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SOCIAL SECURITY: DO WE HAVE TO ACT NOW?

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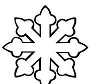

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SOCIAL SECURITY: DO WE HAVE TO ACT NOW?

THURSDAY, FEBRUARY 3, 2005

U.S. SENATE,
SPECIAL COMMITTEE ON AGING,
Washington, DC.

The committee convened, pursuant to notice, at 2:06 p.m., in room 628, Dirksen Senate Office Building, Hon. Gordon H. Smith (chairman of the committee) presiding.

Present: Senators Smith, Martinez, DeMint, Kohl, Lincoln, Carper, Nelson, and Clinton.

OPENING STATEMENT OF SENATOR GORDON SMITH, CHAIRMAN

The CHAIRMAN. I will call to order this hearing of the Senate Special Committee on Aging.

Today's hearing is its first on Social Security in the 109th Congress. This is the beginning of a series of hearings this committee will hold on Social Security in the coming months. Anyone who listened to the State of the Union Address knows that this is Topic A on the Hill right now.

It is with great hope that we convene as colleagues to examine this program, for we are truly at a unique crossroads as a nation. Social Security has been the most successful endeavor by government in attempting to assure income security for the elderly and the disabled and no other program has served the nation's seniors so effectively for so long.

Now itself at age 65, Social Security is a mature program, and as with anything that has evolved over so many years and touched the lives of so many Americans, the complexity of determining how to assure its continuance as an effective base of retirement and disability income for future generations cannot be understated.

Social Security is the cornerstone of the nation's multi-faceted retirement system, and as we will hear from the exchange among our witnesses today, how best to proceed involves more than examining how two trust funds can be brought into balance over the next 75 years. The first of the baby boomers are only a few years from entering the ranks of senior citizens and the challenges that their swelling numbers will place on this and other vital programs of government are enormous.

The President's willingness to confront these issues, to take the lead, gives us a rare and perhaps small window of opportunity to set partisan differences aside, wherever possible, and attempt to achieve what many in recent years have felt was unreachable,

greater retirement security not just for today's seniors, but for our children and our grandchildren.

I am pleased that we are starting off this series of hearings with the heads of Congress' own support agencies. CBO and GAO have been reviewing and studying the problems of Social Security in a nonpartisan fashion for many years and their work has been and remains a vital tool in assisting the Congress in its consideration of these issues.

Before we proceed, I am pleased to turn to my colleague, the ranking member of this committee, Senator Herbert Kohl of Wisconsin, and I know he has some remarks of his own. Senator Kohl.

OPENING STATEMENT OF SENATOR HERB KOHL

Senator KOHL. I thank you, Mr. Chairman, and we welcome our distinguished witnesses here today.

Today, this committee will address the issue of Social Security, which the President pushed to the very top of the national agenda last night in his State of the Union address. I want to make very clear that while Social Security faces financial challenges in the future, it is clearly and indisputably not broke. Even using the most conservative estimates on economic growth for the next 40 years, Social Security will continue to be able to pay full benefits to seniors that have earned and deserve those benefits.

It is important to remember that Social Security has been one of the most successful programs, as Senator Smith said, in our nation's history. This program has reduced poverty among the elderly from what it was in the 1930's, almost 50 percent, to 10 percent today. It has helped seniors live out their retirement years in more comfort and security than otherwise would have been possible or even dreamt of. So as we work to strengthen Social Security, we need to be careful to mend it and not to break it.

We have all heard the arguments that Social Security will be broke, bankrupt, and not able to pay benefits to future retirees, but factually, that is not so, for even if we did nothing to fortify the program, which, of course, is not an option that we intend, but even if we did nothing, Social Security would be able to pay 78 percent of benefits in the year 2052. I believe that CBO will confirm that very important fact today.

We need to take steps to strengthen and mend Social Security so that its promise of a secure retirement is just as real for seniors in the future as it has been for seniors up until today. But those who want to radically change Social Security need to clearly explain why we should so demonstrably alter a program that has been so successful and has kept so many seniors out of poverty over the years.

It is also important to point out that under the President's proposal, as has been explained so far, people are not given a choice between keeping what they have today or starting new private accounts. But whether you choose a private account or not, the President's plan apparently requires significant cuts in the guaranteed benefit that seniors have come to rely on in their retirement.

There are a variety of options to choose from to make Social Security solvent far into the future. We need to start considering those options so we can protect Social Security for the seniors of

today and tomorrow. We need to have an honest dialog that gives us the real picture of Social Security's finances and challenges. We look forward to this hearing with the hopes that we can begin to accomplish exactly that.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Kohl.

Senator Carper, do you have an opening statement?

OPENING STATEMENT OF SENATOR THOMAS CARPER

Senator CARPER. I do, Mr. Chairman. Thank you very much. It is good to be here with you and Senator Kohl and see our witnesses here. We look forward to your testimony. I am going to be called out to another meeting here in just a few minutes, but I want to hear at least the beginning of your remarks, so I will be brief.

I was elected to the U.S. House of Representatives in 1982 and was sworn in on January 3, 1983. One of the first things I learned as I was looking for the men's room was that we had a crisis with regard to Social Security, not a long-time challenge, which is what I think we face today with respect to Social Security, but a real crisis. The system was going to run out of money soon if we did not act.

Ronald Reagan was President then, and a year or so before I was elected, he and Tip O'Neill got together on an idea. They created a true bipartisan commission and their Commission, I think, with a number of members appointed by the President and at least as many members, maybe even more members appointed by the Democratic leaders of the House and the Senate. You may recall that those members included Alan Greenspan, who I think was the Co-Chairman of the Commission. They included Senator Bob Dole, my colleague Claude Pepper from Florida, and a number of other wise men and women.

They came back to us in 1983 with a whole laundry list of recommended steps to take to shore up Social Security well into the 21st century, and very much in a political environment, a highly charged political issue, we adopted those recommendations almost lock, stock, and barrel.

The outcome of those actions with Social Security was it was strengthened, as Senator Kohl says, well into this century, to probably the middle part of this century.

We have had an experience with another bipartisan commission more recently that was created on the heels of 9/11 and chaired by Governor Tom Keane and by my former colleague in the House, Congressman Lee Hamilton, a highly regarded Republican and Democrat, surrounded by folks who were Democrat and Republican, selected by the President and some by our Democrat leaders, but they did great work, I think, for this country, and led us through last year, literally an election year, certainly a highly charged election year, to a consensus around the steps that we needed to take, 40-some recommendations. In the end, we adopted almost all of them.

I don't know if maybe we couldn't take a play out of the playbook of a couple of really good politicians, Ronald Reagan and Tip O'Neill, in this decade and apply it, again, not to a crisis but to a challenge that we face, a long-term challenge that we face in Social

Security, and take a page out of our playbook from last year where we created the 9/11 Commission.

I don't know that Democrats or Republicans or any others should be knee-jerk opponents of creating private accounts, but if we are going to do that, or examine that or support that, I think we need to agree on a couple of basic principles and one of those is we are not going to do so in a way that increases our nation's debt. It is all well and good we talk about giving young workers the opportunity to set aside monies to save for their retirement, but at the same time, increasing the debt, the burden of debt that they are going to inherit, is not what we should be about.

Further, I don't believe we should be doing this at a time and in a way that would reduce the benefits for those senior citizens who are going to be looking for them, either now or a few years down the road.

Let me close with this, Mr. Chairman, if I could. I have just come from a meeting where folks were discussing options if we are ever to further explore not only how to shore up Social Security well beyond the middle of this century, but also to allow people to either establish accounts that are add-ons, which is what I, frankly, favor, or some would suggest a carve-out.

Among the approaches that have been suggested, I think Senator Lindsey Graham has suggested that we help put Social Security on a sounder footing and enable a new benefit by raising the cap that now exists. We pay the payroll tax on income up to about, I want to say $90,000, but it has been suggested that we increase that. I think I have heard Chairman Greenspan talk about whether or not we should apply the CPI, Consumer Price Index, to the annual benefit and use that as the annual benefit increase each year instead of the wage index.

I think President Bush said last night in his address, "I don't know if it was Congressman Tim Penny, my former colleague, good friend, or former Senator Moynihan about indexing the full retirement age with life expectancy." As we live longer, live healthier lives, maybe we could do that.

Someone suggested at a lunch meeting where I was that maybe we should consider allowing Social Security to invest certainly not all or not the lion's share of the trust fund monies in equities, not just in U.S. Treasury obligations, but some portion could be in equities, as well, which is what we do with our pension funds in the State of Delaware and, frankly, in a lot of other places.

So those are all things that are on the table. I wanted to put them on this table, Mr. Chairman and my colleagues, and I thank you for the chance to do that and we welcome you today. Thank you.

The CHAIRMAN. Thank you, Senator Carper. I don't think you put anything on the table that the President didn't put on the table last night.

Senator Nelson, you arrived next. Do you have an opening statement?

OPENING STATEMENT OF SENATOR BILL NELSON

Senator NELSON. Speaking of that, I wish that our distinguished panel, who I have had the pleasure of hearing both of you in these past couple of days, might clarify for us on what was changed in what the President said and what the White House put out with regard to what had been put out by the White House previously in the press. We don't know the details of the President's plan, but some additional information was released yesterday and I would like that to be filtered through the eyes of both of you and give us your interpretation and how that would affect the ultimate final product.

It is no secret, Mr. Chairman. I have made a couple of fairly definitive statements this week, both in Florida and here on the Senate floor, that I am not going to support anything that is going to be a huge transfer of new debt out of the Social Security Trust Fund, nor am I going to support something that will have a diminution of the benefits. Now, I agree that everything ought to be on the table and if everything is on the table, then we can start realistically picking and choosing.

I will just close by saying that I, too, was a Member of Congress when one of the finest examples of bipartisanship has ever been rendered in American history, and that was when Ronald Reagan and Tip O'Neill decided that they were going to save Social Security in the early 1980's. They appointed this Commission, and it was bipartisan, and as a result of that, they came to an agreement and then they came to another very significant agreement, that nobody was going to play "gotcha" politics and that there was not going to be used the final result, which was a give and take in the process of compromise, otherwise known as consensus building, that they were not going to use that to someone's disadvantage in the coming election. They honored that agreement and that is why we had the saving of Social Security back in the 1980's.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator DeMint.

OPENING STATEMENT OF SENATOR JIM DEMINT

Senator DEMINT. Mr. Chairman, I really appreciate you holding this hearing. Obviously, the timing is perfect, as the President threw out a challenge to us and to the Nation last night to fix Social Security. The difficulty has been that there are so many different understandings of Social Security, how it works, the condition it is in. In groups that I speak to, it continues to amaze me, even people in Congress who have a completely different view of things like the trust fund and how the trust fund is going to pay for the program.

I appreciate the folks who turn the numbers here to talk to us and I would hope you would speak to us in as clear of terms as you possibly can and correct me if I am wrong.

My understanding is that within about three years, and maybe CBO has a little different numbers, but within three years, this Senate and its 10-year budget forecast will have to begin to include billions of dollars that go from the general fund to supplement Social Security benefits, and I think you need to tell us if that is true.

There are so many people here who seem to think we can still put this off for decades when, if in 2018 or maybe it is 2020, I think the first year it is $16 billion, the next year it is $30-something billion, and within a relatively short period of time, we are talking hundreds of billions of dollars a year that we have to take from the general fund to supplement payroll taxes in order to pay benefits. I hope I am wrong, but if you gentlemen are here to tell us what the numbers are really like, I hope you will straighten that out.

I hope you will also explain, again, if I understand it correctly, that the Social Security Trust Fund is merely a bookkeeping of how much money that has been borrowed from the Social Security and spent on other things, that there are no real assets in the Social Security Trust Fund, that there are no assets that can actually pay a benefit, that we have to make up every dollar in the trust fund with an exact replica from the general fund. It is one pocket to another.

So I think if you can help us clarify the problem, and I agree with my colleague, Senator Carper, that all ideas should be on the table for a solution. But Social Security is a promise we should keep. It is not like another government program that we make up and start spending something on. This is money that we have taken from people over the years in return for the promise of some security in their retirement.

I don't think the problem with Social Security is that the benefits are too high now. I don't think that the problem is that the taxes are too low. From the math that I have seen on this, if we could even save half of what people have been putting into Social Security, that even the lowest-income American worker would be a millionaire, if not close to it, if it was actually saved and invested in a government bond. That may not be exactly correct, but I know there would be a lot more money than there is now.

But the first step in solving a problem is realizing we have one, and if you could help us clarify that today, I think you would do a great service to us and to the country so that we then, as colleagues, could sit down and say, we do have a problem, and when that problem begins is actually in three or four years. Then, I think we can put our best ideas together and come up with something that works for the future of this country.

Thank you, Mr. Chairman. I yield back.

The CHAIRMAN. Thank you, Senator DeMint.

Senator Martinez.

OPENING STATEMENT OF SENATOR MEL MARTINEZ

Senator MARTINEZ. Thank you, Mr. Chairman. I wanted to thank you and Senator Kohl for holding this hearing and I also wanted to just thank you for allowing me to be a part of this committee. I am looking forward to serving here with you and to dealing with the important issues of aging in America, many of which I have been interested in for some time, particularly housing as people age.

I also want to say it has been a pleasure in the past to work with Mr. Walker and I look forward to hearing from you today, as well.

Mr. Chairman, I believe that the solvency of Social Security affects all Americans in every walk of life. I do believe that there is

uncertainty regarding the funding for Social Security and I look forward to hearing the testimony here today on the issues before us and working with the committee in a bipartisan fashion to take steps that will perhaps help guide Social Security toward a solid financial footing and ensure it be there for the future.

I think it is also vitally important that no matter what steps we take, as Senator DeMint was just saying, that we keep the promises made to seniors, those that are currently collecting Social Security benefits.

I was so pleased last night for President Bush to speak so clearly to the fact that those that are 55 years of age and older will see no change and that our sacred trust and sacred bond to them will be kept, and whatever we do to secure and ensure the system there for a future generation, that it doesn't impact them.

Tomorrow, I am going to be in Florida visiting in Sun City Center, one of our large retirement communities, with my foster parents, dear people to me who took good care of me at a time in my life when I was in desperate need of help. For them in their years of now vulnerability to illness and what not, they and people like them don't need to worry. It isn't fair to say that they are threatened or that they are under some sort of a threat to lose their benefits or have a change that is going to dramatically impact their lives. That is just not what we are about to do or we are talking about doing or what the President's plan, I think, clearly in any way will imply.

I think another thing that I would like to stress as we delve into this debate is that it doesn't appear to me, as I have studied the issue, that doing nothing is responsible. Simply saying there is not a problem, we will deal with it, or someone else will deal with it another day at another time, that is not an acceptable or really a responsible track to follow.

So I would look forward to hearing from the witnesses today and then with my colleagues on both sides of the aisle, working toward crafting, as I think Senator Nelson has stressed so appropriately, in a bipartisan way a solution to this problem so that we can ensure a safe and strong retirement for the next generation, as well.

The CHAIRMAN. Thank you, Senator Martinez, and we will have some housing hearings, as well, so we look forward to those.

Ladies and gentlemen, our first panel consists of Douglas Holtz-Eakin. He is the director of the Congressional Budget Office here in Washington, DC. He will be followed by David Walker, comptroller general of the Government Accountability Office, also here in Washington, DC.

Doug, you are up first.

STATEMENT OF DOUGLAS HOLTZ-EAKIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE, WASHINGTON, DC

Mr. HOLTZ-EAKIN. Mr. Chairman, Senator Kohl, members of the committee, thank you for having the Congressional Budget Office here today to discuss this important issue.

In my opening remarks, I thought I would focus on three things. I will spend a few minutes discussing the outlook for Social Security under current law so that in the interests of helping Senator DeMint, we can have the same sets of facts at our disposal, and

then set the problem in the larger context of budgetary pressures facing the United States and economic policy issues going forward. Finally, I thought I would close with a few illustrative examples of the relative impacts of moving sooner versus later in addressing the Social Security financing problem.

The outlook for Social Security under current law is in the diagram before you. The dotted line are dedicated receipts into Social Security. At the moment, those receipts lie above the outlays for benefits to retirees. Beginning in 2008, the leading edge of the baby boom generation will be eligible to retire. Shortly thereafter, the surplus of receipts in excess of outlays which are currently available to the remainder of the Federal budget will begin to diminish, and at that point, the cushion provided by the Social Security program will diminish thereafter until roughly 2020, at which point the system will take in approximately as much as it sends out. Dedicated taxes in will match benefit payments going out.

In the decades to follow, under law, the accounting mechanism called the trust fund will indicate that benefits may be paid. The benefits paid will exceed receipts coming in. That gap will be made up by funds provided from elsewhere in the overall Federal budget, whether they be lower spending, higher taxes, or borrowing from the public, until in 2052, under our estimates, the trust fund will exhaust. There will no longer be the authority to pay full benefits. There will be an across-the-board cut of roughly 20, 22 percent in our estimates.

At that point, at least some form of the program is sustainable indefinitely, where benefits are paid out equal to dedicated taxes coming in for the remainder of the current law scenario. That, of course, does not match expectations for benefits as scheduled under law, if we go to the next chart.

You can see that under current law, outlays for benefits, benefits scheduled under current law, those that would be calculated given individuals' working histories and payable under the program, exceed dedicated revenues for the foreseeable future. In terms of the magnitude of the problem, that is in the eye of the beholder. It is inevitably the case that with the outlays above the revenues, one must somehow add up that gap, year by year, over longer horizons, and most of the computations of the size of the Social Security problem are some variant of that calculation.

In terms of when it hits, that, of course, depends on when one views the pressures as becoming most pertinent, whether it was when the surplus begins to diminish, whether it is the case when cash-flow deficits begin, or whether it is the case when automatic benefit reductions might come into play.

Finally, there are at least two different notions of "fixed" that float around in this discussion. From the broad budgetary point of view, one notion of fixed would be when those two lines coincide, so that Social Security as a stand-alone program for the indefinite future would be able to finance itself and would require no help from the remainder of the budget. Alternative measures of fixed look at measures of trust fund balance, which may or may not also necessitate some transfers from the remainder of the general fund.

Now, clearly, Social Security is an important policy issue in its own right. The program has a long and important history as a part

of economic and social policy. But it fits in a larger budgetary picture which is quite pressing. Indeed, the rising payments for Social Security, those which coincide with the retirement of the baby boom generation, pale in magnitude when compared to the likely outlays for the health programs, Medicare and Medicaid.

Over this same period, Medicare and Medicaid start at roughly the same place as Social Security, about four cents on the national dollar. While Social Security rises to about 6½ cents on the national dollar, Medicare and Medicaid under extrapolations of history could rise to as high as 20 percent the size of the current Federal budget. No one believes that anything like that is even plausible, so it is typically the case that one assumes a more moderate growth rate going forward. In those scenarios, Medicare and Medicaid typically rise to 12 percent of GDP, or over half the size of the current Federal budget.

Needless to say, the Social Security issues evolve in the context of rising budgetary pressures. To the extent that funds are necessary from the rest of the budget to sustain Social Security, they will compete with those funds, for those funds, with ever-larger demands in other areas.

That suggests that from the point of view of solving this problem, it may be desirable to move sooner versus later, and indeed, one way to think about this is that current law is a de facto wait and reform strategy. Putting the program on autopilot means that you go until 2052, at which point, by law, the program is brought into balance through an across-the-board benefit cut.

Alternatively, one could move proactively and sooner. That could have effects at the level of both the individual and in the aggregate. The next chart.

To get a flavor of this, we included in the testimony, and I would be happy to discuss at greater length, a comparison of benefits as scheduled under current law with those benefits that would be payable if one were to take a very mechanistic approach to the existing Social Security program. I emphasize that this is for illustrative purposes only. It is a 10-percent reduction in retirement benefits at the point of retirement and is done in that mechanistic and simple fashion just to give you a sense of magnitude, not as a suggestion of a solution.

But one can see that if you move that 10 percent cut up to 2012 and thus affect those individuals who are—instead of waiting for a sudden benefit cut in 2053 affect those who were born in the 1950's, it will be possible to pay higher benefits compared to what would have happened with the cut for those in the later generations and that is the tradeoff for having lower benefits for those workers who are older at the moment.

So there is a clear tradeoff at the level of the individual that has budgetary consequences, but it is also very important for economy policy. Social Security affects incentives to work. It affects incentives to save. Both the program and its reform will have large economic consequences. Those consequences will be felt in the aggregate, as well.

To the extent that such a mechanistic move earlier approach were instituted and nothing else changed in the Federal budget, the advantages of moving in 2012 would manifest themselves as

less pressure to borrow from the public and less cumulative debt outstanding. The light blue line shows the benefits of moving in 2012. The darker line, waiting a decade and moving with the same size cut.

In any event, moving sooner reduces overall borrowing, leaves less debt in the hands of the public. For the broad performance of our economy, less Federal borrowing transforms itself into higher national saving, a greater capacity to produce goods and services, and a higher standard of living going forward.

So the tradeoffs involve benefits higher for those later if lower for those in the present and an economy that can perform better in the near term than would be otherwise. These are important issues in thinking about the issue of Social Security, not only in its totality but when it is best to move and to put it into long-term sustainability.

I thank you for the chance to be here today.

The CHAIRMAN. Thank you very much.

[The prepared statement of Mr. Holtz-Eakin follows:]

CBO TESTIMONY

Statement of
Douglas Holtz-Eakin
Director

The Future of Social Security

before the
Special Committee on Aging
United States Senate

February 3, 2005

This statement is embargoed until 2 p.m. (EST) on Thursday, February 3, 2005. The contents may not be published, transmitted, or otherwise communicated by any print, broadcast, or electronic media before that time.

CONGRESSIONAL BUDGET OFFICE
SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515

Chairman Smith, Senator Kohl, and Members of the Committee, thank you for the opportunity to testify on the future of Social Security. In evaluating possible changes to the Social Security system, it is important to consider not only the implications for the program itself but also for the federal budget and the United States' economy.

The Budgetary Context

If current spending and tax policies do not change, the aging of the baby-boom generation, combined with rising health care costs, will cause a historic shift in the United States' fiscal situation. Consistently large annual budget deficits would probably lead to an ever-growing burden of federal debt held by the public. As the government claimed an increasing share of national savings, the private sector would have less to invest in creating new business equipment, factories, technology, and other capital. That "crowding out" would have a corrosive and potentially contractionary effect on the economy. Although placing federal fiscal policy on a sustainable path will not be easy, the sooner that policymakers act to do so, the less difficult it will be to make economic and budgetary adjustments.

Outlays for mandatory programs have increased from less than one-third of total federal spending in 1962 to more than one-half in recent years. Most of that growth has been concentrated in Social Security, Medicare, and Medicaid. Together, those programs now account for about 42 percent of federal outlays, compared with 25 percent in 1975. The aging of the population will accelerate that trend.

The aging of the baby-boom generation is the beginning of a significant, long-lasting shift in the age profile of the U.S. population, which will dramatically alter the balance between people of working age and retirees. Over the next 50 years, the number of people ages 65 and older will more than double, whereas the number of adults under age 65 will increase by less than 20 percent.[1]

As a result, the Social Security trustees project that the number of workers per Social Security beneficiary will decline significantly over the coming decades: from about 3.3 now to 2.0 in 2050. Unless immigration or fertility rates change substantially, that figure will continue to decrease slowly after 2050 as longevity continues to grow. The interaction of that growth in the retired population with the current structure of the Social Security program leads the Congressional Budget Office (CBO) to project that the cost of Social Security benefits will rise from 4.2 percent of gross domestic product (GDP) now to 6.4 percent in 2050.

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1. For a more extensive discussion, see Congressional Budget Office, *The Long-Term Budget Outlook* (December 2003) and *The Outlook for Social Security* (June 2004).

Over the same period, health care costs are likely to continue to grow faster than the economy. Between 1960 and 2001, the average annual growth rate of national health expenditures exceeded the growth rate of GDP by 2.5 percent.

Driven by rising health care costs, spending for Medicare and Medicaid is increasing faster than can be explained by the growth of enrollment and general inflation alone. If spending per enrollee were to grow 2.5 percent faster than per capita GDP in the future, federal spending for Medicare and Medicaid would rise from 4.2 percent of GDP today to about 21 percent of GDP in 2050—roughly the current size of the entire federal budget. The Medicare trustees assume that the difference between the growth in spending per enrollee and the growth in GDP will gradually decline to 1 percent, on average; however, even at that rate, federal spending for Medicare and Medicaid would almost triple—to about 12 percent of GDP—by 2050.

Unless taxation reaches levels that are unprecedented in the United States, current spending policies will probably be financially unsustainable over the next 50 years. Policy changes that restrict the growth in retirement and health programs will be necessary even if outlay growth slows for defense, education, transportation, and other programs funded through discretionary appropriations. The projected imbalances will occur under all but the most favorable assumptions about the aging of the population and the growth of health care costs.

Together, the growing resource demands of Social Security, Medicare, and Medicaid will exert pressure on the budget that economic growth alone is unlikely to alleviate. Moreover, issuing ever-larger amounts of debt or dramatically raising tax rates could significantly reduce economic growth. Consequently, policymakers face choices that involve reducing the growth of federal spending, increasing taxation, boosting federal borrowing, or some combination of those three approaches.

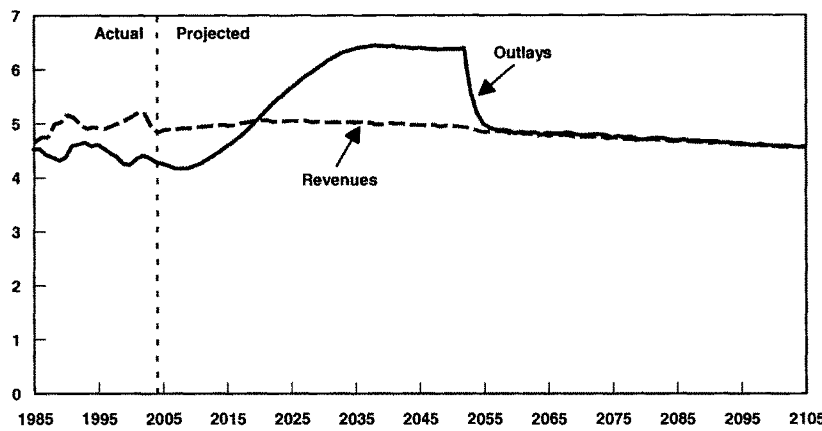
The Outlook for Social Security

Tracing the likely path of Social Security spending under current law may provide some insight into the timing and magnitude of the program's budgetary impact. In 2008, the leading edge of the baby-boom generation will become eligible for early retirement benefits. Shortly thereafter, the annual Social Security surplus —the amount by which the program's dedicated revenues exceed the benefits paid to recipients—will begin to diminish (see Figure 1). That trend will continue until about 2020, when Social Security's finances will reach a balance, with the revenues coming into the system from payroll taxes and taxes on benefits matching the benefit payments going out. Thereafter, outlays for benefits are projected to exceed the system's revenues. To pay full benefits, the Social Security system

Figure 1.

Social Security Revenues and Outlays as a Share of GDP Under Current Law

(Percentage of GDP)



Source: Congressional Budget Office.

Note: Based on the Social Security trustees' 2004 intermediate demographic assumptions and CBO's January 2005 economic assumptions. Revenues include payroll taxes and income taxes on benefits but not interest credited to the Social Security trust funds; outlays include trust-fund-financed Social Security benefits and administrative costs. Under current law, outlays will begin to exceed revenues in 2020; starting in 2053, scheduled benefits will not be able to be paid.

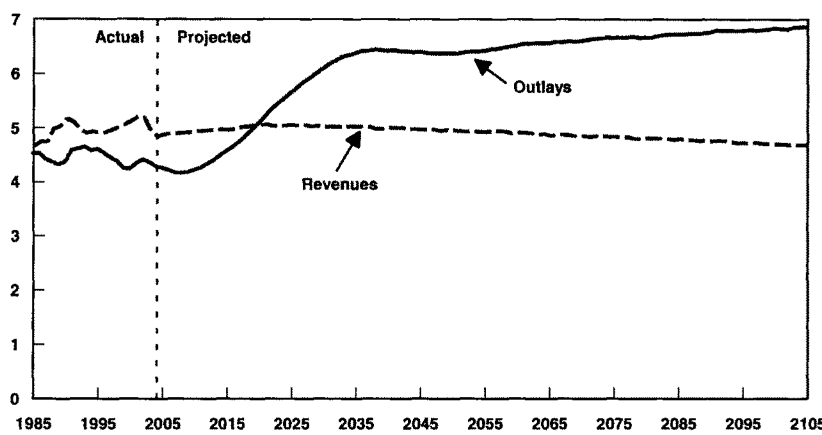
will rely on interest on, and ultimately the redemption of, government bonds held in its trust funds. At that point, the Treasury will have to find the money to cover those obligations. Policymakers can provide that money in three ways: by cutting back other spending in the budget, by raising taxes, or by increasing government borrowing.

In the absence of other changes, the redemption of bonds can continue until the trust funds are exhausted. In the Social Security trustees' projections, that happens in 2042; in CBO's projections, it occurs about a decade later, largely because CBO projects higher real (inflation-adjusted) interest rates and slightly lower benefits for men than the trustees do. Once the trust funds are exhausted, the program will no longer have the legal authority to pay full benefits. As a result, it will have to reduce payments to beneficiaries to match the amount of revenue coming into the system each year. Although there is some uncertainty about the size of that reduction, benefits would probably have to be cut by 20 percent to 30 percent to match the system's available revenue.

Figure 2.

Social Security Revenues and Outlays as a Share of GDP with Scheduled Benefits Extended

(Percentage of GDP)



Source: Congressional Budget Office.

Note: Based on the Social Security trustees' 2004 intermediate demographic assumptions and CBO's January 2005 economic assumptions. Revenues include payroll taxes and income taxes on benefits but not interest credited to the Social Security trust funds; outlays include Social Security benefits and administrative costs.

The key message is that some form of the program is, in fact, sustainable indefinitely. With benefits reduced annually to match available revenue (as they will be under current law when the trust funds run out), the program can be continued forever. Of course, many people may not consider a sudden cut in benefits of 20 percent to 30 percent to be a desirable policy. In addition, the budgetary demands of filling the gap between benefits and dedicated revenues in the years before the cut may prove onerous. But the program is sustainable from a financing perspective.

What is not sustainable is continuing to provide the present level of scheduled benefits (those based on the benefit formulas that exist today) given the present financing. Under current formulas, outlays for scheduled benefits are projected to exceed available revenues indefinitely after about 2020 (see Figure 2). That gap cannot be sustained without continual—and substantial—injections of funds from the rest of the budget.

The Impact of Social Security on the Federal Budget

I would like to make two points about Social Security in the larger context of the total budget. First, Social Security will soon begin to create problems for the rest of the budget. Right now, Social Security surpluses are still growing and contributing increasing amounts to the federal budget. But as explained above, those surpluses will begin to shrink shortly after 2008, when the baby boomers start to become eligible for early retirement benefits. As the rest of the budget receives declining amounts of funding from Social Security, the government will face a period of increasing budgetary stringency. By about 2020, Social Security will no longer be contributing any annual surpluses to the total budget and, after that, it will draw funds from the rest of the budget to make up the difference between the benefits promised and payable under current law and the system's revenues. As noted previously, policymakers will have only three ways to make up for the declining Social Security surpluses and emerging Social Security deficits: reduce spending, raise taxes, or borrow more.

CBO's projections offer some guidance about the potential impact of those developments on the budget. By CBO's calculations, the Social Security surplus (excluding interest) will reach about $100 billion in 2007; but, by 2025, that surplus is projected to become a deficit of roughly $100 billion (in 2005 dollars). That $200 billion swing will create significant challenges for the budget as a whole.

Second, the stresses on the budget from Social Security will take place simultaneously with the even larger demands generated by Medicare and Medicaid. Currently, outlays for Social Security benefits equal about 4 percent of GDP, as does federal spending on Medicare and Medicaid. Social Security outlays are projected to grow to almost 6.5 percent of GDP by 2050, but, as discussed above, spending on the two health programs is expected to grow substantially more. Although Social Security will place demands on the federal budget, those demands will coincide with much greater demands from Medicare and Medicaid.

Comparing the Projections of CBO and the Social Security Trustees

The projections of the financial future of Social Security by both CBO and the Social Security trustees are identical in character: under current law, the program's scheduled outlays will exceed its scheduled revenues over the next 50 years, and annual Social Security deficits will be large and growing over the long term.[2] The projections differ only in numerical detail.

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2. CBO released its most recent projections on January 31, 2005. See www.cbo.gov/showdoc.cfm?index=6064&sequence=0. For the projections of the Social Security trustees, see *The 2004 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (March 23, 2004), available at www.ssa.gov/OACT/TR/TR04/index.html.

CBO has benefited from continued discussions with the Social Security actuaries. CBO also appreciates the support the Social Security Administration has provided to CBO's efforts by sharing much of the data underlying the projections.

Under both sets of projections, outlays for Social Security will grow substantially within the next decade. Looking out 20 years, outlays as a share of GDP will increase by 32 percent under CBO's projections; the trustees project slightly higher growth of 36 percent in their 2004 report. Over the next 30 years, outlays will be 49 percent larger, CBO projects; the trustees project an increase of 51 percent. The differences in projected revenues are somewhat larger, but both projections show substantial imbalances. CBO projects that in 30 years, outlays will be 26 percent higher than revenues; the trustees project that they will be 33 percent higher.

A bit more than half of the differences between the two organizations' projections stem from different modeling techniques; the rest result from varying economic assumptions. CBO's modeling techniques result in lower projected outlays than the trustees' do when using the same economic assumptions. CBO and the trustees take different approaches to projecting the distribution of future beneficiaries' earnings; that and other modeling differences cause CBO to project lower average retirement benefits than the trustees do, especially for men retiring around 2020 and later.

