1091

SOCIAL SECURITY

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE

AND THE

SUBCOMMITTEE ON MONETARY AND FISCAL POLICY

OF THE

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SOCIAL SECURITY

TUESDAY, SEPTEMBER 22, 1981

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in room 2325, Rayburn House Office Building, Hon. Lee H. Hamilton (member of the committee) presiding.

Present: Representatives Hamilton, Long, Heckler, and Rousselot.

Also present: James K. Galbraith, executive director; Charles H. Bradford, assistant director; Mary E. Eccles, Chris Frenze, Richard Vedder, and Fred Soldwedel, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, PRESIDING

Representative HAMILTON. The Joint Economic Committee will begin its session. Our topic this morning is the financial problems of the social security system. Budget Director David Stockman predicts by November 1982, "the most devastating bankruptcy in history will occur . . . severing the financial lifeline to 32 million retired Americans, dependents, and survivors." The array of projections surrounding these programs also tends to generate as much heat as light. Polls report widespread fears—and growing public cynicism—about the ability of social security to pay promised benefits.

The purpose of the hearing this morning is to help clarify the dimension of the current problems facing social security and to explain their sensitivity to overall economic performance. The immediate strains on social security are directly related to the high rates of inflation and unemployment of the recent past, which simultaneously increased the costs of benefits and reduced payroll tax revenues. By the same token, improved conditions will minimize the gaps.

Today's witnesses will assess how differing economic assumptions affect social security financing requirements over the next several years. If inflation and unemployment decline as the administration expects, are there any short-term imbalances in the social security system? What assumptions should guide congressional action on social security?

The hearing will also consider the economic implications of proposals for addressing social security's longer term problems, which result largely from demographic factors. While these strains won't be evident until after the turn of the century, when the post-war baby boom generation reaches retirement age, the solutions involve potentially costly changes in taxes or benefits that require some lead time.

Among the relevant questions for long-term policy: How reliable are the estimates of the long-term inbalances in the social security system? What are reasonable adjustment periods for any fundamental policy changes? What are the consequences of guessing wrong and making changes now that don't fit the circumstances of the future?

We have several witnesses this morning. The first is the Honorable Alice Rivlin, Director of the Congressional Budget Office. Ms. Rivlin, we are delighted to have you with us today.

Before proceeding, I'll take a moment to insert Representative Rousselot's written opening statement into the record, at his request, at this point. He will be here shortly.

[The written opening statement of Representative Rousselot follows:]

Written Opening Statement of Representative Rousselot

We Need Disposable Income, Not Disposable Retirees

Mr. Chairman, the Reagan Program for Economic Recovery is designed to provide additional income for working and retired Americans. Low taxes are essential for low costs and marketable production, a source of the Nation's income and standard of living.

According to "Social Security and Pensions," a Special Study on Economic Change written by this Committee, three-fifths of the Nations' elderly receive more than 50 percent of their income from Social Security. In every year since 1975, Social Security costs have exceeded revenues. Even taking into consideration the budgetary savings from the recently passed Reconciliation Act of 1981, the largest of the three trust funds, the Old Age and Survivors Insurance Trust Fund, from which eighty-five percent of Social Security benefits are paid, would not be able to meet its benefit obligations in a timely manner by early 1981 according to the mid-session 1981 Office of Management assumptions. If the Social Security Trustee Report's "worst case" assumptions resulted, this same trust fund would not be able to pay benefits on time by late 1982. Therefore, under the relatively more optimistic assumptions or more pessimistic assumptions, there is not much of a time range that we have to work with. Either of these assumptions point out the urgency of Congressional action now.

Future outlays look even more alarming. Today, three working Americans are contributing to the payment of one recipient. By 2025, the ratio of participating workers to beneficiaries will be two to one. It is presently estimated that over the next seventy-five years the Social Security cash benefit programs will have a deficit of $1.6 trillion—and this is under the actuaries best estimates. Unfortunately, these estimates are even higher when all three programs, including the Hospital Insurance program from which Medicare payments are made, are combined: possibly as much as a $6 trillion deficit over the entire 75 years.

If Social Security is to be a supplementary means of collectively providing for retirement needs in the future, the System's revenues must meet expenses. Due to the present financial predicament of the Social Security System—which has been losing $12,300 every minute—it is my belief that priority will have to be given to those actions which provide for benefits which are more reflective of the beneficiaries' contributions to the System. As you know, presently it is possible for some beneficiaries to receive a benefit in excess of their tax contributions.

The Social Security System must be put on a sound acturial basis with benefits commensurate to payments if the System is to provide partial retirement support. As Franklin Delano Roosevelt signed the Social Security Act in 1935 he said, "We have tried to frame a law that will give some measure of protection to the average citizen and to his family against poverty-ridden old age. . . ." It is incumbent upon Congress to take those necessary steps during the next few weeks to maintain that commitment.

Representative Hamilton. I understand you have a prepared statement. That statement, of course, will be entered into the record in full and you may proceed, Ms. Rivlin.

STATEMENT OF HON. ALICE M. RIVLIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE, ACCOMPANIED BY NANCY GORDON

Ms. RIVLIN. Thank you, Congressman Hamilton. I'm delighted to be here this morning. I will skip parts of my prepared statement in the interest of saving time, but I'm glad that it will all be in the record.

I'm very pleased to appear today to discuss the problems of the social security system in the context of overall economic performance. I plan to comment both on the effects that changing economic conditions may have on the financial soundness of the social security trust funds and on the net budgetary implications of several policy options for social security.

The social security system is a matter of concern today for two reasons: First, the balance in the Old Age and Survivors' Insurance Trust Fund—the largest of social security's three trust funds—has declined rapidly in recent years; without further congressional action, the OASI fund will be unable to pay benefits sometime late in 1982. Balances in the combined trust funds, which include disability insurance and hospital insurance as well as OASI, are considerably greater, but whether these reserves will prove adequate to insure payment of all benefits for the next 5 to 10 years depends largely on the performance of the economy.

Second, social security payments have been growing rapidly, in relation both to the gross national product and to the Federal budget, as shown in table 1 of my prepared statement. Social security outlays have increased from 2.3 percent of GNP in 1960 to a projected level of about 6 percent of GNP this year, Social security outlays now represent more than one-fourth of the total budget, and the CBO projects that they will account for nearly 30 percent of Federal spending by fiscal year 1984.

Achieving a balanced budget by 1984 will require major reductions in spending if no new taxes are to be imposed. Total spending for benefit payments to individuals will come to about $315 billion in 1981, and is expected to grow to almost $400 billion by 1984. Other major outlays in that year are expected to be $260 billion for defense and $85 billion for net interest costs. Since total revenues in 1984 are projected to be about $750 billion, a balanced budget would leave little room for other Federal spending unless benefits to individuals or spending for defense were to be reduced.

I won't review this history, which I think is familiar to the committee. The basic point is, of course, that when the Social Security Amendments of 1977 were passed, projections were made on reasonable assumptions about the economy, but the economy has not performed as well as was expected. We have had higher inflation and, more important, we have had low growth—indeed, in a couple of years, negative growth—in real wages, and this has put the trust funds into a difficult situation.

Reading again from my prepared statement, any set of economic assumptions is highly uncertain, and the uncertainty grows as the period of projection extends further into the future. Despite such reservations, however, the CBO has prepared two sets of 10-year projections of trust fund incomes, outlays, and balances, using two sets of economic assumptions.

The first set of assumptions is an extension of the CBO's baseline economic assumptions for the next 5 years. In this scenario, it is assumed that the trends in employment and growth projected through 1986 will continue through 1990. This set of assumptions is somewhat more optimistic than those used by the social security actuaries for the lower of their two intermediate economic paths.

The second set portrays a more pessimistic scenario, which builds on an alternative 3-year forecast constructed by Data Resources, Inc. Under this scenario, slow money growth conflicts with the administration's tax and spending policies to produce continued high levels of interest rates. Because nominal interest rates do not fall in line with the slower rate of inflation, real interest rates rise sharply in the early years. The result is significantly slower real growth than in the CBO baseline projection, and a growth rate in real wages comparable to that which occurred over the last decade.

I'd like to emphasize that we aren't predicting this more pessimistic cause of events. It is an illustration of what might happen if things went worse than we are assuming in the near term. Even this set of assumptions is not extremely pessimistic, however, in that it too assumes steady economic growth and declining rates of inflation. Both sets of assumptions are shown in appendix table B of my prepared statement.

Under the CBO's baseline projection, the three trust funds will continue to have a positive combined balance, although balances in the OASI fund will become negative in 1984 and will remain below zero for the rest of the decade, as shown in table 2 of my prepared statement. The combined balances of the three funds will continue to be low relative to total outlays, especially in 1984 through 1986. If borrowing among the three trust funds is authorized, however, the CBO projects at this time that trust fund balances would be just sufficient to allow payment of all benefits through 1990. Negative balances in the OASI fund will be offset by growth in the DI fund, and in the HI fund through 1987. After 1987, however, HI balances will begin to decline due to projected increases in hospital costs. By 1990, the combined balances of the three funds as a percent of outlays will also begin to fall.

Under the more pessimistic scenario, the financial condition of the trust funds would be considerably worse. Under these assumptions, balances in the combined funds would fall below the level needed to pay benefits some time in 1985. Combined balances would continue to decline through the rest of the decade, and they would fall below zero in 1989, as shown in table 3 of my prepared statement. As under the baseline assumptions, the situation would be most critical in the OASI fund, although the HI fund would also begin to decline rapidly after 1986 and would be depleted by 1990. The balance in the DI fund would continue to increase as a result of the higher tax rates for this fund enacted in 1977. The growth in this fund's balance, however, would not offset the declines in the other two.

In short, although the CBO currently projects that the combined trust funds will maintain an aggregate balance sufficient to allow expected benefits to be paid over the next decade, the margin for error is very small. If economic conditions—especially real wage growth—are even slightly worse than now projected, legislative action beyond the authorization of interfund borrowing would probably be necessary to insure the viability of the system.

Four major types of action could be taken with respect to the social security trust funds. First, the Congress could choose to make no changes beyond the adoption of interfund borrowing. Some risks are inherent in this strategy, however, given the sensitivity of trust fund balances to adverse economic conditions and the very small margins for error anticipated over the next decade. Further, since social security does represent a long-term commitment that affects people's plans, making decisions about changes in the system as early as possible is desirable to allow potential beneficiaries some time to adjust.

Transfers to the social security trust funds from other parts of the budget represent a second possible course of action. One such plan—financing of one-half of HI benefits from general revenues, with the reallocation of about one-half of HI taxes to the other two funds—has been proposed by Representative Pickle. The CBO estimates that this would result in about $21 billion in additional revenues to the OASDI funds in fiscal year 1983, and about $100 billion through 1986. This amount would be enough to raise the combined reserve ratio to more then 40 percent by 1986. A change of this type would be simply a reallocation within the unified budget, however, and would not contribute either to balancing the budget or to reducing the growth of Government spending.

A third type of option would generate additional trust fund revenues through tax increases. This could be accomplished by further increasing the social security tax rates, by raising the taxable wage base, or by taxing a portion of social security benefits and allocating the resulting revenues to the trust funds. Any of these options could be designed to restore financial soundness to the system, and all would move toward a balanced budget. Such tax increases might, however, have negative effects on labor supply and work incentives, and would do nothing to decrease the size of the Government sector.

Reductions in benefit payments are the fourth possible course of action and the only one that would both contribute to a balanced budget and help to reduce the growth of Government spending. So far, most social security benefit reductions—such as those in reconciliation—have applied only to specific and relative by small groups of beneficiaries. Examples of further cuts of this type might include the cancellation of the earnings test exemption for workers between 70 and 72 years old scheduled to become effective in 1983, the elimination of benefits for otherwise unentitled parents of entitled children over 6 years old, and the extension of the family maximum benefits rates now applied to disability cases to retired worker and survivor families as well. Each of these proposals would save about $2 billion to $3 billion over the next 5 years, and total savings would be small relative to trust fund outlays. Only relatively few beneficiaries would be affected, but reductions for many of these people would be very large.

In contrast, broad-scale benefit reductions affecting all beneficiaries in the same way would produce much greater savings and would not disproportionately affect specific recipients. Such benefit reductions could be designed to affect new beneficiaries only, or they could apply to both current and prospective beneficiaries.

Shortrun savings would generally be limited for changes that affected only new beneficiaries, since even new beneficiaries would need some warning of major reductions. Longer run savings, however, could be very large. Examples of this type of proposal would include raising the age of retirement, reducing incentives for early retirement, and changing the formula used to calculate initial social security benefits. Proposals to raise the retirement age almost all include lengthy phase-in periods, so there would be no immediate savings. On the other hand, the administration's plan to reduce incentives for early retirement by lowering benefits for workers retiring at age 62 to 55 percent of the full benefit could save up to $17.6 billion by 1986. This proposal could seriously disrupt the retirement plans of people now nearing 62, however, if it were implemented without a phase-in period. The administration's proposal to index the "bend points" in the social security benefit computation formula by only 50 percent of the rise in covered wages over the next 5 years would be less disruptive. It would also produce substantial longrun savings—enough, in fact, to offset almost entirely the projected longrun deficit in the system. Savings through 1986 under this proposal would be about $4 billion.

Much larger shortrun savings would result from changes in the way social security benefits are indexed—an approach that would affect current as well as prospective beneficiaries. Since benefit increases would be smaller for all recipients, immediate savings would be large. Benefits in relation to contributions would also differ less for workers retiring in different years than they would under proposals affecting new beneficiaries only. In addition, many observers believe that social security benefits have been overindexed in the recent past, because of both the now-corrected technical flaw in the social security benefit formula and the way homeownership costs are treated in the CPI. Further, prices have risen faster than wages over the last 3 years, which means that incomes of workers have declined relative to those received by social security beneficiaries.

On the other hand, large reductions in the cost-of-living adjustment could create substantial hardships for those among the elderly with relatively low benefits and little other income. This would be especially likely if the changes applied not only to social security but also to means-tested entitlement programs such as supplemental security income.

Benefit outlays could be reduced through indexing changes in several ways. Cost-of-living increases could be postponed for a short period, an index other than the CPI could be used to calculate COLA's, or somewhat less than the total increase in the CPI could be used to adjust benefits. A 3-month postponement of the COLA, from July to the start of the fiscal year in October, would save an estimated $2.9 billion in 1982. If this change were made permanent, total savings through 1986 would be $14 billion to $15 billion. Using the lower of wage and price increases to index benefits would save nothing in 1982, wages and prices are expected to increase at similar rates, although this option would help to maintain trust fund balances if real wages fell in the future—it would have saved a lot if we had done it this year. Finally, if benefits were simply increased less than the full amount of the CPI, savings in the immediate future would probably also be less than under the proposal to postpone the COLA. Savings could be very large, however, if the cut in the COLA were repeated over several years. If the COLA were restricted to 85 percent of CPI in each of the next 5 years, cumulative savings through 1986 would be about $22 billion.

In summary, the performance of the economy is crucial to the financial position of the social security trust funds. Under the CBO's baseline assumptions, interfund borrowing alone will be just sufficient to allow benefits to be paid in a timely fashion throughout the 1980's. On the other hand, under slightly more pessimistic assumptions, trust fund balances are projected to decline below a viable level by the middle of the decade. Under these circumstances, either additional revenues to the trust funds or reductions in benefits will be necessary. Moreover, if the size of the Federal budget is to decrease relative to the GNP, and substantial growth in spending for defense is to occur, reductions in social security benefits will almost certainly be needed.

Thank you, Congressman Hamilton.

Representative HAMILTON. Thank you, Ms. Rivlin.

[The prepared statement of Ms. Rivlin follows:]

Prepared Statement of Hon. Alice M. Rivlin

Mr. Chairman, I am pleased to appear today to discuss the problems of the Social Security system in the context of overall economic performance. I plan to comment both on the effects that changing economic conditions may have on the financial soundness of the Social Security trust funds, and on the net budgetary implications of several policy options for Social Security.

The Social Security system is a matter of concern today for two reasons. First, the balance in the Old Age and Survivors' Insurance (OASI) trust fund--the largest of Social Security's three trust funds--has declined rapidly in recent years; without further Congressional action, the OASI fund will be unable to pay benefits sometime late in 1982. Balances in the combined trust funds, which include Disability Insurance (DI) and Hospital Insurance (HI) as well as OASI, are considerably greater, but whether these reserves will prove adequate to ensure payment of all benefits for the next five to ten years depends largely on the performance of the economy.

Second, Social Security payments have been growing rapidly, both in relation to the Gross National Product (GNP) and to the federal budget (see Table 1). Social Security outlays have increased from 2.3 percent of GNP in 1960 to a projected level of about 6 percent of GNP this year. Social Security outlays now represent more than one-fourth of the total budget, and the CBO projects that they will account for nearly 30 percent of federal spending by fiscal year 1984.

Achieving a balanced budget by 1984 will require major reductions in spending if no new taxes are to be imposed. Total spending for benefit payments to individuals will come to about $315 billion in 1981, and is expected to grow to almost $400 billion by 1984. Other major outlays in that year are expected to

TABLE 1. TOTAL OLD AGE, SURVIVORS, DISABILITY, AND HOSPITAL INSURANCE (OASDHI) OUTLAYS AS A PERCENT OF THE FEDERAL BUDGET AND OF GROSS NATIONAL PRODUCT (in billions of dollars)

Year	OASDHI Outlays	Percent of Federal Budget	Percent of GNP
		Actual	
1950	.8	1.9	.3
1960	11.7	12.7	2.3
1970	36.8	18.7	3.8
1975	78.4	24.2	5.4
1980	152.1	26.2	5.9
		Projected	
1981	169.0	25.6	6.0
1982	190.6	26.6	6.0
1983	210.0	27.9	6.0
1984	231.0	28.9	5.9

NOTE: Projected figures based on CBO economic assumptions, September 1981.

be $260 billion for defense and $85 billion for net interest costs. Since total revenues in 1984 are projected to be about $750 billion, a balanced budget would leave little room for other federal spending unless benefits to individuals or spending for defense were to be reduced.

SOCIAL SECURITY IN THE RECENT PAST

This is the second time in four years that the Social Security system has faced projections of dangerously low reserves. When the Social Security Amendments of 1977 were passed, most analysts believed that financial soundness was guaranteed for the OASI and DI funds for at least the next several decades. At that time, the Social Security Administration's actuaries recognized that, under their economic assumptions, the margin for error in the trust funds would be quite small for at least the next five years. The economy's performance has in fact been significantly worse than was projected, resulting in Social Security's current funding difficulties.

A comparison of actual experience with the economic assumptions used by the Social Security actuaries to project trust fund balances illustrates these problems (see Appendix Table A). The 1977 Trustees' Report, for example, projected an increase in the Consumer Price Index (CPI) of 5.3 percent in 1979 and 4.7 percent in 1980. The actual increases in those two years, however, were 11.3 percent and 13.5 percent, respectively.

Inflation raises trust fund outlays because benefit amounts are linked to the CPI, but in the past such increases have been offset by increased revenue increases resulting from higher wages. In 1979 and 1980, however, prices rose faster than wages, so that real wages declined by about 2 percent in 1979 and by 5 percent in 1980. The 1977 Trustees' Report, in contrast, had projected real wage increases of 2.5 and 2.4 percent for those two years. In fact, real wage growth has been much lower and inflation considerably higher than was anticipated even under the "pessimistic" set of economic assumptions used by the Social Security actuaries to project trust fund balances at the time of the 1977 Amendments.

The trust funds would have even greater financing problems were it not for the large--and to some extent unanticipated--growth in the labor force that has occurred over the last decade, and that has helped to increase tax revenues to the funds. This growth may, however, contribute to the long-run financing problems of the system when the time comes for this exceptionally large cohort of workers to retire.

Despite unprecedented growth in the labor force, the economy's failure to perform as well as projected has resulted in substantially lower trust fund balances than had been expected.

The combined OASI and DI trust funds' reserves at the beginning of calendar year 1981 amounted to 18 percent of annual outlays, compared with the 21 percent anticipated in the 1978 Trustees' Report. Trust fund reserves as low as this are a cause for some concern. A minimum reserve of 9 to 12 percent of annual outlays must be on hand at all times in order to pay benefits without delays and much larger reserves would be needed to provide a cushion against adverse economic conditions.

Given Social Security's sensitivity to economic performance, prudent budgeting may call for much larger trust fund reserves than have been realized in the recent past or than are currently anticipated. Without these reserves, frequent or sudden program changes may be required. In a program that represents a long-term commitment around which people plan their lives, such changes can cause substantial hardship and may undermine overall public confidence in the system. Larger reserves--such as the 75 percent of annual outlays recommended by the 1979 Advisory Council on Social Security--would insulate the Social Security programs from the consequences of unexpectedly poor economic performance.

SENSITIVITY OF THE TRUST FUND BALANCES TO ECONOMIC CONDITIONS

Any set of economic assumptions is highly uncertain, and the uncertainty grows as the period of projection extends further into the future. Despite such reservations, however, the CBO has prepared two sets of ten-year projections of trust fund incomes, outlays, and balances, using two sets of economic assumptions (see Tables 2 and 3).

The first set of assumptions is an extension of the CBO's baseline economic assumptions for the next five years. In this scenario, it is assumed that the trends in employment and growth projected through 1986 will continue through 1990. This set of assumptions is somewhat more optimistic than those used by the Social Security actuaries for the lower of their two intermediate economic paths.

The second set portrays a more pessimistic scenario, which builds on an alternative three-year forecast constructed by Data Resources, Inc. Under this scenario, slow money growth conflicts with the Administration's tax and spending policies to produce continued high levels of interest rates. Because nominal interest rates do not fall in line with the slower rate of inflation, real interest rates rise sharply in the early years. The result is significantly slower real growth than in the CBO baseline projection, and a growth rate in real wages comparable to that which occurred over the last decade. Even this set of assumptions is not extremely pessimistic, however, in that it too assumes steady economic growth and declining rates of inflation. (Both sets of assumptions are shown in Appendix Table B).

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TABLE 2. PROJECTIONS OF SOCIAL SECURITY TRUST FUND OUTLAYS, INCOMES, AND BALANCES, BY FISCAL YEAR (In Billions of dollars): BASED ON CBO ECONOMIC ASSUMPTIONS

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
				OASI						
Outlays	122.5	138.1	151.8	166.2	181.3	196.8	214.2	232.8	253.8	276.5
Income[a]	122.6	128.7	140.4	154.1	172.8	190.0	205.4	222.7	239.1	271.4
Year-End Balance	24.7	15.2	3.8	-8.3	-16.8	-23.7	-32.5	-42.6	-57.3	-62.5
Start-of-Year Balance (as Percent of Outlays)	20.1	17.9	10.0	2.3	-4.6	-8.6	-11.1	-14.0	-16.8	-20.7
				DI						
Outlays	17.5	19.3	20.0	21.0	22.3	24.2	25.7	27.8	29.7	32.0
Income[a]	13.3	21.8	26.0	29.2	36.1	41.8	46.6	52.0	57.6	70.1
Year-End Balance	3.4	6.0	11.9	20.1	33.9	51.5	72.4	96.6	124.5	162.6
Start-of-Year Balance (as Percent of Outlays)	43.9	17.8	29.9	56.8	90.0	139.9	200.5	260.6	324.9	389.2
				HI						
Outlays	29.0	33.2	38.2	43.8	50.1	57.0	64.8	73.6	83.6	94.9
Income[a]	33.0	38.4	42.8	47.3	53.1	61.3	67.4	73.0	78.0	82.8
Year-End Balance	18.4	23.7	28.3	31.8	34.9	39.2	41.8	41.2	35.8	23.5
Start-of-Year Balance (as Percent of Outlays)	49.9	55.6	62.0	64.6	63.6	61.2	60.5	56.8	49.3	37.5
				OASDHI						
Outlays	169.0	190.6	210.0	231.0	253.7	278.0	304.7	334.2	367.1	403.4
Income[a]	168.8	188.9	209.1	230.6	262.0	293.1	319.4	347.7	374.7	424.3
Year-End Balance	46.5	44.9	44.1	43.7	51.9	67.0	81.7	95.0	102.8	123.6
Start-of-Year Balance (as Percent of Outlays)	27.7	24.4	21.4	19.1	17.2	18.7	22.0	24.5	25.9	25.5

SOURCE: CBO. Based on CBO's preliminary economic assumptions. Includes the effects of the Omnibus Reconciliation Bill of 1981.

NOTE: Minus sign denotes a deficit.

a. Income to the trust funds is budget authority. It includes payroll tax receipts, interest on balances, and certain general fund transfers.

TABLE 3. PROJECTIONS OF SOCIAL SECURITY TRUST FUND OUTLAYS, INCOMES, AND BALANCES, BY FISCAL YEAR (In Billions of dollars): BASED ON PESSIMISTIC ECONOMIC ASSUMPTIONS

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
				OASI						
Outlays	122.5	138.3	152.4	166.7	181.6	197.6	214.2	232.1	252.2	274.2
Income[a]	121.5	127.1	137.5	147.6	163.9	179.0	192.6	208.7	224.2	254.9
Year-End Balance	23.6	12.5	-2.4	-21.6	-39.3	-57.6	-79.1	-102.5	-130.5	-149.7
Start-of-Year Balance (as Percent of Outlays)	20.1	17.1	8.2	-1.5	-11.9	-19.9	-26.9	-34.1	-40.6	-47.6
				DI						
Outlays	17.5	19.3	20.1	21.1	22.3	24.2	25.6	27.6	29.4	31.6
Income[a]	13.2	21.6	25.4	28.1	34.4	39.7	44.1	29.4	54.8	66.8
Year-End Balance	3.3	5.7	11.1	18.0	30.1	45.7	64.2	85.9	111.3	146.5
Start-of-Year Balance (as Percent of Outlays)	43.9	17.4	28.3	52.4	80.7	124.4	178.3	232.5	291.9	352.4
				HI						
Outlays	29.0	33.2	38.2	43.8	50.1	57.0	64.7	73.5	83.4	94.7
Income[a]	32.7	38.0	42.0	45.5	50.6	58.1	63.6	68.7	73.2	78.2
Year-End Balance	18.1	22.9	26.6	28.3	28.8	30.0	28.8	24.0	13.8	-2.7
Start-of-Year Balance (as Percent of Outlays)	49.9	54.6	59.8	60.7	56.7	50.6	46.3	39.2	28.8	14.6
				OASDHI						
Outlays	169.0	190.8	210.7	231.7	254.1	278.5	304.5	333.1	365.1	400.5
Income[a]	167.3	186.7	204.9	221.2	249.0	276.9	300.3	326.7	352.2	400.0
Year-End Balance	45.1	41.0	35.2	24.8	19.7	18.0	13.8	7.5	-5.4	-5.9
Start-of-Year Balance (as Percent of Outlays)	27.7	23.6	19.5	15.2	9.7	7.1	5.9	4.2	2.0	-1.3

SOURCE: CBO. Includes the effects of the Omnibus Reconciliation Bill of 1981.

NOTE: Minus sign denotes a deficit.

a. Income to the trust funds is budget authority. It includes payroll tax receipts, interest on balances, and certain general fund transfers.

Under the CBO's baseline projection, the three trust funds will continue to have a positive combined balance, although balances in the OASI fund will become negative in 1984 and will remain below zero for the rest of the decade. The combined balances of the three funds will continue to be low relative to total outlays, especially in 1984 through 1986. If borrowing among the three trust funds is authorized, however, the CBO projects at this time that trust fund balances would be just sufficient to allow payment of all benefits through 1990. Negative balances in the OASI fund will be offset by growth in the DI fund, and in the HI fund through 1987. After 1987, however, HI balances will begin to decline due to projected increases in hospital costs. By 1990 the combined balances of the three funds as a percent of outlays will also begin to fall.

Under the pessimistic scenario, the financial condition of the trust funds would be considerably worse. Under these assumptions, balances in the combined funds would fall below the level needed to pay benefits some time in 1985. Combined balances would continue to decline through the rest of the decade, and they would fall below zero in 1989. As under the baseline assumptions, the situation would be most critical in the OASI fund, although the HI fund would also begin to decline rapidly after 1986 and would be depleted by 1990. The balance in the DI fund would continue to increase as a result of the higher tax rates for this fund enacted in 1977. The growth in this fund's balance, however, would not offset the declines in the other two.

In short, although the CBO currently projects that the combined trust funds will maintain an aggregate balance sufficient to allow expected benefits to be paid over the next decade, the margin for error is very small. If economic conditions--especially real wage growth--are even slightly worse than now projected, legislative action beyond the authorization of interfund borrowing would probably be necessary to ensure the viability of the system.

OPTIONS FOR THE FUTURE

Four major types of action could be taken with respect to the Social Security trust funds. First, the Congress could choose to make no changes beyond the adoption of interfund borrowing. Some risks are inherent in this strategy, however, given the sensitivity of trust fund balances to adverse economic conditions and the very small margins for error anticipated over the next decade. Further, since Social Security does represent a long-term commitment that affects people's plans, making decisions about changes in the system as early as possible is desirable to allow potential beneficiaries some time to adjust.

Transfers to the Social Security trust funds from other parts of the budget represent a second possible course of action. One such plan--financing of one-half of HI benefits from general revenues, with the reallocation of about one half of HI taxes to the other two funds--has been proposed by Representative Pickle.

The CBO estimates that this would result in about $21 billion in additional revenues to the OASDI funds in fiscal year 1983, and about $100 billion through 1986. This amount would be enough to raise the combined reserve ratio to more than 40 percent by 1986. A change of this type would be simply a reallocation within the unified budget, however, and would not contribute either to balancing the budget or to reducing the growth of government spending.

A third type of option would generate additional trust fund revenues through tax increases. This could be accomplished by further increasing the Social Security tax rates, by raising the taxable wage base, or by taxing a portion of Social Security benefits and allocating the resulting revenues to the trust funds. Any of these options could be designed to restore financial soundness to the system, and all would move toward a balanced budget. Such tax increases might, however, have negative effects on labor supply and work incentives, and would do nothing to decrease the size of the government sector.

Reductions in benefit payments are the fourth possible course of action and the only one that would both contribute to a balanced budget and help to reduce the growth of government spending. So far, most Social Security benefit reductions have applied only to specific and relatively small groups of beneficiaries. Examples of further cuts of this type might include the cancellation of the earnings test exemption for workers between 70 and 72 years old, the elimination of benefits for otherwise unentitled parents of entitled children over 6 years old, and the extension of the family maximum benefit rates now applied to disability cases to retired worker and survivor families as well. Each of these proposals would save about $2 billion to $3 billion over the next five years, and total savings would be small relative to trust fund outlays. Only relatively few beneficiaries would be affected, but reductions for many of these people would be very large.

In contrast, broad-scale benefit reductions affecting all beneficiaries in the same way would produce much greater savings and would not disproportionately affect specific recipients. Such benefit reductions could be designed to affect new beneficiaries only, or they could apply to both current and prospective beneficiaries.

Short-run savings would generally be limited for changes that affected only new beneficiaries, since even new beneficiaries would need some warning of major reductions. Longer-run savings, however, could be very large. Examples of this type of proposal would include raising the age of retirement, reducing incentives for early retirement, and changing the formula used to calculate initial Social Security benefits. Proposals to raise the retirement age almost all include lengthy phase-in periods, so there would be no immediate savings. On the other hand, the Administration's plan to reduce incentives for early retirement by lowering benefits for workers retiring at age 62 to 55 percent of the full benefit could save up to $17.6 billion by 1986. This proposal could seriously disrupt the retirement plans of people now nearing 62, however, if it were implemented without a phase-in period. The Administration's proposal to index the "bend points" in the Social Security benefit computation formula by only 50 percent of the rise in covered wages over the next five years would be less disruptive. It would also produce substantial long-run savings--enough, in fact, to offset almost entirely the projected long-run deficit in the system. Savings through 1986 under this proposal would be about $4 billion.

Much larger short-run savings would result from changes in the way Social Security benefits are indexed--an approach that would affect current as well as prospective beneficiaries. Since benefit increases would be smaller for all recipients, immediate savings would be large. Benefits in relation to contributions would also differ less for workers retiring in different years than they would under proposals affecting new beneficiaries only.

In addition, many observers believe that Social Security benefits have been overindexed in the recent past, because of both the now-corrected technical flaw in the Social Security benefit formula and the way homeownership costs are treated in the CPI. Further, prices have risen faster than wages over the last three years, which means that incomes of workers have declined relative to those received by Social Security beneficiaries.

On the other hand, large reductions in the cost-of-living adjustment (COLA) could create substantial hardships for those among the elderly with relatively low benefits and little other income. This would be especially likely if the changes applied not only to Social Security but also to means-tested entitlement programs such as Supplemental Security Income (SSI).

Benefit outlays could be reduced through indexing changes in several ways. Cost-of-living increases could be postponed for a short period, an index other than the CPI could be used to calculate COLAs, or somewhat less than the total increase in the CPI could be used to adjust benefits. A three-month postponement of the COLA, from July to the start of the fiscal year in October, would save an estimated $2.9 billion in 1982. If this change were made permanent, total savings through 1986 would be $14 billion to $15 billion. Using the lower of wage and price increases to index benefits would save nothing in 1982, since wages and prices are expected to increase at similar rates, although this option would help to maintain trust fund balances if real wages fell in the future. Finally, if benefits were simply increased less than the full amount of the CPI, savings in the immediate future would probably also be less than under the proposal to postpone the COLA. Savings could be very large, however, if the cut in the COLA were repeated over several years. If the COLA were restricted to 85 percent of the CPI in each of the next five years, cumulative savings through 1986 would be about $22 billion.

CONCLUSION

In summary, the performance of the economy is crucial to the financial position of the Social Security trust funds. Under the CBO's baseline assumptions, interfund borrowing alone will be just sufficient to allow benefits to be paid in a timely fashion throughout the 1980s. On the other hand, under slightly more pessimistic assumptions, trust fund balances are projected to decline below a viable level by the middle of the decade. Under these circumstances, either additional revenues to the trust funds or reductions in benefits will be necessary. Moreover, if the size of the federal budget is to decrease relative to the GNP, and substantial growth in spending for defense is to occur, reductions in Social Security benefits will almost certainly be needed.

APPENDIX TABLE A. COMPARISON OF SOCIAL SECURITY ADMINISTRATION TRUSTEES' INTERMEDIATE ECONOMIC ASSUMPTIONS WITH ACTUAL EXPERIENCE (in Percents)

Trustees' Report	Average Unemployment Rate	Increase in CPI	Increase in Average Covered Wages	Real Wage Increase
		For 1977		
1977 Report	7.1	6.0	8.4	2.4
1978 Report	7.0	6.5	7.7	1.2
Actual Experience	7.0	6.5	7.3	0.8
		For 1978		
1977 Report	6.3	5.4	8.1	2.7
1978 Report	6.3	6.1	7.2	1.1
1979 Report	6.0	7.6	8.5	0.9
Actual Experience	6.0	7.6	8.0	0.4
		For 1979		
1977 Report	5.7	5.3	7.8	2.5
1978 Report	5.9	6.1	7.9	1.8
1979 Report	6.0	9.4	8.3	-1.1
1980 Report	5.8	11.5	8.4	-3.1
Actual Experience	5.8	11.3	9.3	-2.0
		For 1980		
1977 Report	5.2	4.7	7.1	2.4
1978 Report	5.4	5.7	7.9	2.2
1979 Report	6.2	7.4	8.0	0.6
1980 Report	7.2	14.2	9.6	-4.6
Actual Experience	7.2	13.5	8.5	-5.0

SOURCE: Office of the Actuary, Social Security Administration

NOTE: Minus sign denotes decrease.

APPENDIX TABLE B. ECONOMIC ASSUMPTIONS UNDER TWO SCENARIOS, FISCAL YEAR 1981-1990 (in Percents)

Fiscal Year	Change in Real GNP	Unemployment Rate	Change in CPI	Treasury Bill Rate	Change in Real Wages[a]
1981					
CBO Baseline	1.6	7.4	11.0	14.6	-1.4
Pessimistic	1.4	7.4	10.9	14.6	-1.9
1982					
CBO Baseline	2.7	7.4	7.8	12.7	.3
Pessimistic	1.3	7.6	8.1	14.5	-.7
1983					
CBO Baseline	4.1	7.0	7.0	11.8	1.4
Pessimistic	3.2	7.3	7.2	14.6	-.2
1984					
CBO Baseline	4.0	6.6	6.4	10.4	2.0
Pessimistic	2.2	7.3	6.2	13.6	1.0
1985					
CBO Baseline	3.8	6.3	6.0	9.4	1.3
Pessimistic	3.0	7.2	6.0	12.6	1.0
1986					
CBO Baseline	3.4	6.1	5.9	8.8	1.2
Pessimistic	3.0	7.1	5.7	11.5	2.2
1987					
CBO Baseline	3.1	6.0	5.8	8.1	1.3
Pessimistic	3.0	7.1	5.4	10.6	1.7
1988					
CBO Baseline	2.9	6.0	5.6	8.1	1.2
Pessimistic	2.9	7.0	5.8	9.6	1.7
1989					
CBO Baseline	2.8	6.0	5.6	7.8	1.1
Pessimistic	2.8	7.0	5.6	8.7	1.7
1990					
CBO Baseline	2.7	6.0	5.6	7.6	1.0
Pessimistic	2.7	7.0	5.6	8.1	1.1

SOURCE: Congressional Budget Office

a. Change in real average covered wages calculated on a calendar year basis.

Representative HAMILTON. Ms. Rivlin, we appreciate the excellent statement you've made for us.

What's a reasonable margin of safety in these reserves? What do most of the experts think about that?

Ms. RIVLIN. Well, it's hard to say. A minimum amount is usually thought to be 9 to 12 percent—probably 12 or a little more—to be really sure that you can pay the benefits every month.

Representative HAMILTON. That's 9 to 12 percent of what?

Ms. RIVLIN. The balances should be 9 to 12 percent of the total excepted outlays for the next year. At the beginning of the month you pay out all the benefits for the month, and in order to be able to do that, since the revenues come in over the month, you have to have some balance in the trust fund.

Representative HAMILTON. Now in your baseline assumption you say that the interfund borrowing will just be sufficient to allow benefits to be paid in a timely fashion. I suppose there you have very little, if any, margin of safety; is that right?

