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INCOME TAXES: THE SOLUTION TO THE SOCIAL SECURITY AND MEDICARE CRISIS?

HEARING

BEFORE THE

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INCOME TAXES: THE SOLUTION TO THE SOCIAL SECURITY AND MEDICARE CRISIS?

MONDAY, MARCH 27, 2000

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

The committee met, pursuant to notice, at 2 p.m., in room SD–562, Dirksen Senate Office Building, Hon. Charles E. Grassley, (Chairman of the Committee) presiding.

Present: Senators Grassley, Craig, Collins, Bunning, Breaux, Reid, and Bayh.

OPENING STATEMENT OF SENATOR CHARLES GRASSLEY, CHAIRMAN

The CHAIRMAN. Good morning. Before I start, I would like to have staff for the respective members, except for Senator Breaux and myself, advise members if they come in that, because of Chairman Greenspan's schedule, I have asked to depart from the usual tradition of any member who is present making opening comments, and let Senator Breaux and myself do that, and then have any other members who wish to make an opening comment do that between Chairman Greenspan's testimony and our next panel.

I welcome everybody to the hearing today, and I would like to start by asking a question: Does the year 1990 seem like a very long time ago? For most of us, I think it seems like just yesterday. But then, I would pose the same question as to whether the year 2010 seems like a long way away. It may seem like a long way away, but the fact of the matter is it is as close as 10 years ago was, and that is the year, 2010, when the first baby boomers will begin to retire.

Everybody who has followed this committee very closely in the 4 years that Senator Breaux and I have cooperated on giving direction to the committee knows that we have used this committee to call attention to the nearness of baby boomers retiring at every opportunity we could, and now it is fair to say that we are really in the home stretch. Ten years is not much time to get our house in order. I think everyone agrees that we need to take decisive action to save Social Security and Medicare, meaning saving it in a sound way so that future generations can enjoy it as it has been enjoyed now, to bring some sort of security to retirement and to good health.

Today's hearing will focus on one of the most basic issues, that is, where we find the money to do that. The Congressional Budget office estimates that over the next decade, the non-Social Security surplus will total more than $1.8 trillion. So that is an obvious place to look for funds for Social Security and Medicare. However, I am not sure that we need to tell anyone here that this is not so-called "free money." This surplus will be amassed by taxing the incomes of the American people, and that is not something that we should do lightly.

Sharply increased reliance on income taxes to fund benefits would be a dramatic departure from the original designs of Social Security and Medicare. For the last 60 years, earmarked payroll taxes have funded Social Security money, and for the last 35 years, we have used only payroll taxes for Medicare Part A, although we have used income tax revenues for the smaller Medicare Part B. Our task now is to assess the costs and benefits of making this change so that we can approach it with our eyes wide open. That is what today's hearing is all about.

This hearing is especially timely now, as the Senate works on the budget blueprint for the next year. It has already passed the House, and it is in the Senate Budget Committee this week. What to do with the income tax surplus is obviously one of those budget questions.

I want to be up front about the fact that I have concerns about income tax revenue transfers. Senator Breaux and I have sponsored a Social Security reform bill that largely avoids relying upon these transfers. On the other hand, the President's proposals include substantial general fund transfers for both entitlement programs.

It is important to note, however, that this is not a partisan issue, as there are reform bills from members of both parties taking sharply different approaches on this very question.

Let me lay out some of my key questions that I believe we need to ask ourselves today. How will we maintain discipline in the funding of Social Security and Medicare if we allow these programs to tap income tax revenues?

If these benefit payments rely on income taxes, will that put a strain on funding for all other Government programs? Should we run a deficit in the future? If we turn to income taxes to fund benefits, would this be a permanent change, or just some sort of temporary change? Should general revenue transfers be allowed in the absence of other reforms to Medicare and Social Security? Will general revenue transfers make reform more or less difficult?

These are hard questions, and I am pleased to have these respected experts here today to help us answer them.

[The prepared statement of Senator Grassley follows along with prepared statements of Senator Collins and Senator Bunning:]

PREPARED STATEMENT OF SENATOR CHARLES E. GRASSLEY

Good morning. I'd like to start by asking a question: does the year 1990 seem like a very long time ago? If you're anything like me, it doesn't. Sure, we're all somewhat older, but ten years ago just doesn't seem that far away.

Well, we are now only ten years away from the year 2010, and that's the year in which the first baby boomers will begin to retire. Senator Breaux and I have used this committee to call attention to this at every opportunity, and now it's fair to say that we are really in the "homestretch." Ten years is not much time to get our house in order.

Everyone agrees, I think, that we need to take decisive action to save Social Security and Medicare. Today's hearing will focus on one of the most basic issues: Where can we find the money?

The Congressional Budget Office estimates that over the next decade the non-Social Security surplus will total more than $1.8 trillion. So that is an obvious place to look for funds for Social Security and Medicare. However, I'm sure I don't need to tell anyone here that this isnot "free money." This surplus will be amassed by taxing the incomes of the American people, and that's not something we should ever do lightly.

Sharply increased reliance on income taxes to fund benefits would be a dramatic departure from the original design of Social Security and Medicare. For the last 60 years, earmarked payroll taxes have funded Social Security benefits. For the last 35 years, we have used only payroll taxes for Medicare Part A, though we have used income tax revenues for the smaller Medicare Part B. Our task now is to assess the costs and benefits of making this change, so that we can approach it with our eyes wide open. That's what today's hearing is for.

This hearing is especially timely now, as the Senate works on the budget blueprint for next year. What to do with the income tax surplus is a key question.

I want to be up-front about the fact that I have concerns about income tax revenue transfers. Senator Breaux and I have sponsored a Social Security reform bill that largely avoids relying on these transfers. On the other hand, the President's proposals include substantial general fund transfers for both entitlement programs. It's important to note, however, that this is not a partisan issue, as there are reform bills from members of both parties taking sharply different approaches on this question. Let me lay out some of my key questions that I believe we need to ask ourselves today:

How will we maintain discipline in the funding structure for Social Security and Medicare if we allow these programs to tap income tax revenues? If these benefit payments rely on income taxes, will that put a strain on funding for all other government programs should we run a deficit? If we turn to income taxes to fund benefits would this be a permanent change or a temporary change? Should general revenue transfers be allowed in the absence of other reforms to Medicare and Social Security? Will general revenue transfers make reform more or less difficult? These are hard questions, and I am pleased to have these respected experts here to help us answer them.

I'll now recognize Senator Breaux for his opening statement. I would also ask that any other colleagues who wish to make brief opening statements that they hold their statements until after the first panel because Dr. Greenspan on such a tight schedule.

On our first panel is Dr. Alan Greenspan, Chairman the Board of Governors of the Federal Reserve System. He has served as Chairman under Presidents Reagan, Bush, and Clinton. I think all Americans are indebted to Chairman Greenspan for his steady leadership of our economy, and I am most grateful that he is able to be here with us today.

PREPARED STATEMENT OF SENATOR SUSAN COLLINS

Mr. Chairman, thank you for calling this afternoon's hearing to discuss the use of general revenues to shore up the financing of our Social Security and Medicare programs.

At the root of both Social Security and Medicare's financing 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 the year 2030, there will be only two. With only two workers supporting each beneficiary, the payroll taxes financing Social Security and Medicare will have to double—from less than 16 percent to almost 33 percent—if we are to maintain Social Security and Medicare benefits at current levels.

In the face of these financing challenges, the President has proposed bringing new resources into these programs by transferring income tax revenues from the General Fund into the Social Security and Medicare Trust Funds. While I believe that we must carefully consider all of the options for ensuring the long-term solvency of these critically important programs, I do have serious reservations about the wisdom of expanding the use of income tax revenues for these programs.

A fundamental principle of both the Social Security program since its inception sixty-five years ago is that it is a social insurance, not a welfare program, in which workers can rightly feel that they earned their benefits by making payroll contributions to the trust fund. An infusion of income taxes into the system would blur this distinction and possibly undermine the strong public support that these critically important programs currently enjoy across the generations. Moreover, I am concerned that a transfer of this kind would simply mask the continuing need for the real structural changes that will be necessary if we are to ensure that Social Security and Medicare are there for our children as well as our parents. Finally, economic projections made so far in the future are by no means certain, and we should be cautious about committing these surpluses before they actually materialize.

Mr. Chairman, given the universal importance of the Social Security and Medicare programs, it is critical that any changes to our current system be carefully thought out and thoroughly understood. This afternoon's hearing gives us the opportunity to further assess the potential effects of general revenue transfers to the Social Security and Medicare programs, and I look forward to the testimony of our witnesses.

PREPARED STATEMENT OF SENATOR JIM BUNNING

Mr. Chairman, I appreciate your calling this hearing today about the use of general revenue funds for Social Security and Medicare. It is a very important topic that we need to closely examine because of the profound ramifications it has for not only Social Security and Medicare, but also for all of the other programs actually funded by general revenue.

Let me make very clear at the outset that I am adamantly opposed to using any general revenue money for Social Security or Medicare. Both programs have dedicated funding streams, and I believe that it would be a terrible precedent to begin dedicating general revenue money to these programs.

Both of these programs have fundamental structural problems that will gradually lead them to spend more than they take in. We all know that because the ratio of workers to retirees is steadily dropping, funding pressure is going to increase on these programs. But the reasons that these programs can't compensate for this trend is that they are both behind the times and desperately need to be reformed and brought into the 21st Century.

Social Security was established in 1935, Medicare was set up in 1965. While Congress has tinkered with them from time to time over the years, they are both fundamentally structured the same now as they were then. They are government run, top-down programs that might have been state-of-the-art for their times. Now they are starting to show their age.

Mr. Chairman, I don't know many things that continue to work as well today as they did 35 or 65 years ago. Times change, and our world is changing more quickly all of the time. Even for the Federal Government.

Since Social Security was passed, we have fought a World War. Man has walked on the Moon. Communism has come and gone. We have seen the dawn of the computer age, and the Internet is fundamentally changing much of how our world works. But, Social Security still basically works the same today as it did when FDR was President. That just isn't realistic. Medicare still works as a single-payor health plan, and all of the evidence from around the world continues to show that the quality of care in single-payor, government-administered plans just doesn't match up to what a vibrant marketplace and competitive forces can provide.

We need to pass strong reform legislation to bring Social Security and Medicare into the 21st Century. They have done their jobs at providing security and peace of mind for seniors, but if they are going to continue to meet their mission, they have to change with the times.

We owe it to our seniors.

Reform should empower seniors, and give them more choices and say in how these programs are run. Social Security and Medicare cannot continue to be function as top-down, Washington, DC. programs. All of the trends in government and our world are toward empowering individuals and expanding choice, not toward bigger bureaucracy and more government decision-making.

Mr. Chairman, like others here, I have introduced my own Social Security reform package, and it is a topic that I hope we can address soon. I appreciate the witnesses coming to talk to us today, and I am anxious to hear what they have to say.

The CHAIRMAN. I now want to ask Senator Breaux for his opening statement, and then we will turn to Chairman Greenspan.

STATEMENT OF SENATOR JOHN BREAUX

Senator BREAUX. Thank you very much, Mr. Chairman.

Thank you for convening yet once again what is a very topical hearing on issues such as Social Security and Medicare, the entitlement programs that we as a Nation are facing critical problems and critical choice with in the very near future.

We are delighted to have as our lead-off witness Chairman Alan Greenspan. I look forward to hearing his comments about these two important issues, as well as the next panel, including the administration, to hear what they have to say.

We are looking as a Congress at a proposal from the administration to transfer about $432 billion in general revenues over the next 10 years to the Medicare program. That is unprecedented. It really requires this Congress to look very carefully at what that proposal would entail and what it would do to the program and how the program has traditionally and historically been financed.

The proposal is to add almost $300 billion to the Part A Trust Fund plus an additional $98 billion in the form of money out of general revenues for a drug benefit program, including an additional $35 billion for a catastrophic drug program.

There is no question that Medicare should include prescription drug coverage. The question I have always tried to answer in the affirmative is the question of should you do additional benefits in the context of the overall reform of the program. I think the answer is clearly yes.

I am concerned that adding more general revenues to both Social Security and to Medicare without bringing about comprehensive reform in both programs is a very serious mistake. The administration's program on Social Security is an annual transfer of $100 billion of general revenues starting in the year 2011 and then going to $211 billion in the year 2015.

This committee will hopefully help educate the American public that what we are doing is fundamental change in both of these programs. A step of this magnitude has never been taken in the history of the program, and I have a real serious concern that what it will do is mask the real serious problem and the real serious need for a fundamental program.

I have said it so many times that I am tired of hearing myself say it—but merely adding more money to an existing program and hoping that it reforms the program is sort of like adding more gas to an old car—it will still continue to run like an old car. Until we have had the opportunity to fundamentally fix the program, we will simply add more money and I think will not solve the long-term problem.

So enough said certainly from me. I am looking forward to hearing the distinguished chairman and the other panel of witnesses for their views on what these proposals would mean in the context of both of these very important programs.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

We now go to Chairman Greenspan who has been obviously serving as Chairman for a long time, under Presidents Reagan and Bush and now President Clinton. We thank him for taking the time out of his busy schedule, and I also want to personally thank you for the steady leadership that you give to our economic issues and our economy generally.

Chairman Greenspan.

STATEMENT OF ALAN GREENSPAN, CHAIRMAN, FEDERAL RESERVE SYSTEM, WASHINGTON, DC

Mr. GREENSPAN. Thank you very much, Mr. Chairman and other members of the Committee.

I am pleased to be here today as you begin your discussion on using general revenue transfers to shore up Social Security and Medicare. A thorough consideration of the options available for placing these programs on a firmer fiscal footing is essential given the pressures that loom in the not too distant future. I commend the Committee for your efforts to advance this important discussion.

As you are well aware, the dramatic increase in the number of retirees relative to workers that is set to begin in about 10 years, as you point out, Mr. Chairman, makes our pay-as-you-go Social Security and Medicare programs, as currently constituted, unsustainable in the long run. Eventually, Social Security and Medicare will have to undergo reform. The goal of this reform must be to increase the real resources available to meet the needs and expectations of retirees without blunting the growth in living standards among our working population and, presumably, without necessitating sizable reductions in other government spending programs.

The only measures that can accomplish this goal are those aimed at increasing the total amount of goods and services produced by our economy. As I have argued many times before, any sustainable retirement system, private or public, requires that sufficient resources be set aside over a lifetime of work to fund an adequate level of retirement consumption. At the most rudimentary level, one could envision households saving by actually storing goods purchased during their working years for consumption during retirement. Even better, the resources that would have otherwise gone into the stored good could be diverted to the production of new capital assets which would cumulatively produce an even greater quantity of goods and services to be consumed in retirement.

From this perspective, it becomes clear that increasing our national saving is essential to any successful reform of Social Security or Medicare. The impressive improvement in the budget picture since the early 1990's has helped greatly in this regard, and it appears that both the Administration and the Congress have wisely chosen to wall off the bulk of the unified budget surpluses projected for the next several years and allow it to build. This course would boost saving, raise the productive capital stock, and thus help provide the wherewithal to meet our future obligations.

The idea that we should stop borrowing from the Social Security Trust Fund to finance other outlays has gained surprising, and welcome, traction. It has established in effect a new budgetary framework that is centered on the on-budget surplus and the way it should be used. The focus on the on-budget surplus measure is useful because it offers a clear objective that should help to strengthen budgetary discipline. Moreover, it moves the budget process closer to accrual accounting, the private sector norm, and, I believe, a sensible direction for Federal budget accounting.

Under accrual accounting, benefits would be counted when they are earned by workers rather than when they are paid out. Under full accrual accounting, the Social Security program would have shown a substantial deficit last year; so would have the total Federal budget. To the extent that such accruals are not formally accounted for in the unified budget—as they generally are not—we create contingent liabilities that, under most reasonable sets of assumptions, currently amount to many trillions of dollars for Social Security benefits alone. The contingent liabilities implicit in the Medicare program are much more difficult to calculate, but they are likely also in the trillions of dollars.

For the Federal Government as a whole, an accrual-based budget measure would record noticeable unified budget deficits over the next few years and increasing, rather than decreasing, implicit national indebtedness.

The expected slowdown in the growth of the labor force, the direct result of the decrease in the birth rate following the baby boom, means that financing our debt, whether explicit debt or the implicit debt represented by Social Security and Medicare's contingent liabilities, will become increasingly difficult. I should add parenthetically that the problem we face is much smaller than that confronting the more rapidly aging populations of Europe and Japan. Nonetheless, pressures will mount, and I believe that the growth potential of our economy is best served by maintaining the unified budget surpluses presently in train and thereby reducing Treasury debt held by the public. The resulting boost to the pool of domestic savings will help sustain the current boom in productivity-generating investment in the private sector. Indeed, if productivity growth continues at its recent pace, our entitlement programs will be in much better shape. Saving the surpluses—if politically feasible—is in my judgment the most important fiscal measure that we can take at this time to foster continued improvements in productivity.

The vehicle through which we save our surpluses is less important than the fact that we save them. One method that has been proposed and that is the focus of today's hearing is to transfer general revenues from the on-budget accounts to the Social Security Trust Fund. These transfers in themselves do nothing to the unified budget surplus. The on-budget surplus is reduced, but the off-budget surplus increases commensurately. The transfers have no effect on the debt held by the public and hence no direct effect on national saving. But transferring moneys from the on-budget to the off-budget Social Security accounts could make it politically more likely that the large projected unified surpluses will in fact materialize. Given that our record of sustaining surpluses for extended periods of time is not good, any device that might accomplish this goal is worth examining.

Using general revenues to fund Social Security is an idea that has been considered previously but rejected. Indeed, the commission that I chaired in 1983 was strongly opposed, for a variety of reasons, to the notion of using general revenues to shore up Social Security. One argument was that using general revenues would blur the distinction between the Social Security system, which was viewed as a social insurance program, and other government spending programs.

Both Social Security and, for that matter, Medicare Part A, are loosely modeled on private insurance systems, with benefits financed out of worker contributions. Like private insurance systems, they are intended to be in long-term balance. But the standard adopted for Social Security and Medicare Part A—that taxes and other income are to be sufficient to pay benefits for 75 years—falls short of the in-perpetuity full funding standard of private pension plans, and in many years, Social Security and Medicare have not met even this less stringent standard.

Furthermore, the requirement that Social Security and Medicare be in long-term balance does not mean that each generation gets in benefits only what is contributed in taxes plus earnings. Indeed, most Social Security beneficiaries to date have received far higher rates of return on their contributions than that available, for example, on U.S. Treasury securities. But the reduction in the birth rate following the baby boom and the continued increase in life expectancy beyond age 65 mean that the Social Security system will no longer provide workers with such high returns.

Although the analogy between Social Security and private insurance has never been that tight, the perception of Social Security as insurance has been widespread and quite powerful. Many supporters of Social Security feel that breaking the link between payroll taxes and benefits by moving to greater reliance on general revenue financing would transform Social Security into a welfare program.

But now, when payroll taxes are no longer projected to be sufficient to pay even currently legislated benefits, moving toward a system of general revenue finance raises the concern that the fiscal discipline of the current Social Security system could be reduced. Once the link between payroll taxes and Social Security benefits is broken, the pressure to reform the Social Security system may ease, particularly in this environment of budget surpluses.

For example, Medicaid and Medicare Part B, both of which will face increasing demands as the population ages, are already financed with general revenues, and consequently, there has been much less pressure to date to reform these programs.

The availability of general revenue finance when the baby boom generation begins to enter retirement and press on our overall fiscal resources could make it more difficult to argue for program cuts, regardless of their broader merits. As I have testified on many previous occasions, there are a number of Social Security benefit reforms—such as extending the age of full retirement benefit entitlement and indexing it to longevity, altering the benefit calculation bend points, and adjusting annual cost-of-living escalation to a more accurate measure—that should be given careful consideration.

The potential for enhancing efficiency by restructuring the Medicare program is probably even greater than in Social Security. Relaxing fiscal discipline in the Medicare program by expanding the use of general revenues before the underlying program has been tightened could take the steam out of efforts to improve the way health services are delivered.

That said, I think it is important to note that most government programs are funded through general revenues, so allowing general revenues to finance some of Social Security or Medicare Part A is clearly an idea that would not necessarily eliminate all fiscal responsibility. It might be feasible, for example, to legislate temporary general revenue transfers that would end long before the baby boom generation starts to retire without opening the possibility of completely eliminating need for program cuts in Social Security or changes to Medicare.

It is, of course, difficult to predict the political and economic environment that will be facing policymakers 15 or 20 years in the future. Legislation passed today that affects the distribution of resources between future workers and retirees could easily be changed later. That is why the most important decision facing policymakers today is not about the distribution of future resources but about the level of future resources available for future workers and retirees.

The most effective means of raising the level of future resources in my judgment is to allow the budget surpluses projected in the coming years to be used to pay down the Nation's debt. Congress and the administration will have to decide whether transferring general revenues to the entitlement programs is the best way to preserve the surpluses or whether better mechanisms exist.

Thank you very much, Mr. Chairman. I look forward to your questions.

[The prepared statement of Mr. Greenspan follows:]

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Statement of

Alan Greenspan

Chairman

Board of Governors of the Federal Reserve System

before the

Special Committee on Aging

United States Senate

March 27, 2000

Mr. Chairman and other members of the committee, I am pleased to be here today as you begin your discussion of using general revenue transfers to shore up social security and Medicare. A thorough consideration of the options available for placing these programs on a firmer fiscal footing is essential given the pressures that loom in the not-too-distant future. I commend the committee for your efforts to advance this important discussion.

As you are well aware, the dramatic increase in the number of retirees relative to workers that is set to begin in about ten years makes our pay-as-you-go social security and Medicare programs, as currently constituted, unsustainable in the long run. Eventually, social security and Medicare will have to undergo reform. The goal of this reform must be to increase the real resources available to meet the needs and expectations of retirees, without blunting the growth in living standards among our working population and, presumably, without necessitating sizable reductions in other government spending programs.

The only measures that can accomplish this goal are those aimed at increasing the total amount of goods and services produced by our economy. As I have argued many times before, any sustainable retirement system--private or public--requires that sufficient resources be set aside over a lifetime of work to fund an adequate level of retirement consumption. At the most rudimentary level, one could envision households saving by actually storing goods purchased during their working years for consumption during retirement. Even better, the resources that would have otherwise gone into the stored goods could be diverted to the production of new capital assets, which would cumulatively produce an even greater quantity of goods and services to be consumed in retirement.