Although CBO uses the same demographic assumptions as the trustees, its long-term economic assumptions are consistent with the ones used in its 10-year projections (see Table 1). CBO assumes slightly higher wage growth and lower inflation. On net, those assumptions result in projections of outlays that are slightly lower relative to GDP.

Table 1.

CBO's and the Social Security Trustees' Long-Term Economic Assumptions

(Percent)

	CBO	Social Security Trustees
Real Earnings Growth	1.2	1.1
Real Interest Rate	3.3	3.0
Inflation	2.2	2.8
Unemployment Rate	5.2	5.5

Source: Congressional Budget Office.

Finally, CBO assumes a higher real interest rate than the trustees do. The interest rate does not affect projections of annual outlays or revenues, but it is used as the discount rate in calculations of the present value of future revenues and outlays. Thus, CBO's assumption of a higher interest rate places a lower weight on the large deficits in the distant future and results in lower projected summarized balances. The assumption also results in higher interest being credited to the trust funds, which results in a later projected trust-fund exhaustion date.

Reform Now or Later: The Economic and Budgetary Effects of Postponing Action

The sooner efforts are made to address the long-term imbalance in the federal budget—and in Social Security in particular—the less difficult the adjustments will be. Currently, workers, employers, and beneficiaries face uncertainty about the rules they will face in the future. Actions that resolve this uncertainty will allow them to more confidently plan how to work, save, spend, and hire. Resolving uncertainty about the budgetary outlook for Social Security would also allow policymakers to better understand future budgetary constraints when considering other aspects of federal budget policy.

Economic growth is the principal engine to ensure that future needs, both public and private, can be met. However, it is unlikely that the federal government will "grow its way out" of budget imbalances. Implementing gradual action today avoids the need for precipitous and disruptive action later—which could take the form of either sudden, large reductions in benefits or sudden, large increases in taxes, which can depress work effort and incentives to invest.

Phasing in programmatic changes allows for gradual accommodation, giving people time to modify their expectations and to adjust their work and saving behavior. For example, younger workers who learned that they would receive lower-than-anticipated retirement benefits would have many years to respond. They could work or save a little more each year. If the same benefit reductions were announced as those workers neared retirement, they might be forced to make dramatic changes and still might not have time to accumulate sufficient savings.

One way to gauge the advantage of acting earlier is to examine potential changes to the current pay-as-you-go Social Security program. As noted above, under current law, CBO projects that the Social Security trust funds would become exhausted in 2052; after that, the Social Security Administration would lack the authority to pay full benefits and, without Congressional action, outlays would be limited to annual revenues, which would be 22 percent lower than scheduled costs. Put differently, current law constitutes a "wait and reform" strategy in which beneficiaries in 2052 will actually get lower benefits than they are sched-

uled to receive according to the current formula. In the interim, beneficiaries will continue to receive scheduled benefits, and the program as a whole will contribute hundreds of billions of dollars to annual budget deficits.

Alternatively, policymakers could reduce the benefits paid to earlier cohorts, for example, by lowering benefits by the same fraction for all new beneficiaries. Under such a policy, and assuming no other changes to federal outlays or revenues, the reduced federal outlays would result in a smaller amount of debt held by the public.

CBO has estimated the effects of a simple illustrative example: reduce all new Social Security benefit awards by 10 percent—relative to those currently scheduled—beginning with people retiring or becoming disabled in 2012. This exercise would lower benefits for retirees born in 1950 and later, thereby affecting many more cohorts—including much of the baby-boom generation—than the "wait and reform" policy.

In general, lifetime benefits for current workers—those now 25 or older—would be lower under this policy than if no changes were made to the program. However, holding other government finances constant, such a change would allow greater benefits to be paid to future generations. In Figure 3, which compares the benefits that different generations would receive to those that are scheduled to be paid according to the current benefit formula, the "current law" bars show the benefits that would be paid if no changes were made to the law and all benefits were reduced starting in 2053. The other set of bars demonstrates the effects of acting earlier. The reduced benefits paid to earlier generations would result in government savings, probably in the form of lower debt, that could be used to pay higher benefits to future generations.

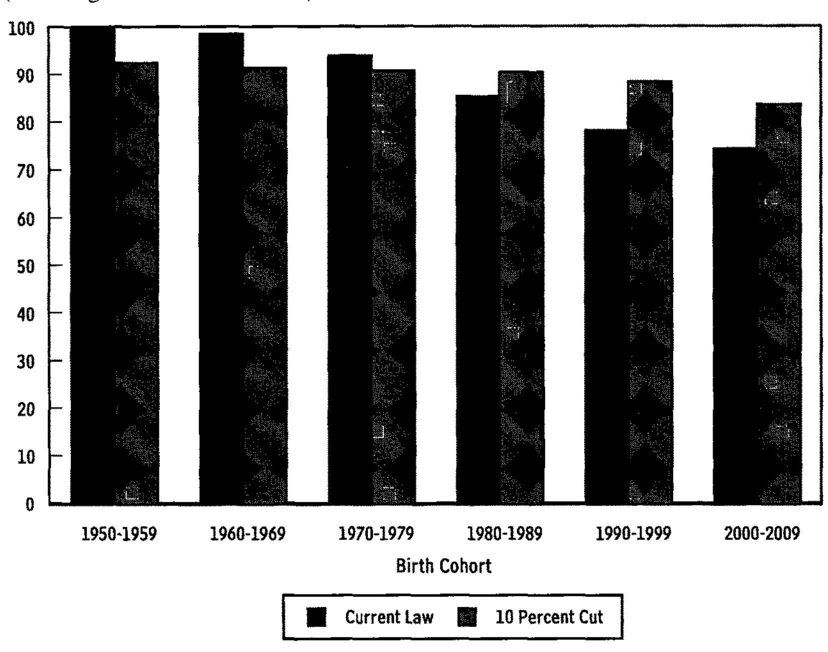
The conclusion of this analysis—that lower benefits for older workers would allow smaller reductions for future generations—is based on the notion that all other tax policy and spending decisions are unchanged. If the savings from earlier benefit reductions led policymakers to adopt tax policies that lowered national saving, the money could not be used to moderate future reductions in benefits. Similarly, if the lower unified deficits induced higher spending in other government programs, there would be no extra resources for future generations to share.

Decreasing benefits by 10 percent beginning in 2012 would substantially reduce debt held by the public (see Figure 4). Delaying action by 10 years would mean higher benefits for retirees born in the 1950s. Allowing that group—approximately 40 million people—to avoid sharing in the burden of the benefit reductions would halve the savings that would be realized over the next 40 years. Alternatively, policymakers could achieve the same savings through more drastic benefit reductions or tax increases borne only by younger generations.

Figure 3.

Lifetime Social Security Benefits Under Current Law and Under a 10 Percent Benefit Cut Beginning in 2012

(Percentage of scheduled benefits)



Source: Congressional Budget Office.

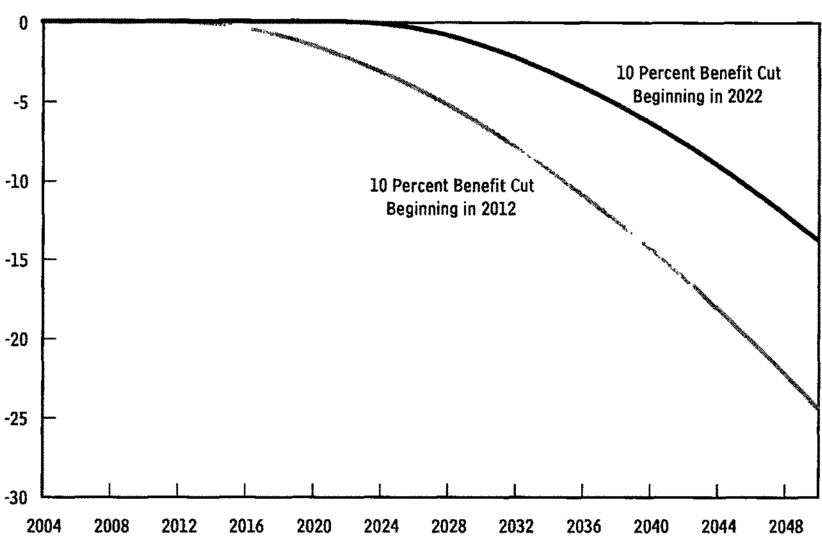
Growing federal debt would most likely slow the growth of investment in business equipment, factories, and housing and thus would curb the growth of the economy and, in the extreme, cause a sustained economic contraction.[3] In contrast, any moderation in the growth of debt will generally lead to stronger economic growth. However, even if different budgetary strategies—such as lowering benefit payments to the elderly or raising taxes—had identical effects on government debt, they would have varying effects on how much people chose to save and work. For example, one would expect that reducing benefits would lead to greater economic growth as individuals worked and saved more in order to accumulate additional assets for retirement and as a cushion against the risk of disability.

3. See Congressional Budget Office, *The Long-Term Budget Outlook*, pp. 12-18.

Figure 4.

Change in Public Debt Under a 10 Percent Cut in Social Security Benefits

(Percentage of GDP)



Source: Congressional Budget Office.

However, policies should not be evaluated on a single dimension. Policymakers may choose to prioritize goals other than economic growth, such as the redistribution of income and wealth between different generations or the protections of a government-financed social insurance system.

The mechanistic approach of this example is not intended as a recommendation or a comprehensive gauge of options. More-realistic proposals would include multiple provisions and would be instituted gradually. Rather, the example is a convenient means of demonstrating the implications of earlier versus later adjustments. Whatever the policy—whether benefit reductions, tax increases, a transfer of resources from other federal programs, or a combination of those approaches—earlier action would allow for a broader distribution of the required changes, time for a gradual phase-in, and time for workers and beneficiaries to adjust their work and saving decisions.

The CHAIRMAN. David Walker.

STATEMENT OF DAVID WALKER, COMPTROLLER GENERAL, GOVERNMENT ACCOUNTABILITY OFFICE, WASHINGTON, DC

Mr. WALKER. Thank you, Mr. Chairman. Senators, it is a pleasure to be here with you to talk about Social Security again.

In the interest of full and fair disclosure, in addition to being comptroller general of the United States and head of the Government Accountability Office and working on this issue there, I was a public trustee for Social Security and Medicare from 1990 to 1995. I was appointed to that position by President George Herbert Walker Bush. I have been on two Social Security Reform Commissions and I was involved with former President Clinton and former Vice President Gore in the effort in 1997 and 1998 to go around the country and help educate the public as to the nature, extent and magnitude of our challenge in this area. So I have been involved in this subject for a number of years and am pretty deep on the subject.

I would respectfully suggest the following. First, I have a full statement I would like to have entered into the record, Mr. Chairman, if that is OK with you. There are lots of neat charts and graphs in there. But I will hit the highlights and get to the bottom line.

While the Social Security program does not face an immediate crisis, it does have a serious financing problem that needs to be fixed and that is growing every day. For example, Social Security currently has a $3.7 trillion—that is trillion, not billion—gap between promised and funded benefits in current dollar terms. Given this gap and the large and growing fiscal challenges elsewhere in the Federal budget, not the least of which involve Medicare, which is roughly $27 trillion-plus, up over $10 trillion last year alone, it would be prudent for the Congress to act sooner rather than later to address Social Security. Failure to take steps to address our large growing and structural long-range fiscal imbalance will have serious adverse consequences over time to our economy, our quality of life, and ultimately our national security.

There are a number of key points that I highlight in my testimony. First, solving Social Security's long-range financing problem is more than making the numbers add up. Social Security is more than a retirement income program. It is also a disability program and a survivors income program. It is critically important to millions of Americans and always will be.

Second, focusing on trust fund solvency alone is not only insufficient, it can be very misleading with regard to the state of the Social Security system. We need to put the program on a path of sustainable solvency. Candidly, the Social Security Trust Funds are nothing more and nothing less than a sub-account in the government's financial records and badger accounts. They are not real trust funds. If you looked in Webster's Dictionary, or if you have been a fiduciary for private pension plans and other arrangements, it is not a trust fund in the sense that any of us normally would refer to as a trust fund. It is a sub-account of the general ledger.

The CHAIRMAN. David, for the benefit of everyone listening——

Mr. WALKER. Yes?

The CHAIRMAN [continuing]. Can you clarify a point? Has the trust fund, the Social Security Trust Fund that so many seniors think is there or should be there, has it ever existed as anything more than just an accounting device?

Mr. WALKER. It has always been an accounting device.

The CHAIRMAN. Is that true from the days of Franklin Roosevelt?

Mr. WALKER. It has always been an accounting device, to my knowledge, but that is not important. Let me explain what happens. Let's take last year, for example.

Last year, the Federal Government took in $151 billion more in payroll taxes attributable to Social Security than it paid out in benefits. The Federal Government ended up spending all of that money on other operating expenses. It replaced it with an IOU that is a non-readily marketable security. You can't sell it to anybody. You can't get any money for it. It is backed by the full faith and credit of the U.S. Government. It is guaranteed as to principal and interest. It has legal, political, and moral significance. It has no economic significance whatsoever.

Ultimately, when you have to start drawing down on those IOUs, and that is what they are, then you are either going to have to increase revenues, cut spending, or increase debt held by the public. The surplus will start to decline in 2008. Social Security (ie, OASDI) it will go negative cash-flow in 2018. In 2042, all of the IOUs will have been redeemed and it is at that point when, if Congress does nothing, benefits will go from everybody being paid a dollar of benefits for every dollar of promised benefits to 73 cents in benefits for every dollar and it will get progressively worse over time.

Yes, Congress could wait until 2042, as it did in 1983. That is where you were in 1983. The trust fund was going to be exhausted. There was still money coming in. Given where Social Security stands as compared to our broader fiscal challenges, it would be imprudent to wait why, because Social Security should be easy lifting as compared to Medicare, Medicaid, and some of our other challenges which are likely to take many years to address and are likely to require a lot tougher choices.

So Social Security is part of our broader fiscal and economic challenge. Acting sooner rather than later can help in many ways, including the fact that by acting sooner, you don't have to make as dramatic of changes and there is more time for transition. Furthermore, it is my earnest belief, having been involved in this issue for many years, that Congress has an opportunity to exceed the expectations of every generation of Americans in connection with Social Security reform. By that I mean every generation can get more money than they think they are going to get, and I will give you a personal example.

My parents who are retired, they are going to get every dime of what has been promised to them. My son is 28. My daughter is 31. They are discounting Social Security to a much greater extent than they should, because even when the trust fund goes dry in 2042, there is 73 cents in revenue for every dollar of promised benefits. But they are discounting it much more than that.

You have an opportunity to leave current retirees and near-term retirees alone, give them everything that is promised, make pro-

gressively greater changes the younger a person is, but you have to do more than just individual accounts and you may or may not want to do individual accounts. If you do that, every generation can get more than they think they are going to get. That is what I would call a win.

What is important about that is right now. Because last year may have been the worst year, in my opinion, in our fiscal history. We had huge current year deficits and, we increased our unfunded obligations by $13 trillion in one year, $8.1 trillion of which was the Medicare prescription drug benefit. We face serious financial and fiscal challenges. We need to send a signal to the markets that we are serious about dealing with these large and growing challenges and we need to send a signal to the American people that we are willing to deal with some of these large and growing challenges before we are about ready to hit the wall.

By hitting the wall, I mean cutting benefits dramatically and suddenly to a bunch of people when the trust fund runs dry rather than trying to deal with it more prudently and more pragmatically over time.

In summary, I note that GAO has been involved in this issue for a number of years. We have recommended three basic criteria for evaluating all Social Security reform proposals. First, how do they stack up against financing, sustainable solvency, not just solvency over 75 years, solvency in perpetuity, because even when the changes were made in 1983, it was known from day one that they were going to be out of balance within a year because of known demographic trends.

Second, we need to balance adequacy and equity with regard to all the different stakeholders that rely upon Social Security in its many forms.

Third, it is important to look at how it will be implemented, including administrative feasibility, which is particularly relevant if the Congress decides it is going to have individual accounts. But if you do have individual accounts, they are not going to solve the problem. There are pros and cons to individual accounts. You have to have other reforms, as well, in order to achieve these objectives.

We stand ready, Mr. Chairman and Senators, to continue to assist this committee and the Congress in analyzing various Social Security reform proposals. But let me just say, it is not an immediate crisis. That is true. It is a large and growing problem and it would be prudent to act sooner rather than later because this is easy compared to the real heavy lifting that is going to have to be done to reconcile our large and growing fiscal gap, which now is estimated to be $43 trillion in current dollar terms, $350,000 for every full-time worker, $145,000 for every American.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Walker follows:]

United States Government Accountability Office

GAO

Testimony
Before the Special Committee on Aging, U.S. Senate

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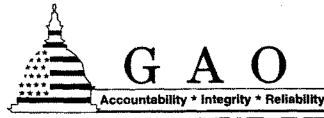
SOCIAL SECURITY

Long-Term Challenges Warrant Early Action

Statement of David M. Walker
Comptroller General of the United States



GAO-05-303T

February 3, 2005

Highlights

Highlights of GAO-05-303T, a report to the Special Committee on Aging, U.S. Senate

SOCIAL SECURITY

Long-Term Challenges Warrant Early Action

Why GAO Did This Study

Social Security is the foundation of the nation's retirement income system, helping to protect the vast majority of American workers and their families from poverty in old age. However, it is much more than a retirement program and also provides millions of Americans with disability insurance and survivors' benefits. Over the long term, as the baby boom generation retires and as Americans continue to live longer and have fewer children, Social Security's financing shortfall presents a major program solvency and sustainability challenge that is growing as time passes.

The Chairman and Ranking Member of the Senate Special Committee on Aging asked GAO to discuss the future of the Social Security program. This testimony will address the nature of Social Security's long-term financing problem and why it is preferable for Congress to take action sooner rather than later, as well as the broader context in which reform proposals should be considered.

www.gao.gov/cgi-bin/getrpt?GAO-05-303T.

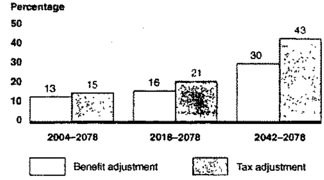
To view the full product, including the scope and methodology, click on the link above. For more information, contact Barbara Bovbjerg (202) 512-7215 or bovbjergb@gao.gov.

What GAO Found

Although the Social Security system in not in crisis today, it faces serious and growing solvency and sustainability challenges. Furthermore, Social Security's problems are a subset of our nation's overall fiscal challenge. Absent reform, the nation will ultimately have to choose among escalating federal deficits and debt, huge tax increases and/or dramatic budget cuts. GAO's long-term budget simulations show that to move into the future with no changes in federal retirement and health programs is to envision a very different role for the federal government. With regard to Social Security, if we did nothing until 2042, achieving actuarial balance would require a reduction in benefits of 30 percent or an increase in payroll taxes of 43 percent. In contrast, taking action soon will serve to reduce the amount of change needed to ensure that Social Security is solvent, sustainable, and secure for current and future generations. Acting sooner will also serve to improve the federal government's credibility with the markets and the confidence of the American people in the government's ability to address long-range challenges before they reach crisis proportions.

However, financial stability should not be the only consideration when evaluating reform proposals. Other important objectives, such as balancing the adequacy and equity of the benefits structure need to be considered. Furthermore, any changes to Social Security should be considered in the context of the broader challenges facing our nation, such as the changing nature of the private pension system, escalating health care costs, and the need to reform Medicare and Medicaid.

Size of Action Needed to Achieve Social Security Solvency



Source: Office of the Chief Actuary, Social Security Administration.

Note: This is based on the intermediate assumptions of the 2004 Social Security trustees' report. The benefit adjustments in this graph represent a one-time, permanent change to all existing and future benefits beginning in the first year indicated. Estimates cover the time period from January 1st of the first year to December 31, 2078.

Mr. Chairman and Members of the Committee:

Thank you for inviting me here to talk about our nation's Social Security program and how to address the challenges presented in ensuring the long-term viability of this important social insurance system. Social Security not only represents the foundation of our retirement income system, it also provides millions of Americans with disability insurance and survivors' benefits. As a result, Social Security provides benefits that are critical to the current and future well-being of tens of millions of Americans. As I have said in congressional testimonies over the past several years, the system faces both solvency and sustainability challenges in the longer term. While the Social Security program does not face an immediate crisis, it does have a $3.7 trillion gap between promised and funded benefits in current dollar terms. This gap is growing rapidly and, given this and other major fiscal challenges, it would be prudent to act sooner rather than later to reform the Social Security program. Failure to take steps to address our large and structural long-range fiscal imbalance, which is driven in large part by projected increases in Medicare, Medicaid and Social Security spending, will ultimately have significant adverse consequences for our future economy and quality of life.

Let me begin by highlighting a number of important points concerning the Social Security challenge.

- **Solving Social Security's long-term financing problem is more important and complex than simply making the numbers add up.** Social Security is an important and successful social insurance program that affects virtually every American family. It currently pays benefits to more than 47 million people, including retired workers, disabled workers, the spouses and children of retired and disabled workers, and the survivors of deceased workers. The number of individuals receiving benefits is expected to grow to almost 69 million by 2020. The program has been highly effective at reducing the incidence of poverty among the elderly, and the disability and survivor benefits have been critical to the financial well-being of millions of others.

- **Focusing on trust fund solvency alone is not sufficient. We need to put the program on a path toward sustainable solvency.** Trust fund solvency is an important concept, but focusing on trust fund solvency alone can lead to a false sense of security about the overall financial condition of the Social Security program. For example, the size of the trust fund does not tell us whether the program is

sustainable—that is, whether the government will have the capacity to pay future claims or what else will have to be squeezed to pay those claims. Furthermore, estimates of what it would take to achieve 75-year trust fund solvency understate the extent of the problem because the program's financial imbalance gets worse in the 76th and subsequent years.

- **Social Security reform is part of a broader fiscal and economic challenge.** If you look ahead in the federal budget, the combined Social Security or Old-Age and Survivors Insurance and Disability Insurance (OASDI) program, together with the rapidly growing health programs, will dominate the federal government's future fiscal outlook. While this hearing is not about the complexities of Medicare, it is important to note that Medicare presents a much greater, more complex, and more urgent fiscal challenge than does Social Security. Medicare growth rates reflect not only a burgeoning beneficiary population, but also the escalation of health care costs at rates well exceeding general rates of inflation. Taken together, Social Security, Medicare, and Medicaid represent an unsustainable burden on future generations. Under the 2004 Trustees' intermediate estimates and the Congressional Budget Office's (CBO) long-term Medicaid estimates, spending for Social Security, Medicare, and Medicaid combined will grow to 15.6 percent of GDP in 2030 from today's 8.5 percent. Absent meaningful changes to these programs, the nation will ultimately have to choose among persistent, escalating federal deficits, huge tax increases, and/or dramatic budget cuts. Furthermore, any changes to Social Security should be considered in the context of the problems currently facing our nation's private pension system. These include the chronically low level of coverage of the private workforce, the continued decline in defined benefit plans coupled with the termination of large underfunded plans by bankrupt firms, and the shift by employers to defined contribution plans, where workers face the potential for greater return but also assume greater financial risk.

- **Acting sooner rather than later helps to ease the difficulty of change.** As I noted previously, the challenge of facing the imminent and daunting budget pressure from Medicare, Medicaid, and OASDI increases over time. Social Security will begin to constrain the budget long before the trust fund is exhausted in 2042. The trust fund cash surpluses that are now helping to finance the rest of the government's budgetary needs will begin to decline after 2008, and by 2018, the cash surpluses will turn into deficits. At that point, Social Security's cash shortfall will begin to place increasing pressure on the rest of the budget to raise the resources necessary to meet the program's costs.

Waiting until Social Security faces an immediate solvency crisis will limit the scope of feasible solutions and could reduce the options to only those choices that are the most difficult. It could also contribute to a further delay of the really tough decisions on Medicare and Medicaid. Acting sooner rather than later would allow changes to be phased in so that future and near-term retirees have time to adjust their retirement planning. Furthermore, acting sooner rather than later would serve to increase our credibility with the markets and improve the public's confidence in the federal government's ability to deal with our significant long-range fiscal challenges before they reach crisis proportions.

- **Reform proposals should be evaluated as packages.** The elements of any package interact; every package will have pluses and minuses, and no plan will satisfy everyone on all dimensions. If we focus on the pros and cons of each element of reform by itself, we may find it impossible to build the bridges necessary to achieve consensus. It is also important to establish the appropriate comparisons or benchmarks against which reforms should be measured. Given the current projected financial shortfall of the program, it is important to compare proposals to at least two benchmarks—one that raises revenue to fund currently scheduled benefits (promised benefits) and one that adjusts to current tax financing by reducing benefits (funded benefits). Comparing the benefit impact of reform proposals solely to currently scheduled Social Security benefits is inappropriate since all current scheduled benefits are not funded over the longer term. Estimating future effects on Social Security benefits should reflect the fact that the program faces a long-term actuarial deficit and that benefit reduction and/or revenue increases will be necessary to restore solvency. The key point is that there is a significant gap between scheduled benefits and projected revenues. In fact, a primary purpose of most Social Security reform proposals is to close or eliminate this gap.

Failure to address the Social Security financing problem will, in combination with other entitlement spending, constitute an unsustainable burden on both the federal government and, ultimately, the economy. However, this problem is about more than finances. It is also about maintaining an adequate safety net for American workers against loss of income from retirement, disability, or death. Social Security has prevented many former workers and their families from living their retirement years in poverty. As the Congress considers proposals to restore the long-term financial stability and viability of the Social Security system, it will also need to consider the impact of the potential changes on the millions of

Americans the system serves: specifically, the effects on different types of beneficiaries and the resulting implications for the adequacy and equity of the benefits structure. The fundamental nature of the program's long-term financing challenge means that timely action is needed. I believe it is possible to craft a solution that will protect Social Security benefits for the nation's current and near-term retirees, while ensuring that the system will be solvent, sustainable, and secure for future generations. Stated differently, I believe that it is possible to reform Social Security in a way that will ensure the program's solvency, sustainability, and security while exceeding the expectations of all generations of Americans. I also believe that, given our other fiscal challenges, it is prudent to act sooner rather than later to address this large and growing problem.

Social Security's Long-term Financing Problem Is More Urgent than It May Appear

Today, the Social Security program does not face an immediate crisis, but it does face a long-range financing problem driven primarily by known demographic trends that is growing rapidly. While the crisis is not immediate, the challenge is more urgent than it may appear. Acting soon to address these problems reduces the likelihood that the Congress will have to choose between imposing severe benefit cuts and unfairly burdening future generations with the program's rising costs. Acting soon would also allow changes to be phased in so that the individuals who are most likely to be affected, namely younger and future workers, will have time to adjust their retirement planning while helping to avoid related "expectation gaps." On the other hand, failure to take remedial action will, in combination with other entitlement spending, lead to a situation unsustainable for both the federal government and, ultimately, the economy.

The Social Security system has required changes in the past to ensure future solvency. Indeed, the Congress has always taken the actions necessary to do this when faced with an immediate solvency crisis. I would like to spend some time describing the nature, timing, and extent of Social Security's financing problem.

The Causes of Social Security's Long-Term Financing Problem

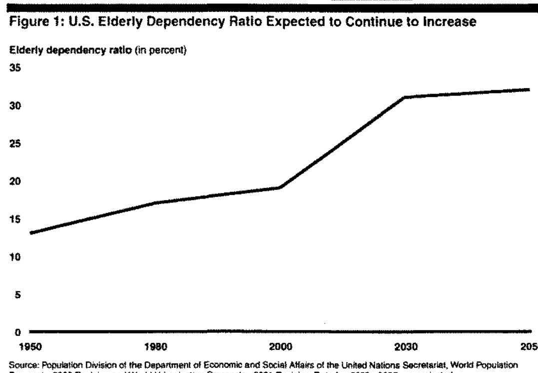
As you all know, Social Security has always been a largely pay-as-you-go system. This means that the system's financial condition is directly affected by the relative size of the populations of covered workers and beneficiaries. Historically, this relationship has been favorable. Now,

however, people are living longer, and spending more time in retirement. As shown in figure 1, the U.S. elderly dependency ratio is expected to continue to increase.[1] The proportion of the elderly population relative to the working-age population in the U.S. rose from 13 percent in 1950 to 19 percent in 2000. By 2050, there is projected to be almost 1 elderly dependent for every 3 people of working age—a ratio of 32 percent. Additionally, the average life expectancy of males at birth has increased from 66.6 in 1960 to 74.3 in 2000, with females at birth experiencing a rise of 6.6 years from 73.1 to 79.7 over the same period. As general life expectancy has increased in the United States, there has also been an increase in the number of years spent in retirement. Improvements in life expectancy have extended the average amount of time spent by workers in retirement from 11.5 years in 1950 to 18 years for the average male worker as of 2003. A falling fertility rate is the other principal factor underlying the growth in the elderly's share of the population. In the 1960s, the fertility rate was an average of 3 children per woman.[2] Today it is a little over 2, and by 2030 it is expected to fall to 1.95—a rate that is below what it takes to maintain a stable population. Taken together, these trends threaten the financial solvency and sustainability of this important program.

[1]The elderly dependency ratio is the ratio of the population aged 65 years or over to the population aged 15 to 64.

[2]The fertility rate is the average number of children a hypothetical cohort of women would have at the end of their reproductive period if they were subject during their whole lives to the fertility rates of a given period and if they were not subject to mortality. It is expressed as children per woman.

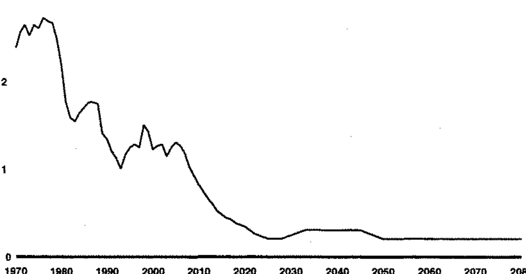
Figure 1: U.S. Elderly Dependency Ratio Expected to Continue to Increase



Source: Population Division of the Department of Economic and Social Affairs of the United Nations Secretariat, World Population Prospects: 2002 Revision and World Urbanization Prospects: 2001 Revision. Data for 2030 - 2050 are projected.

The result of these trends is that labor force growth will continue to decline in 2006 and by 2025 is expected to be less than a fifth of what it is today, as shown in figure 2. Relatively fewer U.S. workers will be available to produce goods and services. Without a major increase in productivity or increases in immigration, low labor force growth will lead to slower growth in the economy and to slower growth of federal revenues. This in turn will only accentuate the overall pressure on the federal budget.

Figure 2: U.S. Labor Force Growth Will Continue to Decline



Source: GAO analysis of data from the Office of the Chief Actuary, Social Security Administration.

Note: Percentage change is calculated as a centered 5-year moving average of projections based on the intermediate assumptions of the 2004 Trustees Reports.

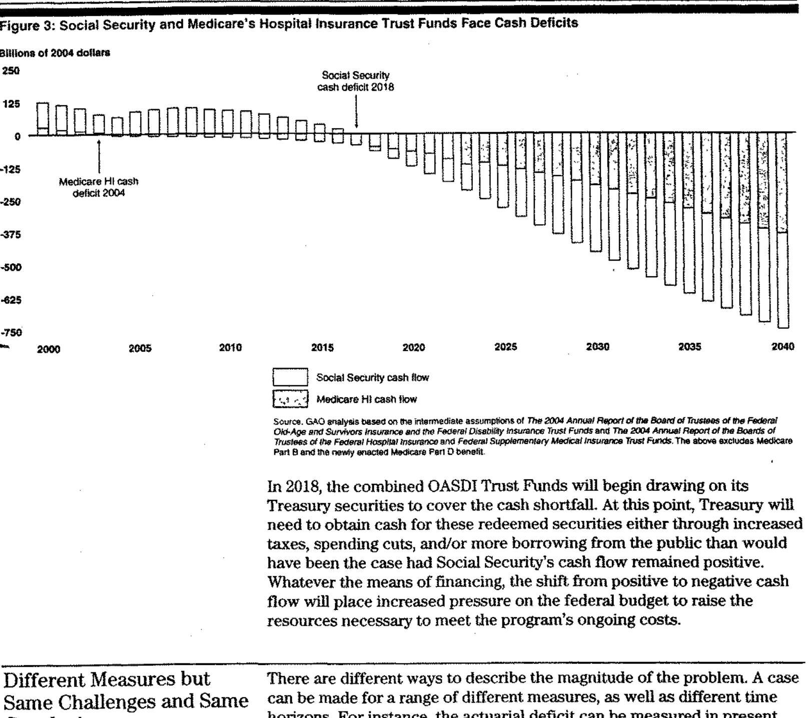
This slowing labor force growth has important implications for the Social Security system. Social Security's retirement eligibility dates are often the subject of discussion and debate and can have a direct effect on both labor force growth and the condition of the Social Security retirement program. It is also appropriate to consider whether and how changes in pension and/or other government policies could encourage longer workforce participation. To the extent that people choose to work longer as they live longer, the increase in the amount of time spent in retirement could be diminished. This could improve the finances of Social Security and mitigate the expected slowdown in labor force growth.

The Social Security program's situation is one symptom of this larger demographic trend that will have broad and profound effects on our nation's future in other ways as well. The aging of the labor force and the reduced growth in the number of workers will have important implications for the size and composition of the labor force, as well as the characteristics of many jobs in our increasingly knowledge-based economy, throughout the 21st century. The U.S. workforce of the 21st century will be facing very different opportunities and challenges than those of previous generations.

