commission uses three baselines – the two just described as well as a baseline that simply reflects the benefit levels provided today, as adjusted for inflation in future years. The problem with simultaneous use of multiple baselines is that they are more likely to confuse than to illuminate the debate. By using a single baseline to evaluate all aspects of a reform plan, we assess both changes in benefit levels and the fiscal implications of the proposals relative to the same standard. This removes the temptation to use selectively one or another of multiple baselines, in order to make the proposals appear more or less attractive than comparisons to a single baseline would suggest.[15]

In a boxed separate presentation below, we also compare Model 2 with two baselines that are constructed to have the same cost as Model 2. This helps consideration of both aspects of a retirement income system – how to allocate benefits for a given level of costs as well as the benefit implications of different levels of revenues.

[14] President's Commission to Strengthen Social Security, *Strengthening Social Security and Creating Personal Wealth for All Americans*, page 35.

[15] For example, pages 19 through 23 of the Commission Report compare the proposed combined benefit levels under Models 1 through 3 to benefit levels for current retirees (not to scheduled benefits for future retirees) while

Our use of the "scheduled benefits" baseline is not meant to imply that reforms to the current system are not necessary. To the contrary, some combination of a reduction in benefits and an increase in revenues is necessary to bring the system back into balance, even if there is an increase in the rate of return earned on the reserves of the Social Security Trust Fund. Since it is unlikely that a reform plan would restore long-term solvency solely on the revenue side, restoring long-term balance to Social Security will likely involve some reduction in "replacement rates." The fundamental issue is whether the balance among the various potential elements of a reform plan is appropriate.

Retirement benefits

Model 2 makes several changes to traditional Social Security benefits. The most important change is that for everyone younger than 55 on January 1, 2002, Model 2 would alter the formula for determining a worker's benefits at retirement in a way that results in lower benefits than under the formula in current law.

By applying the details of the proposed reduction to the intermediate cost assumptions from the 2001 Social Security Trustees Report, which were the assumptions the actuaries used to evaluate the Commission plans, we see that a worker who is 35 years old today and retires at age 65 in 2031 would have his or her benefits reduced by 17.4 percent, compared to the benefits scheduled under current law (see Table 1). Benefits for a baby born in 2001 who retires at age 65 in 2066 would be reduced by 41.0 percent relative to the scheduled benefit level.

Model 2 achieves these benefit reductions by introducing a factor in the Social Security benefit formula that uses the change in *prices* each year in the economy, rather than, as under current law, using only the change in *average wages* in the economy each year in determining initial benefits. (Under current law, once an individual retires and begins receiving Social Security benefits, benefits are adjusted each year by the change in prices in the economy. But the initial benefit level that an individual receives at retirement is determined by a formula that includes an adjustment each year to keep pace with average

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comparing budgetary implications of the proposals to that with scheduled benefits (not benefit levels for current

wage growth in the economy.) Model 2 would alter how initial benefit levels are determined, so that over the years they would keep pace only with increases in prices rather than increases in average wages. We refer to this change in the Social Security benefit formula as changing from "wage indexing" to "price indexing," although there continues to be use of a wage index as well.[16]

Table 1: Effect of "Price Indexing" under Model 2

Age on January 1, 2002	Year in which the worker attains age 65	Benefit change from "price indexing" as proposed under Model 2 (change from benefits scheduled under current law)
55	2011	-0.0%
45	2021	-9.0%
35	2031	-17.4%
25	2041	-25.0%
15	2051	-31.8%
5	2061	-38.1%
0	2066	-41.0%

Source: 2001 Trustees Report and authors' calculations.

The proposed shift to price indexing will reduce benefits by the cumulative difference between wage growth and price growth in years after 2008, when this change in the benefit formula would go into effect. In particular, for those workers who become eligible for benefits in years after 2008, initial benefits at retirement will first be computed as under the current benefit formula. Then the benefits will be reduced by the ratio of the cumulative growth in prices to the cumulative growth in wages since 2008. Since the projected difference between those two growth rates is about one percent per year under the assumptions used to evaluate the Commission plans, a worker's benefits would be reduced by about one percentage point for each year between 2008 and the year in which the worker becomes eligible for retirement benefits.

The proposed change would represent a fundamental shift in the concept behind Social Security. Under current law, the benefit system is designed to maintain a constant

retirees).

[16] Several different versions of "price indexing" are possible; the approach proposed by the Commission in Model 2 involves larger benefit reductions than the approach proposed the Panel on Social Security Financing appointed by the Senate Finance Committee in 1974-5. For further detail on the alternative approaches, see Stephen C. Goss, "Long-Range OASDI Financial Effects of a Proposal to CPI-Index Benefits Across Generations," Office of the Chief Actuary, Social Security Administration, May 3, 1999.

"replacement rate" across generations: that is, to ensure that the percentage of wages that Social Security replaces when workers retire remains roughly constant from one generation to the next. The current system is able to achieve this goal by adjusting the formula used to determine benefits at retirement by the growth in average wages in the economy each year. Thus, the initial level of benefits remains constant in relation to wages in the economy. Since the initial level of benefits keeps pace with average wage growth, the ratio of initial benefits to pre-retirement wages remains constant over time for successive generations of workers.

A constant "replacement rate" across generations may seem like an abstract concept, but it serves the crucial purpose of allowing beneficiaries to share in the general increase in the standard-of-living that society as a whole experiences from one generation to the next. A focus on replacement rates also recognizes the psychological phenomenon by which families become accustomed to a given standard of living; substantial declines in income during retirement can pose difficult problems for families and individuals. As shown in Table 2, Model 2 would replace the current system for determining benefits at retirement with a system under which benefits would replace an *ever-smaller* share of previous wages. As noted, the formula for determining benefits would be adjusted each year after 2008 to reflect the increase in consumer prices in the economy, rather than the increase in average wages.

Table 2: Effect of Price Indexing under Model 2 on Replacement Rates for Two-Earner Couple with Medium Earnings Claiming Benefits at Age 65

Age on January 1, 2002	Year in which the worker attains age 65	Replacement rate under current law*	Replacement rate under Model 2*
55	2011	39.4%	39.4%
45	2021	38.5%	35.0%
35	2031	36.6%	30.2%
25	2041	36.6%	27.5%
15	2051	36.6%	25.0%
5	2061	36.6%	22.7%
0	2066	36.6%	21.6%

Source: 2001 Trustees Report and authors' calculations.
* Replacement rates show Social Security benefits as a percentage of previous wages. Under current law, the replacement rates decline modestly between now and 2025 because of the scheduled increase during this period in the "normal retirement age" – that is, the age at which an individual can receive full Social Security benefits. As a result of changes to Social Security enacted in 1983, the normal retirement age is gradually increasing from age 65 to age 67. It reaches age 67 for those workers turning 65 in 2025

Under current law, for example, Social Security is scheduled to replace slightly more than 36 percent of former earnings for a two-earner couple each with average earnings retiring

at age 65 in 2025 or thereafter. Under Model 2, according to calculations based on figures produced by the Office of the Chief Actuary of the Social Security Administration, the replacement rate from traditional benefits would fall to 30 percent by 2032 and 20 percent by 2075.[17] Table 2 shows the figures based on a worker's age in 2002: As it shows, the replacement rate under Model 2 would become steadily smaller over time. The role of traditional Social Security benefits in allowing the elderly to maintain their standard of living in retirement would decline sharply in future decades under this proposal.

These benefit reductions are so substantial that they are sufficient, by themselves, to *more than* eliminate the long-term deficit in Social Security. Model 2 uses the extra resources made available in this way to finance modest increases in benefits for workers who earned low wages throughout a long career, as well as for elderly widows and widowers with below-average Social Security benefits. Eventually, the benefit protections provided to such people would be outweighed, however, by the ongoing reductions in traditional benefits from the shift to "price indexing," so that traditional Social Security benefits even for these sub-groups of beneficiaries would decline relative to the benefits they are scheduled to receive under the current benefit formula. These details are described in our companion paper.

Turning now to Model 3, we note that the proposal would eliminate two-thirds of the projected long-term deficit in Social Security through benefit reductions, and would close the remaining one-third with new dedicated revenue transfers to Social Security. The Commission does not indicate where the revenue for these transfers would be found; the infusion of these revenues is simply assumed, despite the substantial deficits projected outside Social Security for the foreseeable future.[18] The assumed availability of revenue transfers mitigates the need to rely more heavily on benefit cuts to restore long-term balance to Social Security. The benefit reductions are thus less severe than under Model 2.

[17] The "replacement rate" is calculated with regard to the wages the couple earned before beginning to draw Social Security benefits. The figures cited here are computed by comparing the benefit levels from page 75 of the actuaries' memorandum analyzing the Commission plans to the projected wage level in the relevant year as shown in the 2001 Trustees Report.

[18] The precise timing of the new revenues in the projections of the actuaries matches that of the revenues that would be generated for Social Security by an increase in the level up to which an individual's earnings are subject to the Social Security payroll tax and a transfer of the portion of the revenue from the partial income taxation of Social Security benefits that currently accrues to Medicare to Social Security. Such proposals, however, were not recommended by the Commission.

The primary mechanism used to reduce benefits in Model 3 is tied to improvements in life expectancy. The logic is that if workers live longer, they will receive their monthly Social Security benefits for a longer period of time, which will raise their *lifetime* benefits. Model 3 attempts to avoid the increase in lifetime benefits that would result from longer lives by reducing *monthly* Social Security benefits in line with increases in life expectancy. (The purpose is to balance the reduction in the monthly benefit against the increase in the number of months that an average worker would be expected to receive that benefit as a result of improvements in life expectancy. For example, assume that life expectancy for the average retiree increases by 20 percent. If monthly Social Security benefits are reduced by 20 percent, expected *lifetime* benefits would be essentially unaffected.[19])

Table 3: Effects of Major Benefit Reduction Proposals under Model 3

Age on January 1, 2002	Benefit change for those retiring at normal retirement age (change from benefits scheduled under current law)	Benefit change for those retiring at age 62 (change from benefits scheduled under current law)
55	-0.0%	-0.0%
45	-4.9%	-14.4%
35	-9.5%	-18.6%
25	-14.0%	-22.6%
15	-18.2%	-26.4%
5	-22.2%	-30.0%
0	-24.1%	-31.7%

Source: Authors' calculations. Note: These figures do not reflect the changes for long-career low earners or high earners under Model 3.

The implications of such reductions are shown in Table 3. Under this provision of Model 3, the monthly Social Security benefit that a worker who is 35 years old today would receive when he or she retires would be 9.5 percent below the level scheduled under the current Social Security benefit structure (see the middle column in Table 3). A baby born in 2001 would experience a 24.1 percent reduction in monthly benefits relative to the scheduled level.

[19] In reality, the calculations required to produce an equivalent expected lifetime benefit are more complicated, and require an adjustment for interest and the use of mortality tables rather than a single life expectancy figure.

Model 3 includes a further reduction in benefits for workers who claim their benefits before the "normal retirement age," which is the age at which full Social Security benefits can be received. (The normal retirement age is increasing gradually under current law from 65 to 67. It will reach 67 for those who turn 65 in 2025.) Most beneficiaries claim their benefits before the normal retirement age: In 1999, some 69 percent of men and 73 percent of women claimed Social Security benefits before the normal retirement age. Under Model 3, a worker who is 35 today would experience a 9.5 percent benefit reduction if he or she waited to claim benefits until age 67 (which, under current law, would be the "normal retirement age" at the time this worker would retire), but an 18.6 percent benefit reduction if he or she claimed benefits at age 62 (the earliest age at which retirement benefits can be claimed and the most common age for the start of benefits).

Model 3 also reduces benefits for high earners and (like Model 2) provides modest benefit increases for low earners with long careers and surviving spouses who receive low Social Security benefits. There is also a benefit increase for those claiming benefits after the normal retirement age. The details of these provisions are described in our companion paper.

Disability and young survivor benefits

The same Social Security benefit formula that is used for retirement benefits is also used for disability benefits and benefits for young survivors (that is, the young children of deceased workers). As a result, the switch from wage indexing to price indexing proposed under Model 2 would result in disability benefit reductions of the same magnitude as the reduction in retirement benefits. A worker who becomes disabled in 2020 would have his or her disability benefits reduced by 10.7 percent; a worker who becomes disabled in 2040 would experience a 26.4 percent reduction in disability benefits; and a worker who becomes disabled in 2075 would have his or her disability benefits reduced by 47.5 percent (see Table 4). Under Model 3, the benefits of a worker becoming disabled in 2075 would decline by 29 percent (see Table 4). The same reductions in benefits would apply to the young children of deceased workers.

Many disabled workers would have little opportunity, however, to accumulate substantial balances in their individual accounts to offset these benefit reductions, because of

interruptions in their careers as a result of their disability. Workers who are collecting disability benefits do not have substantial earnings from which to make contributions to their individual accounts. In any case, under the Commission plans, they would not be allowed access to any individual account balances prior to reaching retirement age.[20]

Table 4: Effect of Major Provisions in Models 2 and 3 on Disability Benefits

Year worker begins to receive disability benefits	Benefit reduction Model 2 (reduction from benefits scheduled under current law)	Benefit reduction under Model 3 (reduction from benefits scheduled under current law)
2010	-1.8%	-1.0%
2020	-10.7%	-5.8%
2030	-18.9%	-10.4%
2040	-26.4%	-14.8%
2050	-33.1%	-19.0%
2060	-39.3%	-22.9%
2070	-44.9%	-26.7%
2075	-47.5%	-28.5%

Source: 2001 Trustees Report and authors' calculations. Note: Figures for Model 3 do not include additional benefit changes for disabled workers with high earnings.

Since, on average, disabled beneficiaries are poorly off financially, the proposed changes represent a large reduction in benefits for a needy group. In addition, minorities have higher rates of disability, on average, than the rest of the population and thus disproportionately benefit from the disability benefits that Social Security provides. Social Security data show, for example, that the percentage of black workers aged 50-59 who became disabled in 1997 was nearly double the percentage of all workers in that age group who became disabled. Blacks account for 13 percent of working-age Americans, but 17 percent of disabled worker beneficiaries. Thus, the reductions in disability benefits would disproportionately harm minorities. (The reductions in survivor benefits also would disproportionately harm minorities: African-American children currently constitute 15 percent of Americans under age 18 but more than 22 percent of the children who receive Social Security survivor benefits.)

The Commission was aware of this issue. It stated that some other group needed to examine disability benefits and that "the calculations carried out for the commission and

[20] In the case of a young worker who has children and dies before retirement, the accounts would similarly be small. Moreover, the accounts could not be drawn upon to support the surviving family until the surviving spouse retired (if there were a surviving spouse).

included in this report assume that defined benefits will be changed in similar ways for the two programs. *This should not be taken as a Commission recommendation for policy implementation.*"[21] Nonetheless, the Commission dedicated no revenue to mitigating any of the reductions in disability benefits that would result from its plans. That is, the Commission counted all of the savings from the dramatic reductions in benefits for the disabled as part of its solution to restoring long-term balance to Social Security. Without these large savings, none of the Commission's plans would achieve long-term balance (unless even more revenue were transferred from the rest of the budget).

To avert the reductions in disability benefits that are part of Model 2 would require additional revenue equal to roughly 0.3 percent of payroll over the next 75 years. This amount is equal to roughly one-sixth of the deficit projected in Social Security over this period under current law.[22] It may be noted that the revenue required to insulate the disabled from the benefit cuts under Model 2 is less than the revenue the Commission devoted to subsidizing the individual accounts under that model. (These subsidies are discussed below.) Similarly, averting the reductions in disability benefits that result from the adjustment for life expectancy in Model 3 would require revenue of roughly 0.2 percent of payroll over the next 75 years.

Summary

Both Model 2 and Model 3 involve substantial reductions in scheduled Social Security retirement and disability benefits. In Model 2, these reductions are sufficiently large to more than eliminate the long-term deficit in Social Security. In Model 3, the benefit reductions are large enough to eliminate about two-thirds of the long-term deficit in Social Security; the other third of the shortfall is covered by assumed, unspecified sources of revenue. In other words, both Model 2 and Model 3 achieve long-term balance in Social Security *without* their individual account components. They do so entirely (Model 2) or mostly (Model 3) by reducing Social Security benefits.