Ms. RIVLIN. That's right. That would be saying that if the economy performed worse than is now expected, then you would have to do something about it.

Representative HAMILTON. As your baseline assumptions line up, could you tell me how those assumptions—how would you describe those assumptions? Are they set out somewhere in your statement?

Ms. RIVLIN. Yes, they are in appendix table B of my prepared statement, describe them as moderately optimistic. If you look at appendix table B, you will see that, for 1983 and beyond, we're assuming real growth in the Gross National Product at 4 percent, declining slightly by the end of the decade to about 2.7 percent. But to sustain that level of real growth through an entire decade would be very good luck indeed.

Representative HAMILTON. I'm having a little trouble with this appendix table B. You have the CBO baseline for 1981 and 1982, then you have underneath that the pessimistic—that's the pessimistic projection? The baseline is the somewhat optimistic projection; is that right?

Ms. RIVLIN. Yes. The baseline is essentially an extension of what is now our shortrun forecast for the economy. It's saying that we, along with others, are relatively optimists about the economy for the next several years.

Representative ROUSSELOT. Would the gentleman yield?

Representative HAMILTON. Yes. Congressman Rousselot.

Representative ROUSSELOT. When you say, "we," are you speaking of CBO?

Ms. RIVLIN. Yes.

Representative ROUSSELOT. That's your best projection in a little more optimistic fashion?

Ms. RIVLIN. Well, I don't know what you mean by "more optimistic."

Representative ROUSSELOT. More optimistic than some of the other projections we have heard.

Ms. RIVLIN. It's a little less optimistic that the Administration's in the short run. I would characterize it as a forecast that we think is likely; but in a world of uncertainty, things might be worse.

Representative ROUSSELOT. What do you mean by pessimistic? Is that your pessimistic projection or somebody else's?

Ms. RIVLIN. Well, as I explained in my prepared statement, we used a second alternative set of forecasts, which is characterized here as pessimistic. We made that up. We took a path that had been used by Data Resources, Inc., as one of theirs, and then ran it out.

Representative ROUSSELOT. So Data Resources helped you formulate your pessimistic projection?

Ms. RIVLIN. DRI didn't help us. We just picked a forecast that they happened to have done. What it shows is slightly lower rates of real growth in the near term.

Representative ROUSSELOT. How close is your pessimistic projection compared to the most pessimistic one issued by the social security trustees?

Ms. RIVLIN. Their worst case is more pessimistic than ours.

Representative ROUSSELOT. OK.

Ms. RIVLIN. Our so-called pessimistic case is close to the lower of the Social Security Administration's intermediate ones I believe. Let me ask Ms. Gordon if that's right. I didn't introduce her, but Nancy Gordon is here with me.

Ms. GORDON. The pessimistic path here isn't really comparable to any of the ones in the actuaries' path.

Representative HAMILTON. If you take the administration's economic projections for the near term, then you've got no problem at all in the social security trust funds?

Ms. RIVLIN. I don't know what the administration has done about running it out, but in the near term——

Representative HAMILTON. In the short term?

Ms. RIVLIN. In the short term, the administration shows a higher growth rate than we do for 1982 and 1983 and a lower inflation rate. So, according to the administration's projection, the funds would be in better shape than we show.

Representative HAMILTON. And there would be no need under those circumstances for the Congress to take any action at all? The margin of safety would be adequate?

Ms. RIVLIN. No action except for interfund borrowing.

Representative HAMILTON. Even under the administration's projection you would need interfund borrowing?

Ms. RIVLIN. That's right.

Representative Hamilton. For 1982?

Ms. RIVLIN. Right.

Representative HAMILTON. Now, Mr. Myers, in the newspaper this morning, Mr. Robert Myers, says that we are going to run out of money this winter. I take it you don't agree with that observation. I think you said we would run out of money in 198–, what did you say?

Ms. RIVLIN. I'm not sure what Bob Myers means by winter, but if no action is taken——

Representative HAMILTON. That means before spring, I think, in 1982.

Ms. RIVLIN. It's clear that if no action is taken on interfund borrowing, the Old Age and Survivors' trust fund will be in trouble within the next year. So everybody is agreed on that. I don't think that's an issue.

Representative ROUSSELOT. Everybody is agreed on that?

Ms. RIVLIN. Yes, as far as I know. It's nice to have something everybody is agreed on.

Representative HAMILTON. Let me ask you a question about the bend points and the impact that has on a monthly check, if you can figure it that way. You talk about the possibility of changing the bend points—I guess that's the administration's recommendation—in the benefit computation formula. Their recommendation is you change that by—well, you would permit the index to be 50 percent of the rise in covered wages. What kind of impact does that have on the monthly check of most beneficiaries? Can you translate that for me?

Ms. RIVLIN. It reduces it slightly for people retiring after the damage had been instituted.

Representative HAMILTON. Slightly or substantially?

Ms. RIVLIN. Well, roughly speaking, instead of getting about a 43-percent replacement rate of the computed prior wages, the rate would go down to about 37 or 38 percent.

Representative HAMILTON. Can you put that into dollars for me? What's the average benefit of social security and what would it do to the average benefit?

Ms. GORDON. I think the average benefit for a retired worker is around $350 a month now. The thing about this change in benefits to bear in mind is that it would affect only new beneficiaries. People who are already retired have already had their benefits calculated and so, as time passed—for example, by 1987—changing the bend point indexation that way would lower the average benefit by about 10 percent.

Representative ROUSSELOT. You mean increase?

Ms. GORDON. If you think in current dollars right now, the reduction would be perhaps $35 a month.

Ms. RIVLIN. The other thing to remember about bend points is they affect the people at the top of the income scale more than those at the bottom. The people who have low benefits—below the lowest bend point—would not be affected.

Representative HAMILTON. Let me ask one other question. How much do we save as a result of the budget reconciliation measures we passed, the program changes there? How much of the social security is saved?

Ms. GORDON. About $7.2 or $7.3 billion.

Representative ROUSSELOT. Over what time period?

Representative HAMILTON. $7.2 billion?

Ms. GORDON. $7.2 billion over a 5-year period for eliminating the minimum benefit alone.

Ms. RIVLIN. We'll check that.

Ms. GORDON. All the changes would total roughly $22 billion for OASDI, and $4 billion for HI over a 5-year period.

[The following information was subsequently supplied for the record:]

Reconciliation savings: Roughly OASI $20 billion, DI $6 billion, and HI $4 billion over 5 years.

Representative HAMILTON. Then one other comment before I turn to Congressman Long. You mentioned that the farther out on your projections you go, the less reliable they become. Are the projections that are now being made for the difficulties we're going to run into after the turn of the century sufficiently reliable that the Congress should act on those now and begin to made adjustments?

Ms. RIVLIN. Well, there are two basic things that affect social security. One is the state of the economy and the other is the size of the population. There is no doubt now that we will have a very large number of retired people around 2010 or 2015, when the baby boom generation retires. That is not an uncertain number. Those people are with us. Some of them are already in Congress and there are——

Representative HAMILTON. Present company excepted.

Ms. RIVLIN. That's a very large group of people. The fact that there will be strain on any retirement system when those people retire is not a subject of uncertainty.

Representative HAMILTON. So where are we?

Ms. RIVLIN. So it's very hard to say what the economy will be like by then. Clearly, a more productive economy will make it easier to support a large number of older people, but it's hard to make exact projections about what the state of the economy will be by then.

Representative HAMILTON. But your best judgment is that the Congress ought to begin to act fairly soon to make some long-run changes because of the demographic projections, even though we don't know what the economy would be like?

Ms. RIVLIN. You would certainly make it easier on yourselves if you did. It's not that I think the system need come to a screeching halt, but certainly if you do not cut back on the benefits and continue to raise them relative to average wages over a long period, then when that baby boom generation hits the retirement system some major adjustment would have to be made. Either the tax rates would have to be raised drastically or benefits would have to be cut.

Representative HAMILTON. When we take these long-term projections and you give us all these statistics, do you take into account the retirement behavior and the immigration rates and the labor force participation and those things?

Ms. RIVLIN. We do attempt to take all those things into account, Congressman, though it can't be done perfectly.

Representative HAMILTON. But you do try to include them on long-term projections?

Ms. RIVLIN. That's right.

Representative LONG. Thank you, Congressman.

Ms. Rivlin, you have estimated that the President's proposal for a 3-month delay in the annual cost-of-living adjustment of beneficiaries would save $2.9 billion in 1982 and as much as $12, $13, or $14 billion through 1986, if we delayed those.

Ms. RIVLIN. That's adding the savings for the 5 years.

Representative LONG. The administration, which tends to describe these types of savings as relatively minor changes, has a considerably lower estimate of the savings over a 5-year period, if I recall correctly. What explains your higher figures there?

Ms. RIVLIN. The administration is a little bit more optimistic about inflation than we are, and therefore the delay would not save as much under their calculations as under ours.

Representative LONG. Further, looking at the short range rather than the long range, you note that restricting the COLA to 85 percent of the CPI would save about $22 billion over 5 years, if my addition is correct.

Ms. RIVLIN. That's correct.

Representative LONG. Does this mean that the President's proposal is equivalent, from the point of view of the recipient, to a limit on the COLA of 90 to 91 to 92 percent of the CPI? Is that what the effect of that comes down to?

Ms. RIVLIN. Well, I think one could think of it as roughly equivalent to that. The President's proposal would have more immediate effect, however, in fiscal 1982. That's the big difference. If you change the COLA next July by some moderate amount—by capping it somewhere in the range of 85 to 90 percent—you will save money over time, but you won't save much in 1982.

Representative LONG. Not nearly so much as you do by delaying the effective date of the increase?

Ms. RIVLIN. That's correct, because you wouldn't have much of fiscal 1982 to go.

Representative LONG. What is an ideal period of t me in which Congress ought to deal with this general subject? As you know it's nothing but a guess because you have to take so many variables into consideration. You can't really cite them all, much less give appropriate weight to each, and you're dealing with such volatile situations in the economy. Of course, insurance companies do this all the time under their actuarial standards to some degree. What would be the ideal period which we ought to stay ahead of this problem?

Ms. RIVLIN. Well, I'm not sure that there's any single answer to that. It would seem to me that a major nation running a big pension system ought to have enough reserves in the system to assure everybody that they are going to get their benefits and not have to make short-term adjustments just because of a wrong guess about the economy. We ought to strive to put the system in shape so that we don't have to keep changing it all the time. That probably means building up the reserves rather substantially over time—not necessarily this year—but to strive for a system that has sufficient reserves so that, even if things go badly for a year or two, we don't have to take precipitous action.

Representative LONG. In that regard, have you ever had an opportunity, or anybody on your staff ever had an opportunity, to do a study of the pension funds and their ability to deal with this problem as compared with the Social Security Administration and Congress dealing with the subject matter?

Ms. RIVLIN. Private pension funds?

Representative LONG. Yes.

Ms. RIVLIN. We have not done a study exactly of that sort. In general, private pension funds tend to budget for a worst case, I think.

Representative ROUSSELOT. Than we do?

Ms. RIVLIN. Than we are doing at the moment.

Representative ROUSSELOT. In social security?

Ms. RIVLIN. In the long history of social security, there wasn't a problem; the economy was growing rapidly, the labor force was growing rapidly, and there wasn't much inflation. But recently, it has turned out that the system has not been set up to deal with economic change of the sort that we have actually had.

Representative LONG. The scare stories that we read in the newspapers relatively often with respect to people, were participating under private pension programs and then found the companies were merged or sold, or the companies went bankrupt are cases that obviously were not examples of operating under the type of situation which you're referring to.

Ms. RIVLIN. That's right, and they were probably never adequately funded to begin with.

Representative LONG. If they were, as you indicate, they obviously wouldn't be in the position that they are in at the time that something happens to the company.

Ms. RIVLIN. That's right. But of course, one thing to remember is that most private pensions are usually not indexed. That is hard on the beneficiary, but there isn't so much calculating to be done.

Representative LONG. But that really ought to make them more easily controlled, insofar as the actuarial balance with which they're dealing, than those that are indexed, should it not?

Ms. RIVLIN. That's right.

Representative LONG. Thank you. That's all the questions I have.

Representative HAMILTON. Congressman Rousselot.

Representative ROUSSELOT. Thank you, Congressman.

Nice to see you again, Ms. Rivlin.

Ms. RIVLIN. Nice to be here.

Representative ROUSSELOT. Congressman, I have an opening statement I understand you've inserted at the beginning of the hearing.

Representative HAMILTON. Yes, indeed.

Representative ROUSSELOT. Thank you, Congressman Hamilton.

Ms. Rivlin, I was interested to see in your prepared statement where you said that if COLA were restricted to 85 percent of the CPI in each of the next 5 years, cumulative savings through 1986 would be about $22 billion. Is that your current estimate?

Ms. RIVLIN. That's our current estimate.

Representative ROUSSELOT. What happened between now and February of 1981? In your report entitled "Paying for Social Security, Options for the Near-Term," in February 1981; you said, "The Congress might, for example, want to limit or cap the cost-of-living increases at 67 percent or 85 percent of the CPI in each year of the 1981–86 period." And then a little further on you say, "Thus, this option alone would not immediately generate enough money to solve the fund's short-term problems entirely, however, these savings would put the fund in the position to meet its obligations through the end of the 1981–86 period. The 85-percent cap would save more than $44 billion." So there's a differential of $22 to $44 billion and I wonder if you could help explain this.

Ms. RIVLIN. Two things account for the difference. One is you've got an additional year in there; 1981 to 1986 is 1 more year than 1982 to 1986.

Representative ROUSSELOT. But that much difference?

Ms. RIVLIN. The other difference is that inflation has come down, and we have lowered our forecast of future inflation.

Representative ROUSSELOT. Inflation has come down since February of 1981?

Ms. RIVLIN. Yes.

Representative ROUSSELOT. We are making progress then. That's good to know, isn't it?

Representative LONG. Is that news to the gentleman?

Representative ROUSSELOT. No. I just thought it might be helpful for all of us.

Representative LONG. It just surprised me that it surprised you.

Representative ROUSSELOT. I just wanted to make note of it. Now looking beyond the immediate financial problems of the system which I think you have done very well by presenting us with some options to consider in solving the system's problems, what approach do you favor to deal with the rising burden associated with an increase in the number of beneficiaries relative to the number of contributors to the system? What is you recommendation to us? As you know, I'm on the Social Security Subcommittee and we are struggling with writing a bill on this matter, and I would like your recommendation as someone who used this from 'an objective point of view.

Ms. RIVLIN. As you know, we don't make recommendations. We always hide behind options. We always try to present an array of choices.

Representative ROUSSELOT. I'm trying to pull you out from behind that.

Ms. RIVLIN. Well, you won't succeed.

Representative ROUSSELOT. I'm sorry about that.

Ms. RIVLIN. I think there are several ways, but they really boil down to two. If you have a rising number of beneficiaries relative to workers—which you will have in a big way after about 2010—then there are only two choices. Either you tax more or you pay lower benefits.

Representative ROUSSELOT. Slow down the increases in benefits?

Ms. RIVLIN. That's right. There are only those two choices in the end. Either you find more revenue as a percent of the total gross national product at that time——

Representative ROUSSELOT. We can't vote "maybe" in this business. How would you suggest we do that? Do you think it's better for the economy for Congress to raise taxes or to find a way to slow down the increases in benefits?

Ms. RIVLIN. I think that is a value choice.

Representative ROUSSELOT. Thank you We appreciate that. It's hard to go home and tell our constituents that, but——

Ms. RIVLIN. It really depends on what else you want to do. It's one of those very basic things about how important is it to provide generous pensions for old people relative to defense and everything else that has a claim on the public responsibility. There really isn't any answer that I can give you as an economist. That is a pure political choice, which the elected representatives have to make, and it's the hardest kind.

Representative ROUSSELOT. Yes. Well, I appreciate that. I just wondered, from your viewpoint, as one who helps us constantly through recommendations to the Budget Committee and the Congress, to which would be the most preferable way.

Ms. RIVLIN. From a technical economic point of view, I really don't think there is an answer to that. It's a choice you just have to make.

Representative ROUSSELOT. Well, thank you, Congressman.

Representative HAMILTON. Congresswoman Heckler.

Representative HECKLER. Thank you, Congressman.

I can see that your situation, as difficult as it is at times, is somewhat easier than ours at the moment. I would like to have you elaborate on the question of the interfund borrowing because it appears that is perhaps the most attractive option at the moment.

Ms. RIVLIN. Well, yes, I think that interfund borrowing is really a technical adjustment that would solve the imbalance between the old age and survivors' fund, which is running out of money, and the other two funds, which are in better shape. There are alternative ways to handle that, of course. At the time that the Congress wrote the 1977 amendments, you adjusted the various tax rates for what then seemed to be the likely outgo. You guessed wrong.

One thing you could do now is readjust the allocation of tax revenues, the OASI fund got more and the other two funds got less, within the same total. An equivalent approach would be to let the funds borrow from each other. I frankly don't think which approach you choose matters very much. Either is a way of adjusting to what proved to be a wrong guess about the relative outgoes of those particular funds.

Representative HECKLER. What is the degree of security that we gain by allowing the funds to borrow from each other?

Ms. RIVLIN. Well, if you allow——

Representative HECKLER. How does that option deal with the basic problem in the short run, for example in the next 10 years?

Ms. RIVLIN. In the next year, it would solve the immediate crisis, which is that the old age and survivors' fund is too low. It would probably, without other action, get you through the next several years. Our scenario would indicate that, if the economy grows at a healthy rate through the end of the decade, the combined balances would be sufficient to allow the system to squeak by.

Now, of course, you can't count on that, and it would seem to me not to be prudent to count on interfund borrowing for 10 years. But it would certainly mean that you didn't have to do anything next year and that you would likely be all right for a couple years.

Representative HECKLER. Would interfund borrowing have to be legislated?

Ms. RIVLIN. Yes.

Representative HECKLER. Do you have any figures or information on the number of people who rely on social security totally as their only income?

Ms. RIVLIN. As their only income?

Representative HECKLER. What percentage of older recipients rely exclusively on social security? Do you know?

Ms. RIVLIN. I'm going to give that to Nancy Gordon, who gets all the hard questions.

Ms. GORDON. I don't remember the exact number that get income only from social security. But I do recall that a very high proportion of elderly women—perhaps as much as 75 percent—rely solely on social security. That's in large part because pension plans in the past didn't always provide survivors' benefits. Now plans must provide the option of such benefits, although workers don't necessarily choose to take advantage of them. As a result, once an elderly woman becomes a widow, it's much more likely that social security would be her only source of income. We could provide information about percentages of people who get only social security. Another type of information that I think is even more important concerns people who get the vast bulk of their income from social security. Some people have a very small savings account, for example, so they might get $100 in interest income. That doesn't have much impact on them, but it takes them out of the category of having income only from social security.

[The following information was subsequently supplied for the record:]

RELATIVE IMPORTANCE OF SOCIAL SECURITY: PERCENTAGE DISTRIBUTION OF AGED UNITS[1] IN 1978

	Proportion of aged (65 and older) units	
	All elderly units	Social security recipients only
Social security as a percentage of total income:		
50 or more	58	66
90 or more	23	26
100	14	16

[1] Aged units include unmarried individuals age 65 or older and married couples with at least 1 spouse age 65 or older.

Source: Social Security Administration, Office of Research and Statistics.

Representative HECKLER. You referred to the year 2010. Is that a special year for some reason?

Ms. RIVLIN. That's about when the influx of the baby boom hits. Birth rates went up rapidly, as you know, in the 1940's, and so the baby boom generation will be retiring starting about 2005.

Representative HECKLER. Now that is the long-range problem. It's not the problem of this decade.

Ms. RIVLIN. Right.

Representative HECKLER. So the most extreme pressure on the system will occur after the year 2000; is that correct?

Ms. RIVLIN. That's correct. In the intervening years, the demographic situation is somewhat better. Those of us who had sense enough to be born in the 1930's will be relatively well off, because there aren't very many of us, and the baby boom generation will still be in the labor force to support our benefits. But then the situation gets worse.

Representative HECKLER. So the pressures on the system in the 1980's are in a sense the short-term serious pressures which should be somewhat lessened in the 1990's?

Ms. RIVLIN. From a purely demographic point of view; yes.

Representative HECKLER. Have you ever computed what the return on investment would be if the amount that had been invested in the social security system by individuals had been invested in the private market? Are they better off or worse off because the money has been invested in the social security system?

Ms. RIVLIN. Most people now drawing social security—probably all of them—are doing much better than they would have if they had bought a private annuity, simply because the Congress over the years has raised the benefits; with a growing labor force, it was possible to do that. So that, for people now drawing social security, it's been a very good deal indeed.

Representative HECKLER. But what about those who are contributing to the funds today, those who have the withholding tax withheld from their income? If they were to invest in the private market, what would the relative benefits be?

Ms. RIVLIN. Well, I think that depends on what the Congress does about the benefits in the future.

Representative HECKLER. Presuming constancy and presuming that nothing happens to them?

Ms. RIVLIN. Again, it depends on income level. For people at the lower end of the scale, social security is a very good deal. At the upper end, it's not as good.

Representative HECKLER. And in the middle?

Ms. RIVLIN. In the middle, it's in the middle.

Representative HECKLER. If you're in the middle income level it depends on how wise an investor you are?

Ms. RIVLIN. Right.

Representative HECKLER. So obviously the real crunch is now and there are ways of dealing with this. But it seems that the question of increasing the reserves is a matter of prudence that cannot be dealt with by just interfund borrowing; is that correct?

Ms. RIVLIN. The problem could be dealt with in the short term by interfund borrowing. But I think, to be prudent over a longer period—a period as long as a decade—it's probably necessary to do something more.

Representative HECKLER. If medicare had not been funded out of this source, what would the situation of the funds be?

Ms. RIVLIN. If you took out the medicare payments and kept the tax rates the same levels?

Representative HECKLER. Yes.

Ms. RIVLIN. Oh, it would be very good indeed.

Representative HECKLER. So, in other words, the real pressure, the one single draw on the system that has created the most extreme pressure has been the introduction of medicare funding from this mechanism; is that correct; and not the general——

Ms. RIVLIN. I'm not sure that's correct, although certainly the outlays—because of the rise in health care costs, use of health services, and the size of the elderly population have risen at a very rapid rate.

Representative HECKLER. Thank you, Congressman.

Representative HAMILTON. Ms. Rivlin, where do you get these assumptions you put in this prepared statement of yours? There must be a million assumptions you could bring in before us. You just picked out two of them. What's the basis of your selection?

Ms. RIVLIN. The set of assumptions described as the CBO baseline is one that we labored over very hard. We are required to produce a forecast for the Budget Committees for 5 years, and that represents our 5-year set of assumptions. They constitute our best guess.

Representative HAMILTON. That's your best guess as to what's going to happen to the economy in the next 5 years; is that right?

Ms. RIVLIN. Well, the first couple years are our best guess; after that, we assume that the economic situation continues for another

2 or 3 years in the same way. I don't want to dignify the longer range projection as having certainty.

Representative HAMILTON. So for 1981 and 1982 that is the best guess you and your top economists can make as to how this economy is going to perform?

Ms. RIVLIN. That's right, and for the next 2 or 3 years, we run out those assumptions. Then if we're asked—as we were asked by you—to project for another 5 years, we get very queasy. But we ran this one out another 5 years.

Representative HAMILTON. Now in the updated economic forecast that you just put out, is there any difference between that and your baseline economic assumptions here?

Ms. RIVLIN. No. That's what that is.

Representative HAMILTON. It's the same thing?

Ms. RIVLIN. That's right.

Representative HAMILTON. And under that, you find there's no shortfall in the combined social security trust funds in the short term?

Ms. RIVLIN. In the combined trust funds, there's no shortfall in the short run, provided you enact interfund borrowing.

Representative HAMILTON. As a matter of fact, under that projection, you find balances equivalent to 20 to 25 percent of the year's benefits payments?

Ms. RIVLIN. Right.

Representative HAMILTON. Now under the pessimistic——

Ms. RIVLIN [continuing]. But not all the way out. That's only in the next couple years.

Representative HAMILTON. Again in the short term?

Ms. RIVLIN. Right.

Representative HAMILTON. In the pessimistic scenario, as you call it, you show those combined balances still positive but weakening, and under that you see the need for additional financing?

Ms. RILVIN. That's right.

Representative HAMILTON. OK, and the question is then, how much and how soon?

Ms. RIVLIN. That's the question.

Representative HAMILTON. Right.

Ms. RIVLIN. Right.

Representative HAMILTON. You're not going to help us on that?

Ms. RIVLIN. No; I could give you the options again, but I'm not going to tell you what to do.

Representative HAMILTON. As usual, your statement have been very lucid and helpful to us. Are there any other questions of Ms. Rivlin?

[No response.]

Ms. RIVLIN. Thank you. And if there's anything else we can do, Mr. Chairman, please let us know.

Representative HAMILTON. I'm sure we will. Thank you very kindly.

Our next witness is William Niskanen from the Council of Economic Advisers. Mr. Niskanen, we are very pleased to have you. You have a rather extended prepared statement here. Your statement will be entered into the record in full and you may proceed as you wish, to summarize the statement, if you will.

STATEMENT OF HON. WILLIAM A. NISKANEN, MEMBER, COUNCIL OF ECONOMIC ADVISERS

Mr. NISKANEN. Congressman, my thanks for this opportunity to discuss the mutual relation between the social security system and the economy. My paper addresses two issues: What are the effects of alternative economic outlooks or scenarios for the near term on the funding balances of the social security system in that period; and, second, what are the major identifiable effects of the social security system on the economy? An understanding of the effect on the economy will respond to the questions raised by Congressman Rousselot and will help guide the Congress as to whether they resolve the longer term issue by increasing taxes or by some progressive or phased reduction of benefits.

Maybe contrary to popular impression, there is substantial agreement among economists on many issues and I think you'll find that the perspective on the short-range funding problem of the administration is very similar to that by Ms. Rivlin.

Under a wide range of economic scenarios, interfund borrowing is required by the end of 1982. Under a range of scenarios from that of the administration to a quite pessimistic scenario, trust fund balances are not really healthy throughout the rest of the decade. Even in the case of the administration's assumptions the trust fund balances amount to only 2 or 3 months of outlays for the remainder of the period.

It is important to distinguish between what is necessary and what is prudent. Interfund borrowing is clearly necessary in the sense that under all plausible economic scenarios for the next several years interfund borrowing is necessary to prevent complete depletion of the OASI trust fund.

What is prudent, however, I think implies a rather more extended set of actions than merely interfund borrowing. None of us expect to die in the near future, but we all take out some form of life insurance. For a similar reason we should be considering a variety of measures that would strengthen the social security trust funds to assure that we are able to meet the benefit payments from each of these funds under conditions which we cannot now anticipate. We should be chastened by the experience of 1977. At that time, Congress predicted with some confidence, that they had solved the problem of the social security system indefinitely. We are now back 4 years later with a necessary problem of addressing the fund balances of the major trust fund.

The short-range problem, again, is that the interfund borrowing is necessary by the end of 1982. Prudent action, in addition, imply some additional measures to assure that the trust fund balances are insured or protected against unexpected conditions. That may include a variety of measures that both Congress and the administration have been considering.

I would like to turn now to a more general discussion of the relationship between the social security system and the economy. The social security system is the second largest source of public revenues in the United States. One would expect that it would have significant effects on the economy and I think that these longer term effects on the economy are going to be or should be the major considerations that affect the choice by Congress between ways to resolve the long-term funding problem.

The long-term funding problem, as Ms. Rivlin suggested, develops around the end of the century and increases rather dramatically toward the years 2010 and 2020 as a consequence of identifiable changes in demographics, the increase in real benefits which were legislated in the 1970's, and the possibility of something less than our historical pattern of real wage growth.

We give a prospect that to fund the social security benefits in the year 2010 we may need combined tax rates of up to 30 percent compared to present combined tax rates of 13.3 percent. Whether we choose to meet that long-range problem by more than doubling the existing tax rates or by some measures to progressively, on a phased basis, reduce benefits, is a choice that Congress must make, but I think that economists have an opportunity to contribute some relevant information to that choice.

The major potential effects of the social security system on the economy concern the effect on the flow of savings and the stock of capital and the effect of social security taxes and benefits structure on the supply of labor. A variety of studies have indicated that the potential effect of social security may very well have reduced the aggregate capital stock in the United States by as much as 20 percent. It may have reduced our national savings rates by about a third. There is no broad consensus within the economic research community on what the specific consequences of social security have been and are likely to be. In this circumstance, however, where the estimates by careful scholars ranges from essentially no effect on aggregate savings on the capital stock to potentially very large negative effects on the capital stock and savings, it is only prudent to consider the possibility that social security may have substantially reduced the amount of private capital with which we augment our labor force and, in turn, reduced the income base for funding of all types of public programs.

On labor supply, the evidence is more clear. The very high marginal tax rates faced by elderly people as a consequence of the social security system are almost surely responsible for a large part of the major reduction in the labor force participation of older people. The most dramatic effects are observed by looking at the differences in the labor force participation between age 61 and 62, the first year people qualified for early retirement, or between 64 and 65 when they are eligible for full retirement. Only the particular benefit structure of social security could explain their dramatic effects.

We find ourselves in the perplexing situation that the American elderly are much healthier now than they were 30 or 40 years ago and have a longer expected future life and, at the same time, the labor force participation is substantially lower than it was some years ago. Most of that difference must be attributed to the high marginal rates faced by social security beneficiaries, the high marginal tax rates in effect on any labor force participation and earnings.

There is reason to believe that the social security system has had a strong negative effect on the labor force participation of wives because the benefits which accrue to wives from participation in social security are very low but they face the whole of social security tax from their first dollar of earnings.

There is developing evidence that social security has also reduced the labor force supply of prime-age males, but the effect on that age group is probably a good bit less.

In summary, given the magnitude of the social security system and the characteristics of the tax and benefit structure, we have reason to be concerned that the social security system may have substantially reduced our aggregate capital stock and annual savings rates, and we have reason to be concerned that the social security tax and benefit structure may have significantly reduced the labor force participation of the elderly, of wives, and to some smaller extent, that of prime-age males.

These effects of the social security system on the economy should be helpful guides to the necessary choice which Congress must make, hopefully in the near future, between tax increases or benefit reductions as a means to resolve the longer term problem.

In this regard, I commend to you a report by the Committee for Economic Development, concerning the Federal policies affecting social security, private pensions, and the savings rate. This is a careful, clear representation of the problem and, from my personal point of view, the policy recommendations that they suggest deserve the most serious consideration.

Long-term problems require long leadtime solutions. Also, problems as important as the social security problem should be resolved on the basis of a broad bipartisan consensus. Social security has close to a constitutional status in the American fiscal structure and should not be changed on the basis of short-term considerations or narrow partisan interests suggest that prospects for change should build upon the suggestions developed by Representative Pickle by Senator Armstrong and others, and those proposals by the administration.

It is important to start to address the long-term problem now, to give people a leadtime to make their own personal decisions on labor force behavior and on savings, to give them enough leadtime to adjust to what will be either a very high tax environment or a somewhat reduced benefit environment in the next 30 years.

With that summary, I would be pleased to answer your questions.

Representative HAMILTON. Thank you very much.

[The prepared statement of Mr. Niskanen follows:]

Prepared Statement of Hon. William A. Niskanen

Mr. Chairman and Members of the Committee:

My thanks for this opportunity to discuss the mutual relationship between the social security system and the economy. Our social security system faces both short-term and long-term funding problems. For a range of economic scenarios, the short-term funding problem must be resolved by the end of 1982. While these short-term problems are significant and must be addressed, the long-term financial picture is more disturbing. The potentially massive shortfalls between benefit payments and tax collections projected for the early part of the next century reflect both recent declines in U. S. fertility rates and the major increase in benefit levels that were enacted in the 1970s. Early action is also needed to address the long-term financial problems associated with the demographic transition; under pessimistic assumptions, social security tax rates could rise to 30 percent to meet projected benefit payments by the middle of the next century.

We should act with the clear understanding that social security legislation enacted in the near future will also affect the nature of this system for many years. It is important to address the long-term issue now, in order to provide ample time for people to make adjustments in their personal savings and labor supply decisions. Long-term problems require long lead-time solutions. The social security system is the second largest source of public revenues in the United States after the Federal income tax. As such it has a pervasive influence on the performance of the economy, and changes in economic conditions have a substantial influence on the financial integrity of the social security system in the U. S. economy today. Expenditures this year on social security will account for over one-quarter of the Federal budget. Many of the nation's taxpayers now pay more social security taxes than Federal income taxes; social security currently provides income to one out of every seven citizens and nine of every ten people age 65 and over. Payments under Medicare cover about fourteen percent of the nation's health bill. The net long-run obligations to current participants in the system have been estimated to exceed $2 trillion, two times the level of regular federal debt.

A system this large cannot be viewed in isolation from the total economy. This morning I would like to discuss two dimensions of the relationship between social security and the economy: first, the effect that economic developments have on the short-term financial position of social security; second, the effect that the social security system has on saving and the supply of labor.

The Economy and the Financing of Social Security

Economic developments over the next few years will have a major influence on the financial health of the social security system. This condition is illustrated in Table 1, which presents the trust fund balances as a fraction of outgo during the year under three sets of economic assumptions. These tables include the spending changes enacted earlier this summer under the Omnibus Budget Reconciliation Act of 1981. The Administration's official projection, as presented in the mid-session review, foresees a strong economy over the next five years. If the Administration's outlook is realized, the combined trust fund balance reaches a low of 22 percent of expected outgo during the following year in 1982 and 1983, rising thereafter. Under an intermediate view of the economy's path, the trust fund balances fall continually over the decade, reaching a level of 9 percent of expected outgo -- the minimum reserve for operating the system -- in 1989. On the other hand, under a pessimistic projection, the trust fund balances fall to the critical 9 percent level at the beginning of 1984.

The effect of the various economic assumptions is also apparent in Table 2, which presents the difference between the income and outgo each year for the trust funds

Table 1. Trust Fund Balances [1/] Under Three Sets of Economic Assumptions, 1980-1986 (or 1990).

Calendar Year	Assets at beginning of year as a percentage of outgo during year				
Administration's Mid-Session Review Assumptions					
	OASI	DI	OASDI	HI	Total
1980	23%	35%	25%	52%	29%
1981	18	20	18	47	23
1982	14	14	14	58	22
1983	8	38	11	69	22
1984	3	73	11	75	23
1985	-1	115	11	77	24
1986	-1	183	18	78	31
Intermediate Economic Assumptions [2/]					
1980	23%	35%	25%	52%	29%
1981	18	20	18	47	23
1982	13	13	13	58	21
1983	6	35	9	67	20
1984	-2	64	6	71	18
1985	-10	97	1	71	14
1986	-17	152	1	69	14
1987	-24	210	(*)	69	14
1988	-32	268	-2	64	12
1989	-41	328	-4	56	10
1990	-51	388	-6	44	6
Pessimistic Economic Assumptions					
1980	23%	35%	25%	52%	29%
1981	18	20	18	47	23
1982	13	13	13	57	21
1983	4	32	7	64	17
1984	-10	52	-3	64	9
1985	-23	77	-13	60	1
1986	-34	125	-18	58	-4

1/ Figures reflect the program as modified by the "Omnibus Budget Reconciliation Act of 1981."

2/ Alternative II-B in the 1981 Trustees Report.

* Between 0 and -0.5 percent.

Note: Estimates for 1982 (1983 under the Administration's assumptions) and later are theoretical since the OASI Trust Fund would become depleted late in 1982 (early in 1983) when assets become insufficient to pay benefits when due.

Table 2. Net Increase of Combined Funds in OASI, DI, And HI Trust Funds 1/ Under Three Sets of Economic Assumptions, 1980-1986 (or 1990).

(in billions)

Calendar Year	Economic Assumption: Administration	Intermediate 2/	Pessimistic
1980	-\$3.3	-\$3.3	-\$3.3
1981	1.8	1.0	0.7
1982	4.4	2.0	-1.9
1983	6.9	.3	-14.7
1984	9.1	-3.9	-21.4
1985	23.2	3.9	-14.8
1986	31.5	3.7	-15.2
1987	N.A.	-1.3	N.A.
1988	N.A.	-7.7	N.A.
1989	N.A.	-14.0	N.A.
1990	N.A.	7.2	N.A.

1/ Figures reflect the program as modified by the "Omnibus Reconciliation Act of 1981."

2/ Alternative II-B in the 1981 Trustees Report.

Note: Estimates for 1982 (1983 under the Administration's assumptions) and later are theoretical since the OASI Trust Fund would become depleted late in 1982 (early in 1983) when assets become insufficient to pay benefits when due.

n.a. - The Administration and pessimistic sets of assumptions do not extend beyond 1986.

Source: Same as Table 1.

under the three sets of economic assumptions. These figures indicate the combined annual operating deficits or surpluses of all the OASDHI programs and show whether the balance between social security revenues and benefit payments increases or reduces the deficit in the total Federal budget. Under the Administration's outlook for the economy, the combined trust funds run a surplus in each of the next five years, reducing the overall Federal deficit and the strains that the Federal budget puts on credit markets. The intermediate view foresees the funds operating essentially in balance through 1986, running surpluses of less than $4 billion each year, except one year of deficit. Under a pessimistic scenario, the trust funds have an operating deficit in each of the next five years, worsening the prospects for a balanced federal budget.

One conclusion holds, however, regardless of economic assumptions: interfund borrowing is necessary, and necessary soon, whatever other changes may be required. Under all three sets of assumptions, the OASI trust fund reaches a 9 percent balance sometime in late 1982.

What features of the social security system make it so sensitive to the course of economic events? The problem is that the economic conditions that most influence benefit payments are different from those that determine social security revenues. Inflation, as measured by the consumer price index, is the main force raising benefits, while revenues respond quickly to covered wages and the level of employment. When prices rise faster than wages, so that real covered wages fall as they have for the last several years, the financial position of the trust funds deteriorates. Other economic and noneconomic factors also affect social security's financial condition, but real covered wages is by far the most important variable affecting the short-run financing of social security. It is fair to say that what is good for the economy is good for the social security system.