From this perspective, it becomes clear that increasing our national saving is essential to any successful reform of social security or Medicare. The impressive improvement in the budget picture since the early 1990s has helped greatly in this regard. And it appears that both the Administration and the Congress have wisely chosen to wall off the bulk of the unified budget surpluses projected for the next several years and allow it to build. This course would boost saving, raise the productive capital stock, and thus help provide the wherewithal to meet our future obligations.

The idea that we should stop borrowing from the social security trust fund to finance other outlays has gained surprising--and welcome--traction. It has established, in effect, a new budgetary framework that is centered on the on-budget surplus and the way it should be used. The focus on the on-budget surplus measure is useful because it offers a clear objective that should help to strengthen budgetary discipline. Moreover, it moves the budget process closer to accrual accounting, the private-sector norm, and--I believe--a sensible direction for federal budget accounting.

Under accrual accounting, benefits would be counted when they are earned by workers rather than when they are paid out. Under full accrual accounting, the social security program would have shown a substantial deficit last year. So would have the total federal budget. To the extent that such accruals are not formally accounted for in the unified budget--as they generally are not--we create contingent liabilities that, under most reasonable sets of assumptions, currently amount to many trillions of dollars for social security benefits alone. The contingent liabilities implicit in the Medicare program are much more difficult to calculate--but they are likely also in the trillions of dollars. For the federal government as a whole, an accrual-based budget measure would record noticeable unified budget deficits over the next few years and increasing, rather than decreasing, implicit national indebtedness.

The expected slowdown in the growth of the labor force, the direct result of the decrease in the birth rate following the baby boom, means that financing our debt--whether explicit debt or the implicit debt represented by social security and Medicare's contingent liabilities--will become increasingly difficult. I should add, parenthetically, that the problem we face is much smaller than that confronting the more rapidly aging populations of Europe and Japan. Nonetheless, pressures will mount, and I believe that the growth potential of our economy is best served by maintaining the unified budget surpluses presently in train and thereby reducing Treasury debt held by the public. The resulting boost to the pool of domestic saving will help sustain the current boom in productivity-generating investment in the private sector. Indeed, if productivity growth continues at its recent pace, our entitlement programs will be in much better shape. Saving the surpluses--if politically feasible--is, in my judgment, the most important fiscal measure we can take at this time to foster continued improvements in productivity.

The vehicle through which we save our surpluses is less important than the fact that we save them. One method that has been proposed, and that is the focus of today's hearing, is to transfer general revenues from the on-budget accounts to the social security trust fund. These transfers in themselves do nothing to the unified budget surplus. The on-budget surplus is reduced, but the off-budget surplus increases commensurately. The transfers have no effect on the debt held by the public and, hence, no direct effect on national saving. But transferring monies from the on-budget to the off-budget social security accounts could make it politically more likely that the large projected unified surpluses will, in fact, materialize. Given that our record of sustaining surpluses for extended periods of time is not good, any device that might accomplish this goal is worth examining.

Using general revenues to fund social security is an idea that has been considered previously but rejected. Indeed, the commission that I chaired in 1983 was strongly opposed, for a variety of reasons, to the notion of using general revenues to shore up social security. One argument was that using general revenues would blur the distinction between the social security system, which was viewed as a social insurance program, and other government spending programs.

Both social security and, for that matter, Medicare part A are loosely modeled on private insurance systems, with benefits financed out of worker contributions. Like private insurance systems, they are intended to be in long-term balance. But the standard adopted for social security and Medicare part A--that taxes and other income are to be sufficient to pay benefits for 75 years--falls short of the in-perpetuity full funding standard of private pension plans, and, in many years, social security and Medicare have not met even this less stringent standard.

Furthermore, the requirement that social security and Medicare be in long-term balance does not mean that each generation gets in benefits only what it contributed in taxes plus earnings. Indeed, most social security beneficiaries to date have received far higher rates of return on their contributions than that available, for example, on U.S. Treasury securities. But the reduction in the birth rate following the baby boom and the continued increase in life expectancy beyond age sixty-five mean that the social security system will no longer provide workers with such high returns.

Although the analogy between social security and private insurance has never been that tight, the perception of social security as insurance has been widespread and quite powerful. Many supporters of social security feared that breaking the link between payroll taxes and benefits by moving to greater reliance on general revenue financing would transform social security into a welfare program.

But now, when payroll taxes are no longer projected to be sufficient to pay even currently legislated benefits, moving toward a system of general revenue finance raises the concern that the fiscal discipline of the current social security system could be reduced. Once the link between payroll taxes and social security benefits is broken, the pressure to reform the social security system may ease, particularly in this environment of budget surpluses. For example, Medicaid and Medicare part B--both of which will face increasing demands as the population ages--are already financed with general revenues, and, consequently, there has been much less pressure to date to reform these programs.

The availability of general revenue finance when the baby boom generation begins to enter retirement and press on our overall fiscal resources could make it more difficult to argue for program cuts, regardless of their broader merits. As I have testified on many previous occasions, there are a number of social security benefit reforms--such as extending the age of full retirement benefit entitlement and indexing it to longevity, altering the benefit calculation bend points, and adjusting annual cost-of-living escalation to a more accurate measure--that should be given careful consideration. The potential for enhancing efficiency by restructuring the Medicare program is probably even greater than in social security. Relaxing fiscal discipline in the Medicare program by expanding the use of general revenues before the underlying program has been tightened could take the steam out of efforts to improve the way health services are delivered.

That said, I think it is important to note that most government programs are funded through general revenues, so allowing general revenues to finance some of social security or Medicare part A is clearly an idea that would not necessarily eliminate all fiscal responsibility. It might be feasible, for example, to legislate temporary general revenue transfers that would end long before the baby boom generation starts to retire, without opening the possibility of completely eliminating the need for program cuts in social security or changes to Medicare.

It is, of course, difficult to predict the political and economic environment that will be facing policymakers fifteen or twenty years in the future. Legislation passed today that affects the distribution of resources between future workers and retirees could easily be changed later. That is why the most important decision facing policymakers today is not about the distribution of future resources but about the level of future resources available for future workers and retirees. The most effective means of raising the level of future resources, in my judgment, is to allow the budget surpluses projected in the coming years to be used to pay down the nation's debt. The Congress and the Administration will have to decide whether transferring general revenues to the entitlement programs is the best way to preserve the surpluses, or whether better mechanisms exist.

The CHAIRMAN. We thank you very much for your insightful statement. We will take 5-minute turns, and on my side it will be Grassley, Bunning, Collins, Craig, and on the Democrat side, it will be Breaux, Reid, Bayh, and we will go in that order.

One of the arguments in favor of using the general fund transfers is that it would allow Social Security and Medicare benefits to continue to be paid without having to cut benefits or increase the payroll taxes. Even though your statement touches on this, I would like you to respond specifically to that argument.

Mr. GREENSPAN. Mr. Chairman, obviously, that is true. But the key question, it strikes me, is do we wish to move away from a very longstanding practice of having social insurance funds. These were endeavors on the part of the Congress to set into place a system in which benefits would somehow, at least partially, be tied to the contributions made by employees and employers, and the whole concept of the Social Security Trust Fund concept, for example, has always rested on that idea.

So the issue really comes down to do you wish to dispose of what has been over the years a not unreasonable form of fiscal constraint—namely, to make sure that the receipts and outlays roughly balance. And it strikes me that over the years, the requirement that taxes essentially meet benefit needs has constructed a set of retirement benefits commensurate with the economic capacity of the country to pay them.

I raise that issue as a very important underlying statement, because it is only if we have a means to constrain the outlays to what the GDP, in effect, can help supply—it is only under those conditions that we can have a viable system. So it is an issue ultimately of a tool for fiscal restraint, and it is up to the Congress to decide whether it is useful or a tool which is no longer serving the purpose that it served in the past.

The CHAIRMAN. Another fairly basic question relates to the President's 2001 budget request, which is recommending transferring income tax revenue to Social Security and Medicare Trust Funds in the future. As I understand it, that would depend on whether the Federal Government is running a surplus or a deficit. What implications would such a policy have for future Federal budgets? This would be in the context of how does such a decision affect not only Social Security and Medicare, but also how does it affect, then, all the rest of Government funding.

Mr. GREENSPAN. Mr. Chairman, you are raising the more important question here, which really should not be focused on any particular Administration initiative or those coming from the Congress. What we have to do—or, more exactly, what specifically the Congress must do—is to make judgments about how it views the budget control issue will proceed in the decades ahead.

There is nothing sacrosanct about social insurance as a particular mechanism. It is not the same as private insurance, which is fully funded and has an economic base to it. Social insurance is halfway between general revenues and full funding, and clearly, in the past, it has created a degree of fiscal prudence over the years.

I would suggest that the more fundamental question that has to be addressed is not the particular issues that you are confronted with in this current budget, but what does the Congress wish to do to formalize the means by which it makes certain that government spending is well within the means of future populations to afford?

The CHAIRMAN. My last question asks you to respond to a comment of a witness on our next panel, Dr. Posner of the General Accounting Office, and I quote from his remarks: "Some consideration should be given to a process that could guard against the risk that growing program financial needs will routinely be met with additional general fund infusions, thereby further mortgaging the future and crowding out other national needs."

Do you agree, and if so, do you have any thoughts about what such a process might be?

Mr. GREENSPAN. I have not seen the full text, so it is hard for me to comment about any particular statement. I would just merely reiterate what I have said, namely, that with the onset of a significant portion of our outlays being entitlement programs, we have to look to the future, over the full life of these programs, to make judgments as to whether they fit into the productive capacity of the economy and still leave a vibrant free market economy out there.

So I would suggest that the broader question is what are our total revenue resources available in the budget, what are the priorities that the Congress and the Administrations will see in the years ahead, and the question is how do you make the spending fit into the income. If we cannot do that, we cannot find the mechanism, which we could not find as you may recall for a vast number of years prior to running into surpluses, we will have considerable difficulty in this country especially as the baby boomers retire in very large numbers, as you point out, starting in about 10 years.

The CHAIRMAN. Senator Breaux.

Senator BREAUX. Thank you very much, Mr. Chairman, and thank you, Chairman Greenspan as well.

Your entire testimony goes toward answering this question, but I would like you to comment on my question in this context. I think most Americans know that the Medicare and Social Security programs are paid for by taxes, and they probably do not really distinguish to a large degree whether they are income taxes or payroll tax of 12.4 percent for Social Security and 6.2 percent for each employer and employee, or the 1.45 percent tax that pays for Medicare.

Both of these entitlement programs are paid for by taxes that the Federal Government levies on individuals in this country. So what is wrong, when these two programs get in trouble, with the concept of just taking income taxes and shoring these programs up financially? It is all Federal taxes. The average person in my State sends it to Washington, and a lot of them would say if they are in trouble, just pay for it—we are sending you enough money up there—and they do not really distinguish out of which slot it comes. So how do I explain that to folks back home when I try to say there is a difference, and it does make a difference?

Mr. GREENSPAN. Senator, I think the issue lies basically in the process of how budgets work. It is a general principle which we are increasingly beginning to learn in this country that if you can tie specific outlay programs to specific revenue sources, you will find that you have the ability to make certain that the overall outlays tend to fit into the overall receipts. If you can find methods of doing that at a more detailed level than just the aggregate, it will be far easier to make the totals come together.

Senator BREAUX. Is the gas tax an example of that, perhaps?

Mr. GREENSPAN. It is; and indeed so is, in a different form, the pay-go procedures which you have employed in the budget process generally. What they do is try to match receipts and outlays, or outlays versus outlays, receipts versus receipts, at a level far below just these two huge aggregate numbers.

So I think the real answer to this question gets down to a management and a procedural question when you are dealing with such huge amounts of money. The thought of two, three, four, or five billion dollars seems like petty cash in the existing system, and it is very easy to pick up five billion, five billion, five billion, and to paraphrase a former colleague of yours, it soon turns out to be a lot of money.

Senator BREAUX. You are right. The Breaux-Frist Medicaid Reform Bill tries an approach that says, look, when general revenues reach 40 percent of the total money used to finance the Medicare program in this country, we have essentially a time out and a mechanism that attempts to force Congress to really make specific decisions about whether we want to continue unlimited funding of Medicare out of general revenues, or do we want to talk about premium increases or benefit reductions. We tried to say at some point you really ought to be concerned about this, and we suggested, since it is now at about 37 percent, we use the number 40 percent.

Are you familiar with that, Mr. Chairman, and do you have any thoughts about the concept of trying to utilize that mechanism?

Mr. GREENSPAN. Senator, I am familiar with it, but I am not sufficiently knowledgeable about the implications of what happens if you do that. So I would just reiterate that anything you can do to any benefit program which creates a known and directed source of funds is a major step in the right direction toward budget control.

There are all different ways of doing it, and I am sure that there is considerable imagination here to find the most appropriate ways. I never thought, for example, that pay-go would work; I never thought that caps would work, largely because it would require a majority of the Senate to reverse them. It has worked, and the reason that it has worked is essentially an awareness of what it is they do and why they are important. And to the extent that you can have dedicated revenues for an individual expenditure program, the ability to control the total system is clearly enhanced.

Senator BREAUX. I would note as an aside—although it is hard to say that anything you say is an aside—but on page 3, you say "Saving the surplus, if politically feasible, is in my judgment the most important fiscal measure we can take at this time to foster continued improvements and productivity." I take it that that obviously includes it being more important fiscally than a large tax cut or a tax cut of any size, which we are considering this week in the budget?

Mr. GREENSPAN. Yes, Senator. As I have indicated in testimony previously on numerous occasions, I believe that in today's environment where increasing domestic savings is a very important issue considering the huge increase in capital investment that is coming forward and that we need to be certain gets financed, that having the surplus there would be significantly helpful.

If that turns out not to be feasible, I clearly would argue very strongly for cutting taxes rather than allowing expenditures to increase because I believe, without getting into detail, that long-term fiscal capacity is far better achieved through reducing revenues than increasing open-ended expenditures and entitlement programs without limit.

Senator BREAUX. I appreciate that. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Bunning.

Senator BUNNING. Mr. Chairman, what is the national savings rate presently?

Mr. GREENSPAN. It depends on how you define it, Senator.

Senator BUNNING. Well, we will let you define it.

Mr. GREENSPAN. If you want to define the household savings rate, it is exceptionally low; if you want to define the total savings rate the reason why it is different is because it depends on some definitions which are arbitrary, and it is only the trend that often is relevant.

Senator BUNNING. What would the normal human being who lives in this country consider a national savings rate?

Mr. GREENSPAN. I think the normal human being would probably consider the savings rate that they have in their households.

Senator BUNNING. Which would be——

Mr. GREENSPAN. Quite low.

Senator BUNNING [continuing.] Quite low. Under 1 percent?

Mr. GREENSPAN. One to 2 percent, depending on what period you are taking.

Senator BUNNING. OK. Can you give us an estimate of how large the unfunded liabilities are for the Social Security and Medicare programs? Since most Americans are not economists—thank God—how can you best describe the magnitude——

Mr. GREENSPAN. I sympathize with that.

Senator BUNNING [continuing.] Of these numbers in terms that make sense to the average American? How would dealing with this liability affect their day-to-day lives?

Mr. GREENSPAN. The liability is a function of what particular interest rates you choose, but all the estimates that are reasonable run in the area something close to $10 trillion for Social Security. Medicare is far more difficult to estimate because of the lack of knowledge we have about future medical technology, but there are obviously several trillions of dollars involved there.

This, I might add, is a contingent liability if we continue the program as it now stands. If we bring in general revenues, then the meaning of it changes, but the absolute amounts do not. In other words——

Senator BUNNING. They stay fixed.

Mr. GREENSPAN [continuing.] They are what they are, because it is the benefits that have been promised under the law which creates the contingent liability, not the nature of the programs.

Senator BUNNING. Assuming that in the future, we do reform Social Security and Medicare, and we take into some Social Security individual accounts, how do you think we should structure that?

Would you favor giving seniors some individual investment options for their FICA contributions, and if so, how should they work?

Mr. GREENSPAN. Senator, about a year or two ago, maybe 3 years ago, there were considerable discussions about the issue of partial privatization of Social Security, and I think that many of the arguments back then rested on the issue of going to complete privatization—like the Chilean model—which would require effectively moving that contingent liability into an essentially fixed debt of the Government, but thereafter, the private system would be in control of the Social Security benefits or the alternates which were always some version of that—in other words, to make certain that the beneficiaries who are, let's say, in their late thirties or early forties stay in the system until the complete benefits are paid out, but with some of the younger generation starting with some form of partial privatization. That discussion has essentially come to a halt as far as I am concerned, and frankly, I regret it. I think there is a lot to be said for trying to think through how we might have some add mixture of a private system and public system, which I think would essentially benefit the whole system of workers and retirees, and the particular form which is less important than trying to think of a way to improve the overall system.

I regret that that conversation has come to a halt——

Senator BUNNING. Mr. Chairman, that conversation has not come to a halt. It has come to the realization—and not to sound partisan—but this current administration is not going to allow that to happen on their watch, so we are delaying the further discussion until we have an administration that might be more friendly to some type of privatization, whether it be from a very little bit of privatization to the total privatization like the Chilean form.

So we have maybe 10 bills right now in the Senate that deal with that type of privatization, but they are not going anywhere because it is kind of an effort in futility.

One more question. How can you explain for the average American the importance of waiting too long to reform Social Security?

Mr. GREENSPAN. It gets down to answering first the question of maintaining at least the social insurance form that we have today, which means that there is zero privatization, and indeed, that might be the choice of the Congress after this debate is joined fully and conclusions are made.

But if you stay with the Social Security system, then in order to make certain that the benefits are paid out of the funds dedicated to the Social Security system, that either a very significant increase in economic growth must occur, and as I have said previously, that is not to be completely ruled out, but if that does not happen—and even if it does—you still end up with the potential of significant Social Security tax increases or benefit cuts, or the system runs out of money.

The CHAIRMAN. Thank you, Senator Bunning.

Senator Reid.

Senator REID. Thank you, Mr. Chairman.

Just to follow up a little bit on my friend from Kentucky's statements, I do not think that it has been the Clinton and Gore administration that stopped privatization; I think it has been the American people who, in any poll you see, are scared to death of privatization, and I think it would be very, very difficult to get anything like that passed here.

I would like to elaborate on a little bit of what Senator Breaux said. Yesterday's Washington Post and other newspapers around the country had as the heading—and I am paraphrasing but not very much—that Federal income taxes are the lowest they have been in 40 or 50 years according to what category you look at.

Last year, the majority talked about an $800 billion tax cut, and that did not go anyplace, thank goodness. This year, the likely Presidential nominee for the Republicans is talking about a trillion-dollar tax cut, and the Republican Whip in the House said that that is not enough.

It seems to me that if we are talking about savings, wouldn't we be better off putting any surplus that we have, for example, toward reducing the $5 trillion debt we have, and pay off some of that, rather than reducing income taxes?

Mr. GREENSPAN. Senator, I have testified and continue to testify that, in my judgment, that would be the first priority to use the unified budget surplus for.

Let me just say parenthetically with respect to the issue of privatization I must say that I agree with you that that is the answer that has come across, and I sense very much the same thing, but I would hate to have it die away without a full discussion. I grant you that at the end of the day, we may conclude as a Nation that this is not the right way to go. I would hate to have it happen without appropriate discussion since this is such a crucial issue and it will have such an extraordinary effect on the American society and economy for decades to come that we ought to get the best judgment that we can in that respect.

Senator REID. Mr. Chairman, I appreciate that very much, and I think that my colleague, the Senator from Louisiana and the ranking member of this committee, has worked very, very hard to keep a discussion going, having everything on the table, to talk about what we should do with Medicare and with Social Security, and frankly, he has not gotten the support that I think he should.

I would say to my friend from Louisiana that he has not shut anybody out; he has not said this is the only thing that will work. He wants a discussion. And I repeat, it is too bad, and it appears that you and Senator Breaux agree that there should be a full discussion on these issues.

Mr. GREENSPAN. Yes, sir.

Senator REID. There is one last question I would like to ask, Mr. Chairman. I was curious—you indicated in your testimony that in the 1983 Social Security Commission—I was a brand new Member of Congress that year, and you were the chairman of that Commission, as I recall—you specifically—when I say "you," I mean the Commission—rejected the idea of using general revenue transfers. You talk about that a little bit in your testimony today. Would you elaborate on that?

Mr. GREENSPAN. Certainly. The reason the Commission was formed was that we effectively were running out of Social Security trust funds, and something had to be done to create a new law which would prevent shutting off benefits, which is legally what would have been required by the statutes then in existence.

The Commission met, and very frankly, I had assumed that the easiest way to solve the problem was essentially just to go to general revenues, or at least in part, because that would then supply the funds required to meet the benefits without any cuts or any changes.

I was really quite surprised and impressed by the vehemence of the members appointed by both parties for maintaining the social insurance system. What surprised me about it was the extent to which the notion of social insurance had embedded itself into our whole view of our fiscal system that the desire to move away from it struck many individual members of the Commission as the wrong direction, and indeed, I may be mistaken about this, but it may have been unanimous on that question, and it was a relatively large Commission.

The views have changed and I am not saying that there is anything sacrosanct about social insurance. It has many deficiencies, not the least of which is that it is not a fully funded program, but there is no question that it does act to dedicate certain forms of revenues to a specific program, and if you effectively have dedicated revenues for all outlays, by definition you will always have budget balance. I think that is the crucial issue. It is not Social Security per se; it is not protecting benefits. It is basically the view of what fiscal management structure Congress wishes to create for the generations ahead.

Senator REID. I will say, Mr. Chairman, that I think one of the finest moments of recent Congress was its Social Security Commission. It had Reagan on one side, Tip O'Neill on the other, and they and the other people who were involved in that I think did some extremely good work, and we will have to come back and take another look at it with I hope as successful an organization as that.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Collins.

Senator COLLINS. Thank you, Mr. Chairman.

Chairman Greenspan, I first want to thank you for being with us today as we attempt to evaluate the President's plan for transferring general revenues into the Social Security trust fund. I have often thought, however, that the President put forward that plan in lieu of really working with Congress to do the hard work that remains to be done on Social Security, which I think is unfortunate.