Cash Flow Turns Negative in 2018

Today, the Social Security Trust Funds take in more in taxes than they spend. Largely because of the demographic trends I have described, this situation will change. Although the trustees' 2004 intermediate estimates project that the combined Social Security Trust Funds will be solvent until 2042, program spending will constitute a rapidly growing share of the budget and the economy well before that date. Under the trustees' 2004 intermediate estimates, Social Security's cash surplus—the difference between program tax income and the costs of paying scheduled benefits—will begin to decline in 2008. By 2018, the program's cash flow is projected to turn negative—its tax income will fall below benefit payments. At that time, the program will begin to experience a negative cash flow, which will accelerate over time. Social Security will join Medicare's Hospital Insurance Trust Fund, whose outlays exceeded cash income in 2004, as a net claimant on the rest of the federal budget. (See figure 3.)

Figure 3: Social Security and Medicare's Hospital Insurance Trust Funds Face Cash Deficits



Source: GAO analysis based on the intermediate assumptions of *The 2004 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and the Federal Disability Insurance Trust Funds* and *The 2004 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds*. The above excludes Medicare Part B and the newly enacted Medicare Part D benefit.

In 2018, the combined OASDI Trust Funds will begin drawing on its Treasury securities to cover the cash shortfall. At this point, Treasury will need to obtain cash for these redeemed securities either through increased taxes, spending cuts, and/or more borrowing from the public than would have been the case had Social Security's cash flow remained positive. Whatever the means of financing, the shift from positive to negative cash flow will place increased pressure on the federal budget to raise the resources necessary to meet the program's ongoing costs.

Different Measures but Same Challenges and Same Conclusion

There are different ways to describe the magnitude of the problem. A case can be made for a range of different measures, as well as different time horizons. For instance, the actuarial deficit can be measured in present value, as a percentage of GDP, or as a percentage of taxable payroll in the future. The Social Security Administration (SSA) and CBO have both made projections of Social Security's future actuarial deficit using different horizons. (See table 1.)

Table 1: Different Measures, Same Challenge

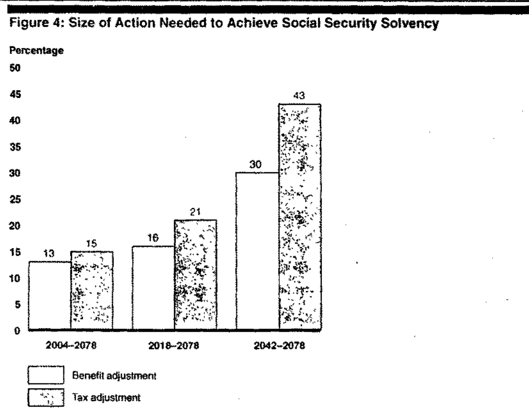
Projection horizon	Projections of actuarial deficit in terms of		
	Present value	Percent of GDP	Percent of payroll
75 year (SSA)	$3.7 Trillion	0.7%	1.89%
100 year (CBO)	$4.6 Trillion	0.54%	1.44%
Infinite horizon (SSA)	$10.4 Trillion	1.2%	3.5%

Sources: Social Security Administration, *The 2004 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*. Washington, D.C., March 2004. Congressional Budget Office, *The Outlook for Social Security: Potential Range of Social Security Outlays and Revenues Under Current Law*. Washington, D.C., June 2004.

CBO uses a 100-year horizon to project Social Security's future actuarial deficit, while the Social Security Administration utilizes both 75-year and infinite horizon projections to estimate the future deficit. In addition, both the Social Security Administration and CBO have different economic assumptions for variables such as real earnings, real interest rates, inflation, and unemployment.

While their estimates vary due to different horizons and economic assumptions, each identifies the same long-term challenge: The Social Security system is unsustainable in its present form over the long run. Taking action soon on Social Security would not only make the necessary action less dramatic than if we wait but would also promote increased budgetary flexibility in the future and stronger economic growth. Some of the benefits of early action—and the costs of delay—can be seen in figure 4. This figure compares what it would take to keep Social Security solvent through 2078, if action were taken at three different points in time, by either raising payroll taxes or reducing benefits. If we did nothing until 2042—the year SSA estimates the Trust Funds will be exhausted—achieving actuarial balance would require changes in benefits of 30 percent or changes in taxes of 43 percent. As figure 4 shows, earlier action shrinks the size of the necessary adjustment.

Figure 4: Size of Action Needed to Achieve Social Security Solvency



Source: Office of the Chief Actuary, Social Security Administration.

Note: This is based on the intermediate assumptions of the 2004 Social Security trustees' report. The benefit adjustments in this graph represent a one-time, permanent change to all existing and future benefits beginning in the first year indicated.

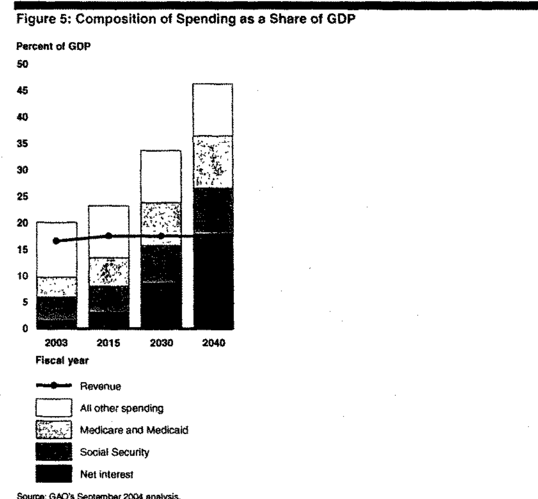
Social Security Reform Is Part of a Broader Fiscal and Economic Challenge

As I have already discussed, reducing the relative future burdens of Social Security and health programs is essential to a sustainable budget policy for the longer term. It is also critical if we are to avoid putting unsupportable financial pressures on Americans in the future. Reforming Social Security and health programs is essential to reclaiming our future fiscal flexibility to address other national priorities.

Changes in the composition of federal spending over the past several decades have reduced budgetary flexibility, and our current fiscal path will reduce it even further. During this time, spending on mandatory programs has consumed an ever-increasing share of the federal budget. In 1964, prior to the creation of the Medicare and Medicaid programs, spending for mandatory programs plus net interest accounted for about 33 percent of total federal spending. By 2004, this share had almost doubled to approximately 61 percent of the budget.

If you look ahead in the federal budget, the Social Security programs (Old-Age and Survivors Insurance and Disability Insurance), together with the rapidly growing health programs (Medicare and Medicaid), will dominate the federal government's future fiscal outlook. Absent reform, the nation will ultimately have to choose among persistent, escalating federal deficits and debt, huge tax increases and/or dramatic budget cuts. GAO's long-term budget simulations show that to move into the future with no changes in federal retirement and health programs is to envision a very different role for the federal government. Assuming that discretionary spending grows with inflation and all existing tax cuts are allowed to expire when scheduled under current law, spending for Social Security and health care programs would grow to consume over three-quarters of federal revenue by 2040. Moreover, if all expiring tax provisions are extended and discretionary spending keeps pace with the economy, by 2040 total federal revenues may be adequate to pay little more than interest on the federal debt. (See figure 5.)

Figure 5: Composition of Spending as a Share of GDP



Source: GAO's September 2004 analysis.

Notes: Although expiring tax provisions are extended, revenue as a share of GDP increases through 2014 due to (1) real bracket creep, (2) more taxpayers becoming subject to the AMT, and (3) increased revenue from tax-deferred retirement accounts. After 2014, revenue as a share of GDP is held constant.

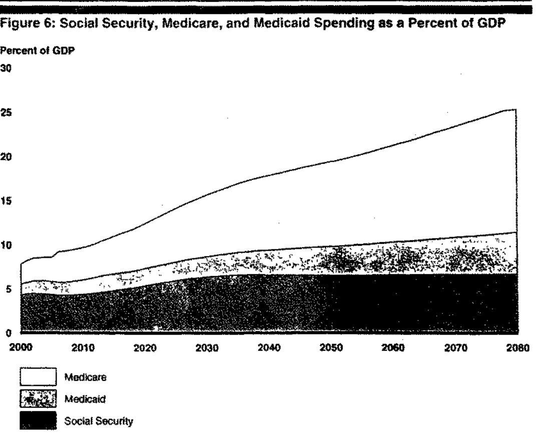
Alternatively, taking action soon on Social Security would not only promote increased budgetary flexibility in the future and stronger economic growth but would also make the necessary action less dramatic than if we wait. Indeed, long-term budget flexibility is about more than Social Security and Medicare. While these programs dominate the long-term outlook, they are not the only federal programs or activities that bind the future. The federal government undertakes a wide range of programs, responsibilities, and activities that obligate it to future spending or create an expectation for spending. GAO has described the range and measurement of such fiscal exposures—from explicit liabilities such as

environmental cleanup requirements to the more implicit obligations presented by life-cycle costs of capital acquisition or disaster assistance.[3] Making government fit the challenges of the future will require not only dealing with the drivers— entitlements for the elderly—but also looking at the range of federal activities. A fundamental review of what the federal government does and how it does it will be needed.

Also, at the same time it is important to look beyond the federal budget to the economy as a whole. Under the 2004 Trustees' intermediate estimates and CBO's long-term Medicaid estimates, spending for Social Security, Medicare, and Medicaid combined will grow to 15.6 percent of GDP in 2030 from today's 8.5 percent (See figure 6.) Taken together, Social Security, Medicare, and Medicaid represent an unsustainable burden on future generations.

[3]GAO, *Fiscal Exposures: Improving the Budgetary Focus on Long-Term Costs and Uncertainties*, GAO-03-213 (Washington, D.C.: Jan 24, 2003).

Figure 6: Social Security, Medicare, and Medicaid Spending as a Percent of GDP



Source: GAO analysis based on data from the Office of the Chief Actuary, Social Security Administration, Office of the Actuary, Centers for Medicare and Medicaid Services, and the Congressional Budget Office.

Note: Social Security and Medicare projections based on the intermediate assumptions of the 2004 Trustees' Reports. Medicaid projected based on CBO's January 2004 short-term Medicaid estimates and CBO's December 2003 long-term Medicaid projections under mid-range assumptions.

Considerations in Assessing Reform Options

As important as financial stability may be for Social Security, it cannot be the only consideration. As a former public trustee of Social Security and Medicare, I am well aware of the central role these programs play in the lives of millions of Americans. Social Security remains the foundation of the nation's retirement system. It is also much more than just a retirement program; it pays benefits to disabled workers and their dependents, spouses and children of retired workers, and survivors of deceased workers. In 2004, Social Security paid almost $493 billion in benefits to more than 47 million people. Since its inception, the program has successfully reduced poverty among the elderly. In 1959, 35 percent of the elderly were poor. In 2000, about 8 percent of beneficiaries aged 65 or older were poor, and 48 percent would have been poor without Social Security. It is precisely because the program is so deeply woven into the fabric of our nation that any proposed reform must consider the program in its entirety, rather than one aspect alone. Thus, GAO has developed a

broad framework for evaluating reform proposals that considers not only solvency but other aspects of the program as well.

The GAO Criteria for Reform

The analytic framework GAO has developed to assess proposals comprises three basic criteria:

- **Financing Sustainable Solvency**—the extent to which a proposal achieves sustainable solvency and how it would affect the economy and the federal budget. Our sustainable solvency standard encompasses several different ways of looking at the Social Security program's financing needs. While a 75-year actuarial balance has generally been used in evaluating the long-term financial outlook of the Social Security program and reform proposals, it is not sufficient in gauging the program's solvency after the 75th year. For example, under the trustees' intermediate assumptions, each year the 75-year actuarial period changes, and a year with a surplus is replaced by a new 75th year that has a significant deficit. As a result, changes made to restore trust fund solvency only for the 75-year period can result in future actuarial imbalances almost immediately. Reform plans that lead to sustainable solvency would be those that consider the broader issues of fiscal sustainability and affordability over the long term. Specifically, a standard of sustainable solvency also involves looking at (1) the balance between program income and costs beyond the 75th year and (2) the share of the budget and economy consumed by Social Security spending.

- **Balancing Adequacy and Equity**—the relative balance struck between the goals of individual equity and income adequacy. The current Social Security system's benefit structure attempts to strike a balance between the goals of retirement income adequacy and individual equity. From the beginning, Social Security benefits were set in a way that focused especially on replacing some portion of workers' pre-retirement earnings. Over time other changes were made that were intended to enhance the program's role in helping ensure adequate incomes. Retirement income adequacy, therefore, is addressed in part through the program's progressive benefit structure, providing proportionately larger benefits to lower earners and certain household types, such as those with dependents. Individual equity refers to the relationship between contributions made and benefits received. This can be thought of as the rate of return on individual contributions. Balancing these seemingly conflicting objectives through the political process has resulted in the design of the current Social Security

program and should still be taken into account in any proposed reforms.

- **Implementing and Administering Proposed Reforms**—how readily a proposal could be implemented, administered, and explained to the public. Program complexity makes implementation and administration both more difficult and harder to explain to the public. Some degree of implementation and administrative complexity arises in virtually all proposed changes to Social Security, even those that make incremental changes in the already existing structure. Although these issues may appear technical or routine on the surface, they are important issues because they have the potential to delay—if not derail—reform if they are not considered early enough for planning purposes. Moreover, issues such as feasibility and cost can, and should, influence policy choices. Continued public acceptance of and confidence in the Social Security program require that any reforms and their implications for benefits be well understood. This means that the American people must understand why change is necessary, what the reforms are, why they are needed, how they are to be implemented and administered, and how they will affect their own retirement income. All reform proposals will require some additional outreach to the public so that future beneficiaries can adjust their retirement planning accordingly. The more transparent the implementation and administration of reform, and the more carefully such reform is phased in, the more likely it will be understood and accepted by the American people.

The weight that different policy makers may place on different criteria will vary, depending on how they value different attributes. For example, if offering individual choice and control is less important than maintaining replacement rates for low-income workers, then a reform proposal emphasizing adequacy considerations might be preferred. As they fashion a comprehensive proposal, however, policy makers will ultimately have to balance the relative importance they place on each of these criteria. As we have noted in the past before this committee and elsewhere, a comprehensive evaluation is needed that considers a range of effects together. Focusing on comprehensive packages of reforms will enable us to foster credibility and acceptance. This will help us avoid getting mired in the details and losing sight of important interactive effects. It will help build the bridges necessary to achieve consensus.

One issue that often arises within the Social Security debate concerns the appropriate comparisons or benchmarks to be used when assessing a particular proposal. While this issue may seem to be somewhat abstract, it has critical implications, for depending on the comparisons chosen, a

proposal can be made more or less attractive. Some analyses compare proposals to a single benchmark and as a result can lead to incomplete or misleading conclusions. For that reason, GAO has used several benchmarks in assessing reform proposals.[4] Currently promised benefits are not fully financed, and so any analysis that seeks to fairly evaluate reform proposals should rely on benchmarks that reflect a policy of an adequately financed system. Similarly, it is important to have benchmarks that are consistent with each other. Using one that relies on action relatively soon versus one that posits no action at all are not consistent and could also lead to misleading conclusions. Estimating future effects on Social Security benefits should reflect the fact that the program faces a long-term actuarial deficit and that conscious policies of benefit reduction and/or revenue increases will be necessary to restore solvency and sustain it over time.

Reform Will Have Pervasive Impact on the Social Security Program

A variety of proposals have been offered to address Social Security's financial problems. Many proposals contain reforms that would alter benefits or revenues within the structure of the current defined benefits system. Some would reduce benefits by modifying the benefit formula (such as increasing the number of years used to calculate benefits or using price-indexing instead of wage-indexing), reduce cost-of-living adjustments (COLA), raise the normal and/or early retirement ages, or revise dependent benefits. Some of the proposals also include measures or benefit changes that seek to strengthen progressivity (e.g., replacement rates) in an effort to mitigate the effect on low-income workers. Others have proposed revenue increases, including raising the payroll tax or expanding the Social Security taxable wage base that finances the system; increasing the taxation of benefits; or covering those few remaining workers not currently required to participate in Social Security, such as older state and local government employees.

A number of proposals also seek to restructure the program through the creation of individual accounts. Under a system of individual accounts, workers would manage a portion of their own Social Security contributions to varying degrees. This would expose workers to a greater degree of risk in return for both greater individual choice in retirement investments and the possibility of a higher rate of return on contributions

[4]GAO, *Social Security Reform: Analysis of Reform Models Developed by the President's Commission to Strengthen Social Security*, GAO-03-310 (Washington, D.C.: Jan 15, 2003).

than available under current law. There are many different ways that an individual account system could be set up. For example, contributions to individual accounts could be mandatory or they could be voluntary. Proposals also differ in the manner in which accounts would be financed, the extent of choice and flexibility concerning investment options, the way in which benefits are paid out, and the way the accounts would interact with the existing Social Security program—individual accounts could serve either as an addition to or as a replacement for part of the current benefit structure.

In addition, the timing and impact of individual accounts on the solvency, sustainability, adequacy, equity, net savings, and rate of return associated with the Social Security system varies depending on the structure of the total reform package. Individual accounts by themselves will not lead the system to sustainable solvency. Achieving sustainable solvency requires more revenue, lower benefits, or both. Furthermore, incorporating a system of individual accounts may involve significant transition costs. These costs come about because the Social Security system would have to continue paying out benefits to current and near-term retirees concurrently with establishing new individual accounts.

Individual accounts can contribute to sustainability as they could provide a mechanism to prefund retirement benefits that would be immune to demographic booms and busts. However, if such accounts are funded through borrowing, no such prefunding is achieved. An additional important consideration in adopting a reform package that contains individual accounts would be the level of benefit adequacy achieved by the reform. To the extent that benefits are not adequate, it may result in the government eventually providing additional revenues to make up the difference.

Also, some degree of implementation and administrative complexity arises in virtually all proposed changes to Social Security. The greatest potential implementation and administrative challenges are associated with proposals that would create individual accounts. These include, for example, issues concerning the management of the information and money flow needed to maintain such a system, the degree of choice and flexibility individuals would have over investment options and access to their accounts, investment education and transitional efforts, and the mechanisms that would be used to pay out benefits upon retirement. The Federal Thrift Savings Plan (TSP) could serve as a model for providing a limited amount of options that reduce risk and administrative costs while still providing some degree of choice. However, a system of accounts that

spans the entire national workforce and millions of employers would be significantly larger and more complex than the TSP or any other system we have in place today.

Harmonizing a system that includes individual accounts with the regulatory framework that governs our nation's private pension system would also be a complicated endeavor. However, the complexity of meshing these systems should be weighed against the potential benefits of extending participation in individual accounts to millions of workers who currently lack private pension coverage.

Social Security Reform Should Be Considered in the Context of Broader Challenges

Another important consideration for Social Security reform is assessing a proposal's effect on national saving. Individual account proposals that fund accounts through redirection of payroll taxes or general revenue do not increase national saving on a first order basis. The redirection of payroll taxes or general revenue reduces government saving by the same amount that the individual accounts increase private saving. Beyond these first order effects, the actual net effect of a proposal on national saving is difficult to estimate due to uncertainties in predicting changes in future spending and revenue policies of the government as well as changes in the saving behavior of private households and individuals. For example, the lower surpluses and higher deficits that result from redirecting payroll taxes to individual accounts could lead to changes in federal fiscal policy that would increase national saving. On the other hand, households may respond by reducing their other saving in response to the creation of individual accounts. No expert consensus exists on how Social Security reform proposals would affect the saving behavior of private households and businesses.

Finally, the effort to reform Social Security is occurring as our nation's private pension system is also facing serious challenges. Only about half of the private sector workforce is covered by a pension plan. A number of large underfunded traditional defined benefit plans—plans where the employer bears the risk of investment—have been terminated by bankrupt firms, including household names like Bethlehem Steel, US Airways, and Polaroid. These terminations have resulted in thousands of workers losing promised benefits and have saddled the Pension Benefit Guaranty Corporation, the government corporation that partially insures certain defined benefit pension benefits, with billions of dollars in liabilities that threaten its long-term solvency. Meanwhile, the number of traditional defined benefit pension plans continues to decline as employers increasingly offer workers defined contribution plans like 401(k) plans

where, like individual accounts, workers face the potential of both greater return and greater risk. These challenges serve to reinforce the imperative to place Social Security on a sound financial footing.

Regardless of what type of Social Security reform package is adopted, continued confidence in the Social Security program is essential. This means that the American people must understand why change is necessary, what the reforms are, why they are needed, how they are to be implemented and administered, and how they will affect their own retirement income. All reform proposals will require some additional outreach to the public so that future beneficiaries can adjust their retirement planning accordingly. The more transparent the implementation and administration of reform, and the more carefully such reform is phased in, the more likely it will be understood and accepted by the American people.

Conclusions

Social Security does not face an immediate crisis but it does face a large and growing financial problem. In addition, our Social Security challenge is only part of a much broader challenge that includes, among other things, the need to reform Medicare, Medicaid and our overall health care system.

Today many retirees and near retirees fear cuts that would affect them in the immediate future while young people believe they will get little or no Social Security benefits in the longer term. I believe that it is possible to reform Social Security in a way that will ensure the program's solvency, sustainability, and security while exceeding the expectations of all generations of Americans.

In my view, there is a window of opportunity to reform Social Security; however, this window of opportunity will begin to close as the baby boom generation begins to retire. Furthermore, it would be prudent to move forward to address Social Security now because we have much larger challenges confronting us that will take years to resolve. The fact is, compared to addressing our long-range health care financing problem, reforming Social Security should be easy lifting.

We at GAO look forward to continuing to work with this Committee and the Congress in addressing this and other important issues facing our nation. In doing so, we will be true to our core values of accountability, integrity, and reliability.

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Public Affairs

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The CHAIRMAN. Gentlemen, a bipartisan group, including myself, recently were in Europe at a conference. I was in one meeting in which European demographics and economics were shared with us. I think to your point, David, if we don't begin to do something, we will do serious damage to our economy, and my question is, are some of those European models examples of the damage that can occur, because what I saw is that their demographics are worse than ours. Their promises are greater than ours. They, frankly, make our problem look like a fairly good time.

I don't know whether you believe that to be true, but I would be interested in your opinion. But as I look at what you have just shared with us about the share of the nation's payrolls that will be required to finance what is current law, I am wondering what you see for the American economy if we don't figure this out, because you have used a static economic projection model, I assume, in what you have shared with us, and I am wondering what that will do to American competitiveness if we don't fix this as against China and other emerging nations that have very different demographics, much younger workforces, and burgeoning economies. Do you have a comment?

Mr. WALKER. Mr. Chairman, first, it is true that there are other nations, including in Europe, that have more difficult demographics to deal with than we do. It is true that there are certain nations that have larger relative unfunded commitments to deal with than we do, and in some cases, they are not as transparent with regard to the nature and magnitude of those commitments.

But it is also true that some of them have started to deal with their problems before we have, the U.K. and Norway, just to name a couple off the top. It is also true that I don't take a whole lot of comfort in the fact that if we have serious problems, just because somebody else has more serious problems than we do, that we should be comforted by that. I don't think we should be comforted by that.

As I said, "One can't look at Social Security standing alone." Yes, it is $3.7 trillion, but we face a $43 trillion problem and it would be nice if we could make a good downpayment by doing something with this $3.7 trillion, because ultimately, we are going to have to end up starting to deal with the balance.

The CHAIRMAN. Do you have a comment, Doug?

Mr. HOLTZ-EAKIN. The CBO does examine Social Security proposals in the context of a model that captures both the direct and the indirect effects on long-term economic growth. We have not done formal analyses of payroll tax increases that look to be on the order of 5.5 percentage points to close the long-term gap between the benefits promised and the receipts dedicated to the program.

We have, however, looked in the context of the larger budgetary pressures, at the run-up in Social Security along with Medicare, Medicaid, projections for defense. These estimates were done at the end of December 2003. Qualitatively, it is the case that the United States' success rests on three pillars, the reliance on private markets, a relatively small, contained government as a result, on low and relatively efficient taxes by international standards, and on flexibility.

A large run-up in Federal spending of the magnitudes in that report would require much higher taxes and the taxes imposed, in our estimates, would have lowered capital accumulation, lowered labor supply, and reduced GDP over the long term, and that is a numerical result that we can go through with you. But qualitatively, that kind of spending has to financed somehow and it will have economic ramifications.

The CHAIRMAN. How much of the future growth of Social Security can be attributed to tying its initial benefits to wages as opposed to inflation and how much can be attributed to the aging of the population?

Mr. HOLTZ-EAKIN. In some work we did about two years ago, it broke about 50–50. Half of the rise in real outlays come from aging of the population, half from higher real benefits per recipient.

The CHAIRMAN. Senator Kohl.

Senator KOHL. Thank you, Mr. Chairman.

Gentlemen, just to cover some of the ground that you have talked about in your statements, is Social Security going to be broke in 2052, as we hear it said so often, or is it true that after the trust fund is exhausted, then retirees will, in fact, continue to receive benefits as a result of contributions that will continue to be made?

Mr. HOLTZ-EAKIN. As I said in my opening remarks, some form of the program is sustainable indefinitely.

Senator KOHL. Right.

Mr. HOLTZ-EAKIN. I think that the date, whether it is 2052 or 2042, is somewhat uncertain. But any group that has looked at this, whether it be the GAO, the Social Security actuaries, the CBO, agrees on the basic trajectory of the program.

Senator KOHL. Your estimate was, I think, something like 78 percent?

Mr. HOLTZ-EAKIN. We see a 22 percent across-the-board cut necessary. The SSA actuaries have a bigger cut and earlier.

Senator KOHL. Right. Depending on who looks at it, maybe somewhere between the mid 70's up until the upper 70's of what people expect will continue to be paid.

Mr. HOLTZ-EAKIN. Yes.

Senator KOHL. So it is not fair, or is it fair to say that Social Security at some point will be broke or bankrupt or anything else of that sort in the common vernacular as people think about it?

Mr. WALKER. The program will never go broke.

Senator KOHL. Right.

Mr. WALKER. The trust fund will go dry.

Senator KOHL. Right.

Mr. WALKER. The program will never go broke.

Senator KOHL. Right.

Mr. WALKER. But Senator Kohl, you probably recall the real controversy about the "notch baby" issue back a few years ago. Imagine a notch baby issue of the magnitude of tens of millions of persons where on one day, you are receiving a dollar of benefits for every dollar promised, and the next day, you are receiving 73 cents in benefits for every dollar promised. I mean, that is what would happen if Congress does nothing and waits until the trust fund goes dry.

Senator KOHL. That is true. There is no argument about that. But I just wanted to get those——

Mr. WALKER. You are right.

Senator KOHL [continuing]. Again, very clear, that we are not talking about a program that at some point is going to be broke in the sense that people will not get any money out of it. That is not true.

Mr. WALKER. It will never go broke.

Senator KOHL. Right. Is it true that with relatively small changes, that decisions would have to be made, we could get Social Security solvent for another 75 years? Maybe not into perpetuity, if you want to put that as the goal, but in terms of making relatively small changes in terms of our economy, its size, we can get this program solvent through the 21st century into the 22nd century, is that true?

Mr. HOLTZ-EAKIN. Small is in the eye of the beholder. I would caution you that any fix that involves making the trust fund last 75 years involves a period where the trust fund is declining——

Senator KOHL. Sure.

Mr. HOLTZ-EAKIN [continuing]. Each year in which that is true, those funds are coming from the remainder of the Federal budget. So it is far from the case that the overall problem is easy to fix. You could make the Social Security problem and hold it essentially harmless, but you will have a bigger problem elsewhere in the budget.

Senator KOHL. Of course, but what we are talking about in the context, for example, of the President's speech last night is Social Security. We are not talking about the entirety of our economy, the entirety of our—we are talking about Social Security and whether or not there are ways and means to make that program whole. The question I asked is whether it is true that we can make that program whole for many more years beyond 2040 or 2050 with relatively small changes in terms of our national economy. David.

Mr. WALKER. Three comments, Senator. Relatively small is in the eyes of the beholder. Second, clearly, relatively small as compared to Medicare.

Senator KOHL. Yes.

Mr. WALKER. No doubt about that. You are going to have to take much more dramatic actions there.

Second, I think there are a lot of positive things you can say about the changes that were made in 1983, but one of the things I would respectfully recommend to the Congress is that if you are going to go after Social Security again, you need to look for sustainable solvency, not just look for 75 years, why, because in 1983, they knew that the problem was going to reemerge because of known demographic trends.

Right now, you have a situation that every year, we take a surplus year that gets lower each year and we add an increasingly large deficit year. That is due to known demographics. So if you are going to take it on again, I would strongly suggest you try to solve it for the long-term.

Last, you could look at Social Security in isolation and say it is not that difficult, we can solve that for 75 years or in perpetuity. But I would respectfully suggest that one of the problems that we

have is that we are looking at everything in isolation and we shouldn't be doing that. We have to recognize that Social Security is a subset of a much bigger challenge. Not only do we have to deal with Social Security, we have to deal with Medicare, we have to deal with Medicaid, we have to deal with many other issues, and whatever you do with Social Security is going to have an impact on private pensions, personal savings, et cetera.

Senator KOHL. But it is true that the President raised the issue last night and so he is making it front and center, and so we have to discuss it because he has directed our attention to a single, what he describes as a catastrophic problem, Social Security, and that is why we are talking about it and that is why we are addressing it.

In that context and last, if it is true that we look to Washington to keep our eye on the ball, to see problems as they are and as they emerge and to look for ways in which we can solve those problems, and if it is true, as you have said, "That Medicare is by far a more serious problem", then why are we focusing on Social Security today, other than the fact that the President has decided that we are going to talk about Social Security? If Medicare is a much more serious and urgent problem that needs to be——

Mr. WALKER. I think you would have to ask the President. I would say that one of the reasons that it may be the case is because Social Security is a problem that is actually solvable. It is solvable in a way that you can exceed the expectations of every generation of Americans, and if you can do that, it would send a positive signal to the markets that we are willing to get serious about dealing with some of our large and growing long-term deficits, and second, that it could serve as a confidence builder among the public and potentially a momentum builder within the Congress to take on some of the more difficult challenges.

You do have to deal with Medicare. I would respectfully suggest, Senator, that may take many years and many installments——

Senator KOHL. My time is up, but didn't we just, at the President's urging and request, just add on an enormous liability to Medicare? Didn't we just do that with our eyes wide open, understanding then the same facts that we understand today? I mean, there was just a vote a few months ago.

Mr. WALKER. Senator, you are correct in saying that when the Medicare prescription drug bill was passed, it added $8.1 trillion to our unfunded obligations. It dug the hole much deeper. Part of the problem is because at the time that that bill was discussed and debated, Congress did not have access to its long-term cost. That has got to change. Congress needs——

Senator KOHL. Well, the administration had access to it. We didn't.

Mr. WALKER. I don't know that they had the 75-year costs. There was a difference——

Senator KOHL. It was very clear that people within the administration knew that the cost of that was far more than what we were told what it was. But, and finally, I end, because I know my time is up, it is ironic and perplexing that now the President is talking about these unfunded, probably, Social Security, and we have got to deal with it, got to understand what it means into the future, and if it is not dealt with, there are dire things that can occur. But

just a few months ago when we were dealing with the Medicare situation and he and others were urging that we pass this tremendous unfunded liability, there was no discussion of it in that context at all. So if we are mixed up and confused and trying to understand what is really happening, I hope you, at least, Mr. Walker, can understand.

Mr. WALKER. I have for several years, Senator, said that the Congress should have at its disposal before it passes legislation, whether it be tax legislation or spending legislation, the estimated long-term cost and implications of that legislation because we have been digging the hole deeper rather than filling the hole lately.

The CHAIRMAN. Thank you, Senator Kohl.

We have been joined by Senator Clinton and Senator Lincoln. We have each made opening statements, if you would like to make one, please feel free to do so or we will get to you shortly on questions.

Senator Nelson, you are next.

Senator NELSON. Could you all address the question that I had raised in my opening comments? What was changed last night?

Mr. WALKER. Do you want to go first?

Mr. HOLTZ-EAKIN. With the stipulation that we are far, far, far from a lot of detail on what we know was proposed, we have looked at the transcript of the speech, at the policy book that has been released, and at the transcript of a briefing which provided some background, and I think three things stand out in contrast to Commission Plan 2, which was widely discussed prior to the State of the Union.

First is in the contributions to the plan itself, as we understand it, there is a $1,000 cap which is now indexed to general wage growth and which then also goes up by $100 each year in addition to whatever wage growth there might be. So there is a rising cap on the contributions.

Second, there is a series of phase-ins in both when the program starts and then who is eligible to contribute to individual accounts.

Then third, in terms of the computations at the end of the working career, there are accumulations in the individual accounts that come from contributions. In Commission Plan 2, each contribution was, for purposes of calculating total benefits, that contribution was assumed to have a 2-percent real return. At the end of the working career, all these fictitious 2 percent earnings were used to calculate offsets to the traditional benefit. That 2 percent return has now been changed to 3 percent.

So there have been some, essentially, details on money going in, timing of eligibility, and calculation of total benefits at the end that look a little different from Commission Plan 2, but an enormous amount remains to be specified in terms of annuitization and many details.

Mr. WALKER. Senator, I would say there are still a lot of issues that have to be addressed to figure out how you are going to pay for the individual accounts. Commission Plan 2 provides some insights, potentially, as to what the administration has in mind, but it is not clear that they intend to necessarily go with Commission Plan 2.

There are several things that I took out of last night's State of the Union, and I was there as you were and others. First, I heard

the President say that if you are 55 years old or older, you will not be affected in any way, shape, or form. Presumably, that means that whatever the benefits people 55 and older have been promised and in whatever form they will get it.