[21] *Strengthening Social Security and Creating Personal Wealth for All Americans*, page 149 (italics in original).

II. Introduction of Individual Accounts

Under the Commission proposals, workers would be given the option of having part of their payroll taxes deposited into individual accounts. The individual account system would involve two components: the assets of the individual account, which would come from a worker's deposits and the accumulated earnings on them, and a "liability account" (explained below). If a worker chose to participate in the individual account system, a portion of his or her payroll taxes would be diverted into an individual account. These amounts would accumulate in the account during the worker's career and be available to the worker upon retirement. But since the revenue diverted to this account would reduce the financing available to the traditional Social Security system, a "liability account" would also be created. This liability account is designed to track the debt owed back to Social Security because of the diverted funds. Upon retirement, the debt would be repaid by reducing the worker's traditional Social Security benefit. Moreover, if a worker dies before retirement, the surviving spouse would inherit *both* the asset account and the liability account.[23]

Individual accounts

The size of the permitted contributions into individual accounts differs across the Models. Model 2 allows a diversion of 4 percent of earnings into the individual account, up to a limit of $1,000 per year (with the $1,000 limit indexed annually to reflect average wage growth in the economy). Model 3 would allow a diversion of 2.5 percent of taxable earnings into an individual account, again up to an indexed level of $1,000. Under Model 3, a worker setting up an account would also be required to make an additional deposit equal to one percent of his or her taxable earnings (i.e., earnings that are subject to the Social Security payroll tax).[24]

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[22] This estimate does not include the cost of protecting young survivors from the reductions, nor does it include the cost of protecting the disabled after their conversion to retirement benefits at the normal retirement age. See our technical companion paper for more details.

[23] Similarly, in the event of divorce, the accumulations during marriage in *both* the asset and liability accounts would be shared with the former spouse. Since the asset account might not have secured a higher rate of return than the interest rate that was charged on the liability account, a divorcee or surviving spouse could receive a liability account that was larger than the asset account.

[24] The Report anticipates that general revenues would be used to subsidize the additional deposits of low earners. The details of the subsidy, however, are not specified and the estimated cost to the Treasury of these subsidies is not included in the Commission's overall analysis.

The design of the individual accounts would allow workers to choose from a limited menu of alternative investment options. A worker would not be allowed access to account balances before retirement. Upon retirement, the balance in the individual account could be used to purchase an annuity (that is, the accumulated balance could be exchanged for a monthly payment that would last as long as the worker or his or her spouse was alive). Alternatively, instead of being used to purchase an annuity, some or all of the accumulated balance could be taken as a lump sum and/or as monthly withdrawals, provided that both spouses agree and that the withdrawals are of sufficient size to keep the worker and spouse out of poverty. (Note that if all of an account were annuitized upon retirement, none of the balance would be bequeathable to heirs. Conversely, to the extent that some of an account were designated to be bequeathed, the life-long monthly benefits that could be paid during the retirement of a worker and his or her spouse would be reduced.)

In projecting how much would accumulate in the accounts, the Commission assumed that Treasury bonds would have a 3 percent average real yield (that is, they would yield, on average, 3 percent more than the inflation rate per year), corporate bonds would have a 3.5 percent real yield, and stocks a 6.5 percent gross real yield. Based on historical experience and expected demographic developments, these figures are reasonable. The Commission also assumed an annual administrative charge of 30 basis points -- or 0.3 percent of the value of the assets in an account. This level of administrative charge appears optimistic (i.e., it appears unrealistically low). It ignores the cost of setting up the accounts, the cost of providing significant financial education in connection with the accounts, the option (allowed by the Commission) of additional investment options for larger accounts, and the possibility that the restrictions on asset choices (which reduce administrative costs) would be relaxed over time. If the administrative costs were higher, the balances in the accounts would be smaller than the Commission projected.

Individual liability accounts

Since the revenue that was contributed to an individual account would be diverted from the Social Security Trust Fund, the Commission would also create a "liability account" to track the amounts owed back to Social Security by workers who elect to contribute to

individual accounts. Upon retirement, this liability account would be "repaid" by reducing a worker's traditional Social Security benefit.

The Social Security Administration (SSA) would keep records of the amount of payroll tax revenue that each worker diverted to an individual account. These amounts would be entered as balances in the worker's "liability account." Each year, SSA would update the results on the amount diverted and would charge interest on the balance in the liability account. Upon retirement, the balance would be paid off by reducing traditional Social Security benefits. In particular, SSA would convert the accumulated balance in the "liability account" into an equivalent amount per month. The debt to Social Security would then be repaid by subtracting that computed monthly payment from the worker's Social Security benefit.[25]

Both Model 2 and Model 3 *subsidize* the individual accounts by charging an interest rate on the liability accounts (i.e., on the amounts diverted from the Trust Fund) that is projected to be lower than the return the Trust Fund earns on its reserves. *Since the interest rate charged on the amounts diverted from the Trust Fund would be lower than the interest rate the Trust Fund would have earned on those funds if they had not been diverted, the individual accounts cause deterioration in Social Security's financial status.* Stated another way, the Trust Fund earns the interest rate paid on Treasury bonds on a dollar that is *not* diverted into an individual account; but on a dollar that is diverted into an individual account, the Trust Fund earns only the interest rate charged on the liability account, which is a lower rate. An example of this loss to the Trust Fund is provided in the Box below. Charging an interest rate on the liability accounts that is below the interest rate the Trust Fund earns on its reserves represents a subsidy to individuals who establish the individual accounts. The subsidy comes from the Social Security Trust Fund, the financial condition of which is made worse by having to pay the subsidy.[26]

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[25] In the event of a worker's death before retirement, both the asset and the liability accounts are inherited by the worker's spouse. The debt in the liability account is then paid back from the benefits of the surviving spouse. Similarly, in the event of divorce before retirement, part of the debt is paid out of the benefits of the worker's former spouse.

[26] There is a small further subsidy because the individual account, but not the liability account, is inherited by heirs if a worker dies before retirement without a surviving spouse.

Subsidizing the Individual Accounts Through a Low Interest Rate on the Liability Accounts

By charging an interest rate on the liability accounts that is lower than the rate the Trust Fund earns on its balances, Models 2 and 3 impose costs on the Social Security system and subsidize the individual accounts. To see this, imagine $100 is diverted from the Trust Fund into an individual account under Model 2.

The $100 diverted into the individual account would trigger an entry of $100 in the worker's liability account. Model 2 charges an interest rate on the liability accounts of 2 percent per year (after inflation). If the worker were 40 years away from retirement, the interest charges would cause the $100 entry to grow to $221 (in constant dollars) by the end of the worker's career.

If the $100 had been retained by the Trust Fund, however, it would have grown to $326 by the time the worker retired. The difference between the amount in the liability account ($221) and the amount that would have accrued in the Trust Fund ($326) represents a subsidy to the individual account and a loss to the Trust Fund. Such a subsidy arises whenever the interest rate on the liability account is below the interest rate the Trust Fund earns on its reserves.*

* The subsidies to the accounts are actually larger than shown here, because the lower interest rate on the liability accounts is also used to transform the accumulated balances in those accounts into annuity values. See our companion paper for further discussion of this issue.

To see the magnitude of the subsidies, consider the example of an average worker who makes nearly the maximum allowable contribution to an individual account under Model 2 and claims benefits in 2072 at age 62 (the typical age at which beneficiaries currently claim their benefits). To measure the subsidy, we compare the debt that would be repaid to Social Security if a 3 percent interest rate were changed on the liability account to the debt repayment that would actually occur under Model 2.[27] Three percent is the real interest rate that the Social Security Trust Fund earns on its reserves. By using such an interest rate in this

[27] To undertake these calculations, we built a small model that incorporates the details of Model 2 and the assumptions used by the actuaries to evaluate the Commission's models. The model is able to replicate the published results of the actuaries. We then used the model to evaluate changes to variables such as the interest rate charged on the liability account. Our companion technical paper describes the assumptions in more detail.

computation, we can see how much debt would be repaid to Social Security if Social Security were not required to subsidize the individual accounts. Table 5 presents the results.

At a 3 percent interest rate on the liability accounts, the diversion of revenue would trigger an annual repayment to Social Security when the worker retires of $6,499 (in 2001 dollars). In other words, the worker's annual Social Security benefits would be $6,499 lower than would otherwise be the case. However, at the 2 percent interest rate that the liability accounts actually would be charged under Model 2, the projected annual repayment to Social Security would be only $4,612. The difference between these two amounts -- $1,887 per year -- is the subsidy given to the average worker after retirement and the amount by which the Trust Fund is shortchanged by the transaction.[28]

Table 5: Subsidization of Individual Accounts under Model 2

In 2001 dollars	Annual benefits for each of a two-earner couple, claiming at age 62 in 2072		
	Low earner ($15,875 in 2002)	Medium earner ($35,277 in 2002)	High earner ($56,443 in 2002)
Debt that would be repaid to Social Security each year if Social Security did not subsidize the individual accounts	$3,952	$6,499	$6,759
- Debt repaid under Model 2	$2,833	$4,612	$4,768
= *Subsidy per year under Model 2*	*$1,120*	*$1,887*	*$1,991*

Source: Authors' calculations

A worker who makes smaller contributions to an individual account receives less of a subsidy. Thus, low-wage workers would receive less of a subsidy than higher earners. As shown in Table 5, a high earner receives $871 *more* in subsidies each year than does a low earner.

Effects on Social Security financing

As a result of the subsidies provided to individual accounts under Models 2 and 3, the effect of the individual account option, by itself, would be to worsen Social Security's long-

[28] The subsidies under Model 3 would be smaller, since the interest rate charged on the liability accounts under this Model would be higher than under Model 2. This interest rate would still be lower, however, than the interest rate the Trust Fund earns on its reserves.

term actuarial balance, and to do so on an ongoing, or permanent, basis. In addition, substantial revenues would be diverted from the Social Security Trust Fund to individual accounts long before the Trust Fund would receive the associated "debt repayments" from the liability accounts, since the "debts" would not be repaid until workers retired and their traditional Social Security benefits were reduced. This would further worsen the actuarial balance over the usual 75-year projection period.

Consider Model 2. If all eligible workers chose to contribute to the individual accounts created under Model 2, the cost of the revenues diverted from the Social Security Trust Fund would amount to 2.2 percent of taxable payroll over the next 75 years. The accompanying reduction in Social Security benefit payments for those who opted for the individual accounts would amount to 1.1 percent of payroll over the 75-year period. Thus, the individual accounts would cause deterioration in Social Security's 75-year balance by 1.1 percent of payroll. (In other words, the Trust Fund would lose an amount equal to 2.2 percent of payroll from the diverted payroll taxes, while saving an amount equal to 1.1 percent of payroll from the associated reductions in benefits.) The amount by which the individual accounts would worsen the shortfall in Social Security – 1.1 percent of payroll over the next 75 years – is more than half the entire Social Security deficit under current law.

To cover the Trust Fund losses that the individual accounts would create, Model 2 would transfer substantial amounts from the general budget to Social Security. The transfers would amount to 1.2 percent of payroll under Model 2 (see Table 6). These transfers reflect the financing difficulties the individual accounts would create, since Social Security would be in actuarial balance under Model 2 *without* such accounts (due to the large reductions in scheduled Social Security benefits it contains for all beneficiaries, including those who do not opt for the individual accounts), but is in need of large general revenue transfers once the individual accounts are added.

The ultimate impact of the accounts on Social Security's financing is thus a 1.1 percent of payroll net *cost* caused by the accounts, combined with an injection of 1.2 percent of payroll from general revenue transfers. The actuarial balance improves by 0.15 percent of payroll, but only because of the large general revenue infusions. The present value of the transfers amounts to more than $2.2 trillion.

Table 6: 75-Year Actuarial Effects of Individual Accounts under Model 2

	Assumed participation rate in individual accounts	
	67 percent	100 percent
Actuarial balance with no individual accounts	*0.01*	*0.01*
+ Impact of individual accounts	-0.72	-1.08
Actuarial balance with individual accounts but no general revenue transfers	*-0.71*	*-1.07*
+ General revenue transfers	0.84	1.23
= *Actuarial balance*	*0.13*	*0.16*

Source: Memorandum from the Office of the Chief Actuary; President's Commission to Strengthen Social Security, *Strengthening Social Security and Creating Personal Wealth for All Americans*, page 94; and authors' calculations.

The results for Model 3 are similar. The individual accounts, including the diverted revenue and the associated reductions in Social Security benefits for those opting for the accounts, would cause a deterioration in the 75-year actuarial balance of 0.4 percent of payroll if two-thirds of eligible workers opted for the accounts and 0.7 percent of payroll if all workers did so. Here, also, large amounts of general revenue are assumed to be transferred to Social Security to cover the shortfall created by the individual accounts. As with Model 2, the plan restores long-term actuarial balance to Social Security only because substantial general revenue transfers are assumed (see Table 7).

Table 7: 75-Year Actuarial Effects of Individual Accounts under Model 3

	Assumed participation rate in individual accounts	
	67 percent	100 percent
Actuarial balance with no individual accounts	*0.07*	*0.07*
+ Impact of individual accounts	-0.44	-0.65
Actuarial balance with individual accounts but no general revenue transfers beyond the dedicated revenue in the base plan	*-0.36*	*-0.58*
+ General revenue transfers not including dedicated revenue in base plan	0.38	0.65
= *Actuarial balance*	*0.02*	*0.07*

Source: Memorandum from the Office of the Chief Actuary; President's Commission to Strengthen Social Security, *Strengthening Social Security and Creating Personal Wealth for All Americans*, page 94; and authors' calculations

The impact of the individual accounts on Social Security actuarial balance thus is clearly negative in Models 2 and 3.[29] This result contradicts various assertions in the Commission's Report. For example, the Report claims that "every dollar invested in a personal account reduces the cost of future Social Security payments by one dollar, plus the offset rate of interest that is proposed for each plan (ranging from 2 percent to 3.5 percent after inflation)...So long as the personal account earns a return higher than the offset rate, both Social Security and the individual come out ahead."[30] The final sentence is simply incorrect – Social Security comes out behind under Models 2 and 3, not ahead. The sentence is inaccurate because it ignores the interest earnings that the Social Security Trust Fund would have received on the diverted funds if the funds had not been shifted out of Social Security and into the individual accounts. Models 2 and 3 are purposefully designed so that the Social Security Trust Fund would be expected to lose more in diverted revenue from the individual accounts than it would gain from reduced benefit obligations – that is, the Models are designed to subsidize the individual accounts at the expense of the Trust Fund.

III. COMBINED EFFECTS OF TRADITIONAL SOCIAL SECURITY CHANGES AND INDIVIDUAL ACCOUNTS

Effects on Social Security financing

As noted at the outset, the cost of current law scheduled benefits is greater than projected revenues by 1.86 percent of taxable payroll (under the 2001 Trustees assumptions). While actuarial balance could be restored by transferring this much general revenue to Social Security, such a proposal is not recommended by policy analysts. The combinations of the reductions to scheduled benefits and the cost of individual accounts under both Models 2 and 3 result in decreases in the levels of general revenue transfer that would be needed to restore actuarial balance. Nevertheless, the needed transfers remain very large. The Commission

[29] The 75-year actuarial figures do not reflect the full long-term impact of the individual accounts because they exclude the accumulated balances in the liability accounts at the end of the 75-year projection period. In our companion paper, we show that the actuarial impact of the individual accounts (exclusive of general revenue transfers) is still negative once this ending liability adjustment is made. The presence of a net cost even after adjusting for the ending liability balances is not surprising, since the interest rate on the liability accounts under both Model 2 and Model 3 is below the interest rate the Trust Fund earns on its reserves. See our companion technical paper for more details.
[30] *Strengthening Social Security and Creating Personal Wealth for All Americans,* page 149.

does not recommend any sources for these transfers, leaving them as unspecified transfers from general revenues.