Senator Reid mentioned the aptly named Greenspan Commission's unanimous or near-unanimous opposition to transferring general revenues into the trust fund. More recently, in July of last year, you testified before the Banking Committee that you would very much prefer that we not move in the direction of using general revenues, because in effect, once you do that, you have opened up the system completely, and the issue of what Social Security taxes becomes largely or utterly irrelevant.

Is that still a good summary of your concerns about this?

Mr. GREENSPAN. Yes. I have refined it somewhat at today's hearing to get to a broader question, but it is fairly apparent, as I point out in my prepared remarks, that once you eliminate the pressures to keep programs under specific fiscal limits, the point of reform loses a good deal of its political urgency. It has always been my experience that if there is no pressure to cut a benefit program, it will not be cut.

Senator COLLINS. You also raise a very good point when you talk about programs that are supported entirely with general revenues that are similar in some respects to Social Security, and I am thinking of Medicare Part B, for example, or the Medicaid program. If you look at their rates of spending and their rates of growth, they have grown faster than Medicare Part A, which does have a payroll tax structure.

So is one of the points that you are making to us that if you take away the link to the payroll tax, you are taking away some natural restraint on the growth of the program?

Mr. GREENSPAN. That is exactly right, Senator.

Senator COLLINS. The final point I want to ask you about has to do with the issue of the program being a social insurance program rather than a welfare program. Again, this is the way that it is financed with payroll taxes, but when I talk to the senior citizens of my State they tell me they do not want a welfare program, they want a retirement program, a social insurance program, that they have helped contribute to.

So if we break that link to payroll taxes and instead fund a substantial amount of Social Security from general revenues, are we not reshaping in a very fundamental way the whole purpose and intent of this program?

Mr. GREENSPAN. There are differing views on that, Senator, but clearly that is one of the strong views that one can argue if you move from social insurance to general revenues.

There are a number of other reasons that people give, but I recall that the major reason that the arguments in the Commission—now, this was almost 20 years ago—but the argument which held the greatest force was the issue of a very strong reluctance to move toward any semblance of a welfare program because people who had contributed substantial amounts to their social insurance system believed that it was their money, their program, their benefits, and it was not anything resembling a welfare program.

The view has gotten a lot more sophisticated in recent years, but that is the one that struck me and somewhat surprised me, I must say, at the time of the deliberation of the 1983 Commission.

Senator COLLINS. I think a lot of seniors are still surprised to learn that their current benefits are actually being financed from the payroll taxes paid by today's workers. I think a lot of them believe that there is an account with their name on it that their payroll taxes are deposited into. But even though we know that that is not how the system works, it is still a social insurance program into which people contribute, and I personally think that it is important that we retain that fundamental structure of the program as we look at ways to preserve and protect the program not only for today's seniors but for future generations.

Thank you very much for your assistance.

The CHAIRMAN. Thank you, Senator Collins.

Senator BAYH.

Senator BAYH. Thank you, Mr. Chairman, and you as well, Chairman Greenspan.

I am sure you are aware that last week, we voted to do away with the earnings limit on Social Security. I supported that effort, and it was the right thing to do, but quite frankly, Mr. Chairman, it was hardly a profile in courage for this body. It was overwhelmingly popular with the American people, did not require much political capital, and it seems to me that once again, we took the path of political least resistance.

A lot of this discussion, it seems to me, boils down to a question of political will. So I would like to ask my first question about what use of the on-budget surplus makes it most likely to generate the political will necessary to make long-term systemic reform in these entitlements. In this regard, I have two observations, and I would like to ask for your reaction.

On the one hand, it seems to me that some use of general fund surplus to cushion whatever steps we have to take in the long run might make those steps more palatable. On the other hand, by doing so, it puts off the day of reckoning and the sense of crisis which seems to me to make it most likely that we would have the political will to take those steps in the first place. So this is a circular argument in my mind.

Can you shed any light on my internal debate?

Mr. GREENSPAN. No. I think you have phrased it as succinctly as can be done. That is the problem. I wish I could help you.

Senator BAYH. Well, then, I will continue my struggle. Let me try a couple of other things in this regard in terms of generating political will, because there has been some discussion of polls here, and you mentioned the laudatory step of at least taking the off-budget surpluses and reserving those for Social Security. I would like to think that that had something to do with virtue or wisdom, but in fact I think that represents the public's judgment that using those funds is not appropriate and therefore politically unpalatable.

I have read estimates, Mr. Chairman, that at a certain point in time, if nothing is done, spending on entitlements, if we go down this path of taking on-budget surpluses and devoting them to entitlements, we consume the entire Federal budget, leaving nothing for education, nothing for health care, the national defense, the environment, children's programs. My guess is that if the American people realized this—and Social Security and Medicare are top priorities and there are other priorities as well—but if the American people realized the long-term fiscal implication for other priorities, we must just generate more of the political will necessary to do something about the current imbalance in the entitlement programs.

Are these estimates accurate?

Mr. GREENSPAN. They are not for Social Security, but they very well may be for Medicare, in the sense that when you are dealing with an open-ended program financed with third-party transfers, where the technology is changing in such a dramatic way, what is capable of being done in the medical area, say, 15, 20, 30 years from now is not something we can even remotely fathom.

A lot of people argue that technology is going to reduce medical costs, and I think it has and will continue to do so. Indeed, productivity in the medical area is just awesome. But it also, almost surely, by making available such a wide variety of potential uses of that technology without the constraint of a budget of some form, can use potentially endless amounts of resources.

Indeed, if you take a look at the current projection of Medicare as a percent of the GDP going out, the numbers rise very dramatically, but it is awfully clear that the rate of growth flattens out, and the reason it flattens out can only be the result of a statistician saying if we continue to project this rate, we will consume the entire GDP, and therefore, it must slow down.

So the truth of the matter is we really do not know, but it is not a meaningless concern because it is at least theoretically possible with a product such as medical care, the demand for which is inelastic and which can be supplied through third party transfer insurance-type systems, that it is not clear that you can restrain the level of outlays by any technical financial means. So that while the issue that you raise is largely a scare story, the underlying forces which engendered that story are all too real.

Senator BAYH. Well, at the very least, if the 100 percent figure is an alarmist tactic thrown out there, at least there is a crowding out effect, I would assume. Fewer resources would be available by definition for these other priorities, which it seems to me the American people would have some interest in as well.

Mr. GREENSPAN. Of necessity, Senator.

Senator BAYH. If I could just ask one final question, Mr. Chairman, it has to do with accrual accounting. Again, this is in the spirit of trying to mobilize public attention on the magnitude of the challenges that we may face. Did I understand your testimony to be that under accrual accounting which prevails in the private sector, that this year in both the Social Security system and in the on line budget, we would in fact be running a deficit?

Mr. GREENSPAN. That is correct, technically. The issue rests with whether in fact you perceive of the commitments to Social Security and Medicare as being irrevocable. If you do, then indeed what are contingent liabilities as a practical matter from an accrual basis are real.

To the extent that the Congress views the commitments on these programs as being capable of being altered, then the added uncertainity increases the degree of contingency and the expected present value, or I might say, the equivalent debt that would be related, goes down. But it is very difficult for me to envisage a major change in the various different benefit programs that are now in place, and as a consequence of that, were we on an accounting system which is employed by the private sector the budget would be in deficit. I might even go a little bit further, since there are some private sector accountants who say that if you cannot know exactly what the contingent liability is, the number you put down is zero. Now, accountants may believe that, but I do not know of any economist who would.

Senator BAYH. Mr. Chairman, if you would indulge me just one final point along these lines.

Chairman Greenspan, I have read other figures that suggest that if we do dedicate the on-budget surpluses to paying down the national debt as you suggest and I support, after 13 years or so, we might very well retire the publicly held national debt in its entirety, but in these stories I have also read, and I think the American people would be interested, that if true, the total amount of national indebtedness not held by the public would in fact have risen over that period of time. Is that accurate?

Mr. GREENSPAN. There are two questions here. One, there is a gross public debt issuance by the Treasury which will continue to rise because it includes the trust funds securities holdings. That is not a terribly relevant number, frankly; it is an intergovernmental transfer which does not have very great meaning. But what is certainly the case is that if you add the contingent liabilities or the present value of those in the same way that we adjust credit scoring in the budget, then the deficit continues for quite a while.

Senator BAYH. Thank you, Mr. Chairman. The reason I mention this is that I believe that if the American people were more focused on the crowding out effect that will exist over time for other priorities and the potential magnitude in the long run from a fiscal challenge standpoint, we would have more political will to deal with this systemically, regardless of whether the chicken or the egg comes first, as I would describe it.

Mr. GREENSPAN. Yes. The fundamental problem that we have to confront is demographic. The fact is we will have a very substantial increase in the proportion of the population which will be retiring, as the Chairman says after the year 2010, and that will mean that unless we extend the working age of the average person beyond the normal 65 years, as average age also increases, we will run into a very major fiscal problem which essentially is the issue which is what we are talking about today. If that did not exist, we would not have a Social Security problem, we probably would not have a really severe Medicare problem, but it is the demographics which are almost inconceivably difficult to get around.

Senator BAYH. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Craig.

Senator CRAIG. Thank you, Mr. Chairman.

I would only comment in passing about Senator Bayh's reaction about our activity here last week to take down finally the earnings limitation, Mr. Chairman. I say that because back in 1982 when I and others were talking about it and introducing it as legislation—and that was prior to the reforms of 1983 in Social Security—the reason it did not happen then, even though economically speaking, we were being told by Social Security that it would in general be a wash out there in time, was culture, and it was the politics of the day—let us face it. Labor policy coming out of the thirties wanted people out of the work force so that new people coming in could fill those slots. The politics of today is much different. We are at near full employment. We are at a deficit when we want older, more experienced people in the work force.

So the time was right—the stars were aligned. It was the right thing to do. It was not a lack of or a great abundance thereof in courage; it was the reality we were facing, I think, that we should have done some time ago.

But having said that, here is my frustration, Mr. Chairman, with part of what you say, but I think it is important that we put it all together. When we first entered the politics of surplus well over a year and a half ago, when it was evident that we in Congress would be having surplus revenues into the foreseeable future when we had spent nearly 40 years in the politics of deficit, I asked you as chairman of the Republican Policy Committee to come before Republicans with the simple question: What do we do with it?

I do not remember at that time that you talked about paying down debt. But there was a secondary question asked: But if we choose not to pay down debt, and we spend it, isn't it better to give some form of tax relief as an option over spending it and increasing the baseline needs of our Government? And I believe at that time, your answer was yes, absolutely.

The frustration I have today, because I think we have created the environment of relatively balanced budgets, or at least we have convinced the American people that that is the right thing to do, and they are now working to convince us to keep doing it, and we will as long as it is easy—and it is easy when you have a surplus, or easier when you have a surplus—but last year, we did a pretty good job of spending surpluses, and we are very much involved in that again this year, and there is a real tug of war going on internally here at the moment as it relates to spending the surpluses—not buying down debt, but actually creating greater obligations in future outyears for revenue.

Those of us who believe that we have no capacity to limit our ability to spend would suggest that we do not get the money here to spend, or at least that we limit the ability to collect some of those revenues. And while I was fascinated by the story in The Washington Post yesterday, I notice that they did not analyze the accumulative taxes that all citizens pay, only the Federal tax. We are told that that is much larger.

I guess my concern at this moment is creating a mechanism that disallows us the ability to ever increase the need for Government spending, or at least allow Democrats and Republicans to do so by cautioning or at least providing some stop on revenue, keeping it within the framework that we need it. And I do not know of any other way to do it than to try to bring about some form of tax relief. I say that because we could write all the bills and pass all the laws we wanted to that suggest that the surpluses ought to go to Federal debt, but when there is a "national emergency" so defined by a politician, then that kind of law can always be surpassed.

Are you willing yet to say today as you have in the past that secondarily to buying down debt, the real issue is not increasing the need for Government to spend beyond the capacity of the economy to fund it?

Mr. GREENSPAN. Yes, Senator, I in fact repeated it earlier on in this session. As you have heard me say before, the current period is a very extraordinary one in which the availability of domestic savings which comes, from the surplus is valuable and quite important in the development of economic growth and productivity currently.

But I have also said, and I repeat it today, that should it turn out that maintaining that surplus is infeasible, then I clearly would opt very strongly for cutting taxes rather than the option of increasing spending.

Let me say, Senator, that it is not without moment that there has been an agreement essentially between the Administration and the Congress that a very large share of the surplus should be walled off the surplus from any new programs, and I think that is a wise choice.

Senator CRAIG. And you are talking primarily about Social Security.

Mr. GREENSPAN. Solely about Social Security.

Senator CRAIG. And I very much agree with you. That is a major plus.

Mr. GREENSPAN. That exhibits, in my judgment an understanding and an awareness that there are limited fiscal resources in this country and that, until we have strong evidence that there is a major structural increase in the surplus, trying to commit it to various different programs or even tax cuts is unwise.

Senator CRAIG. I current Fed policy and some that was just announced last week—and obviously, the world is looking at it now, and a lot of articles are being written, and most of us here who are interested in that—and we all should be if we look at our surplus projections and our revenues—are trying to make of it.

We also have a group meeting in Vienna at this moment that could have as much impact on our economy as can Fed policy. Let us assume that OPEC has decided that we are going to pay a good deal more for our energy than we have over the last several years; that we really do see a crude price in the mid–20's and their ability to stay together to assure that, and that that settles in on this economy, not just at the fuel pump, but the whole petrochemical industry and all that it fuels in this country.

You have said in the past that energy spikes generally have some impact down the line, or at least they are to be noticed. With where we are right now with this economy as it relates to interest and energy and the general stock market, your reactions on that—because it is a great concern to me that if we project into the out-years all of these surpluses, they are obviously tied directly to the vitality of this economy and our ability to sustain it, and there are some forces at work out there right now that would suggest we might not be able to sustain it, at least at the level that has allowed consumer purchasing, which is obviously the major driving force.

Mr. GREENSPAN. Senator, currently, we do not as yet—and I emphasize "as yet"—see any significant indication that crude oil price increases are in the process of embedding themselves in other areas of the economy and inflating the general price structure. And I doubt very much if it would occur if the average West Texas Intermediate crude price averaged somewhere in the mid-twenties, per barrel as indeed it has in the not too distant past.

There is a question, of course, of how much this economy has lessened its need and tie to energy. Since we are becoming increasingly high-tech and a less energy-consuming nation per dollar or btu of GDP it is pretty obvious that a crude oil price significantly higher than one that would have created a major problem for us in the past would be necessary to create one today because we are less dependent on it. But that does not say it cannot happen.

What we do know about crude oil, and in fact energy generally, is that even though there has been a very substantial decline in the intensity of energy requirements in the United States economy, it is still quite formidable, and there is no doubt in my mind that energy, which tends to cut across all aspects of this economy, if it gets sufficiently costly, could have some materially negative effects on the economy, inflation, growth, productivity, and a variety of other related areas.

I do not know where that number is. I do not think it is to the interest of oil producers to have a price which would undercut the demand of their consumers, especially if they had very large reserves whose present value is a function of longer-term demand projections.

If you get into that type of situation, the endeavor to reduce dependence on energy will escalate very dramatically, and that would clearly accrue negatively to oil producers. So I trust that there is a general awareness in these deliberations that this is not a conflict between producers and consumers, but that there is a mutuality of interest here in getting a price which is supportive of their investments and their well-being and maintaining a price that is consonant with the continued economic growth not only of the United States, obviously, but throughout the world, especially the major oil-consuming nations.

Senator CRAIG. Well, I am certainly not going to disagree with you as it relates to the broad impact. I think many of you here, who oftentimes focus on what in a bigger economy would be viewed as a micro economy—right now, I am looking at doubling the fuel cost of agriculture, an economy that is not thriving today, as it relates to the cost of production versus commodity yields, and there, it will have a sizable impact on the profitability of production agriculture, for example; the transportation industry, especially independents, their inability to immediately pass through those costs. I know that it will not mean much to the cost of a computer keyboard, but in a broad sense, there will be some impact. Does that blight the desire of the consumer if he or she is paying $100 more a month than energy costs collectively as it relates to their desire to consume other kinds of goods and services?

Mr. GREENSPAN. I agree with that, Senator.

Senator CRAIG. Thank you, Thank you, Mr. Chairman.

The CHAIRMAN. Thanks to Senator Craig's question, the oil statement will obscure the point of this committee meeting.

Senator CRAIG. I do not think so at all——

The CHAIRMAN. Well, I am being somewhat——

Senator CRAIG [continuing.] I say that because we are looking at a proposed policy that might suggest that we are going to have surpluses endlessly into the future, and here is a way to handle general fund surpluses.

The CHAIRMAN. People will think you have been appearing before a meeting of the Banking or the Commerce Committee, not the Aging Committee.

Senator CRAIG. Well, I apologize, but I do think my seniors are interested in their gas bills.

The CHAIRMAN. Yes, Mr. Chairman. In defense of your colleague, I think he is raising quite important questions.

The CHAIRMAN. He is. He does not need your defense, but that is OK.

Senator CRAIG. Thank you, Mr. Chairman.

The CHAIRMAN. Chairman Greenspan, we want to thank you very much. You have given us a lot of your valuable time, and you responded to our request to come here for testimony on this very important issue of Social Security and Medicare and its long-term viability. We thank you for that, and we will dismiss you now.

Thank you.

Mr. GREENSPAN. Thank you very much for inviting me.

The CHAIRMAN. Senator Craig, you are the only one who did not make an opening statement, and I offered people an opportunity to do that after Chairman Greenspan had concluded, so if you want to do that, you may do so now.

Senator CRAIG. Thank you very much, Mr. Chairman.

I would just ask that my prepared questions be part of the record and that I would have them sent down for the Chairman to respond to them; but I have no opening statement.

The CHAIRMAN. Thank you.

I will call forward the next panel. Dr. David Wilcox has served as Assistant Secretary of Treasury for Economic Policy since October 1997. He advises the Secretary on a variety of issues including social insurance programs and the current state of the macro economy.

Dr. Paul Posner has studied tax policy at the United States General Accounting Office during his 20-year career there. He is currently Director of budget issues, where he leads a study on the long-term outlook of the Federal budget.

Last, Dr. Gene Steuerle is a Senior Fellow at The Urban Institute. He has served as tax analyst in the Treasury Department in four administrations and is the author of many books, reports and columns on entitlement programs.

I will ask you to give your testimony in the order in which I have introduced you, so Mr. Wilcox, please proceed.

STATEMENT OF DAVID WILCOX, ASSISTANT SECRETARY FOR ECONOMIC POLICY, U.S. DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. WILCOX. Mr. Chairman, Senator Breaux, I appreciate the opportunity to present the administration's views on the topic of general revenue transfers to Social Security and Medicare.

The Social Security and Medicare programs are the cornerstones of American social policy. Unfortunately, while both programs are on solid financial ground in the near term, they both face financing challenges over the longer term. The administration believes that while general revenue transfers are by no means the whole solution, they are an appropriate and important part of the solution to these financing challenges.

I have a written statement for the record, but today I would like to briefly outline the context in which the administration puts forward its proposal for general revenue transfers.

The CHAIRMAN. Each of your statements will be printed in the record as submitted, and a summary is preferred. Thank you.

Mr. WILCOX. Then I will sketch the administration's proposal and finally, conclude with a few observations about the essential aspects of the proposal.

First, as to context, suffice it to say that with unemployment low, inflation low, and productivity growth surging, the American economy is now enjoying its best performance in decades. And the Federal budget picture is equally bright. Indeed, under the projections of the President's policies that were presented in this February's budget, we are on a path to eliminating the debt held by the public on a net basis by 2013.

Nevertheless the aging of the U.S. population and the resulting demands on the Social Security and Medicare trust funds are hard upon us, and in that context, the question arises: Could general revenue transfers be one part of the solution to the long-term funding challenges confronting Social Security and Medicare?

The administration firmly believes that they could and they should.

Let me now briefly sketch the President's proposal for general revenue transfers. The President proposes to transfer resources from the Government's general fund into the Social Security trust funds starting in 2011 and running through 2050. The amount of these transfers would be linked to the interest savings that would be achieved by using the Social Security surpluses to pay down the debt held by the public. The transfers would extend the projected solvency of the Social Security trust funds to 2050 or, if combined with the modest amount of equity investment proposed by the President, 2054.

The President also proposes to transfer additional resources from the general fund into the trust fund for Medicare Part A. These transfers would begin in 2001 and continue through 2015.

Together with the President's comprehensive proposal for Medicare reform, the transfers would extend the projected solvency of the Medicare trust fund to at least 2025.

I would like to highlight four points about these transfers. First, the central economic principle underlying the President's approach to general revenue transfers is that trust fund accumulations should be matched dollar for dollar by improvements in the net financial position of the Government.

The President's approach ensures that increments to the trust funds over and above current law reflect increases in the resources available for private capital accumulation that are the key to expanding the productive capacity of the economy. This is exactly the same principle underlying the bipartisan consensus in favor of using the Social Security surpluses exclusively for the purpose of paying down the debt held by the public.

Second, the general revenue transfers that we have proposed would put Social Security and Medicare in a better position to meet their existing commitments and thereby enhance their long-term sustainability. They would accomplish this crucial objective by increasing Government saving and committing the benefits of that increase to Social Security and Medicare. In turn, linking debt reduction to the preservation and extension of Social Security and Medicare is likely, in our view, to help ensure that the projected surpluses actually materialize.

Third, as I noted at the outset, the President views these transfers as only part of the solution to the projected funding shortfalls. As the President has consistently stated, structural reforms are another essential part of preparing these programs for the 21st century. We have put forward a detailed and comprehensive proposal for Medicare reform and made clear our interest in working with Congress on broader Social Security reform.

Fourth, these general revenue transfers are part of a larger strategy of debt reduction and fiscal discipline that will be essential in helping to prepare both the Federal Government and the economy as a whole for the aging of the population in coming decades.

To conclude, Mr. Chairman, the President has proposed a disciplined program of general revenue transfers to Social Security and Medicare in which each dollar of transfer would be matched dollar for dollar by a reduction in debt held by the public. Enacting these transfers would represent an important first step toward further reform. The President and the administration look forward to working with you and the other Members of Congress to tackle these important challenges.