It is, therefore, a matter of much importance to the social security system to determine which of the three sets of economic assumptions best anticipates the path that the economy will follow over the next few years. While no one has yet found the crystal ball that lets them predict the future with any confidence, I would like to make a few comments about the three sets of assumptions that will put them in perspective.

First, how do they compare with past experience in terms of the key variable, real wages? In the 1960s, average covered real wages grew by about 2 percent per year.

In the early 1970s this growth rate dropped precipitously to only about 0.2 percent per year. In the last half of the decade, real wages actually fell by an average of 0.3 percent per year, and last year preliminary figures show they plummeted by 5 percent. In contrast to this history, real wages for 1981 through 1986 are projected under the Administration's forecast to grow at about the same rate as they did in the 1960s; the intermediate projections assume real wage growth similar to that experienced in the early 1970s; the pessimistic projection involves declines in covered real wages similar to those experienced in the late 1970s.

So far in 1981, economic performance has been generally consistent with the Administration's projections, suggesting that experience for the full year will be at least as strong as the intermediate projections of the social security actuaries. Real wages in covered employment fell during this period at an annual rate of -0.2 percent, compared to -0.1 percent expected for the full year under the mid-session review assumptions, -0.7 percent under the intermediate view, and -1.9 percent under the pessimistic outlook. So far in 1981 the economy clearly is not following the pessimistic set of projections for real wage growth.

For the future, the views of other forecasters generally range from a little less optimistic than the Administration's outlook to a little more pessimistic than the intermediate set of assumptions. Interestingly, the Congressional Budget Office's recent economic forecast comes in closer to the Administration's outlook than to the intermediate view. Judging by the opinion of private forecasters, the sluggish growth through 1983 projected in the pessimistic scenario is extremely unlikely to occur. Still, it is important to keep this pessimistic scenario in mind. We should recognize that recent forecasts have proved to be too optimistic. Indeed, this pessimistic scenario is not cautious enough to encompass another real shock to the economy, such as the 1974 and 1979 oil price increases.

From these comments on the effect of the economy on social security's short-term financing problems, I draw two main conclusions for policy: First, interfund borrowing becomes necessary in 1982 under all three sets of economic assumptions, unless significant changes are made in the system.

Second, beyond interfund borrowing, how much needs to be done in the short-term to protect the trust funds depends on the future performance of the economy. Three kinds of responses can be made to this uncertainty. One possibility is to make little or no change in social security financing, counting on the economy to remain at least as strong as the intermediate set of projections. If the Administration's or the intermediate forecast is realized, the trust funds will be sufficient to pay benefits on a timely basis at least until the end of the decade. This is a financially risky approach, however. Second, some limited changes could be made that would not radically alter the structure of benefits and taxes, but that would be sufficient to resolve the short-term problem and protect the system in the event of falling real wages. The indexing of benefits to the lower of the growth of wages or prices, as has been suggested by Congress, is one such approach that has the desirable feature of spreading the risks of declines in real wages among all members of society. Third, major changes could be made in the structure of the social security system so that the trust fund positions would improve in both the short and long term. This is a structural reform approach. The legislative package that the Administration proposed this spring is one example of such a structural reform, and I welcome your debate on this and other proposals to secure the financial integrity of the social security system.

Social Security and the Economy

The past few years have witnessed a growing concern over the level of real net investment. This concern reflects the economy's slow growth in the last decade relative to previous experience and to that of many of our principle trading partners. The savings data themselves suggest lower rates of net capital formation in the last decade than in either the 1950s or 1960s. In the 1960s the average net investment rate was 7.6 percent of net national product. In contrast, the average for the 1970s was only 7.0 percent. The reduction in our net investment rate in nonresidential plant and equipment is more striking; annual rates of net investment in nonresidential capital averaged 4.8 percent in the 1960s, falling to 4.1 percent in the 1970s.

International comparisons are equally troubling. In the last decade our net investment rate averaged 30 percent of the Japanese rate, 50 percent of the German rate, 50 percent of the French rate, 51 percent of the Canadian rate, 54 percent of the Italian rate, and 70 percent of the British rate.

What does this savings reduction have to do with social security? Potentially, a lot. Research by Martin Feldstein and others has directed our attention to the fact that social security's unfunded liabilities represent an enormous accumulation of government debt. The Federal government's debt represented by unfunded promises by social security to future net benfit payments equals roughly 2 trillion dollars, more than twice the regular Federal debt on the Treasury's books.

The fact that social security's "pay-as-you-go" financing is essentially deficit financing does not appear to be widely understood, in part because of the misleading use of language in describing certain of social security's transactions. When we collect social security contributions from American workers, we call these contributions "taxes"; however, workers may perceive these contributions as "deposits". When a U. S. worker contributes to social security, the worker receives an implicit but risky "bond" from the Federal government promising that he or she can redeem this bond at retirement age and be paid back in the form of retirement benefits. Certainly social security debt has many different characteristics from those of regular government debt, primarily its fungibility; however, for the issue of U. S. savings, social security debt can potentially crowd out private savings in exactly the same way regular government debt can reduce the nation's accumulation of real productive capacity.

Let me first elaborate the potential for crowding out of investment by social security and then describe two opposing views of social security's impact on savings held by segments of the professional economic community.

The unfunded financing of social security is central to the crowding out view. Had the government taken tax dollars from the young, invested them in a trust fund, and returned the principal plus interest as benefit payments to the actual contributors, then social security would simply have substituted public for private savings with no effect on total savings. This, however, did not occur; instead, after a short period, taxes paid in were paid out as benefits to elderly people who had themselves contributed little or nothing into the system. This intergenerational transfer, the argument goes, leads to greater consumption by the elderly than would otherwise have been the case. The initial (start-up) generation of young people, on the other hand, treat their tax contributions as equivalent to savings, since they anticipate receiving benefits when old in return for their past tax contributions. Rather than saving privately, the young feel that they are saving through social security. The substitution of public for private savings does not lead the initial generation of young to alter their consumption. Since the consumption of the initial generation of young is not affected, but the consumption of the start-up generation of old people is increased, total consumption increases and aggregate savings falls. Aggregate savings is not only reduced in the short run, in this scenario, but it is permanently lowered; under "pay-as-you-go," unfunded financing, young people are forever handing their savings (tax contributions) over to old people as benefits; the old people consume these benefits; hence, the savings of the young never get invested in the economy and never augment the capital stock.

Simulation studies of the effect of unfunded social security on savings indicate a potential reduction in the long-run capital stock of 20 to 25 percent. These simulation results are based on mathematical models of the economy and assume that no alternative public assistance program would have been introduced in the absence of social security. The key assumption in these models is that individuals make lifetime (or life cycle) consumption and labor supply decisions based on their lifetime resources and neither receive nor make bequests. Associated with these estimates of capital stock reductions are estimates of reductions in wage rates and levels of welfare of generations that reached adulthood under a fairly mature unfunded social security system such as our own. The estimates on the reduction in total lifetime welfare range from 9 to 12 percent; i.e., had social security never been instituted, the standard of living of U. S. workers might be as much as 12 percent higher today than its current value.

Robert Barro has raised a major theoretical objection to this view. Barro points out that intergenerational transfers occur in the absence of social security; these transfers take the form of support by young people of their older relatives, as well as bequests and gifts from the elderly to younger cohorts. Barro suggests that the imposition by social security of a forced transfer from young to old may simply lead to an offsetting change in private, voluntary, intergenerational transfers, with no effect on any real variables. The unearned benefits received by the initial (start-up) generation of the old are handed back to the young as gifts or bequests; alternatively, benefits paid to the old reduce private voluntary transfers from the young to the old, dollar-for-dollar, resulting in no change in consumption by either young or old, and no change in aggregate savings. In recent years several studies have shown that saving for bequests accounts for the vast bulk of U. S. capital formation. This fact adds considerable strength to Barro's argument, although it certainly does not settle the matter; the distribution of bequests like the distribution of wealth is highly skewed in the U.S. economy. Thus, the type of offsetting intergenerational transfer behavior posited by Barro may occur only among a small segment of U.S. families.

Empirical investigation of the impact of social security on savings using time series data may be summarized by one word -- inconclusive. Numerous economists have examined time series data relating U.S. savings to social security variables. The estimated effect of social security is highly sensitive to statistical specification. These estimates range from a slight positive impact of social security on savings to Feldstein's most recent estimate of a one-third reduction in savings from its potential level.

One of the main problems with these time series analyses is that social security variables are highly correlated with other variables that affect savings, such as the unemployment rate. Hence, it is difficult to disentangle a separate social security effect from the data. However, there are additional major statistical problems with these time series studies; indeed, a recent study demonstrates how the statistical time series procedure currently used to analyze this issue could reject the theory that social security lowers savings even given data that perfectly conform to that point of view.

Cross sectional studies provide little support for the notion that social security has reduced national savings. One study used the best available data from the Social Security Retirement History Survey to test the life cycle theory upon which the social security savings reduction hypothesis is based. The authors conclude: "while the data do not deliver a strong rejection of the life cycle theory, they provide very little support for it." Another study tested the theory on the same data set and found that "...crowding out of private savings by social security is substantially less than dollar for dollar." The results of this latter study is consistent with the view that the young people may be forced to cut their consumption rather than their savings in response to large payroll taxes because of the reduction in disposable income and their inability to borrow against social security benefits. Other empirical micro studies support the view that social security does depress household savings, but these earlier studies are based on data of a much lower quality than that of the Social Security Retirement History Survey.

Let me summarize what we know and what we don't know about social security's effect on our nation's rate of capital formation. Empirical research to date has not been able to isolate convincingly the effect of social security on savings; it is also unlikely that future empirical tests will provide a convincing answer to this important question. We are left, effectively, with several competing theories of social security and savings and no obvious way to choose among them. There simply is no hard empirical evidence that social security or other forms of government debt have reduced the nation's rate of saving. There is also no hard evidence that government debt has not reduced national savings. One hopes that either better data or more refined statistical procedures will some day resolve this important issue. The simulation studies provide, however, a warning that future increases in the scale of the social security system that are associated with additional creation of social security debt may greatly reduce savings and economic growth.

There is mounting evidence that the social security earnings test has contributed to the dramatic increase in early retirement. Other factors, including higher incomes, more generous and prevalent private pensions, and larger accumulations of private savings, have also influenced this trend. In 1950 the labor force participation rate of males 65 and over was 46 percent; today it is only 20 percent. Not only are there fewer elderly men working on any given day during the year, but there are fewer elderly men who work at any time during the year. The fraction of men 65 to 69 who are completely retired during the year has risen from 40 percent to 60 percent since 1960. For males 60 to 64, the retirement fraction is now 30 percent, double the 1960 figure of 15 percent. Those elderly males who do choose to work are working fewer hours during the year. Since 1967, the fraction of working males 65 and over who work part time has increased from one-third to almost one-half.

The social security earnings test for workers aged 65 and over currently reduces benefits 50 cents for every dollar of earnings beyond $5,500 and represents a 50 percent implicit tax rate for workers aged 65 to 72; in combination with the Federal income tax, state income taxes, and the social security tax, this 50 percent tax on earnings penalizes the work effort of the elderly at rates that can easily exceed 80 and even 90 percent.

These exceedingly large tax rates extend over a wide range of the typical elderly worker's potential supply of labor hours. Consider a 65 year old who is currently eligible for the average annual social security benefit of $4632, but could earn $15,000 a year by staying on the job. Under current law this elderly individual faces those high tax rates on all earnings between $5,500 and $14,764. $14,764 is, by the way about $1,500 more than average annual earnings in the U. S. economy today.

Reasonable people are simply not going to work for unreasonable levels of compensation. Data from the Current Population Survey for the years 1967 to 1974 bear this out. In 1967 the exempt amount of earnings, the amount before which no benefits were lost, was \$1,500. Of those males 65 to 71 who worked in 1967, 11.5 percent arranged their labor supply to earn \$1,400 to \$1,600. In vivid contrast, only 1.9 percent earned \$1,600 to \$1,800. As the exempt amount increases over time, the proportion of both male and female elderly workers earning just under the exempt amount increases as well.

Age-specific labor force participation rates also suggest social security's adverse effects on the labor supply of the aged. From 1940 to the present, the participation rate for males age 55 fell from 89 percent to 85 percent, a 4 percentage point drop. For 61 year old males the drop is 11 percentage points, from 81 to 70 percent. For 62 year old males the drop is 23 points, from 80 to 57 percent. For men aged 65 years old there is a 32 percentage point reduction in the labor force participation rate. Certainly we have observed a general trend towards early retirement at all ages, but what besides social security can explain the differentially greater reduction in labor supply at 62 than at age 61 or the sharp reduction in labor force participation rates at age 65?

Empirical analyses support the view that the social security earnings test has made a significant contribution to the decline in labor supply of the elderly. A study using 1972 data indicates that eliminating the earnings test would lead to an additional 151 annual hours of work for workers age 65 to 72. Using the current $7.26 average hourly wage in the private nonfarm sector, 151 additional hours would translate into an additional $230 in income tax revenue and $150 in payroll tax revenue per elderly worker. Since there are about 2.25 million workers age 62 to 72, roughly $855 million in annual tax revenue might be generated from this source alone. About 9 million people age 65 to 72 do not work at all during the year. While no estimates are currently available, it seems quite likely that a sizable fraction of this group would return to the labor force if the earnings test were eliminated. Many of these people may currently be unable to find part time jobs but would work full time if social security benefits were not subtracted. The 62 to 65 age group is another major source of additional payroll tax revenue.

Despite actuarial reduction, the earnings test appears to be reducing labor supply for this group as well.

There are, of course, other factors related to the trend towards early retirement; general postwar increases in the average American's standard of living together with a desire for more leisure is surely responsible for some of the dramatic change in early retirement behavior. Another point is that the current population of elderly may be spending their social security windfalls in the form of increased leisure. This windfall, intergenerational wealth transfer to the current elderly population is not an enduring feature of the system; one would expect, therefore, that future elderly cohorts will spend more time in the labor force provided we lessen taxes on old age labor supply.

In my view, a phaseout of the earnings test, which is part of the Administration's proposal, would unquestionably increase the incomes of the elderly as well as generate tax revenues that would offset a portion of the costs of doing so. Because of impending changes in the demographic structure of the population, the need to reverse the trend towards early retirement is greater today than at any time in this century. By the year 2025 the proportion of the population age 62 and over will rise from 13.6 percent to 24.5 percent. The ratio of workers paying social security taxes to beneficiaries will fall from a current level of 3.2 to about 2. Unless the elderly are encouraged to remain employed, U. S. per capita income will decline and social security taxes will rise as the ratio of dependent to nondependent persons in the economy increases.

Social security was established to raise the relative income position of the aged. Despite the massive growth of the program, the relative income position of aged families with household heads age 65 and over is lower today than it was thirty years ago. Between 1947 and 1980, median nominal family income increased by a factor of 7.04 for families with heads age 65 and over. For other age groups over age 24, the increase ranged from 7.14 to 7.85. It is ironic that the social security system may, itself, be partly responsible for this relative decline in the income position of the elderly.

Provisions of our social security system also generate troubling work disincentives for a significant fraction of married women in the U. S. work force. While married women are joining the labor force in increasing numbers, the typical wife's earnings are still 1/3 to 1/2 of that of the husband's. Consequently, for many wives their marginal contributions to social security will yield essentially no marginal social security benefits because they will collect benefits

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on their husband's earnings record. This is true only of retirement and Medicare benefits. A wife who becomes disabled cannot currently collect disability benefits on her husband's account. The combined employer-employee retirement and Medicare tax rate totals 13.30 percent and represents a pure marginal tax on the work effort of those females under discussion. The empirical evidence on the supply response of females to the level of net compensation is that they are quite responsive. Hence, the current structure of marginally free dependent and survivor benefits is lowering the nation's supply of labor by married females.

For prime age males the effect of social security on labor supply is more ambiguous. If we view social security contributions as simply a tax and ignore the marginal benefits associated with social security tax contributions, then social security appears to be reducing the labor supply for this group as well. Recent econometric estimates based on this view of the payroll tax suggest the social security system reduces the labor supply of prime age males by roughly 3 percent. However, some economists point out that the life-time benefit and tax provisions of social security provide sizable subsidies to certain males, in particular, married males. To date there is little convincing evidence available on social security's effect on the labor supply of this group.

Summary

These comments concerning social security's impact on the nation's supplies of capital and labor suggest two guidelines for future social security legislation. First, we should reduce or at least not increase the outstanding stock of social security debt. We simply can no longer afford to promise retirement benefits to people without requiring that they pay for the full value of those retirement benefits during their working lives. This guideline, of course, requires either that social security taxes be increased or that future benefits be reduced. Second, we should reduce or at least not increase social security's sizable disincentives to work, especially for the elderly and for married females.

Representative HAMILTON. Mr. Niskanen, are you appearing here as the administration's spokesman on social security?

Mr. NISKANEN. I'm a member of the Council of Economic Advisers, sir, and I speak for myself and for the Council. The administration's social security proposals were made in May and, with the exception of those few changes that have been reflected in the existing budget and tax laws, those proposals are still the only administration proposals outstanding.

Representative HAMILTON. Those are the proposals which suggested to us that savings of $88 billion are needed to assure adequate financing for the next 5 years?

Mr. NISKANEN. The administration's proposals in May reflected a set of measures that were addressed to both the short-term and the long-term funding problems of social security. It is quite clear to anybody who has looked at this problem that, in a narrow sense, the short-term funding problem could be resolved by interfund borrowing, plus a subset of those proposals made by the administration, or a comparable savings from other proposals.

Representative HAMILTON. I want to understand the current position of the Council of Economic Advisers: Is it that we have to have a savings of $88 billion in order to save the financial integrity of the social security system in the next 5 years?

Mr. NISKANEN. The position of the Council of Economic Advisers is that in the next 5 years interfund borrowing is necessary and that some additional savings would be prudent to make sure that we can maintain one to several months of reserves in the social security system.

Representative HAMILTON. So it is not your position that a savings of $88 billion is needed?

Mr. NISKANEN. A savings of $88 billion is not necessary, but may very well be wise because——

Representative HAMILTON. When Secretary Schweiker testified in support of the original plan, he based his point of view, I think, on what he called a worst case assumption, and is it your judgment that that's the assumption that ought to be used as the basis for social security policy changes in the future?

Mr. NISKANEN. I think it is appropriate to test the viability of the social security trust fund against a number of economic scenarios, including what was called the worst case or, in my testimony, a pessimistic case. Even that pessimistic case would not provide for the kind of major supply shock that we had in 1974 and 1979.

Representative HAMILTON. I'm just trying to understand what kind of advice you're giving the Congress. Are you telling the Congress that we ought to proceed to modify the social security system on the basis of a worst case economic assumption that assumes, for example, that we've got an $88 billion shortfall in the next 5 years? Is that what your advice to the Congress is at this point?

Mr. NISKANEN. I think, sir, that it is prudent to consider conditions that we do not expect but might arise in making insurance-type decisions. All of us do that in our personal lives. Any portfolio manager——

Representative HAMILTON. Mr. Niskanen, I appreciate that and I don't have any disagreement with that at all, but I'm trying to get you to be more specific than that.

Mr. NISKANEN. I think that it would be——

Representative HAMILTON. And the question is, Do you think the Congress ought to proceed to modify social security on the basis of an $88 billion shortfall in the next 5 years in social security?

Mr. NISKANEN. I think that Congress should take whatever measures are necessary to maintain an adequate trust fund balance under pessimistic economic assumptions. I'm not in the position to assure you that $88 billion is enough or too much. Under the estimates that are presented in my paper, the aggregate trust fund balances would decline to about 1 month of outgoes by 1984 in the pessimistic scenario, and then become less than that in subsequent years.

Representative HAMILTON. How, as a member of the Council of Economic Advisers, can you recommend to us that we proceed on the basis of a pessimistic assumption when we're dealing with social security, but when you're making economic projections for the overall economic policy your recommendations are at the other end of the scale? They are the most optimistic of any of the projections.

Mr. NISKANEN. For some purposes, I think it is appropriate to use expected conditions for your planning. For other purposes, I think it's appropriate to use pessimistic conditions. And, in general, for insurance-type planning, it is appropriate to use pessimistic conditions.

Representative HAMILTON. And when we're planning the budget of the U.S. Government, you think we ought to pick the most optimistic projections and base it on that?

Mr. NISKANEN. I think that every responsible group involved in the budget process should use those economic assumptions which they feel are appropriate. The administration has chosen to use these particular economic assumptions, which I think are achievable, but whether they are achievable depends in part on actions that will be taken in Congress and on conditions that we cannot forecast.

I'm intrigued that at least in terms of the near-term forecast the recent forecasts by the Congressional Budget Office are very much closer to the administration's forecasts than the other scenarios that I discussed.

Representative HAMILTON. I think the messenger is working on your side. He just told me my time limit is up, Mr. Niskanen. I wanted to pursue this with you a little further.

Representative LONG. I'm not sure the time is working on his side, Mr. Chairman, Congressman Hamilton's. Because I would like to pursue the same line of questioning.

What you're saying, Mr. Niskanen, is that with respect to the preparation of the budget we are all entitled to be optimistic as to what's going to happen but with respect to the actuarial basis of social security, that we need to take a much more pessimistic attitude?

Mr. NISKANEN. I think all of us use different assumptions for different types of issues that we address, and for insurance-type planning, to assure that we don't have to open up the social security again in 2 years or maybe 4, as we are now after the 1977 amendments, it would be prudent to use somewhat more pessimistic assumptions for social security planning.

Representative LONG. Don't we find ourselves, because the budget we have just now considered and acted upon was predicated upon assumptions that were so optimistic that many of us could not agree to them at all, in a position where the administration is having to come back and say that we made a terrible mistake and we've got to review this, and we've got to give additional cuts, more than were ever contemplated at the time that budget was drawn?

Mr. NISKANEN. Congressman Long, the administration's social security proposals were made in May before there was high confidence or assurance that the administration's budget or tax measures would pass. Whatever has happened with the budget in the last month or so does not bear on the specific conditions of the social security system.

Representative LONG. That's not the point I'm making. The point I'm making is that the Congress used and went along with—I did not, but the Congress used and went along with the very optimistic assumptions with respect to inflation, with respect to interest rates, with respect to unemployment—all these things on which you economists make these predictions—we used there a very, very optimistic set of figures and that has not come to pass and, as a result of that, we now find ourselves, by using that optimistic thinking, in my opinion, in an untenable position.

Mr. NISKANEN. Congressman Long, you are addressing an important problem that is not the direct subject of our discussions this morning. If you look at the administration's forecast of short-term economic conditions last winter, the economy has performed remarkably close to those forecasts. The one major surprise has been the surge of interest rates this summer which is of concern to all of us. Interest rates, I believe, have peaked. The short-term rates have declined rather sharply in the last 3 or 4 weeks. Those increases in interest rates have changed the necessary near-term budget assumptions, but for the most part, the economy has performed close to the administration's forecasts in the short period to date.

Whether the economy will trouble the administration's assumptions over a longer period is something that we can't know until after the fact. Congress is in a position with the able assistance of Ms. Rivlin's staff to make assumptions of its own.

In terms of the social security system, the posture or the guideline that I'm suggesting is to make social security planning in the short run based upon the pessimistic economic assumptions and then, as we all hope, if those pessimistic assumptions are not realized, we will have made a start at addressing the longer term problems of the social security system which must before too long be addressed.

Representative LONG. The thing that surprised me as we went through your statement was that knowing you, like us, are not entitled to the position that Ms. Rivlin finds herself, without having to make recommendations, that other than general recommendations with respect to structural approaches to the problem, I find no recommendations at all. I find no justification or attempt to justify the administration's recommendations made last May. I find no arguments attempting to justify those at this time. I find at the bottom of page 9 and a substantial part of page 10 three different ways in which the problem could be approached.

I wonder, though, particularly since I can't find anything that would support your statement—or nothing in your statement that would support a suggestion that major structural changes are really required to insure the integrity of the system. Indeed, it appeared to me that you were in agreement with what Ms. Rivlin was suggesting, that short-term technical financial arrangements aside, the big question is, what political decision we want to make? Do we want to reduce the benefits, which is a political choice, in order to meet the other objectives of the administration such as higher defense spending and a smaller Federal sector. Is this correct?

Mr. NISKANEN. Congressman Long, you have correctly noted that my paper does not address the major policy alternatives. I did that for two reasons. One is that my letter of invitation from Chairman Reuss was to specifically address the effect of economic conditions on the social security system during the next several years and, second, I'm not the administration spokesman on social security. I understand Secretary Schweiker will be testifying before you tomorrow and will be pleased to answer your questions. I did want to discuss the economic conditions and considerations that bear upon your choices. I think that the administration's proposal last May, which was made to address both the short-term and long-term problems of the social security system, deserve serious consideration.

At the same time, a resolution of these important problems should be based upon a broad, bipartisan concensus in both Houses of Congress, and we would look with favor to build on the recommendations that have been developed by Congressman Pickle, Senator Armstrong, and others. That is the only way that we will address these longer term problems.

You are correct in saying that, in the short run, we have to do interfund borrowing and, if we're lucky, we can get away with that. That is not a prudent course of action, however. A more prudent course of action would be to address the shortrun problem in a way that gives us high confidence of assuring a continuation of benefits in each of these categories for the next several years, plus gives us a head start on addressing the much more difficult longer term problems.

Representative LONG. Thank you. My time has expired. Thank you, Congressman.

Representative HAMILTON. Mr. Niskanen, let me simply observe this very prudent and major course that you recommend for us in Congress is not exactly advanced when the Budget Director comes before us and says that the most devastating bankruptcy in history is going to occur. That does not exactly set a climate for careful, measured, prudent deliberation on social security problems.

Congresswoman Heckler.

Representative HECKLER. I would like to pursue the question of the disincentive to employment built into the social security system. It seems to me the greatest disincentive on the part of older people is the earnings limitation. It is not the amount of the withheld taxes.

Mr. NISKANEN. That's correct. The earnings limitation in effect imposes a very high marginal tax rate on elderly people.

Representative HECKLER. Now if we were to change the earnings limitation, have you worked out what the ramifications of that would be in terms of a healthy system?

Mr. NISKANEN. I think there is a prospect of substantial increase, maybe returning somewhat to earlier historical levels of labor force participation of the aged. We have not done the formal econometric studies that seem to make people feel more confident than they should on that matter, but I think there is reason to believe that there would be a substantial increase in the labor force participation of the aged. That would, in turn, pay for part of the cost to the social security system of eliminating the earnings test, because it would return money both to the social security system and to general Federal revenues.

I don't expect that the effect would be large enough to pay for itself, and so it would have some net cost to social security. The administration's estimate, as I recall, is that it would lead to maybe $5 or $6 billion cost to social security, but I think both in terms of the fairness of the system to individuals and in terms of the consequences on the economy, I think we should strongly consider eliminating the the earnings test and take whatever other measures are necessary to pay for those costs.

Representative HECKLER. Would it be possible for you to provide the committee with some statistics and computations to stand behind the statement you've made?

Mr. NISKANEN. We will do what we can on that——

Representative HECKLER. I really feel I'm beginning to have a different perspective on the whole issue of social security as a result of your statements and it seems that aside from the question of the individual recipient there is the question of the aging process in America and the changing viability and dynamism of the older population. I have been informed that the World Health Organization did a study of the aging process in comparable societies and found in the industrialized enviromnent in which we live and in other countries such as Canada, Japan, and Western European countries that the average individual who avoids or is fortunate enough not to be plagued with heart problems or cancer that for that individual in these societies with the level of health care and nutrition, that the aging process begins at 80. This is a study that was actually documented by the World Health Organization and mentioned to me by the president of that organization.

Now I wonder, has the private insurance industry done any reexamination of our aging statistics in their consideration of whether 65 should be that magical year or tragic year of becoming old? Is there a revision in our own actuarial thinking on the process of aging? There has to be, obviously.

Mr. NISKANEN. The age 65 has a interesting historical background. It was chosen by Bismarck when he established the German social security system at a time when the expected life of people once they reached age 65 was only 5 years, and most poeple died before that age.

Now a most fortunate fact of our lives is that we expect to live longer and once we reach 65 we expect to live much longer than was formerly the case. Americans, as well as people elsewhere in the world, are much healthier. That creates problems which we have to resolve one way or the other for the private pension systems and the social security system as well. One of the most telling ratios I have seen recently is when social security was founded something like 6 percent of the American population was over 65. Right now that number is 12 percent. By the turn of the century it will be 18 percent. So the fraction of our population 65 and over will have tripled from the time social security was founded to sometime around the end of the century; and that is the most important reason for the longer term problemand why that issue shouldn't be put off very much longer.

Representative HECKLER. Is there anything happening in the private sector in pension funds and in the pension industry to consider a revision in the determination of that triggering date of 65?

Mr. NISKANEN. Well, as you know, Congress itself has changed the date of the required mandatory retirement in most occupations from 65 to 70, reflecting I think a realistic change in the health status and expected life of people and the changes that have happened over the last 30 or 40 years.

That will, over time, affect private pension plans as well. I think that there were some interesting questions raised earlier to Ms. Rivlin about the private pension plans versus social security. I think it is important to recognize that they are enormously different in character. Private pension plans, for the most part, are mostly funded. The average unfunded liability of private pension plans could be paid by 3 or 4 months of 1 year's profits of the company. The unfunded liability of the social security system is on the order of $2 trillion, which is about eight times the annual outgoes of the social security system. And, in fact, private pension plans, which sometimes do fail but which are now at least substantially insured, are in good financial health and have made major contributions to savings in our economy compared to the social security system.

Representative HECKLER. Thank you, Congressman.

Representative HAMILTON. Thank you very much, Mr. Niskanen. We have appreciated your comment on the way the economic conditions bear on the social security system. You have made some helpful suggestions to us and observations. We thank you for your testimony.

Mr. NISKANEN. Thank you.

Representative HAMILTON. The next witness will be Henry Aaron of the Brookings Institution. Mr. Aaron is a former chairman of the 1979 advisory council on social security. We are very pleased to have you before us and we look forward to your testimony.

STATEMENT OF HENRY AARON, SENIOR FELLOW, THE BROOKINGS INSTITUTION, AND PROFESSOR OF ECONOMICS, UNIVERSITY OF MARYLAND, COLLEGE PARK, MD.

Mr. AARON. I thank you very much, Congressman.

I would like to start with three commonly accepted facts about the social security system.

The first fact is the social security system is running a large deficit and soon it's going to run out of money. The second fact is that taxes are going to have to be increased immediately and continuously to cover a growing aged population. And the third fact is that when the baby-boom generation retires, starting about 2005, enormous increases in taxes will be necessary to pay for the benefits promised under current law.

Each of these three commonly believed assertions is false. I would like to use my time to explain why they are false and to try to put the present financing issues relating to social security in a somewhat clearer perspective than has been done in a number of public statements.

When I'm done, I shall advocate some reductions in social security benefits, but I believe we should undertake any changes in a measured, sober manner, unafflicted by calls to hysteria regarding the financial condition of the system.

First, the social security system, including retirement and survivors, disability, and hospital insurance in 1981 is in surplus, not deficit, by about $1.8 million, based on the administration's assumptions; by $200 million based on CBO's projections. Going forward to the succeeding 3 years, the surplus will accumulate to $20 billion if you accept the administration's projection; under CBO's projection there will be a deficit in the next 3 years of about $7 billion.

Representative HAMILTON. Excuse me. You've got $1.8 million in the assumptions used in the administration's review and only $200 million if you use CBO's?

Mr. AARON. That is correct for 1981.

Representative HAMILTON. The administration has more optimistic projections?

Mr. AARON. That is correct, and that is what creates the greater surplus in 1981.

Representative HAMILTON. I see. OK.

Mr. AARON. Now under both CBO and the administration's forecast, surpluses begin in 1985, larger ones if you accept the administration's scenario, smaller ones under CBO. That means that the current problems of social security result from two things. The first is a misallocation of revenues among the three funds, with the OASI fund shortchanged, and the DI and HI funds in sizeable shortrun surplus; and the second is the depletion of past social security reserves, because of past recessions and the inflation-producing price increases of OPEC. If reserves were higher, we would not be concerned about the present situation. With adequate reserves and with the projected surpluses of $76.9 billion between now and the end of 1986 under the administration's assumptions and a surplus of $20 billion between now and the end of 1990 under CBO's assumptions, anyone who cried jeremiads about the threat of the biggest bankruptcy in history would properly be ignored.

Concerning the second so-called fact about social security, the cost of social security benefits, measured as a percent of covered wages, will not rise for nearly 30 years. Even people who hold responsible positions seem to be unaware of the fact that for the next three decades, favorable demographic events will hold the cost of current social security benefits at or below the level they have reached this year. Taking the projections II–A and II–B of the recently released trustees' reports, the cost of social security benefits will be 11.3 percent of payroll in 1981 and about 11.45 percent in 1982. Under projection II–A, these levels will not be reached again until about 2010, and under projection II–B the cost will oscillate between 11.1 and 11.88 percent of payroll until after 2010.

The reason for this 30-year respite is the one to which Alice Rivlin alluded earlier; the baby boom generation is going to be in the labor force and working full time during this period and the much smaller cohorts born during the 1920's and 1930's—and, along with Ms. Rivlin, I had the sense to be born in one of those as well—will be retiring and keeping costs relatively low.

The final point is that if presently legislated OASDI benefits—I'm not speaking of health benefits—are not modified, the tax increases necessary to pay for those benefits are significant, but easily supportable by a growing economy. According to the 1981 trustees' report, retirement, survivors, and disability insurance will cost two percentage points of GNP more in the year 2030 than they cost this year. That means that if we were willing over the next 50 years to permit taxes to rise by 1 percent of GNP we would pay for existing benefits. This change is not minor—1 percent of GNP is a lot of money—but it is half of the increase in the share of gross national Government represented by Federal expenditures that occurred between 1970 and 1975 or the decrease that is projected to occur between 1981 and 1984.

My own view is that some long-term reductions in benefits should be enacted now, but no one should doubt the financial capacity of this country to meet its obligations under current law. The tax increases necessary to meet them, which we can spread over 50 years, are no larger than those which in fact occur over very brief periods of time.

Were it not for the depletion of social security reserves, the economic projections of the administration and CBO would not be a cause for any concern about social security.

But reserves have been depleted. Congress for good reasons regards separate financial accounting for social security as important. As a result, the system could run into problems if economic events turn out less favorably than the administration or CBO projects. The question is what we should do about it.

The first thing Congress should do is straighten out the misallocation of reserves among the three funds by interfund borrowing or by reallocating revenues. The present distribution is based on past projections by the actuaries that they take great care not to call forecasts. Their projections turned out not to be accurate. Decisions based on them should be corrected immediately.

Beyond this essential step, Congress faces three broad alternatives: One, it can raise payroll taxes, a course that has no appeal in the present political climate and that I am not recommending.

Two, it can make permanent and immediately effective cuts in benefits, as the administration has urged. This course has several drawbacks. It would violate the important principle that people should be given ample warning before cuts in benefits are put into effect. The particular benefits proposed by the administration are hard to defend, for reasons that I indicated in remarks made before the Select Committee on Aging of the House of Representatives on May 20, 1981. I attach a copy of those remarks for inclusion in the record. Finally, they will be unnecessary on financial grounds if economic events are no less favorable than those foreseen by either the administration or CBO.

Three, the third course is either to adopt structural changes in the financing of social security, desirable on other grounds, that would improve the ability of social security to withstand bad economic news, or to put in place safety valves that would come into play only, if reserves drop to an unacceptably low level. In the first category the past two advisory councils on social security, one appointed under President Ford, one under President Carter, and the National Commission on Social Security all have advocated that general revenues be used to pay for part or all of medicare. Medicare benefits are unrelated to earnings; the rationale for using an earnings-related tax to pay for hospital insurance, therefore, is much weaker than it is for earnings-related retirement, survivors, and disability insurance. If general revenues were allocated to medicare, an equivalent amount of payroll taxes could be shifted to the cash benefits programs. This step would have no effect on the deficit of the Federal Government. A decision to replace as little as one-fifth to one-fourth of the medicare roll tax with general revenues would be sufficient to protect social security against serious economic adversity.

In the category of safety valves there are at least two possible measures. The most effective would be to authorize the social security trust funds to borrow from the Treasury if revenues dropped to unacceptably low levels, subject to strict conditions for repayment and, if necessary, for either tax increases or benefit cuts to make repayment possible. Less powerful, but nonetheless desirable, would be to stipulate that annual adjustments in currently payable benefits be limited to the lesser of the rate of increase in prices or in wages. This measure would provide protection against the kinds of recessions we have experienced in the 1970's caused by supply shocks external to the United States from OPEC and draught; but it would not provide protection against ordinary recessions when, typically, wages continue to rise faster than prices.

The present benefit formula guarantees higher benefits for workers who retire at later dates with the same earnings history than for workers who retire at earlier dates. This pattern arises because new benefits not only rise with prices, but also reflect increasing productivity. For reasons set forth in the attached statement appended to the report of the last advisory council, joined by former CEA Chairman Gardner Ackley and the three business representatives on the council, I urge that after a suitable period of warning, the formula used in computing initial benefits be increased automatically only for prices. I believe that such a change would enable Congress to respond to changing priorities in social security benefits—such as an improvement in the relative benefits for two-earner families—without boosting costs as much as would be necessary if such changes were piled on top of present law.

I'm wondering if I ought to leave my last paragraph out in view of the reception I received when I advocated this position in the past, but I really can't resist expressing——

Representative HAMILTON. It's enormously popular among some people, Mr Aaron.

Mr. AARON. Yes, I know. Perhaps I'll simply leave the proposal to include a portion of social security benefits in taxable income in my prepared statement.

Representative HAMILTON. Thank you, Mr. Aaron.

[The prepared statement of Mr. Aaron, together with an outline and an attachment, follow:]

PREPARED STATEMENT OF HENRY AARON*

As everyone "knows", 1) the social security system is running a large deficit and will soon run out of money, 2) taxes are going to have to be increased immediately and continuously to cover a growing aged population, and 3) when the baby-boom generation retires starting about 2005, enormous increases in taxes are ncessary to pay for the benefits promised under current law.