In contrast with the 1.86 percent of payroll needed to finance scheduled benefits under current law, Table 8 shows the total revenue transfers that would be entailed under Models 2 and 3, assuming all eligible workers participate in the individual accounts.[31] The table also shows the transfers that would be required if the disabled were to be protected from the benefit cuts in the plans. Although less than the current actuarial deficit, the transfers involved are substantial. This heavy reliance on revenue infusions is troubling in the absence of a specific source for the revenue and in light of the large deficits expected in the rest of the federal budget in coming decades.

Table 8: Revenue Transfers under Models 2 and 3 Assuming All Eligible Workers Participate

Percent of taxable payroll, 2001-2075	Model 2	Model 3
General revenue transfers under Model 3 to restore solvency *before* the individual accounts are added	NA	0.63
General revenue subsidies to assist low-income workers in making the additional contributions required to participate in the individual accounts under Model 3	NA	0.23
General revenue transfers to make up for the losses the Trust Fund incurs as a result of the individual accounts	1.23	0.65
General revenue transfers required if the disabled are to be insulated from benefit reductions prior to retirement	0.30	0.17
Total cost of transfers as a percentage of payroll over 75 years		
As specified by Commission (without protection for the disabled)	1.23	1.51
Including protection for the disabled	1.53	1.68
Total cost of transfers in present value (2001 dollars)		

[31] The 100 percent participation rate assumption is used here for simplicity. As the actuaries' memorandum notes, the actual participation rate "cannot be determined with any degree of certainty." See Memorandum from the Office of the Chief Actuary, page 16. The assumption of universal participation is likely to better approximate the outcome for Model 2 than for Model 3, since Model 3 involves a smaller subsidy to the individual accounts and requires additional contributions by workers equal to one percent of their earnings.
The actuaries' memorandum also presents figures reflecting an assumption that two-thirds of eligible workers participate. Under that assumption, the general revenue transfers over the next 75 years would amount to 1.1 percent of payroll under Model 2 and 1.3 percent of payroll under Model 3 if the disabled are held harmless from the benefit reductions, and 0.8 percent of payroll under Model 2 and 1.1 percent of payroll under Model 3 if disability benefits are reduced in line with retirement benefits.

Without protection for the disabled	$2.2 trillion	$2.8 trillion
Including protection for the disabled	$2.8 trillion	$3.1 trillion

Source: Memorandum from the Office of the Chief Actuary; President's Commission to Strengthen Social Security, *Strengthening Social Security and Creating Personal Wealth for All Americans*, page 94; and authors' calculations

Without the general revenue transfers, Model 2 would accelerate the year in which the Trust Fund is exhausted. Under the assumptions in the 2001 Social Security Trustees report, which are the assumptions the actuaries used to evaluate the Commission plans, the Trust Fund was expected to be exhausted in 2038. Under Model 2, if all eligible workers participated in the individual accounts, the exhaustion date would become 2025 in the absence of general revenue infusions – or 13 years sooner. Our technical companion paper discusses this result in more detail.

Effects on combined monthly benefits

To consider the impact of the Models on retirees, we need to consider both the reduction in traditional Social Security benefits and the net change in retirement income that would come from the individual accounts for those who participate in the accounts. For a straightforward comparison, we consider annuities provided from the individual accounts that are adjusted for inflation each year, as Social Security benefits are. Moreover, we assume that the entire balance of the accounts is used to purchase an annuity, leaving no wealth to be bequeathed thereafter. Allowing possible bequests would reduce the amount of retirement income that could be financed from the accounts.

We initially focus on the expected combined benefits, assuming that the individual accounts earn a rate of return (after administrative costs and inflation) of 4.6 percent per year. That return is the rate of return the actuaries assume in their basic analysis of the Commission plans. We examine two sets of retirees: Those who claim benefits at age 65 in 2052 and those who claim benefits at age 65 in 2075. The first set of retirees are just beginning their careers when the principal changes to traditional benefits begin to take effect under Models 2 and 3, and therefore illustrate the effects of a full career under the proposed changes; the second set of retirees claim benefits at the end of the conventional 75-year horizon.

Under the 4.6 percent real return assumption, a medium-earning two-earner couple who opted for the accounts and claimed benefits at age 65 in 2052 would receive an expected combined benefit under Model 2 (including the annuity from the individual account) that is 7 percent below the Social Security benefits the couple would receive under the benefit structure in current law (see the middle column in Table 9). The medium-earning two-earning couple claiming benefits in 2075 would have a combined benefit under Model 2 that is 21 percent below scheduled benefit levels (see the middle column in Table 10).

Table 9: Combined Monthly Benefit Levels for Each Member of a Two-Earner Couple Claiming Benefits at Age 65 in 2052 under Model 2

In 2001 dollars	Low earner ($15,875 in 2002)	Medium earner ($35,277 in 2002)	High earner ($56,443 in 2002)
Scheduled benefit	$986	$1,628	$2,151
- Benefit reduction for all such beneficiaries	-$180	-$529	-$699
+ Annuity from individual account	$478	$819	$860
- Further Social Security benefit reduction for those selecting individual accounts (to repay Social Security partially for the funds shifted into individual accounts)	-$234	-$392	-$407
= *Total expected benefit*	$1,050	$1,525	$1,907
Percent change without the individual account (change from benefits scheduled under current law)	-18%	-33%	-33%
Percent change with the account (change from benefits scheduled under current law)	+7%	-6%	-11%

Source: Memorandum from the Office of the Chief Actuary, pages 75-76, and authors' calculations. Based on intermediate assumptions from 2001 Trustees Report and an assumed net return (after administrative costs and inflation) of 4.6 percent per year. Assumptions are identical to those adopted by the actuaries in analyzing the Commission plans.

Table 10: Combined Monthly Benefit Levels for Each Member of a Two-Earner Couple Claiming Benefits at Age 65 in 2075 under Model 2

In 2001 dollars	Low earner ($15,875 in 2002)	Medium earner ($35,277 in 2002)	High earner ($56,443 in 2002)
Scheduled benefit	*$1,231*	*$2,032*	*$2,685*
- Benefit reduction for all such beneficiaries	-$425	-$933	-$1,233
+ Annuity from individual	$577	$989	$1,040

account			
- Further Social Security benefit reduction for those selecting individual accounts (to repay Social Security partially for the funds shifted into individual accounts)	-$281	-$473	-$489
= Total expected benefit	*$1,102*	*$1,615*	*$2,003*
Percent change without the individual account (change from benefits scheduled under current law)	-35%	-46%	-46%
Percent change with the account (change from benefits scheduled under current law)	-10%	-21%	-25%

Source: Memorandum from the Office of the Chief Actuary, pages 75-76, and authors' calculations. Based on intermediate assumptions from 2001 Trustees Report and an assumed net return (after administrative costs and inflation) of 4.6 percent per year. Assumptions are identical to those adopted by the actuaries in analyzing the Commission plans.

To see how the different pieces of Model 2 would affect such couples, consider the couple claiming benefits at age 65 in 2075 (shown in Table 10). Under current law, each member of the couple would receive a monthly scheduled benefit of just over $2,000 (in 2001 dollars). The shift to price indexing under Model 2 would reduce the benefit by $933 per month (for all such couples, regardless of whether they participated in the individual accounts). If the couple had decided not to participate in the individual account, the resultant benefit would be $1,099 per month. This would be 46 percent below scheduled levels – or $933 a month for each member of the couple. If the couple *did* divert funds into an individual account, the annuity from the individual account would be expected to amount to $989 per month, and the debt that would have to be repaid to the Social Security Trust Fund because of the accumulated liability account would amount to $473 per month.

In other words, traditional Social Security benefits would be reduced by an additional $473 per month for each member of the couple and thus would total $626 per month ($2,032 minus $933 minus $473). The combined benefit for each member of the couple thus would be $1,615, including the income from the individual account. This combined benefit is 21 percent below the scheduled benefit level of $2,032 – or $417 per month for each member of the couple. A similar couple retiring at age 62 in 2072 would have a 23 percent decline relative to scheduled benefits.

Model 3 does not use price indexing in the Social Security benefit formula as Model 2 does, but it reduces monthly Social Security benefits based on increases in life expectancy and contains additional benefit reductions for workers who retire before the normal retirement age. Since age 62 is the most common retirement age today, Tables 11 and 12 show combined benefits for couples retiring at age 62 in 2049 and in 2072. Table 11 shows that each member of the medium-earning couple participating in the accounts and claiming benefits in 2049 would receive a combined benefit approximately equal to the benefit scheduled under current law. It should be noted that part of this benefit is financed by the payments by workers of an additional one percent of earnings to the accounts (over and above their payroll tax contributions). The payment by workers of this additional one percent of earnings is a condition of having an account under Model 3. Without this contribution, combined benefits would be 16 percent below scheduled benefit levels.

Table 12 shows that each member of the medium-earning couple claiming benefits in 2072 would receive $1,485, including the income from the individual account. This is 9.5 percent – or $156 a month – below the scheduled benefit level of $1,641. Again, part of this benefit is financed by the payments by workers of an additional one percent of earnings to the accounts (over and above their payroll tax contributions). Without this contribution, the decline in scheduled benefits would be 24 percent.

Table 11: Combined Monthly Benefit Levels for Each Member of a Two-Earner Couple Claiming Benefits at Age 62 in 2049 under Model 3

In 2001 dollars	Low earner ($15,875 in 2002)	Medium earner ($35,277 in 2002)	High earner ($56,443 in 2002)
Scheduled benefit	$796	$1,314	$1,737
- Benefit reduction for all such beneficiaries	-$104	-$285	$410
+ Annuity from individual account	$330	$735	$968
- Further Social Security benefit reduction for those selecting individual accounts (to repay Social Security partially for the funds shifted into individual accounts)	-$144	-$324	-$377
- Reduction factor for early retirement	-$80	-$131	-$174
= *Total expected benefit*	$799	$1,309	$1,744

Percent change without the individual account (change from benefits scheduled under current law)	-23%	-32%	-34%
Percent change with the account (change from benefits scheduled under current law)	0%	0%	0%
Percent change with the account but without the additional contributions by workers of one percent of their earnings (change from benefits scheduled under current law)	-12%	-16%	-19%

Source: Memorandum from the Office of the Chief Actuary, pages 75-76, and authors' calculations. Based on intermediate assumptions from 2001 Trustees Report and assumed net return (after administrative costs and inflation) of 4.6 percent per year. Assumptions are identical to those adopted by the actuaries in analyzing the Commission plans.

Appendix Tables 1 and 2 shows the analogous results for workers who retire at age 65 in 2052 or 2075. The combined benefit levels are somewhat higher than under current law for two-earner couples who claim benefits at age 65 under Model 3 and opted to participate in the accounts. That result differs from those in Tables 10 and 11 because the increase in the actuarial reduction is less for someone retiring at age 65 than at age 62.

Table 12: Combined Monthly Benefit Levels for Each Member of a Two-Earner Couple Claiming Benefits at Age 62 in 2072 under Model 3

In 2001 dollars	Low earner ($15,875 in 2002)	Medium earner ($35,277 in 2002)	High earner ($56,443 in 2002)
Scheduled benefit	*$994*	*$1,641*	*$2,168*
- Benefit reduction for all such beneficiaries	-$221	-$491	-$685
+ Annuity from individual account	$400	$890	$1,173
- Further Social Security benefit reduction for those selecting individual accounts (to repay Social Security partially for the funds shifted into individual accounts)	-$174	-$391	-$456
- Reduction factor for early retirement	-$99	-$164	-$217
= Total expected benefit	*$900*	*$1,485*	*$1,983*
Percent change without the individual account (change from benefits scheduled under current law)	-32%	-40%	-42%

Percent change with the account (change from benefits scheduled under current law)	-9%	-10%	-9%
Percent change with the account but without the additional contributions by workers of one percent of their earnings (change from benefits scheduled under current law)	-21%	-24%	-27%

Source: Memorandum from the Office of the Chief Actuary, pages 75-76, and authors' calculations. Based on intermediate assumptions from 2001 Trustees Report and assumed net return (after administrative costs and inflation) of 4.6 percent per year. Assumptions are identical to those adopted by the actuaries in analyzing the Commission plans.

Appendix Tables 3 and 4 present the results for one-earner couples who claim benefits at age 65 under Models 2 and 3 in 2075. The benefit reductions are more substantial for such couples, primarily because Social Security provides a subsidy to one-earning couples whereas individual accounts do not. Under Social Security, a non-working spouse is entitled to a benefit equal to 50 percent of the worker's benefit. The individual accounts proposed under the Commission's plans would not subsidize "stay-at-home" mothers in this fashion.

Adjusting for risk

The figures in Tables 9 through 12 and Appendix Tables 1 through 4 do not adjust for the risk that is inherent in individual account portfolios (or in any investment in stocks). The combined benefits under Models 2 and 3 would depend on the performance of the stock market. Stock market investment involves risk: stock returns vary significantly from year to year. Most individuals, however, are averse to risk. For example, an investment that has a higher expected return but carries a substantial risk of producing lower returns (or outright losses) may not be more attractive than an alternative investment with a somewhat lower expected return but much less risk. As a result, many analysts believe that in undertaking comparisons of benefits with different degrees of risk, the expected returns should be compared after adjusting for risk.

One simple method of adjusting for risk assumes that the full difference in expected returns between stocks and bonds reflects the greater risk associated with stocks.[32] Indeed, in evaluating recently enacted legislation to allow the Railroad Retirement Fund to invest in equities (i.e., stocks), the Office of Management and Budget stated:

> "Equities and private bonds earn a higher return on average than the Treasury rate, but that return is subject to greater uncertainty...Economic theory suggests, however, that the difference between the expected return of a risky liquid asset and the Treasury rate is equal to the cost of the asset's additional risk as priced by the market. Following through on this insight, the best way to project the rate of return on the Fund's balances is to use a Treasury rate."[33]

In other words, in estimating the rate of return that the Railroad Retirement Fund will receive from investments in stocks, OMB concluded that the rate of return on Treasury bonds should be used rather than the higher average rate of return that stocks are expected to earn. OMB assumed that all of the difference between the average expected rate of return on stocks and the interest rate on Treasury bonds is due to the substantially greater risk that stocks carry. To the extent that OMB's approach is valid, risk adjustment is straightforward: It entails projecting the individual account balances as if account balances were invested entirely in government bonds.

The actuaries produced figures for the individual accounts under this assumption. As Appendix Table 5 shows, under this approach, combined benefits under Model 2 for a medium-earning two-earner couple that retires at age 65 in 2075 would be 40 percent lower than the scheduled Social Security benefit levels. Under Model 3, the benefit reduction for such a couple on this risk-adjusted basis would be 19 percent. These numbers contrast with a reduction of 21 percent and an increase of 3 percent without risk adjustment.

The Impact of Various Factors on the Benefit Comparisons

The figures produced here make two assumptions that tend to produce artificially high benefit levels under Models 2 and 3 and thus to understate the benefit reductions under these plans. The first assumption that inflates the retirement benefit figures is the assumption of

[32] The assumption upon which this risk-adjustment method is predicated is not likely to be valid for all workers: In particular, the expected return to equities may exceed the level required to compensate some investors for the riskiness of equities relative to bonds.
[33] Office of Management and Budget, *Budget Systems and Concepts*, Fiscal Year 2003, pages 15-16.

significant reductions in disability and child survivor benefits. If those reductions did not occur and general revenue transfers were not increased to make up for the lost savings from those benefit cuts, the required reductions in Social Security retirement benefits would have to be correspondingly larger to ensure long-term Social Security balance. The second assumption that inflates the retirement benefit figures for Models 2 and 3 is that individual account balances are assumed to be transformed in full at retirement into lifetime annuities. One of the arguments the Commission advanced for individual accounts, however, is that such accounts would facilitate bequests to heirs. The benefit levels cited here leave no funds remaining to be passed on to heirs after retirement, since the full balances in the accounts are assumed to be converted into annuities. If only part of the account balances were annuitized, a portion of these account balances would be available to heirs, but the monthly income paid to retirees would be correspondingly lower – and hence the combined benefit reductions under the Commission plans would be larger. Each dollar that a pensioner bequeaths to heirs means a dollar less in lifetime monthly benefits that the pensioner can use for expenditures after retirement, because the pool of funds available to cover living costs during retirement is reduced.