Second, the language that I heard appeared to say that individual accounts would be optional. He didn't actually use the word optional, but that is what I inferred, at least, that it would be optional for people under 55.

Senator NELSON. He said voluntary.

Mr. WALKER. Voluntary. Well, then that is optional. That tells me it is optional. The question is——

Senator NELSON. What does that mean to you?

Mr. WALKER. Well, what it means to me is that you wouldn't automatically have to take part of your payroll tax and use it to fund an individual account. You might be able to stick with the current system, and part of the question would be is if you did take part of the payroll tax and use it for an individual account, what would the tradeoff be? How would your defined benefit promise otherwise be affected? That hasn't been defined yet, and that is something that obviously would have to be defined.

There are a number of important details that would have to be defined before, A, you can really understand it, and second, before you can cost it and think about what the potential implications would be for individuals.

Senator NELSON. So we are really reacting to something that we don't know what the specifics are. We are having an academic discussion about various things that we might put on the table, but at this point, we don't know what is on the table by the President.

Mr. WALKER. Senator, I would suggest there is one thing that is important in addition to getting the details filled out. As was mentioned by one of the members earlier, you can't solve a problem until you admit that you have a problem and I think there is work still to be done in trying to help convince people, not only here within Washington but outside the beltway, what is the nature, extent, magnitude, and timing of the problem and what are the relative pros and cons of acting sooner rather than later? But you are right, a lot more details have to come out as to what the potential solution might be and what the pros and cons of that potential solution might be.

I might mention one more thing, Senator. It is very important in analyzing reform proposals that, as we have said at GAO, you have to look at a package. There are pros and cons of every reform element.

The other thing is to benchmark the reform package against both promised benefits and funded benefits, because not all promised benefits are funded. Therefore, if somebody is to say, "Well, this represents a cut of X percent from promised benefits." Well, if you are under 40, all your promised benefits aren't funded and if you're under 30 none of your benefits are fully funded. As a result, you are really comparing apples and oranges unless you consider both the funded benefits as well as the promised benefits.

Senator NELSON. You know, you talk about you don't have a problem unless you recognize there is a problem, and we had a problem back in the Great Depression and it was addressed. I

know that just on a basic set of values that we have a problem if we don't, and are not admonished and follow the necessities put out in the Good Book about honor your father and your mother and take care of the widows and orphans. I know that elderly poverty is now 10 percent, and it is down from 35 percent in 1959, and I sure don't want it to go back the other way where it is increasing. So I am going to look at this with a very, very careful eye, Mr. Chairman.

The CHAIRMAN. Thanks, Senator.

Senator DeMint.

Senator DEMINT. Thank you. I believe I heard you say that it confirmed what I thought that in 2018, or thereabouts—I know there may be some difference between CBO—the real strain is going to begin from Social Security on our general fund, that it is going to require billions of dollars of infusion from the general fund to supplement the current Social Security system to meet promised benefits, that the trust fund is an accounting mechanism that just tells us how much the general fund owes Social Security.

So there is no money there to pay and we have to come up with new money to make good on our promises to seniors in 2018, which I believe, as I said before, that this Congress, this Senate, and our budget cycle three or four years from now is going to have to begin to budget for huge amounts of transfers to Social Security. To me, that is an urgent crisis that we need to address, particularly if we are going to address it differently than we have before.

Mr. Walker, you talked about the fix in 1983. What did we do to fix the program in 1983?

Mr. WALKER. Well, there were a number of reforms. I mean, there was an increase in revenues——

Senator DEMINT. How was that——

Mr. WALKER [continuing]. In payroll taxes——

Senator DEMINT. An increase in payroll taxes.

Mr. WALKER. There was an increase in payroll taxes. There was a gradual increase in the normal retirement age from 65 to 67, phased in over a number of years.

Senator DEMINT. So a reduction of benefits.

Mr. WALKER. You could look at it that way——

Senator DEMINT. Yes, you could.

Mr. WALKER [continuing]. As many people probably did, a modification, at least. Others. Those are two that I recall right off the top of my head. The taxation of the Social Security benefits——

Senator DEMINT. Right.

Mr. HOLTZ-EAKIN. Expanded coverage for seniors.

Mr. WALKER. That is right. There was an expansion of coverage, as well, as to who would be covered by the Social Security system.

Senator DEMINT. Well, it is my understanding that this program has been fixed many times that same way, is to increase the taxes and to somehow, through raising the age or indexing, as we are talking, as cutting the benefits. My contention is people are putting enough in the system not to have their benefits cut. I think what we are struggling for, is there a way to fix this system, which I think we have established by any rational basis today that we are in a crisis if we consider hundreds of billions of dollars, even trillions, of debt that faces an unfunded liability, is there a better way

to fix the program than cutting benefits again and raising taxes again.

I think we are at the point now where we are taxing labor at such a high rate, and these payroll taxes are part of it, that corporations are beginning to wonder, should they locate their headquarters in America anymore. It is an additional tax on labor.

We are providing a poverty-level, or just barely above it, a poverty-level benefit for folks who have paid into this, and I think the program should be focused on low- and middle-income workers.

The idea of raising retirement to people who need it the most are the ones that are most likely to have done manual labor their whole life and are the least likely to want to continue to work well into their old age, my hope is that we won't look at cutting benefits again and we won't look at raising taxes again.

For my colleagues, I think that is what we have struggled to look at. The only solution to me appears to be, unless you are willing for these little adjustments, which these little adjustments are always cutting benefits and raising taxes, is to make the money that we are collecting work harder, and I think that is all the President is talking about.

The average American family now is putting in over $5,000 a year of taxes into Social Security, if you count the employer and the employee side. If we can just begin to save and let compound interest work with a part of that to supplement Social Security, it is not going to fix the whole problem, but it could lower the financial strain, and as you said, and I think the best thing said today is exceed the expectations of every generation.

We have got to meet our promises to seniors, and I think we have the opportunity now to make every American a saver and investor, to begin to actually save Social Security taxes for the first time, which I think it is interesting when I talk to groups back home and I explain to them all this money that has been going into it and I say, "You know, we haven't saved one penny of that", and they smile like I am teasing them because they think we are doing that.

But I appreciate the presentation today, just the clarity of the financial strain that we have. I recognize that we have even a bigger unfunded liability with Medicare, but the solutions there will be much more abstract. The demand on the system is much less predictable. I think, as you said, again, Mr. Walker, this is solvable, but only solvable if we take it on now before we get right in the middle of these huge deficits.

So thank you for putting the numbers to an issue we have been talking about and I think that will help us solve the problem.

Mr. Chairman, I yield back.

The CHAIRMAN. Thank you.

Senator Clinton.

Senator CLINTON. Thank you, Mr. Chairman, for holding this very timely hearing, and I thank our witnesses.

This is an issue that generates as much heat as light, and there is so much emotion, ideology, that it would be very welcome to have this debate basically run by the two of you. Let us look at the facts, let us look at the evidence, and then let us try to reach the appropriate conclusions.

I must confess that I am disappointed in the President's decision to pursue this issue in the way that he has chosen to do so. I do not agree there is a crisis. I agree there are some long-term challenges, as there are with every aspect of government. Addressing those challenges requires people to work in good faith and to arrive at solutions that will hopefully solve the problems we confront.

I have been asking myself for quite some time, what is the reason for the President's approach, which does emphasize a lot of crisis language, a lot of very dramatic rhetoric, and I conclude, in large measure, because of ideological drivers as opposed to policy or values that are at stake.

When I look at the unfunded liabilities that we have, we compare Social Security to $3.7 trillion, Medicare to $8.1 trillion, the tax cuts, if extended, to $11.1 trillion. When I think about the situation that we were in in 2001, where we had balanced our budget on a current account basis, where we were building up a surplus, where we had our financial destiny much more in our control than we had had previously or that we have today, when I realize that we are at the beck and call of foreign lenders to pump in approximately $50 billion, give or take a month, to buy our debt, it is very discouraging to me that we would take this issue, put it in isolation, whip up a lot of scare tactics for ideological reasons, and I hope that the American people are smarter than that.

There are steps that we could take, depending on our choices and values, right now to deal with Social Security. We could do some things that some in this body would call tax increases, such as rolling back income tax cuts for those above a certain level of income or retaining the estate tax at some level, that would make a big contribution.

But what really concerns me is that the average working American, who has been paying in with a payroll tax into Social Security, whether you call it a trust fund or you call it an accounting device, it is an obligation of the U.S. Government. Those payroll dollars have largely funded the upper-end income tax cuts and it is, you know, a transfer of wealth. We talk about building wealth and building ownership for middle-income and working-class people. This is one of the biggest transfers of wealth that we have seen in our country, and now we are sitting here talking about ripping the rug out from under the existing social insurance system and it is just astonishing to me that we would be having a conversation on these terms.

What is also troubling to me is that the third of the people who are in Social Security who receive survivor benefits and disability payments are basically left out of this conversation. These are people, especially on disability, for whom this is, in most instances, their sole income. For survivors, it is often the difference between being able to afford some luxuries for a child growing up and going to school than not. So there is a whole third of our people on Social Security that are being left out of this conversation.

So I think there is room to have an honest, evidence-based conversation about what to be done with Social Security, to raise the issues, to have a mature conversation in the American public, and to make some tough decisions. You know, it is a social insurance

program. There are other ways we could incentivize wealth creation and savings.

We could, for example, as some have recommended, make 401(k)s automatic unless you opt out. That would dramatically increase the participation rate in 401(k)s. We could come up with different ways of funding add-on accounts that would not go to the point of carving out payroll tax. There are ways we could address both the long-term solvency of Social Security and we could address wealth creation and ownership.

But we are just whistling in the dark if we don't think our long-term fiscal situation is heading us right off a cliff, and it just is beyond me how people who call themselves conservative could have the gall to support economic policies that are sending the younger generation into the biggest deficit and debt hole that any generation has ever inherited.

So I respect greatly the purpose of this hearing and am glad we are having it and particularly these witnesses, but if we have ever needed an honest debate where people look really at what is happening and put it into the context of the Medicare debt and the fiscal debt, our trade account deficit, and then try to say to ourselves, what are the responsible positions to take, it is now and I fear that we are going off on this tangent on Social Security in the wrong direction. It will make the situation worse and it will break faith with the social insurance program that Social Security is supposed to be.

Mr. Chairman, thank you for giving me the opportunity to vent. [Laughter.]

The CHAIRMAN. Senator Lincoln?

Senator LINCOLN. Thank you, Mr. Chairman, and I would like to add my thanks to you and to Senator Kohl for your leadership and bringing us to a timely hearing on such a very important issue, allowing us to vent, but also to discuss some of our options of what we want to do in terms of these long-term solutions.

I was with both of these gentlemen yesterday. I am delighted to be with you today. I am not sure if I am going to see you tomorrow, but—— [Laughter.]

I am hoping that you both will be a very real part of helping us find the solutions in the long term of how we can create solvency in a program that truly has meant a tremendous amount to a lot of the elderly people. Again, I want to reiterate Senator Clinton, not forgetting the disabled community as well as the survivors of many recipients.

I have got a couple of questions and I think I will go straight to those. Mr. Holtz-Eakin, according to an analysis by your own CBO, future retirees would fare worse under the Commission's plan than if no action were taken at all in Social Security. I think the chart under there says the current benefit which a median wage earner born in the 1990's and retiring at 65 would receive $23,300 annually. If no action is taken the trust fund runs out but does not go broke, the system does not go broke, the worker would receive $18,000. Then under the Commission's plan, the worker would receive only $14,500.

So it appears from this that retirees would be worse off under the Commission's plan than even if no action were taken. Is that accurate?

Mr. HOLTZ-EAKIN. Yes. Those are our estimates for the middle quintile of the earnings distribution.

Senator LINCOLN. So, in essence, we know we have something to do, but we also know that there is great potential to go in the wrong direction in terms of making decisions and taking action that could, in turn, really do more harm than good.

I guess especially concerning our younger workers, because if the graph is correct, our younger workers would be hit twice, it appears. First, they will have a reduced benefit, and then, second, they will be responsible for repaying additional borrowing, as Senator Clinton mentioned, this enormous pitfall of debt that we are going to be establishing—that would be required to set up these private accounts. Is that fair to say?

Mr. HOLTZ-EAKIN. In our estimates in the aggregate, it is the case that the introduction of the individual accounts early on have a negative impact on the balance in the program between receipts and outlays, but past 2065, it switches as the accounts begin to accumulate.

Senator LINCOLN. Sixty-five?

Mr. HOLTZ-EAKIN. Two-thousand-sixty-five, in the aggregate.

Senator LINCOLN. Right. So it takes us a little while to get there, before that turnaround happens.

Mr. Walker, I appreciate your input. I understand that the Federal spending for Medicare, something we talked about yesterday, is rising at a much faster rate than the Federal funding for Social Security, and you have mentioned that here today. I know as a matter of fact that the Medicare costs we see will exceed Social Security costs by 2024, twice as much as Social Security by 2078. In addition, the Medicare Health Insurance Trust Fund, which alarms me enormously, will be insolvent by 2019, the year after the general treasury is supposed to pay back that IOU to the Social Security Trust Fund that we borrowed in 1983 that Senator DeMint brought up.

So I guess I am not trying to negate the fact that Social Security is facing a very long-term, real financial challenge and we need to address that, but if we were to prioritize these in terms of economics, in terms of crises that we are talking about, I don't know, but what has been presented almost seems to me that Medicare and health care costs are a bigger issue. How do you see it?

Mr. WALKER. The Medicare unfunded obligations are over $27 trillion of which $8.1 trillion relates to the new prescription drug benefit alone, as compared with $3.7 trillion for Social Security. Arguably, Medicare and Medicaid are a subset of a much larger challenge, and that is the overall health care system. There are many who believe that our health care system is in crisis and that it represents our No. 1 domestic policy challenge. I would say that other than our large and growing fiscal imbalance, they're right. So there is absolutely no question.

But I would also respectfully suggest, Senator, that the nature, extent, magnitude and emotion associated with health care is also multiple times greater than Social Security and that, ultimately,

there is going to have to be a comprehensive reform of the entire system in installments which will require many years and many tough decisions. While I would encourage the Congress to get on with it sooner rather than later——

Senator LINCOLN. On Social Security?

Mr. WALKER. On both.

Senator LINCOLN. Both.

Mr. WALKER [continuing]. I would encourage Congress to recognize the totality of the challenge and the need to start getting on with it sooner rather than later. I do honestly believe, as I said before, that while the Social Security challenge in dollar terms is much less, that it is something where you can exceed the expectation of all generations. You can gather some momentum. You can gain some credibility. You can enhance your confidence. There is something to be said for that.

Senator LINCOLN. So if we are looking for legislation, don't look for a work of art. Let us consider it a work in progress as we do things incrementally to improve both of these programs.

Mr. WALKER. My personal opinion, Senator, is to deal with our large and growing fiscal gap, it is going to take a generation or more to deal with it, and I am just being straight with you.

Senator LINCOLN. All right. Mr. Chairman, just briefly, if I may, I am also especially concerned about the effects of privatization on women. We know that women do live longer. They become more dependent on these programs, both Medicare as well as Social Security because of various demographic factors, some of which I have mentioned. But they also have a greater chance of exhausting sources of income. Social Security's progressive benefits provide women with some sense of economic security, and without these benefits, I know from the statistics in Arkansas that 66 percent of the women in Arkansas would be poor.

Do you all agree that privatization will put more women at risk? Is that an agreeable thing to say, that women are at a far greater risk if we don't do this correctly than if we do—instead of doing no harm, we do great damage?

Mr. HOLTZ-EAKIN. I think the question is, what is "this," and I would echo what David said earlier about looking comprehensively at any reform plan. The major risk comes in two pieces. The first is longevity and the degree to which the plan includes an annuity that is similar in type to the one that Social Security offers now, indexed for inflation and lasting the lifetime of the recipient.

The second is the degree to which those who have adverse labor market careers are reliant exclusively on the individual contributions to the account to fund such an annuity.

So to the extent that there are provisions somewhere else in the plan that make sure the annuity is present and make sure that it is of sufficient magnitude, that can be addressed.

Senator LINCOLN. Definitely, it is a part of the principles we are espousing. I just would like to echo Senator Clinton, because in Arkansas, nearly 40 percent—we are way above the national average of Social Security beneficiaries that are receiving those benefits as disabled or survivors and we have not addressed that at all and I hope that we will. I know with the leadership of these two gentlemen and this committee, we will.

Thank you, Mr. Chairman. Thank you, gentlemen, for joining us.

The CHAIRMAN. Thank you very much.

Are there Senators with any further questions? If not, thank you, gentlemen. We appreciate your contribution to this hearing. We no doubt will be calling on you in this and other committees in the future, as you certainly described well the problem we have to resolve.

We will call next our second panel. Our first witness will be David John, research fellow, Thomas A. Roe Institute for Economic Policy Studies of the Heritage Foundation, Washington, DC; Robert L. Bixby, executive director of the Concord Coalition, Arlington, VA; and John Rother, director of Policy and Strategy, American Association of Retired Persons, here in Washington, DC.

Gentlemen, thank you. David John, we will start with you. Welcome.

STATEMENT OF DAVID C. JOHN, RESEARCH FELLOW, THOMAS A. ROE INSTITUTE FOR ECONOMIC POLICY STUDIES, THE HERITAGE FOUNDATION, WASHINGTON, DC

Mr. JOHN. Thanks for having me. Chairman Smith and Senator Kohl, thank you very much for having me. As mentioned, I am David John. I am a research fellow at the Heritage Foundation specializing in Social Security, other retirement, corporate governance, and other such fun topics.

Social Security has a major place, but it is only one of a number of significant aging discussions that we need to have as a people over the next few years. We can't ignore the whole question of weaknesses in both our defined benefit and defined contribution pension plans. We can't ignore the whole question of what is retirement. Currently, it seems to be a bright line. One minute, you are employed; the next minute, you are retired. I don't know that as a people we can afford that in the future. I don't even know that it is desirable for those of us who are going to be approaching that. Last but not least, of course, we have medical questions. But for the moment, let us concentrate on what is doable, which is to save Social Security first.

Social Security, as Senator Kohl mentioned, has been an incredibly successful program. My grandmother, who actually lived in Milwaukee, financed all of her retirement based on Social Security. However, times change and companies and programs need to change over time, also. In 1935, U.S. Steel was one of the biggest companies in the United States. It no longer exists, at least not under that name. AT&T was the controller of telephones, and now AT&T is changing. In 1935, the Chicago Cubs were in the World Series. They lost. But times have shifted over the last 70 years. My grandfather, for instance, was a master mechanic at Harley-Davidson at that point.

This is a debate that gets lost, unfortunately. We talk about billions and trillions and bend points and trust funds and things and that is really not what this is all about. This is about people. This is about not necessarily my 85-year-old father, who lives in retirement. This is about my 18-year-old daughter, who is a freshman at Villanova studying nursing.

If the current activities continue, if we do nothing, Meredith faces a future where she will pay 100 percent of her Social Security taxes throughout her working life. She will pay 100 percent of her share of a total of $5.6 trillion to repay the bonds in the Social Security Trust Fund. Ten years before she retires, if you use the Social Security estimate, the same year she retires if you use the CBO estimate, the Social Security Trust Fund runs out and essentially she gets 73 cents on the dollar. That is not exactly the kind of future I want to leave for my daughter.

This is a real problem. The trust fund is a real problem. My daughter is thoroughly convinced that her credit card is not a real problem because she doesn't pay it. However, it is a major part of the family finances, or at least it can be if she gets carried away. [Laughter.]

If we do nothing for Social Security at this point, we will start to run $100 billion annual deficits in 2022. Those will go up to $200 billion annually in today's dollars 5 years after that.

According to the Social Security Administration, doing nothing adds $600 billion a year to the cost of reforming Social Security. That is about $50 billion a month.

What to do? I happen to be very strongly in favor of a personal retirement account. The simple fact is that Social Security, because of an index change that was done during the Jimmy Carter administration, has offered my daughter significantly higher benefits than it can afford to pay. We need a simple structure that is easy to understand with a default fund which is something similar to a lifestyle fund.

A lifestyle fund has most of your investments in index funds when you are young and it gradually shifts to bonds when you are old. What that means is that the difference between retiring in 1999 and 2000 is taken care of, essentially, because virtually all of your money is in bonds at that point.

The future Social Security benefits will be paid from a Social Security Part A, which is the government-paid benefit, and Social Security Part B, which is a personal retirement account. There is a fairly simple formula that would determine how much would be paid from what.

What is key about this is that the sad fact is that only about 50 percent of the American workers have some sort of a retirement savings plan outside of Social Security. A personal retirement account would allow these workers the opportunity to build assets.

The sad fact is that no matter what, Social Security can't afford to pay my daughter what it has promised her, but at least with a personal retirement account, she has the opportunity to make up all or most of the difference between what it promises and what it will be able to pay.

There are a lot of other proposals out there. Let me just address one very quickly. One of them suggests that all we have to do is raise the payroll tax cap from $90,000 to $150,000 or $200,000 and we have solved most of the problem. The Social Security Administration addressed that in an October 2003 scoring memo which found that if you completely got rid of that, which means that Donald Trump gets to pay payroll taxes on 100 percent of his earnings, what that does is to move the date where Social Security starts to

spend more than it takes in from 2018 to 2024. If Donald Trump is allowed, as under the current system, to receive benefits on all of that money, then basically the $100 billion deficits in today's dollars begin in 2029, not 2022. That is scarcely saving the system.

If, on the other hand, we make a major shift in the way Social Security is operated and we start to make Social Security into some form of a welfare program, meaning that we are only going to pay Donald Trump benefits on the first $90,000 of his income, and basically we are going to take all the taxes on the amount above that and say, "Thank you," then the $100 billion deficits start in 2031 instead of 2029 or 2022.

Essentially, small thoughts and small solutions aren't going to work. This is too big a problem. We need to think very seriously outside of traditional boundaries and come up with a solution that guarantees people like my daughter a decent retirement income. Thank you.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. John follows:]

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CONGRESSIONAL TESTIMONY

Fixing Social Security

Testimony before
Special Committee on Aging
United States Senate

February 3, 2005

David C. John
Research Fellow
Thomas A. Roe Institute for Economic Policy Studies
The Heritage Foundation

I appreciate the opportunity to appear before you today to discuss the need to fix Social Security and my broad policy recommendations for doing so. This is an extremely important subject, and I would like to thank the Chairman and Senator Kohl for scheduling this hearing. Let me begin by noting that while I am a Research Fellow at the Heritage Foundation, the views that I express in this testimony are my own, and should not be construed as representing any official position of the Heritage Foundation. In addition, the Heritage Foundation does not endorse or oppose any legislation.

Social Security in the larger context of retirement security

Social Security is an extremely important part of a larger debate about retirement and overall retirement security. As the basis for retirement income security in this country, it is difficult to over-emphasize its important, but it is still only part of a larger debate.

In addition to discussing Social Security, both Congress and our society need to have a serious examination of a number of other questions. In the short run, we need to also examine our country's defined contribution and defined benefit pension systems. Defined benefit programs are often seriously under funded, while the participation levels in Defined contribution plans leaves much to be desired.

In the longer run, we also need to re-examine the entire notion of retirement. Today, it seems like a bright line that sharply defines the difference between a 9-to-5 world or work, and a life of unscheduled leisure. In the future, it is likely to become a process that gradually transitions between full-time employment through some form of part-time employment to a life where work is an option. It will be important to re-examine our retirement systems to eliminate disincentives to working after a set age.

Then, of course, there is the question of medical care and its cost. This is both larger than the pension related issues, and much more complex. Hopefully, the experience and working relationships built during the Social Security debate will allow for a more bipartisan discussion of what to do about medical care.

The consequences of delaying action

Fixing Social Security is not important to my 85 year old father or 83 year old mother, both of whom live in retirement in South Carolina. Their retirement security is guaranteed by both Social Security and the President's pledge never to reduce their benefits. It is also not important to me, a baby boomer, as there will be plenty of assets available to pay my benefits. However, it is essential to my 18 year old daughter Meredith. A freshman nursing student, she faces a future where she will pay 100 percent of her Social Security taxes throughout her working life in addition to her share of paying the $5.7 trillion that will be needed to repay the bonds in the Social Security trust fund between 2018 and 2042. Then, about 10 years before she is to retire, the trust fund runs out, and she faces immediate 27 percent plus benefit cuts. Again, this debate is not about my parents, it is about younger people like my daughter.

Doing nothing to fix Social Security will only increase the eventual cost of fixing the system. Every year that passes means one less year of Social Security surpluses that could be used to help reduce the cost of reform. The key date to remember in deciding the appropriate time horizon for taking action is 2018, when the system is expected to begin to run annual cash flow deficits.

The Social Security "trust fund" is essentially a bookkeeping system through which the government lends money to itself.

There is no pool of actual assets that is being reserved to pay the benefits of future retirees. The Social Security trust fund contains nothing more than IOUs (in the form of special issue U.S. Treasury bonds), which the federal government can repay only though higher taxes, massive borrowing, or massive cuts in other federal programs. While many workers thought that the system's annual surpluses were being used to build up a reserve for baby boomers, the federal government has been spending this money to fund other government programs and to reduce the government debt.

According to the Social Security Administration, in less than 5 years the size of the Social Security surplus will begin to drop, and in less than 15 years, Social Security will begin to run a deficit requiring it to begin cashing the IOUs. Hence, the government will need to find additional money just to repay the bonds as Social Security cashes them. Between 2018 and 2042, the government will have to make up for a total funding deficit of over $5 trillion (in today's dollars without inflation)..

In the private sector, trust funds are invested in real assets ranging from stocks and bonds to mortgages and other financial instruments. Assets are used only for specifically designated purposes, and the fund managers are held accountable if the money is mismanaged. Funds are managed in order to maximize earnings within a predetermined risk level. Investments are chosen that will provide cash at set intervals, allowing the private trust fund to pay its obligations.

The Social Security trust funds are very different. As a report from the federal Office of Management and Budget (OMB) during the Clinton Administration noted:

> The Federal budget meaning of the term "trust" differs significantly from the private sector usage.... [T]he Federal Government owns the assets and earnings of most Federal trust funds, and it can unilaterally raise or lower future trust fund collections and payments or change the purpose for which the collections are used. Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2000: Analytical Perspectives* (Washington, D.C.: U.S. Government Printing Office, 1999), p. 335, at *www.whitehouse.gov/omb/budget/fy2005/pdf/spec.pdf* (September 23, 2004).

Furthermore, Social Security trust funds are "invested" exclusively in a special type of Treasury bond that can only be issued to and redeemed by the Social Security Administration. According to a Congressional Research Service report,

> [W]hen the government issues a bond to one of its own accounts, it hasn't purchased anything or established a claim against another entity or person. It is simply creating a form of IOU from one of its accounts to another. David Koitz, "Social Security Taxes: Where Do Surplus Taxes Go and How Are They Used?" Congressional Research Service, March 31, 1999, p. 3, at *www.concordcoalition.org/entitlements/crs042998.html* (September 28, 2004).

According to OMB, this situation allows funds to appear on the books while in reality they are unavailable:

> These [trust fund] balances are available to finance future benefit payments and other trust fund expenditures—but only in a bookkeeping sense. These funds are not set up to be pension funds, like the funds of private pension plans. 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 large trust fund balances, therefore, does not, by itself, make it easier for the government to pay benefits. Office of Management and Budget, *Analytical Perspectives*, p. 337.

In short, the Social Security trust funds are only an accounting mechanism. They show how much the government has borrowed from Social Security, but do not provide any way to finance future benefits. It is true that these bonds are legal obligations, and will be repaid on schedule, but it is not true that they contain the cash necessary to pay benefits.

Thus, while Social Security has enough paper assets to finance benefits until 2042, the reality is quite different. Social Security will have enough cash to pay benefits only until 2018. After that, the program will have to rely on ever-growing amounts of additional tax dollars to pay promised benefits.

Broad prescriptions for fixing Social Security

There are only three real solutions to Social Security's rapidly approaching fiscal problems: raise taxes, reduce spending, or make the current payroll taxes work harder by investing them through some form of personal retirement account (PRA).

Establishing PRAs is the only solution that will also give future retirees the opportunity to receive an improved standard of living in retirement. These accounts would give them more control over how to structure their income and allow them to build a nest egg that could be used for emergencies during retirement, used to start a business, or left to their families. However, establishing PRAs will be complex and—as experience from other countries shows—will require careful planning.

Any plan to fix Social Security should:

- **Improve the retirement income of future retirees without reducing the benefits of current retirees or those close to retirement.** Social Security reform should not reduce the benefits of today's retirees or those close to retirement.

- **Add voluntary PRAs that include a savings/ nest egg component to the current system.** In the future, Social Security retirement benefits should come from both the current government-paid program, which would become Social Security Part A, and from the individual worker's PRA, which would be known as Social Security Part B.

- **Reduce the unfunded burden that today's Social Security system will impose on future generations.** A sensible reform would reduce the benefits promised to younger workers to more affordable levels while also allowing them the opportunity to make up the difference through investment earnings. Continuing to promise those who are a long way from retirement more than Social Security can realistically deliver only makes the system unstable by pushing the burden of paying for it onto future generations.

Having said that, to set up a workable PRA system, Congress needs to:

- **Create an account structure that uses a portion of existing payroll taxes and allows workers of all income levels an opportunity to build family nest eggs.** PRAs would be voluntary and would not affect current retirees in any way. Workers would own their Social Security PRAs, which would be funded by directing a portion of their Social Security retirement taxes into their PRAs. About 5 percent of income would be best, but the directed portion should not be less than 2 percent or more than 10 percent. The larger the account, the more likely that it could pay for all or a substantial portion of workers' retirement benefits without requiring more than a token amount of funding through the existing government-paid system.

- **Create a simple, low-cost administrative structure for the accounts that uses the current payroll tax system and professional investment managers.** Probably the simplest and cheapest structure would be the existing payroll tax system. Rather that having the government invest PRA money, the agency overseeing the accounts should contract out fund management to professional fund managers.

- **Create a carefully controlled set of investment options that includes an appropriate default option.** Initially, workers would be allowed to put their PRA contributions into any one of three balanced and diversified mixes of stock index funds, government bonds, and similar pension-grade investments. The default fund for workers who do not make a choice would be a lifestyle fund in which the asset mix changes with the age of the worker. Younger workers would be invested fairly heavily in stock index funds; but as they age, their funds would automatically gradually shift toward a portfolio that includes a substantial proportion of bonds and other fixed-interest investments. This would allow

workers who are far from retirement to grow with the economy while older workers would lock in that growth with a portfolio made up predominantly of lower-risk investments.

- **Adjust Social Security benefits to a more sustainable level for future generations.** Despite promises from both the left and the right to pay promised benefits in full, this is simply not realistic. While current retirees and those close to retirement should receive every cent that they are due, future benefit promises must be scaled back to more realistic levels.

- **Create a realistic plan for paying the general revenue cost of establishing a PRA system.** The necessary money will have to come from some combination of four sources: borrowing additional money, collecting more general revenue and other taxes, reducing other government spending, and reducing Social Security benefits more than is required under current law or in the reform plans. While some Representatives and Senators will be tempted to cover Social Security's deficits with higher taxes, this is the wrong approach. The necessary amounts are so large that such a tax increase would consume enough resources to harm the economy.

- **Create a system that allows workers flexibility in structuring their retirement benefits while ensuring that they receive an adequate monthly benefit.** To protect both the retiree and the taxpayer, a PRA plan should require all retirees to use some of their PRAs to purchase annuities that would guarantee at least a minimal level of income for life, including an adjustment for inflation. This would protect taxpayers from retirees who would otherwise spend their entire PRAs, expecting some form of government handout to meet their monthly expenses.

One approach that will not work:

Some opponents of establishing PRAs, such as Representative Charles Rangel (D-NY), argue that "There is no crisis" in Social Security's funding that demands wholesale reform and that Social Security's shortfall is only a "challenge" that can be addressed by making small changes to the current program.

One such change that has been proposed would be to raise payroll taxes enough to render Social Security solvent. Opponents of real reform are right that raising payroll taxes could close a portion of Social Security's funding gap, but they are wrong in saying that doing so would require only a small change. Raising payroll taxes would make Social Security a worse deal for millions of working Americans, harm the economy, and cost thousands of jobs, and still would not fix Social Security.

The Social Security's Trustees estimate in their most recent annual report that increasing the payroll tax by 1.89 percentage points, to 14.29 percent in total, would be sufficient to make Social Security's Old Age, Survivors, and Disability programs solvent. This is the sort of "small change" that opponents of reform paint as a reasonable solution to Social Security's developing crisis.

The average worker might disagree. If payroll taxes were increased by 1.89 percentage points, a worker earning $35,000 would forego an additional $662 in pay every year. Raising payroll taxes by 1.89 percentage points would cost this worker, on average:

- As much as he spends on gasoline over three months;
- As much as he spends in two and a half months on clothing;
- As much as he spends in one month on food for consumption at home; or
- As much as he spends in two months on food outside of the home.

In other words, this "small change" in the payroll tax would have a major impact on most workers' household budgets.

Using the Global Insight U.S. Macroeconomic Model, economists at The Heritage Foundation's Center for Data Analysis simulated a 1.89 percentage point increase in the payroll tax.

It should be no surprise that a tax increase of this magnitude would increase the cost of labor in the economy and thereby have an impact on jobs. The CDA study found that a 1.89 percentage point increase in the payroll tax would reduce potential employment by 277,000 jobs per year, on average, over the next 10 years relative to the baseline.

There are spillover effects on economic growth as well. Increasing the payroll tax would reduce U.S. gross domestic product (GDP), a broad measure of economic activity, by $34.6 billion per year, on average, over the next 10 years.