Each of the three commonly believed assertions in the preceeding paragraphs is false. I want to use my time before this committee to explain why they are false. Understanding the facts is important because inflated rhetoric bordering on hysteria is misleading and frightening the American public into believing that the social security system must be cut for financial reasons. My own view is that some reductions in promised social security benefits are called for. Congress should decide now what cuts it thinks desirable on programmatic grounds and make these changes effective after beneficiaries have been given suitable warning. But, neither Congress nor the American public should believe that cuts in social security benefits are necessary because we cannot afford them.

(1) The social security system -- including retirement and survivors, disability, and hospital insurance -- is in surplus, not deficit. Combined revenues of the three trust funds will exceed expenditures in 1981 by $1.8 billion if the assumptions used in the administration's mid-session review turn out to be correct and by $200 million if CBO's assumptions are correct. The picture for the succeeding three years is less certain, a cumulative surplus of more than $20 billion if the administration's projections turn out to be

*Henry Aaron was Chairman of the 1979 Advisory Council on Social Security and is a Senior Fellow at the Brookings Institution and Professor of Economics at the University of Maryland.

correct, a deficit of just over $7 billion if CBO's projections are correct. Under either set of assumptions, surpluses begin in 1985, large ones given the administration's forecasts, smaller ones under CBO's.

The current financing problems are a result of 1) a misallocation of revenues among the three funds, with the OASI fund shortchanged, and the DI and HI funds in sizeable short-run surplus; and 2) the depletion of past social security reserves, because of past recessions and the inflation-producing price increases of OPEC. If reserves were higher, we would not be concerned about the present situation. With adequate reserves and with the projected surpluses of $76.9 billion between now and the end of 1986 under the administration's assumptions and a surplus of $20 billion between now and the end of 1990 under CBO's assumptions, anyone who cried jeremiads about the threat of the biggest bankruptcy in history would properly be ignored.

(2) The cost of social security benefits (measured as a percent of covered wages) will not rise for nearly 30 years. Even people who hold responsible positions are unaware of the fact that for the next three decades, favorable demographic events will hold the cost of current social security benefits at or below the level they have reached this year. As always, the projections depend on assumptions. But, if we focus on the central two projections of the 1981 Trustees Report (projections II-A and II-B), the cost of social security benefits will be 11.3 percent of payroll in 1981 and about 11.45 percent in 1982. Under projection II-A, these levels will not be reached again until

after 2010, and under projectionsII-B the cost will oscillate between 11.1 and 11.88 percent of payroll until after 2010.

The reason for this thirty-year respite is that the children of the baby-boom generation will be in the labor force and the much smaller cohorts born during the years between 1915 and 1945 will be retiring. It is true that when the baby-boom generation retires, costs will increase sharply and we may wish to cut promised benefits or to permit already legislated tax increases go into effect to build up reserves in anticipation of that event. But the bottom line is that the cost of social security benefits will not rise perceptibly and perhaps not at all, for thirty years.

(3) <u>If presently legislated OASDI benefits are not modified, the tax increases necessary to pay for those benefits are significant, but easily supportable by a growing economy</u>. According to the 1981 trustees report, retirement, survivors, and disability insurance will cost two percentage points of GNP more in the year 2030 than they cost this year. That means that if we were willing over the next fifty years to permit taxes to rise by two percent of GNP we could pay for existing benefits. This change is not minor -- two percent of GNP is a lot of money -- but it is no larger than the increase in the share of gross national government represented by federal expenditures that occurred between 1970 and 1975 or the decrease that is projected to occur between 1981 and 1984.

My own view is that some long-term reductions in benefits should be enacted now, but no one should doubt the financial capacity of this country to meet its obligations under current law. The tax increases necessary to meet them, which we can spread over fifty years are no larger than those which in fact occur over very brief periods of time.

Implications for Action: Short Run

Were it not for the depletion of social security reserves, the economic projections of the administration and CBO would not be a cause for any concern about social security.

But reserves have been depleted. Congress for good reasons regards separate financial accounting for social security as important. As a result, the system could run into problems if economic events turn out less favorably than the administration or CBO projects. The question is what we should do about it.

The first thing Congress should do is straighten out the misallocation of reserves among the three funds by interfund borrowing or by reallocating revenues. The present distribution is based on past projections by the actuaries that they take great care not to call forecasts. Their projections turned out not to be accurate. Decision based on them should be corrected immediately.

Beyond this essential step, Congress faces three broad alternatives. 1) It can raise payroll taxes, a course that has no appeal in the present political climate and that I am not recommending. 2) It can make permanent and immediately effective cuts in benefits, as the administration has urged. This course has several drawbacks. It would violate the important principle that people should be given ample warning before cuts in benefits are put into effect. The particular benefits proposed by the administration are hard to defend, for reasons that I indicated in remarks made before the Select Committee on Aging of the House of Representatives on May 20, 1981; I attach a copy of those remarks for inclusion in the record. Finally, they will be unnecessary on financial grounds if economic events are no less favorable than those foreseen by either the administration or CBO.

3) The third course is either to adopt structural changes in the financing of social security, desirable on other grounds, that would improve the ability of social security to withstand bad economic news, or to put in place safety valves that would come into play only if reserves drop to an unacceptably low level. In the first category, the past two advisory councils on social security, one appointed under President Ford, one under President Carter, and the National Commission on Social Security all have advocated that general revenues be used to pay for part or all of medicare. Medicare benefits are unrelated to earnings; the rationale for using an earnings-related tax to pay for hospital insurance, therefore, is much weaker than it is for earnings-related retirement, survivors, and disability insurance. If general revenues were allocated to medicare, an equivalent amount of payroll taxes could be shifted to the cash benefits programs. This step would have no effect on the deficit of the federal government. A decision to replace as little as one-fifth to one-fourth of the medicare payroll tax with general revenues would be sufficient to protect social security against serious economic adversity.

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In the category of safety valves are at least two possible measures. The most effective would be to authorize the social security trust funds to borrow from the Treasury if revenues dropped to unacceptably low levels, subject to strict conditions for repayment and, if necessary, for either tax increases or benefit cuts to make repayment possible. Less powerful, but nonetheless desirable, would be to stipulate that annual adjustments in currently payble benefits be limited to the lesser of the rate of increase in prices or in wages. This measure would provide protection against the kinds of recessions we have experienced in the 1970s caused by supply shocks external to the United States from OPEC and draught; but it would not provide protection against ordinary recessions when, typically, wages continue to rise faster than prices.

Implications for Action: Long Run

The present benefit formula guarantees higher benefits for workers who retire at later dates with the same earnings history than for workers who retire at earlier dates. This pattern arises because new benefits not only rise with prices, but also reflect increasing productivity. For reasons set forth in the attached statement appended to the report of the last advisory council, joined by former CEA chairman Gardner Ackley and the three business representatives on the council, I urge that after a suitable period of warning, the formula used in computing initial benefits be increased automatically only for prices. I believe that such a change would enable Congress to respond to changing priorities in social security benefits -- such as an improvement in the relative benefits for two-earner families -- without boosting costs as much as would be necessary if such changes were piled on top of present law.

Finally, I cannot close without expressing regret at continued congressional unwillingness to subject even part of social security benefits to tax. Taxing half of benefits would affect no age-65 retiree dependent exclusively on social security. The revenues from taxing half of social security benefits, if returned to the trust funds, would go far toward protecting social security reserves against stormy economic weather. Rather than making the Draconian cuts in social security that the administration has proposed, would it not be preferable to treat social security the same way we treat private pensions, allow beneficiaries to recover tax free the portion of their benefits that they have paid for out of after-tax dollars and include the rest in adjusted gross incomes, and return the proceeds to the social security trust funds?

Outline of Testimony
of
Henry Aaron

Before the Select Committee on Aging
U.S. House of Representatives

May 20, 1981

*Henry Aaron was Chairman of the 1979 Advisory Council on Social Security and is a Senior Fellow at the Brookings Institution and Professor of Economics at the University of Maryland

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Mr. Chairman, I should like to make the following six points regarding the President's proposed reductions in social security benefits:

- The reduction in social security benefits sought by the Administration in its budget amendments and May 12 announcement would reduce benefits by more than twenty-three percent. These cuts are more than twice as large as necessary to close the long-run deficit under current law. If one agrees with the Administration's short-run economic forecast, nothing other than interfund borrowing is necessary to deal with the short-run financing problem.
- The reduction in benefits for early retirees would leave those who retire at age 62 in 1987 with benefits 43 percent smaller than those payable under current law. No age 62 retiree in 1982, single or couple, would receive a benefit as high as the official poverty threshold. Moreover, the abruptness of the proposed implementation of the cuts would reduce benefits for millions of persons on the eve of their retirement.
- The Administration proposes to eliminate age, education, and experience as criteria for determining disability. Of those who apply for disability, more than seventy percent are now refused -- up from fifty-three percent six years ago. Of those refused, eighty percent never work regularly again. Disability insurance is not unduly soft. On the basis of recent experience, there is no need to tighten the eligibility criteria.

- The proposed increase in the required proportion of recent quarters applicants for disability insurance must have worked to be eligible for benefits would have major effects on the eligibility of women. For example, a woman who quits work to have a baby and returns to work on her child's third birthday never loses eligibility under current law. Under the new proposals, this woman would lose eligibility when the child is two years old and would not regain it until seven years after she returned to work.
- The Administration proposes to reduce replacement rates because they are higher today than they were in 1972. However, the average $359.25 benefit paid at the end of 1980 does not seem to be too generous to many people. Moreover, the size of the cut depends on the actual rate of inflation and wage growth; if prices and wages rise 3 percentage points more per year than the Administration assumes, replacement rates will be cut fifteen percent on the average.
- Other methods of dealing with the short- and long-run problems of social security are at hand -- correction of the overindexing of benefits in the recent past, use of general revenues to pay for part of Medicare as urged by the last two advisory councils and the National Commission on Social Security, a gradual increase in the age at which unreduced benefits are paid starting in the year 2000, and taxation of part of benefits -- and the time has come to extend social security coverage to all workers. These steps would improve the structure of social security, give beneficiaries fair warning of planned changes, and put the system on sound financial footing for the next seventy-five years.

Supplementary Statement
On the Future Course of the Replacement Rate

By Mr. Aaron, Mr. Ackley, Ms. Falvey, Mr. Porter and Mr. Van Gorkom

In 1977 Congress enacted a system for adjusting social security benefits over time which assures that workers with any given level of real earnings, who reach retirement in successively later years, will receive progressively higher real benefits. It chose this method of adjustment because it concluded that the ratio of social security benefits to wages—i.e., the "replacement rate"—for workers at any *given relative position* in the earnings distribution should remain the same in the future as it is today. An implication of this method of adjustment is that workers at any *given level of real earnings* will receive progressively higher benefits, through operation of the weighted benefit formula.

Based on the projections of the Social Security Administration, under present law, a single worker with average monthly earnings of $1,000 who retires in 1980 will receive a basic monthly benefit of $433 in 1980 dollars; a worker with the same real earnings history who retires in 1995 would receive $471, one who retires in 2025 would receive $570, and one who retires in in 2045 would receive $670 (all of the above expressed in 1980 dollars).[1] The justification advanced for such increasing benefits is that a worker who earns $1,000 per month is better off in 1980, *relative to other workers*, than would be a worker with the same real earnings in 2000, and much better off than a worker with the same real earnings would be in 2025 or 2045. We understand this argument, and it has some merit.

Our proposal would retain the present method of adjustment for the next 15 years, so that all workers approaching retirement age would have ample notice about the change in the benefit formula that we propose. But we recommend the enactment now of an alternative adjustment mechanism that would come into effect in 1995, and that would automatically assure successive generations of retirees who have the same real earnings history the same real benefit. Thus, retirees with average earnings of $1,000 a month in all years after 1995 would receive a benefit of $469 (in 1980 dollars). Enactment of this proposal would leave to successive Congresses the opportunity to decide whether workers with a given real earnings history should receive increased real benefits, and to impose the taxes necessary to pay for them. We support this modification in the benefit formula for two reasons.

Our first reason is based on our judgment that future Congresses will be better equipped than today's Congress to determine the appropriate level and composition of benefits for future generations. Beginning early in the 21st century, the ratio of social security beneficiaries to active workers is projected to increase sharply. The cost of OASDI benefits under present law will rise from 10.3 percent of covered payroll in 1980 to 12 percent in 2010 and 16.8 percent in 2030, and would average 16.3 percent over the period 2029 to 2053. The cost of benefits under the alternative formula we are here proposing would remain virtually unchanged at an average of 12.2 percent of payroll over the period 2029 to 2053. If this formula were adopted, we fully

[1] For single workers with average real earnings of $1,500 (in 1980 dollars), the basic benefit would be $538 in 1982, $631 in 1995, $730 in 2025, and $829 in 2045.

anticipate that later Congresses would indeed elect to increase real benefits as real wage levels rise over time. We doubt, however, that they would choose to do so in the precise way implied by the present method of automatic adjustment, nor that the average percentage increase would necessarily be the same as present law prescribes. Congress might elect to give more to certain groups of beneficiaries than to others, or to provide protection against new risks that now are uncovered. But precisely because we cannot now forecast what form those desirable adjustments might take, we feel that the commitment to large increases in benefits and taxes implied under current law will deprive subsequent Congresses, who will be better informed about future needs and preferences, of needed flexibility to tailor social security to the needs and tastes of the generations to come.

Our second reason is that, as per capita income rises, the case for increasing the amount of mandatory "saving" for retirement and disability through social security is far weaker than was the rationale for establishing a basic floor of retirement and disability protection at about the levels that exist today.

At levels of real income prevailing in the 1930s (or perhaps even the 1950s), it can well be argued that it was appropriate, indeed, highly desirable—perhaps even necessary for the preservation of our society—that government should, by law, have guaranteed to the aged and disabled and their dependents replacement incomes sufficient to avoid severe hardship, and to have required workers (and their employers) to finance this system with a kind of "forced saving" through payroll tax contributions. But as real incomes continue to rise, it is not so easy to justify the requirement that workers and their employers "save" through payroll tax contributions to finance ever higher replacement incomes, far above those needed to avoid severe hardship. Perhaps not all workers will want to save that much, or to save in the particular time pattern and form detailed by present law; some may prefer to save in quite different time patterns, or in forms involving quite different tradeoffs between risk and probable return. The case for government compulsion is not easily justified when it requires, as does present law, a maximum earner retiring in 2045 to guarantee himself an annual social security retirement income of $18,950 in 1978 prices, and to support, through a redistributive tax and benefit system, a retirement benefit for a minimum wage earner of $7,750 a year (in 1978 prices). The purchasing power of the benefit paid the minimum wage worker in 2045 is roughly what the *maximum* earner retiring in 1979 is guaranteed. This compulsion is especially questionable when we recall that, by that time, a combined payroll tax rate of around 16.5 percent on workers and employers will probably be required to support such benefits.

Some may argue that this generation need not make such a decision for its descendants. When the time comes, if the benefit level begins to seem unnecessarily high, it can be lowered. However, given the appropriate reluctance to alter benefit levels downward, except with a very long lead time, there is an obligation to act now, even though the first (extremely modest) difference in retirement benefits would only begin to occur for persons retiring after 1995. If, as 1995 approaches, people should decide to allow payroll tax rates to increase substantially after about 2005, so as to provide benefit levels close to those now in the law, it will be little problem to amend the law to provide income replacement at the now-scheduled levels.

Representative HAMILTON. What's the margin of safety that we ought to have in the social security system?

Mr. AARON. The answer is enough of a margin of safety to guarantee the payments that you think are desirable on social grounds get made. That principle has different implications depending on the state of the trust funds.

At the present time, trust funds are depleted and as a practical matter you can't build them up very fast. That means that some margin of safety has to come from sources other than the trust fund if present benefit obligations are going to be met. That is why I recommended one of the two broad approaches described in my testimony; either borrowing authority or some infusion of general revenues into medicare. Over the longer haul, I believe it would be desirable to build up the trust funds. As a steady state, long-term goal I would aim for a reserve of a minimum of 75 percent of 1 year's outlays, but as a practical matter, it's going to take a long while to get there.

Representative HAMILTON. If you were sitting in the Congress now, what set of economic projections would you use to shape the social security system?

Mr. AARON. I would base my design of the program on the tax rates that I think will be necessary against the background of the economic projections I think most likely, and that would be something in the vicinity of the CBO forecasts.

Now I believe Mr. Niskanen is correct in suggesting that just doing that would be imprudent, even with interfund borrowing. The question is what you do to become prudent. The administration has said let's cut benefits permanently by over 20 percent, which is what the May proposals cumulated to. I think Congress should take a look at the social security system, decide whether it thinks the benefits are overly generous—and in doing that calculation I would point out that the new benefits for newly entitled beneficiaries, retirees, are about $360 a month. If, as I think you should, you conclude that they are not excessively generous, then I think you have to look for safety valves other than cutting benefits. The provisions for borrowing from the Treasury with repayment arrangements stipulated or the use of general revenues in a limited fashion to pay for a portion of medicare benefits would be the preferred ways to go.

Representative HAMILTON. Your short-run solutions are interfund borrowing, borrowing from the Treasury, and some adjustment in the benefits limiting those benefit adjustments to the increase in prices—or the lesser of the increases in price or wages?

Mr. AARON. My short-run adjustments would not include the latter conditions.

Representative HAMILTON. You're saying that with the borrowing from the Treasury and the interfund borrowing alone we would be able to get through?

Mr. AARON. That is correct.

Representative HAMILTON. And what do you do about the long-run problem?

Mr. AARON. The long-run problem is one I believe should be dealt with through adjustment in the provisions for automatically increasing the formula used in computing initial benefits.

Representative HAMILTON. And that would be sufficient?

Mr. AARON. That would be sufficient to take care of the long-run problem.

Representative HAMILTON. Even with that baby boom becoming a senior boom at the turn of the century?

Mr. AARON. That is correct. The result would be almost no increase in the cost of social security measured as a percent of payroll over most of the planning horizon.

Representative HAMILTION. You don't accept business of prudence and the worst case scenario that we have heard about previously this morning?

Mr. AARON. I don't think it is the basis for cutting benefits, but I feel very deeply that if, through failure to enact sufficient safety valves at the present time, this issue is back on your agenda in 2 or 3 years, the fate of the social security system will be put in jeopardy. For that reason, I believe it would be a grave error to rely exclusively on interfund borrowing. There is a nontrivial chance that economic events will turn out worse than CBO is projecting and assuredly nontrivial chance that they will turn out worse than the administration is projecting. If that happens, interfund borrowing may not be enough. The damage to public confidence that would arise from the dashing of a second round of assurances about the financial integrity of social security that I'm sure will accompany the next round of legislation could be fatal to the system.

Representative HAMILTON. Congressman Long.

Representative LONG. Thank you, Congressman.

Mr. Aaron, I want to compliment you on having the political courage to go a different direction than most everybody else is going with respect to this problem. I think your analysis of it—I'm not expert in this—it seems to me confirms a suspicion that I had in the back if my mind which I was talking to Mr. Niskanen about, and that is that perhaps the administration really wants to reduce benefits as a political choice in order to meet their other objectives, and that the appearance by the Budget Director hollering, to the extent that he does, "Chicken Little, the sky is falling; the sky is falling"; is a common political technique that is used for doing such things as that. I'm not asking you to comment on that, but I'm suggesting that it does to some extent confirm my suspicions in that regard.

Thank you, Congressman, and thank you, Mr. Aaron.

Representative HAMILTON. Thank you very much, Mr. Aaron. The committee stands adjourned.

[Whereupon, at 12:05 p.m., the committee adjourned, subject to the call of the Chair.]

SOCIAL SECURITY

WEDNESDAY, SEPTEMBER 23, 1981

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON MONETARY AND FISCAL POLICY
OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9 a.m., in room 1318, Dirksen Senate Office Building, Hon. Roger W. Jepsen (chairman of the subcommittee) presiding.

Present: Senators Jepsen and Symms; and Representatives Reuss, Richmond, Heckler, and Wylie.

Also present: James K. Galbraith, executive director; Charles H. Bradford, assistant director; Betty Maddox, assistant director for administration; Francis McGrath, Douglas N. Ross, Mary E. Eccles, and Chris Frenze, professional staff members.

OPENING STATEMENT OF SENATOR JEPSEN, CHAIRMAN

Senator JEPSEN. The subcommittee will please come to order.

This morning the Subcommittee on Monetary and Fiscal Policy meets to examine the economics of social security and its relationship to employment, saving, and retirement. I am pleased to welcome Secretary Schweiker and other distinguished witnesses. I look forward to a stimulating discussion of an issue which is of great concern to millions of Americans.

One point I am especially interested in discussing is the relationship between social security and interest rates. As we all know, the administration has suggested delaying the inflation adjustment for social security recipients next year in order to reduce the budget deficit, and, hopefully, restore some stability to financial markets. Needless to say, this suggestion has not been greeted enthusiastically by the millions of Americans receiving social security benefits or looking forward to retirement.

Perhaps if we knew with certainty that the projected budget deficit was the only factor causing our high interest rates, and social security was the only place in the budget to make cuts, I would feel better about the administration's proposal. Despite what some on Wall Street tell us, the budget deficit is not the only cause of high interest rates, and there are certainly other areas of the budget to cut besides social security.

If we are truly interested in bringing interest rates down again we should be looking at the whole range of options, and not just focusing exclusively on cutting social spending. We need to look at monetary policy, off-budget spending, and we must expedite the reform that's taking place in regard to Government regulation. We must also consider the effects of inflation and the dismal rate of saving in this country.

I fully agree with the need to reduce Government's slice of our Nation's economic pie. I feel we have already made an important start in this direction and we should press forward with the President's economic program in a balanced and thoughtful way. Furthermore, I agree with the necessity of strengthening the social security system to insure its financial soundness. However, I am not convinced that this requires benefit reductions for those people currently receiving social security. This is particularly true when we are talking about cutting social security as a sop to the "Chicken Littles" on Wall Street and the "Nervous Nellies" right here in Washington, rather than discussing the issue of strengthening the social security system.

I would remind everyone that interest rates hit current record levels last December and have been virtually unchanged since May. In the interim the budget has been cut by $35 billion without having any noticeable impact on interest rates. So, what reason do we have to believe that a few billion dollars worth of social security cuts next year will necessarily produce lower interest rates? I, for one, do not.

Some are now suggesting that we renege on the tax cut to reduce interest rates. But again, what reason have we to believe that this will produce positive results? For one thing, the tax cut hasn't even gone into effect yet. Furthermore, the tax cut may be the only thing we have going for us right now. By increasing the aftertax return to saving the recently enacted tax bill will produce lower interest rates rather than higher.

Since our Nation's retirement income system—pensions, insurance and annuities—are the major source of saving in our economy, and because social security is such a major part of the retirement income system, I would hope that today's witnesses will be able to comment on some of the points I have just raised.

The individuals scheduled to testify this morning represent a wide range of backgrounds. We have Secretary Schweiker, representing the administration. We have three individuals who will give us some insights as to how the academic community views social security; and we have two witnesses who will give us the private sector viewpoint.

It is fitting that Secretary Schweiker is here with us today to present the administration's position on this vital issue. As a U.S. Senator, Secretary Schweiker was one of the foremost champions of the working men and women in this country. Although I had the honor of working with you for a very short period of time, Mr. Secretary, I want you to know that your dedication to improving the quality of life for working men and women, as well as the sick and the infirmed, has earned my respect and the respect of all your colleagues.

In the relatively short time that you have served as Secretary of Health and Human Services, this concern for your fellow man has been most evident. It's a pleasure to have you with us this morning Secretary Schweiker, and I look forward to hearing your testimony.

Before we proceed, Mr. Secretary, I would ask if there are any opening statements?

Opening Statement of Representative Richmond

Representative RICHMOND. Thank you, Senator.

Yesterday, the full committee held a hearing on social security examining the relationship between the system's financing needs and overall economic conditions. The hearing clearly established the groundless nature of claims that the social security system will go bankrupt—or that it even faces a serious crisis over the next several years.

All of the witnesses—Alice Rivlin of the Congressional Budget Office, William Niskanen of the Council of Economic Advisers, and Henry Aaron of Brookings—agreed on the dimensions of the problem. If the economy performs as well as the administration and the CBO project that it will, the combined balances of the three trust funds will show surpluses, not deficits. There are risks under more pessimistic conditions. If inflation and unemployment remain high, trust fund reserves—already strained by the stagflation of the recent past—will fall below acceptable levels by the middle of the decade.

Preparing the social security system for less favorable economic events requires some action, some action beyond a relatively simply shift of revenues among the trust funds. But the short-term problems are manageable without radical cuts in benefits, as this administration proposed in May.

At yesterday's hearing, Council Member Niskanen acknowledged that the slashes aren't needed as a short-term solution. Instead, he argued, they provide a "headstart" in dealing with social security's longer term problems. But these strains won't materialize for three decades, when the baby boom generation reaches retirement age. Since its support will depend on less numerous generations of working age people, some changes in social security will be needed. But we have a range of options, and the time to consider them thoroughly. The long-range arithmetic should not be an excuse for precipitous cuts in benefits.

Lacking either a short-term or long-term justification for major immediate cuts in social security, we are left with the real issue of political choice: Should benefits be reduced to accommodate other objectives of this administration; namely, higher spending for defense and a smaller Federal sector?

If we regard current social security benefit levels as desirable, we should look at changes in financing that would protect the system against the effects of bad economic news. Why not consider a safety valve that allows the trust funds to borrow from the Treasury when reserves are too low and repay the loans when reserves are replenished? This step, together with the provision for interfund borrowing, would remove the risks to the system in the short run without hastily dictating the future shape of the programs.

Senator JEPSEN. I have an opening statement from Senator Paula Hawkins welcoming Secretary Schweiker as well as an opening statement from Representative Rousselot, and I would ask that these be entered into the record without objection.

[The written opening statements of Senator Hawkins and Representative Rousselot follow:]

Written Opening Statement of Senator Hawkins

Mr. Schweiker, it is a pleasure to welcome you today. Less than four years ago then-President Jimmy Carter assured Congress and America that, with the passage of his 1977 amendments to the Social Security Act, the social security fund would be solvent and sound "for the next seventy-five years." Obviously, the fund is not sound.

The 97th Congress has given close attention to the social security issue. This year the Senate Finance Committee, the House Ways and Means Committee and the Joint Economic Committee are all conducting extensive hearings on the financial integrity of the system.

We are here today to examine the key to a financially secure social security system—a strong economy. No individual retiree is secure without a healthy economy. Yet every retiree must receive adequate retirement income.

We are well aware that the social security system faces both short and long term financing problems. We stress that everything will be done to insure the integrity of social security. The financial integrity of the Social Security system means that benefits that people count on will be paid.

This subcommittee can play an important role in determining the causes of a healthy economy. And it can also seek out where other countries have gone astray as a way to prevent us from doing the same. Together, these actions will help establish for all time a sound retirement system.

Secretary Schweiker, I look forward to your testimony.

Written Opening Statement of Representative Rousselot

Mr. Chairman, inflation is a cruel tax on growing incomes, new jobs and economic security. Inflation discourages saving for future benefits. Inflation encourages high interest rates as lenders set financing charges above the expected inflation level. Increasing the price of production prices our goods and services out of national and international markets, until, after depression, capital deficits and foreign exchange dollar devaluations make the sale of domestic production profitable again.

Inflation is a drain on the Nation's productive potential by expanding entitlement outlays for each increase in the CPI. Presently, the Federal Government operates 38 major retirement programs of which most are indexed to inflation. Stabilizing our currency is a concern not only for workers interested in sound retirements, but other hard-working citizens interested in stable and sound returns for their work and their company.

Only the debtor is benefited by inflation.

Inflation can be reduced by expanding the Nation's money supply no faster than the growth of the Nation's production. Fortunately, the Reagan Administration is dedicated to non-inflationary money growth, and, since January, the 12.4 percent consumer price inflation of calender year 1980 has fallen to an annual rate of 9.5 percent. As was developed in yesterday's hearing on Social Security, reductions in inflation can substantially reduce entitlement program outlays. In addition, free entry will enable competition to lower prices and make our production more marketable. Tax and spending reductions will lower business costs.

Mr. Chairman, this subcommittee has a mandate to advance policies for stable prices, and I hope this hearing will serve as a forum for a wide range of views on the economy.

Senator Jepsen. All right. Secretary Schweiker, welcome, and you may proceed.

STATEMENT OF HON. RICHARD S. SCHWEIKER, SECRETARY, DEPARTMENT OF HEALTH AND HUMAN SERVICES

Secretary Schweiker. Thank you.

Mr. Chairman and members of the subcommittee, I welcome the opportunity to appear before you and this subcommittee today to discuss our Nation's retirement system, both private and public, and the relationships between that system and the national economy.

Perhaps the most fundamental question in this area is what should be the respective roles of the public and private sectors in providing retirement income—the extent to which Government programs should be expected to provide for retirement income needs, and conversely, the extent to which people should be encouraged to make provisions, through their pensions, personal savings, continued work, or other means, for their own retirement income needs. The choices made on their questions have a profound effect on the economy, and on how retirement income is affected by changes in the economy.

The retirement income system that we have built in this country consists of three major elements: first, social security; second, private pension programs and individual asset accumulation; and third, programs of means-tested income assistance for the needy aged. Each of the elements has its own unique structure, and each has its own particular role to play. To be effective, each must complement the others so that, taken together, the three elements will produce a rational and equitable retirement income system that assures adequate retirement income for the Nation's aged.

In recent years, an increase in the role of private investment has been advocated as a way of promoting economic growth and avoiding any need for further expansion of the role of social security.

We recognize that the United States suffers from a lack of capital formation and that this is due in large part to the present extremely low rate of private savings and investment. Indeed, as you know, the President's economic recovery program is explicitly designed to provide incentives for increased private savings and investment.

The social security benefit structure has been overexpanded in recent years. It has too many built-in incentives to claim benefits before age 65. It unduly penalizes continued work efforts, and it overemphasizes the social adequacy or welfare aspects of the system. Our social security financial reform proposals are designed not only to insure the financial stability of social security, but also to restore the program to its proper role in the national retirement income system.

What we are proposing does not, by any means, amount to reducing social security to a minor role in the retirement income system. On the contrary, once it is restored to a proper balance of social adequacy and individual equity, social security will once again serve effectively as the basic retirement income maintenance program for the United States, providing the base upon which individuals and groups can, and will, build other retirement income.

Social security affects virtually every American—either by providing benefits today or by providing protection against possible loss of income tomorrow. No other Government program reaches so many people. Currently, about 115 million workers are building protection for themselves and their families. This month, some 36 million beneficiaries will receive social security cash benefits payable at an annual rate of about $145 billion. About 95 percent of those who currently turn age 65 are eligible for social security benefits, either as retired workers or their spouses or as survivors of deceased workers.

Social security, however, is not structured to meet the total income needs of all beneficiaries. On the contrary, social security benefits are designed, for most workers, to be augmented by other income.

As President Franklin Delano Roosevelt said on January 16, 1939:

> We shall make the most lasting progress if we recognize that Social Security can furnish only a base upon which each one of our citizens may build his individual security through his own individual efforts.

In assessing the extent to which social security benefits are reasonable and meet the income needs of the elderly, it is important to keep in mind the two goals—social adequacy and individual equity—that social security combines. Neither of these two concepts can be defined with precision, but it is clear that each has a different emphasis. If all the emphasis in social security were on the goal of individual equity, we would have a strictly proportional benefit formual, related entirely to social security contributions paid. That procedure would, depending on the level of the contribution rates, either produce benefits that are inadequate for low-wage earners or benefits which are much larger than present-law benefits for high-wage workers.

On the other hand, putting too much emphasis on the social adequacy goal would weaken the link between benefits and earnings and also the taxes paid. Instead, social security should strike a reasonable balance between the two objectives of social adequacy and individual equity. The private sector is a more appropriate vehicle for providing retirement benefits based on pure equity principles. Means-tested programs are the proper approach for meeting current needs without regard to past work effort.

The supplemental security income program performs this function by providing income to aged people, as well as the blind and disabled, who have limited income and resources. SSI benefits serve as a nationally uniform floor of income that can be supplemented by State benefits to take care of regional variations in the cost of meeting basic needs and can also be augmented by recipients' earnings and other income.

No single retirement income vehicle is able or intended to satisfy all retirement income needs and desires. Public programs such as social security and SSI attempt to satisfy social needs and provide a floor or protection, but they cannot provide everyone with desired retirement income levels.

We believe that private investment should increase substantially and that private pensions should be encouraged. With social security being returned to its proper role, and with the revitalization of the economy that will occur under the President's economic recovery program additional discretionary income will be available for individuals to invest in the private sector. The flow of some of these funds into private pension plans would be healthy, both for the economy and for the well-being and security of future retirees.

Individuals always have provided, and still do provide, a significant amount of economic security for themselves and their families. One of the principal means has been through equity growth in real estate holdings, primarily homeownership. Also significant are life insurance and various forms of individual savings.

The opportunity for individual savings for retirement has been enhanced in recent years by the creation of individual retirement accounts—IRA's and Keogh plans—which encourage individuals to save by allowing them to defer taxes on the income they invest in these plans, and the interest it earns, until after they reach retirement age. By expanding eligibility for IRA's to all workers, the recently enacted Economic Recovery Tax Act of 1981 will provide a major boost to individual savings for retirement.

It should be noted that a return to healthy economic conditions will not only benefit private pensions plans, but it will also have a significant and beneficial effect on social security financing.

A healthy economy—one in which expanding production of goods and services produces additional jobs and in which productivity gains allow noninflationary wage growth—provides an expanding base upon which social security contributions are collected. A stagnant or shrinking economy, however, such as the one we have experienced in the last 4 or 5 years, has a large negative impact on social security financing.

High unemployment, for example, means that fewer workers contribute to the system. However, the economic factor with the greatest effect is the growth in real wages—that is, the excess of the increase in wages over the increase in prices. When wages do not keep up with price inflation, increases in social security tax revenues do not keep pace with the increase in expenditures arising from the automatic adjustment of benefits to increases in prices. The decline in real wages—by an average 1.5 percent per year from 1977 to 1980—has had a devastating effect on the social security trust funds.

Mr. Chairman, in addition to issues which I have discussed already, you asked that I address two specific topics. The first of these is how the social security earnings test affects work incentives.

It is clear that the present earnings test is a work disincentive. The earnings test tends to discourage work because it reduces social security benefits by $1 for every $2 of earnings, over an annual exempt amount—$5,500 for people aged 65 and over in 1981. In many cases, older workers have marginal tax rates of 70 percent or more because the earnings test operates as a 50-percent tax on earnings above the annual exempt amount and the earnings are further reduced by Federal, State, and local income taxes and social security taxes. In addition, the workers have expenses of going to work.

For these reasons, as part of our package of social security reforms, we propose that the earnings test be gradually eliminated for those aged 65 and over.

The elimination of the earnings test will fulfill a commitment of President Reagan which is in concert with legislative initiatives that Senator Goldwater and you, the distinguished chairman of this subcommittee, have advocated for several years.

Our proposal will stop penalizing senior citizens aged 65 and over because they choose to remain in or reenter the work force. Rather, it will encourage them to continue to contribute their valuable skills to our Nation's productive effort, while supplementing their social security benefits.

Finally, Mr. Chairman, you asked that I discuss the implications of taxing social security benefits. We all are aware, of course, that the Senate has approved a resolution opposing the taxation of social security benefits. At the outset, I want to say that the administration also is opposed to taxing these benefits.

President Reagan is committed as part of his economic recovery program to lowering taxes, rather than raising them. Our approach to spurring economic growth and productivity is to provide incen-

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tives for people to work harder and to save and invest their money. It was to this end that the Congress last month enacted the Economic Recovery Tax Act of 1981, which is designed to remove disincentives for work, savings, and investment contained previously in the tax system. To make social security benefits taxable would result in a new economic disincentive by lowering discretionary income and by placing beneficiaries who have other retirement income, from a lifetime of work and savings, in higher tax brackets where additional work or investment effort is poorly rewarded.

Social security is the foundation of our retirement income system—it is a foundation which this administration is committed to strengthen. We believe social security should remain the cornerstone of our Nation's retirement system, but individuals should be encouraged to accept an increased role in preparing for their retirement security.

Therefore, we must encourage the continuing development and use of private means, such as private pensions and savings, to augment social security. Individuals who are financially able to do so should take responsibility for financing part of their retirement. In addition to reducing dependence on social security and pressure on social security financing, increased private savings and pensions will provide the capital which is essential to economic growth.

The administration's economic program includes provisions designed to make the necessary changes in social security and to expand private savings. When these changes are in place, there will be a balance between social security and private forms of retirement protection, both of which have a vital role in meeting the overall retirement needs of this country.

Mr. Chairman, that concludes my testimony. I will be glad to answer any questions which you may have.

Senator JEPSEN. Thank you, Secretary Schweiker.

[The prepared statement of Secretary Schweiker follows:]

PREPARED STATEMENT OF HON. RICHARD S. SCHWEIKER

Mr. Chairman, I welcome the opportunity to appear before you and this committee today to discuss our Nation's retirement system, both private and public, and the relationships between that system and the national economy.

Perhaps the most fundamental question in this area is what should be the respective roles of the public and private sectors in providing retirement income--the extent to which government programs should be expected to provide for retirement income needs, and, conversely, the extent to which people should be encouraged to make provisions, through their pensions, personal savings, continued work, or other means, for their own retirement income needs. The choices made on their questions have a profound effect on the economy, and on how retirement income is affected by changes in the economy.

Background

The retirement income system that we have built in this country consists of three major elements: (1) Social Security, (2) private pension programs and individual asset accumulation and (3) programs of means-tested income assistance for the needy aged. Each of the elements has its own unique structure, and each has its own particular role to play. To be effective, each must complement the others so that, taken together, the three elements will produce a rational and equitable retirement income system that assures adequate retirement income for the Nation's aged.

The Old-Age, Survivors, and Disability Insurance program, together with the Medicare program, are the Social Security element of our retirement income system. The Supplemental Security Income program, enacted in 1972, is this Nation's most important program of income assistance for the needy aged. Both Social Security and Supplemental Security Income are administered by the Department of Health and Human Services.