Although scheduled benefits represent the best single benchmark for understanding reform plans (see the first Box above), the current benefit structure cannot be financed in full out of projected Social Security revenue. It may therefore be illuminating to also compare the Models to alternative plans that reach 75-year balance in Social Security with the same amount of general revenue being transferred to Social Security as under the Models and which simply reduce traditional benefits to eliminate the 75-year imbalance that remains after these transfers. (It should be noted that such alternatives are discussed only for illustrative purposes. They do not represent our preferred reform option.) The box below compares such alternatives to Model 2. It shows that on a risk-adjusted basis, Model 2 generally produces significantly lower combined benefits over the next 75 years – that is, it results in larger benefit reductions compared to the benefits scheduled under current law – than does an alternative with the same level of general revenue transfers. The reason for the generally larger benefit reductions under Model 2 than under the alternatives is that Model 2 would leave the Social Security system with more assets at the end of the 75-year period. Under Model 2, but not under the alternatives, the Social Security system would remain in balance after 2076.

Model 2 Compared To Two Alternatives That Achieve 75-year Balance With the Same Level of General Revenue Transfers

If the disabled are held harmless from the benefit reductions under Model 2 and all eligible workers participate in the individual accounts, this Model would entail general revenue transfers equal to 1.53 percent of payroll. One can compare the results of Model 2 to alternative baselines that have the same level of general revenue transfers as Model 2 and that reduce benefits to the degree necessary to eliminate the 75-year imbalance remaining in Social Security after these transfers are made. These alternatives are described for comparative purposes only.

Under the alternative baselines, the actuarial deficit remaining after the transfers would be 0.33 percent of payroll (the 1.86 percent of payroll deficit under the 2001 Trustees assumptions used to evaluate the Commission plans, minus the 1.53 percent of payroll in general revenue transfers). To make the alternatives as comparable as possible to Model 2, the alternatives also are assumed to include benefit expansions for widows and widowers with low benefits, and for low earners with long careers, that cost as much as the provisions in Model 2. The cost of these provisions is 0.21 percent of payroll, raising the actuarial deficit after these provisions are added to 0.54 percent of payroll.

The alternative baselines would reduce Social Security benefits enough to lower costs by 0.54 percent of payroll to achieve 75-year solvency. The alternatives differ in how they would phase in these benefit reductions. The first alternative baseline would phase in the required benefit reductions over the 75-year period in the same way as the traditional benefit reductions are phased in under Model 2.[34] The second alternative baseline would simply reduce benefits by the same percentage for all newly eligible retirees after 2008, rather than allowing that percentage to increase over time as under the other alternative. Since both alternatives achieve the same level of overall benefit reductions over the 75-year period, the first alternative involves smaller benefit reductions in the early years and larger reductions in

[34] To produce the same pattern of phasing in the benefit reductions as under Model 2, we simply scaled back the benefit reductions under Model 2's shift from wage indexing to price indexing to the degree necessary to produce benefit levels that generate savings equal to 0.54 percent of payroll over the next 75 years.

later years. Both alternatives maintain disability benefits (and benefits for current retirees and near retirees) at their levels under the current benefit formula. Our technical companion paper describes the calculations in more detail.

Appendix Table 6 compares the benefit reductions under these alternative baselines to the benefit reductions under Model 2 for different generations of medium-earning two-earner couples that claim benefits at age 65. As the table shows, such a couple retiring in 2032 would experience an 18.2 percent reduction in benefits under Model 2 if it did not participate in the individual accounts. If it did participate in the accounts, its expected combined benefits (adjusted for risk) would be 15.2 percent below scheduled benefit levels.[35] The first alternative baseline, by contrast, would require a 5.5 percent benefit reduction for such a couple. The second alternative would require a 5.9 percent benefit reduction. By 2075, Model 2 would involve a 40 percent reduction in expected combined benefits (adjusted for risk) for the couple if it participated in the individual accounts, whereas the alternatives would involve reductions of between 6 and 14 percent.

The reason for the generally larger expected benefit reductions under Model 2 than under the alternatives is that Model 2 would leave the Social Security system with more assets at the end of the 75-year period. Under Model 2, but not under the alternatives, the Social Security system would remain in balance after 2076.

IV. Conclusion

Models 2 and 3 involve substantial reductions in traditional Social Security benefits, coupled with subsidized individual accounts that would make Social Security's financial situation worse without substantial infusions of revenue from the rest of the budget (albeit less than would be needed to pay all of scheduled benefits under current law). Because the individual accounts exacerbate Social Security's financing deficit, large general revenue infusions are necessary for sustained periods to ensure long-term balance in Social Security, even though these models also include large reductions in Social Security benefits.

[35] As noted above, it is important to adjust for financial market risk in the individual accounts since the alternative plan would involve no such financial risk.

A claim of long-term balance that is heavily dependent on substantial, unspecified general revenue transfers, however, raises questions of credibility, especially when the Commission makes no recommendations regarding where to find the money to be transferred. Indeed, Congress could erase the long-term deficit in Social Security without any other changes simply by legislating that the Trust Fund would be able to draw upon general revenue as needed to finance scheduled benefits.[36] If no other budget changes were made, such legislation would raise serious questions about how the general revenue transfers could be financed when the need arrived, and in fact, in its Interim Report, the Commission underscored such questions when discussing – and disparaging – the idea of financing scheduled benefits by transferring funds from the rest of the budget.[37] These same questions apply to the Commission's proposals themselves. Given the current budget outlook, simply assuming the availability of such large transfers is highly problematic and could be regarded as fiscally reckless.

Furthermore, it must be regarded as a distinct possibility that these large assumed transfers would not fully materialize. To the extent that the amount of assumed funding did not become available, Social Security benefits might have to be reduced further (i.e., to a greater degree than the Commission already has proposed) as part of subsequent efforts to adapt the system to the level of available funds. In the absence of a major shift in the budget outlook, such a scenario seems a significant political risk. Introducing personal accounts that depend upon large transfers to Social Security without making room for such transfers in the rest of the budget could place the benefits of seniors at risk.

[36] Under the 2002 Social Security Trustees assumptions, such revenue infusions would not be needed until 2041.
[37] President's Commission to Strengthen Social Security, *Interim Report*, August 2001, pages 20-21.

Appendix Table 1: Combined Monthly Benefit Levels for Each Member of a Two-Earner Couple Claiming Benefits at Age 65 in 2052 under Model 3

In 2001 dollars	Low earner ($15,875 in 2002)	Medium earner ($35,277 in 2002)	High earner ($56,443 in 2002)
Scheduled benefit	$986	$1,628	$2,151
- Benefit reduction for all such beneficiaries	-$129	-$353	-$508
+ Annuity from individual account	$418	$930	$1,243
- Further Social Security benefit reduction for those selecting individual accounts (to repay Social Security partially for the funds shifted into individual accounts)	-$173	-$383	-$465
= *Total expected benefit*	$1,103	$1,821	$2,423
Percent change without the individual account (change from benefits scheduled under current law)	-13%	-22%	-24%
Percent change with the account (change from benefits scheduled under current law)	+12%	+12%	+13%
Percent change with the account but without the additional contributions by workers of one percent of their earnings (change from benefits scheduled under current law)	0%	-5%	-7%

Note: Based on intermediate assumptions from 2001 Trustees Report and assumed net return (after administrative costs and inflation) of 4.6 percent per year. Annuitization assumes actuarially fair, CPI-indexed joint-and-two-thirds-survivor annuities and the mortality projections from the 2001 Trustees Report.

Source: Memorandum from the Office of the Chief Actuary, pages 75-76, and authors' calculations.

Appendix Table 2: Combined Monthly Benefit Levels for Each Member of a Two-Earner Couple Claiming Benefits at Age 65 in 2075 under Model 3

In 2001 dollars	Low earner ($15,875 in 2002)	Medium earner ($35,277 in 2002)	High earner ($56,443 in 2002)
Scheduled benefit	*$1,231*	*$2,032*	*$2,685*
- Benefit reduction for all such beneficiaries	-$273	-$607	-$848
+ Annuity from individual account	$505	$1,123	$1,502
- Further Social Security benefit reduction for those selecting individual accounts (to repay Social Security partially for the funds shifted into individual accounts)	-$208	-$462	-$560
= Total expected benefit	*$1,255*	*$2,086*	*$2,779*
Percent change without the individual account (change from benefits scheduled under current law)	-22%	-30%	-32%
Percent change with the account (change from benefits scheduled under current law)	+2%	+3%	+4%
Percent change with the account but without the additional contributions by workers of one percent of their earnings (change from benefits scheduled under current law)	-9%	-12%	-15%

Note: Based on intermediate assumptions from 2001 Trustees Report and assumed net return (after administrative costs and inflation) of 4.6 percent per year. Annuitization assumes actuarially fair, CPI-indexed joint-and-two-thirds-survivor annuities and the mortality projections from the 2001 Trustees Report.

Source: Memorandum from the Office of the Chief Actuary, pages 75-76, and authors' calculations.

Appendix Table 3: Combined Monthly Benefit Levels for One-Earner Couples Claiming Benefits at Age 65 in 2075 under Model 2

In 2001 dollars	Low earner ($15,875 in 2002)	Medium earner ($35,277 in 2002)	High earner ($56,443 in 2002)
Scheduled benefit	$1,823	$3,009	$3,975
- Benefit reduction for all such beneficiaries	-$629	-$1,381	-$1,825
+ Annuity from individual account	$577	$989	$1,040
- Further Social Security benefit reduction for those selecting individual accounts (to repay Social Security partially for the funds shifted into individual accounts)	-$281	-$473	-$489
= *Total expected benefit*	$1,490	$2,144	$2,701
Percent change without the individual account (change from benefits scheduled under current law)	-35%	-46%	-46%
Percent change with the account (change from benefits scheduled under current law)	-18%	-29%	-32%

Appendix Table 4: Combined Monthly Benefit Levels for One-Earner Couples Claiming Benefits at Age 65 in 2075 under Model 3

In 2001 dollars	Low earner ($15,875 in 2002)	Medium earner ($35,277 in 2002)	High earner ($56,443 in 2002)
Scheduled benefit	$1,823	$3,009	$3,975
- Benefit reduction for all such beneficiaries	-$404	-$899	-$1,255
+ Annuity from individual account	$505	$1,123	$1,502
- Further Social Security benefit reduction for those selecting individual accounts (to repay Social Security partially for the funds shifted into individual accounts)	-$208	-$462	-$560
= *Total expected benefit*	$1,716	$2,771	$3,662
Percent change without the individual account (change from benefits scheduled under current law)	-22%	-30%	-32%
Percent change with the account (change from benefits scheduled under current law)	-6%	-8%	-8%

Note: Based on intermediate assumptions from 2001 Trustees Report and assumed net return (after administrative costs and inflation) of 4.6 percent per year. Annuitization assumes actuarially fair, CPI-indexed joint-and-two-thirds-survivor annuities and the mortality projections from the 2001 Trustees Report.

Source: Memorandum from the Office of the Chief Actuary, pages 78-79, and authors' calculations.

Appendix Table 5: Risk-Adjusted Combined Monthly Benefit Levels for Each Member of a Medium-Earning Two-Earner Couple Claiming Benefits at Age 65 in 2075

Model 2

In 2001 dollars	Base scenario (no risk adjustment)	*Low yield/Risk-adjusted returns*
Scheduled benefit	$2,032	$2,032
- Benefit reduction for all such beneficiaries	-$933	-$933
+ Annuity from individual account	$989	$600
- Further Social Security benefit reduction for those selecting individual accounts (to repay Social Security partially for the funds shifted into individual accounts)	-$473	-$473
= *Total expected benefit*	$1,615	$1,227
Change from benefits scheduled under current law	-21%	-40%

Model 3

In 2001 dollars	Base scenario (no risk adjustment)	*Low yield/Risk-adjusted returns*
Scheduled benefit	$2,032	$2,032
- Benefit reduction for all such beneficiaries	-$607	-$607
+ Annuity from individual account	$1,123	$692
- Further Social Security benefit reduction for those selecting individual accounts (to repay Social Security partially for the funds shifted into individual accounts)	-$462	-$462
= Total expected benefit	$2,086	$1,655
Change from benefits scheduled under current law	+3%	-19%

Notes: Based on intermediate assumptions from 2001 Trustees Report

Base scenario assumes net return (after administrative costs and inflation) of 4.6 percent per year. Annuitization assumes actuarially fair, CPI-indexed joint-and-two-thirds-survivor annuities and the mortality projections from the 2001 Trustees Report.

Low yield reflects the Treasury bond yield for all assets. In addition, annuitization interest rate is reduced by 30 basis points relative to Treasury bond yield.

Source: Memorandum from the Office of the Chief Actuary, pages 75-76, and authors' calculations.

Appendix Table 6: Benefit Reductions under Model 2 and Alternatives that Achieve 75-Year Balance With the Same Level of General Revenue Transfers as Model 2

Medium-earning two-earning couple retiring at age 65 in:	Model 2			Alternative 1: benefit reductions phased in as under Model 2	Alternative 2: same percentage reduction for all newly eligible retirees after 2008
	Traditional benefits	Expected combined benefits	Expected combined benefits on a risk-adjusted basis		
2012	-0.9%	0.0%	-0.5%	-0.3%	-5.9%
2022	-9.9%	-6.1%	-8.5%	-3.0%	-5.9%
2032	-18.2%	-8.3%	-15.2%	-5.5%	-5.9%
2042	-25.7%	-5.9%	-20.5%	-7.8%	-5.9%
2052	-32.5%	-6.3%	-26.1%	-9.9%	-5.9%
2075	-45.9%	-20.5%	-39.6%	-14.0%	-5.9%

Source: Memorandum from the Office of the Chief Actuary, and authors' calculations

Written Questions for Peter Orszag

Senator Kyl

1. In your testimony, you compare the Commission's benefit levels, not to today's levels, and not to the benefits actually payable by the current system, but to a "scheduled benefits" baseline that under current law could not be financed. If I understand correctly, your justification for doing this is that you were seeking to 'avoid confusion.' But I am concerned that a significant amount of confusion may have been created by your basis of comparison.

Political communications in a number of states are frightening seniors by alleging "benefit cuts" – not relative to your hypothetical baseline of comparison, but relative to today's levels, and citing your paper as the source for these figures. As you know, the Commission proposals do not change benefits for those now in retirement, nor do they reduce benefits below today's levels. What are you doing to ensure that your paper is not inappropriately cited in such a way in the future, and to stop such misleading tactics in your name?

In my analysis of the Commission's plans undertaken with Professor Peter Diamond of M.I.T., we clearly explain our justification for comparing benefits under the Commission models to those scheduled under the current benefit formula. The relevant section from the *Tax Notes* version of our paper is included as an appendix to this document. The justification does not depend solely on avoiding confusion; the scheduled benefit baseline is also fundamental, for example, because a reduction from scheduled benefits represents a reduction in the percentage of a worker's pre-retirement earnings that Social Security (or combined benefits from Social Security and individual accounts) will replace. I would refer you to the appendix for a complete description of our justification for comparing benefits to the scheduled benefit baseline.

It may, however, be worth noting that the Commission argues against using the scheduled benefit baseline for benefit comparisons because "confusion occasionally arises when comparisons are made between two different plans that employ different levels of tax revenue." As we describe in our analysis, the Commission's plans themselves involve substantial amounts of general revenue transfers, whereas the payable benefits baseline assumes no such transfers. Thus, the Commission's comparison of the benefits under its plans to the payable benefits baseline violates its own warning against comparing plans with different levels of assumed tax revenue. Indeed, if one wanted to compare benefits under the Commission's plans to a baseline with a similar level of assumed general revenue transfers, Models 2 and 3 would be more appropriately compared to the scheduled benefit baseline than the payable benefit baseline, because the general revenue transfers under Models 2 and 3 given full participation in the individual accounts are closer to the level of transfers required to finance scheduled benefits than to the lack of any general revenue transfers that the payable benefits baseline assumes. In any case, in our paper, we also provide comparisons of the benefits provided under Model 2 to alternative baselines with the same level of general revenue transfers as Model 2.