Thank you.

The CHAIRMAN. Thank you, Mr. Wilcox.

[The prepared statement of Mr. Wilcox follows:]

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TREASURY ASSISTANT SECRETARY FOR ECONOMIC POLICY DAVID W. WILCOX TESTIMONY BEFORE THE SENATE SPECIAL COMMITTEE ON AGING

Mr. Chairman, Senator Breaux, and Members of the Committee, I appreciate the opportunity to present the Administration's views on the topic of general revenue transfers to Social Security and Medicare. These transfers play an important role in the Administration's thinking about how to address the long-term financing challenges confronting these programs, as well as an important role in our budget framework, and I am pleased to discuss them with you today.

The Social Security and Medicare programs are the cornerstones of American social policy. Social Security benefits are the largest source of income for nearly two-thirds of Americans age 65 and older, and the only source of income for nearly one-fifth of them. And Social Security is more than just a retirement plan; it is, in addition, a family protection plan, paying survivors' benefits and disability benefits to millions of Americans under age 65.

Medicare plays an equally important role in the lives of older Americans. In 1965, nearly half of Americans over the age of 65 had no health insurance. Today, virtually all older Americans have health insurance through Medicare, and thereby have access to the kind of high-quality, dependable medical care that can help extend their lives and improve the quality of their lives.

Today, nearly everyone agrees on the importance of Social Security and Medicare, and the crucial role they will continue to play for senior citizens in the 21st Century. Unfortunately, while both programs are on solid financial ground in the near term, they both face financing challenges over the longer term. The key factors behind the funding shortfall are the aging of the U.S. population and, for Medicare, the projected increase in spending per beneficiary due to rapid advances in health care technology. As a result, significant steps will need to be taken to put these programs on a secure foundation for the long term.

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The Administration believes that, while they are by no means the whole solution, general revenue transfers are an appropriate and important *part* of the solution to the financing problems faced by Social Security and Medicare. A comprehensive solution should include structural reforms to these programs. The President has expressed his desire to work with Congress in a bipartisan fashion on broader Social Security reform. And he has put forward a specific proposal for Medicare reform that would: make the program more competitive and efficient; modernize its benefits, including the addition of a long overdue prescription drug benefit; and extend the life of the trust fund.

In my testimony today, I will address three topics:

- first, the opportunity for pre-funding provided by our favorable budget outlook;
- second, the proposal that the President has put forward for limited and prudent general revenue transfers into Social Security and Medicare; and
- third, the way that the transfers would help to prepare the economy and the budget for the coming demographic changes.

The Budget Outlook and the Opportunity for Pre-Funding

The Current Situation

The American economy is now enjoying its best performance in decades. The unemployment rate has been below 5 percent since July of 1997, and inflation has averaged just over 2 percent during the same period. Productivity growth in nonfarm businesses has averaged nearly 3 percent over the past four years – the strongest performance for any such period since the late 1960s. Real wages have increased, even for low-wage workers who had not previously experienced proportionate increases in their earnings. Altogether, the economic expansion has now become the longest in U.S. history and remains quite robust.

The Federal budget picture is equally bright. The skills and efforts of American workers and businesses have combined with a policy of fiscal discipline to produce budget surpluses that even optimists would not have predicted 7 years ago. In the budget agreements of 1993 and 1997, the President worked with Congress to balance the budget, and he is now working with Congress to save the surpluses. Strong economic performance has boosted revenues and reduced outlays, and our continued focus on fiscal discipline is helping to sustain the expansion.

Last year, the budget was balanced even leaving aside the operations of the Social Security system, the first time in nearly 40 years that this occurred. In 1998 and 1999, we paid down $140 billion of public debt; during this fiscal year alone, we expect to pay down $157 billion more. Perhaps most encouraging of all, we have forged a bipartisan consensus in favor of using the Social Security surpluses exclusively for the purpose of paying down the debt held by the public. Indeed, under the projections of the President's policies that were presented in the budget, we are on a path toward eliminating this debt, on a net basis, by 2013.

The Challenge

Nevertheless, the aging of the U.S. population and the resulting demands on the Social Security and Medicare trust funds are hard upon us. The oldest members of the baby boom generation will reach the age for earliest eligibility for Social Security benefits within this decade. They will become eligible for Medicare benefits a few years later. All told, the number of Americans over age 65 is projected to double by 2033, and seniors will represent about 20 percent of the population compared with roughly 12 percent today.

This remarkable demographic shift will push up both Social Security and Medicare outlays. Medicare costs will be boosted further by continued improvement in the types and quality of medical care that will be available. To be sure, some of these advances in pharmaceutical treatments, bioscience, and medical technology will reduce costs, but many others are likely to raise the cost of providing state-of-the-art care.

In this context, the question arises: Could general revenue transfers be one part of the solution to the long-term funding challenges confronting Social Security and Medicare? The Administration firmly believes that they *could*, and they *should*.

The President's Proposal for General Revenue Transfers

Social Security

The President proposes in this year's budget, as he did in last year's budget, to transfer resources from the government's General Fund into the Social Security Trust Funds. The amount of these transfers is motivated by the interest savings that would be achieved by using the Social Security surpluses to pay down debt. These transfers would begin in 2011, after a decade of debt reduction, and continue through 2050. The transfers would extend the projected solvency of Social Security to 2050, or – if combined with the modest amount of equity investment proposed by the President – to 2054.

The transfers would shift resources from the on-budget account to the off-budget account, and thereby reduce the on-budget funds available for spending or tax cuts. At the same time, they would augment the Social Security funds protected by the President's proposed lockbox by an equal amount. Thus, the transfers would be matched dollar-for-dollar by an increase in government saving and – accordingly – an improvement in the government's balance sheet.

Medicare

The President also proposes to transfer additional resources over and above current law from the General Fund into the Trust Fund for Medicare Part A. These transfers would begin in 2001 and continue through 2015. Together with the President's comprehensive proposal for Medicare reform, the transfers would extend the projected solvency of the Medicare trust fund to at least 2025. The President's program would also combine general revenue with beneficiary premiums to pay for the new prescription drug benefit, analogous to the current financing arrangement for Medicare Part B..

The Medicare transfers take place within the on-budget account, so they would not represent an on-budget outlay in the traditional sense. However, the President's Medicare legislation would require the reported on-budget surplus to be reduced by the amount of the transfers. In parallel with the approach we are recommending for the transfers into Social Security, our proposed accounting treatment of the transfers into Medicare would ensure that these funds are, in fact, used to improve the government's balance sheet and not for other purposes.

Relation to Pre-Funding Under Current Law

To summarize, the transfers proposed by the President would bring new resources into the Social Security and Medicare Trust Funds, allowing them to better meet their existing commitments. The transfers would also cause the government to run a bigger surplus than otherwise, because the amounts transferred could not be used for new spending or tax cuts. An essential aspect of the President's policy is that the transfers to the respective trust funds over and above current law would be backed dollar-for-dollar by increments to the unified budget surplus, and hence by equal-sized improvements in the government's balance sheet.

I also want to emphasize the close conceptual relationship of these actions to the pre-funding already provided for in current law. It is enormously important that a bipartisan consensus has now coalesced around the idea that Social Security surpluses should be used to pay down the debt held by the public. The core economic principle behind both this approach to pre-funding and the framework for general revenue transfers that we have proposed is exactly the same: that Trust Fund accumulations should be matched dollar-for-dollar by an improvement in the government's balance sheet.

Comprehensive Reform

Transfers of general revenue to Social Security and Medicare would make an important contribution to the long-term financial soundness of these programs. But I want to emphasize that we view these transfers as only *part* of the solution to the projected funding shortfalls. As the President has consistently stated, structural reforms are another essential part of preparing these programs for the 21st Century.

The President has made clear his interest in working with the Congress to enact reasonable changes that would extend Social Security solvency still further while reducing poverty among elderly women. As the President said last week, we should build on the bipartisan spirit evidenced in the elimination of the retirement earnings test for people over the age of 65 by enacting our proposed transfers as a down-payment on comprehensive Social Security reform.

The President has also put forward a detailed and comprehensive proposal for Medicare reform. This proposal would modernize Medicare by adding a prescription drug benefit, and it would give the program more flexibility to use private-sector purchasing mechanisms. The proposal would also require traditional fee-for-service Medicare and managed-care plans to compete head-to-head on price and quality. By improving efficiency in Medicare, we believe that it is possible to both raise quality and reduce costs. Yet, even with comprehensive reform, extending solvency to at least 2025 without the proposed transfers would require severe cuts in benefits, sharp increases in payroll tax revenues, or drastic cuts in provider payments.

Clearly, general revenue transfers are a complement to structural reforms of Social Security and Medicare, not a substitute. Just as clearly, the scale of the future demands on both programs implies that structural reforms will not be enough. These programs will need the additional resources that general revenue transfers would provide.

It is also worth emphasizing that our proposal preserves fiscal discipline at its core, because under the approach we are proposing, each dollar of transfer effectively must be funded out of available on-budget surpluses. To illustrate, consider the situation in 2011, when we project that the combined Social Security and Medicare transfers would be $122 billion. With these transfers, there would be $122 billion less in on-budget resources available for policies that reduce receipts or increase outlays. This is simply not a situation, contrary to what is sometimes charged, where arbitrary amounts of bonds can be added to the trust funds.

Indeed, when all is said and done, the lion's share of funding for Social Security and Medicare would still come through the traditional channels. For Social Security, the present value of our proposed general revenue transfers would represent less than 7 percent of the present value of all projected Social Security revenues over the next 75 years. And for Medicare, the proposed general revenue transfers would represent a similarly small portion of the total resources projected to flow into the Part A trust fund over the next 25 years.

Preparing the Economy and the Budget to Meet Future Commitments

The transfers that the President has proposed would improve the budget outlook and better prepare the Federal government to meet our existing commitments to Social Security and Medicare. And because additional government saving would boost national saving, the transfers would better prepare the economy as a whole to meet the challenge posed by an aging population. Let me elaborate briefly on these points.

Improving the Budget Outlook

Paying down the debt improves the budget outlook in several ways. First, it will reduce interest payments, creating future "fiscal space" that can be devoted to Social Security, Medicare, or other government functions. We now spend more than $200 billion each year making net interest payments on the debt held by the public. If we pay off the debt, that amount will be freed up for other uses – such as paying Social Security and Medicare benefits as the baby boom generation retires.

Second, paying down the debt now puts us in a stronger position for any future contingency. The extra government saving can be thought of as an important insurance policy against the possibility that the future turns out to be less bright than we currently project.

Strengthening the Economy

Paying down the debt also strengthens the economy. For the nation as a whole, the central challenge of population aging is to provide a high standard of living for both workers and retirees, even though a smaller share of the population will be in the workforce. A natural solution is to make workers more productive in the future by increasing saving and investment now.

Reducing government debt raises national saving, because private saving is supplemented by public saving rather than being drained by public borrowing. More resources are made available for private investment, and capital accumulation proceeds more rapidly. Over the long run, national wealth and the productive capacity of our economy will be that much greater, leading to higher standards of living. At the same time, a larger economy will generate more tax revenue at the same tax rate, making it easier to meet our existing fiscal obligations.

Less government borrowing also helps to hold down interest rates. Of course, interest rates are affected by many factors, including inflation, international developments, and private saving and borrowing decisions. However, a broad consensus of economists believes that reducing the government's public debt will allow for lower interest rates over time than if the debt increased or were held steady.

Conclusion

In conclusion, the President has proposed a disciplined program of general revenue transfers to Social Security and Medicare, in which each dollar of transfer would be matched dollar-for-dollar by a reduction in debt held by the public. This policy would result in incremental government saving, over and above what would happen if we merely agreed to balance the on-budget account. The additional government saving this policy would generate would make both the economy and the government better able to meet the demands of the growing number of retirees.

The Administration believes that dedicating the benefits of debt reduction to Social Security and Medicare is the best use of those funds. Simply put, we should be sure that we can finance our existing commitments before launching new programs or tax cuts. And we should work together to enact the structural reforms to these programs that are also needed. This is why the President has consistently grounded his budgets in a framework of debt reduction, fiscal responsibility, and prudent stewardship of our long-term economic prospects.

Thank you.

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The CHAIRMAN. Dr. Posner.

STATEMENT OF PAUL L. POSNER, DIRECTOR, BUDGET ISSUES, ACCOUNTING AND INFORMATION MANAGEMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE, WASHINGTON, DC

Mr. POSNER. Thank you, Mr. Chairman. I am pleased to be here.

I am going to focus my remarks on the Medicare program, as you have suggested. Overall, current policy decisions can help us prepare for the challenges of an aging society in several important ways that suggest what we have otherwise called a new fiscal paradigm for the Federal Government.

One is reducing public debt to increase national savings and investment. Two is reforming significantly entitlement programs to reduce their future claims on the future taxpayers, and clearly a part of that is establishing a more sustainable Medicare program.

As you have acknowledged, leading reform proposals, including Breaux-Frist and the President's, contemplate some use of general revenues as part of the Medicare program, and what we need to do is carefully examine those to ask whether such general fund transfusions/infusions can be structured so as to facilitate and not impede the needed reform for the program.

In fact what this means is that financial reform should not be considered alone, outside the broader reform package. In fact, recent history with these programs shows that benefit and revenue expansions are more compelling than the tough choices that need to be made.

Accordingly, caution is warranted when we consider general fund financing. We know that it can extend the solvency of the program, but may not do anything to make the program more sustainable and in fact may make it worse by reducing the urgency of reform, and that is the basic concern.

Whenever we consider general financing, we also need to consider other kinds of what we might call "trip wires"—rules of the road and criteria to guard against the risk that the growing financial needs of the program will be routinely met with additional general fund financing. So mechanisms need to be put in place to monitor costs over time, to prompt Congress to periodically review these kinds of trends.

What I want to do is refer briefly to six charts that will show trends in the Medicare program and how this change might affect it.

The first is the familiar chart with the Hospital Insurance Trust Fund. As you know, this is Part A; Part B is the program that is already financed with general funds with 75 percent. As it shows, the solvency date has been extended through 2015 thanks to some tough choices the Congress has already made in the Balanced Budget Act of 1997. Nonetheless, on a cash basis, which is what really matters for the fiscal burden of these programs, this program has been in the red for most years since 1992. In other words, it has been a net draw on the Treasury. Payroll tax revenues have been insufficient to pay benefits, and the program has been using its corpus of assets and interest on those assets to pay benefits.

Having said that, when the program runs out of cash, it has to cash in its assets, which requires the Government to find the money by cutting benefits, raising taxes, or increasing borrowing above what otherwise would happen.

What this suggests is that the real, meaningful measure of trust funds—while solvency of trust funds has always been an important bellwether and a clearly understood criterion—the sustainability of the program and measures of that sustainability are even more important. Understanding the net burden the program imposes on the rest of the budget and the economy is critical.

The next couple of charts show that this program is clearly moving in the unsustainable direction. The first one shows how the program will more than double as a share of GDP over the long term when combining Part A and Part B. The second one shows what it looks like if we combine just the Medicare hospital insurance costs for the future with the Social Security costs for the future—in other words, current payroll tax rates, assuming we solve this problem entirely in the payroll tax, would rise to absolutely unacceptable levels for the American people. This suggests that there is clearly a problem with the sustainability of this program.

In the third chart, I want to show how these trends look in the broader budget picture. GAO has been doing simulations for some time of the long-term outlook for the budget, which is absolutely critical to supplement our kind of routine yearly focus on the budget. We think that these choices that we are making now have long-term implications, and we have the opportunity to address them if we are more aware of these trends. So we have been modeling what the long-term outlook looks like. These charts suggest that if we make no changes in Social Security, Medicare and Medicaid, the programs will gradually encumber all the resources in the budget; there will be no money left for anything else. This is assuming we save the entire Social Security surplus and spend the rest or reduce taxes with the rest.

Having said that, let me just emphasize what remarkable restraint that would be compared to our recent or modern American history—that a surplus that large for 20 years, which is what this is premised on, would constitute extraordinary restraint. And even with that—and in this scenario, the Government would go into the black on debt; in other words, we would be a net investor in the credit markets—even with that, these programs would gobble up almost all discretionary spending over the next 40 or 50 years.

What that shows us is that while debt reduction is important to expanding future capacity and reducing interest costs and eliminating them ultimately, possibly, you need to reform these entitlement programs. That is a necessary and important part of this picture.

Having said that, we know that Medicare in particular is an expensive and unpredictable program, and the Comptroller General has testified before that additional general revenues in fact may be necessary, but that such a change marks a marked departure from the payroll financing of the program with significant implications.

The President's proposal is fairly comprehensive. He has not just proposed these transfers that have been talked about; he has also proposed some other changes to make the program potentially more efficient and to modernize the benefit package as well.

With regard to the transfers, they would extend the solvency of the trust fund from 2015 to 2025, and HI would now receive for the first time an explicit grant of funds from the general revenues not supported by the underlying payroll tax receipts.

In the next chart, we tried to graphically depict this. The first two lines show the normal transactions—in other words, when the trust fund has a surplus, it donates that to the general fund—it essentially invests that in Treasuries. In return, it gets securities to represent the value of its contribution or if its cash.

Senator BREAUX. What is the average rate of return on that investment?

Mr. WILCOX. It is the Treasury bond rate. I believe it is roughly 3 percent.

What the administration proposes is to add a new set of securities from the general fund to represent this new grant of general revenues for the program. So that is mechanically what this looks like. And let me suggest, as has been suggested, that the extent to which these transfers would help us reduce publicly held debt further than we are already committed to, that is obviously a big plus. Significant short- and long-term benefits accrue to reducing interest and reducing debt for the economy and the budget.

However, we are concerned that the mechanism used to achieve this debt reduction poses risks, and we are concerned particularly that if this mechanism is used without underlying reform, in fact the program would not be more sustainable, but in fact this mechanism could interfere with the signaling function that trust fund mechanisms can serve for policymakers and thereby reduce that sense of urgency that I talked about before.

In this case, more of the long-term shortfall of the program would be made up not on the backs of the program's financing and the program's structure, but on the backs of other programs that must be sacrificed to provide the general revenue when the time comes. So this is an important issue with many implications not just for Medicare but for the rest of the budget as well.

Breaux-Frist also would effect substantive and structural changes to Medicare and would contemplate recognizing the general fund financing of Medicare as well by introducing a new concept—combining the trust funds as they currently are and trying to introduce a new trip-wire threshold of 40 percent general revenue financing to define insolvency beyond which the program could not make payments, and Congress would have to act.

These kinds of thresholds we think are critical. Once you lose your moorings to the conventional trust fund self-financing structure, we have to search for these kinds of thresholds and trip-wires.

As you can see in the next chart, the 40 percent level would be reached, in our calculations, in 2008, so we are not that far off already, within the 10-year-budget window, from already reaching that threshold that has been defined.

In my testimony I talk about a few suggestions that we have beyond just establishing this trip-wire. It would be helpful to also suggest what might happen as a result, not in terms of detailed benefit cuts but to further articulate a process for Congress and the President to be held accountable for this kind of result. It could be keyed to the budget resolution and other kinds of things. Moreover, other kinds of triggers and trip-wires could be thought of as well, such as the program outlays as a share of GDP, general revenues used for Medicare as a share of total revenues and the like.

The important thing is that the trust fund mechanism is credible with the American people and with people in Congress. It is a legal limit. Defining a new mechanism would have to attain that same level of credibility to be effective. We have seen examples where that has not been the case in the past for other areas in the budget, Gramm-Rudman being an example, where the level of restraint in action was simply too large to be acted on, and those kinds of thresholds fell by the wayside. In other words, we have to be very careful in how we design these things to make them realistic and credible.

In conclusion, much is at stake, as I do not need to tell you—not only the future of Medicare, but really the future of the budget and the economy. As the Comptroller General said, the greatest risk lies in doing nothing to improve the long-term sustainability, or worse, in adopting changes that could aggravate the long-term financial outlook for the program.

That concludes my statement.

The CHAIRMAN. Thank you, Dr. Posner.

[The prepared statement of Mr. Posner follows:]

United States General Accounting Office

GAO

Testimony

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MEDICARE REFORM

Issues Associated With General Revenue Financing

Statement of Paul L. Posner
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Accounting and Information Management Division

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GAO/T-AIMD-00-126

Mr. Chairman and Members of the Committee:

I am pleased to be here today as you discuss the use of general fund revenues as part of Social Security and Medicare reform. As you requested, I will focus my remarks specifically on general revenue financing of the Medicare program. Despite some very positive, short-term developments regarding our economy, the federal surplus, and Medicare spending, the bigger picture remains virtually unchanged. Long-term cost pressures facing the program are considerable. Even before adding a prescription drug benefit, for example, projected program spending threatens to absorb unsustainable shares of the nation's budgetary and economic resources. The Office of the Actuary at the Health Care Financing Administration has estimated the actuarial imbalance for the Hospital Insurance (HI) portion of Medicare at $2.9 trillion through 2074—this is the present value of the amount by which future payments exceed projected revenues for the program. In testimony before this and other congressional committees, the Comptroller General has expressed concern about the expanded use of general revenues in program financing and the need for comprehensive reform that will address the program's long-term sustainability.[1] My statement today will underscore these concerns.

It is tempting to push aside this gloomy forecast in light of recent surplus projections. However, the recent good news on the budget does not mean that difficult budget choices are a thing of the past. First, it is important to recognize that, by their very nature, projections are uncertain. This is especially true today because, as the Congressional Budget Office (CBO) notes, it is too soon to tell whether recent boosts in revenue reflect a major structural change in the economy or a more temporary divergence from historical trends. Indeed, CBO points out that assuming a return to historical trends and slightly faster growth in Medicare would change the on-budget surplus to a growing deficit. This means we should treat surplus predictions with caution.

Moreover, while the size of future surpluses could exceed or fall short of projections, demographic and cost trends will, in the absence of meaningful reform, drive Medicare spending to levels that will prove unsustainable for future generations of taxpayers. Accordingly, we need to

[1]See *Medicare: Program Reform and Modernization Are Needed But Entail Considerable Challenges* (GAO/T-HEHS/AIMD-00-77, Feb. 8, 2000); *Medicare Reform: Leading Proposals Lay Groundwork, While Design Decisions Lie Ahead* (GAO/T-HEHS/AIMD-00-103, Feb. 24, 2000); *Medicare Reform: Observations on the President's July 1999 Proposal* (T-AIMD/HEHS-99-236, July 22, 1999).

view this period of projected prosperity as an opportunity to begin addressing the structural imbalances in Medicare, Social Security, and other entitlement programs before the approaching demographic tidal wave makes the imbalances more dramatic and possible solutions much more difficult and painful.