Respective Roles of Social Security and Private Pensions

In recent years, an increase in the role of private investment has been advocated as a way of promoting economic growth and avoiding any need for further expansion of the role of Social Security. Because private savings and private pension plans accumulate substantial reserve funds, whereas Social Security does not, it is argued that greater reliance on the private sector will increase the amount of money available for productive investment and will help spur economic growth.

We recognize that the United States suffers from a lack of capital formation and that this is due in large part to the present extremely low rate of private savings and investment. Indeed, as you know, the President's Economic Recovery Program is explicitly designed to provide incentives for increased private savings and investment.

The Social Security benefit structure has been overexpanded in recent years, it has too many built-in incentives to claim benefits before age 65, it unduly penalizes continued work efforts, and it over-emphasizes the social adequacy or welfare aspects of the system. Our Social Security financial reform proposals are designed not only to ensure the financial stability of Social Security, but also to restore the program to its proper role in the national retirement income system.

In developing the Social Security financial reform proposals, we rejected the idea of raising taxes to finance the present Social Security program, because we recognized that higher taxes would be a serious drag on the ecomomy. Moreover, we believe that it would be unfair to current taxpayers to pass along to them the burden of paying for the excessive welfare elements and benefit over-expansions that have been built into the present system. We have therefore proposed that certain nonessential, welfare-related benefits that have been added over the years be phased out or curtailed. We have also proposed that the over-expansion of the general benefit level in the early 1970's be corrected.

The Role of Social Security

What we are proposing does not, by any means, amount to reducing Social Security to a minor role in the retirement income system. On the contrary, once it is restored to a proper balance of social adequacy and individual equity, Social Security will once again serve effectively as the basic retirement income maintenance program for the United States, providing the base upon which individuals and groups can, and will, build other retirement income.

Social Security has many advantages that have long been recognized by both business and labor, Republicans and Democrats, taxpayers and recipients. It applies to nearly everyone. The benefits are paid without a means test. Its financial stability is ultimately guaranteed by the Federal Government. It is administered with great efficiency--the administrative expenses in recent years have been only 1 1/2 percent of benefit payments.

Social Security affects virtually every American--either by providing benefits today or by providing protection against possible loss of income tomorrow. No other government program reaches so many people. Currently, about 115 million workers are building protection for themselves and their families. This month, some 36 million beneficiaries will receive Social Security cash benefits payable at an annual rate of about $145 billion. About 95 percent of those who currently turn age 65 are eligible for Social Security benefits, either as retired workers or their spouses or as survivors of deceased workers.

Social Security, however, is not structured to meet the total income needs of all beneficiaries. On the contrary, Social Security benefits are designed, for most workers, to be augmented by other income.

From Social Security's beginning, the benefit formula has been designed to provide retirement benefits at an appreciably higher replacement rate for lower-wage workers than for higher-wage workers. This deliberate design--a balancing of social adequacy and individual equity--provides, for the same overall cost of the program, higher benefits and a higher standard of living to lower earners than they would have if benefits were strictly proportional to earnings.

Social Security explicitly recognizes that lower-paid workers are less likely to be able to substantially supplement their Social Security benefits, while higher-paid workers are more able to save for retirement and are more likely to have worked in employment that provides them with private pension income.

Studies have verified that this is, in fact, what happens--workers at lower earnings levels have consistently lower savings and less in the way of pension income than do higher-paid workers. Higher-paid workers tend to supplement their Social Security benefits with income from such private resources. For example, 80 percent of all individuals earning $20,000 to $50,000 a year are covered by a private pension plan. In turn, the design, funding, and operation of private pension plans generally take into account the Social Security benefits to which workers will be entitled.

In assessing the extent to which Social Security benefits are reasonable and meet the income needs of the elderly, it is important to keep in mind the two goals--social adequacy and individual equity--that Social Security combines. Neither of these two concepts can be defined with precision, but it is clear that each has a different emphasis. If all the emphasis in Social Security were on the goal of individual equity, we would have a strictly proportional benefit formula, related entirely to Social Security contributions paid. That procedure would, depending on the level of the contribution rates, either produce benefits that are inadequate for low-wage earners or benefits which are much larger than present-law benefits for high-wage workers.

On the other hand, putting too much emphasis on the social adequacy goal would weaken the link between benefits and earnings and also the taxes paid. Instead, Social Security should strike a reasonable balance between the two objectives of social adequacy and individual equity. The private sector is a more appropriate vehicle for providing retirement benefits based on pure equity principles. Means-tested programs are the proper approach for meeting current needs without regard to past work effort.

The Supplemental Security Income program performs this function by providing income to aged people, as well as the blind and disabled, who have limited income and resources. SSI benefits serve as a nationally uniform floor of income that can be supplemented by State benefits to take care of regional variations in the cost of meeting basic needs and can also be augmented by recipients' earnings and other income. Currently, about 4 million people receive SSI benefits or federally-administered State supplementary payments.

The Role of Private Pensions

No single retirement income vehicle is able or intended to satisfy all retirement income needs and desires. Public programs such as Social Security and SSI attempt to satisfy social needs and provide a floor of protection, but they cannot provide everyone with desired retirement income levels. Employer pensions, private savings and investments should assume an expanded role in providing retirement income security.

Private pensions are an increasingly important source of private retirement income. About 55 percent of married workers and about 45 percent of single workers now aged 45-64 already have rights to a private pension, and this proportion will be much higher for those who retire in the future.

This rising proportion reflects the expansion of the private pension system over the past 40 years. Today, about 54 percent of private sector workers aged 25-64 are in jobs covered by private pensions. Coverage rises with increases in length of service with the same employer--for example, 82 percent of workers with 20 or more years of service with the same employer are covered by a pension plan.

The percentage of workers with vested pension rights will increase in the future as those in jobs covered by pension plans work longer. The Employee Retirement Income Security Act of 1974 requires certain vesting in private pension plans. Although only about one-fourth of currently retired workers actually receive private pension income, as a result of the growth of coverage in private plans and the extent of vesting, the proportion of retired workers who will receive private pensions can be expected to increase significantly in the future.

We believe that private investment should increase substantially and that private pensions should be encouraged. With Social Security being returned to its proper role, and with the revitalization of the economy that will occur under the President's Economic Recovery Program, additional discretionary income will be available for individuals to invest in the private sector. The flow of some of these funds into private pension plans would be healthy, both for the economy and for the well-being and security of future retirees. We are philosophically attuned to the wish of many individuals to use their own initiative in financing a substantial part of their retirement.

<u>The Role of Individual Efforts</u>

Individuals always have provided, and still do provide, a significant amount of economic security for themselves and their families. One of the principal means has been through equity growth in real estate holdings, primarily home ownership. Also significant are life insurance and various forms of individual savings.

The opportunity for individual savings for retirement has been enhanced in recent years by the creation of Individual Retirement Accounts (IRA's) and Keough plans which encourage individuals to save by allowing them to defer taxes on the income they invest in these plans, and the interest it earns until after they reach retirement age. By expanding eligibility for IRA's to all workers, the recently enacted Economic Recovery Tax Act of 1981 will provide a major boost to individual savings for retirement.

Also, many individuals generate income by continuing to work past age 65. As I will discuss later, we believe the Administration's proposal to eliminate the Social Security earnings test will remove a major disincentive for retirees to work to supplement their pension income.

Role of the Economy

It should be noted that a return to healthy economic conditions will not only benefit private pension plans, but it will also have a significant and beneficial effect on Social Security financing.

A healthy economy--one in which expanding production of goods and services produces additional jobs and in which productivity gains allow non-inflationary wage growth--provides an expanding base upon which Social Security contributions are collected. A stagnant or shrinking economy, however, such as the one we have experienced in the last 4 or 5 years, has a large negative impact on Social Security financing.

High unemployment, for example, means that fewer workers contribute to the system. However, the economic factor with the greatest effect is the growth in real wages--i.e., the excess of the increase in wages over the increase in prices. When wages do not keep up with price inflation, increases in Social Security tax revenues do not keep pace with the increase in expenditures arising from the automatic adjustment of benefits to increases in prices. The decline in real wages--by an average of 1.5 percent per year from 1977 to 1980--has had a devastating effect on the Social Security Trust Funds.

The fact that the performance of the economy has such a broad effect on Social Security is reflected in the actuarial cost estimates in the 1981 Social Security Trustees Report. As you know, this report shows estimates based on five sets of economic assumptions, ranging from optimistic to pessimistic. These estimates clearly indicate that the Social Security cash-benefit trust funds will have financing difficulties in the next few years.

Of course, these estimates did not include the effect of the recently enacted legislation, P.L. 97-35, which reduces costs by $23 billion over the next 5 years. Taking account of these savings does not change the basic forecast. The Social Security program will still have financing difficulties in the next few years.

In the long range, P.L. 97-35 reduces Social Security costs by 0.17 percent of taxable payroll. Since the long-range deficit under intermediate II-B assumptions in the 1981 Trustees Report is 1.82 percent of taxable payroll, the effect of P.L. 97-35 is obviously only a small beginning toward solving the long-range financing problem.

Elimination of the Earnings Test

Mr. Chairman, in addition to issues which I have discussed already, you asked that I address two specific topics. The first of these is how the Social Security earnings test affects work incentives.

It is clear that the present earnings test is a work disincentive. The earnings test tends to discourage work because it reduces Social Security benefits by $1 for every $2 of earnings, over an annual exempt amount ($5,500 for people aged 65 and over in 1981). In many cases older workers have marginal tax rates of 70 percent or more because the earnings test operates as a 50 percent tax on earnings above the annual exempt amount and the earnings are further reduced by Federal, State and local income taxes and Social Security taxes. In addition, the workers have expenses of going to work.

The earnings test currently affects about 900,000 retired workers aged 65 and over who earn over the exempt amount and

200,000 auxiliary beneficiaries of such workers. But these numbers underestimate the total number of people affected. There are many retirees who want to work more than they actually do, but who hold down their earnings so that they will not lose benefits. For example, many workers hold down their earnings to just below the annual exempt amount so as to avoid triggering the earnings test.

The number of people aged 65 and over who would continue to work (or return to work) if there were no earnings test is difficult to estimate. Those who have examined this question differ fairly widely in their results.

We do, however, have some indication of how many people want to continue working from a 1979 study performed by Harris and Associates. Their Study of American Attitudes Toward Pensions and Retirement found that nearly half (46 percent of today's retirees would prefer to be working and that 51 percent of current employees would prefer, as an alternative to retirement, to work either full-time or part-time. Clearly, many senior citizens want to work.

For these reasons, as part of our package of Social Security reforms, we propose that the earnings test be gradually eliminated for those aged 65 and over.

The Administration's proposal would raise the exempt amount for persons aged 65 and over to $10,000 for 1983, $15,000 for 1984, and $20,000 for 1985. After 1985, the test would be eliminated altogether for those aged 65 and over. The elimination of the earnings test will fulfill a commitment of President Reagan which is in concert with legislative initiatives that Senator Goldwater and the distinguished Chairman of this Subcommittee have advocated for several years.

Our proposal will stop penalizing senior citizens aged 65 and over because they choose to remain in or re-enter the work force. Rather, it will encourage them to continue to contribute their valuable skills to our Nation's productive effort, while supplementing their Social Security benefits.

Taxing Social Security Benefits

Finally, Mr. Chairman, you asked that I discuss the implications of taxing Social Security benefits. We all are aware, of course, that the Senate has approved a resolution opposing the taxation of Social Security benefits. At the outset, I want to say that the Administration also is opposed to taxing these benefits.

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President Reagan is committed as part of his Economic Recovery Program to lowering taxes, rather than raising them. Our approach to spurring economic growth and productivity is to provide incentives for people to work harder and to save and invest their money. It was to this end that the Congress last month enacted the Economic Recovery Tax Act of 1981, which is designed to remove disincentives for work, savings, and investment contained previously in the tax system. To make Social Security benefits taxable would result in a new economic disincentive by lowering discretionary income and by placing beneficiaries who have other retirement income, from a lifetime of work and savings, in higher tax brackets where additional work or investment effort is poorly rewarded.

Conclusion

Social Security is the foundation of our retirement income system--it is a foundation which this Administration is committed to strengthen. We believe Social Security should remain the cornerstone of our Nation's retirement system, but individuals should be encouraged to accept an increased role in preparing for their retirement security.

Therefore, we must encourage the continuing development and use of private means, such as private pensions and savings, to augment Social Security. Individuals, who are financially able to do so, should take responsibility for financing part of their retirement. In addition to reducing dependence on Social Security and pressure on Social Security financing, increased private savings and pensions will provide the capital which is essential to economic growth.

The Administration's economic program includes provisions designed to make the necessary changes in Social Security and to expand private savings. When these changes are in place, there will be a balance between Social Security and private forms of retirement protection, both of which have a vital role in meeting the overall retirement needs of this country.

Mr. Chairman, that concludes my testimony. I will be glad to answer any questions which you may have.

Senator JEPSEN. I would remind the members of the subcommittee that the jurisdiction of this subcommittee is policy and not legislation. The emphasis of the hearing will be on how social security affects the national economy rather than on the administration's legislative specifics.

I also suggest to the panel members that we follow a 6-minute rule this morning rather than 5 or 10. I promised the Secretary he would be out by 10 a.m. so he could make an important appointment. If we have other members join us we will be safe by having 6 minutes, and should we not, we will simply go around a second time. Does that meet with your approval?

Representative RICHMOND. Anything you say, Mr. Chairman.

Representative WYLIE. Fine.

Senator JEPSEN. With that, I will recognize Congressman Wylie to begin the questioning.

Representative WYLIE. Thank you, Mr. Chairman; and welcome to the panel this morning, Mr. Secretary, and again, many thanks for your recent appearance on the television show which was well received. It's good to see you here.

At your press conference this spring you suggested that the social security trust fund was in some difficulty from a financial standpoint and threw out as a possible suggestion a reduction of benefits for early retirement at age 62 from 80 percent to 55 percent, and I might say that I was deluged with mail and telephone calls in protest after that, and it's my understanding that the administration has rather backed off of that proposal at the present time. Is that a fair statement?

Secretary SCHWEIKER. Well, I think, Congressman, the proposals that we put forth were at the request of Congressman Pickle, who was at that time marking up a bill, and we made some suggestions about how we thought the funds could get in balance. We put them forth on the basis that they would hopefully provide a foundation for some bipartisan approach to solving the problem.

I think, in retrospect, the one aspect of those proposals that I would change if I were doing it again would be to take the one proposal that received the most criticism and phase it in on a gradual basis over a long time frame, because I think that the immediate impact would have difficult consequences.

But at this point we are pretty much where we were before, which is that we believe there's a problem; the problem ought to be met; we ought to try to join hands politically to try to solve this jointly; and we have at this point only two principles that are guiding us. We are strongly opposed to a tax increase because social security taxes have gone up horrendously anyway, and we are opposed to using money from the general Treasury because we feel the Government balance is enough in the red now without making it a lot worse in the long run. Within those two principles we are willing to look at any reasonable proposal to solve this problem.

Representative WYLIE. I think it's also fair to say that the reduction in the minimum provision was not very well received and since then the House has gone on record in opposition to that. There was something like 14 votes in favor of it. So I think we're going to have to solve the problem at least in the short run, Mr. Secretary, without reducing benefits. Would you agree with that?

Secretary SCHWEIKER. Well, I think, Congressman, that some reduction of benefits is needed in the proposal. Whether you gradually phase in something over a long period of time is something that we're willing to negotiate and consider at the time we get a package. We do think there should not be an arbitrary reduction that sets people back, and the President feels very strongly that he didn't want to cut the present benefits of people who are now receiving them. He held to that in our proposals.

Representative WYLIE. I might say that I approve enthusiastically your outside earnings limitation suggestion and I've suggested that over the years. That brings us back to the problem. You suggested there is a lot more money going out of the trust fund than is coming in and so we have to decide some way to solve that problem in the short run. I might say that Alice Rivlin was before another subcommittee of this Joint Economic Committee yesterday and came up with the suggestion for the relatively—well, long or short term, until about 1990, of having interfund borrowing. There are three trust funds, as I understand it, and she suggested that the largest of these is the social security trust fund and that's declined rapidly over the years, but that the health insurance fund and the disability insurance fund may have some money in them which could be transferred.

Is that a possible solution in the short term?

Secretary SCHWEIKER. Congressman, it all depends on which group of economic assumptions comes true. I noticed that Ms. Rivlin had two sets of economic assumptions; what I would call an optimistic and a pessimistic set; and I think her statement that was picked up in the paper this morning was based on the assumption that the most optimistic set of assumptions would come true.

So it gets back to exactly which assumptions will ultimately prevail. Social security trustees have had the job to promulgate an optimistic set, an intermediate set, and a pessimistic set of assumptions. We have to look at all three sets. That's exactly what we did and I think, depending on which set comes true, certain things are needed. We do not believe that it's financially secure to go on the basis that interfund borrowing alone will do the job. If everything worked hunky-dory and everything was functioning 100 percent and everything came out exactly the way we hope and pray it will, then, yes, that would get us by. But historically, that has not been the case.

In fact, the reason we are in the bind today is because we went on overly optimistic assumptions when Carter signed the last bill in 1977 and said that this change would make social security secure to the middle of the next century. We are only 50 years off. That's the problem when you always assume the optimistic assumption is going to work.

So we don't feel we can afford to do that. We are for interfund borrowing. We think it will help, but we really believe we probably need more than that.

Representative WYLIE. I would agree. I think we need more than that, but is there money—I should go back a step. Based on present payouts and the projection of the amount of money coming into the old age and survivors' insurance fund, how soon will it go broke?

Secretary SCHWEIKER. Congressman, under our pessimistic assumptions, if we changed nothing beyond the changes made in the Reconciliation Act, we estimate that the OASI fund will run out of money by some time next year, probably late next year. If we interfund borrow, that probably will push it back about a year and a half under those assumptions.

Two things need to be said. There are three funds. The biggest fund is the old age and survivors fund, and that fund and the disability insurance fund together have been losing money since 1974. They have been putting out more money than is coming in and we have lost billions of dollars from those two funds since then. Presently those two funds are losing about $13,000 a minute.

Although the assets of the hospital insurance fund are growing, medicare costs will be more than triple in the next decade and our projections show that by the end of this decade the HI fund could be bankrupt.

So it's true that interfund borrowing will buy some time, but we don't think, unless everything goes rosy perfect, hunky-dory, that it will do the job.

Representative WYLIE. I'm sorry to say that my time has expired. I do have a couple more questions and maybe I'll have some more time.

Senator JEPSEN. Congressman Richmond.

Representative RICHMOND. Thank you, Mr. Secretary.

Mr. Secretary, I listened to your testimony carefully and apparently you agree with the Congressional Budget Office and other administration officials that the social security fund in general is really not in jeopardy. Is that true?

Secretary SCHWEIKER. No, I certainly don't agree.

Representative RICHMOND. I think you seemed to say that we're not in imminent danger of having the fund go bankrupt if indeed we can have a certain amount of interfund borrowing.

Secretary SCHWEIKER. No. I just said we expect the fund to go bankrupt about the end of next year and the interfund borrowing might push it off for some months.

Representative RICHMOND. Wouldn't you say, Mr. Secretary, that the reason you're suggesting cuts in the social security fund would be to reduce the Federal budget in order to get to President Reagan's hoped for $42 billion deficit in 1982? Wouldn't you say perhaps that the poor people of the United States have taken enough of a cut and perhaps we ought to look to the defense area to look for some reasonable and substantial cuts?

Secretary SCHWEIKER. First of all, I don't agree that we're going to balance the budget through the social security trust fund. The law is very specific, Congressman. It says not a dollar of that money can be used for any other purpose but for social security. That's why we have the trust fund. That's my duty as a trustee. So any money we take into the trust fund has to be used to pay out a benefit. To say it is used any other way is not only inaccurate, it's illegal. I couldn't possibly use the money for any other purpose.

Representative RICHMOND. Mr. Secretary, with several very minor elements of interfund borrowing, we can keep the funds solvent for the next couple years and we could also address ourselves to some of the major expenses of the United States where we know there's enormous waste. The Secretary of Defense himself, when he first took office, admitted there's an $8 billion added-on waste. Suddenly there's only a projected $2 billion cut in the defense budget. Don't you think maybe your agency has made enough cuts in all the welfare programs together and all of its education programs, in all the health programs, all the programs that you yourself administer and many that you administer so well? Don't you think it's about time the defense sector took its share of the necessary cuts in order to hit that $42 billion deficit that we all want so desperately in 1982?

Secretary SCHWEIKER. There's no question we made significant and substantial cuts. I certainly think we have to look at the overall picture. I'm not in the position to comment on anybody else's budget. That's the President's and the OMB's job, but I certainly think we have made some significant cuts in our social programs.

Representative RICHMOND. Don't you think perhaps we ought to look to interfund borrowing, more efficient operation of everything we have, and perhaps make the cuts in defense where the Secretary of Defense said there's $8 billion worth of waste, before we look to cutting your social security funds any more?

Secretary SCHWEIKER. Well, I do concur that we should interfund borrow. That's been one of our premises all along.

Representative RICHMOND. If we can interfund borrow, that means the social security funds are safe for the next couple years. Why can't we look to other areas of the administration for the necessary cuts in order to keep our deficit at $42 billion?

Secretary SCHWEIKER. Well, frankly, I just don't believe that the interfund borrowing alone will solve the problem.

Representative RICHMOND. You said it will for 2 years.

Secretary SCHWEIKER. What's that?

Representative RICHMOND. You said the interfund borrowing could solve the problem for the next 2 years and these are the 2 years where President Reagan has said, due to these great, wonderful individual tax cuts that I voted against, that that stimulation of the economy will put everything just in great shape.

Now if we're going to back the President and we're going to back Reaganomics, shouldn't we use the vehicle of interfund borrowing for the next 2 years and see if, indeed, the President's wonderful tax cut is going to change the general economy of the United States?

Secretary SCHWEIKER. Well, we still believe that our economy is going to pick up and we still believe that it's going to pick up significantly, but we would be derelict in our duties if we just looked at the most optimistic assumption, Congressman. That's exactly why we went through the same exercise last time when we all voted for a big tax increase in social security in 1977 on the sole premise that it would make everything solvent until the year 2010, and that's what Carter said when he signed the bill and that's what Chairman Ullman of the Committee on Ways and Means said in 1977 when the House passed the bill, and that's what I assumed as a Senator when I voted for it, and we were all dead wrong, and now we're in a mess, and I just hate to see us repeat and repeat those same mistakes and that's why we're trying to get a positive, constructive approach so we won't repeat the mistakes of the last 4 years.

Representative RICHMOND. Mr. Secretary, I'm not an expert in social security, as you are. It seems to me what we should be doing right now is putting our attention on running the program more efficiently, improving our work incentives, both in social security and public assistance fields, in order to make it more attractive for people who work and less attractive for people to take Government money.

Then, on the other hand, it seems to me we should do whatever is necessary to keep our funds solvent and reduce other expenditures in the administrative area. Apparently that would be a reasonable, sensible way to run this country with this Reagan tax cut, which as I said I have been so much against.

Secretary SCHWEIKER. Of course, keep in mind we made some 13 proposals and certainly some of those proposals could be combined with interfund borrowing, not only to get us over the next 2 or 3 years, but also over a longer timeframe. You could pick up some of those proposals without going all the way and reach the middle ground. The point we're trying to make is that we are willing to make some compromises, but we honestly don't believe just interfund borrowing alone will do it. But some combination of interfund borrowing and some of the other proposals that didn't quite draw the attention that changes to early retirement benefits drew could well do that.

Representative RICHMOND. If we don't do that we will have to start cutting social security benefits right now?

Secretary SCHWEIKER. We have to pick up some changes in the social security system. For example, in the disability program, GAO reported that, as of about a year or so ago, one out of five people getting disability shouldn't have been awarded benefits and that we are wasting about $2 billion a year there. My point is that there are a number of the 13 things that we proposed that we could pick and get the package through. But I still think it has to be more than interfund borrowing.

Representative RICHMOND. What you're saying is through better administration of the social security plan, which you control, you believe you can pick up some savings without materially reducing all social security benefits; is that correct?

Secretary SCHWEIKER. Through changing some of our welfare concepts in the fund and through making some adjustments. These are negotiable. By the same token, we just don't believe it can be done on a one-shot basis with interfund borrowing.

Senator JEPSEN. Senator Symms.

Senator SYMMS. Thank you, Mr. Chairman, and welcome, Mr. Secretary. It's always nice to have you back in your old stomping grounds here on the Senate side of the Hill, and I guess you spent some time in the House side too before I got here.

I was interested in looking at some numbers that you sent, and I asked the staff to come up with that if the COLA was set over from July over to October for the increase that it would save some $15 billion in the fund over a future of 6 years. Does that match what your figures are?

Secretary SCHWEIKER. I think that's approximately correct, yes, but the savings can vary greatly depending on future levels of inflation.

Senator SYMMS. So how much is the COLA increase this year and what would your projections be next year for the July increase for the entire year? How much will be cut?

Secretary SCHWEIKER. You mean the total COLA amount for the year or for the month?

Senator SYMMS. On an annualized basis, how much is it?

Secretary SCHWEIKER. I think the answer to your question, if I understand it correctly, is about $16 billion.

Senator SYMMS. $16 billion?

Secretary SCHWEIKER. The COLA increase for the year.

Senator SYMMS. How much of that goes to the higher end of the scale? Do you have those kinds of figures? In other words, there are some people in the system who have a lower benefit basis and have a bigger need for an increase than the ones that are higher.

Secretary SCHWEIKER. We would have to break that down for you.

Senator SYMMS. I'd like to get those figures of what it would cost for each category from 1 percent through 25 percent, 25 percent through 50 percent, 50 percent through 75 percent, and the top 75 percent.

Secretary SCHWEIKER. By quarter of population? [1]

Senator SYMMS. By quarter of population on the basis of what they receive, who's getting the increases. And the reason I ask that question is in the month when we were in recess I came across several people at home who came up to me and volunteered that they are people who are receiving in excess of $1,000 a month on the basis of a married couple from the Social Security Administration and then they read in the paper that the budget is out of balance in Washington and interest rates are up and then they come up to me and say:

> My own grandson can't borrow the money to buy a home and he and his wife have a combined income of $28,000 and they can't borrow the money to buy a home because of the high interest rates, and yet we're getting an increase in social security.

So the next question I want to ask you, are the recipients—and this goes to the higher income. I wanted to keep this separated. The reason I'd like those figures is to know where this money goes. When we do have a COLA, who gets it? And then, if you have any figures of any polls or any actuarial tables of what the average of each one of those categories would be of their other income, it would be interesting also I think to the committee.

I think you may have answered this to Congressman Wylie, but I didn't quite get the answer. What would happen in the case of interfund borrowing to the other funds? For example, what would the impact be on the health insurance money?

Secretary SCHWEIKER. Right now, if we keep paying benefits the way we are and make no changes in current services in medicare, we'll just about triple the payment by the end of this decade and at that point the fund is broke, under pessimistic assumptions. The point is, we are living on borrowed time. We have known about this problem since 1974. The OASI and OI funds on a combined basis have been operating at a loss since 1974. The only reason we got by with it was that back at the end of 1974 we had enough assets in the combined funds to pay about 8 months of benefits in the absence of any income. So we could use that to get us over the last 7 years of red ink, and now the chicken is coming home to roost and we don't have that

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[1] Information will be supplied to the subcommittee when necessary data are available from the Department.

reserve any more. So as soon as you start doing the same thing on the medicare fund you're kidding yourself. It's just a matter of time before you're going to have to face up to this. You're going to have to face up to this problem in some way. We can borrow and put off and borrow, but that isn't very reassuring to the people that want to know we're going to solve the problem.

Senator SYMMS. What's the actuarial tables that Social Security Administration has today of the present recipients of what they get back and what they and their employer, including the interest, was that they put in? Is the recipient, say, that 75-year-old today that's been drawing it for 10 years, on the average getting back 80 percent more than they invested in or 20 percent or getting back equal?

Secretary SCHWEIKER. First of all, the first figure is that for the worker with average earnings you only have to be drawing on the fund for around 15 months and you get back all the money you put in. People don't understand that.

Senator SYMMS. You get all the money back you put in and your employer put in, plus interest?

Secretary SCHWEIKER. Fifteen months would not include interest on the employer's share of the taxes. You have to factor interest in.

Senator SYMMS. My point is, I personally believe that the suggestions you made to the Congress, although I wouldn't agree with them in entirety, I think it's good that you have made them in spite of the fact that I'm sure you've taken a lot of criticism from different quarters of the press and so forth and the news media and your critics, but it has to be addressed. It's a national problem. It's not a Republican or Democrat problem and I'm very disappointed frankly that the Speaker of the House has chosen to make this a partisan issue because I believe it's a problem that has to be faced as Americans, not as Republicans and Democrats, and I think if we get this into politics we are going to compound the problem.

We are looking at a lot of ways in the Senate Finance Committee to try to approach this from a rational way and what I'm trying to get at is different examples of whether or not the wealthy social security recipient who has other means of income and who is on the top part of the receiving end—if it would be unreasonable to try to consider some kind of a means test after they've gotten back everything they've invested in the program.

I think those are questions we're talking about and that's why I asked that question. I would like to have those figures as to where these COLA's go, who gets them, and whether they really need them or not, and then there are two other questions—if I could just indulge the committee for one more question—I know my time has expired, but there are some suggestions that have come to the Senate Finance Committee.

One is the NFIB proposal to phase in over a 36-year period a sound annuity program with 10-year transition costs being financed by general revenues. There's another insurance proposal, INA, to allow increasing IRA accounts to a maximum of $6,000 in exchange for one-half of 1 percent decrease in the individual social security benefits while keeping social security taxes at the present level.

It's my understanding the Social Security Administration is running some actuarial estimates and it may be premature to ask you this, but do you have any opinion of either of these plans or do you have a preferred plan for a long-range solution that would have a great deal of appeal to the American public going in this direction, to make this an actuarially sound program for the long haul?

Secretary SCHWEIKER. I think the answer, Senator, to your question is that we are aware of proposals. In fact, we met with some of the people involved and they presented them to us and we are having our actuaries study them and the long-range implications of them.

Frankly, we are obviously willing to look at any constructive idea. I think that the one from INA particularly was constructive, but we haven't formed any conclusion as to what our recommendation would be.

Senator SYMMS. Well, thank you, and I know I have gone past my time, Mr. Chairman, and I would just say in closing, don't be feint-hearted by the first round of this struggle that you've gotten involved in. I know it may be somewhat discouraging to you, but I personally believe this has to be addressed by the American people and I do believe, knowing the Speaker as I do know him, and Jim Wright and others, that sooner or later partisanship will be set aside in this issue and we will have to get together as Americans and solve this problem or else we have no hope to resolve the present economic dilemma that the country is in because this, after all, will consume some 60 percent of the budget by the middle 1980's and we have to recognize that that's where most of the budget is going.

Senator JEPSEN. The Chair would advise the subcommittee and the distinguished chairman of the Joint Economic Committee, Congressman Reuss, that we are using a 6-minute rule here today, I have not taken my 6 minutes yet but I would be very pleased to yield to you.

Representative REUSS. Thank you very kindly. Please take yours and then I'll come after.

Senator JEPSEN. Well, I will try to shorten mine. We did promise the Secretary that he would be out of here at 10 a.m. and I would advise the subcommittee now, regardless of who is speaking at that time, I will adjourn the subcommittee for about 3 minutes to permit the Secretary to leave.

Representative REUSS. Five and five then. It's 10 until 10.

Senator JEPSEN. I will just try to summarize some of the things that have been said for the record rather than questioning, so if you have questions, would you please proceed, and then I will wind it up.

Representative REUSS. Thank you very much, Mr. Chairman; and welcome, Secretary Schweiker.

Your statement acknowledges that the administration's social security proposals go far beyond what's necessary to insure the short-run financial integrity of social security. That could be done by a combination of interfund borrowing and some safety valve measures such as borrowing from general revenues in the event that the economy in the days ahead doesn't go as well as the projections.

Isn't the administration's social security program just another example of the general supply-side thesis of cutting people's benefits in order to validate some kind of a preconceived economic theory? In short, why do all this?

Secretary SCHWEIKER. Well, I'm not particularly a supply-side economist, Congressman, and as a trustee, I came upon a couple of facts.

No. 1 is that the old-age and survivors trust fund and the disability insurance trust fund together have been paying out more money than they receive each year since 1974. So for 7 years the two funds have been running in the red to the point where it's getting to be a significant factor. We have to deal with that fact and the reason we have that fact. You're a good economist and you know we have had a negative real wage growth in the last few years. That caused President Carter to be totally in error when he said in signing the 1977 bill that we have taken care of the trust fund problem until the next century. Negative real growth in wages causes us to have to pay benefits for escalating cost-of-living adjustments at the same time the wage base for revenues is shrinking in real terms. That's caused the problem and that's exactly why we're in the mess we are.

Representative REUSS. Well, why not do interfund borrowing and, if the projections don't work out as planned, use general revenues until we can pass legislation taking care of the long-term situation? Why cut benefits now when it may not be necessary?

Secretary SCHWEIKER. Well, we do agree that there should be interfund borrowing. I certainly agree with that. We should have interfund borrowing and we support that. We just don't think honestly that's going to be sufficient to insure the integrity of the fund and we do believe that as soon as you go into general revenues you're going to open up a Pandora's box and make the thing subject totally to our budgetary red ink.

We have been unable to balance a budget for I guess 19 of the past 20 years, Congressman. I have been here, so I can't believe that our record is going to be any better on the budget with this program than any other program.

Representative REUSS. My point, Mr. Secretary, was why balance the budget on the backs of the present generation of social security recipients? Why not take a precautionary safety valve measure now and then, if the worst hypothesis develops, we may have to do these terrible things to the old folks? Why do it before you have to?

Secretary SCHWEIKER. The point I was making was that by borrowing from the fund all we are doing basically is assuring that we are going to be taxing our younger people more. So you're borrowing today's benefits on the backs of our kids and I just think that's morally wrong. Why kid everybody and say we don't have the money so we're going to borrow from my kids' payroll in the future to pay the recipients because we don't have the guts to face up to the problem now? I just think that's morally and fiscally wrong.

Representative REUSS. Well, we can't seem to get our projections on the same level. I'm against doing things that are morally wrong. I don't see why you have to take it now out of the hides of the old folks when it is not presently necessary. I guess that's a difference between us, and my 5 minutes seem to be up, Mr. Chairman.

Secretary SCHWEIKER. Well, does it become presently necessary when there's no money in the fund to pay a check? Is it necessary when the checks can't be mailed because there are no funds? Is that when it's necessary or should we, in all prudence, Congressman, do something before that occurs?

Representative REUSS. Well, I think you can set up in effect an insurance fund out of the general revenues so that that situation where you can't send out the checks doesn't happen. Then if that worst scenario turns out to be true, you make whatever permanent decision you have to.

Senator JEPSEN. Thank you, Congressman.

Just to briefly recap, Mr. Secretary, your knowledge of this has been most refreshing and most helpful. It's characteristic of your usual preparedness and general ability to express things and I believe everybody can understand what the problem is.

You have said time and time again what the facts are and they have been well known to everybody across the board—that the social security fund has been losing money since 1974.

Secretary SCHWEIKER. Exactly. Senator, we have been losing money for 7 years, and everybody closes their eyes to it.

Senator JEPSEN. In a poll conducted earlier this year by Lance & Associates, a national public opinion research firm, it was found that 68 percent of the American people believed that social security was in financial trouble and most of these people are also worried about the adequacy of their own retirement income. I think the record should show that the Reagan administration, to its credit, has attempted to draw attention to the seriousness of this problem and the President and yourself, Mr. Secretary, have had the courage and the honesty to present this issue to the American people in a manner unlike previous administrations.

When the social security program was started over 40 years ago, a promise was made to the working men and women of this country that when they retired social security would be there to provide a basic retirement benefit, and I want the record to be clear that neither Congress nor President Reagan intends to let that promise be broken.

Now there are those who would have us believe that the problems facing the social security system can be solved by a quick fix solution. Allowing interfund borrowing will not solve the problem. You have evidenced here a willingness to consider that as one of a number of options to proceed with while you are shoring up and doing whatever is necessary to strengthen social security. I congratulate you on that, but allowing interfund borrowing is a quick fix solution and is only going to postpone the day of reckoning if that is what we use as an answer. Is that correct, Mr. Secretary?

Secretary SCHWEIKER. That's exactly correct.

Senator JEPSEN. It is like putting a band-aid on a gunshot wound, it only covers up the problem, it does not cure it. The fact of the matter is—and let us make this perfectly clear for the record for now, for tomorrow, for next month and next year while we are working on this problem—that more money is being paid out of the social security system than is going into it. You do not need to be an economist to understand this and it can only go on for so long before the funds' money runs out, and rest assured that the American people understand that. Do you agree with that, Mr. Secretary?

Secretary SCHWEIKER. I strongly concur.

Senator JEPSEN. I have been advised that Congresswoman Heckler has arrived and we are running out of time. I promised the Secretary he would be out of here at 10 a.m. and we have 2 minutes. The Chair recognizes Congresswoman Heckler for questioning.

Representative HECKLER. Thank you very much, Mr. Chairman.

Mr. Secretary, I think that the problems in the social security system, as Senator Jepsen has mentioned, are quite well known and they are becoming better recognized, but my concern is about the level of social stress that is being created while Congress ponders the options.

There are temporary answers that are not real answers and there's no doubt the Band-Aid approach is not going to solve the basic underlying problems. But really, isn't there a question about how deeply this society can undergo vast comprehensive changes? The level of stress created by the issue of social security alone, in addition to other changes in the society, creates a tension that is almost reaching, in my district among the older people, a level that's unbearable. Isn't there a way to resolve the problem thoughtfully and rationally but on a basis that allays the fears of the elderly and is fair to everybody?

Secretary SCHWEIKER. I think that you're exactly right. There is a stress coming along and I think that we should try to resolve it and that's exactly what we had in mind when we suggested some kind of bipartisan approach. As I mentioned to Chairman Jepsen here today, we are perfectly willing to look at interfund borrowing as one of the bases on which to add some other things in a package, and if we were willing on both sides of the aisle to meet this head-on, I think we could find a solution that wouldn't be that far off from either point of view because there is some middle ground. It's unfortunate that we don't want to strive to do that.