With regard to how the Diamond-Orszag paper has been characterized publicly, I am aware of several serious mischaracterizations of the paper's analysis and methodology, including from those who appear to support the Commission's plans. When I have been presented with evidence of mischaracterizations of the study and judged that there was a reasonable opportunity to correct the record, I have pursued and obtained appropriate corrections.

If you or your staff have specific evidence of mischaracterizations of the Diamond-Orszag study, I would very much appreciate your informing me of them so that Professor Diamond or I could pursue any appropriate clarification or remedy.

2. You criticized the Commission proposals but did not yourself offer a comprehensive proposal to attain permanent sustainability for Social Security that lacks the flaws you ascribe to the Commission proposals. What is your specific proposal to make Social Security permanently sustainable? Are you willing to provide such a proposal for analysis by the Social Security actuaries using standards as stringent as those applied to the Commission's proposals? In answering, please do not simply outline concepts but provide a specific program analogous to those put forward by the President's Commission. Do you believe that those who have not offered a superior program for making Social Security permanently sustainable are in a credible position to criticize the Commission's work?

To answer the final question first, I do not believe that the credibility of an analysis should depend on whether the author has proposed an alternative reform (or the details of that reform, should an author have proposed one). Rather, the credibility of the analysis should depend solely on the quality thereof, which the collective community of academics, analysts, and policy-makers can judge for itself. It may therefore be worth noting that the Comptroller General has referred to the Diamond-Orszag papers as "a highly professional piece of analysis" and the more technical version of our analysis has been published in a professionally peer-reviewed journal (*Contributions to Economic Analysis and Policy*, Volume 1, Issue 1, Article 10, 2002).

As you know, I have not put forward my own full proposal to address the long-term deficit in Social Security, nor do I think that doing so now would advance the cause of achieving Social Security reform. I have repeatedly emphasized, however, that restoring long-term balance to Social Security will require some combination of benefit adjustments and additional revenue. I also indicated at the hearing two provisions that warrant serious consideration as part of any reform plan: maintaining the estate tax and dedicating its revenue to Social Security; and updating the indexation of the Social Security system (along with other components of the budget) to conform to the new, more accurate price index (C-CPI-U) being produced by the Bureau of Labor Statistics. In addition, my colleague Henry Aaron and former CBO Director Robert Reischauer have provided an array of possible reform options that could address the rest of the long-term deficit in Social Security (see *Countdown to Reform,* The Century Foundation Press,

2001). In my opinion, the Aaron-Reischauer plan is a better approach to Social Security reform than any of the Commission plans.

Finally, I would agree that any proposal to address Social Security's long-term deficit should be evaluated by the Office of the Chief Actuary at the Social Security Administration, who should remain the final arbiter of whether such a plan succeeds in restoring long-term solvency to Social Security.

3. Your testimony criticizes the mix of revenue requirements and benefit levels in the Commission proposals. Please describe the mix of revenues and benefit levels that you believe are appropriate, and provide a specific proposal to achieve this.

Please see my response to Question 2 above.

4. In your testimony you imply that the Commission does not use a consistent baseline. But in your testimony as well as your paper you claim that Commission Models 2 and 3 would cause benefit reductions and require general revenue transfers. Relative to what consistent baseline is this true? In comparison with the scheduled benefits baseline, would these models cost revenue or save revenue? In your own testimony you say that the Commission proposals would reduce benefits relative to the scheduled benefit baseline and require additional revenue relative to the payable-benefits baseline. Have you proposed a detailed plan for sustainability for which this would not be the case? If no such plan can be offered, how is the decision-making process advanced by applying this unattainable standard to the Commission's proposals?

All of the comparisons for both benefit and financing results in my testimony and in the Diamond-Orszag papers (with the exception of the alternative baseline comparisons that adjust for the general revenue transfers in Model 2) are relative to the scheduled benefit baseline. Indeed, in my written testimony, the table on financing results (Table 3) explicitly compares the general revenue transfers under Commission Model 2 to those required under the scheduled benefit baseline. It is therefore not correct to assert that my testimony states that the Commission proposals would require additional revenue relative to the payable-benefits baseline. To be sure, my testimony and the Diamond-Orszag papers present the present value of general revenue transfers required under the Commission's models in both dollars and as a percent of payroll, but that does not imply a comparison to the payable benefits baseline, especially when a comparison is then made to the level of general revenue transfers required under the scheduled benefit baseline.

As my testimony notes, the Commission models would generally reduce benefits relative to the scheduled benefit baseline. As my testimony also notes, the models would also reduce general revenue transfers relative to the scheduled benefit baseline, but the general revenue transfers would remain too high to be fiscally responsible in the face of substantial projected budget deficits. Reform plans that rely on assumed general revenue transfers when the on-budget account is projected to be in significant deficit, even if those transfers are lower than under the scheduled benefit baseline, should identify a specific source for such transfers.

Thank you for the opportunity to answer these questions, and I look forward to working with you and others interested in Social Security reform to restore long-term balance to the system while maintaining its essential social insurance function.

Appendix: Excerpt from Peter R. Orszag and Peter A. Diamond, "Assessing the Plans Proposed by the President's Commission to Strengthen Social Security," *Tax Notes*, July 29, 2002

In describing proposed benefit changes to Social Security, the first step is to define an appropriate benchmark with which the proposed benefits can be compared. There are many possible benchmarks, and the choice of the benchmark affects how the nature of the proposed changes is communicated to, and understood by, the public.

One possible baseline is "scheduled benefits" – the benefits scheduled to be paid under the current Social Security benefit formula. As is well known, the projected cost of the scheduled benefits under current law exceeds the projected revenue available to Social Security. Nonetheless, comparing the proposed benefit levels and financing requirements to scheduled benefits is the clearest way of describing the proposed changes, since the workings of current law are readily understood and since this type of comparison is the standard method used to evaluate the effects of Social Security changes on Social Security benefits. For example, both the Greenspan Commission in the 1980s and the bipartisan, Congressionally chartered Advisory Council on Social Security in the 1990s employed this approach despite projected long-term deficits in Social Security at those times.

In addition, using scheduled benefits as the benchmark in evaluating proposed benefit changes is helpful because a reduction from scheduled benefits represents a reduction in the percentage of a worker's pre-retirement earnings that Social Security (or combined benefits from Social Security and individual accounts) will replace. The current Social Security benefit structure is designed to keep the percentage of a worker's pre-retirement earnings that Social Security replaces roughly constant over time; as a result, a reduction in scheduled benefits causes a reduction in the percentage of earnings that Social Security replaces. In debates over Social Security changes, it is critical to identify changes in the percentage of wages that retirement benefits would replace, since these "replacement rates" affect how people's standards of living are altered when they retire. Finally, no other reasonable standard of comparison is readily available for measuring changes in benefits.

For example, the Commission proposed an alternative baseline of "payable benefits." It defined this baseline as the benefits that could be financed by projected revenues under current law, assuming there would be no effort to address the long-term imbalance in Social Security until the Trust Fund was exhausted. It then assumes no provision of additional revenue to Social Security after the Trust Fund exhaustion date, so that benefits would be cut each year to equal available revenues.

There are two problems with this alternative baseline beyond its complexity. First, the payable benefit baseline is highly implausible politically. As Chairman Greenspan recently emphasized, a pattern of no action for nearly four decades followed by a closing of the imbalance that emerges when the Social Security Trust Fund is exhausted entirely

through sharp benefit cuts – which is what the "payable benefits" baseline assumes – simply will not be allowed to occur.

Second, the Commission argues against use of the "scheduled benefit" baseline because "confusion occasionally arises when comparisons are made between two different plans that employ different levels of tax revenue. For example, scheduled benefits for the current system could be provided only if significant tax increases are enacted. It is not an equal comparison to assume these tax revenues will materialize for the current system, but not for a specific personal account system." The problem here is that the Commission's plans themselves involve substantial amounts of general revenue transfers. The "payable benefits" baseline, by contrast, involves *no* general revenue transfers and assumes only the revenue available to Social Security under current law. Thus, the Commission's comparison of the benefits under its plans to the "payable benefits" baseline violates its own warning against comparing plans with different levels of assumed tax revenue. Indeed, if one wanted to compare the plans to a baseline with a similar level of assumed general revenue, Models 2 and 3 would be more appropriately compared to the "scheduled benefit" baseline than the "payable benefit" baseline, because the general revenue transfers under Models 2 and 3 are much closer to the level of transfers required to finance scheduled benefits than to the lack of any general revenue transfers that the "payable benefits" baseline assumes.

One possibility given the tradeoffs between the baselines would be to use more than one benchmark for evaluating the proposed benefit levels throughout the analysis. The Commission uses three baselines – the two just described as well as a baseline that simply reflects the benefit levels provided today, as adjusted for inflation in future years. The problem with simultaneous use of multiple baselines is that they are more likely to confuse than to illuminate the debate. By using a single baseline to evaluate all aspects of a reform plan, we assess <u>both</u> changes in benefit levels and the fiscal implications of the proposals relative to the same standard. This removes the temptation to use selectively one or another of multiple baselines, in order to make the proposals appear more or less attractive than comparisons to a single baseline would suggest.

In a boxed separate presentation below, we also compare Model 2 with two baselines that are constructed to have the same cost as Model 2. This helps consideration of both aspects of a retirement income system – how to allocate benefits for a given level of costs as well as the benefit implications of different levels of revenues.

Our use of the "scheduled benefits" baseline is not meant to imply that reforms to the current system are not necessary. To the contrary, some combination of a reduction in benefits and an increase in revenues is necessary to bring the system back into balance, even if there is an increase in the rate of return earned on the reserves of the Social Security Trust Fund. Since it is unlikely that a reform plan would restore long-term

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[1] For example, pages 19 through 23 of the Commission Report compare the proposed combined benefit levels under Models 1 through 3 to benefit levels for current retirees (not to scheduled benefits for future retirees) while comparing budgetary implications of the proposals to that with scheduled benefits (not benefit levels for current retirees).

solvency solely on the revenue side, restoring long-term balance to Social Security will likely involve some reduction in "replacement rates." The fundamental issue is whether the balance among the various potential elements of a reform plan is appropriate.

COMMUNICATIONS

STATEMENT OF LEANNE J. ABDNOR, BOULDER, CO

October 10, 2002

The Honorable Max Baucus, Chairman
The Honorable Charles Grassley, Ranking Republican
Committee on Finance
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senators Baucus and Grassley:

As a member of the President's Commission to Strengthen Social Security, I would like to thank you for holding a hearing in the Finance Committee on October 3, 2002, on the final report issued by the Commission. Other Commission members and I are appreciative that you extended an opportunity for one of the Commission members, Olivia Mitchell, to testify. In the interest of providing additional information to the Committee, I am enclosing a summary of the three reform models described in our final report. I would appreciate it if both this letter and the summary could be included in the hearing record.

The Commission's task was two-fold. First, President Bush instructed us to report recommendations that would **"restore fiscal soundness to Social Security."** As you know, this is a difficult and painstaking responsibility. There are <u>no</u> easy answers. We spent hundreds of hours discussing the options and the implications of each. We produced three models for reform that would restore the system to fiscal sustainability in varying degrees, and which cover the wide range of available choices for cost and benefit levels that faces the Congress.

The Commission was not constrained in the options we could explore to restore fiscal sustainability, excepting the President's prohibitions against raising payroll taxes, and against changing benefits for those now in or near retirement. We could have chosen to finance personal accounts either within the existing payroll tax structure, or to develop "add-on" accounts that were unrelated to Social Security's benefit or revenue structure. In the end, however, we repeated the conclusions of previous bipartisan commissions, in finding no responsible, equitable method of balancing traditional Social Security that did not include personal accounts <u>within</u> the existing system.

If you examine the independent report of the actuaries using the assumption of 0% participation in the personal accounts, you will see **confirmation that with all three recommended models, retirees would get a better deal with personal**

retirement accounts than without them. I stress this because the misimpression sometimes exists that advocates of personal accounts treat the accounts as a desirable end in themselves before addressing the system's financing. Though there are certainly many good reasons to desire personal accounts, it is also true that objectively exploring the available methods of attaining fiscal sustainability leads one inevitably to personal accounts. This is the path the Commission took, and I believe the Committee will reach the same conclusions if you analyze the actuaries' data.

I would also stress that because of our commitment to the financial welfare of our elderly, **two of the three models would make the system more progressive than it is today**. In other words, lower wage workers would get a better deal from these plans than they would if the existing program were fully funded! This reflects the Commission's finding that the program must better target its future resources on those most in need if it is to serve important anti-poverty goals while withstanding future fiscal strains.

The Commission's work is unique among recent examinations of Social Security. In addition to being bi-partisan, we subjected our work to a completely independent impartial analysis—the Social Security Chief Actuary—which was not subject to editing or any control by the Commission itself. We published the analysis of the Social Security Chief Actuary with our final report, in the interest of providing a full, open, and honest report to the public—nothing hidden. We believe that all responsible participants in this debate should be willing to subject their proposals to the same independent, external analysis by the Social Security Administration. I regret to say that none of the critics of the Commission's work who promised to provide us with their proposals have done so. My hope is that they will be more forthcoming to you when the Committee's deliberations begin.

Thank you again for your continuing interest in the well-being of today's elderly – and of the future elderly. Ultimately, the responsibility for reforming Social Security rests on your shoulders. I, like other members of the Commission, stand ready to be of service to the Committee in any way.

Sincerely,

Leanne J. Abdnor, Commissioner
President's Commission to Strengthen Social Security

Attachment

The Recommendations of the President's Commission to Strengthen Social Security: A Summary

Significance of the Commission
For the first time in history, a bipartisan Presidential Social Security Commission unanimously recommended that Social Security participants be given the opportunity to generate "a measure of wealth" through personal accounts, as described by Commission Co-Chairman Daniel Patrick Moynihan. Commission members included eight Republicans and eight Democrats; in addition to former Senator Moynihan, the group included two former Members of Congress (Democrat Tim Penny and Republican Bill Frenzel), a former Social Security Commissioner (Gwen King), a Social Security Public Trustee (Tom Saving), a former member of the Social Security Advisory Council (Fidel Vargas), and of the Social Security Council's Technical Panel (Olivia Mitchell) and several other acknowledged experts.

Unanimous Findings
The Commission issued several unanimous findings:
- Social Security can be strengthened by including voluntary personal accounts.
- Social Security should be extended to produce inheritable assets.
- Personal accounts in Social Security can enhance protections for widows, divorced persons, low-income households, and other Americans at risk of poverty in old age.
- Personal accounts in Social Security would permit workers to seek a higher rate of return on their Social Security contributions and would offer higher total expected benefits than can be paid under the current system.
- Personal accounts can reduce the long-term cost growth of the Social Security system, thus contributing to fiscal sustainability.
- Personal accounts can be administered in an efficient and cost effective manner.

The President's Principles for Social Security Reform
The Commission's recommendations follow the President's principles for Social Security reform:
- Modernization must not change Social Security benefits for retirees or near-retirees.
- The entire Social Security surplus must be dedicated to Social Security only.
- Social Security payroll taxes must not be increased.
- Government must not invest Social Security payroll taxes in the stock market.
- Modernization must preserve Social Security's disability and survivors components.
- Modernization must include individually controlled, voluntary personal retirement accounts, which will augment the Social Security safety net.

The Commission's Reform Models:
The Commission concluded that its proposed reforms would offer workers higher expected benefits than can be paid under the current system. The Commission's reform plans would achieve system solvency and help the most vulnerable. These goals can be achieved at much lower long-term cost than the tax increases of more than 50% required to maintain solvency while maintaining the current system's scheduled benefits.