As the foregoing suggests, the stakes associated with Medicare reform are high not only for the program but also for the rest of the federal budget, both now and for future generations. Without meaningful reform, the long-term financial outlook for the Medicare program is bleak. Current policy decisions can help us prepare for the challenges of an aging society in several important ways: (1) by reducing public debt to increase national saving and investment, (2) by reforming entitlement programs to reduce future claims and free up resources for other competing priorities, and (3) by establishing a more sustainable Medicare program that delivers effective and affordable health care to our nation's seniors.

Leading reform proposals that address comprehensive reform such as those of the President and Breaux-Frist include the use of general funds part of their financing mechanisms. While some precedent exists for the use of general funds in federal trust funds, we need to ask how such general fund infusions can be structured so as to facilitate, not impede, needed reform and fiscal discipline.

In this context, I would like to make a few summary points before delving into the specifics of Medicare's financial health and issues raised by increased reliance on general revenue financing.

- To qualify as meaningful reform, any proposal should make a significant down payment toward ensuring Medicare's long-range financial integrity and sustainability—the most critical issue facing Medicare. Reform efforts ought not to be piecemeal. Financial reforms such as general revenue financing should not be considered alone but as part of a broader reform package. Recent history with Medicare reform shows that benefit expansions are compelling while fiscal controls and constraints are difficult to enact and sustain.
- General fund infusions may well be a necessary part of program reform, but caution is warranted in considering the commitment of additional general revenues. General revenue financing can extend the solvency of the program but does not alone do anything to make the program more sustainable in the long term. In fact, without underlying reforms, general revenue financing could very well serve to reduce the sense of urgency to

make needed program changes that impending trust fund bankruptcy provides to policymakers.

- In addition, some consideration should be given to a process to guard against the risk that growing program financial needs will routinely be met with additional general fund infusions, thereby further mortgaging the future and crowding out other national needs. Accordingly, any additional general revenue infusions should be coupled with mechanisms to monitor costs over time and to alert policymakers of the need to take timely action when total projected costs exceed thresholds or triggers related to some indicator of sustainability.

Health care costs compete with other legitimate priorities in the federal budget, and their projected growth threatens to crowd out future generations' flexibility to decide which competing priorities will be met .In making important fiscal decisions for our nation, policymakers need to consider the fundamental differences between wants, needs, and what both individuals and our nation can afford. This concept applies to all major aspects of government, from major weapons system acquisitions to issues affecting domestic programs. It also points to the fiduciary and stewardship responsibility that we all share to ensure the sustainability of Medicare for current and future generations within a broader context of providing for other important national needs and economic growth. Given the size of Medicare's projected funding needs, it is realistic to expect that reforms intended to bring down future costs will have to proceed incrementally. The time to begin the difficult but necessary steps to reclaim our fiscal future is now, when we have budget surpluses and a demographic "holiday" with retirees a far smaller proportion of the population than they will be in the future.

Federal Trust Funds

Before I turn to a more detailed description of Medicare's financial structure including the Hospital Insurance (HI) trust fund, it is helpful first to look more generally at what the term "trust fund" means in the context of the federal budget.

The federal budget consists of several fund types: the general fund, special funds, public enterprise funds, intragovernmental funds, and trust funds.[2] All of these except trust funds are considered to be "federal funds." All unified budget transactions fall within either of two fund groups: (1) federal funds and (2) trust funds.

[2] There are both revolving and nonrevolving trust funds, but that difference is not relevant to this analysis.

Although some budget summary tables show only about a dozen major trust funds, in fiscal year 1998 there were 112 trust funds.[3] These covered a wide range of purposes: from social insurance (Social Security and Medicare), employee compensation (pensions and health benefits), insurance, natural resources and environmental cleanup to transportation. Social Security is by far the largest trust fund, followed by federal employee retirement funds (civilian and military) and the Medicare trust funds.

In the federal budget, the term "trust fund" neither means what it does for a private trust fund nor indicates unique characteristics within the federal budget.[4] The manager of a private trust has a fiduciary obligation to the beneficiary and must manage the trust's assets on behalf of that beneficiary according to the stipulations of the trust. The manager cannot unilaterally alter the terms of that trust. In contrast, the federal government both owns the assets of most trust funds and can, through legislation, raise or lower the fund's collections or payments, or alter the purposes of the trust fund.

Unlike a private trust fund, which can set aside money for the future by increasing its assets, federal trust funds are not vehicles to park "real" savings for the future. They are simply budget accounting mechanisms used to record receipts and expenditures earmarked for specific purposes. This is unlike state governments, which can "park" surplus resources in "real" pension funds and other trust funds that are routinely invested in "assets" (e.g., readily marketable securities) outside the government. Under current law, when a federal trust fund like the HI trust fund runs a surplus of payroll tax revenues over benefit payments, that surplus must be invested in Treasury securities and used to meet current cash needs of the government. These securities are an asset to the trust fund, but they are a claim on the Treasury. When a trust fund runs a cash deficit, as the HI trust fund did between 1992 and 1998, it redeems these securities to pay benefit costs exceeding current payroll tax receipts. Medicare will be able to do this until 2015 under current law when the HI trust fund securities are projected to be exhausted. However, in order to redeem these securities, the government as a whole must come up with cash by

[3]Based on GAO analysis. This count represents trust funds and trust fund groupings for similar purposes.

[4]Within the federal budget, there is no substantive difference between a trust fund and a special fund. Both are internal accounting devices used to track the collection and use of funds earmarked for specific purposes. The only difference between a "special" fund and a "trust" fund is the word "trust" in the legislation establishing account. In fiscal year 1998 there were 102 special funds.

increasing taxes, reducing spending, reducing projected surpluses, or borrowing more from the public if projected surpluses are not realized.

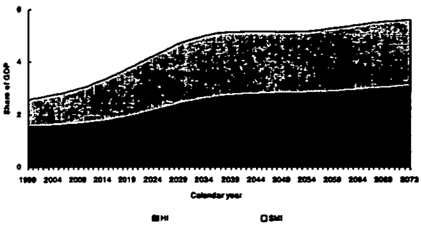
Since the trust fund's securities constitute a legal claim against the Treasury, increasing the balances of Treasury securities held by the HI trust fund would extend its solvency and increase the formal claim that HI has on future general revenues. However, increasing the HI trust fund balances alone, without underlying reform, does nothing to make the program more sustainable. From a macro perspective, the critical question is not how much a trust fund has in assets, but whether the government as a whole has the economic capacity to finance the trust fund's claims to pay benefits now and in the future and at what cost for other competing claims for scarce resources. From a micro perspective, trust funds can provide a vital signaling function for policymakers about underlying fiscal imbalances in covered programs. However, extending a trust fund's solvency without reforms to make the underlying program more sustainable can obscure the warning signals that trust fund balances provide, thereby creating a false sense of security and delaying needed reform.

Medicare's Financial Condition

Medicare Is Fiscally Unsustainable in the Long Term

Without meaningful reform, the long-term financial outlook for the Medicare program is bleak. Under the Trustees' 1999 intermediate projections, HI and Supplementary Medical Insurance (SMI) expenditures taken together are expected to increase dramatically, rising from about 12 percent in 1999 to about a quarter of all federal revenues by mid-century, even without adding to the benefit package. Over the same time frame, Medicare's expenditures are expected to double as a share of the economy, from 2.5 to 5.3 percent, as shown in figure 1.

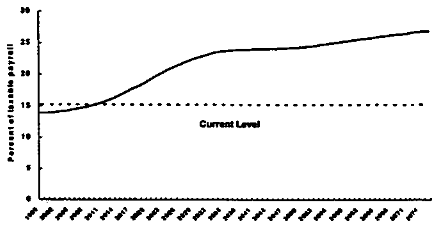
Figure 1: Medicare Spending as a Percentage of Gross Domestic Product (GDP) 1999 to 2073



Source: *1999 Annual Report*, Board of Trustees of the Federal Hospital Insurance Trust Fund and *1999 Annual Report*, Federal Supplementary Insurance Trust Fund.

Absent reform, the financial burden of Medicare and Social Security on future taxpayers becomes unsustainable. As figure 2 shows, the cost of these two programs combined would nearly double as a share of the payroll tax base over the long term. Assuming no other changes, these programs would constitute an unimaginable drain on the earnings of our future workers.

Figure 2: Social Security and Medicare HI Costs as a Percentage of Taxable Payroll, 1999 to 2074

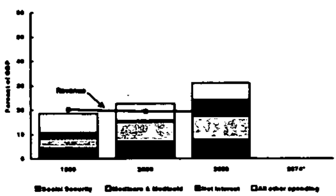


Source: *1999 Annual Report*, Board of Trustees of the Federal Hospital Insurance Trust Fund, and *1999 Annual Report*, Board of Trustees of the Federal Old Age and Survivors Disability Insurance Trust Funds.

While the problems facing the Social Security program are significant, Medicare's challenges are even more daunting. To bring Social Security into actuarial balance today would require raising the payroll tax by 2.07 percentage points–a 17-percent increase–whereas the HI payroll tax would have to be raised by 1.46 percentage points–a 50-percent increase–to restore actuarial balance to the HI trust fund. This analysis, moreover, does not incorporate the financing challenges associated with the SMI and Medicaid programs.

When viewed from the perspective of the entire budget and the economy, the growth in Medicare and Social Security spending will become progressively unsustainable over the longer term. Our updated budget simulations show that to move into the future without making changes in the Social Security, Medicare, and Medicaid programs is to envision a very different role for the federal government. Assuming, for example, that the Congress and the President adhere to the often-stated goal of saving the Social Security surpluses, our long-term model shows a world by 2030 in which Social Security, Medicare, and Medicaid increasingly absorb available revenues within the federal budget. Under this scenario, these programs would require more than three-quarters of total federal revenue. (See fig. 3.) Budgetary flexibility would be drastically constrained and little room would be left for other federal spending priorities such as national defense, the young, infrastructure, and law enforcement.

Figure 3: Composition of Spending as a Share of GDP Under the "Eliminate Non-Social Security Surpluses" Simulation



[a]The "Eliminate non-Social Security surpluses" simulation can only be run through 2066 due to the elimination of the capital stock.

Notes:

1. Revenue during the simulation period is lower as a share of GDP than the 1999 level due to unspecified permanent policy actions that reduce revenue and increase spending to eliminate the non-Social Security surpluses.

2. Medicare expenditure projections follow the Trustees' 1999 intermediate assumptions. The projections reflect the current benefit and financing structure.

Source: GAO's January 2000 analysis.

The levels of public saving assumed in the simulation exceed both U.S. historical levels and those sustained by most other countries we have studied. Essentially, saving just the Social Security surplus would eliminate debt held by the public—an outcome with benefits for both the budget and the economy. But it would require sustained fiscal sacrifice unlike any seen in our modern experience. Under this simulation, debt held by the public would not only be eliminated; the U.S. would be investing federal surpluses in nongovernmental assets for several years. Moreover, the levels of public saving assumed in the simulation will not by themselves be enough in the long term to promote the kind of economic growth to which we have become accustomed. Even assuming these significant and unprecedented levels of fiscal restraint over many years, entitlement spending will still encumber an unsustainable share of federa resources in the future.

As with Social Security, the progressive absorption of a greater share of the nation's resources for health care is in part a reflection of the increasing growth in the elderly population, but Medicare cost growth rates also reflect the escalation of health care costs at rates well exceeding general rates of inflation. Increases in the number and quality of health care services have been fueled by the explosive growth of medical technology. Moreover, the actual costs of health care consumption are not transparent. Third-party payers generally insulate consumers from the cost of health care decisions. In traditional Medicare, for example, the impact of the cost-sharing provisions designed to curb the use of services is muted because about 80 percent of beneficiaries have some form of supplemental health care coverage (such as Medigap insurance) that pays these costs. For these reasons, among others, Medicare represents a much greater and more complex fiscal challenge than even Social Security over the longer term.

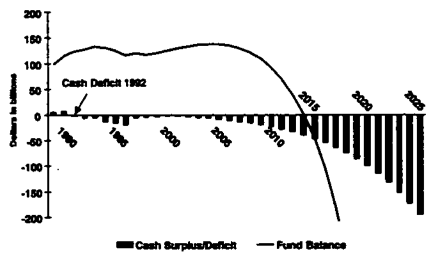
Medicare's Current ogram and Financing Structure

Under the current Medicare structure, the program consists of two parts. Medicare's HI Trust Fund, also known as part A, is financed primarily by payroll taxes paid by workers and employers.[5] SMI, also known as part B, is financed largely through general revenues. Currently, the financial health of Medicare is often gauged by the solvency of the HI trust fund. This measure, however, presents an incomplete picture of total program solvency. In addition, because of the nature of federal trust funds, the HI trust fund balances do not provide meaningful information about program sustainability—that is, the government's fiscal capacity to pay benefits when the program's cash inflows fall below benefit expenses.

The 1999 Trustees' annual report showed that Medicare's HI component was, on a cash basis, in the red from 1992 to 1998; in fiscal year 1998, earmarked payroll taxes covered only 89 percent of HI spending. Although the Office of Management and Budget has recently reported a $12 billion cash surplus for the HI program in fiscal year 1999 due to lower than expected program outlays, the Trustees' report issued in March 1999 projected continued cash deficits for the HI trust fund. (See fig. 4.)

[5]Old-Age and Survivors Insurance and Disability Insurance (OASDI) beneficiaries whose adjusted gross income exceeds certain threshold amounts must pay income taxes on up to 85 percent of their annual benefits. The Omnibus Budget Reconciliation Act of 1993 increased the maximum amount of Social Security benefits subject to income tax from 50 to 85 percent and provided that the additional revenues would be credited to the HI trust fund. Revenue from this source totaled $5.1 billion in fiscal year 1998.

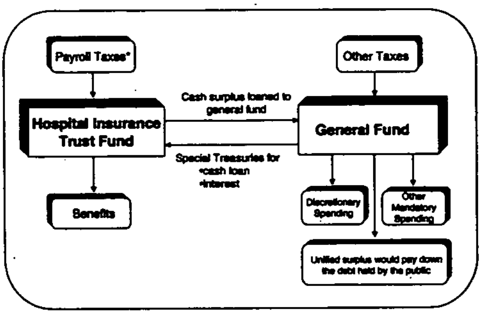
Figure 4: Financial Outlook of the Hospital Insurance Trust Fund, 1990 to 2025



Source: GAO analysis of data from the Office of the Actuary, Health Care Financing Administration.

Much of the public debate focuses on trust fund balances—and the 1999 Trustees' report estimates that the HI trust fund will remain solvent through 2015. However, the more important measure is the net cash impact of the trust fund on the government as a whole. From this perspective, when the HI trust fund has an annual cash deficit, as it did from 1992 through 1998, Medicare is a net claimant on the Treasury—a threshold that Social Security is not currently expected to reach until 2014. To finance these cash deficits, Medicare drew on its special issue Treasury securities acquired during the years when the program generated a cash surplus. In essence, for Medicare to "redeem" its securities, the government must raise taxes, cut spending for other programs, or reduce projected surpluses. Figure 5 depicts the relationship of the HI trust fund to the unified budget and the general fund under current law when the trust fund has a cash surplus.

Figure 5: Hospital Insurance Trust Fund Flows Under Current Law



[a]Since 1994, the HI trust fund has also received a share of income taxes paid on Social Security benefits.

Note: If the trust fund has a cash surplus, debt held by the fund increases because special Treasuries are issued to the fund. If the fund is in deficit, the flow is reversed with the fund redeeming special Treasuries and receiving cash from the general fund to make benefit payments.

Source: GAO analysis.

In contrast to HI, SMI, also known as part B, is financed through general revenues and beneficiary premiums. The history of SMI financing illustrates the difficulties of maintaining fiscal discipline. Originally the part B premium was set at a level to finance 50 percent of SMI program costs. However, less than 10 years later, the method for setting the SMI premium was tied to changes in the cost of living, resulting in premiums dropping below 25 percent of program costs. Under current law, the premium is now set at 25 percent of program costs, with general revenues paying the remaining 75 percent.

Currently, the financial health of the entire Medicare program is generally gauged by the solvency of the HI trust fund–not the imbalance between total program revenue and total program spending (both HI and SMI). Clearly HI trust fund solvency is an incomplete measure, and since SMI is projected to grow faster than HI in the coming decades, the HI trust fund risks becoming an increasingly inadequate signal of future fiscal imbalances. This measure could in fact become misleading if additional general revenue were used in program financing.

When outlays outstrip revenues in the HI fund, it is tempting to shift some expenditures to SMI. Such cost shifting extends the solvency of the HI Trust Fund but does nothing to address the fundamental financial health of the program. Worse, it masks the problem and may cause fiscal imbalances to go unnoticed. For example, in 1997 the Balanced Budget Act modified the home health benefit, which resulted in shifting a portion of home health spending from the HI trust fund to SMI. Although this shift extended HI trust fund solvency, it increased the draw on general revenues in SMI while generating little net savings. Ultimately, the critical question is not how much a trust fund has in assets, but whether the government as a whole can afford the promised benefits now and in the future and at what cost to other claims on scarce resources.

Use of General Funds in Medicare Reform Raises Design Issues

A consensus appears to be emerging that substantive financing and programmatic reforms are necessary to put Medicare on a sustainable footing for the future. The current Medicare program, without improvements, is ill-suited to serve future generations of seniors and eligible disabled Americans. On the one hand, the program is fiscally unsustainable in its present form, as the disparity between program expenditures and program revenues is expected to widen dramatically in the coming years. On the other, the program is outmoded in that it has not been able to adopt modern, market-based management tools, and its benefit package contains gaps in desired coverage. Thus, while financial questions loom, pressure is mounting to update Medicare's outdated benefit design. However, doing so carries with it the potential to exacerbate Medicare's spending trajectory.

Given the aging of our society and the increasing cost of modern medical technology, it is inevitable that the demands on the Medicare program will grow. The National Bipartisan Commission on the Future of Medicare noted that the program will require additional resources as the percent of the population eligible for benefits increases. One major uncertainty in Medicare's future financing needs, the Commission noted, is the inability to predict the evolution of the health care delivery system or the impact that technology will have on health care costs. At the same time the Commission emphasized the urgent need for reforms that will slow the growth in Medicare spending.

Consider the case of prescription drug coverage. In 1965, when the Medicare program was first established, outpatient prescription drugs were not nearly as important a component of health care as they are now. Used appropriately, pharmaceuticals can cure diseases, improve quality of life, and substitute for more expensive services in some cases. Most private insurance options recognize these advantages by including pharmaceutical coverage in their benefit packages. Many seek to similarly modernize Medicare's benefits. However, this desired expansion comes at a time when prescription drug spending is increasing rapidly. From 1993 to 1998, prescription drug spending grew at an average annual rate of 12.4 percent compared with 5 percent average annual growth in health care expenditures overall. A recent study has suggested that expanding Medicare's benefit package to include prescription drugs could add between 7.2 and 10 percent annually to total program costs,[6] and CBO estimates the cost of the President's proposed prescription drug benefit at $149 billion in additional federal spending between 2003 and 2010.[7] Although the case for adding a prescription drug benefit to Medicare is appealing, any benefit expansion needs to be targeted, include appropriate cost controls, and other program reforms that will begin to close the gap between existing promised and funded benefits.

Given the size of Medicare's projected funding needs, it is realistic to expect that reforms to bring down future costs will have to proceed in an incremental and iterative fashion. Comprehensive Medicare reform cannot, once implemented, be put on automatic pilot. Recent experience implementing changes shows that reform is a dynamic process requiring vigilance and flexibility.

Last year, when the Comptroller General testified before the Congress on the financing of the HI trust fund, he said that additional general revenues may very well be necessary, but such a change would represent a marked departure from payroll tax financing with implications that warrant explicit and serious debate.[8] Leading reform proposals that address comprehensive reform such as those of the President and Breaux-Frist include the use of general funds as part of their financing mechanisms. While some precedent exists for the use of general funds in federal trust

[6] M.E. Gluck. *National Academy of Social Insurance Medicare Brief: A Medicare Prescription Drug Benefit* (April 1999), p. 8. *http://www.nasi.org/Medicare/medbr1.htm*

[7] CBO. *An Analysis of the President's Budgetary Proposals for Fiscal Year 2001: A Preliminary Report* (March 9, 2000), p. 4.

[8] *Medicare and Budget Surpluses: GAO's Perspective on the President's Proposal and the Need for Reform* (GAO/T-AIMD/HEHS-99-113, March 10, 1999).

funds, we need to ask how such general fund infusions can be structured so as to facilitate, not impede, needed reform and fiscal discipline.

The proposed changes to Medicare financing raise some important issues that are not unique to the Medicare program but arise whenever general revenues are commingled with other types of revenues such as payroll taxes and beneficiary premiums in a federal trust fund. Whatever the financing structure of Medicare, a continuing need will exist for a signal of future fiscal imbalances to alert policymakers of the need to take timely and prudent action. In addition, some consideration should be given to a process that could guard against the risk that growing program financial needs will routinely be met with additional general fund infusions, thereby further mortgaging the future and crowding out other national needs. Such a process could also be used to periodically re-assess the mix of differing sources of program financing.

In the remainder of this testimony I would like to examine design issues raised by leading reform proposals' expanded use of general revenue, focusing on the implications for program fiscal discipline and consequences for the unified budget.

The President's Proposal

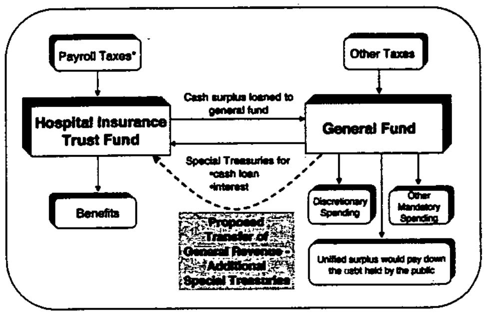
The President's proposal is intended to make Medicare more efficient, modernize the benefit package, and extend the program's long-term solvency. The proposal consists of several programmatic changes. Private health plans would set their own premiums for a standard package of benefits, competing on the basis of price and quality. Beneficiaries who joined relatively inexpensive plans would pay little or nothing. Those who joined relatively expensive plans would pay more. The system is intended to make beneficiaries more sensitive to the cost consequences of their decisions. The proposal maintains the traditional Medicare fee-for-service program and includes measures intended to improve its efficiency and strengthen future financing.[9] The proposal also includes a prescription drug benefit.