Senator JEPSEN. This subcommittee will stand in recess for 3 minutes.

[A short recess was taken.]

Senator JEPSEN. The Chair will advise the subcommittee that we will now hear from Alan Blinder from Princeton; Martin Feldstein from Harvard; and Anthony Pellechio, Acting Deputy Assistant Secretary, Office of Income Security Policy, Department of Health and Human Services.

Can you decide among yourselves in what order you wish to proceed? We will hear all of your testimony individually before the panel submits questions so you may proceed.

STATEMENT OF ALAN S. BLINDER, PROFESSOR OF ECONOMICS, PRINCETON UNIVERSITY, PRINCETON, N.J.

Mr. BLINDER. Thank you, Senator.

I'd like to especially thank you and the subcommittee for the privilege of speaking here today at what is quite clearly, based on what's just gone on, a very critical juncture in the social security system's future.

It seems to me that it's a foregone conclusion that social security benefits will be cut in one way or another. That may not come this year but it will have to come. So I think it's a good idea to ask why.

I believe that the fundamental reasons why we are coming up against the absolute necessity to cut social security are budgetary and/or political ones and not fundamentally economic in nature. An economic case for cutting social security benefits would arise if the system were not achieving the goals for which it were designed, or if it were achieving those goals but having very harmful side effects elsewhere in the economy. In my view, neither of those is the case.

The major goal of social security is to enable social security recipients who might not otherwise adequately provide for their own retirement to retire on a decent income; and I think the system has met this goal extremely well. More people are retiring today and living better than retired people ever did.

A secondary objective of the system, I think, is to redistribute income in a lifetime sense from the people who are better off to the people who are not as well off. Senator Symms a while ago alluded to the fact that people at the lower end of the income spectrum get a better deal through social security than people at the upper end. This has been true for a very long time. I think that's a good idea. It's a little out of fashion these days, but nonetheless, I think that's a proper role of government; and social security is a very good vehicle for achieving that goal. I'll come back to that in a second.

That leaves a question of whether social security has had ill effects elsewhere; so that despite the good effects it's had in helping people retire, it's doing harm elsewhere. The written statement which I submitted to the committee concentrates on the ill effects that social security has allegedly had on economic incentives. In particular, social security has been accused of inducing people to retire earlier than they otherwise would, and it's also been accused of inducing people to save less than they otherwise would.

The main conclusion, which is dealt with in some detail in the written statement, is that while the second charge—that social security reduces private savings—makes good theoretical sense, there's really very little evidence in support of it; and that the first charge—that social security encourages early retirement—does not make basic theoretical sense but nonetheless may be true, at least there is circumstantial evidence that it is true. I won't try to go over the written statement here, though I would be happy to answer any questions you have on it. Instead, I would like to call attention to a couple points in the statement.

The first is to explain why I say that social security does not really encourage early retirement, even though most people claim the opposite. Let me try to explain that a little bit.

Think of a case of a married 62-year-old man deciding whether or not to retire now at age 62 or wait until 65, and ask what does he gain or lose. Obviously, he loses the benefits he could otherwise draw today, his current social security benefits. One thing he gains is his annual salary minus payroll taxes. Another thing he gains is an increase in his future social security benefits.

This happens for two reasons. The first is that benefits at age 62 are only 80 percent as large as at age 65. So, for example, if a typical person would be entitled to $4,000 a year in benefits today, if he were to wait 3 years—until 65—he would be able to draw $5,000 in benefits; and that's in terms of today's money, because social security benefits are indexed for inflation.

So he faces the following calculation: He can give up $4,000 for 3 years and in return can get an extra $1,000 a year in real benefits for the rest of his life.

Now it turns out, for people with an average life expectancy, that this is a very good investment. Put differently, the actuarial adjustment now offered by social security for postponement of retirement from 62 to 65 is more than fair for the average man. For example, in a study that I did with two colleagues cited in the testimony, we calculated that for a typical married man of age 62 in 1973—that happened to be the year we did this calculation—the law offered $1.54 in future benefits for every $1 he gave up in current benefits. That's for a married man. For a single man, the corresponding figure was $1.14 for giving up $1. That is to say, there is a financial inducement as the law now reads to postpone retirement.

But there's a second effect that I want to explain also, which encourages work and can be just as strong as the one I just mentioned. This effect derives from the fact that the person's entitlement to social security benefits depends on his earning history. A vast majority of workers at age 62 are earning much more than they did during the worst years that are included in their social security earnings history. So by continuing to work at age 62, the worker could in some years in the past replace a bad year in his earnings history by a good year, and thereby raise the whole base, the so-called AIME, upon which his future social security benefits are based.

This effect is also well known, but most people mistakenly believe it's unimportant. In fact, it's very important. In our study we looked at men who turned 65 in the year 1975. It turned out that the vast majority of these people were potentially eligible for the recomputation of benefits to which I have just alluded. If you asked how large was this recomputation on the average, the astonishing fact that we discovered was that for the average married man the increase in future social security benefits was equivalent to 54 cents for every $1 of earnings.

I'd like to rephrase that because it's very poorly understood. What this means, in effect, is that the Social Security Administration is kicking in an extra 54 cents of additional wages for every $1 that a typical married, 62-year-old man earned. And I think that potentially provides a strong incentive to stay at work, if indeed that provision is understood by people as they turn 62 or 65, which I think is another question entirely.

So if you put those two effects together—the actuarial adjustment and this recomputation of benefits, and take it up to the year 1981 instead of the year in which we did the study the conclusion seems to be that for workers between the age of 62 and 65, there's an actuarial bonus for postponing the receipt of social security benefits.

In addition, for the vast majority of 65-year-olds who are earning more today than they did in the worst year included in their earnings base, there's an additional incentive to stay at work. Because of the 1977 amendments, this incentive is not as strong now as it was when we did our study in 1975, but we estimated that if those same people—the married men who reached 65 in the year 1975—had been subject to the 1977 amendments—which they weren't—then their added social security benefits would still have averaged 36 cents for every $1 of earnings—instead of 54 cents. So the effect was reduced by the 1977 legislation, but not by any means eliminated.

When you put these two effects together, the actuarial adjustment and the benefit recomputation, the conclusion is that a married, 62-year-old man may give up almost $2 in future social security benefits for every $1 of benefits he collects by retiring now.

That's why I say that on a priori, theoretical grounds it would seem odd that a system like that seems to encourage people to retire early. That does not mean it does not, but that it should not if the people understand how the law functions.

Let me turn to the effect on savings. I explain in the statement what I found in my own research with my two colleagues, and I also explain why I think the well-known work of Professor Feldstein on my left does not really establish a strong case for a strong negative effect of social security on savings. I won't try to repeat all that here now, but once again, I would answer questions if there are any. I would like, instead, to call your attention to the only graph in my prepared statement.

What it shows is the rate of personal savings as a fraction of disposable income roughly from the beginning of the 20th century to now. It shows that, on average, the savings rate of individuals in the period since social security has been about the same as it was before we had a social security system. That is, people have saved in the postwar period roughly the same fraction of their disposable income that they did before there was a social security system—not exactly the same, but roughly the same.

This means, if we are really to believe that social security has strongly reduced savings—for example, halved private savings, as has sometimes been claimed—we have to believe that had Congress never created the social security system back in the 1930's that savings in the United States today would be twice as high as they are now, which is to say also twice as high as they were in the first third of the 20th century. That's not totally impossible, but I frankly find it hard to believe when you look at this evidence over a long period of time. In fact, you could take this graph back further and conclude that for a period of about 120 years, marked by great social upheavals, migrations, and demographic changes, the rate of personal savings relative to disposable income has been more or less constant once you corrected for the business cycle—for about 120 years or so. So I think that really makes you wonder about how it could be the social security has halved private savings.

Now let me just take a few minutes to talk about potential principles for truly reforming the social security system instead of applying a Band-Aid approach, as you correctly put it.

Taking a longer term view, how would we get benefits down, if that is the route taken, rather than raising taxes, which I think is likely. Cutting social security means changing some aspect of the benefit formula. And I think it's useful to think of a social security system as a bank account that is locked in until retirement. But it has at least three rather odd features that distinguish it from a bank account. All three are critical.

The first is that it's indexed by act of Congress.

The second is that how much you get out depends on the pattern of your work effort late in life, which is not true for your own bank

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account. I think it would be useful to make total lifetime benefits depend on all earnings for your whole lifetime up to some age, say 62, and not depend at all on your pattern of work effort after that. Then whether or not you work at 62, 64, or 68 would not affect the total lifetime benefits that you draw from the system. This could be done by, first of all, using fair actuarial corrections at all ages past the initial age when you first become eligible for benefits, and then matching the increases in whatever benefits were earned after the age of 62, if that's the age, to the payroll taxes that you pay after that age. For example, if the computation of social security benefits stopped at age 62, you could suspend the payroll tax for people after age 62. That's just one example of the general principle.

I think it's also worth saying that there's nothing wrong with letting people retire on social security early, say at 62, if they want to, if by so doing they don't actually increase the lifetime benefits they draw from the system.

Now I have essentially argued that the current benefit reductions made for early retirement at age 62—80 percent of the amount of 65—are already too large. That is to say, you get more lifetime benefits by waiting until 65. The administration proposal made in May would make it even lower, and personally I find that a bad idea.

Problems arise in making fair actuarial adjustments because different groups in our society have different mortality tables. For example, blacks have a worse mortality experience than whites. And that leads to the third aspect of the system that I alluded to before, that it's a redistributive system. It does pay more to people at the lower end of the income spectrum relative to what they put in.

The current social security system, once it's fully mature—and it's not fully mature because it takes a few generations after you make a change for the system to reach maturity—this current system will give people with low lifetime income more if they live long enough. Those are the important words here—if they live long enough. It will give high-income people less. The problem, however, is that many of these low-income people will not in fact live long enough.

As I said in the beginning of the testimony, I personally find the social security system a very sensible way to redistribute income for a variety of reasons, of which I think the most important is that it's the only feature of our tax and transfer system that basically uses the lifetime as the unit. So what we are doing is redistributing income to people who are lifetime poor, not to people who have a bad year or something, but to people who are poor for a lifetime, from people who are lifetime rich. And I think that's a good way to redistribute income.

Even if you don't agree with that argument, and don't view social security as the proper way to redistribute income, you must realize that the poor, the black, et cetera, generally have worse survival experience than those who are better off. Since they won't, on average, live as long as the people who are better off, the social security system must be redistributive simply to compensate them for the fact that they have a worse life expectancy. If it doesn't do that, the system will in fact play a reverse Robin Hood role of robbing from the poor to give to the rich.

And I'd like to point out in that respect also that the administration's proposals in May would have sharply reduced the redistributive aspect of the social security law, and I would view that as a mistake as well.

What does that lead me to? It doesn't lead me to a piece of legislation which I'm going to suggest. That was not my charge and it's not my intent. It leads to a couple of general principles which I will mention very briefly and then conclude.

In considering the long-term problem—not the Band-Aid approach—of what to do about the system, first, I think we should preserve the redistributive aspects, and not take the cuts out of the hides of the people that have the worst mortality experience—as would be done, for example, by drastically cutting early retirement benefits.

Second, we should try to make the system neutral with respect to the retirement age. It is not at the present time. It encourages the 62-year-old to stay at work. It may discourage the 66-year-old from working. It should be neutral in that respect. We should not try to change people's retirement decisions on the basis of their social security benefits.

Third, we should fix the indexing formula but maintain indexing. We don't want to leave old people who are relying on social security open to the vagaries of inflation. The Bureau of Labor Statistics is going to reform the CPI in the next couple years. Everybody knows by now the problems with the housing component, which is the main issue here as well, and is the main reason why older people have been overindexed in the last couple of years. The BLS will fix that, and could go even further.

The BLS is very good at computing price indexes. It's a marvelous statistical agency, the best we have in the United States probably. They could very easily design an index directed specifically at the consumption basket purchased by older people. It would be an easy job for BLS. They could do it very well, and I think it would be a good idea to have an index constructed specifically for that purpose.

And there's one last principle which I think is very important and which was also violated by the administration's proposal in May. The principle has only three words: Do it slowly. Retirement is a long-range issue, something that people plan for and build quite a few other decisions around. It's essentially a lifetime decision. If we're going to make large changes in the nature of the social security system, I think it's terribly important that we give very long, advanced notice of these changes so that people within 5, 10, or even 20 years of retirement have some inkling about what things are going to be like when they in fact retire.

Thank you, sir.

[The prepared statement of Mr. Blinder follows:]

Prepared Statement of Alan S. Blinder

1. Introduction

The short-run financing problem of the social security system, which makes it imperative that either benefits be reduced or receipts increased, makes this an opportune time to reexamine the nature and effects of the system. Research on social security by economists has centered around two questions:

(1) Has the existence of social security benefits led to a reduction in private saving by individuals?

(2) Has the structure of social security benefits and taxes encouraged older Americans to retire earlier than they would have otherwise?

These are important questions. If answered in the affirmative, they constitute a powerful indictment against the system. Because promised social security benefits are not funded, if social security leads to a reduction in private saving by individuals, then the nation as a whole winds up saving less. This, in turn, means less capital formation, lower productivity, and so on. If people are retiring earlier because of social security even though they are living longer, then the nation's total supply of labor is less than it might be, with corresponding deleterious effects on potential output, inflation, and so on.

Though I certainly think our present social security system could stand improvement, my role here today is that of the defense attorney. My claim is that one charge is probably false, although it should be true, while the other charge might possibly be true, although it should be false! Specifically, the first indictment--that social security discourages private saving--makes perfectly good sense. But there is precious little supporting evidence. The other indictment--that social security encourages earlier retirement--flies in the face of the actual work incentives set up by the law. But there is nonetheless of least circumstantial evidence suggesting that it may be true.

The rest of my testimony backs up these claims. In the course of the testimony I will rely heavily on the results of a research project conducted jointly by myself, Dr. Roger Gordon of Bell Telephone Laboratories, and Dr. Donald Wise, of Mathematica, Inc., although they are in no way implicated in the conclusions I draw.[1] Because the committee staff requested that I do so, I will concentrate on the first charge.

2. Social Security and the Incentive to Retire

I begin by dealing briefly with the second charge--that social security has led to earlier retirement--because it is here that I think I may have something to say which you have not already heard.

[1]See A. S. Blinder, R. H. Gordon and D. E. Wise, An Empirical Study of the Effects of Pensions on the Saving and Labor Supply Decisions of Older Men, report submitted to the U.S. Department of Labor, March 30, 1981; A. S. Blinder, R. H. Gordon, and D. E. Wise, "Reconsidering the Work Disincentive Effects of Social Security," National Tax Journal, December 1980, pp. 431-442; R. H. Gordon and A. S. Blinder, "Market Wages, Reservation Wages, and Retirement Decisions," Journal of Public Economics, October 1980, pp. 277-308; A. S. Blinder, R. H. Gordon, and D. E. Wise. "Social Security, Bequests, and the Life Cycle Theory of Saving: Cross-Sectional Tests," National Bureau of Economic Research Working Paper No. 619, January 1981.

My point is that, contrary to popular belief, the structure of the social security law, if properly understood, actually provides strong incentives for most 62-64 year olds to stay at work rather than to retire. Since so many people believe the opposite, let me try to explain the reasoning behind my statement.

Consider the case of a married 62-year-old man deciding on whether or not to retire and claim early social security benefits. Everyone knows that, if he waits until 65, he will get a basic benefit that is 25% higher than what he can collect at age 62. (This is usually stated by saying that the benefit at age 62 is 80% of the benefit at age 65.) What does he gain and lose by waiting? One thing he obviously gains is his annual salary, net of any taxes he must pay. Another thing he gains is higher social security benefits in the future. This happens for two reasons.

(1) The first reason was just mentioned. Suppose he is entitled to $4000/year right now. If he waits until age 65, he will be able to draw $5000 in terms of today's money (because benefits are indexed for inflation). Thus, by giving up $4000 per year for three years, he can obtain an extra $1000 real dollars in benefits, for the rest of his life. For people with average life expectancy, this is a good investment. Put differently, this means that the "actuarial adjustment" offered by social security for postponing retirement is more than fair for the average man. For example, Gordon, Wise and I calculated

that, for a typical married man reaching age 62 in 1973, the law offered him $1.54 in future benefits for each $1 in current benefits he gave up. For a single man, the corresponding figure was $1.14.[1] Thus there is a financial inducement to defer benefits, even if you actually retire.

(2) But there is a second effect which encourages work and which can, in many cases, be just as strong. This effect derives from the fact that a person's entitlement to social security benefit depends on his earnings history. The vast majority of workers are earning much more late in life than they were during the <u>worst</u> years that are included in their social security earnings histories. By continuing to work at age 62 (or even at age 65), a worker can throw a "bad year" out of his earnings base and replace it by a "good year," thereby increasing his entitlement to social security benefits.

This effect is also well known; but most people mistakenly believe that is is unimportant. It is not. Let me illustrate, using as my example a married man who turned 65 in 1975, because this was the group considered in our study. For people of this age, social security benefits were based on the best 19 of their last 24 years of covered earnings. Thus, as long as earnings at age 65 exceeded the <u>worst</u> earnings in any of these 19 years, staying at work would raise future benefits. It turned out that over 90% of the men we studied were potentially eligible for this increase in benefits. How large was the increase? The astonishing fact we discovered was that, on average, <u>the increase in future social security benefits was equivalent to 54¢ for each</u>

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[1]These are based on a 1% real interest rate. At a 3% interest rate, the corresponding figures are $1.22 for a married man and $0.94 for a single man.

$1 of earnings! I'd like to rephrase this because it is so poorly understood. Our finding was that, in effect, the social security administration kicked in 54¢ of additional wages for each dollar that a typical 65-year-old earned. This is a strong incentive to stay at work.

While this number was obtained by considering the detailed earnings history of each of 907 men, I can show quite simply why 54¢ was the average figure. Each dollar of additional earnings at age 65 added $1/19 = 5.3¢ to average annual earnings. For a typical worker, this in turn raised his Primary Insurance Amount (PIA) by 2.4¢ on an annual basis. For a married man, this increase in PIA raised annual social security benefits by about 3.6¢ per year for life, which after allowing for discounting, survival probabilities, and the likelihood that the wife will outlive the husband, was equivalent to about 54¢ in additional social security benefits.

Let me now try to bring these two provisions together and illustrate how they work in 1981.

For workers between 62 and 65, there is an actuarial bonus for postponing the receipt of social security benefits. Even if they want to retire anyway, it pays many people to postpone claiming benefits. This is just as true today as it was in 1973.[1]

In addition, for the vast majority of 62-year-olds who are earning more today than they did in the worst year included in their earnings base, there is an additional incentive to stay at work

[1] It was not true between 1974 and 1977 when, through a quirk in the law that has since been corrected, the actuarial adjustment was much smaller.

Because of the 1977 amendments, this incentive is not as strong now as it was in 1975. But Gordon, Wise and I estimated that if our sample of men who reached 65 in 1975 had been subject to the 1977 amendments, their added social security benefits would still have averaged 36¢ (rather than 54¢) for each dollar of additional earnings. Thus, on balance, a married 62-year-old man may give up almost $2 in future social security benefits for each $1 of benefits he collects by retiring now.

The story is not quite as strong for a 65-year-old because the law does not offer full actuarial compensation for deferring benefits past age 65. But the other half of the story--the effect of current earnings on the earnings history--remains in force.

Why, then, are more workers taking early retirement today than was true 20 or 30 years ago? This is a good question, about which I have thought a good deal since doing the study. Though I do not know the answer, I can offer a few possibilities:

(1) It may well be that few workers understand the way the law actually works, and think (mistakenly) that it is in their best financial interest to retire at 62. Though some economists refuse to entertain the notion that people make systematic errors, I do not find it totally outlandish to suppose that people do not understand a terribly complex law--especially since hardly any social security "experts" understand it either!

(2) In contrast to social security, most private pension plans offer strong inducements to take early retirement. And these plans have expanded greatly, both in coverage and generosity, during the past few decades.

(3) The effect of current earnings on future social security benefits that I have discussed was actually far stronger in the 1950s, when earnings histories included only a few years, than it was in the 1970s. Hence the incentive to continue at work has grown weaker over the years.

(4) The average worker reaching retirement age in the 1970s was richer, in a lifetime sense, than the average worker reaching retirement age in the 1950s. One way to spend this greater wealth is to "buy" a longer retirement period.

I am not sure which of these factors was most important. And there are others that I have not mentioned. But this short list should illustrate that there are suspects besides social security. Just because retirement rates have increased does not imply that social security is the culprit. We should not rush to convict the system on circumstantial evidence.

3. Social Security and Private Saving: The Application of Common Sense

Let me now examine why many people believe that social security discourages private saving. As indicated earlier, their reasoning seems theoretically sound and makes good common sense. However, Section 4 will show that there is very little evidence to support their case.

The basic argument is simple. While people save for a variety of reasons, one obviously important one is saving for retirement. If the government, through the social security system, forces them to set aside a portion of their earnings for their retirement, it seems natural to suspect that people will do less retirement saving on their own. But how much less?

A Simple Case

Let's start with a simple case, and then consider some qualifications. Suppose that (a) John Doe saves only to finance retirement spending, (b) social security does not induce Doe to change his planned age of retirement, (c) the social security program provides less income for retirement than John Doe wants. Under these circumstances, each dollar of accumulated social security benefits will displace exactly one dollar of private wealth. For example, suppose that John Doe wants to retire at age 65 with $50,000 in assets. If the government provides him with $35,000 in entitlements to social security benefits he will accumulate $15,000 on his own, for a total of $50,000.

Now suppose legislation raises his social security benefits to $40,000. His natural reaction is to reduce his private wealth accumulation at age 65 to $10,000, so as to keep the total at

$50,000. In this case, an increase of $5,000 in social security wealth <u>displaces</u> $5,000 in private wealth. This is the <u>full displacement effect</u> emphasized by Feldstein.[1]

<u>First Qualification: Forced Oversaving</u>

Now let's consider some qualifications to this argument. The first qualification is obvious. What if John Doe only wanted to accumulate $30,000 by age 65? Then the social security system forces him to accumulate more ($35,000) than he wants. If his social security benefits are then raised to $40,000, he cannot reduce his private saving for retirement, because he has not done any. There is, in this case, a <u>zero displacement effect</u>.

Is this case realistic? One naive argument against it goes as follows. If people are forced to oversave for their retirement, they should enter retirement with no assets other than social security. But they do not. Therefore, they are not being forced to oversave. This argument would be valid if people saved <u>only</u> to finance retirement. But there are other motives for saving. For example, people hold small amounts of liquid assets to protect themselves against unforeseen emergencies. People may also hold assets late in life because they want to leave bequests. There may also be a pure "King Midas effect"-- people derive happiness from holding wealth. For these reasons and others, people who are forced to save too much for their retirement by social security may nonetheless have some assets of their own.

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[1]M. S. Feldstein. "Social Security, Induced Retirement and Aggregate Capital Accumulation," <u>Journal of Political Economy</u>, Sept./Oct. 1974, pp. 905-926.

Besides, the vast majority of people enter their retirement years with very little in the way of assets, apart from their homes, consumer durables, and claims to (private and public) pensions. In our study of the assets accumulated by a random sample of white men aged 60-65 in 1971, Gordon, Wise and I found that financial assets averaged less than 4% of lifetime earnings--and this 4% included life insurance! Similarly, Diamond and Hausman found that 50% of men aged 45-59 in 1966 held less than $1500 in wealth, excluding their homes.[1] With private wealth-holding this low for most people, it is easy to imagine that social security may represent forced oversaving for retirement for many households.

Finally, it is worth remembering one of the basic rationales for having a <u>compulsory public</u> pension system in the first place. Before social security, people apparently were not providing enough for their old age.

All of these facts suggest that the first qualification is probably very important.

<u>Second Qualification: Induced Retirement</u>

A second possibility, which was raised by Feldstein in his original paper, is that social security might induce people to retire earlier. If so, they will need to accumulate more wealth to finance their longer retirement periods.

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[1] P. Diamond and J. Hausman, "Individual Savings Behavior," mimeo, September 1980.

This argument seems quite plausible. But I have just shown that the social security law--_if properly understood_--might actually encourage _postponement_ of retirement. If social security really induces people to stay at work longer, then they will need to do _less_ saving for retirement.

Third Qualification: The Nature of Social Security Wealth

The third qualification is really a laundry list of reasons why John Doe may not view $1 of accrued social security benefits as equivalent to $1 in his own bank account. Among the reasons why "social security wealth" is not as good as $1 of private wealth are:

(1) Social security wealth cannot be spent until age 62 or age 65.

(2) To start spending it, it is necessary to retire almost completely from the labor force--something that John Doe may not be anxious to do.

(3) Even if he gets access to these funds by retiring, it is the government, not John Doe, that decides how quickly "social security wealth" can be spent.

(4) Social security wealth cannot be used as collateral on a loan.

(5) Social security wealth cannot be used as a bequest to one's children (except where there are minor children, and even then only a fraction can be "bequeathed").

(6) Receipt of social security benefits is subject to the uncertainties of future legislation.

For all these reasons, and more, John Doe may reduce his private saving by <u>less than $1</u> (or not at all) when the government raises his social security wealth by $1. On the other hand, there are factors pointing in the other direction--reasons why $1 in social security wealth may be <u>better</u> than $1 in private wealth:

(1) Social security benefits are protected from inflation by indexing.

(2) Individuals can purchase annuities only on very unfavorable terms. The social security system provides annuities cheaply.

(3) Income from social security wealth is not taxable, even though half of the original contributions (the employer's share) were not taxed when earned.

<u>Fourth Qualification: Desired Bequests</u>

The next qualification is based on the bequest motive for saving. When the government raises John Doe's social security benefits, it does so by pledging to raise the taxes of the younger generation. Thus the government transfers income from children to parents. If John and Jane Does all over America want to leave bequests to their children, they may react to this forced transfer by <u>raising</u> their saving for bequest purposes, thereby compensating their children. Thus while John Doe's saving <u>for retirement</u> may decline, his saving <u>for bequests</u> may simultaneously rise.

Fifth Qualification: Demonstration Effects

The fifth, and final, qualification is contrary to the economist's way of thinking about human behavior, but may nevertheless be quite important. Social security may have a "demonstration effect" which reminds people that it is "appropriate" to save for their retirement years--a subject most people want to ignore ("I'll never retire!"). It is a fascinating fact, I think, that private pension plans were almost nonexistent before the social security system began. This fact hardly suggests that social security has supplanted private savings for retirement.

Where do all these qualifications leave us? Not with anything very concrete, I am afraid. On balance, I think we would be very surprised if social security wealth actually displaced private wealth on a dollar-for-dollar basis, as some have claimed. But we would probably also be surprised if there were no displacement at all. Apart from these rather weak predictions, theory will tell us little. We must look to the evidence.

4. Social Security and Private Saving: The Evidence

A defendant may be found innocent either because there is insufficient evidence to convict, or because there is powerful evidence that he is not guilty. My claim is that there is virtually no evidence to make the saving indictment against social security stick. Even though the system may be guilty, we do not have enough evidence to warrant a conviction.

I'll organize my case as follows. First, I'll describe what we have found in our own research. Then I will consider some of the important work of Martin Feldstein, which provides most of the evidence on the prosecution side. I will argue that our results are not that different from Feldstein's and that Feldstein's evidence is really not very strong.

The question is: does social security wealth displace private wealth, and therefore reduce national saving? There are two ways to look for answers to this question. First, we can study different individuals at the same point in time and ask: have people with more social security wealth accumulated less private wealth? Of course, before we do this, we will want to control--in a statistical sense--for other influences on wealth. This is difficult, but not impossible, to do.

Second, we can look at the private savings of the whole economy in different years. Since the structure of social security benefits has changed from time to time, we can try to learn whether private savings went down when social security benefits became more generous, and so on. Of course, we must once again try to control for other influences on national saving. Only here the problem is much harder because the potential "other influences" are numerous, and the amount of data we have is quite limited.

Cross Sectional Evidence

Let me start with the evidence obtained by studying individual behavior. Gordon, Wise, and I looked at the accumulated assets of white men nearing retirement age. Our sample included 4,130 men aged 60-65 in 1971 who were not self-employed. We found that, on average, these men held financial assets amounting to only $3\frac{1}{2}$% of their lifetime earnings, real estate (net of mortgage indebtedness) amounting to about $3\frac{1}{4}$% of lifetime earnings, and private pensions averaging about $1\frac{1}{4}$% of lifetime earnings. These are rather small amounts. By contrast, their "social security wealth," that is, the present value of their claim to future social security benefits, averaged about 7% of lifetime earnings --almost as much as all private assets combined. Those who claim that social security wealth has displaced private wealth on a dollar-for-dollar basis must then be asserting that private wealth would be almost twice as large as it now is in the absence of social security. This is a bit hard to believe.

To address the question directly, we estimated an econometric model which sought to explain the accumulated savings of individuals by a variety of variables, including their social security wealth. Our best guess, based on individual wealth holdings, was that each $1 of additional social security wealth reduced private wealthholding by 39¢. Put differently, this means that if John Doe has $1 more in social security benefits than John Smith, and the two men are identical in all other respects, we estimate that Doe will have 39¢ <u>less</u> in private wealth than Smith. Hence Doe will have 61¢ <u>more</u> in total retirement wealth (private plus social security) than Smith.

The arguments presented in Section 3 make this estimate seem perfectly plausible. But I do not want to defend it. Instead, I want to explain why I have very little confidence in this, or any other, estimate.

The reason is that estimates like these, derived from statistical procedures, have a degree of imprecision associated with them. The most common measure of this imprecision is what statisticians call the <u>standard error</u> of the estimate. And in this case, the standard error is large, meaning that the estimate is very imprecise. The standard error in our study was 45¢, which means that, for example, we can be only 68% sure that the true displacement effect lies between -6¢ and +84¢ on the dollar. This is a very wide range of uncertainty.

Now I realize that members of Congress are not statisticians; nor should they be. So I hesitate to bring up something as technical as the standard error. But I do so for a very good reason. Economists who adhere strongly to the view that social security retards private saving will emphasize the best guess. And ours, as I have just stated, is that each dollar of social security wealth displaces 39¢ of private wealth. But there is a world of difference between an estimate of 39¢ with a standard error of 5¢ and the same 39¢ estimate with a standard error of 45¢. And there is also a world of difference between a situation in which different researchers, using different models and different sources of data, all come up with similar "best guesses" and a world in which the "best guesses" of different researchers are all over the map.

My point is that the situation with respect to research on social security and saving is more like the latter than the former. Let me try to illustrate the difference with two familiar examples.

As an example of what it means to have a big standard error, consider the performance of a .250 hitter in a game in which he gets four at bats. Since he averages 1 hit per four at bats, our "best guess" will be that he will get exactly 1 hit. But would you want to bet on it? Probably not, because there is a lot of imprecision surrounding this best guess. It is not an estimate in which we can have much confidence. In statisticians language, the standard error of this estimate is 0.9 hits per game--which is almost as large as the best guess itself. Because the standard error is so large relative to the best guess, the best guess itself is not terribly <u>useful</u> information.

By contrast, consider the problem of predicting the high temperature in Washington on a day in early August. The best guess may be 88°. But its standard error is far less than 88°. It may be only 5° or so. This means, for example, that you can be 68% sure that the high temperature will be between 83° and 93°. Information like this is worth acting on. If I come to Washington in August, I wear lightweight clothes; if I come in January, I wear woollens. This is quite a contrast to the ball park, where it is not terribly informative to be told that a batter is a .250 hitter.

This is why I stress that economists' (or anyone else's) best guess should be taken seriously if the standard error is fairly small (as in the case of Washington's summer weather), but not taken seriously if the standard error is very large (as in the case of the baseball player). My point is that the evidence on social security is more like the baseball player than the weather.

In the light of this discussion, it is interesting to consider the evidence turned up by Feldstein in a recent study of individual behavior. While his statistical model was quite different from our own, the two studies are worth comparing because they utilized the same basic source of data--the Retirement History Survey of the Social Security Administration. Feldstein concluded that his evidence provided "quite strong support" for the notion that social security displaces private saving. On the surface, his conclusion seems quite different from our own. But I will show now that our results were really quite similar. It is just that Feldstein judged the bottle to be half full, while we judged it to be half empty.

Let me be more specific. Feldstein estimated his equation 12 different ways, and hence obtained 12 different estimates of the degree of displacement. His two preferred estimates were 72¢ on the dollar (with standard error 58¢) and 35¢ on the dollar (with standard error 27¢), which are reasonably consistent with our estimate. However, included among his other 10 estimates is one as high as $1.34 and another as low as -16¢.

Specialists can argue whether 39¢ or 72¢ or -16¢ is really the best estimate. The basic point is that widely divergent estimates like these are precisely what we expect to happen when the "best guess" is so unreliable, just as a .250 hitter can easily go 0-for-4 or 2-for-4.

Time Series Evidence

I turn next to evidence obtained by studying the behavior of the whole economy over time. Feldstein's famous original paper estimated that each $1 of social security wealth reduced private saving by 2.1¢ per year (with standard error 0.6¢). If you follow through the logic of this estimate, it again implies that social security has virtually halved private saving. But, once again, I don't think we can accept this estimate at face value.

The least important reason for this skepticism is the famous computer error pointed out by Leimer and Lesnoy.[1] Even though

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[1]See Dean Leimer and Selig Lesnoy, "Social Security and Private Saving: A Reexamination of the Time Series Evidence Using Alternative Social Security Wealth Variables," Working Paper No. 19, Social Security Administration, Office of Research and Statistics, November 1980.

they pointed out that correcting this error reduced the 2.1¢ estimate in Feldstein's original equation to only 1.1¢, Feldstein has recently offered a new version of his equation, with the error corrected, in which the estimate is that each $1 of social security wealth depresses private saving by 1.8¢ (with standard error 0.9¢).[1] If we accept this estimate at face value, we can be 68% sure that the true number is between 0.9¢ and 2.7¢.

But I think we must not accept it at face value. There are several reasons why the true uncertainty surrounding this estimate is _far_ greater than the standard error of 0.9¢ suggests.

(1) The first reason was really the main point of the Leimer-Lesnoy critique, but seems to have gotten lost in all the fuss about the computer error. To estimate the kind of equation Feldstein estimated, it is necessary to decide how "social security wealth" has changed over time. To do this, it is necessary to make some suppositions about how people at various points in time projected the future evolution of social security benefits. Feldstein did this in one particular way, and it led to his original 2.1¢ estimate. But nobody really knows the "right" answer, and there are many other methods

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[1] See M. S. Feldstein, "Social Security, Induced Retirement and Aggregate Capital Accumulation: A Correction and Update," National Bureau of Economic Research Working Paper No. 579, November 1980.

which are just as reasonable. In fact, Leimer and Lesnoy displayed 20 such methods, and obtained estimated effects of social security wealth on private savings as high as 1.8¢ per dollar and as low as -0.2¢ per dollar. This is a very wide range. Thus even if we accept Feldstein's version of the "best guess" instead of Leimer and Lesnoy's, the true "standard error"--once one accounts for the uncertainty involved in estimating social security wealth--must be far greater than the 0.9¢ standard error reported in Feldstein's paper.

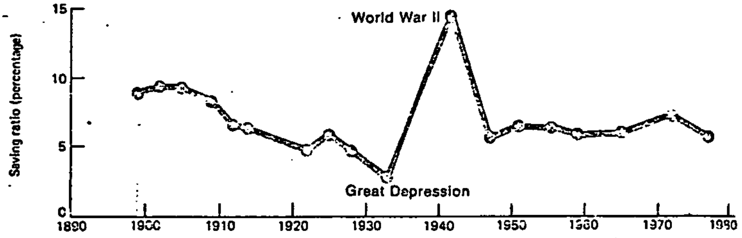
(2) The second reason is a purely technical one, which I will state, but not attempt to develop, for I am quite sure that Professor Feldstein will agree with it. The equation in Feldstein's latest paper suffers from a technical defect that statisticians call "autocorrelation." I mention this only because the main effect of autocorrelation is to cause standard computer programs to report estimated standard errors that are too small. A correction for autocorrelation would surely raise the standard error.

(3) The third point is more important. No one, not even Feldstein, has purported to have found a systematic negative effect of social security on saving <u>for the postwar period</u>. To get the effect Feldstein finds, it is necessary to include the depression years, when the social security system first started, and personal savings were abnormally low. This point is significant because we would expect, on basic theoretical grounds,

that the effect of social security on private saving should be much larger when the system is just starting up than when the system is mature. It could well be that the negative effects of social security on saving are a thing of the past.

Let me now sum up my argument so it is not misunderstood. I am not claiming that economic research has definitively established that social security has not harmed national savings. Nor am I claiming that Feldstein's theoretical argument is implausible. I am claiming that a fair assessment of all the available evidence does not give any strong reason to believe that social security has seriously depressed private saving. The best guess may be that social security has had some negative effect on saving, though some economists would dispute even this. But the imprecision surrounding this "best guess" makes it hazardous to use it as a basis for policymaking.

And finally, we should remember that the effect on saving that Feldstein claims to have found is not a small one. His estimates imply that personal saving in the United States today would be running anywhere from 50% to 100% higher in the absence of the social security system. It may therefore be of interest to ask what savings rates were typical before the advent of social security. The figure below gives the answer. Savings rates during the postwar period have averaged just about the same as in the period from 1898 to the Great Depression. This means that Feldstein is implicitly claiming that national saving would have increased dramatically above historical norms were it not for social security. Before we believe a claim like this, we should require strong evidence indeed. The evidence is not there.



Ratio of Personal Saving to Disposable Income,
Averages over Business Cycles, 1898-1979

SOURCE: R. J. Gordon, Macroeconomics, Second Edition, Little Brown, 1980, p. 396.