Key Questions and Answers about the Commission's Proposals

1. Do the Commission's proposals cut benefits for those now in or near retirement?
No. There are no benefit cuts for current or near-retirees.

2. Do the Commission's proposals change the retirement age?
No. The proposals do not change the retirement age.

3. Do the Commission proposals include increases in the payroll tax?
No. The Commission's proposals do not raise payroll taxes.

4. Do the Commission's proposals reduce future benefits for anyone below the levels paid today?
No. After adjusting for inflation, with or without personal accounts, benefits under the Commission's proposals are higher than those received by today's retirees.

5. Would the Commission's proposals reduce COLAs?
No. The Commission's proposals do not change the system's annual Cost of Living Allowances that protect against inflation.

6. Why do some people claim that the Commission's proposed reforms would cut benefits?
Under the Commission's proposals, workers opting for personal accounts could expect higher benefits than are paid to today's retirees and higher benefits than the current system can afford to pay over the long term. Some charge that the Commission proposals would "cut" benefits by comparing to scheduled benefits that would ultimately be up to 50 percent higher than the current system can sustain, and by excluding the retirement income provided by personal accounts. Including accounts, all workers would receive substantially more than the current system can afford to pay, and low-wage workers would receive more than the current system even promises (but cannot pay.)

Specific Reform Plans
The Commission offered three models for reform that show a range of alternative strategies available to strengthen Social Security through personal accounts.

Under Model 1, workers would have the opportunity to invest a portion of their payroll taxes in a personal account (2% in the example scored by the Commission) to seek a higher rate of return than those contributions would otherwise buy from Social Security. Model 1's overall fiscal needs would be very similar to the current system (budgetary pressures would be reduced by 8% in terms of real dollars, increased by 4% if measured in net present value, relative to the cost of meeting the existing benefit schedule from the current system.) Despite leaving the fiscal picture largely unchanged, participants could expect higher benefits than under current law.

Model 2 would make Social Security solvent and permanently sustainable without reliance on permanent infusions of new revenues. Model 2 would permit individuals to invest up to 4% of their wages from their payroll taxes in a personal account, up to a maximum of $1,000 annually (indexed to national wage growth.) For those who remain in the traditional system, benefits

would grow at the rate affordable under the current system. Model 2 also incorporates new benefit increases above current law for low-wage workers and widows. All account holders under Model 2 would receive more than the current program can afford to pay, and low-wage workers would receive more than the current system promises. Overall, this model would reduce budgetary pressures by 68% in real dollars, and 46% in present value, relative to the cost of paying promised benefits from the current system.

Model 3 allows workers who contribute an additional one percent of their wages to a personal account, to receive a match of 2.5% of their wages from existing payroll taxes. Under Model 3, all account holders could expect higher retirement benefits than promised by the current program. Model 3 reduces budgetary pressures by 53% in real dollars, and 36% in present value, relative to the cost of maintaining the current system's benefit schedule. Like Model 2, Model 3 includes additional benefits for widows and lifetime low earners.

Key Progressivity Aspects

- Models 2 and 3 would boost widows' benefits for survivors of below-average earners. This benefit would be at least 75% of the combined benefit provided to both spouses based on their own earnings records, rather than 50-66% under the current program.
- The Commission specifically recommended that personal accounts be inheritable, benefiting low-income groups with shorter life expectancies, such as African American males.
- Models 2 and 3 would enhance benefits for low-wage earners, so that a 30-year minimum wage earner would be insured against retiring into poverty. For example, a low-wage account participant retiring in 2052 would expect benefits that are 78% higher than a low-wage worker now receives – higher than even a medium-wage worker receives today.[1]
- The Commission proposals also provide additional protections to women. Currently a woman who is divorced prior to ten years of marriage has no right to a benefit based on her husband's earnings. Many divorced women suffer poverty in old age as a result. With the Commission's personal account proposals, balances in the personal accounts would be the joint property of husband and wife, and earnings in the accounts during the marriage would be divided equally in event of divorce.

Fiscal Impact

Solvency: The Social Security's Office of the Chief Actuary has certified Models 2 and 3 as being fully actuarially sound for the full 75-year valuation period.[2]

Sustainability: Models 2 and 3 would make Social Security permanently sustainable beyond the 75-year valuation period. Model 2 would generate permanent cash surplus in the Social Security program before the end of the valuation period *without* annual reliance on ongoing general revenues.[3]

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[1] pp. 19-21, Final Report of the President's Commission to Strengthen Social Security
[2] January 31, 2002 Memorandum from SSA Office of the Chief Actuary to Commission, page 22
[3] ibid.

Reduced Revenue Requirements: The Commission models would *reduce* the need for on-budget revenues relative to the cost of paying scheduled benefits under the current system. Model 2 would reduce these costs by 68% in inflation-adjusted terms, and 46% in present-value terms.[4]

Transition Costs: Social Security's Office of the Chief Actuary estimates that transition costs for the two solvent Commission proposals were $900 billion in present value (Model 2) and $400 billion (Model 3.)[5] Of this, all but $400 billion (Model 2) or $100 billion (Model 3) can be fully financed by projected near-term Social Security cash surpluses.

[4] July 22, 2002 Memo from SSA Office of the Chief Actuary, available at www.csss.gov. Present-value assumes a 3% real discount rate, and is thus a lower bound on estimates of the savings under the Commission proposal, in that it assumes a worst-case scenario in which personal accounts are wholly debt-financed.
[5] Ibid. Assumes a 3% real discount rate.

Testimony

of

The Alliance for Retired Americans

on

The Final Report

Produced by the

President's Commission to Strengthen Social Security

Committee on Finance
United States Senate
Washington, D.C.

October 3, 2002

888 16th Street, N.W., Suite 520 ♦ Washington, D.C., 20006 ♦ (202) 974-8222 ♦ www.retiredamericans.org

Senator Baucus and members of the Finance Committee, the Alliance for Retired Americans thanks you for the opportunity to submit our statement for the record on the final report of President Bush's Commission to Strengthen Social Security.

The Alliance for Retired Americans is a national organization of over 2.7 million members that works to create an America that protects the health and economic security of seniors, rewards work, strengthens families and builds thriving communities.

As you know, Mr. Chairman, the Commission sets forth three alternative plans for creating individual investment accounts. Briefly, they are:

- Workers shift two percentage points of their Social Security tax into individual accounts;
- Workers shift four percentage points into individual accounts; and
- Workers put in one percent of pay in addition to current Social Security taxes, with a matching contribution up to $1,000 from the payroll tax.

The Commission report also suggests several alternative plans for reductions in future Social Security benefits; increasing benefits for low-income workers and surviving spouses; and using federal general revenues to cover costs of the Commission's plan not covered by benefits cuts.

In setting forth its rationale, the Commission claims that Social Security in its present form cannot pay promised future benefits and that the Commission plans "move forward" in making Social Security more financially sound. The Commission also asserts that current workers "can reasonably expect" the Commission plans to give them more retirement income than Social Security.

The truth is that the Commission has set up a straw man in the form of a future financial problem which even its own words about the future of the economy contradict: To support its argument for investment in the private market, the Commission co-chairs write "the modern market economy appears to have settled down to impressive long-term growth." Yet, that very same growth will mean that the current Social Security system will be able to pay future benefits.

The government's official Social Security projections showing insolvency by 2041 are based on an unrealistic assumption that the national economy will grow only half as much in the next 75 years as it did in the past 75 years. The Bush Administration's own federal budget projections assume a much higher rate of economic growth that, if applied to Social Security, would mean that it will be able to pay all promised future benefits.

Saying that their plans "move forward" financial solvency is an open admission that they do not achieve financial solvency. None of the Commission's alternative plans solves the financial problem that the Commission claims exists. The Commission calls for general revenue subsidies yet all surplus general revenues are being consumed by the tax cuts and the war on terrorism. There are no general revenues available for Social Security. In fact, the federal budget is currently in deficit.

None of the Commission plans provides any guarantee that current workers will get as much as they will get under Social Security. The claim that workers "can reasonably expect" to do as well with individual investment accounts is a classic case of smoke and mirrors. The truth is that current workers could do much worse under individual investment accounts than under Social Security. Benefits could be reduced by 40 percent or more. But, current Social Security benefits are guaranteed by law and protected against inflation. Individual investments, as many 401(k) investors are now painfully aware, are not guaranteed and are not protected against inflation.

The Commission has violated one of President Bush's own key principles: to preserve Social Security disability benefits. The Commission plans include cuts in disability benefits. In addition, the Commission plan to increase benefits for low-wage workers is a bait-and-switch trick. It offers small benefit increases for a few beneficiaries but at the same time drastically cuts benefits for the vast majority of beneficiaries.

Social Security's survivors benefits are far more advantageous to women than the Commission's private market could provide. The transfer of private accounts to survivors will result in lower guaranteed benefits. Provisions that allow a worker to "cash-out" a portion or all of the account balance leaves the survivor even more vulnerable.

The Commission reveals its true goal of cutting Social Security benefits in order to "reduce pressure on the remainder of the federal budget." The Commission is not trying to help America's working families; it is trying to shrink Social Security. The only winners under the Commission's plans are investment managers.

The Commission's report is a misleading, one-sided, incomplete presentation on a matter of supreme importance to America's 150 million working people, their families and 46 million Social Security beneficiaries. Instead of objectively presenting the pros and cons of its plans, the Commission has tried to sell its plans like used cars—exaggerating their advantages and saying nothing about their defects and dangers

In sum, the Commission plans would weaken Social Security and eventually destroy the system altogether. Calling it the Commission to "strengthen" Social Security was misleading. Truth in labeling would require it to be called the Commission to Replace Social Security.

Social Security should not be privatized, but should be strengthened and improved. The Alliance for Retired Americans demands that the development of any plan that would divert Social Security revenues into individual accounts subject to investment and market risks should cease immediately. The Alliance hopes that after today's hearing, the Finance Committee and the entire Congress will not give any further attention to this shameful attempt to jeopardize the income security of America's workers and retirees.

Statement for the Record

of the

American Federation of State, County and Municipal Employees (AFSCME)

Submitted to The Senate Committee on Finance

Regarding The President's Commission to Strengthen Social Security

October 8, 2002

On behalf of the 1.3 million members of the American Federation of State, County and Municipal Employees (AFSCME), I thank you for the opportunity to submit a statement for the record regarding the Final Report of the President's Commission to Strengthen Social Security.

After almost a year of study, hearings, and deliberations *The President's Commission to Strengthen Social Security* completed its work by recommending three privatization options. An analysis of these options clearly shows that the commission's privatization recommendations, even partial privatization, would not offer the same level of financial security that workers are guaranteed under the present system nor improve the long term solvency of the program. Any privatization of Social Security fails for many reasons:

- The Commission's Option 1 does nothing to restore long term solvency to the Social Security program. The Commission's Option 2 and Option 3 address solvency of the Social Security program but only by making massive reductions in the current level of guaranteed benefits and requiring a combination of huge general revenue transfers from other federal budget program areas, large tax increases and long term deficit spending.

- Diverting a portion of Social Security revenue into individual accounts, which all of the Commission's options rely on will result in less revenue for Social Security itself, resulting in benefit cuts to all three basic Social Security programs – retirement, disability, and survivorship. All three options would result in cutting guaranteed benefits by as much as 43 percent for those retiring in 2075.

- The large benefit cuts required by the Commission's options would not be offset by higher returns from individual accounts. And, if the stock market were to be in a steep decline at the time of retirement, as it has been over the past three years, workers would see especially large declines in their accounts and hence a reduction in overall benefit levels. Henry Arron of the Brookings Institute has projected that the accumulated savings in the individual accounts will on average cover only one-third to one-half of the loss in benefits.

- Under one of the Commission's options, workers would also face a higher retirement age as well as benefit cuts.

- Privatization cannot be considered voluntary because it would affect every beneficiary - retirees, the disabled and survivors of beneficiaries. Every Social Security recipient would receive dramatically reduced benefits including those who do not elect to open a private investment account because the payroll tax funds flowing into the trust fund will diminish as a result of the transition and continuing costs of establishing private accounts for some.

- Each of the privatization proposals would require potentially massive infusions of tax dollars to implement over an indefinite period. Moving from the current system of guaranteed benefits to even a partially privatized plan would incur massive transition costs that could raise the unified budget deficit by $1.2 trillion to $1.5 trillion from 2003-2012.

In summary, the establishment of private accounts under the Commission proposals would make no contribution to restoring the Social Security solvency. On the contrary, the private accounts themselves would worsen Social Security's fund balance over the next 75 years. The private accounts would have a negative impact on Social Security's financial condition on a permanent basis and not just during a transition period. As Peter Diamond of M.I.T. and Peter Orszag of Brookings have shown in their analysis of the Commission's proposals, Option 2 would require general revenue transfers that would be two-thirds as large as the entire Social Security shortfall over the next 75 years and under Option 3, the shortfall would be three-fifths as large as the entire Social Security shortfall. Option 1 does not restore long-term balance to Social Security at all.

The Commission's recommendations prove that the proposal to privatize Social Security is a bankrupt policy and should be rejected. The debate on the future of Social Security should be resumed with a discussion on how to strengthen the existing program for the next 75 years without privatization or benefit cuts or an increase in the retirement age.

Economic Opportunity Institute

October 3, 2002

Written Statement for the United States Senate, Committee on Finance Hearing on the Final Report of the President's Commission to Strengthen Social Security, October 3, 2002

by Marilyn P. Watkins, Ph.D., Policy Director,
Economic Opportunity Institute, Seattle, Washington

The final report issued by the President's Commission to Strengthen Social Security presents a highly distorted picture of Social Security's purpose and long-term financial viability. The current system is easily sustainable for coming generations with at most minor tweaking. The alternatives the Commission proposes for transforming Social Security into a partially privatized system would fundamentally undermine the economic security of all Americans, increase poverty, and leave our children and grandchildren to face a bleak future.

As a social insurance system, Social Security protects all Americans when disaster strikes an individual family, when an economic downturn affects large numbers, and through old age – no matter how long or how short that may be. I have learned first hand how important this program is. In March of 1997, my husband died suddenly from a heart attack. Our two sons were 9 and 11 years old at the time, and I worked in a part-time job with no benefits or job security. Because of Social Security, our family tragedy was not compounded by a sudden plunge into financial crisis. We were able to stay in our house and our neighborhood, and I could feed and clothe my children while I looked for a better job. Even now, Social Security continues to provide the additional income we need to cover expenses in a household with two teenagers.

It was not predictable that this situation would happen to my children and me, although it is fully predictable that 17% of workers will die before reaching retirement age, many of them leaving behind young families who depended on their income.[1]

My grandmother is 95 years old. Since the death of my grandfather over 30 years ago, Social Security has provided over 90% of her income. It has allowed her to live independently and in modest comfort. My grandmother has outlived all of her 9 brothers and sisters and their spouses. It was not predictable that *she* would be the one out of her generation to live to 95, although we can predict that 17.5% of men and 31.4% of women who reach age 65 will live past 90 and need a means of economic support well past average life expectancy.[2]

My parents are 71 years old and had been living comfortably in retirement with their combination of income from Social Security and retirement savings. Last month, with their long term financial outlook increasingly uncertain, my father went back to work. Fortunately, he is still in excellent health and in a profession where jobs appropriate to his situation are available, and in the long run, he and my mother can count on their Social Security income not diminishing. My parents had no way of predicting that a stock market crash would happen in the early years of *their* retirement, although we know well that economic downturns happen periodically and will continue to happen, significantly reducing the assets of whole cohorts in our population.

In every one of the cases from my family, Social Security's progressive benefits and the fact that the system is structured as social insurance rather than as individual investments have proven essential for maintaining the family unit's economic security. No program in our country has been more effective at building and sustaining the American middle class. Fewer than 10% of our seniors now live in poverty, and millions of children and younger adults also benefit. Any reform that weakens rather than strengthens the social insurance protections of Social Security would threaten the financial stability of America's current and future workers.