Overall, raising the payroll tax would have a major impact on U.S. households. On average, every American would have $302 less in disposable income per year for each of the next 10 years, amounting to over $1,200 per year for a family of four. Personal savings would also decline in the aggregate by $46.9 billion per year, on average, over the next 10 years. Ironically, this decline in savings would make worse the very problem that Social Security is intended to fix—workers retiring with insufficient savings.

But the problem is even more fundamental: Social Security's very structure is such that even all this sacrifice would not be enough to save it. Currently, the system is in a cash-flow surplus, which means that it takes in every year more money in taxes than it pays out. But these extra funds don't really accumulate. Instead, the government spends them and issues the Social Security Trust Fund special bonds, which are really just IOUs to pay back the money at a later date.

According to Social Security's Trustees, the system is set to have a negative cash flow beginning in 2018. To pay out promised benefits, it will have to cash in the government's IOUs, and the money to pay them will have to come from somewhere—either higher general revenue taxes (e.g., income taxes), lower government spending, or,

ironically, more government debt. Because of the way the Trust Fund operates, raising payroll taxes would only delay the date when Social Security's cash flow goes negative. Future tax increases or benefit cuts would still be on the table.

Other "small" changes

Several other "small" fixes have been proposed that supposedly would save the program. These range from raising the payroll tax cap above the current $90,000 threshold, to government investment of the trust fund, to forcing state and local workers who are currently outside the Social Security system to participate.

Each of these has major negatives. For instance, an October 20, 2003 SSA scoring memo showed that eliminating the payroll tax cap completely would only delay Social Security's cash flow deficits from 2018 to 2024 or 2025. If SSA paid benefits on these additional earnings, it would start to run deficits that exceeded $100 billion a year (in 2003 dollars) starting in 2029, only seven ears later than the current estimates of 2022. On the other hand, if SSA taxed all earnings, but only paid benefits on income up to the current payroll tax cap (which would be a large step into turning the program into a welfare program), those $100 billion annual deficits would begin in 2031.

Each of the other proposals for "small" fixes has similar problems, ranging from major conflict of interest problems for government investment of the trust fund, to the wisdom of forcing state and local workers who are happy with their current non-Social Security retirement plan to join Social Security. Is forced participation in a system that is likely to pay these workers lower benefits than they would receive otherwise really an appropriate way to fix Social Security?

Conclusion.

It is not fair either to force senior citizens into poverty because of low Social Security benefits or to beggar their children and grandchildren by requiring them to pay for unrealistic promises. Establishing Social Security PRAs is the only way to avoid both of these extremes.

Because PRAs would earn higher returns than the current system can afford to pay, they could preserve retirement benefits at a sustainable level and reduce the unfunded promises imposed on future generations. However, PRAs are not a magic bullet. To work properly, a PRA system must be carefully structured and administered. The system must neither promise more than it can reasonably be expected to deliver in benefits nor attempt to hide its true cost through budget tricks.

Thank you for giving me the opportunity to testify. I look forward to your questions.

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The CHAIRMAN. Robert Bixby, welcome.

STATEMENT OF ROBERT L. BIXBY, EXECUTIVE DIRECTOR, THE CONCORD COALITION, ARLINGTON, VA

Mr. BIXBY. Thank you, Mr. Chairman, Senator Kohl. This is an incredibly well-timed hearing. I congratulate you on your foresight. Thank you for inviting me to testify.

I am here representing the Concord Coalition, which is a bipartisan organization that argues for fiscal responsibility. It is co-chaired by former colleagues of yours, Bob Kerry and Warren Rudman.

Sitting here, it occurred to me that you get some interesting experiences working with the Concord Coalition. Last night, when I was listening to the State of the Union Address, I agreed with many of the comments that President Bush made about the future of Social Security and the nature of the problem. Then this afternoon, hearing some of Senator Clinton's remarks, I agreed with those, too. If you think about why, it defines how the Concord Coalition thinks about this problem and how we suggest you might want to look at it.

If you look at the cost of the system in the out years, just look at it as it builds over time and ask yourself, how are we going to pay for it? You see that the cost gradually increases and that the taxes flowing into the system don't keep up with that and so a gap opens up in 2018 or 2020. We know it is coming sometime around that time. It gets bigger and bigger and wider and wider from that point on.

That is the essential problem with Social Security. Promised benefits can't be paid under the stream of revenue that we have dedicated for them, and the trust fund really doesn't have too much to do with that. It does have legal significance, but it doesn't have an economic significance. It doesn't change the equation.

But Social Security is part of a larger picture. It is part of the retirement security challenge. It is part of the budget. It is the largest program in the budget. It is part of the economy. What we do with Social Security has a big effect on those things.

When I heard Senator Clinton talking about the larger fiscal challenge, I think she is absolutely right to raise that issue, as well. You can't really separate them. These things are intertwined.

I have been looking at some numbers that the Government Accountability Office did last year. Every year, they do long-term scenarios and they look at the consequences of current law over 50 years, 75 years, whatever. If you look at 2042, which is only significant because it is the year we talk about as the year of trust fund exhaustion, and people say, "Well, the trust fund is solvent until 2042", so there is no problem.

In 2042, under the so-called baseline extended scenario, which assumes that all of the tax cuts are allowed to expire on schedule and that discretionary spending grows no faster than inflation, Federal spending at that point would be up to 34 percent of GDP and the debt as a percentage of the economy would be at 164 percent of GDP. It is at 38 percent of GDP today. Net interest would cost us more than Social Security, Medicare or Medicaid.

In other words, we are headed toward a fiscal cliff and we are going to go over that fiscal cliff long before 2042. So—and by the way, this is not the worst scenario by any means. I mean, we could run much bigger budget deficits if we don't get them under control.

So my point here is that we are—our overall fiscal policy is unsustainable and it is going to be unsustainable sometime in the 2030's. So if what you are saying is, "Well, we don't need to worry because the trust fund is going to be solvent until 2042", or if in the case of private accounts you are saying, "Well, we can do the borrowing now because we are going to get big savings in the 2050's or 2060's, my point is we are going to go over the cliff before that." The government is going to be bankrupt before the trust fund is, and that is the larger problem that Senator Clinton talked about.

So I will wrap up by saying that as we address Social Security reform, and I think it is essential that we do so and it is essential that we do so sooner rather than later, we can't duck the hard choices here. We can't fund all future benefits and not raise taxes. You are going to have to make some hard choices, and this is true regardless of private accounts. Private accounts don't solve the gap. They may have some good effects for younger workers. They may be very sound. The Concord Coalition is perfectly in favor of private accounts. But we think they should be funded with new contributions, new savings into the system, and not with borrowed funds.

But whether you do private accounts or don't do private accounts, you are going to have to face some hard choices about can we afford all the future benefits that are promised, and if we are going to, then you are going to have to raise taxes to pay for them because the deficits that occur in the rest of the budget just become unsustainable.

Thank you.

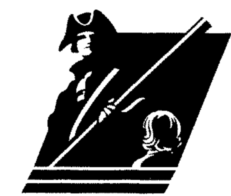
The CHAIRMAN. Thank you.

[The prepared statement of Mr. Bixby follows:]

The Future of Social Security

Senate Special Committee on Aging

February 3, 2005



THE CONCORD COALITION

Statement of Robert L. Bixby

Executive Director, The Concord Coalition

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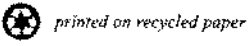

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Executive Director, The Concord Coalition

SUMMARY OF KEY POINTS

Any Social Security reform plan should be designed to meet three fundamental objectives—ensuring Social Security's long-term fiscal sustainability, raising national savings, and improving the system's generational equity:

- **Reform should ensure Social Security's long-term fiscal sustainability.** The first goal of reform should be to close Social Security's financing gap over the lifetimes of our children and beyond. The only way to do so without burdening tomorrow's workers and taxpayers is to reduce Social Security's long-term cost.

- **Reform should raise national savings.** As America ages, the economy will inevitably have to transfer a rising share of real resources from workers to retirees. This burden can be made more bearable by increasing the size of tomorrow's economy. The surest way to do this is to raise national savings, and hence ultimately productivity growth. Without new savings reform is a zero-sum game.

- **Reform should improve Social Security's generational equity.** As currently structured, Social Security contributions offer each new generation of workers a declining value ("moneysworth"). Reform must not exacerbate—and ideally it should improve—the generational inequity underlying the current system.

Meeting these objectives will require hard choices and trade-offs. There is no free lunch. Policymakers and the public need to ask the following questions to assess whether reforms honestly face up to the Social Security challenge—or merely shift and conceal the cost:

- **Does reform rely on trust-fund accounting?** Trust-fund accounting obscures the magnitude of Social Security's financing gap by assuming that trust-fund surpluses accumulated in prior years can be drawn down to defray deficits incurred in future years. However, the trust funds are bookkeeping devices, not a mechanism for savings. The special issue U.S. Treasury bonds they contain simply represent a promise from one arm of government (Treasury) to satisfy claims held by another arm of government (Social Security.) They do not indicate how these claims will be satisfied or whether real resources are being set aside to match future obligations. Thus, their existence does not, alone, ease the burden of paying future benefits. The real test of fiscal sustainability is whether reform closes Social Security's long-term annual gap between its outlays and its dedicated tax revenues.

- **Does reform rely on hiking FICA taxes?** Hiking payroll taxes to meet benefit obligations is neither an economically sound nor a generationally equitable option. The burden will fall most heavily on lower and middle-income workers and on future generations. Younger Americans in particular will 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 reform rely on new debt?** Paying for promised benefits—or financing the transition to a more funded Social Security system—by issuing new debt defeats a fundamental purpose of reform. To the extent that reform relies on debt financing, it will not boost net savings and may result in a decline. 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 reform rely on outside financing?** Ideally, reform should achieve all necessary fiscal savings within the Social Security system itself. Unrelated tax hikes and spending cuts may never be enacted, or if enacted, may easily be neutralized by other measures, now or in the future. Unless the American public sees a direct link between sacrifice and reward, the sacrifice is unlikely to happen.

- **Does reform use prudent assumptions?** There must be no fiscal alchemy. The success of reform should not depend upon rosy projections of future economic growth, presumed budget surpluses or lofty rates of return on privately owned accounts. All projections regarding private accounts should be based on realistic assumptions, a prudent mix of equity and debt, and realistic estimates of new administrative costs.

While fixing Social Security's problems, reform must be careful to preserve what works. Social Security now fulfills a number of vital social objectives. Policymakers and the public need to ask the following questions to assess whether reform plans would continue to fulfill them:

- **Does reform keep Social Security mandatory?** 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 Social Security system. Choice is not important in a compulsory social insurance program whose primary function is to protect people against poor choices.

- **Does reform preserve Social Security's full range of insurance protection?** Social Security does more than write checks to retirees. It also pays benefits to disabled workers, widows, widowers, and surviving children. A reformed system should continue to provide insurance protection that is at least equal to what the current system offers.

- **Does reform maintain Social Security'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 reform 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," personal account reforms should be careful to minimize other kinds of risk, such as investment risk, inflation risk, and longevity risk—that is, the risk of outliving ones assets.

If we reform Social Security today, the changes can be gradual and give everybody plenty of time to adjust and prepare. If we wait much longer, change will come anyway—but it is more likely to be sudden and arrive in the midst of economic and political crisis.

FULL TESTIMONY

Chairman Smith, Senator Kohl, and members of the Committee, thank you for inviting me to discuss the future of Social Security. I am here representing The Concord Coalition, a nonpartisan 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.

My testimony today will address the three questions posed in your invitation:

- How do the issues facing Social Security's future fit into the larger retirement security challenge?
- What are the consequences of delaying action?
- What kinds of broad prescriptions for change would be the most effective?

I. Social Security and the larger retirement security challenge

For over 65 years Social Security has provided a vital floor of protection. Its broad range of retirement, disability, and survivors' benefits for millions of Americans makes it an important issue for people of all ages. But changing demographics render the current pay-as-you-go system fiscally unsustainable and generationally inequitable over the long-term. Reversing this trend will require facing up to some hard choices and making far-sighted decisions.

Social Security's future must be assessed within the broader context of retirement security for a population that is living longer, retiring earlier and spending more on health care than was assumed when our senior entitlement programs were created.

Social Security faces real difficulties, primarily its growing costs an ever-widening gap between dedicated revenues and benefit promises beginning in 2018, but its projected shortfall is only part of a much bigger problem. Put simply, we have promised ourselves an array of future retirement and health care benefits that is unaffordable.

Our nation, along with the rest of the developed world, is about to undergo an unprecedented demographic transformation for whose vast cost it has no idea how to pay. The coming age wave is not a temporary challenge that will recede once the baby boom generation passes away. The boomers' retirement is ushering in a permanent

transformation in the age structure of America's population—and a permanent rise in the cost of programs such as Social Security, Medicare and Medicaid.

It is true that no immediate crisis is confronting Social Security. Nor is an immediate crisis facing Medicare and Medicaid — the other two large entitlement programs for the aged. Yet, a broad bipartisan consensus exits that these three programs are on an unsustainable course. No one can say exactly when a crisis will hit, but by the time it does we will have likely burdened the economy with a debilitating amount of debt; leaving painful benefit cuts and steep tax increases as the only solutions. Waiting for this gut-wrenching outcome, knowing full well that is coming, would be an act of fiscal and generational irresponsibility on a grand scale.

The Social Security trustees project that program expenditures will grow from roughly 4.3 percent of the nation's gross domestic product (GDP) today to 6.3 percent in 2030, rising modestly thereafter to 6.6 percent in 2075.

Perhaps if viewed in isolation, this cost might be bearable. What makes the problem worthy of immediate attention, however, is that it reflects the impact of a rapidly aging society. Older people rely heavily on government entitlement programs and their numbers are soon expected to grow as the post World War II baby boomers enter their advanced years. There are 37 million people in the population age 65 and older today. By 2025, it is estimated that there will be 62 million. By 2045, they will rise to nearly 80 million, or more than double their current number. In contrast, by 2025 the number of people working in the economy is estimated to rise by only 13 percent, and by 2045, only 20 percent.

This dynamic has consequences that go far beyond Social Security. It is equally troublesome for Medicare and Medicaid. And for them, the looming demographics are only part of the issue. Health care prices continue to outpace economic growth and this phenomenon will only compound the growing costs attributable to the rising number of aged. The Congressional Budget Office projects that the combined cost of Medicare and Medicaid could increase from 4.8 percent of GDP today to 11.5 percent in 2050.

Without a policy response, the overall cost of government as a share of the economy could reach levels not seen since World War II. Today, governmental expenditures absorbs almost 20 percent of GDP. Under what CBO sees as the most plausible range, they could rise to as low as 23 percent of GDP in 2050 or as high as 53 percent. While it may be unrealistic to assume that half the nation's economic output could be consumed by government programs, even if the cost of government rose to only 30 percent of GDP, the share of the economy needed would be 50 percent greater than it is today.

Federal tax receipts have hovered in the range of 18 percent of GDP over the past half century. Today they stand at 16.8 percent. The federal budget deficit, now standing at 3 percent of GDP, hovers around $400 billion. If senior entitlements are allowed to grow on autopilot pushing, total federal spending to 30 percent of the economy, and Americans' intolerance for taxes above 20 percent of GDP holds true, the resulting

deficits will rapidly escalate to dangerous levels. A deficit of 10 percent of GDP in today's terms is the equivalent of $1.2 trillion a year. That amount is equal to roughly half of today's total government expenditures. The prospects of being able to carry that amount of new debt year after year without stifling the economy are doubtful.

Whether through increased taxes or constrained spending (or some combination thereof), action by lawmakers will likely be necessary to restore balance between future governmental receipts and expenditures. Economic growth alone will not be enough to close the gap. Moreover, the sooner action is taken, the more gradual the remedies could be. The political system can adjust to unexpected good news. More problematic are the potentially harsh adjustments of deferring action on bad news projections that prove correct.

In addition to addressing the growth of senior entitlements as a share of the economy, a critical strategy for preparing for the demographic transformation is to increase savings to build a bigger economy.

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.

The final report of the President's Commission to Strengthen Social Security aptly linked the idea of prefunding more of our future benefit promises and the need for higher savings:

> 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.

Social Security's current pay-as-you-go financing works against higher savings. In the first place, the program's widening cash deficits threaten to trigger a huge new run-up in the publicly-held debt starting in the 2020s. Moreover, many economists believe that Social Security's pay-as-you-go structure discourages household savings, and hence capital formation, because it promises households future benefit income while creating no real economic resources to generate that income. As a result, households put less into other (fully funded) forms of savings.

The oldest segment of the 75-million strong baby boom generation, now turning 59, will begin drawing on their Social Security benefits in three years ... in six years they will be eligible for Medicare. And while Medicare is projected to grow faster than Social Security, this faster growth only makes achieving savings in Social Security more urgent.

The choices we make now will determine what kind of America our children and grandchildren inherit 20 and 30 years from now. With the first of the 76 million baby boomers on the verge of retirement, the window of opportunity to counteract the generationally inequitable consequences of inaction is rapidly slamming shut.

II. What are the consequences of delaying action?

We have a crisis today only because of the threat of political gridlock. Inaction now increases the prospects of severe changes later. Every year that alterations are put off greatly raises the risk of large tax increases or sudden benefit reductions in the future. Reforming Social Security today would not free society from that future stress, but it would be a good start.

As noted, in just three 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 5.1 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 workers for each beneficiary.

- This dynamic has a profound effect on the system's fiscal sustainability. Social Security will generate ample surpluses, in the range of $100 billion, 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 2018 Social Security's cash flow will turn negative.

- From 2018 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.

- Redeeming Social Security's trust fund assets will have an impact on the rest of the budget and the economy 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.

- At first the gap will be relatively small — $16 billion in 2018 — but it will grow very quickly as those who were born in the peak of the baby boom begin to retire in large numbers during the 2020s.

- The annual shortfall grows to $250 billion by 2030 and in 2041, the last full year of trust fund "solvency," Social Security faces a cash deficit of $370 billion. All told, between 2018 and 2041 paying off the trust fund bonds will require a cash infusion of $5.4 trillion.[1]

- In 2042, when all the trust fund bonds have been liquidated, Social Security's spending authority will be limited to its cash income. This will be sufficient to pay just 73 percent of promised benefits.

- The alternative to cutting benefits by 27 percent to meet available income would be a payroll tax increase of 36 percent.

- Over the trustees' 75-year horizon Social Security's cash deficit of $26 trillion in today's dollars far outweighs the cash surplus of less than $1 trillion through 2017.

- As a percentage of the economy, Social Security will grow by more than 50 percent from 4.3 percent today to 6.5 percent in 2042, according to the 2004 trustees report.

- 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 more than double from 8.4 percent of the economy today to over 18 percent by 2050. By comparison, *all of government* this year equals 19.8 percent of GDP, and revenues equal 16.8 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 roughly 15 percent for today's 30-year olds, by 30 percent for today's 20-year olds, and by 35 percent for today's newborns. Alternatively, payroll taxes would suddenly go up by 36 percent in 2042.

How many of you would rush to endorse this bill? None, I suspect. And yet, these are the 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

[1] This number and all others herein are expressed as 2004 constant (i.e., inflation adjusted) dollars. They are based on the so-called "Intermediate" or central forecast of the 2004 Social Security Trustees' report.

endure the scrutiny and ridicule of specifically advocating the Do Nothing Plan in order for its consequences to take effect. The Do Nothing Plan has already been enacted. It is current law.

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 30-year old will qualify for full retirement benefits in 2042 — the year of projected trust fund insolvency — and that the system will begin to run growing annual cash deficits even before today's newborns enter the workforce.

Ages of Persons in Four Generations at Significant Dates for the Social Security Program

2005	2018[1]	**2042**[2]	2050[3]	2080[4]
90 years old	103 years old			
60 years old	73 years old	**97 years old**	105 years old	
30 years old	43 years old	**67 years old**	75 years old	105 years old
Newborn	13 years old	**37 years old**	45 years old	75 years old

1. In 2018, 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 13.24, up from 10.87 today. Including Medicare Part A, the payroll tax cost rate will be 17.14, up from 14.02 today.

2. In 2042, all of the assets in the Social Security trust fund will be exhausted, leaving the program able to pay only 73 percent of promised benefits. The pay-as-you-go tax rate will be 17.79 percent of taxable payroll. Including Medicare Part A, the tax rate will be 25.23.

3. By 2050, the Congressional Budget Office estimates that the cost of Social Security, Medicare and Medicaid combined will consume nearly 18 percent of GDP, almost all total federal revenues assuming that taxes remain in the range of about 18 percent of GDP as they have over the past 40 years. The pay-as-you-go tax rate will be 17.90 percent of taxable payroll. Including Medicare Part A, the tax rate will be 26.31.

4. 2080 is the last year of the trustees' 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 19.39 percent of taxable payroll. Including Medicare Part A, the tax rate will be 32.78.

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 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.

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.

It is worth recalling that President Bush is not the first president in recent years to put Social Security on the political agenda. In 1998, President Clinton made Social Security reform one of his top domestic priorities. Here is how President Clinton summarized the problem at a forum hosted by The Concord Coalition and AARP in July 1998:

> Today, the system is sound, but we all know a demographic crisis is looming. There are 76 million of us baby boomers now looking ahead to retirement age and longer life expectancies. By 2030, there will be twice as many elderly as there are today, with only two people working for every one person drawing Social Security. After 2032, contributions from payroll taxes to the Social Security trust fund will be only enough to cover about 75 cents on the dollar of current benefits.
>
> We know the problem. We know that if we act now it will be easier and less painful than if we wait until later. I don't think any of you want to see America in a situation where we have to cut benefits 25 percent, or raise inherently regressive payroll taxes 25 percent, to deal with the challenge of the future and our obligations to our seniors.
>
> I can tell you, I've spent a lot of time talking to the people I grew up with; most of them are middle-class people with very modest incomes and they are appalled at the thought that their retirement might lower the standard of living of their children, or undermine their children's ability to raise their grandchildren. So let's do something now in a prudent, disciplined way that will avoid our having to make much more dramatic and distasteful decisions down the road.

President Clinton ended with an admonition that is as relevant today as it was in 1998:

> We dare not let this disintegrate into a partisan rhetorical battle. Senior citizens are going to be Republicans and Democrats and independents. They're going to come from all walks of life, from all income backgrounds, from every region of this country, and therefore, so will their children and their grandchildren. This is an American challenge and we have to meet it together.

Any genuine reform has a fiscal and political price, so it's tempting to pretend that the status quo can continue indefinitely. It can't. Not acting is itself a choice, and one that will have grim consequences for today's midlife adults and even grimmer ones for their children.

III. What kinds of broad prescriptions for change would be the most effective?

There are just two ways to close Social Security's financing gap without burdening tomorrow's workers and taxpayers:

- Reduce Social Security's long-term cost, and:
- Make the remaining cost more bearable by increasing national savings and hence the size of the economy.

A workable plan should do both. Ideally, it should also pay for itself from day one and find savings within the Social Security system through some combination of reduced benefits and new contributions.

The bottom line is that the system requires change and this cannot happen without sacrifice in one form or another. The choice we face is not between guaranteed future benefits under the current system and a risky path of reform. It is between reform options that, in different ways, attempt to ensure the fiscal sustainability of fair and adequate benefits over the long-term.

Despite widespread recognition that hard choices are unavoidable, this difficult work is forced to compete for attention with an assortment of arguments for inaction and reform ideas that purport to fix the problem without asking anyone to give up anything.

Here are four of the most frequently used arguments:

Argument #1: Social Security can pay full benefits until the year 2042.

This argument is true as far as it goes, but it does not tell the full story. The trustees now project that Social Security will be "solvent" until the year 2042 — meaning that its trust funds will possess sufficient assets, and hence budget authority, to cover benefits until that date. However, trust fund solvency says nothing about fiscal sustainability.

The problem is that the trust funds are primarily an accounting device. Social Security's assets consist of Treasury IOUs that can only be redeemed if Congress raises taxes, cuts other spending, uses surpluses, or borrows from the public. Thus, their existence, alone, doesn't ease the burden of paying future benefits. It is true that when trust fund surpluses are used to reduce the publicly-held debt it does result in higher savings. But experience has shown that trust fund surpluses are just as likely to be spent as saved. It therefore cannot be assumed that a trust fund surplus will result in higher savings.

Trust fund accounting minimizes the magnitude of the problem because it implies that there really are resources being held in reserve... real assets that can be drawn down in the future to pay benefits. However, real assets are not created by giving the trust fund an IOU and promising to sell the IOU to the public when the money is needed to pay benefits. The IOUs will no doubt be honored, but that's not the point. The real issue is how the government and society will afford them. The debate over Social Security reform should concentrate more on economic and budgetary consequences than on governmental bookkeeping. Fiscally, it is not the trust fund balance, but the program's operating balance that matters — that is, the annual difference between its outlays and earmarked tax revenues. Social Security's current operating surplus is due to begin falling in 2009 and turn into an operating deficit in 2018. This deficit is projected to widen indefinitely into the future.

Argument #2: A mere 1.89 percent of payroll increase would cure the problem.

A related argument is that a tax hike of merely 1.89 percent of payroll is all that is needed to restore Social Security to long-term solvency — technically an increase of less than one percent each for employers and employees. 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 2004, Social Security's actuarial balance was a shortfall of 1.89 percent of payroll. In theory, this is the amount that Congress would have to raise payroll taxes or cut Social Security benefits, starting immediately, in order to keep the trust funds "solvent" for 75 years.

Proponents of this idea neglect to mention a couple of important caveats. For one thing, "mere" is a relative term. A tax hike of 1.89 percent of payroll is equivalent to a $1.2 trillion tax increase over the next 10 years. For another, the solution is not permanent. If the combined 12.4 percent tax rate were raised by 1.89 percent (the amount of the average 75-year deficit), it would only keep the program's cash flow positive through 2023, or for five additional years. If the payroll tax were hiked to cover the subsequent shortfalls, by 2025, it would have to be 14.8 percent; by 2040, it would have to be 16.9 percent; and by 2075, 18.2 percent. Those rates reflect increases that are a long way from what the 75-year "averaging" method implies. A 14.8 percent tax rate translates into a 20 percent increase in taxes; a 16.9 percent rate translates into a 36 percent increase, and an 18.2 percent rate translates into a 47 percent increase.

Moreover, this "solution" 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.

And there's a more fundamental problem. Any trust-fund surplus is immediately lent to Treasury, leaving Congress free to spend the money it is supposedly saving. For the 1.89 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 more than

30 years — a proposition that seems highly unlikely and in any event cannot be guaranteed.

Argument #3: The Trustees are too pessimistic about the future.

Another frequently heard argument is that the Social Security Trustees are too pessimistic—that the projections are unduly gloomy about future economic growth and that with more realistic assumptions the Social Security problem disappears.

It is true that the Trustees project that the economy will grow more slowly in the future than it has in the past. But this is a matter of prudence, not pessimism. Economic growth (GDP) depends, in part, on workforce growth, and this will fall to near zero when the boomers start retiring.

- Since 1973, the U.S. workforce has grown by 1.7 percent per year.
- Over the next seventy-five years, it is projected to grow by just 0.3 percent per year.
- Given the demographics, it is unlikely that GDP growth will not slow.

A more legitimate question is whether the trustees are too pessimistic about the growth in productivity, or output per worker hour. In the future, the trustees may have to raise their assumption. Since 1995, productivity has unexpectedly surged. Some believe that this heralds the arrival of a "new economy" in which information technologies and globalization will lead to permanently higher rates of productivity growth. But there are reasons to be skeptical:

- The new-economy thesis remains just that: a thesis. No one yet knows whether the surge in productivity that began in the mid-1990s will persist. The trustees' current long-term assumption for productivity growth—1.6 percent per year—is in line with the record of the past twenty-five years.
- Even if the enthusiasts are right about the new economy, higher growth is not a long-term fix for Social Security. When productivity goes up, average wages go up, and this adds to long-term tax revenues. But when average wages go up, average benefit awards also go up, and this adds to long-term outlays.
- Practically, the only way to get big savings from higher productivity growth is to sever the link between average wages and new benefit awards. Without such a fundamental change, higher productivity growth alone cannot possibly save Social Security.

There is one aspect in which the Trustees are indeed pessimistic—but here greater optimism would obviously add to Social Security's costs. The Trustees project that

mortality rates will decline more slowly in the future than they have in the past—and that longevity will therefore grow more slowly.

- According to the Trustees, life expectancy at age 65 will grow at just half the pace over the next seventy-five years as it has over the past seventy-five.

- Some biotech optimists are now predicting that a life expectancy of 100 or more is attainable within a generation.

- If anything approaching that came to pass, the entire structure of old-age entitlements would be rendered instantly and massively unaffordable.

- But one doesn't have to agree with these visionaries to conclude that the Trustees are too conservative. Accepting their projections means believing that Americans will have to wait until the mid-2030s to achieve the life expectancy that the Japanese already have today.

Argument #4: Investment returns provide a "pain free" solution.

Moving toward a more funded Social Security system could indeed have enormous benefits: not just higher returns to retirees, but greater national savings and productive investment, and hence greater wage growth for workers in the years before retirement. It would also be the surest method of locking up any new contributions because it would prevent the government from spending the money on other programs. But it cannot be supposed that directly funding more of Social Security's benefits is a way to avoid the hard choices. It *is* the hard choice:

- The challenge is that, until the transition is complete, workers will have to pay more, retirees will have to receive less, or both. Reform plans that do not face up to this transition cost will not result in new net savings or a larger economy. Any gains for future beneficiaries will necessarily come at the expense of future taxpayers.

- It is neither realistic, nor economically sound to count on the historic spread between the investment returns on stocks and bonds to fund a reform plan without cost reductions or higher contributions.

- 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. A new system of unfunded accounts, like trust fund solvency, avoids the real challenge, which is to ensure that adequate resources are set aside to meet the cost of future benefits.

Reform options that might do the job

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.[2]

That is why, 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.

The Concord Coalition does not support raising the payroll tax rate. For one thing, it is regressive tax that falls most heavily on middle and low-income workers who might wonder why they must pay more to subsidize the high-income old. A payroll tax increase would also deepen the generational inequities within the system. Young workers might ask why they must pay more than today's midlife boomers for the same (or worse) benefits.

Some advocate getting the wealthy to contribute more by raising, or eliminating, the payroll tax cap on wages, now at $90,000. A modest increase in the wage base would bring in a modest amount of new revenue, but wouldn't do much to reduce the system's long-term cash deficit. Eliminating the cap would have a bigger impact, but would substantially alter Social Security's traditional focus on both fairness to individuals and protection of the needy. It would destroy the whole presumption of a contributory system—that what people get back be at least somewhat proportional to what they pay in.

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[2] According to Urban Institute calculations, the typical single male retiring at age 65 in 1970 earned a return of 7.1 percent on his lifetime Social Security (Old-Age and Survivors) taxes. Today, the typical single male retiring in 2005 can expect to earn a return of 2.4 percent. The typical single male retiring in 2040 is due to earn a return of 1.8 percent—and this assumes that current-law benefits can be paid in full without any increase in current-law contributions. Social Security continues to offer a better deal to some categories of workers than to others. But among younger Americans, virtually all categories—including low-earners—will earn a lower return on their Social Security contributions than they could if their contributions were invested in risk-free Treasury debt.

In any case, the savings would diminish over time. While higher FICA contributions would initially swell the Social Security trust funds, these contributions would eventually require that higher benefits be paid out. And even though the benefits would represent a low or even negative return on contributions, they would still be large in absolute terms. The ultimate effect of eliminating the cap would be to increase the cost of Social Security and the total fiscal burden of government. It wouldn't generate enough new revenue to balance the system and in the absence of some mechanism to save the money its primary short-term effect would be to simply bring in higher taxes to fund current government operations.

Cost reduction options

Several benefit reduction strategies are possible, including raising the so-called normal retirement age and shifting from wage-indexing to price-indexing for calculating new benefits. The most reasonable strategies stress gradualism and fair warning.

The Concord Coalition believes that the necessary savings could be achieved using some variation of the following options:

1. Raise the "normal retirement age" for full benefit eligibility

One of the most logical options to consider is raising the age for full benefit eligibility. It makes good sense for two reasons:

- Longevity is increasing steadily, and longer life spans mean longer, and more costly, benefit spans.

- In coming decades, the pool of working-age Americans will virtually stop growing, depriving our nation of this engine of economic growth. Raising the full benefit-eligibility age could help augment the labor force by encouraging older people to remain at work for a few more years.

It's conventional wisdom that our population soon will be growing older because the huge baby boom generation is poised to begin retiring. But that's only part of the picture. Even if there were no baby boom, the rising longevity and fall in birth rates mean an older America and would spell serious trouble for Social Security (and Medicare as well). Increasing life spans have already increased benefit spans.

- In 1940, when the first benefits were paid, 65-year-old men could expect to live almost another 12 years and women another 13.4 years.

- Today, men retiring at 65 can expect, on average, 16 years of benefits and women can expect 19 years.

- By the time today's high-schoolers begin retiring in the 2050s, 65-year old men are expected to live another 19 years and women more than 21 years.

- Or to turn it around, for people today to spend the same number of years collecting benefits as the typical 65-year-old when the program began, they would have to wait until 72, and by 2050 they would have to wait until 75.

But the problem posed by an aging population is not just that benefit spans will lengthen. We also expect to be coping with a labor shortage. Instead of increasing our supply of working age people by 2 percent each year as in recent decades, or even the current 1.3 percent rate today, between 2010 and 2050, workforce growth will slow to a crawl: just 0.3 percent per year. There will be just barely enough new workers each year to replace those who are leaving.