5. Conclusions

The charge that social security reduces private savings makes perfectly good sense. As an economic theorist, I would not be at all surprised if there were reams of evidence suggesting that the system is guilty as charged. However, as an empirical economist, I am forced to conclude that the evidence is lacking. Savings rates are no lower in the postwar period than they were prior to the inception of social security. No one has claimed to have found evidence in economy-wide data for the postwar period that social security has reduced saving. What little evidence economists have turned up in support of this charge is about as convincing as a prediction that a .250 hitter will go one-for-four.
It is the best guess, but it is not a very good one.

The charge that social security has encouraged early retirement does not make sense, once the nature of the social security law is understood. In fact, for most men, social security should discourage early retirement. However, it is a plain fact that labor force participation rates among older men have been declining steadily in the postwar period. One possibility is that the operation of the law has been widely misunderstood, and that people have been retiring early because they failed to appreciate the financial benefits of waiting. If this is so, then the "problem" can be easily cured by explaining the nature of the law better to potential retirees. But I think it more likely that people have retired <u>despite</u> the financial inducement to remain at work provided by social security. We may just have to entertain the notion that the reason for the trend toward early retirement lies elsewhere.

Senator JEPSEN. Thank you, Mr. Blinder. Your prepared statement will be entered into the record as if read, and I would also advise Mr. Feldstein, if you choose to summarize your statement, it will be entered into the hearing record as well.

I understand, Mr. Feldstein, you have to leave by 11:15. We can try and hold to approximately 10-minute presentations and, Mr. Feldstein, you may now proceed.

STATEMENT OF MARTIN FELDSTEIN, PRESIDENT, NATIONAL BUREAU OF ECONOMIC RESEARCH, CAMBRIDGE, MASS.

Mr. FELDSTEIN. Thank you very much, Mr. Chairman.

As you know, and as the Secretary said earlier this morning, the social security program is in very serious financial trouble. The Government's actuaries predict, we were told again today, the retirement fund will run out of money next year if their is no reduction in benefits or increase in revenue. And looking to the longer term, about which we heard less this morning, the actuaries also warn that the changing age distribution of the population means that the tax rates of more than 20 percent and perhaps more than 30 percent would eventually be required to finance the benefits implied by existing law. If such high payroll taxes are piled on top of other Federal and State taxes, most individuals would find themselves paying a tax of more than 50 cents of every extra dollar that they earn.

The primary reason for these financial problems is the unprecedented explosion of social security benefits in the past decade. It's not the higher unemployment rates of recent months. It's not the slowdown of wage growth and productivity in the last 3 years. It's the explosion of benefits. Between 1970 and 1980, old age and survivor benefits per recipient rose 55 percent when measured in dollars of constant purchasing power. During the same period, average constant dollar gross weekly earnings of private nonagricultural workers were essentially unchanged, rising less than 2 percent over the entire decade. Thus, the ratio of average benefits to the average earnings of those who pay social security taxes rose by more than 50 percent. This rise that occurred in the 1970's marked a radical departure from the stable ratio of that during the previous decade. By contrast, during the previous decade, the ratio of benefits to earnings showed little change, rising less than 10 percent.

If the ratio of average benefits to average wages had remained at its traditional 1970 level, total benefits to retirees and survivors in 1981 would be $40 billion lower than the actual $120 billion outlay for the current year. There would be no worry about the short-term solvency of the program and the projected long-term tax increase would be virtually unnecessary.

The rapid growth of social security benefits did not reflect a carefully considered decision to provide a sharp increase in transfer to the aged at a time when other incomes were stagnating but was the result of bad judgment and technical mistakes. The problem began in 1972 when overly optimistic estimates were used to justify raising benefits by 20 percent and indexing them to prevent their erosion by inflation. To make matters worse, the fault in the indexing formula which led to a double indexing in which each percentage point of inflation caused benefits to rise by more than 1 percent added to the problem.

Although that fault, the double indexing fault, was eventually corrected, those who were granted the unwarranted benefit increases will receive higher monthly benefits for life. To make matters worse, all benefits are linked to the Consumer Price Index which, because of a variety of technical problems of the sort Mr. Blinder referred to, rose much faster than a better measure, the consumer price deflator. In fact, between 1972 when indexing began and 1980, the CPI rose 23 percent more than the personal consumption expenditure deflator that most economists generally regard to be a much more accurate measure of changes in the cost of living. So benefits were pushed up 23 percent more than they would have been if they had used the personal consumption deflator.

As a result of this series of mistakes, a married man who has had median earnings all his life and retires now at age 65 receives social security benefits for himself and his wife that equal 7.8 percent of his peak pretax earnings. That's for someone who's had average earnings. For someone with lower earnings, the replacement rate is higher than that. It could easily exceed 100 percent. A decade ago, before the benefit explosion began, a similar individual would have received benefits that replaced about 60 percent of after-tax income.

REFORM PROPOSALS

Although there is increasing agreement that slowing the growth of benefits must be part of any long-term solution of social security's financial problem, the proposals for doing so have generally been far too timid. The most common suggestion is a gradual increase in the age at which an individual can claim full benefits, from 65 years to 68 years. This would be a useful change but might do no more than balance the increasing life expectancy of the retired. At most, it would offset only a fraction of the future shift in the age structure of the population and would do nothing to offset the benefit explosion of the 1970's. Postponing retirement can be no substitute for explicitly slowing the benefit growth in a way that can eventually undo the unwarranted 50 percent rise in the ratio of benefits to earnings that occurred in the past decade.

Unfortunately, there is powerful political pressure to allow the benefits of existing retirees to continue their rapid growth while enacting now a program of cuts in the benefits of those who will retire a decade or more in the future. That strategy seems implicit in the administration's position and much of the public's discussion, which would mean that most of those today in their 30s, 40s, and 50s would be forced to pay even higher taxes for another decade or more only to see their own benefits cut when they are ready to retire. If these younger families paid as much attention to social security legislation as today's retirees do, such a financial double-whammy would be politically impossible.

A 2-PERCENT FLOOR

I favor an immediate start to slowing the growth of benefits. I believe, however, that any such slowdown should be gradual. The administration's proposal to reduce the benefits of 62-year-old retirees by 30 percent in 1 year was widely criticized because it would have meant a radical change in the plans and lifestyles of millions of Americans. I agree with Congresswoman Heckler that there is a fear of radical sharp changes of this sort that has made serious reform of the social security system appear to be so difficult.

My own preference would be to introduce a 2-percent floor under the indexation of social security benefits. Retirees' benefits would continue to be adjusted upwards annually but only by the excess of inflation over 2 percent. Thus, if the inflation rate is 8 percent, retirees' benefits would rise by 6 percent. Of course, under no circumstance would retirees' benefits be reduced. And unlike proposals to increase benefits by only a fixed fraction of each year's price rise. The 2-percent floor protects retirees from the uncertainties of changing inflation. I agree again with what Alan Blinder said about wanting to use social security to protect the retired from the vagaries of inflation. One can do that consistent with having a small floor of this sort.

Although a 2-percent floor under benefit indexation would not cause a sudden change in anyone's lifestyle, it would gradually achieve a significant saving in total social security outlays. In that sense, it agrees with Alan Blinder's final recommendation of "Do it slowly." Slowness I think is a substitute for postponement in this case. If the 2-percent floor begins with the 1982 benefit increase, by 1985 outlays would be some $15 billion lower and the program's deficit virtually abolished. By 1992, the payroll tax rates required to finance benefits would be one-fifth lower than under current law. The floor could be eliminated whenever the ratio of benefits to wages has returned to what Congress regards to be a satisfactory level.

INCREASING SAVING

Slowing the growth of benefits would encourage households to provide for their own retirement income through private pensions and direct saving. Individuals who now anticipate unindexed social security benefits that replace 75 percent or more of their maximum net earnings have virtually no incentive to accumulate additional retirement income. The recently enacted changes in tax rules, particularly the changes with respect to IRA and Keoughs which I support strongly, will do little or nothing to encourage additional saving among those who believe that, because of social security, they are already postponing too much of their lifetime consumption until their retirement years.

A high level of social security benefits thus acts to depress private saving and therefore the Nation's rate of capital accumulation. The extent to which increases in social security benefits have depressed private saving is difficult to estimate precisely. My reading of the substantial body of statistical evidence that has been accumulated in recent years is that each additional dollar of permanently higher benefits reduces private wealth accumulation by more than 50 cents but less than $1.

As I have already noted, the rise in the ratio of benefits to income since 1970 has increased real current benefits by about $40 billion and promises even larger increases in future years. If each such dollar of anticipated benefit depresses private accumulation by even 50 cents, the \$40 billion benefit rise corresponds to a \$20 billion fall in savings. A dollar-for-dollar displacement of private wealth by social security would imply a roughly \$40 billion fall in savings. Since total personal savings this year will be about \$110 billion, a reduction of between \$20 billion and \$40 billion obviously represents a very significant decline.

Slowing the growth of social security benefits would provide an immediate incentive for working individuals and pension funds to increase the rate of private saving and therefore capital formation. In the years ahead, instead of paying higher payroll taxes, individuals and companies could devote those resources to real saving that finances investment in plant and equipment. And in the short term, slowing the growth of benefits with no change in the payroll tax rate would contribute directly to a higher national saving rate by reducing the federal deficit dollar for dollar with the reduction in benefits.

In short, the gradual return of social security benefits to the role that they played in the past would prevent the sharp rise in taxes that will otherwise occur in the coming decades. And, equally important, returning the social security replacement rate to an earlier level would provide a substantial incentive for a higher rate of real savings and capital formation.

Thank you, Mr. Chairman.

Senator JEPSEN. Thank you, Mr. Feldstein.

Mr. Pellechio, in the interest of making sure Mr. Feldstein catches his plane and so the panel may question these two, would you mind holding your testimony until we have a chance to ask some questions of him?

Mr. PELLECHIO. That will be fine, Mr. Chairman.

Senator JEPSEN. Thank you. At this time I recognize Congressman Wylie.

Representative WYLIE. Thank you, Mr. Chairman.

Mr. Feldstein, I was interested in your observation that our troubles really began in 1972 when there was a huge increase in social security benefits plus indexing, and I was here at that time and I have since made the observation that it was probably a mistake that we didn't provide for funding of that huge increase. I might say, maybe somewhat in defense, that the bill was brought out of what was known as a closed rule from the House Ways and Means Committee and the chairman of the Ways and Means Committee at that time was former Congressman Wilbur Mills who was in the process of throwing up a trial balloon to run for President. I don't know that there was any connection between the two, but I just make the observation that that's the factual situation.

But you said something about this system not being—I think this was Mr. Blinder—the system not being fully matured. What did you mean by that?

Mr. BLINDER. I meant simply that any time a major change in the system is made—for example, in 1972 and the few years after that when indexing was brought in—a full generation of people has to go through the system and operate under the new rules before the system is mature. After 1972 we started rerunning what happened after 1939 but from a higher level of benefits.

Representative WYLIE. I intended, if I had the opportunity, to ask the question of the Secretary and have him make an observation of a suggestion which was made by a person who has other means of pension benefits or support in his retirement years—if any study or assessment has been made—and the two of you have done a considerable amount of work in this field—as to whether a significant amount of money could be retained in the social security trust fund by asking relatively large recipients to have their monthly payments credited to their account in the social security fund for possible future need if the need arose.

Mr. FELDSTEIN. You mean a voluntary proposal, in which individuals would forgo these benefits now in exchange to getting back some kind of interest? You would just be postponing and compounding the problem. You would delude yourself into thinking you had a small deficit in the short run because instead of borrowing implicitly in the capital market you would be borrowing from the potential recipient.

Representative WYLIE. People of affluence or great wealth who don't necessarily need to borrow from it.

Mr. FELDSTEIN. The amount of money the social security system would get as a voluntary, charitable contribution from an affluent American I don't believe would make a noticeable dent in the vast deficits.

Representative WYLIE. Would you think that, too?

Mr. BLINDER. I would. I would just add that I think a more direct way to accomplish the kind of thing you have in mind would be to make social security benefits, or maybe half of social security benefits, taxable. The half that the employer contributed was not taxed originally. People who are well-off would pay a lot back in income tax, and people who are not well off would not pay a lot back. As Professor Feldstein said, by making these contributions voluntary you don't get very much. If you make it mandatory, then you get it back.

Representative WYLIE. I'm not sure I gathered from either of you just exactly what you suggest we do to make the social security fund solvent.

Mr. FELDSTEIN. I would change the indexing rule so that benefits rise in the future with inflation only be the excess of inflation over 2 percent.

Representative WYLIE. You would have to change the cost-of-living index.

Mr. FELDSTEIN. We wouldn't change the cost-of-living index. It would be exactly as it is now. Only if next year's inflation was 8 percent, then benefits would rise by 6 percent. If inflation was 10 percent, benefits would rise by 8 percent. As you may know, the current law provides that if the inflation rate ever drops below 3 percent, there is no indexing at all. There's a floor built in already, but that floor is turned off completely as soon as the inflation rate rises above 3 percent. What I'm suggesting is a permanent floor of 2 percent, thus disregarding a minimal small amount of inflation.

Representative WYLIE. Have you done any projection of how much that would save?

Mr. FELDSTEIN. Yes. In 1985 it would save about $15 billion in that year alone. That's a little bit less than the projected deficit for that year, so that proposal alone would be almost sufficient to avoid the deficit without any further tax increase.

Representative WYLIE. What do you think of that, Mr. Blinder?

Mr. BLINDER. I think that's a viable alternative, but my personal preference has been for something like a plan that I think—I'm not sure who originated it, but it's been suggested by Congressman Pickle, for example, of raising the retirement age, which is now 65, to 68 at the rate of 1 month a year for 36 years.

There are a couple reasons for that. The most obvious one is that age 65 in terms of biology and life expectancy is just not what it was in 1935, when that legislation was written. People live a lot longer and are healthier in their 60's and 70's now than they were.

Another aspect is it wouldn't cost current retirees anything. The people who are already retired would be—if you'll excuse the phrase—grandfathered in. People nearing retirement, in thier late fifties, would lose very, very little from this. They would have to wait a few months The people who would be the big losers would be people like Professor Feldstein and myself who are something like 30 years away from retirement, but it comes back to what I said about going slowly. In effect, it doesn't look very large in the scheme of things to such people. A 20-percent cut in all the social security benefits that I will ever draw, for example, is probably 1 percent of my lifetime income or something lide that. It's not a major pill to swallow. That's different from a 20-percent cut in the social security benefits of somebody who's now retired, and basically living on social security.

Another thing I would say, another way to get at the same thing about overindexing, is simply to replace the index; that is, to recognize that the CPI has been overcompensating the retirees lately, as Professor Feldstein said. It could soon turn around and start undercompensating them. If mortgage rates start falling, it's going to undercompensate retirees for these years. It's only gone one way so far, but it could go both ways.

Representative WYLIE. Increasing it from 65 to 68 has been brought up by the administration and you can't do it for people who are going to retire next year or the following year or the following year. How long, 10 years?

Mr. BLINDER. I mentioned starting—for example, one plan would be to start immediately but raise the retirement age only 1 month a year. So people who are retiring this year could retire when they're 65 plus 1 month.

Representative WYLIE. So it would be 65 and 1 month this year and——

Mr. BLINDER. Yes, and 65 and 2 months the next and 65 and 3 months the next year. These are very minor changes for anybody.

Mr. FELDSTEIN. Of course, they also have a very small impact on the cost of the program over the next 5 or 10 years. What you really want to do is do something about bringing the high costs down and avoiding tax increases but you have to do something in addition that. I think that's a good idea. I think 1 month a year may be too slow, but that's a side issue. I think that while it's a good idea in terms of the long-run, it doesn't deal with the short run and doesn't deal adequately with the long run.

Representative WYLIE. I have been given a note that my time has expired.

Senator JEPSEN. Congressman Richmond.

Representative RICHMOND. Thank you, Mr. Chairman.

Mr. Feldstein, your 2-percent floor sounds like a way to save some money, but don't you think it's discriminatory? Why should we suddenly say that only people on social security should have to take 2 percent less than inflation? Everybody else gets a proper inflationary index.

Mr. FELDSTEIN. I don't.

Representative RICHMOND. I'm talking about everybody else who's tied into a cost-of-living index tied into inflation. We don't, either, Mr. Feldstein, but people with black lung disease veterans and United Automobile Workers and everybody else gets the full——

Mr. FELDSTEIN. Most private employment provisions are not indexed. This would be more generous than most private COLA provisions. Most COLA provisions are in terms of cents per hour or COLA provisions with a cap. Very, very few people have 100-percent indexing. Social security recipients are by far the largest part, but I agree with the thrust of your comment.

Representative RICHMOND. Other Government retirement plans cost the same thing.

Mr. FELDSTEIN. And I would extend the same principle to them.

Representative RICHMOND. So you would extend the same principle to all Government retirement plans?

Mr. FELDSTEIN. Yes.

Representative RICHMOND. So that would save $15 billion?

Mr. FELDSTEIN. We would save more if we did that. I just focused on the OASI program in giving you that number, but obviously if you extended it to include other Government indexed retirement programs you would save more money.

Representative RICHMOND. Let's say all programs under the Government jurisdiction. That would cut out at least the discriminatory aspect of the thing.

Mr. FELDSTEIN. Again, I have more concern about the——

Representative RICHMOND. I think what you are doing is waving a red flag and saying we're going to discriminate against those people who are receiving social security.

Mr. FELDSTEIN. Well, first, if there's discrimination, it's between them and a small group of other Federal beneficiaries. Second, this is a group that has seen a 55-percent increase in its real benefits over the last decade because of the 1972 incident that Mr. Wylie described, because of the use of the wrong index over that period, because of the double indexing feature for social security. For all of these reasons, this is a group that has seen a much larger increase in benefits, much more than they ever anticipated getting.

Representative RICHMOND. Lord knows, they need it, too.

Mr. FELDSTEIN. Some, yes. Some, no. It's not a needs-based program.

Representative RICHMOND. Mr. Feldstein, if the people in my district didn't have social security, I don't know what they would do.

Mr. FELDSTEIN. The point is, their real benefits have been increased by 55 percent.

Representative RICHMOND. Because we've had inflation.

Mr. FELDSTEIN. No, no, over and above inflation. The benefits have gone up 50 percent more for the retirees than for the workers in your district, if your district is typical of the Nation.

Representative RICHMOND. My district isn't typical even in the State of New York. What about changing the cost-of-living formula to cut out cost of money and cost of housing? What would that do to indexing?

Mr. FELDSTEIN. If it had been done in the 1970's——

Representative RICHMOND. Let's say we did it now.

Mr. FELDSTEIN. Then, we would have benefits are 23 percent lower today than we have. What happens in the future depends on what happens to interest rates and housing prices.

Representative RICHMOND. Assuming that money will continue to cost a lot.

Mr. FELDSTEIN. Then the change wouldn't matter, if you change the indexing formula for the CPI.

Representative RICHMOND. And remove the housing portion?

Mr. FELDSTEIN. Remove the housing only?

Representative RICHMOND. And the cost of money.

Mr. FELDSTEIN. And the cost of money doesn't change?

Representative RICHMOND. The senior citizens don't build housing or borrow too much money.

Mr. FELDSTEIN. What matters for this issue is not the level but the change. If the level of interest rates remains high, the CPI will not show an increase because of that. If the interest rates rise even further, the CPI will move up and if the interest rates drop the CPI will drop.

Representative RICHMOND. If interest rates drop——

Mr. FELDSTEIN. Then the CPI will decline and will show a decrease in inflation.

Representative RICHMOND. If we remove the entire interest and housing factor out of the CPI——

Mr. FELDSTEIN. Then a drop of interest rates would not be reflected in the CPI.

Representative RICHMOND. And if the cost of housing would be removed?

Mr. FELDSTEIN. It depends on how you modify it. If you leave in the rental equivalent, then the CPI will come down.

Representative RICHMOND. What would that give you for social security benefits instead of using your 2-percent floor which I think is certainly worth thinking about?

Mr. FELDSTEIN. If you use this other thing?

Representative RICHMOND. Providing you're willing to apply it to all Government programs and labor applies it to some of their programs.

Mr. FELDSTEIN. As far as labor goes, their programs are not nearly as well indexed as social security. A typical COLA recipient in a collective-bargaining situation does not have uncapped, 100 percent indexing.

Representative RICHMOND. I believe the UAW does.

Mr. FELDSTEIN. Some, I'm sure, do, but generally they don't. And you see what trouble the UAW has gotten into? It's not a model for the social security system. If you switch the CPI to the CPE——

Representative RICHMOND. CPE meaning what?

Mr. FELDSTEIN. Consumer deflator, a better index which avoids some of these housing problems. There's not likely to be a significant change and it might actually be worse for the social security recipient if the interest rates come down.

Representative RICHMOND. Thank you. My time is up.

Senator JEPSEN. Congresswoman Heckler.

Representative HECKLER. First of all, I think that if one should introduce a real proposal of reducing the benefits by 2 percent below inflation it would be very difficult to go back to our districts and go to our elderly housing facilities and explain why social security benefits are not matching the increase in inflation. I think from a political point of view one of the real problems of the whole social security question is that there is a perception on the part of the recipients that they are totally entitled to the benefits that they have right now. They have become accustomed to these; they have paid into the system, therefore, they are entitled to be kept whole.

Mr. FELDSTEIN. How do you explain to them that the money they put in the bank and that they expected to be protected is not at all protected against inflation? In the same sense, social security is a much safer asset than the money in the bank and it really is now fully protected—overprotected—against inflation; and with the 2-percent floor it would be almost fully protected and it would be protected against uncertain or unexpected increased rates of inflation. It would just recognize that the first couple percent of inflation the Government can't guarantee.

Representative HECKLER. I think that, frankly, the complexity of the issue would be too great to really raise before a large audience of beneficiaries. I think the point would simply be lost and I think we have to deal with these perceptions of what is happening and their rights as they see them, which again makes it absolutely mandatory that whatever we do be done very, very slowly and be introduced with sufficient education to start to bring rationality to a discussion of social security. Right now we have such an emotional situation that very few people remember that it was a retirement supplement and not a retirement plan. The average recipient in my district doesn't remember that at all, and I think there has to be a new reeducation on social security in which if any reforms are made we will also channel funds to education.

The question is, if you do it slowly, which you seem to be saying and I personally feel is absolutely essential, what constitutes slowly? From all the answers I've read and heard, the really crucial, really difficult point in social security will occur in the year 2010 when there will be an increase on the burden of the worker contributing to the system, an increase that's been quantified in the testimony at about 30 percent of the current rate of contribution.

Now in a year in which we are having as many social changes as we are this year, there is a question of whether or not it is the time to introduce a very, very essential new change. Would it be prudent in this climate in which changes have not been absorbed in the society yet from the current budget cuts? Would the introduction of future changes in the social security system, the most significant social benefit in America, be wise? How long can we wait and how can this be dealt with, if the year 2010 is really the most severe year? Obviously, if that's not the correct year, what is the turning point? How long can we postpone dealing with the problem and what leadtime will there be?

Mr. FELDSTEIN. As the Secretary said, the interfund borrowing can help you until about 1984 or 1985 and I think that while it's important to deal with the demographic change that will occur when the postwar baby boom generation retires in 2010, that is not the whole problem. The whole problem is that we have now put in place the level of benefits that we can't afford without a substantial tax increase and if Congress is not of a mind to raise social security taxes, then I think your explanation to your constituents has to be if we don't do something the system will collapse. They are going to run out of money and what we're doing is the least painful thing and it's going to be adequate to keep the system afloat. I think a lot of people are not at all sure whether they're going to get their checks 3 years from now or 5 years from now. If you can reassure them by losing a little bit off the bottom of their indexing they will have protected the viability of their benefit, that's a good trade.

Representative HECKLER. On another subject, in all the discussions on social security reform in this current session, I have heard no discussion of the growing role of women in society and the impact of the system on women. Earlier, this committee on two different occasions several years ago had extensive hearings in which the Social Security Administrator, Mr. Ball, openly admitted the inequities built in the system with the changing role of women should have been addressed earlier.

Now have you done any projections on this and should not this be part of the consideration of a social security reform?

Mr. FELDSTEIN. An omnibus social security reform dealing with all of these issues should put the treatment of working women versus nonworking women very centrally, but I think you have a separate financial problem which can be dealt with without achieving at the same time reform of the entire system.

Representative HECKLER. In view of the fact that a majority of married women are now working, to reform the system and totally ignore the changing role of women and their contributions and the built-in inequities of the system to the working women, is to perpetuate the inequities endlessly, if this is the moment of truth on social security.

Mr. FELDSTEIN. I agree with you. I'm not saying that. I'm saying that when you do a serious reform of the structure of a benefit program, that's the time to make changes in that. But there is a virtual crisis of a financial sort that you have to deal with now. Maybe Congress is ready to write a major restructuring of the rules of social security which goes away from our current differential tax treatment of the families with two earners and one earner. I don't think Congress is ready to do that in the next session. I think you're going to have to deal with the short-term problem and I think the way to do that is to separate it off from the broad structural reform.

Representative HECKLER. Well, you're talking about indexing proposals and changing the indexing. It would seem to me that if Congress has the courage to do that, it will be the only time that it will take a hard look at the other issues. If Congress can postpone major difficult controversy, it will do so indefinitely, and it has done so on the subject of the working woman. So I think the postponement would mean the death of another opportunity. My time has expired.

Senator JEPSEN. Well, thank you. Do you have something else?

Representative HECKLER. I would ask, if I might, Mr. Chairman, about this question of the postponement of retirement age. There's a real difference between our two witnesses on that subject. First of all, I'd like to ask Mr. Feldstein how much would be saved if we did postpone the retirement age to age 68 and why do you think that—Mr. Blinder's comment that the social security system should be age neutral—why do you disagree with that?

Mr. FELDSTEIN. I don't disagree with that and I don't think we basically disagree about the desirability of increasing the postponement age from 65 to 68. The only question is how much you gain from doing that. In the long run, when the system is fully mature out to the year 2010, you've taken 3 years off of retirement. That might save roughly one-fifth or one-sixth of the total program costs at that time. If the tax rate would otherwise be 30 percent, it might be 24 percent instead. But it isn't enough to prevent tax rates from going up very substantially, and if you phase it in slowly, which I think you have to, it would do virtually nothing in the short run because it would do nothing for the current retirees as they reach age 65 or 65 plus a month. So there's no disagreement about the fundamentals, but it doesn't——

Representative HECKLER. But if we delay the retirement age to 68, what would be the impact in the next decade?

Mr. FELDSTEIN. If you did it as Alan suggested, a month, a year, you have pushed it ahead 10 months, less than a year, and you would only have affected the new retirees, those that retire in the next decade. It's not very much.

Representative HECKLER. So this is not a realistic solution at all?

Mr. FELDSTEIN. It's part of the long-run solution. I think it should be done. I think it faces the reality of what's happening to life expectancy. Life expectancy has gone up a great deal in the 65-years-plus group in the last two decades. This would help offset the extra costs that imposes, but it doesn't really deal with the problems you have for financing the system for the decades ahead.

Representative HECKLER. No more questions, Mr. Chairman.

Senator JEPSEN. Mr. Feldstein and Mr. Blinder, you seem to disagree strongly—I believe this is correct and I will ask the question first—do you disagree on the social security's effect on savings?

Mr. FELDSTEIN. Well, Alan said it makes good theoretical sense to imagine it but the evidence isn't overwhelming. So we're going to disagree as academic economists about the strength of the evidence, about how precise we can be about it. Yes, there's a disagreement.

Senator JEPSEN. I was interested in trying to probe into where your real disagreement lies and where does it begin to interact.

Mr. FELDSTEIN. You could ask us each for a number and then you could see the gap.

Mr. BLINDER. Had you asked that question, I would try to squirm out of it on the grounds that what I tried to explain in some detail in my testimony—in the written statement—is that the great uncertainty surrounding this number—how many cents of private wealth is squeezed out by every dollar of social security. The statistics that I'd like to focus attention on is not the best guess—which might be 35 cents, 65 cents, 62 cents, or something like that—but the tremendous uncertainty as you look either at one person's study and the sort of statistical uncertainty that is there, or look across different studies by different people of differrent samples or different time periods. The estimates on this are all over the lot. There are certain empirical magnitudes that you could get a panel of five economists up here on, and they would all more or less agree that this is what the evidence says. But this is one issue where you will not be able to do that; and the reason is that our knowledge on this issue is very, very uncertain. I should think the result of that is that as Congress thinks about towering the level of social security wealth, as it's called, I don't think one would hold with any confidence the view that that would raise national savings. That's not a reason to do it. There may be other reasons to do it, but I don't think you will get much in terms of increasing national savings.

Mr. FELDSTEIN. Well, there is a disagreement then. I agree with what Mr. Blinder said about there being uncertainty and reasonable people can say it's as low as 35 cents and others can say it's 65 cents or even 100 cents of private wealth that's squeezed out every time you promise a dollar of social security wealth. My own guess would be that after looking at the evidence it's somewhere between 50 and 100 percent, closer to two-thirds than one-third, but I don't think anybody thinking about the subject, looking at the institutions, looking at the statistics, could come away believing that social security doesn't depress savings and that slowing down the growth of social security benefits won't cause unions to press for more private pensions and won't cause individuals to take more advantage of their IRA and so forth. Of course, it's not going to have much of an effect on the person who makes $50,000 or $100,000, but it can have a big effect on the person who currently feels there's no point in forgoing wages to contribute to a private pension or putting money aside into an IRA when social security, under current law, is replacing 90 percent of his lost income.

Senator JEPSEN. I'd ask both of you to respond to this question and I think you already have, Mr. Feldstein. On the present formulas and the history of the increase in social security, do you feel that the method of computing the increase in social security is accurate or realistic?

Mr. BLINDER. You're referring to the benefit formula that relates an individual's lifetime earnings to the benefits?

Senator JEPSEN. I am referring the CPI, the index you use to increase the general retirement benefits automatically.

Mr. BLINDER. I think the Consumer Price Index is all wrong. It's wrong for this purpose, and it's wrong for 13 other purposes, and I'd like to see a new index introduced explicitly for older people which, as I indicated before, would be an easy job that I'd be very happy to entrust to the Bureau of Labor Statistics which does a very good job at these things.

Senator JEPSEN. Now you answered and said it is wrong, but is it unrealistic?

Mr. BLINDER. It's been unrealistic in the upper direction, as Mr. Feldstein suggested. Something like 23 percent higher real benefits have been created as a kind of mirage by using a bad index. We made people whole relative to the CPI rather than making them whole to a truer measure of the cost of living. I'd like to point out that could go the other way in the next 5 years if mortgage interest rates come down which will badly expose these people and seriously undercompensate them.

Mr. FELDSTEIN. But the interesting implication of that, if we switch over now to a good index, we will have permanently locked in that 23-percent increase. So part of any package of switch over to a good index ought to reconsider the appropriate level. In fact, you would be doing that if you put a 2-percent floor in and said, well, it's going to take us 10 years but 2 percent for 10 years will undo the mischief using the CPI created in the 1970's.

Senator JEPSEN. Mr. Pellechio, you did some early work with Professor Feldstein in savings and the report he has made will be here very shortly. Would you care to comment on the present discussion in light of your work?

Mr. PELLECHIO. Yes, I can summarize that study. Martin Feldstein and I examined the effect of social security on private capital accumulation of households. Our study used individual household data and estimated the effect of social security on the amount of wealth individuals accumulate by the end of a normal working life. Data were collected in a Federal Reserve survey of financial characteristics of consumers. The basic parameter estimates showed that social security substantially reduced the accumulation of household wealth. More specifically, the estimates indicated that each dollar of social security wealth reduces household wealth by somewhat less than a dollar. We tested the sensitivity of our results over a variety of different specifications and we found social security wealth replaces household wealth. We concluded that social security depressed private capital accumulation.

There have been several studies following ours that yield less conclusive results.

Senator JEPSEN. In the remaining few minutes, Mr. Feldstein and Mr. Blinder, I would like to ask you to make a one sentence comment as to what you really feel is the basic problem of the social security system today and then follow that up with why you think it became that way.

Mr. BLINDER. I guess I can throw them both into one sentence. The basic problem is you passed legislation in which Congress promised more benefits than it is prepared to cover through tax receipts. That's both the problem and how it got to be the problem.

So the choice is now either raise taxes, which seems to be unappetizing to almost everybody, or to reduce benefits.

Mr. FELDSTEIN. I would agree with what Mr. Blinder said and only add that it allowed benefits—well, I'll say it slightly differently. Congress made changes which had the unexpected effect of raising benefits to levels that are too high in an absolute sense in terms of their effect on savings and retirement behavior, and that to be financed by future taxes would require taxes that are too high in terms of their adverse effects on workers.

Senator JEPSEN. Being a student of social security and its history, briefly what do you believe to be the basic reason why social security was brought into being?

Mr. BLINDER. I believe it to be two reasons. One was the desire on the part of Congress to insure that people could retire in a decent standard of living and the presumption that they were not doing that before; they were not providing adequately for their own retirement. The reason I think was basically paternalistic. That's a term that's anathema to economists. According to economists, people are rational but the Congress didn't buy that and the President in the thirties didn't buy that and said that as a society we've got to make sure that people are going to have enough. What is enough? That's a political question. What is enough for retirement?

The second thing was the serious accident of the Great Depression which faced a large segment of society, the older segment, with the prospect of being destitute for the rest of their lives without the Government kicking in a lot of money. Remember, the people who retired early under the social security system just got a huge gift from the Government which could be thought of as compensation for suffering through the Great Depression. To me, those are the big reasons.

Senator JEPSEN. Retirement and the Great Depression.

Mr. FELDSTEIN. I think you can't underestimate the importance of the depression on the design of the program. I think it was a program that responded to a current economic situation in the thirties and that has been carried on without ever rethinking whether in a different economic situation of the eighties and on into the next century we really want to have a different system. Banks had collapsed. Savings had been wiped out. People were permanently unemployed. There was a sense that if you could compensate them for their financial losses, and provide an incentive for older members to retire, that would help create jobs for younger workers. Those are not the concerns of the eighties, yet we continue with the same set of incentives, the same structure of the program we put in place in the thirties.

Senator JEPSEN. Dependence on the State has been a problem during the entire history of mankind. Social security basically was put in place to provide for those people who lived too long or died too soon. Their human life value was either diminished or dissipated to the point where they could not provide and those were the two basic reasons for social security. But since then, as you have both very pointedly and capably stated, social security benefits have been promised by the Congress without the Congress providing the wherewithal to actuarily or otherwise provide for them. Another way of putting that is that social security has been used as a poorly lit Christmas tree for many years and each year you add a new ornament on it and soon the branches begin to break. Is that another way of stating it?

Mr. BLINDER. I guess so. But I wouldn't phrase it that way.

Mr. FELDSTEIN. I would add, though, the unexpected consequences of some of the ornaments that were placed there. We didn't realize that inflation, indexing, and using the CPI would have anything like the consequences that it did, just as the double indexing rule was an error at the time.

Senator JEPSEN. One last question for you. Do you believe in light of the basic concepts that were embodied in the history of the social security system when it first went into effect, that all the additional things that it does now—and there is a long laundry list, such as providing the tuition benefits for sons and daughters of millionaires, just to start the list—I could make it much longer—do you believe all of those are proper for social security?

Mr. FELDSTEIN. I believe that probably some of them are, but certainly all of them are not.

Mr. BLINDER. I agree.

Senator JEPSEN. A whole laundry list of things that have gotten far, far removed from what the basic reason for social security was and those have been done without proper financing or any provision for financing, which brings us back to the basic problem.

Mr. Feldstein, I know you have to leave. I appreciate your testimony. And, Mr. Blinder, I hope that you will be able to stay.

Now we will go to Mr. Pellechio.

STATEMENT OF HON. ANTHONY J. PELLECHIO, ACTING DEPUTY ASSISTANT SECRETARY FOR PLANNING AND EVALUATION FOR INCOME SECURITY POLICY, DEPARTMENT OF HEALTH AND HUMAN SERVICES

Mr. PELLECHIO. I want to thank you for this opportunity to discuss the relationship between social security and the economy. I was going to talk about how social security affected two things: One, retirement decisions; and, two, the earnings of individuals who decide not to retire fully. I could talk about the second issue briefly in 3 or 4 minutes or I can simply submit my prepared statement for the record. Mr. Chairman, what would be appropriate at this point?

Senator JEPSEN. Your prepared statement will be placed in full in the hearing record and you may summarize it.

Mr. PELLECHIO. I shall just state what my conclusions were. The overall result of my studies is that social security has induced retirement, both by increasing the rate at which people retire fully and reducing the earnings of retirement-aged individuals who decide not to retire fully.

The main reason for this is the amount an individual can expect to receive from the system is not closely tied to the amount he paid into the system. The administration's proposals remove excessive windfalls and strike a good balance between providing actuarially fair benefits to the individual and socially adequate benefits to the population as a whole. Although everyone enjoys a windfall, the discipline of tying benefits more closely to what people pay into the system through their covered earnings is something that everyone understands and accepts as fair. People now are very concerned about whether they will receive anything at all. People will be a lot happier with the confidence that they will receive fair and adequate benefits rather than a promise of higher benefits that cannot be fulfilled.

That's the conclusion of my testimony.

Senator JEPSEN. Thank you, Mr. Pellechio.

[The prepared statement of Mr. Pellechio follows:]

PREPARED STATEMENT OF HON. ANTHONY J. PELLECHIO

Mr. Chairman and members of the Committee, I want to thank you for this opportunity to discuss the relationship between social security and the economy. Social security is by far the major source of income support for retirement in our country. Benefits for retired and disabled workers and their dependents and survivors are being paid at an annual rate of approximately $145 billion currently. Public transfers on this scale are large enough to have profound effects on the behavior of the U. S. economy. My discussion of the relationship between social security and the economy is built up from a description of how the system affects the economic behavior of individuals. To give some sense of the magnitude of these effects, I shall rely on my recent empirical studies of social security. My results show how the present system induces precisely the behavior that is detrimental to its own financial status. These results provide the basis for understanding how changes in the system will affect individual retirement decisions and aggregate economic activity. The results give strong empirical support to the Administration's proposals.