Is Social Security Sustainable? - Yes

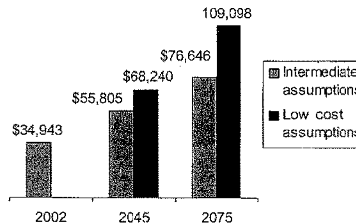
Although the Annual Reports of the Social Security Trustees have been widely interpreted to show that Social Security will "go broke" in about four decades, a closer reading confirms that our nation's premier poverty fighting program is in excellent financial health.

The trustees' intermediate forecasts are based on exceptionally gloomy assumptions of very slow long term economic growth. Over the entire course of the 20th century, and in every decade since the 1940s, our economy grew at an average rate of over 3% each year. In their intermediate forecast, the trustees assume that average annual economic growth will slow to 1.8% by 2015, and fall even further in future decades. Even under this grim scenario, Social Security remains fully funded until 2041 and has the income to pay three quarters of promised benefits after that.

The low cost projections assume a cautious but more realistic long term growth rate averaging 2.5%. Under this scenario, not only are promised benefits always fully funded, but the trust fund is actually increasing in 2075.[3]

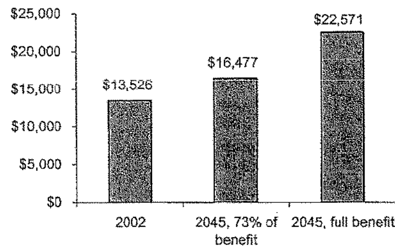
Even with slower economic growth, the trustees still predict that both workers and Social Security recipients will have higher incomes in the future. Although it is true that the aging of the baby boom generation and lengthening life spans will result in a larger elderly population and fewer workers per retiree, future workers will produce more than today's workers, and will also earn more after inflation. Today's average wage is about $35,000. In their intermediate forecast, the trustees project average wages controlled for inflation to reach $56,000 by 2045, and nearly $77,000 by 2075. The low cost projection has wages growing even more, to $68,000 by 2045 and over $100,000 in 2075.[4]

Projected Future Average Wages, in 2002 Dollars
from 2002 Social Security Trustees' Annual Report



As wages rise, so do Social Security benefits. In the highly unlikely event that the pessimistic economic projections of the intermediate scenario came to pass, and Congress and American voters in 2041 chose to cut Social Security benefits rather than modestly increase payroll taxes on their much higher earnings, retirees at that time would still receive benefits worth more than today's typical benefit.

Projected Average Benefits of Intermediate Scenario, in 2002 Dollars



In the event that economic growth is as low as the trustees' intermediate forecast during the 2010s and 2020s, there will be ample time to consider modest adjustments to the benefit formula and/or to the funding stream. Alternatives for increasing funding include eliminating the cap on taxable income, collecting income tax on the full Social Security benefit of higher income recipients, and boosting the base payroll tax.

The Commission's Proposals for Private Accounts

The alternatives for private accounts that the Commission proposes would result in significant reductions in guaranteed benefits for all future Social Security recipients. These proposals would **guarantee** that millions more elderly and disabled workers, and hundreds of thousands more children would live in poverty in future generations.

While the Commissioners claim that on average, workers would be able to do about as well or slightly better with a lower guaranteed benefit plus returns on their private accounts, many Americans would fare worse. Workers who lost time in the workforce due to family care, disability, or unemployment, or who earned persistently low incomes would not be able to accumulate enough to make up for the loss in guaranteed, progressive benefits. Workers who died prematurely leaving young families would never have a chance to accumulate enough to make up for the slashing in survivors benefits that is implicit in the Commission's calculations. Workers who happened to experience prolonged economic downturns in the last years of their working lives would see major losses in their private accounts, and would consequently face retirement with far lower incomes than today's seniors. And seniors who lived beyond the expected lifespan could spend their last decades in poverty and uncertainty.

We cannot afford for so many Americans to face reduced incomes in retirement. Even with Social Security's guarantees and progressive benefit structure, too many seniors live in or near poverty. Social Security has been successful in reducing poverty among seniors to below

10%, but another nearly 15% live between 100% and 150% of poverty. Poverty and near-poverty rates are twice as high for single women and seniors of color.[5]

Building Assets

The President's Commission rightly notes that lower income Americans are rarely able to build assets, and that public policy should provide more asset-building opportunities for low and moderate income workers. However, the Commission is entirely wrong in faulting Social Security for this lack of assets and in concluding that our nation's most successful poverty fighting program should therefore be completely restructured.

Policies that *would* result in significant asset accumulation among lower and moderate income workers are:

1. Raising the federal minimum wage in increments to $7.50 an hour and then indexing it to inflation, so that full-time work pays more than the bare minimum for survival.
2. Providing essential worker supports such as universal health insurance and paid family leave, so that workers don't see their savings periodically wiped out.
3. Providing a mechanism for universal retirement savings at the state or federal level **in addition to** rather than carved out from Social Security, so that the 50% of workers with no work place based retirement plan have income in addition to Social Security in their old age.

Unfortunately, only about half of workers currently have any kind of work-based pension or retirement savings plan. Enabling all workers to build up savings and retirement accounts during their working lives **to supplement** the guaranteed foundation provided by Social Security would greatly add to Americans' long term financial security. In order to maximize returns and minimize loss of earnings to fees, these accounts should be centrally administered, along the lines of proposals for universal pension access currently being developed in some states.[6]

Such accounts must be *in addition* to Social Security and not carved out of Social Security's guaranteed base for the following reasons:

- Social Security recognizes that all who work contribute to our national prosperity. It guarantees that everyone who plays by the rules will have enough to live independently and in dignity, through progressive benefits, annual COLAs, family benefits, and lifetime retirement benefits. In contrast, with individual investments the more you earn, the more you are likely to accumulate. People who suffer early disability, spend time caring for children, earn low wages, live extraordinarily long, or have larger families will be worse off with private accounts.

- Women, who typically earn less, live longer, and take more time out of the workforce to care for family, and African Americans and other minorities, who often earn less and are more likely to suffer early disability, are especially likely to fare worse under a system of private accounts than with Social Security.

- Recent trends make it even more important to keep Social Security structured as a social insurance program. Longer life spans, fewer children per family, and a high divorce rate mean we will have more very elderly people who rely entirely on Social

Security in the future. Half the workforce continues to have no work-based retirement plan. Most workers who do have retirement plans now have programs like 401(k)s, making their retirement income already highly dependent on the ups and downs of the stock market. The stable base of Social Security's guaranteed, inflation-adjusted benefit will be all the more crucial in the future.

- The transition from the current pay-as-you-go system to even a partially privatized system would cost billions, or even trillions, of dollars in new funding.

- If the pessimistic economic forecasts of the trustees prove accurate, returns on investments will be much lower in the future than in the past. Even if our economy prospers, many economists believe that because stocks today are valued at much higher levels than in the past, historical rates of return are unlikely to be realized in the future.[7]

Conclusion

Social Security is highly successful because it is social insurance. Replacing a proven, highly successful, and securely funded program with an untried, highly speculative program that will certainly result in higher poverty rates among the elderly, disabled workers, and children would be extremely poor public policy. By protecting the young and old, the lucky and unlucky, the high earners and low earners, Social Security helps keep individual families, their communities and our whole society prosperous.

Social Security has the resources to continue successfully. Rather than focusing on unlikely problems far in the future, we should be focusing on the modest reforms that would make Social Security work even better today. We can achieve the goal of eliminating poverty and near poverty among elderly Social Security recipients by assuring that all workers have the opportunity to save for retirement in addition to Social Security, making the benefit formula even more progressive, increasing the benefit for elderly survivors to 75% of the couple's combined benefit, and providing for a family care-taking credit. As Americans today it is our duty to maintain and enhance, not dismantle, this valuable heritage.

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[1] Social Security Administration, "Social Security Is Important to Young People," 2000, www.ssa.gov/pressoffice/youngfact.htm. The Social Security Administration estimates that 97% of workers aged 20-49 have met the requirements for their children under 18 to collect survivors benefits in the event of the parent's death. SSA, "Fact Sheet," December 31, 2000.
[2] Jack VanDerhei and Craig Copeland," The Changing Face of Private Retirement Plans," Employee Benefit Research Institute Issue Brief Number 232, April 2001, p. 18.
[3] 2002 Annual Report of the Social Security Trustees, p. 96-97.
[4] Projected benefits for the intermediate assumptions are given in Table VI.E11, p. 179 of the 2002 Annual Report. Benefits for the low cost assumptions are calculated from the average wage index in Table VI.E7, p. 169 (column 2 divided by column 1, multiplied by percent of earnings from Table VI.E11).
[5] U.S. Census Bureau, "Poverty in the United States, 1999," September, 2000, Table 2, p. 2-5.
[6] See Marilyn P. Watkins, "Washington Voluntary Accounts: A Proposal for Universal Pension Access," June 2001, Economic Opportunity Institute, www.eoionline.org.
[7] Peter Diamond, "What Stock Market Returns to Expect for the Future?" Center for Retirement Research at Boston College, September 1999, p. 10; Paul Krugman, "Unhappy Returns?" *New York Times*, May 17, 2000; Dean Baker and Mark Weisbrot, "CEPR Challenges Privatization Advocates on Projected Stock Returns," January 22, 1999, http://www.cepr.net/Social_Security/pr1.htm.

Testimony
For the Senate Finance Committee Hearing
On October 3, 2002
Regarding the Social Security Commissions' Options for Privatization
and
NOW Foundation's Recommendations for Strengthening Social Security to Benefit Women and Low Income Earners

Presented by the NOW Foundation,
Kim A. Gandy, President
733 15th St. NW,
Washington, D.C. 20005
(202) 628-8669

Thank you for the opportunity to submit our views on the presidential commission's recommendations for private investment accounts under Social Security. My name is Kim Gandy and I am president of the NOW Foundation, the research and public education arm of the National Organization for Women, which is the oldest and largest feminist activist organization in the United States. For the past five years, we have actively participated in the national dialogue concerning the future of Social Security -- especially as it pertains to the retirement security of women and lifetime low income earners. In addition to commenting on the presidential commission's recommended options, we would also like to present a set of proposals to make minor adjustments with Social Security that would alleviate many of the inequities the current system imposes on women.

The President's Commission to Strengthen Social Security, along with subsequent evaluations and hearings on the commission's recommendations, leave us with many concerns about how older women will fare under a system that involves, at least partially, private investment accounts. Among the most prominent are questions concerning the predictability of the stock market, funding sources for a transition to private accounts and deep benefit cuts.

The costs and risks associated with each of the three commission options threaten the retirement security of all workers and their survivors -- whether or not they choose to withdraw from Social Security. Each of these options, if

implemented, would hurt the financial well-being of the majority of older women, especially disadvantaging those who tend to be the poorest elderly: divorced, never married, disabled and very elderly women. The changes would, at the same time, undermine the future stability of the current system, affecting workers and their dependents who have chosen to stay with Social Security.

It is not enough for the commission to pay lip service to the inequities faced by women because of their lower lifetime earnings and years spent out of the workforce providing unpaid care-giving while proposing a tepid and contradictory solution. The commission's proposal slightly increases benefits for surviving spouses -- but that modest improvement is negated by lower replacement rates that would reduce benefits as a whole. With two-thirds of women over age 65 depending on Social Security for at least half their income and the remaining third deriving 90 percent of their income from Social Security, projected benefit cuts of up to 43% are wholly unacceptable.

As previous speakers at this hearing have indicated, the commission's options would require transition costs of up to $1.5 trillion, which if financed from general revenues would drain the U.S. treasury of funds needed for other social investments and strain federal budgets over the next decade and beyond. This financing requirement would profoundly limit our nation's ability to contend with a continuing or worsening economic downturn and to meet any future national security crisis such as we experienced after the September 11th attacks.

Given the extensive discussion around long term solvency needs to pay future generations of Social Security beneficiaries, it is remarkable that the administration prevented the commission from even considering a raise in payroll tax rates. NOW Foundation believes that increasing revenues through moderate increases in the payroll tax, raising or removing the ceiling on the amount of income that can be taxed and collectively investing an increased portion of the Trust Fund in securities must be a prominent feature of our national dialogue.

The either-or choice between privatizing or preserving Social Security is a false one and it is unfortunate that opponents of social insurance have been able to cast the debate in such narrow terms. There is a wide range of possibilities for strengthening Social Security through measures that would diminish the long range solvency problem for many decades. At the same time, the features of the current system that harm women must be revised. We believe that this important national discussion in identifying and evaluating all options must be

conducted and are looking to Congress for leadership in advancing solutions that would make the system fairer for women.

Changed social and economic conditions -- such as increased life span, shorter average duration of marriage, increased divorce rates, and increased labor participation by women -- necessitate changes in our system of social insurance. Women age 65 and over live in poverty at a rate two times the rate of men of the same age. Boston College Professor Alicia Munnell attributes this fact to two gender-related trends: the longer life span and lower earning capacity of women. These trends make it more important than ever to correct the current structure so that it eases, rather than worsens the financial vulnerability of women. NOW Foundation, in conjunction with the National Council of Women's Organizations -- an umbrella organization of 160 major women's organizations representing more than 7 million members -- have developed a series of recommendations for improving and strengthening our system of social insurance.

Widows - We propose that the widow's benefit be increased to 75% of the couple's joint benefit, capped at the maximum earner's benefit, and assuring that widows are not penalized by their husband's decision to retire early. According to the Social Security Administration, ninety times more women than men are dependent on a spouse's or ex-spouse's earnings for Social Security retirement benefits.

Disabled Widows and Divorced Disabled Spouses - We propose an increase in benefits for both disabled widows and divorced disabled spouses to 100 percent of the worker's benefit. It is also important that there be a removal of the seven-year limitation on benefit eligibility and the age 50 provision on disabled widows and make divorced disabled spouses eligible on the same basis as widows. These changes would effectively counteract the dependence on spouses and nullify the age, disability, and marriage restrictions for these subgroups.

Divorced Women - The current requirement of ten years of marriage for 50 percent of the ex-husband's benefits is outdated. In light of the cost of maintaining a separate household, as well as the national average of seven years of marriage, we suggest altering the current system in two ways. First, increase the ex-spouse benefits from 50 percent to 75 percent. Upon the beneficiary's death, the ex-spouse would qualify for the full widow benefit of 100 percent. Second, allow ex-spouses to meet the ten-year marriage requirement by combining a new seven year marriage length minimum with work history. Compensating for the average marriage length of seven years contemporizes current

policy while improving its applicability to women.

Low Earners - The next group of proposals focuses on ameliorating the condition of low-wage earners in their retirement years -- the majority of whom are women. We recommend the following changes: establish a 100 percent replacement rate below the first bendpoint; then a 45 percent replacement rate between $6,060 to $9,600, phased out with a 15 percent replacement between $9,6000 and $15,871. Additionally, we recommend a revision of the current Special Minimum to lower earnings required to 50 percent of minimum-wage earnings for full-time, year-round work.

Family Service Credit - Numerous child rearing years taken out of the paid workforce by women exact a penalty for many under the current Social Security system. Care-giving in our society is primarily provided by women and partially accounts for women remaining in low-wage jobs when they return to the paid workforce. A method for improving retirement benefits for low-wage earners and single parents involves recognizing and valuing the unpaid care of dependent children. A "Family Service Credit", totalling $5,000 per year, would go to the account of the lower-earning parent or spouse. The credit, which applies only to the years leading up to a child's sixth birthday, could be combined with a Special Minimum (for example, 50 percent minimum wage earnings in 1999, then indexing in future years). The combination would allow for a maximum of ten years of care, plus two additional "drop-out years" per child in order to acquire the related benefits. The proposed Special Minimum formula would particularly aid those who divide their time between low-paying work and caretaking responsibilities. The importance of this proposal lies in its usefulness to divorced and single mothers whose marriages do not meet the minimum length for spousal benefits. Extended care-giving by women in later years for ill or elderly parents or spouses that requires their leaving the paid workforce should also be addressed in the same manner.