Growing our economy could help finance benefits for a mushrooming retiree population. But, boiled down to essentials, economic growth depends on two factors: increasing the number of workers, and increasing how productive each worker is. Since no one has a sure-fire recipe for boosting worker productivity enough to make up for the slowdown in workforce growth, anything we can do to encourage people to work a few more years and encourage employers to accommodate older workers will help our economy.

2. Index for Longevity

Any reform plan should also index initial benefits to changes in elder life expectancy. Without this provision, Social Security will once again drift out of balance; with it, the system's long-term cost will be stabilized relative to worker payroll.

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 17.5 to 21.6 years, or by 23 percent. Over the long run, this 23 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 President's

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.

3. Treat Social Security Benefits Like Private Pensions for Tax Purposes

Making 85 percent of all benefits taxable is fair, and should be on the table as a means of increasing Social Security's revenues. The 85 percent taxability rule that now applies to beneficiaries with incomes over high thresholds could apply to all beneficiaries. The 15 percent exemption reflects an estimate of the dollar value of most beneficiaries' prior FICA contributions that have already been subject to personal taxation. It would thus bring the tax treatment of Social Security in line with the tax treatment of private pension benefits.

Since this provision would affect only those households with enough income to pay income taxes, it would maintain the progressivity of the program. It's worth noting that because current law does not index the thresholds at which benefit taxation applies, a rising share of total OASDI benefits are now becoming taxable—and eventually 85 percent of all benefits will be taxable. Full benefit taxation is therefore already due to be instituted in the future (and future revenues from it are already included in current projections). What this option would do is to move to full benefit taxation right away.

The new revenue from this provision is not large but it is available immediately and thus generates critical near-term budget savings, which may be needed for the transition costs of any reform plan.

4. Affluence test

An affluence test for upper income beneficiaries could be designed as an alternative to full benefit taxation and generate roughly the same aggregate savings in every future year, which makes the two provisions substitutable. The appeal of full benefit taxation is its simple equity: It would merely subject Social Security beneficiaries to the same tax code as everyone else. The possible drawback is that it reaches deep down into the middle class. The appeal of the affluence test is its greater progressivity. The possible drawback is that it may be regarded as arbitrary.

5. Change the Cost of Living Adjustment (COLAs)

Cost-of-Living Adjustments (COLAs) are used in Social Security, the federal income tax code, and other programs to ensure that specified dollar amounts are adjusted every year for inflation, as measured by the Consumer Price Index (CPI).

There has been substantial debate about how accurately the CPI measures the true cost of living. There are many sources of bias, some very technical. For example, the particular market basket of goods used can rapidly become out of date. The basket based on surveys

taken between 1982 and 1984 was still in use through 1997. This means, for one, that new products can be ignored completely.

Although the government has made some improvements to the CPI in recent years some experts, including Federal Reserve Board Chairman Alan Greenspan, believe that CPI still overstates inflation and thus over compensates beneficiaries. Additional adjustments to the CPI may thus be in order. However, a great deal of caution must be used in deciding whether to make ad hoc COLA reductions. While over-indexing Social Security squanders budget resources, setting COLA's *beneath* a fair measure of inflation is not the right way to balance the system since it would unfairly penalize the oldest and poorest beneficiaries.

6. Change the formula for determining initial benefits

a. Bend points

The determination of a retiree's initial Social Security benefit check is based on the calculation of Averaged Indexed Monthly Earnings (AIME). The amount of money earned by an individual each year of work is multiplied by the increase in average wages that has occurred up to the year of eligibility for Social Security, and then the average of the highest 35 years (fewer for those receiving disability benefits) of indexed wages is taken and divided by 12 to get the AIME.

Once the AIME is calculated, the Primary Insurance Amount (PIA) is determined by applying the "primary insurance amount formula." This progressive formula is designed to replace a share of annual pre-retirement income based on three "bend points." (90 percent, 32 percent, and 15 percent.) For example, in 2005 the replacement rates are 90 percent of the first $627 of average monthly earnings, 32 percent for earnings up to $3,779, and 15 percent of higher earnings up to the taxable maximum.

One way to reduce Social Security's long-term cost would be to lower the bend points across the board. Or if preferred, reduce the replacement rate within each bend point bracket on a progressive basis that would protect low-income workers. This later approach would work particularly well with a system of personal accounts, which in the absence of some other mechanism such as savings matches paid out of general revenues, would make the overall system less progressive than it is now.

b. Price-indexing

Another option would be to index initial benefits to the growth in prices (CPI) rather than to the growth in wages. 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, it is virtually impossible to close Social Security's deficit through an acceleration in productivity growth. 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 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.

For this reason, price-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 purchasing power of benefits would remain the same for each new generation of retirees. 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.

Options for prefunding future benefits

Funding Social Security cannot substitute for measures that raise new contributions or reduce pay-as-you-go benefits. But, in conjunction with cost-saving reform, funding can help create a Social Security system that is not only more sustainable, but that offers a fairer deal and a sounder floor of protection.

The case for funding is simple and compelling. At the macro level, a funded system means higher savings and hence higher productivity and higher national income. At the micro level, it means higher returns and hence higher benefits at any given contribution rate.

Unfortunately, the way that the Social Security trust funds work undermines the whole purpose of funding. Any trust-fund surplus is immediately lent to the Treasury, leaving Congress free to spend the money that it pretends to save. As noted earlier, Social

Security's assets consist of interest-earning Treasury IOUs whose sole function is to keep track of budget authority. They constitute a claim on future tax revenues, not economic savings that can be drawn down to finance future benefits.

In recent years, much attention has been given to various methods of prefunding future benefits. The main options are:

- 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?

1. Budgetary trust fund "lockbox"

In the late 1990s, political leaders promised that henceforth they would translate Social Security's current surpluses into genuine savings by balancing the budget excluding the trust funds. The goal was fiscally responsible, but achieving it rested on a chancy proposition—namely, that policy makers would have the fiscal discipline to "lockbox" large unified budget surpluses year in and year out.

With a booming economy generating windfalls for Treasury, keeping the lockbox promise was initially painless. Even President Bush's first tax cut observed it. But when the economy slowed and September 11 created new spending needs, the promise was quickly forgotten—and forgotten in a big way. This year, the CBO estimates that the budget will run a deficit of at least $540 billion excluding the trust funds. This is the amount that Congress would have to raise taxes or cut spending in order to save the Social Security surplus.

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 the foreseeable future.

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.

2. 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 budgetary 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 being funded.

3. Personally owned accounts

A third method of prefunding is to establish a system in which some portion of workers' 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, under some circumstances, 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.

Personal account reforms come in two basic types: "carve outs" and "add ons." In a carve out, a portion of the current payroll tax would be diverted to personal accounts. For the carve out to result in genuine funding, the diversion must be paid for by reductions in pay-as-you-go benefits beyond those that would need to be made in any case simply to eliminate Social Security's projected cash deficits. In an add on, the accounts would be funded partly or wholly from additional worker contributions. The contributions would be personally owned savings, and so would not constitute a tax—or at least would not function like one.

A pure carve out necessarily entails cuts in current-law Social Security benefits. Because personal account contributions would earn a higher return than contributions to the existing system, a carve-out plan might be able to pay retirees higher total benefits than today's purely pay-as-you-go system can afford. However, it cannot guarantee that retirees will receive everything that the existing system promises. In practice, most personal account carve outs rely on borrowing to substitute for the lost FICA revenue and mitigate benefit cuts. This entails the "free lunch" problem discussed below.

The "add on" approach offers a way to ensure the adequacy of future benefits without recourse to budgetary shell games. In fact, with a 2 percent of payroll add on it may be possible to ensure that every cohort of workers will receive benefits at least as large as

what current law now promises but cannot afford. Is it worth paying a bit more to achieve these superior results? In the end, after all the shell games are played out, this is the central choice that the American public must confront.

To be clear, current law must eventually result in either a steep cut in benefits or a steep hike in taxes. If the choice is to avoid any hike in the Social Security contribution rate, a personal accounts carve out might generate larger benefits than today's pay-as-you-go system can afford. If the choice is to avoid any reduction in promised benefits, an add on might allow for this at a lower ultimate contribution rate. It is impossible to have it both ways: no cuts in total benefits and no new contributions.

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.

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, the President's Commission to Strengthen Social Security confirmed this proposition. The Commission's Model One, does nothing more than dedicate 2 percent of the current payroll tax to personal accounts. As the Commission's final 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."

No Free Lunch on the Menu

Genuine funding requires genuine resource trade-offs. To save more, we must temporarily consume less—at least until the productivity benefits of higher savings kick in. Unfortunately, many personal accounts advocates pretend that there's a free lunch on the menu. Just divert current payroll contributions to personal accounts, they say, and the problem will be solved.

These advocates know that the Treasury will have to borrow to make up for the missing revenue, thus offsetting the new private savings. According to their logic, however, the mere fact that contributions are invested in private capital markets will ipso facto make everybody a winner. Apparently, they believe that each worker's personal account can indefinitely earn greater returns (at no greater risk) on the new equity assets than government would lose on the new debt liabilities.

The truth is that any plan that tries to cash in on the spread between stocks and bonds is a dicey and perhaps even dangerous proposition. Such financial arbitrage cannot work in

the long run. Over time, the yield on bonds would rise and the yield on stocks would fall, narrowing and possibly even erasing the favorable spread on which the plan depends. Either that, or we have to suppose that markets are irrational, and that the general public will willingly disadvantage itself by buying bonds and selling stocks (with no change in the yield spread) so that personal account owners can enrich themselves by doing the opposite.

Plans that issue debt directly to Social Security participants in the form of "recognition bonds" raise an additional concern. By translating implicit benefit liabilities (which have no constitutional protection) into formal Treasury debt (which does), they would in effect render Social Security unreformable. Giving workers property rights to a pay-as-you-go entitlement is folly. The economy might collapse or the nation go to war. But short of default on the national debt, Congress could never reduce taxpayers' liability for Social Security.

Other reform ideas try to conceal the trade-offs by raising taxes or cutting spending outside the Social Security system. Some propose enacting a national sales tax or a value-added tax to help fund personal accounts. Others say we should pay for the transition by cutting discretionary spending.

The problem here is that there is no direct link between sacrifice and reward. The savings measures may never be enacted—particularly if, as is usually the case with discretionary spending cuts, they are just vague injunctions to reduce "government waste." And even if they are enacted, the measures may not result in overall budget savings. In the case of the national sales tax or the value-added tax, the public may view these new forms of taxation as a substitute for existing taxes and demand an offsetting tax cut. If so, a larger deficit would neutralize the private savings boost.

To restate the bottom line: 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. Issuing debt to finance the transition to a funded Social Security system undermines a fundamental purpose of reform because it would not boost, and may even lower, net national savings.

To be sure, reform plans that rely on debt financing usually promise that the debt will be paid back. But in most plans the borrowing is so large and the payback is so distant that it doubtful the payback will ever occur.

Adding personal accounts without using the current payroll tax is not a cost free solution either. It would require higher payroll contributions or a substantial and permanent infusion of general revenues. In the absence of budget surpluses, diverting general revenues to "fund" an add on plan would have the same deficit effects as a carve out.

The problems with debt-financing of a personal accounts were recently addressed by The Concord Coalition in a statement published in the *New York Times*. Concord Board of Directors members, Warren Rudman, Bob Kerrey, Pete Peterson, Chuck Bowsher, Donald Marron, Sam Nunn, Bob Rubin and Paul Volcker, joined in saying:

> Ensuring a more sustainable system will require change, meaning that someone is going to have to give up something — either in the form of higher contributions, lower benefits or a combination of both. No Social Security reform will succeed unless this fact is acknowledged up front.
>
> One reform idea that has received much attention lately is establishing personally owned accounts and "funding" them with borrowed money. Most of the undersigned believe that personal accounts have potential advantages if they are properly funded and adopted as part of a comprehensive reform plan. They are not a free lunch. Simply funding personal accounts with further borrowing, and not with new contributions or contemporaneous benefit cuts, raises many concerns:
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> - It would not add to national savings. A fundamental goal of reform should be to improve national savings. As America ages, the economy will have to transfer a rising share of resources from workers to retirees. This will be easier in a prosperous growing economy. The best way to ensure this is to raise national savings, and ultimately productivity growth. Social Security reform that relies on deficit financing will not boost net national savings, and may even result in lower savings if households respond to the new personal accounts by saving less in other areas. Without additional savings, any gain for the Social Security system must come at the expense of the rest of the budget, the economy, and future generations.
>
> - It would worsen the already precarious fiscal outlook. The 10-year transition cost of roughly $2 trillion would come on top of the $5 trillion deficit that appears likely if current fiscal policies are continued. Yet the greater fiscal danger with most such plans is that they require additional borrowing for decades to come. In the most widely discussed plan produced by the 2001 President's Commission to Strengthen Social Security, the magnitude of the borrowing equals or exceeds the cost of the new Medicare drug benefit well into the 2020s. Meanwhile, the increased deficits and debt exceed the promised savings until the 2050s. Official projections already indicate that current fiscal policies are unsustainable long before then and the new deficits would only make the problem worse. Savings programmed for the 2050s won't be enough to prevent us from going over the cliff well before that time.

- It would send a dangerous signal to the markets that we are not taking our fiscal problems seriously. With our large budget deficit and low domestic savings rate we are borrowing record amounts from abroad. This year's increase in foreign debt is likely to approach $700 billion. If we "pay for" Social Security reform by running up the debt further, rather than making hard choices, it would signal to increasingly wary financial markets that Washington has no intention of doing what is necessary to get its fiscal house in order. This would increase the risks of a so-called "hard landing" such as a spike in interest rates, rising inflation and a plunging dollar. Promises that all the new debt will be paid back starting in about 50 years are unlikely to satisfy the concerns of those who are watching to see what Washington does now to improve its fiscal position. If markets looked out 50 years, current interest rates would be through the roof.

Personal accounts need not mean "privatization"

Critics of personal accounts often charge that they would shift unacceptable risks to individuals. But in fact, a personal accounts system is consistent with any degree of government regulation. It need not and indeed should not amount to "privatizing" Social Security.

A system of personally owned accounts need not allow people to recklessly undersave during their working years. Participation can be made mandatory and restrictions can be placed on the use of account balances. Nor need it put low-income (or simply unlucky) workers at greater risk of poverty and hardship in old age. The government can require workers to shift from equities into fixed-income assets as they grow older, thus protecting them from sudden market declines—even a crash on par with 1929. The government can also match savings contributions for low-earners and provide a guaranteed floor of old-age income protection, thus preserving or even enhancing the progressivity of the current system.

Many personal account advocates, including the President, believe that the accounts should be voluntary. That would be a mistake. 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. Choice is not important in a compulsory social insurance program whose primary function is to protect people against poor choices.

IV. Conclusion

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 2040, not what made sense in the world of 1940.

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.

As the debate gets started, 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.

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 reform 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.

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 the lifetime of today's younger workers putting unthinkable pressure on tax rates, the economy and the budget.

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 circumstances will never again be so favorable for Social Security reform. With a small (Depression) generation in retirement and a large (Baby Boom) generation still in the workforce, America is enjoying the last years of a "Demographic Indian Summer." However, this window of opportunity is closing fast.

THE CONCORD COALITION

SOCIAL SECURITY REFORM MUST CONFRONT THE HARD CHOICES

As our leaders in Washington consider the best way to remedy Social Security's long-term funding gap, it is essential for them to confront the hard choices that a meaningful reform plan requires. They should reject both the "do nothing" approach and the "free lunch" plans that rely on substantial long-term borrowing to appear painless. Both offer a false hope.

We, the undersigned, have different views about the best way to reform Social Security. Some of us prefer changes within the current system. Some of us believe that personal accounts, if properly funded, should be part of a comprehensive reform plan. All of us agree, however, that deficit financing is neither a viable nor a responsible way of avoiding the hard choices that must be made on contribution and benefit levels.

Simple arithmetic, not ideology

The basic case for reform is a matter of arithmetic, not ideology. Well within the lifetime of America's baby boomers, the current system faces a growing gap between what it promises in benefits and what we are setting aside to pay for it. Doing nothing to address this problem will eventually result in steep tax hikes, deep spending cuts, or massive borrowing from the public.

Ensuring a more sustainable system will require change, meaning that someone is going to have to give up something—either in the form of higher contributions, lower benefits or a combination of both. No Social Security reform will succeed unless this fact is acknowledged up front.

More debt is not the answer

Responsible reform options must make sense within the context of sound fiscal conditions and the need to raise national savings. Moreover, the fiscal challenges facing Social Security, while substantial, are not as great as the long-term fiscal, moral, and technological challenges we face on Medicare reform. If we can't make the hard choices on Social Security we can never hope to tackle the problems of our health care entitlements.

One reform idea that has received much attention lately is establishing personally owned accounts and "funding" them with borrowed money. Most of the undersigned believe that personal accounts have potential advantages if they are properly funded and adopted as part of a comprehensive reform plan. They are not a free lunch. Simply funding personal accounts with further borrowing, and not with new contributions or contemporaneous benefit cuts, raises many concerns:

- **It would not add to national savings.** A fundamental goal of reform should be to improve national savings. As America ages, the economy will have to transfer a rising share of resources from workers to retirees. This will be easier in a prosperous growing economy. The best way to ensure this is to raise national savings, and ultimately productivity growth. Social Security reform that relies on deficit financing will not boost net national savings, and may even result in lower savings if households respond to the new personal accounts by saving less in other areas. Without additional savings, any gain for the Social Security system must come at the expense of the rest of the budget, the economy, and future generations.

- **It would worsen the already precarious fiscal outlook.** The 10-year cost of roughly $2 trillion would come on top of the $5 trillion deficit that appears likely if current fiscal policies are continued. Yet the greater fiscal danger with most such plans is that they require additional borrowing for decades to come. In the most widely discussed plan produced by the 2001 President's Commission to Strengthen Social Security, the magnitude of the borrowing equals or exceeds the cost of the new Medicare drug benefit well into the 2020s. Meanwhile, the increased deficits and debt exceed the promised savings until the 2050s. Official projections already indicate that current fiscal policies are unsustainable long *before* then and the new deficits would only make the problem worse. Savings programmed for the 2050s won't be enough to prevent us from going over the cliff well before that time.

- **It would send a dangerous signal to the markets that we are not taking our fiscal problems seriously.** With our large budget deficit and low domestic savings rate we are borrowing record amounts from abroad. This year's increase in foreign debt is likely to approach $700 billion. If we "pay for" Social Security reform by running up the debt further, rather than making hard choices, it would signal to increasingly wary financial markets that Washington has no intention of doing what is necessary to get its fiscal house in order. This would increase the risks of a so-called "hard landing" such as a spike in interest rates, rising inflation and a plunging dollar. Promises that all the new debt will be paid back starting in about 50 years are unlikely to satisfy the concerns of those who are watching to see what Washington does now to improve its fiscal position. If markets looked out 50 years, current interest rates would be through the roof.

Because the trade-offs that genuine reform requires can appear painful, many leaders try to find excuses for not confronting the hard choices. Yet the truth is clear. Social Security reform involves real resource trade-offs. It's time to get serious about reform—and face up to the hard choices.

Hon. J. Robert Kerrey
Former U.S. Senator
Co-Chairman

Hon. Peter G. Peterson
Former Secretary of Commerce
President, The Concord Coalition

Hon. Warren B. Rudman
Former U.S. Senator
Co-Chairman

Hon. Charles A. Bowsher
Former Comptroller General of the United States
Director

Donald B. Marron
Co-Chair, CSIS National Commission on Retirement Policy 1998-99
Director

Hon. Sam Nunn
Former U.S. Senator
Director

Hon. Robert E. Rubin
Former Secretary of the Treasury
Director

Hon. Paul A. Volcker
Former Chairman, Federal Reserve Board
Director

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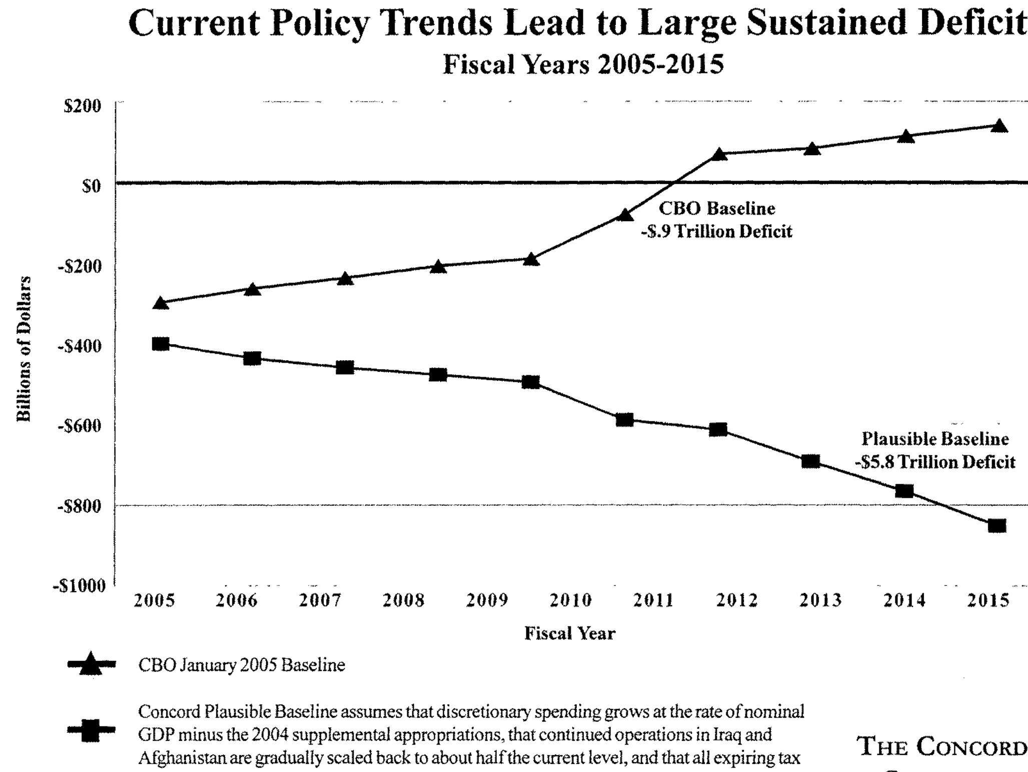
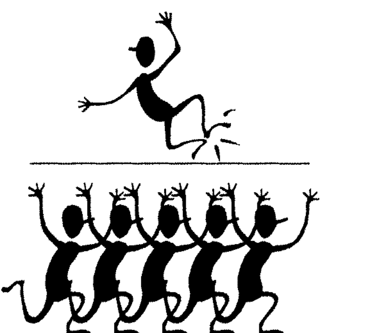
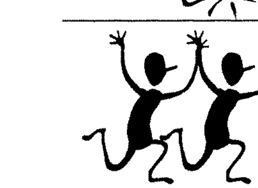

Current Policy Trends Lead to Large Sustained Deficits
Fiscal Years 2005-2015
$200
$0
-$200
-$400
-$600
-$800
-$1000
Billions of Dollars
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
Fiscal Year
CBO Baseline
-$.9 Trillion Deficit
Plausible Baseline
-$5.8 Trillion Deficit
CBO January 2005 Baseline
Concord Plausible Baseline assumes that discretionary spending grows at the rate of nominal GDP minus the 2004 supplemental appropriations, that continued operations in Iraq and Afghanistan are gradually scaled back to about half the current level, and that all expiring tax provisions ~~other than bonus depreciation~~ are extended with AMT relief.
THE CONCORD
COALITION
Source: Congressional Budget Office, January 2005 and Concord Coalition analysis

Americans are living longer and having fewer children

Consequently, fewer workers are available to support each Social Security recipient

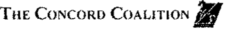



1960: 5.1 to 1

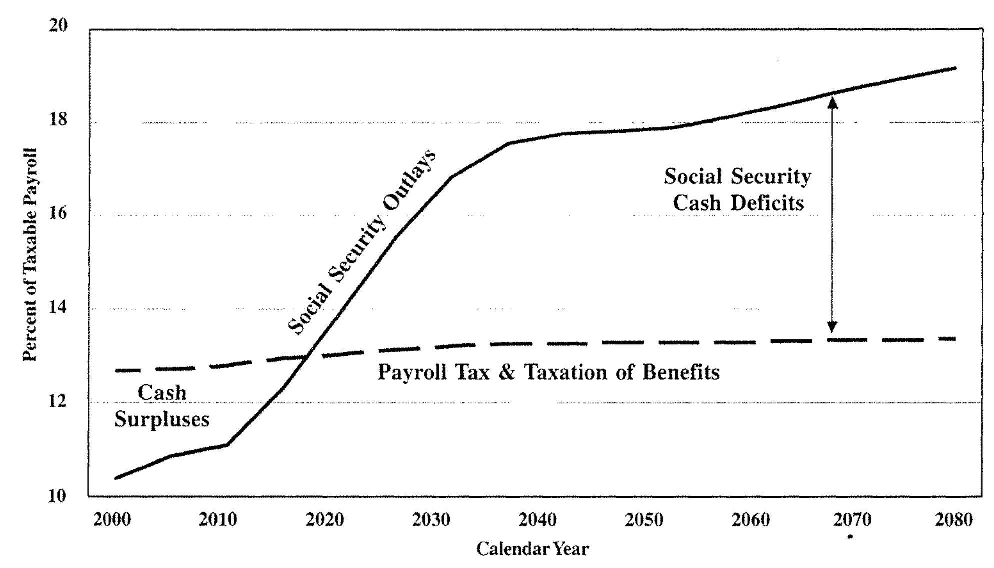
Today: 3.3 to 1

2040: 2 to 1

Source: Social Security Administration, March 2004

THE CONCORD COALITION 

Benefits promised far exceed dedicated tax revenues



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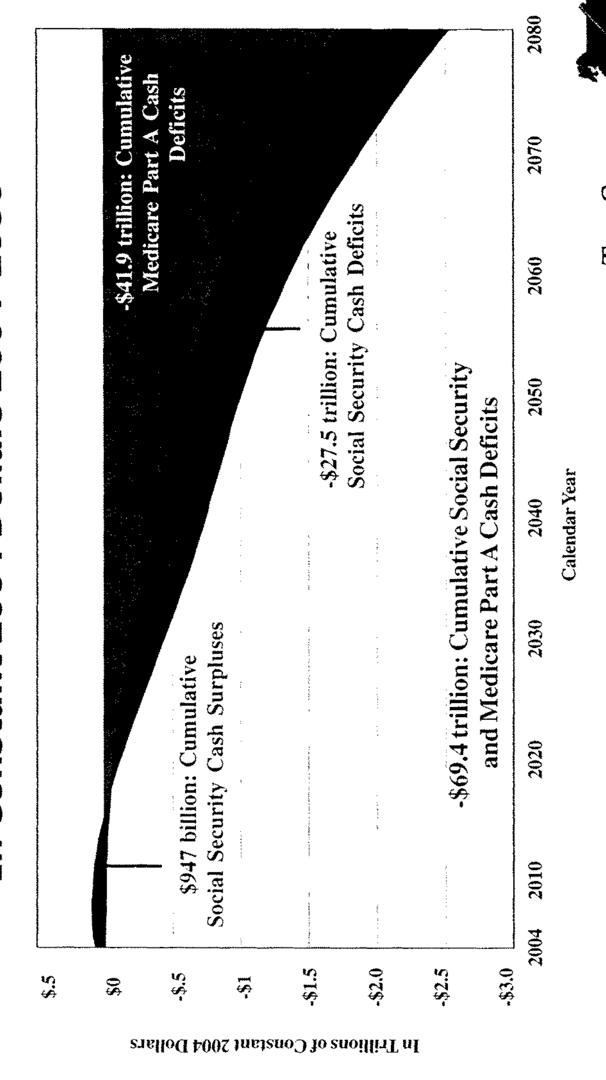
Source: Social Security Trustees' Report, March 2004--Intermediate Projections.


Social Security and Medicare Part A
Cumulative Cash Surpluses and Deficits
In Constant 2004 Dollars 2004-2080
In Trillions of Constant 2004 Dollars
$.5
$0
-$.5
-$1
-$1.5
-$2.0
-$2.5
-$3.0
2004
2010
2020
2030
2040
2050
2060
2070
2080
Calendar Year
$947 billion: Cumulative
Social Security Cash Surpluses
-$41.9 trillion: Cumulative
Medicare Part A Cash
Deficits
-$27.5 trillion: Cumulative
Social Security Cash Deficits
-$69.4 trillion: Cumulative Social Security
and Medicare Part A Cash Deficits
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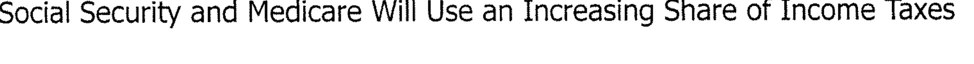
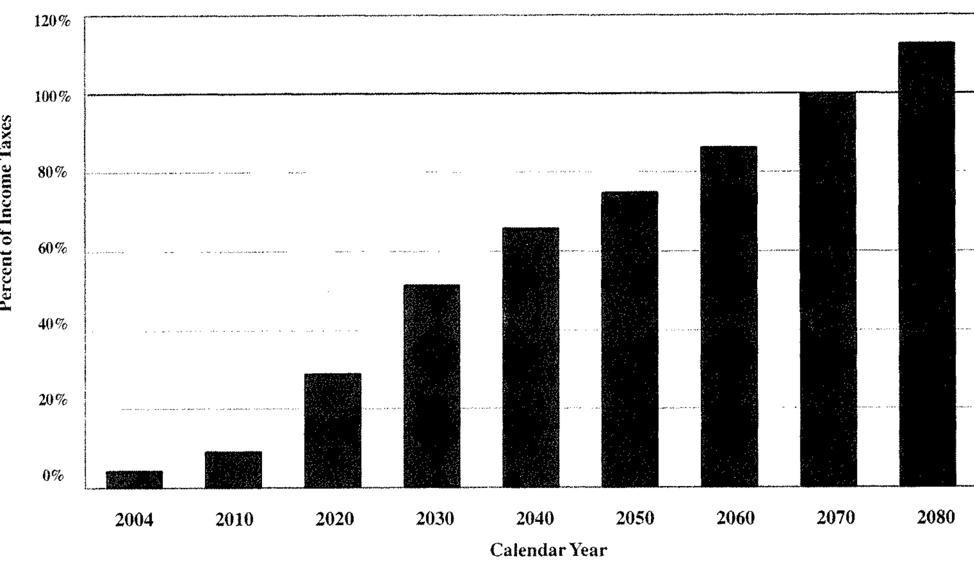
Source: Social Security Trustees' Report, March 2004--Intermediate Projections.

A Growing Tax Burden

Social Security and Medicare Will Use an Increasing Share of Income Taxes



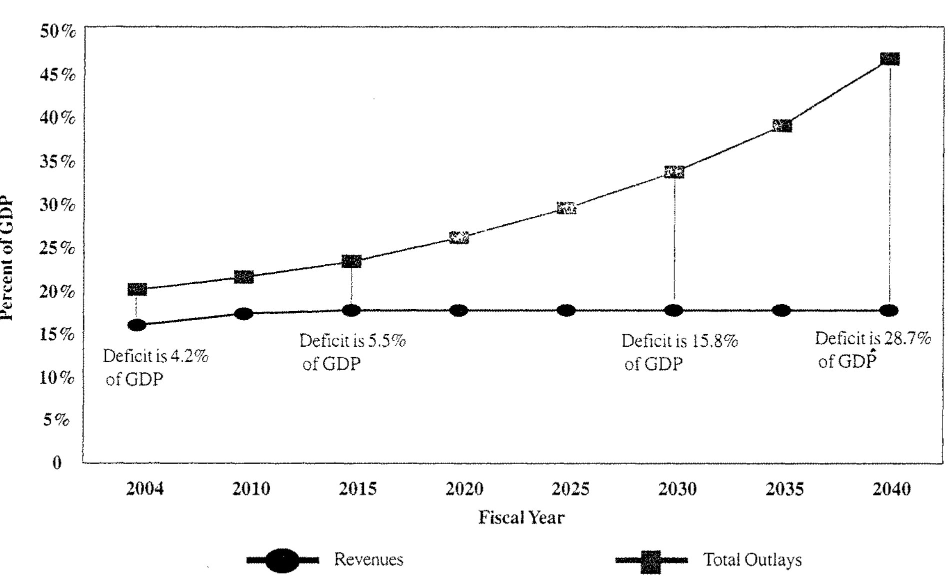


Future percentages are based on the assumption that federal income taxes remain at the same share of GDP as in 2001. The figure represents monies needed from income taxes. This figure includes general revenue transfers to Medicare Part B, which make up 75% of the program's income.

The Concord Coalition

Source: Social Security and Medicare Trustees' Reports, March 2004--Intermediate Projections.

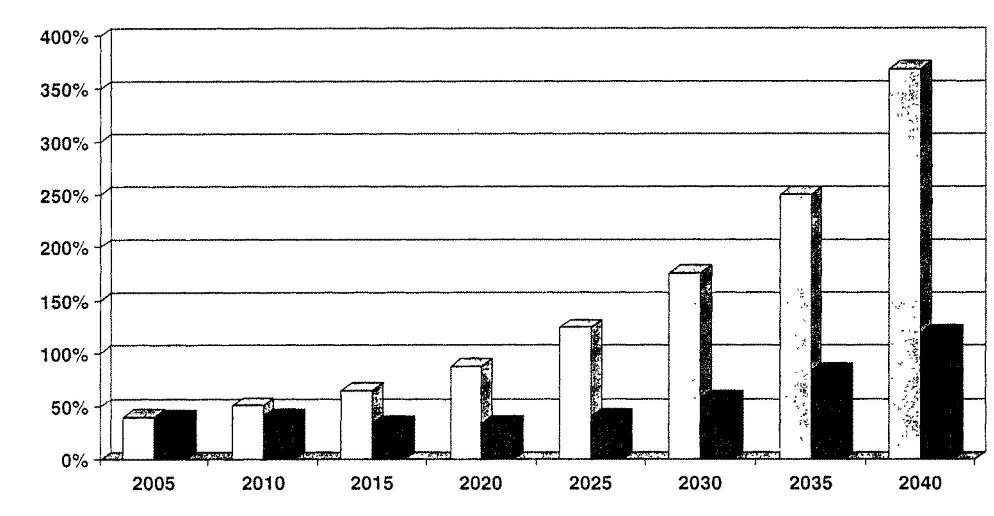
Failure to Change Course in the Near-Term Means Exploding Deficits in the Long-Term



Assumes that discretionary spending grows with the economy after 2004, and that all expiring tax provisions are extended through 2014. After 2014, revenue is held constant as a share of GDP (17.7 percent).

