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CONGRESSIONAL TESTIMONY

Fixing Social Security

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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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