[9]For example, the plan would create a preferred provider option that would reward beneficiaries with lower cost-sharing requirements when choosing certain providers; expand use of centers of excellence, in which providers that specialize in certain procedures receive a global fee for all services provided rather than a separate fee for each service; extend certain Balanced Budget Act (BBA) provisions that reduce provider payment rate increases; impose a 20-percent copayment for clinical laboratory services; and index the part B deductible for inflation. See *Medicare Reform: Observations on the President's July 1999 Proposal* (GAO/T-AIMD/HEHS-99-236, July 22, 1999) and *Medicare Reform: Leading Proposals Lay Groundwork, While Design Decisions Lie Ahead* (GAO/T-HEHS/AIMD-00-103, Feb. 24, 2000).

In addition the proposal would earmark a portion of the projected non-Social Security surpluses for Medicare. According to the Office of Management and Budget, the proposal would use $432 billion, or 58 percent of the projected on-budget surpluses, over the next 10 years for Medicare. Of the $432 billion, $299 billion (40 percent of the on-budget surplus) would be transferred to the HI trust fund and used to reduce debt held by the public. The proposal would use $98 billion of projected on-budget surpluses to pay for the proposed prescription drug benefit. The remaining $35 billion would be used to establish a reserve fund. This fund is to be used for debt reduction or, in the event that the President and the Congress agree, for a policy that provides protections against catastrophic drug costs for Medicare beneficiaries or policies that otherwise strengthen the Medicare program.

The proposed transfer of surpluses would extend the solvency of the HI trust fund from 2015 to 2025 and preserve the divided financing structure (HI and SMI). It would not, however, address the sustainability of the Medicare program and may, in fact, serve to decrease the likelihood of needed reform. The transfer would also represent a significant departure in how HI is financed. Established as a payroll tax funded program, HI would now receive an explicit grant of funds from general revenues not supported by underlying payroll tax receipts. That is, the value of securities held by the HI trust fund would exceed that supported by earlier payroll tax surpluses, and these additional securities would constitute a new claim on the general fund for the future. Figure 6 depicts the flow of funds for the HI program under the President's proposal.

Figure 6: Hospital Insurance Trust Fund Flows Under the President's Proposal



*Since 1994, the HI trust fund has also received a share of income taxes paid on Social Security benefits.

Note: If the trust fund has a cash surplus, debt held by the fund increases because special Treasuries are issued to the fund. If the fund is in deficit, the flow is reversed with the fund redeeming special Treasuries and receiving cash from the general fund to make benefit payments.

Source: GAO analysis.

According to the Administration, the underlying rationale for the transfers is that Medicare should be guaranteed a share of the benefits resulting from the fiscal improvement that debt reduction and lower interest costs would bring about.

With regard to its more general budgetary significance, the President's proposal is part of a broader initiative that would save a major share of the surplus, including all of the Social Security surplus, to reduce debt held by the public. According to the Administration's projections, this initiative will reduce interest payments from $230 billion in 1999 to nearly zero in 2013 when publicly held debt would be virtually eliminated. The reduction in publicly held debt proposed by the President would confer significant short- and long-term benefits to the budget and the economy. Our work on long-term budget outlooks illustrates the benefits of maintaining surpluses for debt reduction. Today, interest on the debt represents the third largest expenditure in the federal budget. Reducing the publicly held debt reduces these costs, freeing up budgetary resources for other programmatic priorities. For the economy, lowering debt increases national saving and frees up resources for private investment. This in turn leads to stronger economic growth and higher incomes over the long term.

The size of the imbalances between Medicare's outlays and payroll tax revenues for the HI program may well justify the need for additional financing from general revenues. However, the mechanism the President has proposed entails significant risks if considered on its own without being coupled to reforms. Indeed, I would note that the President has also included certain reforms as part of his proposal. Without underlying reform, increasing the HI trust fund balances would do nothing to make the program—HI or SMI—more sustainable. In fact, the transfer would interfere with the signaling function that trust fund mechanisms can serve for policymakers about underlying fiscal imbalances in covered programs. The greatest risk is that the proposed transfer will reduce the sense of urgency that impending trust fund bankruptcy provides to policymakers by artificially extending the solvency of the HI program through 2025—well into the peak of the baby boomers' retirement. Furthermore, the SMI portion of Medicare, projected to grow even faster than HI, is unaffected by this transfer.

This is a major change in the underlying theoretical design of the HI program. Whether you believe it is a major change in reality depends on what you assume about the likely future use of general revenues under the current circumstances. For example, current projections are that the HI trust fund will exhaust its securities to pay the full promised benefits in 2015. If you believe that this shortfall would be made up with general funds when the time came, then the shift embedded in the President's proposal merely makes that explicit. If, however, you believe that there would be changes in the benefit or tax structure of the fund instead, then the President's proposal represents a very big change. In this case, less of the long-term shortfall would be addressed through future changes in the HI program itself and more would be financed through higher taxes or spending cuts elsewhere in the federal budget as a whole. Again, we have recognized that the President has now coupled his financing proposal with substantive Medicare reforms. It is critical that these two elements not be severed.

Another issue the proposal raises is whether the transfers would be made regardless of whether the expected budget surpluses are actually realized. The amounts to be transferred apparently would be written into law as a fixed dollar amount rather than as a percent of the actual on-budget surplus in any given year. These transfers would have a claim on future general revenues even if the actual on-budget surplus fell below the amount specified for the transfers. It is important to emphasize that any proposal to allocate surpluses is vulnerable to the risk that those projected surpluses may not materialize. Proposals making permanent changes to use the surplus over a long period are especially vulnerable to this risk.

The Breaux-Frist Proposal

Like the President's, the Breaux-Frist proposal (S. 1895) would effect both structural and substantive change to Medicare financing. Breaux-Frist addresses the principal elements of reform using a competitive premium approach to contain costs and modernize program benefits.[10] The proposal would also eliminate the HI trust fund by merging it with SMI to create a single unified Medicare trust fund. This change would eliminate the potential for cost shifting between the two programs as well as the use of the HI trust fund as a measure of program solvency. Instead, the proposal would establish a new concept for measuring "programmatic insolvency" as the point at which general fund contributions exceed 40 percent of total program expenditures. Under Breaux-Frist, the Trustees would be required to report annually on the percentage of total expenditures financed by general fund contributions and identify the first fiscal year (if any) in which the program was projected to become "programmatically insolvent." Congressional approval would then be required to authorize any additional contributions to the Medicare trust fund.

In these and certain other respects, the Breaux-Frist proposal incorporated recommendations made by the National Bipartisan Commission on the Future of Medicare. The Commission called attention

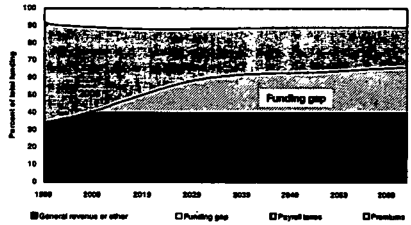
[10]Under Breaux-Frist, each participating health plan (including traditional fee-for-service Medicare, which would be administered by the Health Care Financing Administration) would determine its own premium for a benefit package that must cover all benefits offered by traditional Medicare. The percentage of the premium paid by the beneficiary would be set through a formula that compares a plan's premium with a national average of all plan premiums. Beneficiaries who joined relatively inexpensive plans would pay little or nothing. Those who joined relatively expensive plans would pay more. The system is intended to make beneficiaries more sensitive to the cost consequences of their decisions. Because plans would compete for market share, they would have an incentive to operate efficiently and attract beneficiaries by setting premiums that reflect that efficiency. The proposal includes provisions to ensure low-income beneficiaries access at little or no cost. Breaux-Frist would require plans to offer high option coverage that would modernize Medicare's benefit package by providing outpatient prescription drug and stop-loss benefits. The incremental cost of high option coverage would be subsidized for low-income beneficiaries while other beneficiaries would pay such costs themselves. An independent Medicare board would be established to administer the program as a whole.

to the inadequacy of the HI trust fund as a measure of total program solvency, noting that the portion of Medicare expenditures paid by general funds has increased over time relative to the share paid by payroll taxes and beneficiary premiums. According to the Commission, a new measure of solvency was needed that would couple the uncertainty inherent in the task of gauging program financing in light of the difficulty in predicting future health care technology with the real need for the public to evaluate the cost of Medicare and how we should choose to fund this program over time.

The 40-percent threshold for general fund contributions proposed by Breaux-Frist would provide a mechanism that would require policymakers to revisit Medicare reform if program financing demands continue to grow in the coming decades as the proportion of the population eligible for benefits grows. This mechanism could prompt future Congresses to periodically revisit Medicare financing issues and enact needed reforms. In concept the use of a threshold holds the potential to enhance future federal budgetary flexibility by calling attention when Medicare's share of general revenues is about to exceed specified levels. If coupled with an effective oversight process, a threshold mechanism could also prompt Congress to debate the appropriate proportions of general fund contributions, payroll taxes, and premiums for Medicare financing in the context of contemporary economic and budgetary environments.

Current spending projections show that absent reform that addresses total program cost, this limit would be reached in less than 10 years. (See fig. 7.) These data underscore the need for reform to include appropriate measures of fiscal sustainability as well as a credible process to give policymakers timely warning when fiscal targets are in danger of being overshot.

Figure 7: Projected Funding Gap Under a 40-Percent Threshold for General Revenue Contributions



Source: *1999 Annual Report*, Board of Trustees of the Federal Hospital Insurance Trust Fund and *1999 Annual Report*, Federal Supplementary Insurance Trust Fund.

Designing a Threshold for General Fund Contributions

As I discussed earlier, the introduction of general revenue financing to trust fund programs raises some important design issues, one of which is that such financing interferes with the signaling function that the trust fund account structure provides. Accordingly, it would be desirable to put in place some mechanism to constrain general revenue contributions or at least to signal that they are growing and ought to be addressed. Both Breaux-Frist and the President's proposals include elements designed to moderate future Medicare spending, but their approaches are untested. It would be imprudent to adopt a financing structure relying on general revenues without a mechanism to gauge spending and revenues and sound an early warning if policy course corrections are warranted.

The Breaux-Frist approach would deem the trust fund "programmatically insolvent" if the general revenue transfer needed to make payments exceeded 40 percent of total Medicare expense for the fiscal year. While this establishes a "trigger" for insolvency, it does not specify what would happen if insolvency occurs. Both a trigger and some resulting specified course of action would be necessary to ensure that imbalances between trust fund receipts and payments are addressed before they become an unending drain on general revenues.

Given that Medicare cost growth has generally been faster than growth in the rest of the budget, a trigger that permits the dollar amount of general revenue financing to float upward as Medicare expenses increase would allow increasingly larger shares of general revenues from other government programs. To avoid this potentially unencumbered draw on general revenue a number of different indicators might be explored as possible triggers to action. For example, a trigger could be defined as when the general revenue transfer reaches some specified percent of total federal revenues. Such a trigger could limit general revenue support to a certain share of federal revenue rather than letting it grow at the same rate as Medicare expenses as in Breaux-Frist. Other possible triggers could be a specified floor in the trust fund, such as the balance falling below 1 year's worth of payments; the percentage of gross domestic product devoted to Medicare; or program spending per enrollee.

Whatever the trigger, the key question would be what happens when the trigger limits are reached. One approach in designing such a trigger would be to couple it with specified actions to occur if the trigger is reached. A "hard" trigger would include specific provisions that would automatically go into effect if the trigger is reached. Perhaps more realistically, a "softer" trigger could require the Congress or the President to take some action or to re-affirm acceptance of the Medicare cost growth and provide additional general revenues to cover it. This would at least ensure that the Congress and the President periodically review and decide how to address cost growth if it occurs.

Several alternatives might be considered for implementing such a trigger. For example, reaching a trigger could require the President to propose how to deal with the growth and the Congress to vote on the proposal, either accepting it or developing an alternative. Or the congressional budget process could be used to require the Congress to deal with Medicare cost growth by establishing a point of order against a budget resolution that includes a Medicare spending path that exceeds a specified trigger measure. Raising the point of order could require the Congress to propose changes to Medicare to bring it within the specified measure or vote to accept the cost growth. If program changes are desired, reconciliation instructions could be included in the budget resolution. The President would be brought into the process as it progressed because changes to Medicare would require enactment of a law. In fact, the current budget process contains a similar point of order against worsening the financial condition of the Social Security trust funds.

Discipline cannot be instilled by a process change alone; leaders must be committed to enforcing discipline for it to be effective. The trust fund mechanism has shown that when such processes or mechanisms are viewed as credible, they can help focus the debate and promote timely actions. If the signaling feature of trust funds is to be weakened by general revenue injections, it is imperative that some other process discipline be developed, either as I have suggested or in some other way. We will be happy to work with your staff to further develop any of the ideas I have mentioned or others that may be proposed to inject the necessary discipline.

Concluding Observations

In determining how to reform the Medicare program, much is at stake—not only the future of Medicare itself but also assuring the nation's future fiscal flexibility to pursue other important national goals and programs. As the Comptroller General has said, the greatest risk lies in doing nothing to improve the program's long-term sustainability or, worse, in adopting changes that may aggravate the long-term financial outlook for the program and the budget.

It is my hope that we will think about the unprecedented challenge facing future generations in our aging society. Relieving them of some of the burden of today's financing commitments would help fulfill this generation's fiduciary responsibility. It would also preserve some capacity to make their own choices by strengthening both the budget and the economy they inherit. While not ignoring today's needs and demands, we should remember that surpluses can be used as an occasion to promote the transition to a more sustainable future for our children and grandchildren. While reducing debt is important, debt reduction alone will be insufficient to secure our economic future. We need to view this period of projected prosperity as an opportunity to address the structural imbalances in Medicare, Social Security, and other entitlement programs before the approaching demographic tidal wave makes the imbalances more dramatic and meaningful reform less feasible.

The bottom line is that surpluses represent both an opportunity and an obligation. We have an opportunity to use our unprecedented economic wealth and fiscal good fortune to address today's needs but an obligation to do so in a way that improves the prospects for future generations. This generation has a stewardship responsibility to future generations to reduce the debt burden they will inherit, to provide a strong foundation for future economic growth, and to ensure that future commitments are both adequate and affordable. Prudence requires making the tough choices today while the economy is healthy and the workforce is relatively large. National saving pays future dividends over the long term but only if meaningful reform begins soon. Entitlement reform is best done with considerable lead time to phase in changes and before the changes that are needed become dramatic and disruptive. The prudent use of the nation's current and projected budget surpluses combined with meaningful Medicare and Social Security program reforms can help achieve both of these goals.

Mr. Chairman and Members of the Committee, this concludes my prepared statement. I will be happy to answer any questions you may have.

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The CHAIRMAN. Dr. Steuerle.

STATEMENT OF C. EUGENE STEUERLE, SENIOR FELLOW, THE URBAN INSTITUTE, WASHINGTON, DC

Mr. STEUERLE. Thank you, Mr. Chairman. It is a privilege to speak before you and Senator Breaux today.

Let me also add that I have had the opportunity over time to work directly and indirectly with the two gentlemen on my right and with their staffs, and I believe they are among the finest in Government and truly add meaning to the term "public servant." As a member of the baby boom generation, I grew up with individuals who, whether conservative or liberal, considered themselves idealists when it came to the role of the Federal Government. Today this cohort has come into full power as members of the labor force, the business community, the White House, and the Congress itself.

It is ironic that the legacy that baby boomers would now bequeath is one in which almost the sole purpose of the Federal Government would be to care for their own consumption needs in retirement.

I do not believe this legacy is intended. It is largely the consequence of laws written decades ago that pretend to determine almost all the spending priorities for this Congress as well as for future generations. In particular, it is the consequence of designing Social Security and health programs so that they grow forever faster than the economy without regard to factors that determine the number of taxpayers and beneficiaries.

The total economic burden of this entitlement system depends mainly on how much national and governmental resources it absorbs over time. According to both the administration and the Congressional Budget Office, Social Security, Medicare and Medicaid together are estimated to rise from about 40 percent of revenues today to almost 90 percent in the future, as is shown on the graph to my immediate left.

While much of this growth occurs once the baby boomers start retiring, the share of revenues available for other domestic priorities is already—I repeat, already—in a state of decline. In my view, it would not be helpful simply to pre-commit or earmark more revenues to try to catch up to promised spending that itself may not be viable.

If reform were to involve the building of a viable and balanced system unlikely to rely upon future deficit spending, a case could be made that general funds be used to pay for a part of that reform. Unique problems and needs, in particular the demographic problems that the chairman of the Federal Reserve just spoke about, sometimes require an infusion of funds. If reform also means that people work longer or save more, they will also contribute more tax dollars that can be shared among various societal needs.

Certainly, when reform proposals are compared, all the changes in the budget that they achieve, including an increase in general revenues, need to be compared on a consistent basis. This was one of the recommendations of the Technical Panel on Social Security that I recently chaired.

Unfortunately, the upcoming decline in workers relative to retirees is not just a problem of financing the Social Security. It also affects Medicare. It affects Medicaid long-term care expenses. But it also affects education, environmental programs, defense, and every other budget item as well. More work as we live longer, I believe, will inevitably be one of the adjustments we will make as a society, one way or the other. But if we live longer, we also have obligations to help pay for public goods other than transfer payments made to those in old age. Once again, then, I conclude that any general revenue transfer should not be made perpetual in nature but should help finance the transition to a balanced system.

I must confess that it is hard to be a purist about general revenue financing. Programs for the elderly and non-elderly are already partially financed directly and indirectly out of general revenues, and I list many of these mechanisms in my testimony. Despite moderate temporary surpluses in some trust fund programs for the elderly, these programs as a whole would be running substantial deficits if their sources of general revenues were not counted.

Despite the many general revenue sources already used for elderly and near-elderly programs, a good case can be made that the remaining tie between taxes and benefits as reflected in the concept of trust fund balances is a source of fiscal discipline and does help prevent further deficit financing, at least in Social Security.

It is possible, of course, that some general fund transfers now might encourage more short-run saving by Government, reducing future interest costs. In the administration's proposal, success depends on transferring bonds to Social Security in a way that would effectively reduce current non-Social Security spending and/or tax reduction by the amount of additional bonds turned over today. Then, later, the additional interest and principal paid from Treasury to Social Security would again reduce the measure of non-Social Security surplus, further reducing—at least, they hope—the tendency to spend it.

Let us be clear. Neither the administration nor the Congress at this point is contemplating saving more than current law already implies. On the contrary, both anticipate a significant reduction in what used to be called the primary deficit, now the primary surplus—that is, those items of the budget that exclude interest. Thus, both sides of the aisle are considering how to remove discretion from future Congresses by trying to allocate today future surpluses expected for tomorrow, usually before those surpluses are realized and before the needs of tomorrow are fully known.

The administration's proposal attempts somehow to put future Presidents and Congresses under a regime where the accounting switch or bond transfers will lead to a smaller measures of the non-Social Security surplus in exchange for a smaller measure of future Social Security deficits. The net result, however, is that it creates confusion in both discretionary and entitlement spending accounts. Funds available for discretionary spending appear smaller, but discretionary spending is already projected at what most believe to be unrealistically low levels of total revenues. Social Security, in turn, appears to be running smaller deficits than when its own-source revenues are compared to expenditures.

In summary, if more general revenues are used for Social Security reform, I conclude that they should either finance some temporary transition to a sustainable system or a general revenue program related to private pensions or a well-designed retirement saving program.

Thank you.

[The prepared statement of Mr. Steuerle follows:]

GENERAL FUND TRANSFERS TO ENTITLEMENT PROGRAMS

Statement before the Special Committee on Aging
United States Senate

March 27, 2000

C. EUGENE STEUERLE
Senior Fellow

Any opinions expressed herein are solely the author's and should not be attributed to the Urban Institute, its officers or funders.

THE URBAN INSTITUTE

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Mr. Chairman and Members of the Committee:

As a member of the baby boom generation, I grew up with individuals who, whether conservative or liberal, considered themselves idealists when it came to the role of the federal government. They might have disagreed over the optimal size of government or the degree of taxation, but they did believe that government should serve its citizens well and should promote civil rights, defend against totalitarianism, and provide opportunity, especially to the poor. Today this cohort has come into full power as members of the labor force, of the business community, of the White House, and of Congress itself. *It is ironic that the legacy that baby boomers would now bequeath is one in which almost the sole purpose of the federal government would be to care for their own consumption needs in retirement.*

I do not believe this legacy is intended. Yet it would come about under current law, under the President's proposals, and under many of the Republican and Democratic budget alternatives now being considered in Congress. It is largely the consequence of laws written decades ago that pretend to determine almost all of the spending priorities for this Congress, as well as for future generations. In particular, it is the consequence of designing Social Security and health programs so that they forever grow faster than the economy, without regard to changes in fertility and mortality rates and other factors that determine the numbers of taxpayers and beneficiaries.

The total economic burden of this entitlement system depends mainly on how much of national and governmental resources it absorbs over time. As a matter of economics, different financing options may have only moderate effects on that burden. According to both the Administration and the Congressional Budget Office, Social Security, Medicare, and Medicaid together are estimated to rise from about 40 percent of revenues today to about 90 percent in the future. While much of this growth occurs once the baby boomers start retiring, the share of revenues available for other domestic priorities is already in a state of decline. In my view, it would not be helpful simply to pre-commit or earmark more revenues to try to catch up to promised spending that itself may not be viable. Such a use of general revenues could mislead, deter attention to society's greatest needs, and delay any reform efforts required.