Source: General Accounting Office, March 2004

The Concord Coalition



Projected Debt Held by the Public as a Percent of GDP (2005-2040)
400%
350%
300%
250%
200%
150%
100%
50%
0%
2005
2010
2015
2020
2025
2030
2035
2040
Assumes discretionary spending grows with the economy and all expiring tax cuts are extended
Assumes discretionary spending increases only with inflation and tax cuts expire
Source: Congressional Budget Office-baseline extended simulation; General Accounting Office; March 2004
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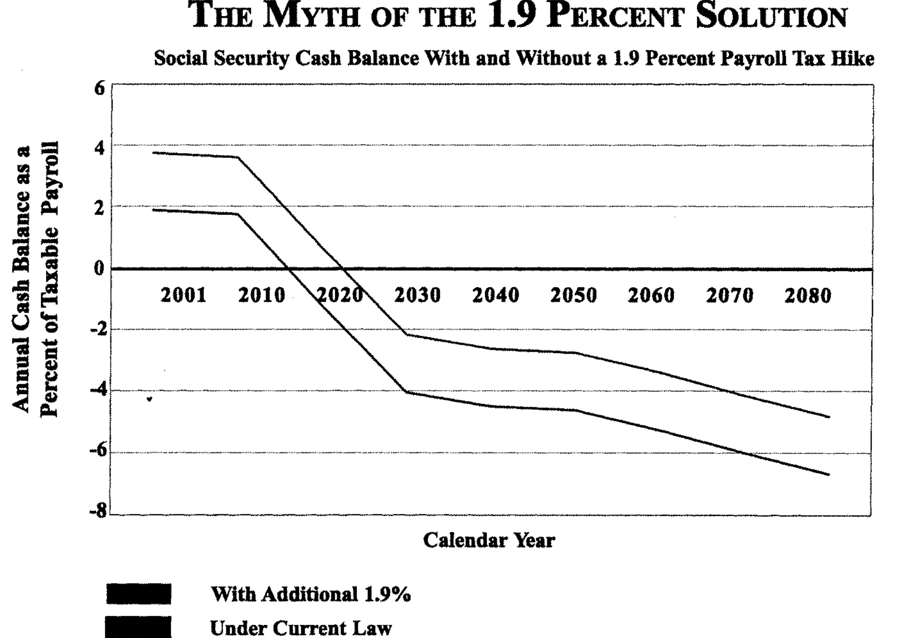

Source: *Social Security Trustees' Report, March 2002 (Intermediate Projections)*

THE CONCORD COALITION

The CHAIRMAN. John Rother, welcome.

STATEMENT OF JOHN ROTHER, DIRECTOR OF POLICY AND STRATEGY, AMERICAN ASSOCIATION OF RETIRED PERSONS, WASHINGTON, DC

Mr. ROTHER. Mr. Chairman, thank you, Senator Kohl, Senator DeMint. It is a privilege to be back in front of the Aging Committee. I was the staff director here for four years. Today, I am the policy director for AARP.

I will leave my full testimony with you and just summarize briefly, given the time.

The CHAIRMAN. We will include it in the record.

Mr. ROTHER. I agree that this debate needs to be about people just as much as it is about dollars. AARP believes that Social Security does need to be strengthened for our children and our grandchildren, but that the solution should not be worse than the problem. In our view, private accounts that drain money out of Social Security will only cut its guaranteed benefits, increase the federal debt, and pass the bill on to future generations. Private accounts are risky, expensive, and unnecessary as replacements for Social Security's guaranteed insurance protections. AARP is working to strengthen Social Security, not dismantle it.

We believe that all Americans, young and old, have a stake in this debate. We do not find the generations divided. When it comes to Social Security, America, we believe, is a house united. We have done a series of recent surveys, the latest one we release today, of Americans 18 and older that shows that people of all incomes and all generations would prefer to strengthen the existing system with as few changes as possible. They would not favor radical changes that would undermine its purposes.

There are sensible and workable solvency options to explore that could make a real and lasting difference and restore the program to fiscal stability. My full testimony includes several of those that we have been using in an educational way around the country to help people understand the tradeoffs that will need to be made in order to strengthen this program.

We do believe that we should avoid Social Security changes that add huge new sums to our nation's debt. I certainly agree with Bob and the Concord Coalition on this point. Doing so would burden all taxpayers with additional interest costs and further increase deficits, which in turn threaten our ability to finance essential health and service programs for Americans young and old.

So we think that all generations have a stake in this debate and we do not believe that seniors are somehow exempt from it.

Social Security was never intended to be the sole source of retirement income but a foundation and this foundation must be strengthened. Social Security replaces, on average, only about 40 percent of pre-retirement income. We support savings and investment options that are in addition to, not in place of, Social Security.

Last night, the President mentioned the Federal Thrift Savings Plan. That is a very good model, but I want to point out that it is on top of a Social Security benefit and a defined benefit pension for Federal retirees. So it serves a very important savings function

on top of a guaranteed base of Social Security and pension benefits. It should not be used as a model to replace that guaranteed base.

In fact, if there is a crisis in retirement income today, it is the fact that only half of private sector jobs even offer a pension and only 70 percent of employees in those firms participate in one. So we are at eminent risk of the largest generation in our history, the boomers, being completely unprepared to finance their own futures beyond Social Security.

AARP is working to ensure retirement security for all generations. Any agenda to strengthen our nation for the future in addition to Social Security must also include strong Medicare benefits, a viable Medicaid program, and opportunities for meaningful employment for older workers. These are family issues that demand Americans of all ages be engaged. We certainly are going to work with the public across the country and will work with members and Congress on both sides of the aisle to make sure that Americans can continue to age with security and dignity and that we can restore confidence in the single most important domestic social program we have, our Social Security program.

Thank you.

[The prepared statement of Mr. Rother follows:]

TESTIMONY BEFORE THE

SENATE SPECIAL COMMITTEE ON AGING

ON

SOCIAL SECURITY: DO WE HAVE TO ACT NOW?

FEBRUARY 3, 2005

WASHINGTON, D.C.

WITNESS: JOHN ROTHER
DIRECTOR OF POLICY AND STRATEGY

For further information,
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(202) 434-3760

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toll-free TTY 877-434-7598 | Marie F. Smith, President | William D. Novelli, Chief Executive Officer | www.aarp.org

Good morning and thank you for inviting AARP to appear before the Committee to address the important issue of insuring the retirement security of millions of Americans by strengthening Social Security.

Social Security is a crucial part of America's retirement security system and probably the most successful federal program in history. People look upon it as a promise –without an expiration date– that our nation has made to America's workers and to those who have completed their worklife, our retirees.

The program has been periodically re-tuned as the workforce and work skills have changed. Yet, its administrative expenses remain the lowest of any government program—less than 1%. While the program insures families against loss of their breadwinner throughout life, Social Security also has proven to help millions of older Americans maintain their standard of living in retirement.

Social Security is financially strong now and in no danger of "going broke" anytime soon. There is no 'crisis' that demands immediate and radical restructuring of the system. However, it is true that the program is in need of long-term measures to keep it in fiscal balance so that it will be able to pay full benefits to every generation of Americans. The changes do not have to be drastic. However, the longer we wait to adjust the system, the more difficult the adjustments—that is why it is advisable to act sooner rather than later.

One of four pillars. Social Security is only part of the overall retirement security structure. A secure retirement is supported by four pillars: 1. Social Security, 2. Pensions and savings, 3. Continued earnings, and 4. Adequate and affordable health insurance. In that context, the importance of Social Security today is evident as each of the other pillars faces mounting pressures.

Less than 50% of working Americans have a pension plan available at their workplace, so half of all private sector workers have no regular payroll deduction mechanism to save for their future. Traditional defined benefit pensions are disappearing. Many companies that do offer pensions are converting to defined contribution plans, making workers absorb more risk. Defined contribution plans are subject to early withdrawals, poor investment decisions, and the failure to annuitize the account balance upon retirement. So, even if a worker has contributed to a retirement savings plan, it is likely to provide for a much less adequate retirement income level than defined benefit pensions.

Personal savings are at an all-time low according to Federal Reserve figures, and personal debt at an all-time high. In contrast to previous generations, who owned their homes free and clear by the time of retirement, many boomers may retire with substantial mortgages. Many report that they are planning to work in retirement. However, the job market for older workers is difficult for most without recent training and current skills, and age discrimination is still prevalent in the hiring process.

Rising health care costs also put strain on the goal of economic security. As health care expenses go up at almost double digits annually, insurers are reducing offerings, raising prices and shifting costs. Employers are cutting back on employee health benefits and retiree health benefits alike.

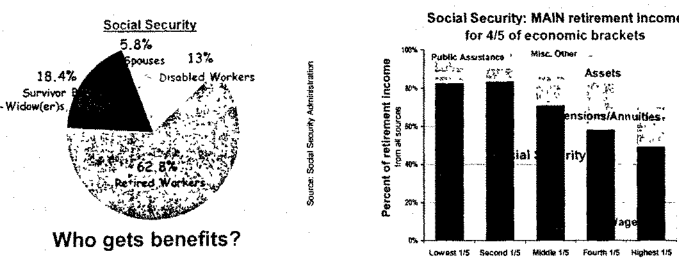
So retirees are paying larger and larger portions of their post-work income for health care. Even with Medicare eligibility the average older American is spending nearly a third of income for health care.

The average American today will need to work longer before retiring in order to: educate the kids, possibly assist elderly parents, save adequately for retirement without supplemental benefits from a company pension to count on, and meet ever-rising out-of-pocket health care costs. Since other pillars are under so much pressure, the need to strengthen Social Security is all the more important.

Who participates in Social Security?

About 96% of all workers contribute to Social Security. Workers pay 6.2% of their earned income into Social Security, matched equally by 6.2 % from their employer. The highest wage earners do not pay in to Social Security on the portion of their salary over the "taxable maximum." This figure is adjusted annually by formula and will be $90,000 a year in 2005.

Those who contribute for 40 quarters will earn retirement benefits. Today, approximately 47 million receive Social Security benefits. About 6% of beneficiaries are non-working married partners (mostly wives) whose payments are based on their spouses' earning record. Close to 19% of annual payments go to widowed spouses and children of deceased workers. Over 13% is paid to workers disabled during their work years. The remaining (less than 63%) goes to retired workers, beginning on a date of their choosing, but after age 62.



Source: Social Security Administration

For the majority of Americans – that is, for *two-thirds* of current and future retirees, Social Security is – or will be – the largest part of their income in retirement.

Adequacy of Benefits

The key measure of adequacy is the "Income Replacement Rate." Social Security is designed to favor the lower-wage worker, who might not have as much opportunity to save over a long worklife at the lower end of the wage scale. The Social Security benefit formula ensures lower-wage workers receive a higher wage replacement rate relative to their earnings so that their benefit might be more adequate.

RATE OF REPLACEMENT[1]

- 53.6% of low-wage workers' earnings replaced
- 39.9% of average-wage workers' earnings replaced
- 32.5% of high-wage workers' earnings replaced
- 24.8% of earnings replaced for those with consistent earnings at the taxable maximum

Any changes to Social Security's formulas must recognize the goal of adequacy. Changes must ensure that, both by initial payment level and by cost-of-living adjustments, the adequacy of Social Security as a partial replacement for pre-retirement income is maintained.

AVERAGE SOCIAL SECURITY BENEFIT - JANUARY 2005

Retired worker	$ 955
Retired couple, both workers	$1574
Widow(er) with 2 children	$1979
Widow(er) of retired worker	$ 920
Disabled Worker	$ 895

Fairness

In an increasingly diverse nation where opportunities in the labor market have not been equally distributed in the past, another duty of those who would change the system is to promote fairness. African-American and Hispanic workers make up a disproportionate segment of the nation's low and moderate wage earners. At present, the Social Security benefit formula ensures some fairness in that all lower-wage workers receive a higher percentage replacement of salary in retirement relative to their lifetime earnings.

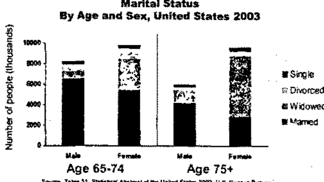
Life-expectancy *at birth* is still significantly lower for males of these groups. The lower life-expectancy has sometimes been used to show lower-wage earners potentially contribute more than they receive in benefits. However, life expectancy *at 65* differs by only about a year, and the gap is closing. A further balancing factor, in terms of distribution of funds, is that a higher percentage of low-wage workers draw disability benefits and a higher percentage of their families draw survivor benefits.

Women's equity issues. Women, too, are concentrated in low-wage work on average. Their median salary is $531 a week compared to $685 a week for men. In other words, women are paid about 78% of what men are paid, a figure which unfortunately tends to stand over a lifetime.

[1] Source: Social Security Administration website: accessed Dec 10: www.ssa.gov/OACT/TR02/lr6E11-4

For *one of every four* unmarried women over 75, the only source of income is their Social Security check. Since women tend to live longer, a Cost of Living Adjustment (COLA) calculated on the Consumer Price Index annually is crucial to keep these women from falling into poverty as they age. Women (and men) who have been married to other workers get the higher of either benefits accruing (as spouses) from their partner's work record or their own work earnings, but not both.

Most women widowed at 75+



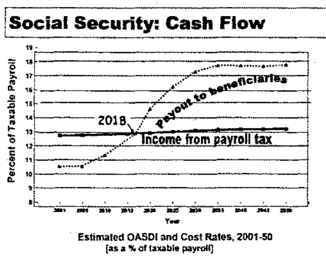
Poor & Near Poor, 2001 (within 150% of Poverty)

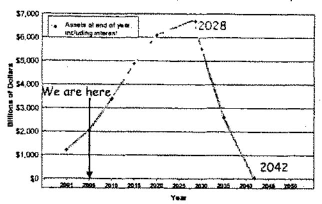
Age	Men	Women
60-64	16%	20%
65-74	17%	24%
75+	20%	33%

Solvency

Solvency is a major focus of the current reform discussion. According to the Social Security trustees, the system is out of long range balance by about 1.89% of payroll. Projections by the Congressional Budget Office show a smaller long-term deficit of only 1.00% of payroll over 75 years.

Because the Social Security system pays retirees, widows, orphans, and the disabled and their families each year out of the funds collected from current workers' payroll checks and some of the income taxes paid on benefits, it is sometimes referred to as a pay-as-you-go system. Demographic changes including slower workforce growth and longer lives affect the projected annual Social Security balance sheet. Recognizing well in advance the population bulge created when births were delayed by World War II (the phenomenon known as the baby boom), excess collections were legislated in the early '80s to create a surplus in the Social Security trust fund designed to meet the nation's obligations to boomers' retirement. For years, Social Security's income has exceeded its pay out, and the trust fund has grown.





Today's trust fund reserve is $1.7 trillion, and another $155 billion will be added in 2005. This surplus is invested in special U.S. Treasury bonds that currently generate almost $90 billion in interest at an average rate of 6% for the trust fund. These bonds are backed by the full faith and credit of the United States. This means that the nation is fully obligated to honor them when they are redeemed.

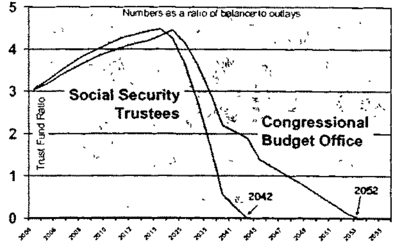
Annual payments *into* the trust fund —payroll contributions and dedicated taxes— are projected to *exceed* annual benefit payments until 2018. By then, the rising number of boomer retirees will have caused benefit payouts to rise. At that point, some of the interest that accrues each year will have to be combined with payroll and income taxes to pay retirees. In other words, the Treasury will have to make interest payments to the Social Security trust fund in cash rather than bonds.

2018 is a significant date for Social Security. It is important not because the program is in financial trouble at that point, but because the rest of the budget may be in trouble due to unsustainable fiscal policies. After more than 30 years of borrowing *from* Social Security, the U.S. Treasury will be called upon to transfer cash resources back to the trust fund. Right now the rest of government is borrowing more than $150 billion a year from Social Security, which Congress is using for various purposes at home and abroad.

So, 2018 is a problem not for Social Security but for Congress. Fiscal policy therefore is the cause for concern, not the ability of Social Security to continue to pay full benefits.

The situation changes again in 2028. Then, the annual payout will begin to exceed annual income plus interest earnings, and the bonds that the trust fund holds will need to start being redeemed. The Social Security actuaries conservatively project that the trust fund balance will be depleted by 2042. However, even after that date, Social Security will not be "bankrupt." *Annual collections from payroll taxes would be sufficient to pay over 70 % of promised benefits.*

The Congressional Budget Office (CBO), charged with projecting the costs of legislation for the U.S. Congress, has created an alternative model. Their model estimates that 2052, not 2042, as the possible trust fund depletion date, and only a 1% of payroll gap between income and benefits over the coming 75 years, assuming no changes.



This is significant because the CBO is using a very sophisticated new econometric model. Various economic and demographic assumptions plugged into the model result in a *broad range* of projected outlays and a narrower –but still significant– *range* of program income. This serves to point out that there is not just one "solution" to Social Security's "problem". The CBO entry into the debate is also significant because the current long-term imbalance looks only half as big through the CBO lens. The short-term cash flow is estimated to be the same. If the CBO projections are correct, more modest changes would be sufficient to guarantee current obligations and continuous trust fund solvency.

SOCIAL SECURITY SOLVENCY OPTIONS

We should work together to shore up the program, as soon as possible, for the long term so it will be there for all generations. But it is not necessary to dismantle Social Security in order to save it. A radical overhaul is not needed. If we make reasonable changes now, the program will be able to pay full benefits to the boomer generation and those that follow.

Here are two examples that, together, would get us more than half the way toward solvency:

First, we can restore the total wages taxed by Social Security to 90 percent of nationwide earnings, a historic level. Currently, only about 85 percent are subject to Social Security payroll taxes. The maximum wage subject to Social Security payments in 2005 is $90,000. Gradually raising that cap to $140,000 (perhaps phased in over 10 years) would lower the projected shortfall by some 43 percent.

Second, we can diversify Social Security's trust fund investments to increase the likelihood of higher returns. Today, the trust fund can only be invested in Treasury bonds. These are safe investments, but they have a modest rate of return. Currently trust fund bonds average about a 6% return. Investing some of these funds in a broad stock index fund -- as most state and other pension systems do -- could yield higher returns and lower the expected shortfall by some 15 percent.

Taken together, these two steps would lower Social Security's shortfall by 58 percent – and that is just for starters. There are a number of other possibilities that have been put forward. For

example, extending Social Security coverage to make it universal, with appropriate transition relief reduces the shortfall by about 9%. AARP could support all three of these steps.

There are other changes that have been suggested for consideration to make Social Security solvent for future generations. Some of the more straightforward options that have been proposed at one time or another include:

- Gradually raise the retirement age to 70 by 2083 (reduces shortfall by 38 percent).
- Increase the number of work years calculated in the benefit formulas from 35 (the current base) to 38 (lowers the projected shortfall by 16 percent).
- Index the starting benefit level for longer lifespans or "average longevity" (lowers the projected shortfall by 25 percent).
- Reduce benefits for new retirees by 5 percent (lowers the projected shortfall by 26 percent).
- Raise the Social Security tax by ½ percentage point (from 6.2 to 6.45 percent each for employers and employees (reduces the shortfall by some 24 percent).
- Use a revised Consumer Price Index being developed by the Bureau of Labor Statistics that includes product substitution data ("superlative" index) for determining cost of living adjustments (COLA). (reduces the projected shortfall by 14 percent).

People are surprised when they learn that incremental steps like these can have such a significant impact on Social Security solvency. In discussions with our members around the country, and in a recent survey, we found that most people support making incremental changes in the program, and sooner rather than later. When these and other options are put before our members and the public, they are willing and able to make the choices to achieve balanced solvency packages. AARP will continue to get the views of our members and the public in general on these and other options and they should not be interpreted as endorsed by AARP.

AARP is opposed to private accounts that divert money from Social Security payroll taxes. Private accounts are expensive. Money would have to be borrowed to fulfill promises to current beneficiaries and those close to retire while simultaneously creating millions of new accounts. Additional borrowing to fund an extended transition period would equal as much as $2 trillion over 10 years. Increasing our national deficit is not prudent fiscal policy at a time when deficit figures are already at record numbers.

Most younger workers today would have to pay twice to finance this new plan. First, current benefits must continue to be paid, even though there would be less revenue due to the diversion of payroll taxes into private accounts. So, borrowing must take place to meet these obligations, requiring additional interest payments and potentially higher interest rates. Second, the added debt must be paid off.

We understand that proponents of private accounts carved out of Social Security contend they would not affect current beneficiaries. But they have yet to tell us where the money would come from to protect them. Even more importantly, our members care about all generations, including, of course, their children and grandchildren. They want their legacy to be a better America for future generations, and they believe they have an obligation to ensure that Social Security remains strong. AARP and its members have good reason to be concerned about radical changes in Social Security.

Another policy to which AARP is strongly opposed is "price indexing." Overall Social Security benefits would gradually become smaller over time by price indexing initial benefit levels. Social Security today calculates initial benefit levels by indexing wage histories to overall growth in wage levels; retirees benefit from rising productivity during their worklife. Price-indexing would freeze the real value of earnings. This would result in about a 1% decrease in initial benefit level *per year* compounded for every year the policy is in effect. For example, *if price indexing had been in effect since 1955, today's benefits would be 42 percent lower. In other words, retirees, survivors and the disabled would have to live as if it were 50 years ago.*

Changing the benefit formula to price-indexing would by itself eliminate the projected trust fund deficit, but at the price of drastically lower income replacement rates for future generations.

Price Indexing Beneficiary Impact:
Income Replacement Rates

Year of Birth	Current Law	Plan #2 Combined
1940	42 9%	42.8%
1950	43 0	39 9
1960	41.0	34 8
1970	40 5	30 9
1980	39 8	27 4
1990	39.5	24 6
2000	39 6	21.7

Beneficiary Impact: In dollars

Year of birth	Current Law	Plan #2 combined
1940	$14,900	$14,900
1950	$15,200	$14,100
1960	$15,500	$13,100
1970	$17,700	$13,600
1980	$20,500	$14,300
1990	$23,300	$14,500
2000	$26,400	$14,600

Source: Congressional Budget Office - July 2004

One example of the effect on Social Security benefits of a plan that combines price indexing with private accounts is the Congressional Budget Office's analysis of one of the plans designed by the President's Commission to Strengthen Social Security several years ago. As the accompanying table shows, *this plan would lead to reduced benefits, even after the returns from the private accounts are taken into account.* That is because the benefit amount provided by Social Security would *decrease at retirement* by the amount that was put into the account over the years plus an interest charge. This policy is referred to as a "clawback" to help fund solvency.

Criteria to Judge Options

This is not a comprehensive list but gives an idea of the range of the measures that might be adopted. Key questions in evaluating any comprehensive plan include: Are future benefits adequate? Are costs and benefits fairly spread? Who bears what risk? Are benefits still "progressive"? What is effect on public support, confidence, and understanding? Can people adjust easily to the change? How will the plan affect rest of the U.S. budget?

Our nation needs a full national discussion of *all* the ideas on the table. Now that Social Security has moved to the top of the political agenda, we must all work together to keep it adequate, equitable, and financially strong.

Policy Highlights

AARP Supports

✓ Increasing wages subject to Social Security tax
✓ Diversifying investment of a portion of trust fund assets to increase return
✓ Adding newly-hired state/local workers
✓ Individual retirement accounts added to Soc Sec

AARP Opposes

X Creating private accounts that divert payroll contributions away from Social Security
X "Price-indexing" benefits
X Reducing cost of living adjustments
X Increasing retirement age
X Means testing

* * *

The CHAIRMAN. John, as I have read the AARP literature, it seems, as you have stated here, that not a lot needs to be done because there isn't really a problem until 2042, but that is not really what you are saying.

Mr. ROTHER. No, not at all.

The CHAIRMAN. You are admitting that there is a problem. Are you saying the sooner we get to it, the better?

Mr. ROTHER. Yes. It is certainly true, as a defender of the system, that more modest changes are possible now than if we wait, and the longer we wait, the more difficult the choices will be. So I think it makes good sense to act sooner rather than later.

The CHAIRMAN. Your proposals are to raise the wage cap, is that correct?

Mr. ROTHER. We have done extensive polling work and community forums around the country. Consistently, we have found the single most popular option of all the ones out there would be to ask those who have benefited the most in recent years to contribute more, and the way to do that is to raise the wage base up from its current $90,000 a year to something more in line with the historical standard, which would probably take it up to around $140,000.

The CHAIRMAN. Some have suggested that we means test Social Security. I am not, but some have suggested that, so Bill Gates doesn't get it or Donald Trump—they always pull those names out of the air. Do you favor such a thing?

Mr. ROTHER. No, Senator. The current Social Security benefit formula returns less of a benefit as a percentage of pre-retirement income to people who have more of an opportunity to save for themselves. It provides a more generous benefit for people at the low end who generally have not had an opportunity to save or be part of a pension plan. We think that is the appropriate way to structure it, and that is the way the system works today.

The CHAIRMAN. David, as you listened to the President last night, and we all listened, clearly, there is a funding obligation here if we are going to be fiscally responsible on this. Whether it is $800 million or $2 trillion, do you have any recommendations as to how we would do that if we were to go to personal accounts?

Mr. JOHN. Essentially, there are going to be four mechanisms that can be used, whether this is used to repay the trust fund or to pay general revenue costs of establishing personal retirement accounts. Those four are fairly simple.

We can borrow the money, which means we are going to pay it back.

We can raise taxes in some form or another, but we have to be very careful with that. For one, it is a slippery slope, and for another thing, it can have a very serious impact on the economy.

Third we can cut other government spending, which has always been one of my favorite choices, but as I learned the hard way, it is a lot easier to talk about than it is to do.

Or last but not least, we can change Social Security benefits, and any of those four would work.

What I personally would love to see done would be to see something like a BRAC, Base Realignment and Closure Commission, type structure that looked over government programs, identified duplicate programs, programs that might have outlived their use-

fulness, and basically close them down or merge them or do something along that line.

But this is going to be a long-term problem. At some point or another over the 30 or 40 years that we deal with these, all four of these methods are going to come into play here.

The CHAIRMAN. As to Social Security or all entitlements?

Mr. JOHN. All entitlements, when it comes down to it.

The CHAIRMAN. Robert, as I listened to my colleague, Senator Clinton, I certainly admire her passion. I was only a Senator for half of the Clinton years. On the surface, a lot of what she said, I agreed with, except I do remember that when I came to the U.S. Senate in 1997, the budget—and I was on the Budget Committee—that President Clinton presented to us showed deficits for as far as the eye could see. What closed that and produced the surplus was a stock market bubble and we began to get tremendous revenues from what eventually exploded in the last year of his Presidency.

Whether you like the tax cuts or not, the recession was short and it was shallow and we are seeing increases to revenues now. I guess as against China, we are certainly not growing at 11 percent, but we are growing at a rate that is the envy of the Western world, of the industrialized world. That is the part that wasn't said.

But clearly, we have got to do something. It does seem to me that we have got a problem on the spending side and obviously the revenue side. My hope is that the revenues will grow with a growing economy.

What does the Concord Coalition, bottom line, what do you want to see us do with this?

Mr. BIXBY. Well, I think there are only two ways to address the problems here. One is to control the long-term cost growth and the other is to try to grow the economy, to make the remaining costs more sustainable. Those are hard choices. Neither one of them is a free lunch.

One could conceive of a plan that could try to trim the promised benefits more to a level that would be sustainable without raising the payroll tax. You would have to do that gradually and over time and you would have to look at the adequacy of the benefits. But at the same time, you could perhaps help the system and increase national savings to help build the economy with a system of mandatory private savings accounts that would be part of the Social Security system. But if you were to do that, in order to result in real savings, they would have to be funded with new money, so there is no free lunch in any of this.

Overall, I would strongly urge you to look at whatever reform you adopt by looking at the year-by-year results for the budget and for the economy and not to get hung up on abstractions about the trust fund or the perceived benefits of private accounts. I think both are important and I think they have a role, but ultimately from the Concord Coalition's, "eat your peas" point of view on fiscal policy, when we add all of these things up, you have to ask, "Is the path that we have set for ourselves sustainable?" Right now, it isn't, and so whether we are talking about Social Security reform or Medicare, Medicaid, taxes, whatever, we need to get back on—a sustainable path.

I should say, Mr. Chairman, I am not one that says, repeal the tax cuts and the problem is solved. I want to be clear about that. Whatever one thinks of the tax cuts, and at Concord, we didn't think they were a particularly good idea, but they didn't cause this problem and repealing them is not going to be the solution to this problem.

The CHAIRMAN. Do you attribute any of the growth we are seeing now, a short and shallow recession and the growth we now enjoy, do you attribute any of that to the tax cuts?

Mr. BIXBY. Yes. I think short-term tax cuts were a good idea. Our problem with the tax cuts is more the long-term effect and whether more was done than needed to be done for short-term fiscal stimulus, although that is probably the subject for a different hearing. [Laughter.]

The CHAIRMAN. My recollection, and I don't mean to be partisan, Herb, and you can counter me here in a second, but my recollection is that when we passed a $1.3 trillion tax cut to get the economy going, we were also turning back additional spending of over $2 trillion from our friends on the other side. So I think there is blame to go around, I suppose, but it does seem to me that the tax cuts at least have helped to get us back to growth and reemploying people.

Mr. BIXBY. I would just say that I agree with what Comptroller General Walker said in that I think last year was a bad year and that cutting taxes while adding a major new entitlement program, is an inconsistent mix and I would hope that we go in the opposite direction, anyway, in our future fiscal policies.

The CHAIRMAN. Thank you.

Herb.

Senator KOHL. Thank you, Mr. Chairman.

Mr. John, back in 1935, if you were engaging in that debate to create Social Security, would you have supported Social Security back then or would you have opposed it? What I am asking you is whether you generally support the idea of any kind of social insurance programs.

Mr. JOHN. I 100 percent support it.

Senator KOHL. You support it?

Mr. JOHN. I do support—if I were living in 1935, I would have supported Social Security at that point. If I lived today and the question comes up, social insurance, yes or no, the answer is yes. This is not a society that is going to let senior citizens starve in the street, and thank goodness for it.

Senator KOHL. Good. Mr. Bixby, some argue that borrowing money to create private accounts would not hurt the economy since we are taking the borrowed money and investing it. Therefore, it would have no effect. What is your view on that?

Mr. BIXBY. Well, I don't agree with it. I think that there is a huge amount of borrowing involved although, you would have to see the details of any plan, obviously. But one of the goals of Social Security reform should be to improve national savings and help grow the economy. Private accounts presumably would do that, but if you are going to borrow the money to do it, you are just taking money from one pocket, putting it into another, and national savings wouldn't be improved that way. They would probably actually

decline because people would tend to save less if they were saving through Social Security and the government would be stuck with the debt.

But the problem I have with a lot of these so-called carve-out accounts that require a lot of borrowing is that even if they promise to pay the money back sometime in the future, the savings are so distant, that they come after we have already gone over the cliff that I talked about. If we are already headed over a cliff by 2040 and we borrow a lot in the interim, presuming that we are going to get savings back in 2060 and beyond.

Well, we are never going to get to 2060 on the current path. That is what we need to worry about. So I would urge not looking at 75-year summaries of these things, whether we are looking at private accounts or the trust funds. Again, just follow the money on a year-by-year path and see if we are on a sustainable course.

Senator KOHL. I believe you have advocated mandatory private accounts. Why shouldn't working people have a choice?

Mr. BIXBY. Social Security is a social insurance program, first and foremost, and frankly, I think everybody should have the same rules. I mean, choice doesn't seem important in a system that is designed to protect people from bad choices. So if we are going to do private accounts, I think that they should be a mandatory part of the system.

The other thing is that if you do voluntary accounts, I just can't imagine the complexities of that sort of thing. There would probably be notches and what not and difficulties with people opting in and then wanting to opt out again. I don't know how you could control that.

The other thing with voluntary accounts is I think there would be a tendency, and John probably knows more about this than I do, having studied savings behavior, but—lower-income people tend to be more risk averse and they might well opt not to take the personal accounts. But they are the ones that would benefit most from it in the sense of building up savings, because if you also at the same time were doing something to reduce the defined benefit, the guaranteed benefit, the cut can get quite substantial over the long term. If they opted not to take the private account that would help make up for they could find themselves in much worse conditions. Upper-income people probably would take the account, but they would probably save less in some other area, so we wouldn't be increasing savings that way.

So I really think there are a lot of, while it sounds like a good idea, I think in practice, voluntary accounts would be very problematic.

Senator KOHL. Mr. Rother, what role will Social Security play in the retirement of future retirees and will it be more or less important than it has been for the prior generation?