Through these proposals, Social Security could become more effective and efficient, appealing to the real-world needs of its beneficiaries -- the majority of whom are women. Increased costs for funding the improved benefits we suggest can be met through a combination of a modest increase in the payroll tax rate (a total of 1.8 percentage points) in 2020, an adjustment of the maximum wage base by making all earnings subject to the payroll tax and crediting them for benefit calculations and an investment of a larger proportion (40 percent) of the Social Security Trust Fund in securities. These same adjustments have the potential for substantially resolving Social Security's long-range solvency dilemma.

In conclusion, NOW Foundation believes that any move from the current system of social insurance which has lifted so many older women out of dire poverty to one that relies, if only in part and voluntarily, on private investment accounts presents unacceptable risks for women. As privatization of the system would surely mean benefit cuts and extensive transition costs that the public would have to bear, women would be disproportionately disadvantaged.

Changing socio-economic conditions require an alteration in the both the benefit structure and revenue sources of Social Security. Adjustments to diminish or remove inequities in the treatment of women are long overdue and should not be marginalized. Social Security carries with it the future well-being of millions of women and their families and, as such, any proposed policy changes are of great importance. We must prevent large-scale benefit cuts and work for improvements in the treatment of all beneficiaries. We urge Congress to guard against benefit cuts, to remove inequities that harm women and to undertake adjustments in financing the system that adequately fund these changes as well as address long range solvency needs.

Congress of the United States
Washington, DC 20515

October 28, 2002

The Honorable Max Baucus
Chairman, Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Baucus:

We would like to bring to your attention the enclosed testimony we have submitted for the record of the October 3, 2002 Senate Finance Committee hearing on "The Final Report Produced by the President's Commission to Strengthen Social Security". We applaud you and Senator Grassley for your leadership on this issue.

As cochairmen of the House Public Pension Reform Caucus, we have been working for many years with our colleagues on both sides of the aisle to encourage fiscally responsible Social Security reform. It is clear that many in the House understand and acknowledge the fiscal and demographic pressures facing the Social Security system and are willing to engage in a constructive dialogue on reform. However, other Members don't want to accept the need for reform and are concerned about the politics swirling around the debate. We are confident that only through strong leadership by the President, and our leaders in the House and Senate, will we be able to strengthen Social Security for younger workers and future generations.

In this often murky debate, one thing is clear -- the long-term financial outlook of the Social Security system is deteriorating rapidly. Absent structural reforms, it will impose an increasing financial burden on today's workers and future retirees. The changes that need to be made require sacrifices; however, small adjustments to the program now will limit the painful reductions in benefits or substantial tax increases necessary in the future. The longer we wait, the harder the choices become and that is why we continue to urge our colleagues to engage in an honest and substantive debate today in preparation for the advancement of Social Security reform legislation early next year.

Our ability to engage in a responsible debate and enact meaningful reforms will leave an indelible imprint on future generations. That is why bipartisanship must lay at the heart of our efforts. Legitimate differences over the solution for the looming Social Security train wreck exist, and those differences should be fully explored. But if we rely on simplistic pledges of "no personal accounts", "no tax increases", "no changes to benefit levels", we will never reach the bipartisan consensus necessary to achieve a solvent and sustainable Social Security system.

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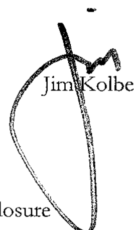
Reaching an agreement on the long-term challenges facing Social Security will be difficult under the challenging circumstances our country now faces, but the difficulty of our task must not prevent us from confronting it. We look forward to working with you next year to modernize the Social Security system.

Sincerely,



Jim Kolbe

Charlie Stenholm

Enclosure

Statement for the Record
Reps. Jim Kolbe (R-AZ) & Charlie Stenholm (D-TX)

Senate Finance Committee
Hearing on:
"Final Report Produced by the President's Commission to Strengthen Social Security"

October 3, 2002

As Members who have dedicated ourselves to ensuring the solvency and sustainability of Social Security, we are increasingly concerned about the white-hot rhetoric surrounding the Social Security reform debate. By embracing reform and appointing a bipartisan Commission to Strengthen Social Security, President Bush provided us with a historic opportunity to overhaul the Social Security system – an opportunity that should not be brushed aside by partisan bickering. We commend the Senate Finance Committee for holding this hearing and we urge policymakers to focus on the fundamental problems plaguing the Social Security system in an objective manner.

Unfortunately, any discussion of the very serious challenges facing Social Security has been buried by the villain in the partisan bickering over Social Security – personal retirement accounts – an idea misleadingly referred to as "privatization." By framing the Social Security debate in terms of whether or not a candidate favors "privatization", the media allows candidates to avoid a serious discussion of the very serious fiscal issues facing Social Security. Bickering ceaselessly about the definition of "privatization" obscures the fact that the status quo in Social Security is unsustainable.

Looming Financial Deficits:

Social Security's long-term financial outlook is deteriorating rapidly. Absent reform, it will impose a substantial financial burden on younger workers and cripple our ability to tackle other priorities. Social Security's bleak outlook is not in dispute. According to the most recent projections of the nonpartisan Social Security Trustees, Social Security will begin to pay out more in benefits than it collects in payroll taxes in 2017. For the first time, the system will run cash deficits. Between 2017-2041, the Federal government (read: American taxpayer) will have to come up with almost $4 trillion to redeem the assets in the Social Security trust funds. By 2041, the system will be insolvent and that generation's retirees (read: today's young workers) will not receive their full benefits on time. In total, we have promised to pay almost $24 trillion more in benefits than we have promised to pay into the fund.

The task of reforming Social Security has become more difficult as fewer additional resources are available to help fund some of the transition costs. However, the need to contain Social Security's unfunded liabilities and pressures on the non-Social Security budget have become even more pressing. The events of September 11 have placed an enormous strain on the budget and have highlighted why we must not allow Social Security to consume a larger and larger portion of the federal budget. If future Congresses are faced with an emergency similar to the one we face now and we have failed to enact Social Security reform, they will find it incredibly difficult to finance additional security measures.

The President's Commission to Strengthen Social Security:

The President's Commission to Strengthen Social Security is to be praised for addressing the financial deficits facing the Social Security system in a responsible and forthright manner. The report presented three alternatives for improving the fiscal sustainability of the Social Security system, and it subjected all three plans to a thorough actuarial and budgetary analysis. All of the alternatives presented by the Commission would improve the financial status of the Social Security system, and two of the alternatives will restore solvency as measured by the actuaries of the Social Security Administration. Furthermore, the analysis of each alternative found that the personal account option would improve the financial outlook of the Social Security system and offer a better deal for retirees.

Opponents of the models proposed by the Commission have repeatedly asserted that placing a portion of payroll taxes into personal accounts will make the problems facing Social Security worse and require deeper reductions in benefits. However, this statement is misleading at best. One can examine what the Commission plans would look like if the Commission had decided to reject personal accounts by looking at the analysis of the plans assuming 0% participation in personal accounts. Tough choices are still necessary and retirement income will be lower.

Similarly, H.R. 3315 introduced by Rep. DeFazio (D-OR) shows the impact of Social Security reform without personal accounts in an honest and forthright manner. In the DeFazio plan, Social Security solvency is restored through a substantial increase in payroll taxes, government directed investment of the trust funds, and modest changes in the benefit formula. A candid examination of the facts demonstrates that a plan with personal accounts would result in a smaller reduction in retirement income and fewer adjustments to the tax rate than a plan that restores solvency without personal accounts.

The benefit analysis presented by the Commission is consistent with the conclusion of a study by the non-partisan Congressional Research Service. CRS concluded that: "Given adequate time to grow…the value of the accounts would substantially offset or exceed the benefit reductions that would occur under a number of the larger Social Security constraints that might be used to restore the system's solvency."

Building a Level Playing Field for Benefit Analysis:

In a report released in June, economists Peter Diamond of MIT and Peter Orszag of the Brookings Institution argued that the current Social Security program could offer higher benefits than personal account-based proposals made by the President's Commission to Strengthen Social Security if the current system were provided with the same injections of general tax revenue transfers. However, this analysis had several shortcomings.

First, unlike the Commission reform models, the alternative baseline did not restore Social Security to a position of sustainable solvency (defined as having a stable and growing trust fund ratio and the revenues increasing faster than outlays at the end of the 75-year period). While Commission Model 2 put Social Security on a sustainable course permanently, the alternative baseline contained a "cliff effect" in which the system would face a rapidly deteriorating fiscal condition and return to insolvency at the end of the valuation period, which the authors of the paper acknowledge was the

reason that the alternative baseline was able to provide higher benefits. Second, the alternative did not have the same net impact on the federal budget over the 75-year period as the Commissions proposal.

In its final report, the Commission compared its models to two different baselines in common use: the current law "promised" benefits and the benefits payable under current law, which dictates reductions in benefit levels when the trust fund becomes insolvent in 2041. While useful, these standard baselines also have drawbacks. Comparing the benefits under a solvent system – such as Commission Model 2 – to the benefits under the current insolvent system significantly overstates the benefits the current program could provide. At the same time, comparing benefits paid by the Commission proposal to those payable under current law does not take into account the additional general revenues provided to finance individual accounts under Commission Model 2.

In order to produce a more meaningful comparison of the benefits provided under the Commission plans, we requested that the Social Security Administration Office of the Chief Actuary calculate the benefits that could be provided through the traditional Social Security system with the same amount of general revenues as required under Commission Model 2, while achieving sustainable solvency. In other words, this baseline compares the benefits provided under Commission Model 2 to the benefits that the current system could "buy" with the same amount of budgetary resources. The alternative baseline assumes transfers from general revenues that are equal to the general revenue requirements under Commission Model 2 assuming two thirds of eligible workers would choose individual accounts (assumed by OACT to be the most likely scenario). The baseline assumes the reductions in benefits necessary to achieve a unified budget impact comparable to Commission Model 2 and sustainable solvency. Therefore, both Commission Model 2 and the alternative baseline improve Social Security fiscal condition by roughly $2 trillion (in present value terms).

The analysis prepared by the Office of the Chief Actuary (OACT) found that in virtually all cases, Commission Model 2 would provide higher retirement benefits for low and average wage earners who chose individual accounts, and in some cases these benefits would be substantially higher. (Total benefits would be lower for average and high wage workers who did not participate in individual accounts) After 2032, Commission Model 2 would pay all retirees who participated in personal accounts higher than expected retirement benefits. The chart below compares benefits for low and average wage earners who participated in individual accounts under Commission Model 2 with the alternative baseline described above.

	Low Earner			Medium Earner		
	Alt baseline	Model 2	% Diff.	Alt baseline	Model 2	% Diff.
2012	$721	$737	+2.2%	$1190	$1194	+0.3%
2022	$742	$868	+14.5%	$1225	$1189	-3.0%
2032	$764	$894	+14.6%	$1260	$1231	-2.4%
2042	$774	$986	+21.5%	$1277	$1392	+8.2%
2052	$774	$1050	+26.3%	$1277	$1525	+16.2%
2075	$774	$1102	+29.8%	$1277	$1615	+20.9%

Estimates provided by Office of the Chief Actuary, SSA, based on 2001 Trustees intermediate assumptions and assumes 50% equity portfolio (or intermediate expected yield) for individual accounts. Estimates are for two-earner couples.

Fiscal Responsibility:

An agreement on fiscally responsible legislation that truly makes Social Security solvent -- without simply shifting costs to future taxpayers -- will require leadership by the President and the Congress. The Directors of the Congressional Budget Office and the General Accounting Office, Federal Reserve Chairman Alan Greenspan, and numerous policy experts all have testified that Congress and the President must make tough choices to return Social Security to solid financial footing.

That is why we have introduced H.R. 2771, the 21st Century Retirement Security Act. Our plan contains a comprehensive set of reforms that maintain the best features of the current system while adding innovative reforms that will strengthen retirement security for all workers. It would augment the Social Security safety net with personal accounts financed by existing payroll taxes. The Kolbe-Stenholm plan enhances the progressive benefit formula of the current system and actually strengthens the government safety net by increasing the defined benefit for low-income workers. Perhaps most important, our plan puts the Social Security system on a sound financial footing in perpetuity.

All advocates of reform, including the President, The Commission to Strengthen Social Security, and the authors of every Social Security reform plan that includes personal accounts, are committed to safeguarding the benefits of current and near retirees (generally those 55 and above), survivors and the disabled. This is a commitment we enthusiastically support and will not violate. But failing to act in a timely manner may make this commitment difficult for policymakers to keep.

It is important to recognize that some of the choices that have to be made require sacrifices; however, small adjustments to the program now will limit the painful reductions in benefits or substantial tax increases necessary in the future. H.R 2771 is the third version of the legislation we authored originally with Senators Gregg and Breaux. As we drafted each version of our plan, the choices we had to make got progressively more difficult. In the end, both workers and seniors will pay the price for our demagoguery and obfuscation.

Bipartisanship:

An agreement on legislation to strengthen Social Security will require bipartisan cooperation. We must put aside party affiliations and think about the future generations who will be affected by the decisions we make today.

Reaching a bipartisan consensus requires compromises and tradeoffs by both sides. Democrats must be willing to acknowledge that the status quo is unsustainable and changes must be made. Republicans must be willing to acknowledge the legitimate concerns that Democrats have about protecting the safety net features of Social Security and maintaining the progressive nature of the system.

We respectfully suggest to the Committee that the bipartisan work embodied by our legislation and the Commission offers a foundation to create meaningful, comprehensive reform that can be enacted into law next year. There are several elements of reform that we believe are essential to reaching a consensus on Social Security reform:

1. **Bipartisan.** Our proposal is a truly bipartisan solution that balances the objectives of different political perspectives.

2. **Solvent.** The legislation we introduced has been scored by the actuaries of the Social Security Administration as restoring solvency to the Social Security program for the next seventy-five years and beyond.

3. **Fiscally responsible.** Our legislation tackles the tough choices that are necessary to control cost and reduce the pressures on future general revenues. It does not use cost shifts or other accounting gimmickry and does not rely on projected surpluses or create new general fund liabilities.

4. **Empower all Americans.** The legislation establishes personal accounts that provide all Americans the opportunity to create wealth, and provides individuals with ownership of and control over their retirement assets.

5. **Enhances the safety net.** Our legislation contains several provisions in both the defined benefit program and personal accounts that provide stronger poverty protections and greater assistance to low-income workers than are contained in current law.

6. **Rewards work.** The legislation makes several reforms to enhance the work incentives in the current system.

7. **Improves Social Security for all Americans.** Our proposal provides all future retirees with a better rate of return than the current system can afford, and it protects all taxpayers from the increased tax burden created by the existing general fund obligations to the Social Security system.

<u>Need for a Responsible Debate:</u>

We respect those who honestly disagree with us on using personal accounts as a solution for Social Security's dilemma. But opposing personal accounts is not a substitute for offering a positive solution. Constantly repeating what you are <u>against</u> is no longer acceptable. At the same time, simply embracing personal accounts while ignoring the need to make tough choices on benefits or taxes is equally irresponsible. It is easy for critics from the left and right to attack proposals for reform, but it is much more difficult to put together a plan that can hold up under independent analysis.

If some succeed in making it politically impossible to pass substantial reforms which manage the growth of Social Security spending, similarly it will become impossible to address other difficult issues, including defense, homeland security, education, health and the environment. Social Security always will be a political issue, and it is perfectly fair for candidates to talk about reform proposals in the election season. It would be a tragedy, however, if campaign rhetoric drives out responsible policy options once the elections are over and we are expected to return to governing.

It is important that we avoid taking positions against specific reform proposals and using rhetoric that restricts our flexibility in finding workable solutions. If everyone determines the acceptability of reform based on adherence to simplistic pledges of "no personal accounts", "no changes to benefit levels" or "no increases in taxes", we will never reach a bipartisan consensus to pass legislation.

Over the past six years, we have worked to strengthen the case for bipartisan Social Security reform through a series of briefings for Members and staff. Many in Congress understand and acknowledge the fiscal and demographic pressures facing the Social Security system and are willing to engage in a constructive dialogue on reform. However, other Members remain skeptical about the need for reform and are concerned about the politics swirling around the debate. Reaching an agreement on an honest solution to the long-term challenges facing Social Security will be difficult, but the difficulty of our task must not prevent us from confronting it.