If reform were to involve the building of a viable and balanced system unlikely to rely upon future deficit spending, on the other hand, a case could be made that general funds be used to "pay" for part of that reform. Even then, I would urge a great deal of caution. Broadly speaking, in the presence of real reform, the primary question switches from one of sustainability and balance to whether the structure we end up with years down the road represents good budget, expenditure, and tax policy. Spending general revenues temporarily to attain a sustainable Social Security system, for instance, still means not spending general revenues on education, or the environment, or defense. However, unique problems and needs sometimes require an infusion of funds. If reform also means that people work longer or save more, then they will also contribute more tax dollars that can be shared among various societal needs. But earmarking general revenues -- especially if the earmarking is perpetual, rather than temporary -- means telling future Congresses that they can't ever allocate some share of general revenues for other purposes.

Earmarked general revenues in a program that pretends to use its own tax source and engages in trust fund accounting, moreover, is confusing. It can easily encourage deficit financing -- perhaps permanent deficit financing -- of the program. Therefore, I conclude that if general funds are used, they should finance some particular program itself (e.g., a workable type of retirement savings account or some private pension incentive) or temporarily finance movement to some new regime, but not be made a permanent part of a trust fund program supposedly financed out of its own revenue source.

Suppose, however, that there is an increase in revenues due to more work -- e.g., under a reform that involves some increase in the retirement age. It would be tempting to allocate all of those additional general revenues to Social Security. Certainly, when reform proposals are compared, all the changes in the budget that they achieve, including any increases in general revenues, need to be compared on a consistent basis. This was one of the recommendations of the Technical Panel on Social Security that I recently chaired. Unfortunately, the upcoming decline in workers relative to retirees is not just a problem of financing for Social Security. It also affects Medicare. It affects Medicaid long-term care expenses. But it also affects education, environmental programs, defense, and every other budget item as well. More work as we live longer, I believe, will inevitably be one of the adjustments we will make as a society, one way or the other. But if we live longer, we also have obligations to help pay for public goods other than transfer payments in old age. Once again, then, I conclude that any general revenue transfer should not be made perpetual in nature, but should help finance the transition to a balanced system.

Background -- A Hybrid System Already

It is difficult, however, to be a purist about general revenue financing. Programs for the elderly and near-elderly are already partially financed directly and indirectly through general revenues. Examples include: the financing of Part B of Medicare out of general revenues; the transfer at times of benefits from Medicare Part A to Part B so that Part A appears more solvent; the expansion of long-term care for the elderly within Medicaid (or, as the President proposes, with income tax credits) rather than as part of a broader reform of the health care benefit package offered as a whole to the elderly; the use of Supplemental Security Income (SSI) to pay for some transfers to low-income retirees even though other large transfers occur within Social Security; the income tax exemption for one-half of Social Security taxes paid, along with the exemption of most Social Security benefits from income taxation; and the transfer to Social Security of income taxes (general revenues) paid on benefits on the basis of a very generous formula for calculating what is paid. In fact, despite moderate temporary "surpluses" in some Trust Funds, programs for the elderly today would be running substantial deficits if these sources of general revenues were not counted.

Historically, Social Security has also had some general revenue infusions to cover the cost of military service wage credits (1956), transitional benefits for those aged 72 and older with fewer than three quarters of coverage (1966), wage credits for U.S. citizen internees of Japanese ancestry (1972), and for taxes which would have been collected on deemed post-1956 military service wage credits (1983).

Despite the many general revenue sources already used in elderly and near-elderly programs, a good case can be made that the remaining tie between taxes and benefits, as reflected in the concept of trust fund balances, is a source of fiscal discipline and does help prevent further deficit financing, at least in Social Security. Reform in 1983 would be an example of benefit reductions and tax increases forced by the projected inability of trust fund revenues to meet trust fund obligations. The trust fund concept and the calculation of trust fund imbalance also seems to be a driving force for reforming Social Security today.

General Fund Transfers in the Absence of Reform

In the absence of reform aimed at achieving a balanced system, general fund transfers might actually discourage making the tough choices required. If so, they would likely add to long-term deficits both in the unified budget and in Social Security, Medicare, or other programs receiving the transfers. In the case of Social Security, general fund transfers with no overall reform would reinforce the misconception that the program has significant assets with which to pay out its liabilities. In fact, it is mainly a cash flow system with a very temporary modest cash surplus during the short period when the baby boom bust population of the Depression and World War II moves into the retirement population.

Merely making an additional transfer from the government's left hand (Treasury) to its right hand (Social

Security) -- over and above any surplus accruing between taxes and benefits - masks too much. The simple fact is that future taxpayers must cover the cost of the interest and principal on any gift of bonds from Treasury to Social Security.

The Issue of Saving

It is possible, of course, that some general fund transfers now might encourage more short- run saving by government -- reducing future interest costs. This is one of the arguments used by the Administration. In its own proposal, success depends upon transferring bonds to Social Security in a way that would effectively reduce current non-Social Security spending and/or tax reduction by the amount of additional bonds turned over today. Then, later, the additional interest and principal paid from Treasury to Social Security would again reduce the measure of non-Social Security surplus, further reducing the tendency to spend it. Much confusion reigns over this proposal, but consider it in two pieces. First, bond transfers today would be treated almost like current expenditures, so that when Congress aims for targets like a zero-deficit in the non-Social Security budget, less will be left over for other tax cuts or spending items. Second, over the long-run the same amount of resources is required for Social Security and other entitlements, only now more is "earmarked" through the additional interest and principal "owed" to Social Security because of the bond transfers. Any current saving will also reduce the interest costs, thus leaving a tiny bit more for other purposes down the road. Also not to be forgotten here is that the Administration proposes to subsidize retirement saving accounts also attempts to direct some of the current surplus toward encouraging saving relative to alternative budget uses.

We must distinguish, however, between the short-run issue of how to limit surplus spending now with the longer-run issue of how future Presidents and Congresses might be constrained. Let's be clear: neither the Administration nor Congress at this point is contemplating saving more than current law implies. On the contrary, they anticipate a significant reduction in what used to be called the primary surplus or deficit (which excludes interest). Thus, both sides of the aisle are considering how to remove discretion from future Congresses by trying to allocate today future surpluses expected for tomorrow -- usually before those surpluses are realized and before the needs of tomorrow are fully known.

The Administration's proposal also attempts somehow to put future Presidents and Congresses under a regime where the accounting switch or bond transfers will lead to a smaller measure of the non-Social Security surplus in exchange for a smaller measure of future Social Security deficits. The net result, however, is that it creates confusion for both discretionary and entitlement spending. Funds available for discretionary spending appear smaller, but discretionary spending is already projected at what most believe to be unrealistically low shares of total revenues (see Figure). Social Security, in turn, appears to be running smaller deficits than when own-source revenues are compared to expenditures.

Other Structural Issues Raised When Social Security and Other Entitlements Are Financed by General Revenues

If general revenue financing were to become more pervasive, other important public finance issues will come to the fore. Although these issues have received scant attention, movement toward general revenue financing would almost assuredly force future Congresses to address them as well.

Should an individual's Social Security benefits be based on his or her own contributions or earnings subject to Social Security tax?

Advocates of today's Social Security system have long argued that benefits are an earned right because one's Social Security taxes helped pay for those benefits. Although never strictly correct, general revenue financing cleanly breaks the relationship between benefits and taxes on earnings alone. The more formal introduction of significant general revenue financing into Social Security would shift public sentiment further toward viewing the system as a transfer program rather than a program paid for out of "contributions." The Administration, moreover, has hinted in the past that some of the remaining imbalances in Social Security (and Medicare) could be met by further gifts of bonds from Treasury beyond what they have proposed. Hence it suggests that the general revenue financing door can be opened even further by this or later Congresses. In a system of transfers from general revenues, the notion that one is entitled to some benefit because he or she has paid a mandate withers away.

An example of the type of issue that will arise is whether or not Social Security should be means-tested. Many transfer programs financed out of general revenues are means-tested. While I generally conclude that means-testing of a substantial portion of the elderly population is hard to police, could be considered degrading, and would discourage saving for retirement, it is among those options likely to be put on the table once general revenue financing becomes more prevalent.

What is the right tax?

Another important public finance question is what is the appropriate tax or combination of taxes to support old age programs – wage taxes, income taxes, or consumption taxes. Although we have already noted many exceptions, a wage tax is still considered the appropriate source of revenues for Social Security and Medicare. General revenue financing re-opens this debate. As only one example, a case can be made for consumption taxation vis-a-vis wage taxation if, as projected, we continue on a path where larger and larger portions of Social Security and Medicare recipients consume at higher rates than many of the workers who pay for those transfers. By the same token, it is doubtful as a matter of simplicity – yes, there are a few of us left who care about simplicity -- that one would want to add yet another tax system onto the ones we already have.

Summary

In summary, we have only begun our journey toward a domestic policy in which our children are allowed some choice and discretion as to what their government will do. Getting our budget into surplus after years of large deficits has been a positive development, but only a step along the way. We still have in place laws that would obligate the children of today to pay almost all of their future federal taxes as transfers to support the consumption of their parents. This is not a recipe for efficient or citizen-led government. The path we are on, I believe, is already deterring us from allocating government resources to society's most pressing needs.

Done the right way, the infusion of some general revenues into a Social Security reform package might help deal with some of the political pain of attaining a balanced and sustainable system. Certainly more saving by government – or limited reduction in projected surpluses -- is also a prudent move. Development of ideas such as subsidized retirement saving accounts, just like other individual account proposals, offers the prospect of addressing the very poor distribution of private pension wealth in society.

Nonetheless, additional general revenue financing of Social Security in absence of broader reform tends to hide the true deficits in Social Security, deter reform, and likely increase total government deficits in the long-term. It is also unclear how much any poorly understood budget accounting shift, even if it passed this Congress, could be placed off-bounds for re-consideration by future Presidents and Congresses. If more general revenues are used for Social Security reform, I conclude that they should either finance some temporary transition to a sustainable system or a general revenue program related to private pensions or a well-designed retirement saving program.

APPENDIX 1

The Nature of Future Obligations

A few examples convey the extraordinary nature of our future obligations, whether financed out of Social Security taxes or general revenues.

- Using today's prices, an average-income couple retiring in 1960 could expect to receive about \$100,000 in lifetime Social Security benefits. A typical couple retiring today would receive about \$1/2 million in Social Security and Medicare benefits (about equal amounts of each). Average-income baby boomer couples, on the other hand, would receive around \$3/4 million, and those who come later are scheduled to receive as much as \$1 million (in today's dollars). General revenue financing does not change that level of obligation.

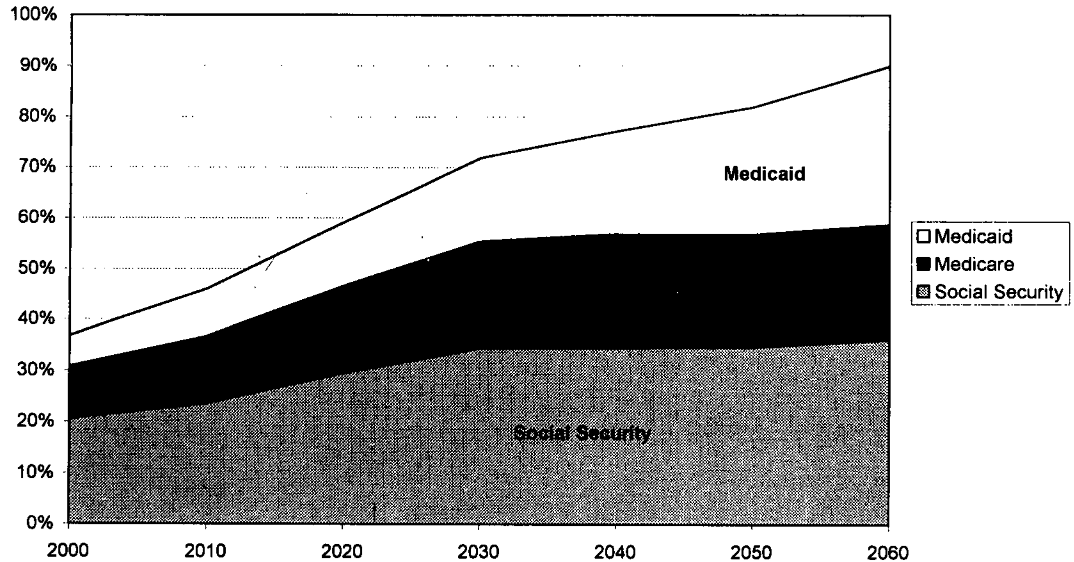
- The number of workers per beneficiary is currently scheduled to drop from more than 3-to-1 to less than 2-to-1. Out of every dollar in cash wages, the government already requires workers to pay 15 cents in Social Security tax, plus several cents in general revenues, to support elderly and disability programs alone. In the future that rate of tax could increase substantially -- 5 to 6 percentage points alone due to Social Security. General revenue financing only changes what type of tax will support those elderly programs.

- One reason for these rising costs is that Social Security and Medicare dictate that successive generations should receive higher levels of real benefits than all previous generations. For example, baby boomers are told that, regardless of other needs of the population, they are entitled to receive higher levels of real benefits from their children than they, the baby boomers, transferred to their parents -- that this is an entitlement. General revenue financing does not change these scheduled increases in benefits.

- Another reason that Social Security and other retirement programs take ever larger percentages of national income is that people are living longer and spending more years in retirement -- almost a decade more than Social Security retirees in the early years of the program. *Today individuals claim an entitlement to retire on Social Security for almost one-third of their adult lives.* More years of retirement also reduce the number of taxpayers for both Social Security and other purposes, thus raising tax rates on those still working. General revenue financing does not change this trend.

- Within a few decades, *close to one-third of the adult population will be receiving SocialSecurity benefits under current law.* Add to those numbers the unemployed or unemployable, or those on other assistance programs, and a substantial portion of the adult population will be largely -- in many cases, primarily -- dependent upon the children of today to support them through their tax dollars. Of course, our children will need to support their own families, as well, but the share of the budget available to meet the educational, environmental, health research, urban, justice and other needs of our children and grandchildren would be drastically reduced. General revenue financing simply reinforces that pressure.

Federal Outlays as a Percentage of Revenue
Long-Run Budget Projections of Clinton's 2001 Budget Policy



Source: Eugene Steuerle and Christopher Spiro, The Urban Institute, 2000. Based on the Budget of the United States Government, FY 2001.

The CHAIRMAN. Thanks to all of you. We appreciate very much you joining us on this very important issue.

I am going to start with a question for Mr. Wilcox, and I think I will ask Dr. Posner and Dr. Steuerle to supplement his answer.

I suppose I could say that all Presidents and Congresses have had to make decisions annually on how to spend income tax revenue for education infrastructure, defense, environment, and a whole host of concerns. What effect will making Social Security and Medicare more reliant on income taxes have on these other areas of Federal responsibility?

Mr. WILCOX. That is an important question, Mr. Chairman, and I think it goes to the heart of why we have felt as strongly as we have that core Government functions must be funded at an adequate level.

In our view, it is absolutely critical that the funding for these general revenue transfers be mapped out in advance as part of the available on-budget surpluses and that this be undertaken in the context of an overall budgetary framework that maintains fiscal discipline by holding the on-budget account either in surplus or in balance and that provides for the other objectives that the Congress and the administration set for the Government. Clearly, those other objectives include the important programs that you have mentioned—education, the environment, and so forth.

We think it is fundamentally exactly what politics in the best sense is all about—balancing resources among competing demands—and we have attempted to strike the balance in a way that seems to us sensible and prudent, hard-headed and responsible.

The CHAIRMAN. Dr. Posner.

Mr. POSNER. I think you have touched on one compelling reason to reform these programs, that if we do not, they will be increasingly encumbering the available Federal revenues at the current revenue constraint in the budget and preventing us from doing all the other things that are important to the American people. And I would say that that is true even without the transfers; those programs are scheduled to outlive or exceed their payroll tax revenues, and there is an implicit general fund commitment but one that might be headed off because the trust fund mechanism would be warning us that you have to do something. With the new general fund commitments here, we are concerned that it would allay that concern and permit these programs to absorb more revenue which could be used for other kinds of priorities.

The CHAIRMAN. Mr. Steuerle.

Mr. STEUERLE. Senator Grassley, I think the administration has proposed what many might consider to be a sound short-run fiscal policy. That is, what they are suggesting is simply that we save not only the Social Security surplus but some of the non-Social Security surplus. However, to achieve this, they propose an accounting scheme which I think is confusing and in the long run could lead to larger deficits. I say confusing because I think very few people in the public or even in the Congress fully understand exactly how all of these bond transfers would occur.

Essentially, what the administration is playing on is the tendency of past administrations and past Congresses to aim simply for a zero target in terms of the deficit. Historically, it was the unified budget deficit , which meant we did not worry about the Social Security surplus. Last year, thanks to the actions of both the administration and the Congress, we decided to make that zero target within the non-Social Security budget, so we would not count the Social Security surplus.

Mind you, this strategy in itself is only good for a short period of time, because once Social Security starts running a deficit, it does not tell you what to do when running a zero deficit in the non-Social Security trust funds means an overall unified budget deficit.

Then, the administration says let us now go an other step and aim for a zero deficit target starts with the unified budget, takes out the money that Social Security is now going to be saving, and then takes out additionally some amount of money which we are going to make as bond transfers to Social Security.

As I said, I think the accounting scheme is confusing. On net, I think it is probably good, sound short-term policy, but because of the confusion in the accounting system, because it does not tell us what to do when these trust funds start running deficits, and because it commits us to a general revenue financing scheme that I am not sure we really want in the long run, I have some problems with the mechanism involved.

The CHAIRMAN. My second question is for you, Dr. Steuerle. Policymakers must address Social Security reform in the near future—I think there is general agreement on that. The main measure now used to assess reform plans is how long they would extend the solvency of the trust fund. General revenue transfers certainly would extend the solvency of the fund. Would you say this is the best way to judge the merits of any reform plan?

Mr. STEUERLE. No, Senator, I would not.

The CHAIRMAN. Then, let me ask you a follow-up question. What would be a better measure for judging the merits of any reform plan?

Mr. STEUERLE. The ideal measure would be what percent of our national resources we want to devote to the particular items in question; that is, how much do we want to devote to Social Security transfer programs, how much do we want to devote to health programs—hopefully keeping in mind other needs of the economy and the limits on how high tax rates can go.

Solvency is certainly a useful device for looking at when we are in or out of balance and when we need to take action, but in and of itself, it is not a measure of the real resources used in the economy.

The CHAIRMAN. Senator Breaux.

Senator BREAUX. Thank you, Mr. Chairman, and I thank this distinguished panel for their presentations. It is very helpful, as always, and it is good to see all of you back again.

Mr. Wilcox, in your testimony, you say on the first page that "The administration believes that while they are by no means the whole solution, general revenue transfers are an appropriate and important part of the solution to the financing problems faced by Social Security and Medicare. A comprehensive solution should include structural reforms to these programs."

I note the administration's proposal on Social Security as far as the general revenue transfer part of it is that there be an annual transfer of $100 billion starting in the year 2011 and then going to $211 billion by 2015. These transfers would stop in the year 2050. That is the general revenue transfer part of the solution, but I do not know what is the current structural recommendation to reform Social Security that is on the table today.

Mr. WILCOX. Senator Breaux, the President has not put forward a detailed structural reform proposal in the same way that he has for the Medicare program, and there is good reason for that. With respect to Medicare——

Senator BREAUX. No, no. Let us talk about Social Security.

Mr. WILCOX. Fine. I was hoping to draw the contextual——

Senator BREAUX. That is the next question; we are still on the first one.

Mr. WILCOX [continuing.] Contrast with Medicare, where the context was set by your important work with the bipartisan commission.

Senator BREAUX. I understand that, but what about the first one?

Mr. WILCOX. On Social Security, the President made the determination some time ago that the process would best be moved forward not by the administration putting forward a specific proposal. In the case of Social Security, the judgment was that that would become in effect the lightning rod for criticism, and the hope was——

Senator BREAUX. To let Congress take the criticism?

Mr. WILCOX. No, sir. I think the hope was that through a joint process of bipartisan conversation and collegial cooperation, we might be able to move the issue forward. And I——

Senator BREAUX. If I were not such a calm person, I would just scream, but it probably would not be recorded properly.

This is the heart of the problem. Everybody wants the dessert. The only thing Congress has done on Social Security this year is to remove the earning limitation so that more people can collect more money. That is what Congress has done. And now, you are telling me that the administration has not put forth in this budget any structural reform of Social Security because you are going to wait for the Congress to do it. And all my Republican colleagues are going to sit there, and every, single one of them is going to say, "I am waiting for the administration to do it." The administration says, "We are waiting for Congress to do it." And as a result, it does not get done.

Now, Judd Gregg, John Breaux, and others in the Senate have a very specific Social Security structural reform plan that is out there. We have introduced it. The same thing with Medicare. It has been introduced in the House as part of a comprehensive Social Security reform plan.

And I could blame everybody, myself included, for not being eloquent enough, I guess, but Republicans blame the President for not putting anything on the table but the easy stuff, and the administration says, "Congress, you do it." And Congress says, "No—you do it." And guess what? As a result, nobody does it.

You put out let us spend more money, but you have not put out anything for structural reform on Social Security. And the only thing Congress has done is to remove the earnings cap. That is not good by any stretch of the imagination of any of us.

I know what I am talking about, and you know what you are talking about, and we both know what we are both talking about. Tell me why I am wrong on that summary?

Mr. WILCOX. If I may, Senator, I think that if the President had been looking to duck this issue, he would not have broached the topic in the 1998 State of the Union Address. Going back to that time, Social Security was still referred to as the third rail of American politics.

Senator BREAUX. Apparently, it is at least three and a half now.

Mr. WILCOX. The easy thing to do would have been simply to suppress the whole topic from discussion.

Senator BREAUX. I just get so unhappy about all this because nobody wants to go first—that is the problem—because we are all scared to death that somebody somewhere is going to get mad. We talk about putting more money into it, and you say, well, that is only half of it, but there is no second half. And Congress is no better, because we are not doing anything; this side blames the other side for not getting the President to go first, and the President says you go first, and you go first—and nobody goes first.

I just get really upset about this, because if we continue with that kind of dialog, obviously, we are not going to touch it. We are not going to do anything on Social Security this year. Nobody in this town thinks we are going to do anything other than what we did. Everybody Member of Congress, myself included, would be issuing a press release on what we did for Social Security. We did not do anything to help save it; we just made it easier for more people to collect more money. That is the pitiful thing about it.