Mr. ROTHER. Today, as you know, about two-thirds of retirees receive most of their retirement income through Social Security, and we would like to think as a result of a rising economy and higher living standards that this would change for the boomers. However, the studies that we have commissioned from leading universities show that, in fact, that is not going to be the case. Part of it is the result of the decline in offering of defined benefit pension plans

from employers. The rise in defined contribution plans, the 401(k) that replaces the old plans have not succeeded in offsetting the losses in plan value that people are not contributing enough, they are not investing very wisely, and they are pulling their money out before retirement.

The other part of the problem is that we have a wage structure in our country that is getting more bifurcated where we have exaggerated winners and losers. People with lower educations are not keeping up with rising standards. This is true for many people in the boomer generation their wages aren't keeping up.

They no longer have a defined-benefit pension. Their health costs are going through the roof, and they are responsible for more of those health care costs. These are the people, and it is going to be a very substantial number of boomers, who are going to be in real trouble when they no longer can work. That is exactly the crisis that I think we should be paying more attention to rather than just the dollar numbers in the trust fund.

Senator KOHL. I thank you. Mr. Chairman, thank you very much. I think it has been a great hearing.

The CHAIRMAN. Thank you, Senator Kohl.

One question, Robert. Is the Concord Coalition opposed to private accounts?

Mr. BIXBY. No.

The CHAIRMAN. You are not?

Mr. BIXBY. No. We have said a lot of very favorable things about private accounts. Our concern is whether they are funded or unfunded. Unfunded private accounts don't seem like much of an advantage over unfunded trust funds.

The CHAIRMAN. I thought it was interesting, your comment that the people at the low end who probably are in jobs with companies that don't provide them with a pension and therefore they only have Social Security those individuals are the ones that would gain the most from the compounding interest of a personal account.

Mr. BIXBY. Yes. I think they have a real advantage, and particularly for younger workers, the people that don't save enough now and people that would have a long time to buildup assets.

My essential point about private accounts is that they are not a free lunch. They have to——

The CHAIRMAN. They have to be paid for.

Mr. BIXBY. Right. Exactly.

The CHAIRMAN. Do you have any recommendation for that?

Mr. BIXBY. The Concord Coalition has not taken a specific position on reform items, but I would say the funding for accounts should come from some sort of new mandatory contribution, which, of course, some people would say is a tax increase. My argument back on that would be at least it is going into directly funding a worker's account and it is not going into the government, which a tax increase would, and so a Republican should say, "It may be a higher tax in that sense, but it is going to fund a private account and it is not going into creating a bigger government."

The CHAIRMAN. John, would it be fair to say that AARP is ideologically opposed to personal accounts on any basis?

Mr. ROTHER. We actually favor private accounts, just so long as they are on top of the——

The CHAIRMAN. So you would favor Social Security Plus?

Mr. ROTHER. Yes, and as I have emphasized the real problem today is that half of our workforce doesn't have access to a payroll deduction mechanism for funding their own savings, so that is where the solution lies. We favor—and we think you could do it on a voluntary basis or mandatory basis, but we do favor a system open to every American worker that would allow them to save for retirement in addition to their Social Security.

The CHAIRMAN. So hypothetically, if we were in gridlock here until 2042, but we were able to do Social Security Plus, you would see the benefit to your members—you and I won't be here, but—well, maybe not—— [Laughter.]

You look pretty vigorous.

Mr. ROTHER. Thank you. [Laughter.]

The CHAIRMAN. But our children who would have a Social Security Plus, the quarter-percent cut that they would take, and they are going to lose roughly 27 percent under current law, that you think Social Security Plus would more than make that up?

Mr. ROTHER. Well, I want to be clear. We favor strengthening the Social Security system first and foremost.

The CHAIRMAN. But say we weren't able to.

Mr. ROTHER. Well, I——

The CHAIRMAN. This system won't allow us to deal with it. One side wants to increase benefits, the other won't raise taxes, and you just get to gridlock, hypothetically. In that instance, the Social Security Plus account would really help your members, I assume.

Mr. ROTHER. Well, I don't know if it would help our members, but it would help our future members, our children, quite a bit——

The CHAIRMAN. Exactly.

Mr. ROTHER [continuing]. Particularly since the current defined benefit pension structure is eroding in the private sector. We need something that is available to all——

The CHAIRMAN. Do you think it would make up at least the 27 percent cut they are scheduled to take?

Mr. ROTHER. Well, only——

The CHAIRMAN. Or would it even be more than that?

Mr. ROTHER. Well, that would depend on how much people put in. The amounts that are being talked about today, two, three percent of payroll, are not going to be sufficient to replace Social Security's guaranteed benefit. I think the amounts serve well as a savings supplement. They do not serve well as a replacement.

The CHAIRMAN. David, do you think with program cuts or ending programs, do you think we could find $2 trillion?

Mr. JOHN. Oh, I am pretty sure of it, especially spaced over a certain period of time, yes.

The CHAIRMAN. Do you have any programs you want to recommend?

Mr. JOHN. I think we actually have a fairly long list that we could send over, if you would like.

The CHAIRMAN. We would be pleased to receive those.

Gentlemen, you have been great. Thank you. We respect your views and we are charged with weighing them and coming up with what we hope will not be gridlock, but something that our country can live with and retire on.

We are adjourned.
[Whereupon, at 4:07 p.m., the committee was adjourned.]

APPENDIX

PREPARED STATEMENT OF SENATOR LARRY CRAIG

I want to thank and commend the Chairman for holding this hearing—and this series of hearings—on the future of Social Security.

These hearings are very much in line with those held by your predecessor. There are many arguments and misunderstandings out there, and much information to be digested and discussed, on the future of Social Security. I don't think it would be possible to hold too many hearings on this topic, to help make Members of Congress, the media, and the public better informed.

The first, critical point to make of course, is this: For everyone now in, or nearing, retirement, Social Security will not change. The President said it again last night, our colleagues have confirmed it, and it bears repeating. We are looking at the future of the system, because we also want the best for our children, our grandchildren, and all of today's younger workers.

The President highlighted the future of Social Security in his State of the Union address last night. He has been discussing it and doing good work on it for four years, including his establishment of the distinguished, bipartisan Commission to Strengthen Social Security in 2001.

I hope and believe we all share the commitment articulated by the President last night: "Social Security was a great moral success of the 20th Century, and we must honor its great purposes in this new century."

Idahoans, of course, have been even farther ahead of this curve. All the way back in 1996, I held a series of town hall meetings across Idaho—the "Seniors to Seniors Meetings"—in which we tried to bring together everyone from seniors in high school to senior citizens for this kind of informed discussion. We've had numerous Idaho events in the following years.

In those gatherings, I have been consistently reassured that, once all the information is on the table, most folks from grandparents to grandchildren are ready to take a constructive part in saving and strengthening Social Security for the 21st Century.

In choosing the topic for this hearing, Mr. Chairman, you have asked: "Do We Have to Act Now?"

Some have said that we do not have to act now. They say, "There is no Social Security crisis." They say Social Security only has a "problem" or faces a "challenge". They say, essentially, "Let's wait until the long term to fix the long term," or maybe, "Let's just tinker, for now".

Waiting for a crisis to happen is never a good strategy. That's why, Mr. Chairman, I appreciate your holding these hearings. And I look forward to us asking, "How should we act?

I also want to join my Chairman in welcoming today's witnesses. We've all worked together before. These witnesses and their organizations are facing the issues squarely and are deeply responsibly involved in the national discussion of Social Security's future.

In fact, David John (Heritage) even joined us a few years ago for one of those town meeting tours around the State of Idaho.

Thank you again, Mr. Chairman. I look forward to continuing to work with you and the Committee.

PREPARED STATEMENT OF SENATOR HILLARY RODHAM CLINTON

Thank you Chairman Smith and Ranking Member Kohl for holding this hearing today. The debate over the future of Social Security has significant implications for every American and it is critical that we bring the facts to light and have a debate that allows the American public to make an informed decision about what they think the future of Social Security should be.

And as we consider this issue, it is important that we recognize the financial challenges facing Social Security and commit ourselves to fixing them. But tactics designed to scare the public into thinking that Social Security is "in crisis" or "about to go broke" are inaccurate and do a disservice to the debate.

In fact, Social Security will continue to run annual surpluses for decades to come. In 2018, Social Security will have $5.3 trillion in reserves, growing to $6.6 trillion in 2027. In fact, Social Security will not be "bankrupt" even in 2042 or 2052 when the Trust Funds are exhausted. This is because payroll taxes coming in to the Trust Funds will be enough to finance 70–80 percent of benefits.

Now, there is obviously a problem, and I do think that we need to act sooner rather than later, but this is not the crisis that some would have us believe. And it certainly doesn't mean we should "throw the baby out with the bathwater."

Social Security is the bedrock of our senior's retirement security and must remain so. Carving private accounts out of the Social Security system undermines the fundamental nature of the program, requires substantial benefit cuts, and drives up the national debt with trillions in new borrowing. The costs and the risk to the retirement security of millions of Americans from privatization are too great.

I look forward to hearing from our witnesses today, and I am hopeful, Mr. Chairman and Mr. Kohl, that your leadership on this issue and the hearings we will hold over the next weeks and months will help inform this debate and bring us to a broadly bipartisan consensus on the future of Social Security.

PREPARED STATEMENT OF SENATOR SUSAN COLLINS

Mr. Chairman, thank you for calling this afternoon's hearing to examine the long-range financing problems facing Social Security. I understand that this is the first in a series of hearings that the Committee will be holding to discuss the challenges facing this tremendously important program, and I commend you for giving us the opportunity to explore these issues thoroughly.

Social Security has been a huge success. It is our nation's largest and most popular government program. More than forty-seven million Americans depend on Social Security, and, for two-thirds of them, it is their major source of income. For many older Americans, Social Security is the safety net that makes the difference between poverty and an adequate standard of living.

And Social Security is not just a retirement program. It is also a disability insurance program and a life insurance program that provides families of active workers with protection worth more than $12 trillion—more than all of the private life insurance currently in force.

Unfortunately, as successful as Social Security has been, the system faces serious long-term financing problems and is not sustainable in its current form. While the system is sound today, it will not be able to meet its obligations to future retirees unless it is modernized.

Social Security is currently running a surplus because the program is taking in more in payroll taxes than it is paying out in benefits. But before too long, this will no longer be the case. Our Social Security cash surplus begins to decline in 2008—the first year in which the baby boomers can begin to collect Social Security. By 2018, payroll taxes will not be sufficient to pay benefits and we will either have to raise taxes, cut spending, go further into debt, or use more general fund money if we are to continue to meet our full obligation to Social Security beneficiaries. By the year 2042, the trust fund will be completely exhausted if steps aren't taken to save the program.

At the root of Social Security's problems is the simple fact that America is growing older. Today, more than 30 million Americans are 65 and older. These numbers will rise dramatically as the "tidal wave" of baby boomers—all 76 million of us—sweeps into retirement. Moreover, it is not just that there will be more older Americans in the next century. It is that older Americans will be living longer and longer.

And the rapidly increasing number of older persons is only part of the equation. The "baby boom" was followed by a "baby bust," and the inevitable result is that there will be fewer workers to support each retiree in the future. In 1960, there were five workers for each beneficiary. Today there are scarcely three, and by 2030, there will be only two.

Last night, the President laid out his plan to overhaul Social Security. Other Social Security reform plans have been proposed by both Republican and Democratic members of Congress, as well as by a variety of public policy groups. While there is a consensus that action needs to be taken, there is less certainly about what should be done, how soon it should be done, and how quickly a consensus plan can be forged.

Clearly, action must be taken to preserve Social Security for not just current, but future generations. And the sooner we begin to deal with Social Security's financing problems, the less disruptive the solution will be.

Given the universal importance of this program, however, it is crucial that any changes be carefully thought out, thoroughly understood, and have a solid basis of bipartisan support that cuts across all age and income groups.

Mr. Chairman, that is why hearings like this are so important. They give us the opportunity to discuss the scope and nature of the problems facing Social Security as well as to explore the ramifications of the various proposals to modernize the program.

Again, I thank you for convening this important hearing, and I look forward to hearing the testimony from our witnesses.

Statement on

Importation of Prescription Drugs and Internet Pharmacies

Prepared for

Senate Special Committee on Aging

Presented by

National Association of Chain Drug Stores, Inc.

February 3, 2005

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Mr. Chairman, and Members of the Committee, the National Association of Chain Drug Stores (NACDS) appreciates the opportunity to submit testimony relating to importation of prescription drugs and Internet pharmacies. NACDS is a national trade association that represents more than 210 chain pharmacy companies that operate nearly 35,000 community retail pharmacies and employ nearly 100,000 pharmacists. Our members dispense more than 70 percent of all outpatient retail prescription drugs in the United States.

NACDS supports access to low cost prescription drugs. Due to serious concerns about patient safety, however, NACDS does not support personal importation of prescription drugs from Canada or other foreign sources. The recent report of the HHS Task Force on Importation indicates that licensed pharmacies in the U.S. are the safest source for prescription drugs.

With regard to commercial importation by licensed wholesalers and pharmacies, we perceive many operational and legal hurtles that would have to be overcome to ensure that drugs could be imported safely and at lower cost. NACDS hopes to work with Congress to address these issues.

NACDS also supports efforts to track down and close rogue Internet pharmacies that illegally sell prescription drugs. We pledge to work with Congress to help stop illegal drug sales without imposing unnecessary burdens on legitimate pharmacies.

Importation of Prescription Drugs

There are two different methods of importation of prescription drugs that should be distinguished and evaluated separately in terms of their safety and cost effectiveness.

1. **Personal Importation by Individuals.** For many of the same reasons cited by the HHS Task Force on Importation, NACDS is strongly opposed to proposals that would encourage or facilitate importation of prescription drugs by individuals. Simply put, there is no realistic way that consumers can know whether the imported prescription

medications that they receive are misbranded, mislabeled, adulterated, counterfeit, or unapproved for use in the United States. Any potential short term savings derived from personal importation are dwarfed by the dangers of purchasing drugs outside the closed system of distribution in the United States.

Federal and state regulators ensure that pharmacies, wholesalers and drug manufacturers in the chain of dispensing prescription drugs to Americans in America satisfy stringent safety standards. But when drugs are purchased from foreign internet sites and mailed into the U.S. from countries not subject to these same standards, there is no way to ensure they are prepared, packaged, transported or stored in compliance with federal and state standards.

Consumers do not know that drugs coming into the United States from Canadian websites and mail order operations are not subject to American regulation, nor are they subject to regulation in the country from which they originate. The Canadian Government has affirmatively stated that it does not and will not assume the responsibility to ensure the integrity and safety of drugs sold to non-Canadians ordering them over the internet or via mail order. There is no expectation that any other foreign government would take a different position.

Millions of packages containing pharmaceutical products – many containing illegal, contaminated, adulterated, counterfeit or harmful controlled substances - are being ordered by consumers and shipped into the United States each year.[1] Many of these drugs look exactly like their authentic counterparts, making it difficult or impossible to determine their authenticity without some form of rigorous testing and validation. Additionally, if a foreign dispensed drug becomes subject to a recall or is withdrawn from the market, there is no way for patients to be told to protect them from harm.

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[1] *See* FDA Press Release, "Recent FDA/US Customs Import Blitz Exams Continue to Reveal Potentially Dangerous Illegally Imported Drug Shipments" (January 27, 2004), available at http://www.fda.gov/bbs/topics/NEWS/2004/NEW01011.html.

Patients take an incredible risk when they shop internationally for health care products. There is virtually no way for consumers to discern a "legitimate" source from a dangerous source. Moreover, many of these international businesses, purportedly doing business in Canada, are not what they advertise to consumers and drug supply may be from questionable sources.[2] In the end, any price savings are lost if the drug is subpotent, adulterated or otherwise ineffective.

Just as important, individual importation of prescription medicines usually eliminates any patient interaction with the pharmacist. This professional interaction is important to ensure that the patient understands how to take the medication appropriately and to avoid any potential interactions with other medications that the patient might be taking. With no knowledge of a patient's foreign purchases, a patient's pharmacist cannot protect the patient. Thus, a patient that receives a medication from another country is not only at risk for the potential problem with the medication, but also for potential harmful drug interactions that may occur with the other medications that the patient is taking. The coordination of care that occurs at pharmacies today cannot occur when a drug is imported by a patient from another country.[3] An incomplete health care profile is a recipe for patient harm, particularly for patients who are using multiple medications. In almost every case, the cost of hospitalization for an iatrogenic event far exceeds any savings that a patient may have realized on the purchase of a drug.

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[2] *See* Testimony of William Hubbard, Associate Commissioner of Policy and Planning and Legislation, FDA, before the Committee on Government Reform, U.S. House of Representatives (June 24, 2003) (discussing purported Canadian pharmacy service website run by three-time convicted felon which delivered drugs made in India to an American who ordered from website); *see also*, Global Options, Inc., "The Analysis of Terrorist Threats to American Medicine Supply," (2003) at 145-48. Also, the Coalition for Manitoba Pharmacy reported on April 2, 2004 that a Vancouver internet pharmacy company is openly selling Americans prescription medicines from Mexico, approved by neither Health Canada nor the FDA. *See* Manitoba Coalition of Pharmacy, Press Release, "Vancouver Internet Pharmacy Selling Mexican Drugs to Americans," April 2, 2004 ("Press Release").

[3] Health plans spend more money treating the adverse consequences of misuse of drugs than they do on the drugs themselves. *See* Frank R.Ernst & Amy J. Grizzle, "Drug-Related Morbidity and Mortality: Updating the Cost-of-Illness Model," Journal of the American Pharmaceutical Association, v. 41, no. 2 (March/April 2001). Patients who fail to take their drugs as directed end up costing the system much more, in terms of increased hospitalization and patient care. Separating patients from their community pharmacists will only make this problem worse.

Importantly, those who focus on importing foreign drugs often miss the fact that a less expensive generic drugs are available in the United States. In most cases, there are safer, cheaper drugs available at your local community pharmacy than in Canada. Generic drugs are less expensive in American pharmacies than in Canadian pharmacies. Further, pharmacists can assist many patients in finding other savings, either through pharmaceutical manufacturer assistance programs or Medicare-endorsed discount cards. The savings generated by those programs do not threaten the integrity of patient care and the prescription drug safety net in the United States.

Additionally, there are broader economic costs that must be considered when we send patients to foreign suppliers of prescription drugs. Drug importation schemes promote unfair competition against American pharmacies. The reason is that foreign pharmacies do not compete on a level playing field in compliance with the strict federal and state regulatory standards to which domestic pharmacies must adhere. Instead, foreign pharmacies are given unfair advantages that make fair trade all but impossible. As examples:

- Foreign pharmacies do not pay U.S. taxes.
- Foreign pharmacies do not comply with federal and state consumer protection laws.
- Foreign pharmacies do not comply with stringent federal and state licensure requirements and U.S. safety standards.
- Foreign pharmacies do not face the frequent lawsuits that are an ever-growing threat in the U.S.; indeed they often require customers to waive all liability.
- Foreign pharmacies do not comply with the thousands of laws and regulations that apply to U.S. pharmacies, such as the stringent HIPAA privacy rules that protect patients against improper use and disclosure of their personal health information.

Drug importation has another negative consequence: Job losses. Community pharmacists fill literally billions of prescriptions for Americans every year, and their work is supported by everyone from pharmacy technicians to cash register operators to truck drivers to janitors and everyone else that makes it possible to operate a community

pharmacy. If prescriptions are sent through international mail order to be filled by foreign "pharmacies", some pharmacists and many other pharmacy employees in the United States will lose their jobs. It's inescapable: When you import drugs, you export jobs.

Finally, drug importation leads to lower tax revenues. Community pharmacies collected about $30.8 billion in state taxes nationwide. The employees of those community pharmacies also pay billions and billions of dollars in federal, state and local taxes. Recently, we have heard some in government argue that states and cities can save money by having prescription drugs mailed into the state from distributors in other states or other countries. But will state and local governments really be better off financially if local retailers lose business and local citizens lose jobs? We believe that is a short-sighted approach. Governments should avoid importation schemes that appear to save money, but in reality hollow out their own tax bases.

2. Commercial Importation by Pharmacists and Wholesalers. NACDS supports efforts to provide lower cost prescription drugs to our patients. However, commercial importation by wholesalers and pharmacists would not benefit patients if it cannot be performed in a safe and efficient manner. Any commercial importation program would face significant safety challenges, whether limited to Canada or expanded to other countries.

Moreover, as noted by the HHS Task Force on Importation, the potential for cost savings may be offset by significant operational burdens associated with commercial importation. We are concerned that the testing, tracking, and paperwork requirements of a commercial importation law will outweigh any cost savings that might be realized from importation. We agree that such requirements would be prudent under any program of importation that introduces foreign supplies of drugs into our closed drug distribution system. However, some of this recordkeeping information may be difficult or impossible for an importer to obtain or validate. For example, under current law, importers are required to obtain lot or control numbers, and sources of origin of

prescription medications. Some of this information may not be available to an importer. Moreover, the current program assumes that manufacturers would be willing to provide information relating to tests and approved labeling to importers of prescription medications. These features are critical to assuring quality of the products, and limiting potential liability to importers from mislabeled medications.

Establishing the infrastructure necessary to effectively and efficiently operate an importation program, coupled with potential testing and other regulatory requirements, would impose significant start-up and operational costs for the entire pharmaceutical distribution system. Additionally, pharmacies would likely have to maintain dual inventories of pharmaceutical products to assure those products that have not been imported, and those that have been imported, are tracked and billed appropriately, particularly to individuals covered under private third party contracts or Medicaid programs. However, space limitations in pharmacies, carrying costs, and other considerations make it virtually impossible to maintain separate pharmaceutical inventories.

Yet if pharmacies do carry dual inventories, no one has answered the question of who decides which patients get domestic versus imported drugs. Also, the potential impact of a dual inventory on pharmacies under the third party payor programs that they service, both government (*e.g.*, Medicaid) and private, must be addressed.

Finally, the relatively small volume of drugs that is likely to be imported into the United States, compared to the overall market, may further create a reluctance to invest in the infrastructure needed to operate this program. The ability of the supply chain to invest in the necessary start up costs will have to be weighed against the long term viability of the program, the prices of medications from foreign countries, and the ability to recover costs and make a reasonable profit.

The bottom line is that once the costs of testing and validation are factored into the overall pricing equation, we cannot be certain that the price of imported medications

would be significantly less expensive than the prices for prescription medications in the United States.

Even if the government limits importation of pharmaceuticals to those from a particular country or countries, it will be an ongoing challenge to assure that drugs made in those countries meet the same standards for quality that are required in this country, or if those drugs were really even manufactured in those specific countries. Also, pharmacies must be assured that products are not counterfeit or diverted. Even if products are thought to be from a particular country that has high manufacturing or quality standards, the products may in fact be diverted from a country that does not. Importation likely will generate growth in "black markets" for pharmaceuticals, raising serious questions about the quality of these drugs.[4]

In addition, many pharmaceutical products sold in other countries – albeit containing the same active pharmaceutical ingredients as those sold here – may have different shapes, sizes, colors, and even trade names. Some are made with different inactive ingredients, while some are sold in different doses because the patients in other countries have different dose-response relationships. Introducing different-looking foreign pharmaceutical products into the U.S. system will only confuse patients and health professionals. This will lead to an increase in medication-related events, which already lead to deaths and injury for thousands of individuals each year, and already results in $177 billion in related health care costs.[5]

There are serious questions regarding which parties will bear the liability if the imported drugs result in harm to individuals. For example, manufacturers currently bear the potential for liability resulting from harm from prescription medications that have been

[4] *See* "Importation of Drugs Into the U.S. Appears Difficult to Stop –Puts Slow Pressure on EPS," Diane Duston and Tim M. Anderson, Prudential Financial (Equity Research) (Oct. 8, 2003) (stating that the "squeeze on Canadian pharmacy supplies" has caused Canadian pharmacies to get their product from Bulgaria, Singapore, Pakistan, among others); "Cross Border web pharmacists could hurt Canada," AP, (September 24, 2003) (reporting on rise of grey market for prescription drugs in Canada due to reduced supply).

[5] *See* Ernst & Grizzle, *footnote 3.*

sold by them through established and licensed distribution channels. It is not clear how the burden for liability might change for a manufacturer or pharmacy if the drug is, in fact, made by the manufacturer for use in another country, but imported here by a pharmacist or pharmacy. Pharmacists and pharmacies that import these drugs may not be willing or able to accept any liability that comes with a program of importation of drugs.

There are also questions of whether international sources of pharmaceutical supply will be adequate and consistently reliable.[6] Pharmacies may be able to obtain sufficient international drug products at one time, but inadequate product supply at another. This might lead to a higher price for consumers – or a different quality of drug – when consumers come back for their medication if the source of supply is unavailable. Pharmacies must have access to consistent, reliable, quality sources of medication supply.

Internet Pharmacies

Some of the bills that would legalize drug importation also impose new requirements on "Internet pharmacies." NACDS supports efforts to prohibit illegal sales by unlicensed, rogue pharmacies that operate primarily through the Internet. However, we are concerned that additional regulations and burdens should not be imposed on licensed "brick and mortar" pharmacies that operate websites for the convenience of their customers. Imposing additional burdens on legitimate pharmacies will only increase drug costs.

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[6] "Ban drug exports, say regulators," Tom Blackwell, *National Post* (Canada), November 15, 2003 (referring to the "reports on drug shortages" referenced by the head of the national Canadian pharmacy regulatory); "Canadians Warn of Rx Shortage." John O'Connor, *Chicago Sun Times*, November 13, 2003 (warning that Canadian pharmacists are concerned that Canada could run out of prescription drugs if states like Illinois implement importation plans); "Net pharmacies hard to stop," www.calgary.cdc.ca/regional, October 14, 2003; "Pharmacist Refutes U.S. Allegations," Eliza Barlow, October 10, 2003, www.brandonson.com (referring to difficulty in getting some brand name drugs); Coalition for Manitoba Pharmacy Submission to Standing Committee on Health, Winnipeg, Manitoba, October 2, 2003 (reviewing negative impact of the Canadian cross-border sales on supply and price of drugs in Canada).

1. **Focus On Rogue Pharmacies, Not Legitimate Pharmacies.** Many licensed community pharmacies maintain Internet sites that provide consumers with convenient access to their products and services. The vast majority of legitimate pharmacy-based Internet sites are operated by traditional state-licensed "brick-and-mortar" pharmacies. Some of these websites help patients order prescription refills or purchase non-prescription items. These legitimate websites do not allow customers to order drugs without a prescription, and they are not affiliated with, and do not provide, a prescriber for the patient.

NACDS is well aware of rogue Internet sites, both domestic and foreign, that engage in a pattern of illegal activity regarding the prescribing and dispensing of prescription medications. These entities sell prescription medications, usually without a legitimate medical relationship with the consumer, and even without a valid prescription. These so-called "pharmacies" are not licensed by any state or other jurisdiction, and are shipping unapproved, counterfeit, mislabeled, or adulterated products within or into the United States.

NACDS wants to work with Members of Congress and regulators to eliminate these rogue illegal Internet suppliers from the market. Federal Internet pharmacy legislation should target the elimination of these sites, without adversely impacting legitimate traditional "brick and mortar" pharmacies that merely operate an Internet site.

2. **Legitimate Pharmacies are Already Highly Regulated.** State boards have effectively regulated the practices of medicine and pharmacy for more than 100 years. We are concerned that Federal regulation of Internet pharmacies will ultimately lead to Federal regulation of pharmacy practice. That will occur unless Federal legislation distinguishes between traditional brick-and-mortar pharmacies with Internet connections that are already licensed by state boards of pharmacy, as opposed to pharmacies whose primary method of access by consumers is via the Internet, where there is no state board licensure.

Currently, all pharmacies must be licensed by the state in which the pharmacy resides, including those that have Internet access. Many states also require licenses for out-of-state pharmacies that ship or mail pharmaceuticals into the state to residents; in other words, many states require non-resident pharmacy licenses. To secure and maintain their state licenses, all legitimate pharmacies must comply with voluminous regulations, which are continuously updated. Illegal "pharmacies" are those without state pharmacy licenses. Federal legislation should not subject state-licensed pharmacies to further regulation, simply because they provide consumers the option of ordering via an Internet site.

3. Entities Subject to Legislation. The entities that any Internet pharmacy bill seeks to regulate must be carefully defined, since the broader the definition, the more likely that traditional brick-and-mortar pharmacies with Internet sites will be unnecessarily swept into the regulatory proposal. For example, proposals that broadly regulate pharmacies if any part of the prescription ordering or sales transaction is conducted through an Internet site are problematic. Legitimate state-licensed pharmacies that merely operate Internet sites for the purposes of allowing patients to order refill prescriptions could be subject to this bill. This would be duplicative of the existing state-based retail pharmacy regulatory scheme. Congress should also avoid legislative language that could prohibit legitimate pharmacies from contacting physicians on behalf of their patients for prescription refills through the Internet.

Legislation should be narrowly tailored to affect only the offending entities that are not properly licensed as a pharmacy in the United States. For these reasons, we believe that an Internet pharmacy should be defined as a pharmacy that: (1) uses the Internet as the primary method to facilitate the ordering of a prescription and the receipt of prescriptions for filling; (2) uses mail or commercial carriers as the primary method to deliver the prescriptions to patients; and (3) is not licensed by the board of pharmacy in the states in which it operates.

4. Certification of Internet Pharmacies. Many legitimate pharmacies have already invested substantial resources in obtaining certification of their Internet site under the National Association of Boards of Pharmacy (NABP) Verified Internet Pharmacy Practice Sites (VIPPS) certification program. NABP is the professional association that represents the state boards of pharmacy in all U.S. jurisdictions. In response to public concerns regarding the safety of pharmacy practices on the Internet, NABP developed the VIPPS program in 1999. A coalition of state and federal regulatory associations, professional associations, and consumer advocacy groups provided their expertise in developing the criteria that VIPPS-certified pharmacies follow. To be VIPPS certified, a pharmacy must comply with the licensing and inspection requirements of their state and each state to which they dispense pharmaceuticals. In addition, pharmacies displaying the VIPPS seal have demonstrated compliance with VIPPS criteria including patient rights to privacy, authentication and security of prescription orders, adherence to a recognized quality assurance policy, and provision of meaningful consultation between patients and pharmacists. The VIPPS program can be considered the gold standard for Internet pharmacy certification programs. The VIPPS program requires rigorous certification and recertification of pharmacies that have Internet sites. More than fifteen pharmacies have VIPPS certification, and many other are currently engaged in the VIPPS certification process.

This VIPPS "seal of approval" should be sufficient for consumers and policymakers to be sure that the Internet site is legitimate and will provide quality pharmacy services to consumers. This recognition of VIPPS certification should be incorporated into any legislative proposal. It would be redundant for pharmacies with Internet sites that are certified by VIPPS to also have to meet Federal requirements. Additionally, we are concerned that multiple Internet pharmacy certification programs may cause public confusion, and may require conflicting and substandard certification requirements.

5. State Causes of Action and Penalties. Some legislative proposals would give state attorneys general the authority to enforce federal law through nationwide

injunctions against Internet pharmacies. A nationwide injunction would prohibit the Internet pharmacy from doing business in all states, rather than just the state in which the state attorney general has jurisdiction.

We recognize that the state attorneys general may want this authority to help shut down illegal entities on a nationwide basis, so that each state attorney general does not have to bring separate actions in their own states. However, we are concerned that this proposal represents an overly broad grant of authority that would give state attorneys general nationwide jurisdiction to take action against legitimate brick-and-mortar pharmacies that happen to have Internet sites. We have serious doubts about the constitutionality of legislation giving a state's attorney general jurisdiction over activities that occur in other states.

Rather than grant nationwide federal powers to states attorneys general, Congress should grant the U.S. Department of Justice discretion to intervene in actions filed by state attorneys general to enforce the Federal Food, Drug and Cosmetics Act. The Department of Justice could then seek a nationwide injunction against an illegal Internet pharmacy. That would respect the principles of federalism while shutting down illegal Internet pharmacies.

Beyond leveling fines against Internet pharmacies that violate the law, penalties should also be assessed against prescribers that order prescriptions for consumers outside a valid physician-patient relationship. Success in eliminating the dispensing of prescriptions from illegal entities will only be reached if all contributing entities are targeted for violations.

Another concern would be exclusion of the advertisers of illegal Internet pharmacies from liability. Advertisers should not be exempt from liability when they publicize illegal drug sales over the Internet. Any bill should be revised to state that advertisers may be held liable when they know or reasonably should have known that they are aiding and abetting illegal drug sales.

6. Workable Solutions. Despite our reservations, NACDS has seen favorable provisions in proposals we believe would help eliminate illegal Internet entities that sell prescription drugs. NACDS encourages the following:

- Narrowly limit the definition of Internet pharmacy to exclude legitimate, state-licensed brick-and-mortar pharmacies in this new regulatory structure, and specifically target rogue Internet pharmacies.
- Encourage and empower federal and state agencies to work together to enforce existing laws against illegal Internet pharmacies in federal and state courts.
- Clearly identify legitimate pharmacy Internet sites through a credible and thorough certification program.
- Educate consumers about the dangers of dealing with illegal Internet pharmacies, and provide a convenient method for consumers to report suspected illegal entities to state boards of medicine and pharmacy, and to the state attorneys general, for investigation.
- Require a pharmacy that maintains an interactive consumer Internet site to list on the site the states in which it maintains valid pharmacy licenses.

Conclusion

NACDS is committed to working with Congress, the Department of Health and Human Services, and the Food and Drug Administration to fully explore the issues associated with importation of drugs and Internet pharmacies. NACDS appreciates the opportunity to submit this statement for the record.