TESTIMONY OF

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Mr. Chairman, Members of the Committee

I would hope that at this point we are well beyond debating whether or not Social Security needs to be reformed.

We can become forever embroiled in semantic debates over what does or does not constitute a "crisis." However, we cannot deny the fundamental facts.

Social Security will begin to run a deficit in just 12 years—that is, it will begin to spend more money on benefits than it brings in through taxes. At that point, in order to continue to pay promised benefits, it will have to draw on the Social Security Trust Fund. We have seen much debate about the Trust Fund recently, with some suggesting that it guarantees Social Security's solvency until 2041, or even 2052. However, as Congressional Budget Office director Douglas Holtz-Eakin has noted "[The Trust Fund] has no real economic resources….The key moments for Social Security are in 2018. Cash-flow benefits will equal cash-flow payroll taxes, and then after that, the Social Security Administration will have to come back to the rest of the budget for additional resources to pay promised benefits."

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

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

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

Urban Development, Justice, NASA, and the National Science Foundation. Simply redeeming the Trust Fund will begin to squeeze out all other domestic spending priorities.

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

Quite simply, Social Security cannot pay the promised level of Social Security benefits with its current level of revenues. Therefore, it is improper to compare benefits under a reformed Social Security system with today's promised level of benefits. Those promises are simply a fantasy. In fact, by law, Social Security will have to reduce its benefits by approximately 27 percent, once it is unable to fund those benefits. This will occur regardless of whether or not individual accounts are created. As former Senator Bob Kerry has said, doing nothing is the same as a 27 percent benefit cut.

However, as troubling as these numbers may be, I believe that the debate over Social Security reform should not solely—or even primarily—be a discussion of solvency. Yes, solvency is important, and any responsible Social

Security reform plan should restore the program to solvency, not just short-term actuarial solvency, but permanent, sustainable solvency.

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

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

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

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

With this goal in mind, not just to restore Social Security to solvency, but to build a better retirement program that would give workers more ownership and control over their money, scholars at the Cato Institute drew on our 25 years of experience studying Social Security, and developed a comprehensive proposal for creating privately invested, personally owned accounts as part of an overall reform of the Social Security system. This proposal became the basis for legislation introduced, on July 19, 2004, by Rep. Sam Johnson (R-Tex.), along with 18 original co-sponsors.[i] Rep. Johnson, together with Rep. Jeff Flake and 10 co-sponsors, reintroduced the bill in the 109th Congress, on January 21, 2005.[ii]

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

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

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

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

- The "transition cost" (in present value) would be approximately $6.5 trillion. This is roughly half the $12.8 trillion unfunded liability of the current system. That is, the "6.2% Solution" ultimately saves taxpayers $6.3 trillion.

- The legislation also compares very favorably to other Social Security reform plans. In terms of giving workers more control and ownership of their retirement funds, the "6.2% Solution" clearly provides the most "bang for the buck."

- On a cash-flow basis, the legislation does require significant short-term transfers of General Revenue. However, by 2046, the system would begin running surpluses, allowing any short-term debt to be repaid. Indeed, by the end of the 75-year actuarial window, the system would be running surpluses in excess of $1.8 trillion (in constant $2005)

- Much of the short-term cash-flow shortfalls are due to the redemption of recognition bonds, not to the diversion of payroll taxes to the individual accounts. These recognition bonds convey many benefits in terms of ownership as well as speeding the date at which Social Security changes from deficit to surplus. They are essentially a prepayment of future Social Security benefits, and not a new expense. The Johnson-Flake bill is the only Social Security reform bill with recognition bonds. The costs of Johnson-Flake also include the cost of increasing the minimum Social Security benefit to 100% of poverty, a significant increase over the current minimum Social Security benefit.

- Individual accounts would eventually accumulate assets in excess of $38 trillion (in constant $2005). That would lead to substantial new savings, new investment, and economic growth.

- Once short-term debt is paid off, the employer portion of the payroll tax could be reduced to 3.04%. This would pay for disability and survivors' benefits.

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

In addition, younger workers who chose the individual account option could receive retirement resources substantially higher than what traditional Social Security can actually pay them. (It is important to remember that comparison of benefits under a reformed plan with the currently scheduled or promised level of benefits is essentially meaningless, because those benefits cannot be paid by the current system. The far more accurate comparison is between benefits under a reformed system and the payable level of benefits under the current system).

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

Thank you.

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[i] HR 4895.

[ii] HR 530.

[iii] Although the Cato Plan and HR 350 apply the wage-index/price-index change to al income levels, I would be open to applying the blended approach advocated by Mr. Pozen.