What do you think about what we did in Breaux-Frist at least to try to put some type of a cap to say time out when it reaches 40 percent of general revenues paying for Medicare? Are you uncomfortable with 40 percent, or are you comfortable with it? How about 50 percent. How about 60 percent. How about 70 percent? It is going up to 90 percent in Mr. Steuerle's charts—90 percent of Medicare and Social Security are going to be paid out of general revenues. How much are we going to have left for national security and education and environment? Ten percent? At what point does it become a problem, from your perspective? It is at 37 percent now, heading toward 40 percent. When do you get worried about it?

Mr. WILCOX. I think it is difficult to say in the context of an arbitrary number. I think the part of the proposal that we feel very comfortable with is the recognition of the need for fiscal discipline, and we fully subscribe to——

Senator BREAUX. Is 37 percent fiscal discipline?

Mr. WILCOX. Well, the aspect of the cap that makes me feel uncomfortable and that I would like to work with your staff to understand further is what the introduction of that type of cap would imply for the ability to pre-fund this system.

It seems to me that the core economic principle underlying the President's proposals for general revenue transfers is that pre-funding has real meaning, and it is difficult for me to discern how one pre-funds the system if the solvency measure is defined in terms of an arbitrary cap on the fraction of program resources that will be funded out of general revenues.

The administration has worked hard to exercise good stewardship over Part B, which I know is a special concern of yours, and I think we take very seriously the need to ensure that future cost growth is as constrained as we can make it within the context of providing high-quality, reliable health care for seniors.

Senator BREAUX. Thank you.

The CHAIRMAN. Thank you, Senator Breaux.

I want to follow up with you, Mr. Wilcox. If you remember the question that I just asked Dr. Steuerle about judging the solvency of the Social Security trust fund by putting general revenue in it, and he said the more basic policy question is the percent of gross domestic product that we might want to spend on various programs or portions of the budget.

Following up on that, another way that there has been general revenue spending from Part A to Part B is that several years ago, we transferred home health spending, and the administration also proposes to transfer income tax revenue to delay the insolvency date of the Part A trust fund. My question is similar to what I asked Dr. Steuerle: Is that the right measure of Medicare's solvency?

Mr. WILCOX. I agree with Gene about a lot of things in economics, but I part company with him on this one. I do think solvency is a relevant measure for assessing the long-term viability of these programs. I think it is relevant not only to look at the exhaustion date but also to look at the actuarial imbalance over a 75-year period.

I think it is important to recognize that we have shifted to, I think, a dual objective for fiscal policy—not only that the on-budget account should be maintained in surplus or in balance, but also that Social Security and Medicare should be put on a long-term solvency basis.

With respect to the economic integrity of these general revenue transfers, I think the key concept that I would really like to emphasize is that trust fund accumulations must be matched by improvements in the net financial position of the Government. I think that what we have suffered from for too long is a situation in which the trust fund was allowed to increase without national saving being boosted commensurately.

The type of program that the President has put forward is fundamentally fiscally disciplined because it matches the Government's contribution to national saving to the amount by which the trust fund increases. That is why I have a greater sense of intellectual comfort with this program than Gene seems to.

The CHAIRMAN. Yes, Dr. Posner—I was going to ask you to comment.

Mr. POSNER. If I could follow up on that, I think the point about pre-funding is well-taken. Again reiterating the statement I made earlier, I think that that must be coupled with reform. Improving national savings is a part of this, but if in doing so you interfere with the signalling mechanism, then you are not really promoting the kind of long-term outlook that you need.

I am wondering if one thing that could be considered would be—I think there is some value in having the trust fund mechanism as kind of an unalterable stop to payments that really gets people's attention, but recognizing the points that sustainability is equally or more important than solvency, whether you can still have some trip-wires or fiscal cautions built into the process alongside the existing trust fund mechanisms that would give you another set of signals which would cause you to pause if the program looks like it is reaching a certain level of GDP.

For example, we know that Breaux-Frist has the share of general revenue 40 percent of the program. We would also note that currently, the share of general revenues of the Medicare program, Parts A and B, is now scheduled to be about 14 percent of general revenues. Of all the general revenues of the Federal Government, 14 percent will go to the Medicare program in 2008 under current law, scheduled to float upwards to 30 percent. That could very well be the kind of trip-wire that you could institute in the process, alongside the trust fund solvency, that might possibly force you to look at it earlier than a trust fund insolvency date of 2015 for Medicare, for example.

The CHAIRMAN. Dr. Steuerle.

Mr. STEUERLE. Senator, if I did not make myself clear before, I do think that solvency is an important signalling mechanism. I only meant to say that it was not the primary mechanism by which one judged the soundness of a particular program.

The CHAIRMAN. My question was should you measure it by the revenue you are putting into it and its longevity solely, and you said no to that; is that correct?

Mr. STEUERLE. That is correct, Senator.

The CHAIRMAN. I am going to ask Dr. Wilcox now—you argue, Dr. Steuerle, that the Social Security program has an inherent discipline because its benefits cannot exceed payroll taxes collected—based on that assessment, if we dip further into general revenues to pay benefits, then, for the administration, what safety valves would it recommend to keep program growth under control?

Mr. WILCOX. I think that ultimately, the answer to keeping cost growth under control is the objective that we all seek, which is the structural reform of the program. There is no question about that.

The CHAIRMAN. The only problem is—and I think it was brought out here pretty clearly by members of this committee—that the extent to which you put that general revenue in there, you are putting off the day of making real reforms—in other words, the pressure is off Congress to make the real reforms, and you just delay making reforms.

Mr. WILCOX. I think there is a separate issue as to whether the act of engaging in general revenue transfers reduces the felt urgency for structural reform of the programs. There need not be any reason why that is so. The fact of the matter is this is a difficult undertaking in the best of circumstances.

The administration believes that these general revenue transfers are a responsible and hard-headed part of the solution and have merit and standing on their own precisely because they give us the potential to grow the productive capacity of the economy and, in that sense, make a real and material contribution to easing the fiscal burden of meeting these obligations.

And I should say that the impact of the general revenue contributions is not to expand the existing obligations of the Social Security and Medicare systems, but to better enable these systems to meet their existing obligations.

The CHAIRMAN. Dr. Steuerle, do you want to respond?

Mr. STEUERLE. Yes, Senator. One of my concerns is that when we do anything that merely extends the date of solvency, we discount the importance of solving problems now.

As I mentioned earlier and in my testimony, I believe that we are already in a situation where the pressure of entitlement programs is having a serious impact on our ability to fund discretionary programs. That is, this is not just an issue for 2010 when the baby boomers start retiring; it is not just an issue for 2015 when Social Security tax revenues are short of the benefits paid; it is not just an issue for the day the trust funds become insolvent even though they have been spending down interest and principal like mad. It is an issue today.

And it is also an issue with respect to labor market changes. The biggest change that we are confronting, as I believe Chairman Greenspan mentioned, is the demographic one. When we hit the year 2008 or 2009, if we continue as projected, we will go to an economy where there will be a significant decline in the portion of the adult population that is employed. And while there is this notion that we continually demand more leisure as we get older, what has actually happened over the last 50 years is that there has been a significant increase in labor force participation largely because women entering the labor force have offset the rapid decline in participation of men. That service of labor is not available to us as we move into the very near future, and that labor market decline which will very soon come upon us and that real resource decline in relative availability of resources, is not measured by the date of solvency.

The CHAIRMAN. I am going to ask Dr. Posner a question about the President's plan to commit us to transferring income tax revenues to entitlement programs even if the projected surplus of such revenues proves to be a mirage. Does the President's plan do that, and if so, is that prudent? And if you say it is not prudent, then I want Mr. Wilcox to respond.

Mr. POSNER. I will say that the legislation does include specific dollars for each of the years of the transfer, and our understanding is that those dollars and those transfers would be made regardless of how large the on-budget surplus is for Medicare.

We generally think that it is not an advisable approach to lock in transfers without at least a periodic review by Congress. I think we are somewhat concerned that we would commit ourselves to that level of decisions before we know what is really going to happen 10 to 15 years away.

The CHAIRMAN. Do you want to comment, Mr. Wilcox, on the President's idea on that?

Mr. WILCOX. Yes. The pre-commitment of the Medicare transfers is an important aspect of the President's proposal. The pre-commitment, I should note, puts these transfers on an equal footing with tax cuts and other spending proposals. After all, when we commit a certain dollar volume over 10 years, say, to tax cuts, we do that on the basis of projections today. We do not know—we cannot peer into the future with total certainty as to what the resources will be—and it is conceivable that as history unfolds, the on-budget resources will not be there to provide for that tax cut out of on-budget surpluses.

That said, we think it is certainly important to show no less a commitment to these general revenue transfers for Social Security and Medicare than we would show to spending increases or to tax cuts. Down the road, if the on-budget surpluses do not materialize to the extent that we project, then future Congresses and administrations will face a more difficult set of choices. That said, it certainly is the case that that set of choices is made better by our decision today to use those resources to pay down the debt rather than to cut taxes or increase spending.

The CHAIRMAN. That concludes my questioning, and I want to thank all of you for testifying today and giving us the advantage of your insight, as you all do quite often and do well.

I started out my opening comments by questioning the use of general revenue transfers, and I think I am still of that opinion. I think I feel some of the same frustration that Senator Breaux does—and maybe we are all guilty of this to some extent—that we are waiting for some sort of painless way to solve the problems. Often enough, we do not realize that easy fixes are seldom very easy, and seldom do they really fix a problem.

So I think that you kind of get a feeling from the members of this committee, including for sure Senator Breaux, that this transfer of revenue puts off the day of reckoning. And obviously, we hope that this committee, albeit not an authorizing committee, lends itself to the debate of keeping this high on the agenda so that if we do not get it done this year, with the beginning of a new Presidency, of whatever party, we will be ready to take off next year to get the job done the way it should be done.

In that respect, that is the goal that I have.

Do you have something to add, Mr. Wilcox.

Mr. WILCOX. Yes, Mr. Chairman. I would like to express my appreciation for your leadership and that of Senator Breaux in openly considering the tough choices that will be required. I think it is crucial to have had that kind of leadership from this committee, and we have had very productive conversations with your staff and look forward to having more of the same. We think it is very important to moving the issue forward.

The CHAIRMAN. Thank you all very much.

[Whereupon, at 4:15 p.m., the committee was adjourned.]

APPENDIX

RESPONSES TO QUESTIONS SUBMITTED BY SENATOR SANTORUM

RESPONSE FROM CHAIRMAN ALAN GREENSPAN

Question. Chairman Greenspan, I tend to agree with the testimony presented to the Committee today by Dr. Eugene Steuerle, that absent structural reforms, the substantial "crediting" of general fund revenues to Social Security would give the illusion that Social Security had been strengthened in terms of trust fund "solvency"—while in reality do nothing to provide the actual resources necessary to meet the program's 2015 shortfall. And this may well lead to forestalling the serious decisions that must be made to guarantee the long-term, viability of Social Security.

And in a larger sense, it is my view that for too long, the nature and scope of Social Security's financing problems have been shrouded by inconsistent and incomplete information—such as an overemphasis on trust fund accounting—which has yielded much public confusion and has polarized the Social Security reform debate.

I would like your input as to the desirability and efficacy of seeking to improve the information contained in current Social Security Administration publications, and thereby enable Americans to better plan for their own retirement and to understand the benefits and costs that the current Social Security system will produce. Specifically, I would like your thoughts on legislation which I will soon introduce, the Social Security Right to Know Act, which aims to provide the public with clear and accessible information about Social Security's long-term financing challenges in order that they might better understand the consequences of a rapidly growing aging population, and the reality of the choices before us. This legislation would:

- Expand the Personal and Earnings and Benefits Statements (PEBES) to include information about the projected date of the program's first financing deficits as estimated by the Social Security Trustees, and the percentage of promised benefits that can be funded under current law.
- Require the Trustees' Report to include an estimate of Social Security's aggregate unfunded liability—i.e., the difference between the program's promised benefit outlays and its cash income over the long-range 75-year evaluation period—and the change in such amount from the previous year's estimates;
- Call on the Trustees to submit to Congress a separate summary publication that highlights salient data pertaining to Social Security's financing, identifying the first year that Social Security is projected to run a cash deficit, as well as the size of projected deficits;
- Expand PEBES statements and the annual Social Security Trustees' Report to include an explanation of the role of the Social Security Trust Funds as debt owed by the Federal Government, as opposed to an asset of the Federal Government;
- Broaden the public accessibility of the economic modeling employed by the Office of the Chief Actuary.

Answer. I share your concerns about the importance of making information about Social Security more accessible to the public. In recent years, the Social Security Administration has been working to address such concerns, and it has made some notable changes in its publications, in some cases to provide the sort of information you highlight in your proposal. As you may know, the 1999 technical panel of the Social Security Advisory Board recommended some additional changes to the presentation of information in the trustees' reports, and the Social Security Administration is now considering those recommendation. Clearly, further improvements in the materials provided by the Social Security Administration are desirable and could add substantially to the public's understanding of the program's long-run financial prospects. The Social Security Administration seems to be making good progress in that regard, and you may with to discuss your proposals with them.

RESPONSE FROM DAVID WILCOX

Question. Social Security has been historically distinct from, and has retained more political support than, other entitlement programs in that it was designed to be self-financing, with benefits provided by the program's own dedicated taxes. Are you concerned that a move towards general revenue financing of Social Security would undermine either the fiscal discipline that has previously been created through self-financing, or the political support that arises from all Americans being shown a direct relationship between their Social Security contributions and their own benefits? More directly, are you concerned by a policy that would end Social Security's historic design in a manner such that the benefits that it pays need no longer be limited to the value of the revenue that it collects?

Answer. The Administration's proposal is modest in scope, and rooted in fiscal discipline as well as program discipline. Fiscal discipline is achieved because the President's proposed lockbox would ensure that transfers will be financed out of on-budget surpluses, and therefore will be matched dollar-for-dollar by increases in government saving. Program discipline is achieved because Social Security benefits would continue to be tied to earnings subject to the payroll tax exactly as they are today. We do not believe that limited general revenue transfers would weaken the program's historical linkage between payroll taxes and benefits.

Beginning around 2010, the aging of the population will accelerate as the early baby-boom cohorts reach age 65, putting a strain on the Social Security retirement system. A transfer of some general revenues could ease this pressure. The transfers that the Administration has proposed be added to the trust fund between 2011 and 2050 would amount to less than 7 percent of projected program financing over the next 75 years. This relatively small amount of general revenue financing should not dilute the discipline imposed on the program from payroll tax financing.

Question. To the extent that Social Security's surplus contributes to Federal saving, the Social Security program is already fully credited under current law with that principal as well as the interest applied to such assumed saving. What economic rationale is there for providing Social Security's trust fund with additional credits, beyond those that measure its actual contribution to the Federal balance sheet?

Answer. The size of the proposed transfers to Social Security is motivated by the interest savings that would be realized from using the Social Security surpluses to pay down publicly held debt, rather than leaving those funds available for other purposes, as in the past. We are simply attributing that "fiscal dividend" back to Social Security. The bipartisan consensus that has now coalesced around using the Social Security surpluses exclusively for the purpose of paying down the debt held by the public is enormously important. The core economic principle underlying that bipartisan consensus, as well as our framework for general revenue transfers, is exactly the same: trust fund accumulations should reflect incremental government saving. By raising national saving, general revenue transfers and the associated debt reduction would increase the productive capacity of our economy, and thereby put us in a better position to meet our future obligations.

Question. Decades in advance, it is impossible to know in detail which Americans will be in greatest need of financial support, or the greater needs and priorities of the nation as a whole. Under current law, projections are that future generations will be required to provide a significantly greater share of their tax dollars to Federal programs for seniors than is the case today. If the Federal Government, in the near-term, does add to national saving by accumulating an on-budget surplus unrelated to Social Security, should future taxpayers be obligated to devote the gains of such saving to redeeming additional debt issued to elderly-support programs, or should they be left to determine the appropriate distribution of the benefits of debt relief among the national priorities of their time?

Answer. First, the Administration's proposal for general revenue transfers does not change the obligations of the Federal Government. These obligations already exist under current law.

Second, the President agrees with the need for structural reform in both Social Security and Medicare. The President has put forward a detailed plan for Medicare reform, and on innumerable occasions made clear his willingness to work with the Congress to put Social Security on a sound footing for the long term.

Third, the most important thing we can do now to address the upcoming demographic shifts is to use projected surpluses to reduce debt held by the public, increase national saving, and expand the productive capacity of the economy. We believe that using general revenue transfers to link debt reduction with the strengthening of Social Security and Medicare is the most effective way of accomplishing this. The future is uncertain, as you note, but no matter what happens in the future, the choices will be made easier by paying down the debt held by the public now.

Question. Currently, the Social Security administration performs calculations regarding the rate of return that different birth cohorts receive, relating their Social Security benefits to the value of payroll taxes contributed. Indeed, when crafting the Social Security program President Roosevelt, Social Security Board Chairman Arthur J. Altmeyer, and others very deliberately designed the system based on the dual principles of social adequacy and individual equity so that it would enjoy broad-based public support. And both President Roosevelt and Mr. Altmeyer were concerned that future beneficiaries ought not be obliged to pay more for their benefits than if they obtained similar insurance in the public sector.

Does the Administration share these concerns about generational and individual equity in seeking to put the OASDI program on sound financial footing? And how would you propose that such measurements of the system's fairness to different birth cohorts be modified in light of significant financing of benefits through incomes taxes and other revenues?

Answer. The Clinton Administration is very concerned about both generational and individual equity in the Social Security program. Measures comparing taxes and benefits are important in quantifying the distributional effects of Social Security.

However, for a number of reasons, these measures (such as money's worth ratios and internal rates of return) provide an incomplete picture of the value of Social Security to individuals. Social Security is a social insurance program, and as such performs a number of functions. In addition to providing retirement benefits, Social Security also provides disability and survivors' benefits. Moreover, the retirement benefits come in the form of an inflation-indexed annuity, which provides valuable insurance to individuals against both price risk and longevity risk. Inflation-indexed annuities are extremely rare in the private marketplace. Lastly, when the Social Security program first started, large amounts of benefits were quite deliberately and intentionally paid to generations that had contributed little to the program, but had endured the brunt of the Great Depression. That action implies that simple comparisons between taxes paid and benefits received are likely to be highly misleading.

Question. Issuing additional credit to the Social Security trust fund today is an intragovernmental transfer, and has no effect upon current public debt. However, it does create new gross debt for the Federal Government, which would presumably be redeemed through income taxes or other general revenue collections in the future. Under current law, the OASDI program is projected to be insolvent in 2034, meaning that Social Security's own taxes would need to be raised in order to finance promised benefits. If $1 trillion were transferred to the OASDI Trust Fund in 2010, would this in any way improve the projected cash revenues and outlays of the Social Security program in 2035? Or would there now simply exist an increased obligation of general taxes at that date? What would be the size of these increased commitments of general tax revenues in the years from 2034 and beyond?

Answer. The core economic principle of the Administration's proposal is to link Social Security transfers to debt reduction. Therefore, the Administration's proposed transfers to the trust fund would improve the balance sheet of the Social Security Trust Fund and the balance sheet of the Government as a whole by equal amounts. This would raise national saving and allow us to truly pre-fund for the coming demographic shifts, using the benefits of debt reduction to increase the future productive capacity of the economy. In turn, this would make it easier to meet our future obligations to Social Security.

Also, the transfers would not increase the future obligations of the Government. The obligation to pay future benefits exists under current law. The transfers proposed by the President would bring new resources into the Social Security trust fund, allowing it to better meet its existing commitment.

RESPONSE FROM DR. EUGENE STEUERLE

Question. Dr. Steuerle, I tend to agree with the testimony presented to the Committee today that absent structural reforms, the substantial "crediting" of general fund revenues to Social Security would give the illusion that Social Security had been strengthened in terms of trust fund "solvency"—while in reality do nothing to provide the actual resources necessary to meet the program's 2015 shortfall. And this may well lead to forestalling the serious decisions that must be made to guarantee the long-term, viability of Social Security.

And in a larger sense, it is my view that for too long, the nature and scope of Social Security's financing problems have been shrouded by inconsistent and incomplete information—such as an overemphasis on trust fund accounting—which has yielded much public confusion and has polarized the Social Security reform debate.

I would like your input as to the desirability and efficacy of seeking to improve the information contained in current Social Security Administration publications, and thereby enable Americans to better plan for their own retirement and to understand the benefits and costs that the current Social Security system will produce. Specifically, I would like your thoughts on legislation which I will soon introduce, the Social Security Right to Know Act, which aims to provide the public with clear and accessible information about Social Security's long-term financing challenges in order that they might better understand the consequences of a rapidly growing aging population, and the reality of the choices before us. This legislation would:

• Expand the Personal and Earnings and Benefits Statements (PEBES) to include information about the projected date of the program's first financing deficits as estimated by the Social Security Trustees, and the percentage of promised benefits that can be funded under current law.

• Require the Trustees' Report to include an estimate of Social Security's aggregate unfunded liability—i.e., the difference between the program's promised benefit outlays and its cash income over the long-range 75-year evaluation period—and the change in such amount from the previous year's estimates;

• Call on the Trustees to submit to Congress a separate summary publication that highlights salient data pertaining to Social Security's financing, identifying the first year that Social Security is projected to run a cash deficit, as well as the size of projected deficits;

• Expand PEBES statements and the annual Social Security Trustees' Report to include an explanation of the role of the Social Security Trust Funds as debt owed by the Federal Government, as opposed to an asset of the Federal Government;

• Broaden the public accessibility of the economic modeling employed by the Office of the Chief Actuary.

Answer. Many of the suggestions in the Social Security Right to Know Act relate to important information that is needed by the public. The Social Security Technical Panel on Methods and Assumptions, which I chaired, for instance, made similar recommendations on reporting on Social Security's aggregate unfunded liability. Some issues, however, are hard to deal with in legislation. For example, the Office of the Chief Actuary does open up much of its modeling over time for review, which was one of the main reasons for the appointment of the Technical Panel which I chaired. Some needed information may have to be developed by the Congressional Budget Office or the Office of Management and Budget, rather than Social Security (which does not have responsibility, for instance, for calculating many of the non-Social Security impacts of changes in work and saving on the budget).

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