Social security can affect retirement in three ways. The first two effects arise from the way the system can change the compensation for work. The first effect is given by benefits. More precisely, the level of benefits relative to earnings influences the decision to work. The higher is the benefit level, the less likely it is that earnings offer sufficient com-

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Social security can affect retirement in three ways. The first two effects arise from the way the system can change the compensation for work. The first effect is given by benefits. More precisely, the level of benefits relative to earnings influences the decision to work. The higher is the benefit level, the less likely it is that earnings offer sufficient compensation for work. In other words, the larger the benefit foregone due to work the lower is the net compensation for work and the more likely it is a person will retire. Thus, the first effect is a benefit effect and the expectation is that a higher benefit raises the likelihood that a person retires.

The second way in which social security can change the compensation for work is more subtle. It arises because an average of an individual's earnings is used to calculate benefits. Earnings in the current year can raise this average and, as a result, raise benefits in future years. Any increase in the value of future benefits becomes part of the compensation for work just like the money wages paid at the time of employment. Such additional compensation is a work incentive that reduces the likelihood of retirement. An excellent discussion of this work incentive coming through the benefit formula is given in an article by one of the witnesses today, Alan Blinder, and his coauthors, Roger Gordon and Donald Wise. My empirical results include this work incentive that Blinder, Gordon, and Wise have pointed out. For now my point is that the second effect of social security on retirement is given by the value of any increase in future benefits induced by earnings.

Finally, the third way in which social security can influence retirement is through the change in lifetime income that the system can bring about. In a recent study I showed that the total amount an individual can expect to receive in social security benefits can be more or less than the total value of the payroll taxes that that individual paid into the system. (My calculation includes the employer's share of the payroll tax as well.) Stated a little more precisely, the actuarial value of the benefits that an individual can expect to receive during retirement does not necessarily equal the total value of payroll taxes plus interest accumulated over his working life. The actuarial value of benefits has come to be known as "social security wealth" in the social security literature. When a person's social security wealth exceeds the accumulated value of his payroll taxes, social security has increased his lifetime income. For present and near-future beneficiaries, their social security wealth is much more than the accumulated value of their payroll taxes. Sometimes this gain in lifetime income is referred to as the "social security windfall." Such a windfall makes it possible to spend less time working and, as such, raises the likelihood of retirement. Thus, the third effect is given by the change in lifetime income brought about by social security. I want to note for the moment that when social security wealth <u>does</u> equal the accumulated value of payroll taxes, then social security is said to achieve individual equity or, in other words, is actuarially fair on an individual basis.

Now that I listed effects and described variables, I want to turn to empirical measures of these effects and variables. I shall discuss social security's influence on the following:

(1) Retirement decisions

(2) Earnings of individuals who decide not to retire fully

I have just finished an empirical study of retirement decisions. The dataset used on my study was a match of the Current Population Survey for 1972 and Social Security Administration records and was particularly well-suited for the study. The data made it possible to calculate accurately the social security variables just discussed. A few of the results pertinent to our discussion today are given on Table 1. As the table shows, I obtained separate results for 62-64 and 65-70 year olds. SSW stands for social security wealth and is used to measure the effect of an increase in lifetime income on the retirement rate. As the table shows, a $10,000 increase in social security wealth raises the retirement rate by 10.3 percentage points for 62-64 year olds and 10.8 percentage points for 65-70 year olds. The effect of an increase in social security wealth is estimated by holding the accumulated value of payroll taxes constant. Thus, the resulting increases in the retirement rate are estimates of behavioral responses to departures from actuarial fairness.

The effect of current benefits, denoted BEN, is shown in Table 1 as well. As you can see, a $500 increase in current benefits raises the retirement rate by approximately 5 percentage points for 62-64 year olds and 15 percentage points for 65-70 year olds. These estimates were obtained holding many variables and, in particular, social security wealth constant. It

TABLE 1

ESTIMATED EFFECTS OF CHANGES IN VARIABLES

VARIABLE	CHANGE	CHANGE IN THE PROBABILITY OF RETIREMENT 62 - 64 YEAR OLDS	65 - 70 YEAR OLDS
SSW	+ 10,000	0.103	0.108
BEN	+ 500	0.049	0.149
DSSW	+ 500	-0.048	-0.061
WAGE	+ 500	-0.008	-0.021
ED	+ 1	-0.013	-0.027
AGE	+ 1	0.042	0.030

is interesting to consider just the opposite — decreasing current benefits by $500 holding social security wealth constant. In this case the retirement rate would be reduced by the magnitudes just given. Such a decrease in current benefits — one that holds social security wealth constant — is actuarially fair. As such, it would not result in lower total benefit payments to the individual, it just defers them until later. However, it would improve the finances of the system because, as people delay their retirement and work more, more payroll taxes are collected.

Lastly, the magnitude of the work incentive that comes through the benefit formula is reported in Table 1. The increase in the value of future benefits that would be obtained by working another year is given by DSSW. If the value of future benefit payments goes up by $500, then the retirement rate drops by approximately 5 percentage points for 62-64 year olds and 6 percentage points for 65-70 year olds. This result corroborates the results just obtained for current benefits. In other words, whether the change is an increase in the value of future benefits or, as before, a decrease in current benefits holding social security wealth constant, the result is the same — retirement is postponed.

Finally and most importantly, I'd like to bring this analysis of retirement decisions to the level of the aggregate economy. Let's consider what would happen if benefit payments were reduced next year holding social

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security wealth constant. In other words, benefit payments are deferred in an actuarially fair way. Based on the results in my retirement study and after making the appropriate adjustments to apply those results in 1982, a $1,000 reduction in current benefits would keep approximately 3 million potential retirees employed one year longer. This would raise the labor force by about three percent. With an output elasticity of labor at about .7 at the aggregate level, the additional employment of three million retirees would have the following effects:

(1) Before-tax wage rates would be lower by one percent but after-tax earnings or take-home pay would be higher.

(2) Aggregate output would increase by two percent, or by over $40 billion in today's dollars.

A reduction of wages by one percent would cost the working population about $14 billion per year in gross wages. However, three million retired households would cost workers over $25 billion per year. Thus, the employment of 3 million potential retirees will benefit the working population. The income of the potential retirees who work makes them at least as well off as they would have been with benefits. Also, there is no loss in lifetime income to anyone by the actuarially fair nature of the change. Further, the system collects additional payroll tax revenue. In short, an actuarially fair deferment of benefit payments produces gains for society as a whole.

Having discussed retirement, I now want to turn to my second issue and that is how social security can affect the earnings of individuals who decide not to retire fully. At this point, the social security earnings test comes into the picture. Currently the earnings test for persons aged 65-71 reduces benefit payments by $1 for every $2 of earnings above an exempt amount of $5,500. This provision of the law was intended to direct benefit payments to individuals whose retirement was outside their control and had reduced their income. However, the earnings test implicitly measures an individual's retirement by his earnings which are subject to his control. Therefore, rather than being outside individual control, retirement may be influenced by the earnings test. In order to examine this the exercise is simple and that is to look at earnings distributions for retirement-aged individuals in different years and see whether they keep their earnings just below the exempt amount. In other words, we look to see if people's earnings "follow" the exempt amount over time. In order to carry out this examination the same rich file of data used for the retirement results was used to construct earnings distributions for retirement-aged workers who face the earnings test.

Earnings distributions for 65-71 year old workers are presented in Table 2 for each year from 1966 through 1974. The percentage of workers whose earnings are in the bracket just below the exempt amount in each year is

Table 2

Earnings Distributions of Workers Age 65 - 71 in 1966 - 1974

Earnings Brackets	Percentage of Workers								
	1966	1967	1968	1969	1970	1971	1972	1973	1974
100.	3.5	2.2	1.3	0.9	1.4	2.2	2.3	1.6	2.3
300.	3.1	2.6	2.5	2.4	4.1	1.9	3.0	2.4	3.1
500.	1.8	3.2	2.2	2.7	3.3	3.0	2.8	2.9	2.1
700.	5.3	3.4	4.6	3.3	4.3	3.7	4.3	3.6	3.3
900.	5.1	5.8	4.2	4.2	3.2	3.8	4.3	2.7	3.0
1100.	5.4	5.1	4.8	2.9	3.0	3.3	4.7	3.7	2.5
1300.	4.3	6.1	6.4	3.6	4.8	4.8	3.4	3.3	3.5
1500.	8.9	8.5	5.9	5.4	4.9	5.4	4.2	3.4	3.6
1700.	2.5	2.8	9.9	11.7	11.8	13.8	15.2	5.5	3.9
1900.	1.9	1.6	1.6	3.2	2.9	3.4	2.2	5.8	4.3
2100.	1.1	0.9	1.3	4.2	2.3	1.8	1.1	9.4	4.1
2400.	1.5	1.6	2.3	1.6	1.7	1.6	2.0	3.0	10.3
2700.	2.9	2.7	1.2	1.7	1.6	2.0	1.9	2.1	3.7
3000.	1.6	2.8	1.9	1.5	2.2	0.8	1.5	1.7	2.5
3500.	2.3	2.7	2.6	3.5	3.5	2.2	1.9	1.9	1.7
4000.	4.2	4.8	3.2	3.2	2.7	2.0	2.0	2.3	2.3
4500.	3.9	4.2	3.2	4.2	3.0	4.4	2.4	1.7	2.5
5000.	4.1	4.9	4.3	3.3	2.1	1.0	2.1	3.4	2.4
.									
.	(Percentages in brackets above $5,000 up to the MTE in each year average 2.5 percent.)								
.									
MTE*	22.6	22.6	20.5	21.9	19.8	24.4	20.7	21.7	24.4
Population (thousands)	857	958	1,044	1,047	1,233	1,229	1,307	1,398	1,407

*MTE denotes maximum taxable earnings under social security; these were $6,600 in 1966-67, $7,800 in 1968-71, $9,000 in 1972, $10,800 in 1973, and $13,200 in 1974.

underlined. These percentages in all years are high relative to the percentages in other brackets. What is particularly significant is how the concentrations of workers drops going from the bracket just below the exempt amount to the bracket just above. The pattern of changes in the distributions provides strong evidence that workers keep their earnings below the exempt amount. The percentage of workers earning just below the exempt amount of $1,500 in 1966 and 1967 was 8.9 and 8.5 percent, respectively. In 1968 the exempt amount was raised to $1,680 and the cluster moved up to the bracket just below the new amount. From 1968 through 1972 the exempt amount stayed at $1,680 and the earnings distribution became more concentrated at that amount. The percentages in the $1,501-$1,700 bracket rose steadily from about 10 percent to over 15 percent while the percentages in the bracket immediately above averaged less than three percent. Although the distribution became more concentrated at the $1,680 exempt amount, as soon as it was raised in 1973 to $2,100 the cluster moved up with it. This happened again in 1974. Overall, the story gotten from Table 2 is that workers keep their earnings low enough so that they do not lose benefits through the earnings test.

Again results at an individual level can be brought up to the level of aggregate economic activity. The first thing to point out is that the total earnings of workers below the exempt amount increased by the same percentage as the exempt amount when it went up in the years given in Table 2. Secondly, total earnings of 65-71 year old workers below the exempt amount in 1979 (the last year for which CPS data are available) are $1.85 billion. Based on this amount in 1979, total earnings below the exempt amount in 1983, the first year in which the Administration proposes an increase in the exempt amount, can be projected to be at least $2 billion. The Administration proposes raising the exempt amount in 1983 to $10,000 from a level that will be around $6,500 under the current legislation. This is about a 50 percent increase in the exempt amount. If total earnings below the exempt amount go up by 50 percent, as the 1966-74 period indicates they would, this means a $1 billion increase in these earnings. At a combined employer and employee payroll tax rate of 13.4 percent in 1983, the social security system would collect an additional $134 million from workers earning below the exempt amount. As these workers increase their earnings to follow the new exempt amount, they still receive their full benefit. In other words, there is a $134 million increase in revenue from workers whose benefit payments will not be affected by the change. Thus, social security pays no more in benefits to workers who earn more in response to an increase in the exempt amount, but collects more payroll taxes on their increased earnings. It is important to point out that my calculation does not take into account the fully retired people or potential retirees who would decide to work if the exempt amount is raised significantly.

The main points in summary are that the earnings test reduces the earnings of retirement-aged workers and relaxation of the earnings test will bring additional payroll tax revenue into the system.

CONCLUSION

The overall result of my studies is that social security has induced retirement, both by increasing the rate at which people retire fully and reducing the earnings of retirement-aged individuals who decide not to retire fully. The main reason for this is that the amount an individual can expect to receive from the system is not closely tied to the amount he paid into the system. The Administration's proposals remove excessive windfalls and strike a good balance between providing actuarially fair benefits to the individual and socially adequate benefits to the population as a whole. Although everyone enjoys a windfall, the discipline of tying benefits more closely [redacted] to what people pay into the system through their covered earnings is something that everyone understands and accepts as fair. People now are very concerned about whether they will receive anything at all. People will be a lot happier with the confidence that they will receive fair and adequate benefits rather than a promise of higher benefits that cannot be fulfilled.

Senator JEPSEN. Congressman Richmond.

Representative RICHMOND. Mr. Pellechio, how do you feel about this concept of Mr. Feldstein of putting a 2-percent floor on social security, 2 percent—or expand it to putting 2 percent on all Federal retirees as a means of putting every one of the systems back in the black?

Mr. PELLECHIO. It's a good idea. It may be better to base the COLA adjustment on a price index that is more appropriate for retired individuals.

Representative RICHMOND. I asked Mr. Feldstein and he said unless interest rates continue to go up—and I don't expect them to go up beyond 20 percent—that that wouldn't affect the retirement.

Mr. PELLECHIO. Excuse me?

Representative RICHMOND. When I asked Mr. Feldstein whether, if we changed the cost-of-living index, it wouldn't put the cost of living of senior citizens into some of the more practical aspect, he indicated unless interest rates continued to go up it wouldn't have any effect on their COLA. I don't expect interest rates are going to go much higher than they are right now.

Mr. PELLECHIO. Well, it's a good suggestion for the subcommittee to consider nonetheless.

Representative RICHMOND. Unless you feel we're going to have further inflation in housing and interest rates, certainly it becomes a very good suggestion to change your totals to something that's more practical for the people you're addressing. They don't borrow money and don't usually buy new houses.

Mr. PELLECHIO. Yes, that is correct.

Representative RICHMOND. On the other hand, if you assume our interest rates are at an all-time high and probably will go down, adjusting the COLA as Mr. Feldstein said—and I probably agree with him—won't affect the index rate.

Mr. PELLECHIO. The suggestion for the 2-percent floor is a good one, but in the context of a long-run package, one that changes the basic structure of the system. That should be considered along with a change in the indexing itself so that it's more appropriate for the consumption needs of elderly Americans.

Representative RICHMOND. Just changing the index on a long-run basis, do you think it should be changed to take out some of those?

Mr. PELLECHIO. I'm sorry. I can't hear you.

Representative RICHMOND. In other words, you're saying we should change the index anyway because the present index doesn't, as a practical matter, have much to do with the people we're addressing, the retirees. They don't borrow money and they don't as a rule build new houses.

Mr. PELLECHIO. Right. It's worth considering adjustments in the price index for elderly Americans in the context of the longer run package.

Representative RICHMOND. You would have to have an adjustment for rental units.

Mr. PELLECHIO. Sure. That would be part of the consideration that goes into this price adjustment.

Representative RICHMOND. As Mr. Feldstein said, unless interest rates drop and unless interest rates go up and housing costs increase, that really wouldn't affect the old anyway.

Mr. PELLECHIO. That's right. I agree with you.

Representative RICHMOND. For the long term, I think we really ought to get that COLA into some sort of practical condition.

Mr. PELLECHIO. Right. We had two suggestions on that.

Representative RICHMOND. So what do you think about the 2-percent floor?

Mr. PELLECHIO. It's worth considering. There would be implications for beneficiaries at different levels of benefits that have to be considered.

Representative RICHMOND. Our own economists say by 1990, due to the age of our citizens and whatnot, the forecasts are that our social security will be back in very good shape. So would you say what we really have to do that would only cover this decade and not necessarily cover perpetuity?

Mr. PELLECHIO. We look at the financial picture over a 50-year period and a crisis in 2010 has to be considered also. That's why we consider long-run or structural changes. So 1990 might be good for a while, but we have the baby boom reaching retirement age after the turn of the century and that's an enormous problem in the long-range perspective. So picking a year like 1990 and saying everything's OK is not really the right perspective, we have to look at in the context of long-range changes.

Representative RICHMOND. We have other forecasts that due to the age of our population unemployment will be virtually nonexistent within the next decade due to the age brackets.

Mr. PELLECHIO. Right.

Representative RICHMOND. Mr. Simon is quite sure unemployment will be the least of our problems in the 1990's and that we're going to have to use robots and every type of equipment possible just to continue to be a great industrial power because there won't be any pool of labor.

Mr. PELLECHIO. Right. As the current working population ages, their continued labor force participation will be an important input. The continued employment of people who are reaching retirement age will be important because of their experience and better health.

Representative RICHMOND. And I'm sure you're in favor of phasing in labor retirement to the age of 68.

Mr. PELLECHIO. Phasing in perhaps, not making immediate changes.

Representative RICHMOND. How would you phase it in?

Mr. PELLECHIO. I haven't thought that through, but in steps over a 5- to 10-year period so people can make adjustments. As Alan Blinder said, it's essentially a lifetime decision.

Representative RICHMOND. Certainly if we attacked some of these three rather central questions I think we could get the social security fund back in shape without unduly taxing the people right now.

Mr. PELLECHIO. That's right.

Representative RICHMOND. Thank you.

Senator JEPSEN. I have no further questions. Do you have statements you would like to make in closing?

Mr. BLINDER. I only thought I might clarify this CPI issue because the arithmetic is a little bit confusing. Should the mortgage interest rates stabilize at their current high rates—just stabilize and not rise further—that would mean that, looking out to the future, the

Consumer Price Index would undercompensate for true inflation because it will have a sizable component with a rate of change of zero which is not in an index that strips away interest costs. So what's critical is that if interest rates come down that effect will be exaggerated, but if they simply stabilize at their current rate, then the CPI will understate inflation. That's the adverse of stating that over the past years, as interest rates have gone up the CPI has exaggerated inflation. So the issue is whether interest rates will stabilize versus whether they will continue to go up. And I agree with you that they are not likely to go up over the next 5 years as they have over the last 5 years. It's almost inconceivable.

Representative RICHMOND. I think these three remedies are quite sensitive and I certainly approve of these three remedies rather than some Draconian cuts in the system, since we know that by 1990 the system will be in reasonable shape anyway.

Senator JEPSEN. Would you list those three remedies?

Representative RICHMOND. Mr. Chairman, I think introducing a 2 percent floor on the whole Federal retirement plan, not only social security but all other Federal retirement plans. That's certainly uninflationary and perhaps everybody would join in participating to reduce inflation.

Second, it would be adjusting the COLA index for all retirees, not only social security retirees but all Federal retirees, to eliminate the interest and housing.

Senator JEPSEN. That would mean revising the CPI?

Representative RICHMOND. Yes, and putting in a rental factor for housing.

And third, raising the age of retirement to 68 in a very reasonable, sensible increment.

Senator JEPSEN. Do you have any comment on that, Mr. Pellechio?

Mr. PELLECHIO. No. It's a reasonable proposal in the context of a long-run package and is worth consideration. I don't like raising the retirement age from the results of my own research. I think that is a cut in benefits and a cut that falls a bit disproportionately on the young.

Representative RICHMOND. I assume we give them plenty of time to get phased in and there's no question that when we invented social security back in the 1930's the average life span was 68 or lower.

Mr. PELLECHIO. Quite a bit lower than it is today.

Representative RICHMOND. By the 1990's, it will be around 80, so I think it's very reasonable to phase in later retirement.

Mr. PELLECHIO. But around the year 2000, people who reach retirement will be bearing the brunt of the cost of that proposal.

Representative RICHMOND. I would phase it in very, very slowly.

Mr. PELLECHIO. I understand. When it's phased in and you've got the extra years on the retirement age in the year 2000, people reaching retirement age will be bearing the full brunt of that change. They are bearing a significant cut in benefits.

Representative RICHMOND. Also, you probably realize, by that age people will by and large not want to retire anyway.

Mr. PELLECHIO. I don't know how to project what people's behavior will be that far in advance. I'm just saying that the benefits that they could receive, their potential total benefits payment, would be substantially cut. The full brunt of a 3-year increase in the age at which you receive full benefits would fall on that group. It's easy to put the burden on that group because they are not as closely identified as the group of current beneficiaries. So it has some expediency to it, but if you want to look at the broad horizon, in fact on all generations, all cohorts, then by the time you get it phased in the benefit cut that's implied by that change will be borne by those people.

Representative RICHMOND. On the other hand, you will have a very solid, sound social security system which is what the American people really want. Every one of these suggestions is deflationary. That's what I like.

Mr. PELLECHIO. It's a solid social security system, but there's a significant benefit cut for people reaching retirement age after the year you have your phase-in completely.

Senator JEPSEN. I would like to thank both of you very much. Your testimony has been very beneficial to the challenging job we have facing us. Thank you very much, gentlemen.

I would now like to invite Mr. Austin and Mr. Greenough to come forward. I welcome you gentlemen to this hearing. I am very familiar with your company, Mr. Austin. Equitable Life Insurance Co. has been one of the pioneers in the insurance industry and has a very proud, and economically sound record in the insurance industry. We are pleased and thankful that you could come to testify before us today.

STATEMENT OF KENNETH R. AUSTIN, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, EQUITABLE LIFE INSURANCE CO. OF IOWA, DES MOINES, IOWA, ON BEHALF OF THE AMERICAN COUNCIL OF LIFE INSURANCE, ACCOMPANIED BY ARTHUR S. FEFFERMAN

Mr. AUSTIN. Thank you. I'm delighted to be here. I am speaking on behalf of the American Council of Life Insurance, which has about 518 members and represents 95 percent of all the life insurance and some 97 percent of all the assets of the life insurance industry in our country. We appreciate the opportunity to be here.

Social security, as has been indicated right along here this morning, still faces some severe short-term and long-term financial problems, and unless remedial action is taken, we project by the latter part of 1982 the OASI trust fund will run out of money.

In view of the tremendous importance of social security to the American people, prompt remedies must be found, and we believe the remedies must be adequate to deal not only with the possibility of favorable economic conditions but also with the possibility that future economic conditions may be unfavorable. Otherwise, we run the risk of repeating the sad experience of the past few years when there was widespread complacency that social security's financial problems had been resolved at least through the end of the century and then they were shattered by the deteriorating economic conditions of the last 3 or 4 years.

Moreover, we seek permanent solutions to these problems and not merely actions which postpone the day of reckoning. We believe that OASI should be authorized to borrow from the disability and hospital insurance funds if this is necessary to prevent the retirement fund from declining to inadequate levels. However, actions of this type are merely Band-Aids, as the term has been used before, and provide only temporary and short-term relief. They do not resolve the underlying financial problems of the social security system and should not be permitted to distract from the basic actions that are required to place the system on a sound financial basis.

In considering remedies, it is important to keep in mind that social security was never intended to provide for the entire retirement income needs of our older population. The function of the compulsory and almost universal social security system is to provide a basic floor of protection for our older population in the areas of retirement and health and for all our population in the areas of disability and survivor protection. Private voluntary pension plans and other voluntary private savings have the job of building on the basic floor of protection provided by social security, thereby bringing retirement income up to levels which more nearly reflect the individual's preretirement standard of living.

We urge that the following basic actions be taken to achieve a financially sound social security system. These actions have two major objectives: First, to provide adequate tax revenue to pay social security benefits when they come due and, second, to keep social security costs within the limits of the Nation's fiscal capacity by moderating projected sharp increases in benefits.

And may I say something here parenthetically, if I may, the recommendations which I'm going to suggest do not involve cutting, other than some fine tuning perhaps. We do not endorse cuts in social security, nor have we ever recommended cuts in social security. Our proposal involves slowing the rate of increase in social security benefits in the future. I think it is most unfortunate to refer to that sort of adjustment as cuts, implying, as I say, that they are cuts, because this is what really heightens the level of social tension which Congresswoman Heckler was talking about a few minutes ago.

Back to the recommendations. Social security should continue to be financed solely through payroll taxes paid equally by covered workers and employers. Such payroll taxes enable covered workers and employers to share the cost of the program in a responsible fashion. These taxes have the capability of producing the large sums necessary to finance social security. Moreover, they have the virtue of being highly visible, which helps to maintain the vital link between an employee's benefits and his or her contributions.

Social security payroll tax rates should be set at levels that are adequate to finance reasonable benefits provided by law even if this means having the OASDI–HI payroll tax increase to 7.05 percent take effect in 1983 instead of in 1985 as under present law. Failure to maintain payroll tax rates at adequate levels would require the use of general revenues to finance social security. This would be particularly undesirable since, in a very real sense, there is no general revenue available to finance social security in view of the large budget deficits confronting us. Accordingly, general revenue financing would reduce confidence in the social security system, as it would be widely construed as a sign that we are not willing to face up to the hard issues involved in placing the system on a sound financial basis. Moreover, unless we are willing to accept continued budget deficits with their unfortunate consequences for inflation, the use of general revenues instead of payroll taxes to finance social security means that the costs of the system will have to be paid later by other forms of taxes In other words, to the extent that payroll taxes are not used to finance social security, other forms of taxation less suited for this purpose will have to be used.

We believe that much of social security's financial difficulties are due to the great financial drains on the system resulting from present procedures for indexing social security benefits. Accordingly, while benefits should continue to be adjusted for inflation in order to preserve their role as a floor of protection and to prevent hardship, a comprehensive review should be made of the present indexing procedures to determine whether they are appropriate in the present circumstances. This review should include an examination of the present Consumer Price Index to determine whether it accurately reflects changes in the cost of living for social security beneficiaries and whether revisions in the index are needed to avoid overstating increases in such living costs. The present indexing procedure, for example, appears to give undue emphasis to the increased cost of homeownership associated with rises in mortgage interest rates, since the bulk of the social security beneficiaries do not purchase new homes. As an employer, I have great difficulty doing that with our own employees and have not done so over the last several years.

One possibility, as has been mentioned, would be to limit the annual increase to some specified percentage of the CPI or perhaps developing another, or perhaps, as has been suggested, would be to go with wages or prices, whichever is lower, or wages in the years in which wages increase less than the CPI.

We endorse the administration's proposal to place automatic increases in benefits on a fiscal year basis rather than on the 3-month basis, as has been done in the past, and to move from July to October based on the CPI for the year ending in June.

We also support the administration's proposal to moderate the increases in initial benefits for active workers when they retire. This, of course, would be done by increasing the bend points on some weighted basis such as 50 percent of the CPI for the period from 1982 to 1987, which is a specific recommendation.

Provision should be made for gradually increasing the retirement age to age 68 after giving ample time to individuals to adjust their plans. Americans are living longer, I believe about 3 years longer on the average, than they were in 1935 when the social security system was designed.

Moreover, in the absence of some sort of measures such as a later retirement age, in the future we will see a very substantial increase in the relative size of the retired population and a relatively small number of active workers to carry on the production process and to pay the bills. At present, there are about 20 persons age 65 or older for each 100 persons at working ages. By the year 2030, 50 years from now, the retirement dependency ratio is expected to reach 38—that is, 38 to 100—based on intermediate assumptions, and we have all seen some predictions which approach 50. A gradual increase in the retirement age would help to stabilize the financial position of the social security system and avoid placing an undue and perhaps unacceptable financial burden on future generations of workers.

Our suggestion is that we start in the year 2000 and increase the retirement age by one-fourth year annually or 3 months annually, over a period of 12 years so it would be age 68 in the year 2012. That is not vastly different from some other suggestions which have been made. We picked that time obviously because it's known from the present demographics that's when the post-war baby boom will really hit. That's when the problem will become extremely acute.

At the same time, we would propose that the early retirement be increased from 62 to 65. We support the two administration proposals which are designed to encourage later retirement under social security, namely the proposal to change the benefit computation point from 62 to 65 and the proposal to eliminate children's benefits for early retirees, again in both cases and in all cases, with sufficient notice of the change to give individuals time to adjust their retirement plans.

In addition to the vital change with regard to indexing of benefits and age of retirement which I have just discussed, there are a number of other actions which would help to stabilize the financial position of social security.

They include elimination of the windfall benefits received under social security by former Government workers and workers in nonprofit institutions, eventual universal coverage of such employees under social security, and elimination of the option of State and local governments and nonprofit institutions to withdraw from social security.

The administration's proposal to extend the family maximum cap that is now applicable to disability cases to retirement and survivor cases merits support. The 1980 disability amendments limited the maximum family disability benefits to the lesser of 85 percent of the worker's average index earnings or 150 percent of the primary benefit, but not less than 100 percent of the primary benefits. Extending a similar maximum to old age and survivor family benefits would help assure that such family benefits will not exceed the worker's previous net take-home pay and put the worker's family in a better financial position when he retires than when he worked.

We support the administration's recommendations to relate disability insurance more closely to an individual's work history and medical condition and to prevent excessive benefits. This includes:

(*a*) Assuring that DI benefits will not be awarded to persons with temporary disabilities by requiring an individual's disability to have lasted or to be expected to last 24 full months;

(*b*) Restoration of the 6-month waiting period requirement in effect prior to 1972, thus conforming to the terms of most private disability programs; and

(*c*) Requiring individuals to have been in covered employment for a minimum of 6 out of the 13 quarters prior to disability and 30 out of the 40 quarters prior to disability in order to qualify for DI benefits. This change would make DI benefits more compatible with their role as a replacement for recently lost wages than the present requirement for coverage in 20 out of the past 40 quarters which makes it possible for a person to be out of covered employment for as long as 5 years and still qualify for DI benefits.

Pressures for placing increased financial burdens on social security should be reduced by maintaining a favorable environment for the growth of voluntary pension plans and other private savings for retirement. As noted above, it is widely recognized that the historic purpose of social security is to provide a basic floor of protection and that voluntary private pension plans and other private savings have the job of supplementing this basic floor. To the extent that such private pension plans and other private retirement savings are encouraged through appropriate tax measures, demands for costly expansion of social security benefits are reduced. Accordingly, we are pleased that the Economic Recovery Tax Act of 1981 increased the tax deductible limits for contributions to IRA's and H.R. 10 plans. This act also encourages employees covered by pension plans to set aside retirement funds by allowing them to participate in IRA's on the same basis as other individuals. It also makes a start on the desirable objective of allowing employees to deduct their own pension contributions by granting employees tax deductions up to the IRA limits for voluntary contributions made to pension plans.

Unfortunately, the 1981 act does not extend comparable tax deductions for mandatory employee pension contributions. This should be remedied. The right of employees to deduct their own pension contributions should not be affected by whether their contributions are voluntary or mandatory under the terms of their plans. Extending the tax deductions for mandatory employee contributions, as well as for voluntary employee contributions, would provide more equitable tax treatment for the employees involved and would be more effective in encouraging retirement savings. It would provide more adequate financing for pension plans, making possible increased pension coverage and higher benefits. It would also increase savings and capital formation. This is especially significant in view of the fact that, in the second quarter of 1981, Americans saved only 5.3 percent of disposable income, which is significantly below the comparable savings rate in other industrial countries.

Finally, we strongly believe it would be most desirable to mandate the adoption of pension plans providing specified benefits to employees. Because such mandatory plans would be imposed on very large numbers of employers in widely different economic circumstances, they would inevitably result in financial hardship for many employers who cannot afford them. This contrasts markedly with voluntary plans whose establishment and development tend to be closely correlated with financial ability. The costs involved in financing the mandatory plans could result in reduction of cash wages and other fringe benefits for employees.

To the extent that the employees prefer the cash wages and other fringe benefits, their overall economic position is likely to be impaired rather than improved. Mandatory plans could also contribute to unemployment among the very people who are the intended beneficiaries of the proposal. The overall welfare of employees is likely to be improved if they, working with their employers, are given as much choice as possible as to the relative importance of each of the components in their total compensation package, instead of having one component; namely pensions, mandated by the Government.

This concludes our specific recommendations. Before closing my remarks, I want to emphasize again that, in view of social security's vital importance to our older people and the Nation, we cannot afford to risk weakening it by continuing expenditure patterns that substantially outrun receipts. We urge the Congress to take prompt action to bring these expenditures and receipts into balance and thereby place social security on a sound financial basis, both in the short run and over the long range.

Thank you.

Senator JEPSEN. Thank you, Mr. Austin.

[The prepared statement of Mr. Austin follows:]

Prepared Statement of Kenneth R. Austin

I am Kenneth R. Austin, Chairman and Chief Executive Officer of the Equitable Life Insurance Company of Iowa and hold comparable positions with several affiliated life insurance companies. I also serve as Chairman of the Committee on Social Security of the American Council of Life Insurance. With me is Arthur S. Fefferman, Director of Tax, Pension and Social Security Analysis of the Council. We are appearing here today on behalf of the Council which represents 526 life insurance companies. These companies account for 95 percent of the life insurance in force in the United States and 97 percent of the assets of all life insurance companies.

We appreciate this opportunity to present our views on Social Security financing issues. The Omnibus Reconciliation Act of 1981, enacted in August, provides for significant reductions in Social Security expenditures. However, it is apparent that the system still faces severe financial problems. The retirement program, OASI, is encountering acute short-range financial problems which are being accentuated by stagflation which increases benefits and decreases receipts. According to the latest available estimates, unless remedial action is taken, by the latter part of 1982 the OASI trust fund could be depleted to the point where it would be unable to pay the benefits that come due. Social Security also faces long-run deficits on the basis of what now seems to be the most reasonable economic and demographic estimates. The projected deficits become very substantial in the second quarter of the next

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century when the ratio of Social Security recipients to active workers will increase to high levels, placing heavy financial burdens on the active workers who support the system.

In view of the great importance of Social Security to the American people, prompt remedies to these financial problems must be found. We believe that the remedies must be adequate to deal not only with the possibility of favorable economic conditions, but also with the possibility that future economic conditions may be unfavorable. Otherwise, we will run the risk of repeating the sad experience of the past few years when widespread complacency that Social Security's financial problems had been resolved by the 1977 Social Security Amendments was shattered be deteriorating economic conditions.

Moreover, we should seek permanent solutions to these problems and not merely actions which postpone the day of reckoning. We believe that the OASI trust fund should be authorized to borrow from the Disability Insurance (DI) and Hospital Insurance (HI) trust funds if this is necessary to prevent the retirement fund from declining to inadequate levels. However, actions of this type are merely "band-aids" and provide only temporary short-run relief. They do not resolve the underlying financial problems of the Social Security system and should not be permitted to distract from the basic actions that are required to place the system on a sound financial basis.

Finally, in considering remedies, it is important to keep in mind that Social Security was never intended to provide for the entire retirement income needs of our older population. The function of the compulsory and almost universal Social Security system is to provide a basic floor of protection for our older population in the areas of retirement and health and for all our population in the areas of disability and survivor protection. Private voluntary pension plans and other voluntary private savings have the job of building on the basic floor of protection provided by Social Security thereby bringing retirement income up to levels which more nearly reflect the individual's pre-retirement standard of living.

There are good grounds for using voluntary means to supplement the basic protection offered by Social Security. Private voluntary arrangements, including pension plans and other private savings, provide flexibility to meet different needs and circumstances. They are based on the concept that once the floor of protection has been provided, further retirement income protection should not be mandated by a government requirement to set aside additional funds for this purpose. Instead, individuals, working together with their employers and utilizing individual savings, should have the freedom to choose how much of their income should be set aside for additional retirement income protection and how much should be used for other purposes, such as saving to meet the expenses of educating children or to buy a home.

Voluntary pension plans have a record of substantial achievement. In May 1979, such plans included as participants over 68 percent of all civilian nonagricultural employees, age 25-64, working more than 1,000 hours a year and with their current employer more than one year.[*/] Pension plans also help supply the capital formation which is essential to achieve a dynamic growing economy and to combat inflation. By the end of 1980, for example, private pension assets administered by life insurance or held in trust by banks or trust companies totalled some $423 billion. This additional capital is a major factor in the creation of new jobs, increases productivity and helps contain inflationary pressure.

Basic Actions for a Financially Sound Social Security System

We urge that the following basic actions be taken to achieve a financially sound Social Security system. These actions have two major objectives: (1) to provide adequate tax revenue to pay Social Security benefits when they come due and (2) to keep Social Security costs within the limits of the Nation's fiscal capacity by moderating projected sharp increases in benefits.

1. Finance Social Security Through Payroll Taxes, Not General Revenues

We believe that Social Security should continue to be financed solely through payroll taxes paid equally by covered workers and employers. Such payroll taxes enable covered workers and employers to share the cost of the program in a responsible fashion. These taxes have the capability of producing the large sums necessary to finance Social Security. Moreover, they have the virtue of being highly visible, which helps to maintain the vital link between an employee's benefits and his or her contributions.

[*/] Employee Benefit Research Institute, Retirement Income Opportunities in an Aging America: Coverage and Benefit Entitlement, July 1981, Table II-1, p. 25.

Social Security payroll tax rates should be set at levels that are adequate to finance reasonable benefits provided by law even if this means having the OASDI-HI payroll tax increase to 7.05 percent take effect in 1983 instead of in 1985 as under present law. Failure to maintain payroll tax rates at adequate levels would require the use of general revenues to finance Social Security. This would be particularly undesirable since, in a very real sense, there is no general revenue available to finance Social Security in view of the large budget deficits confronting us. Accordingly, general revenue financing would reduce confidence in the Social Security system, as it would be widely construed as a sign that we are not willing to face up to the hard issues involved in placing the system on a sound financial basis. Moreover, unless we are willing to accept continued budget deficits with their unfortunate consequences for inflation, the use of general revenues instead of payroll taxes to finance Social Security means that the costs of the system will have to be paid later by other forms of taxes. In other words, to the extent that payroll taxes are not used to finance Social Security, other forms of taxation less suited for this purpose will have to be used.

2. <u>Reform Present Indexing Procedures</u>

We believe that much of Social Security's financial difficulties are due to the great financial drains on the system resulting from present procedures for indexing Social Security benefits. Accordingly, while benefits should continue to be adjusted for inflation in order to preserve their role as a floor of protection and to prevent hardship, a comprehensive review should be made of the present indexing procedures to determine whether they are appropriate in the present circumstances. This review should include an examination of the present Consumer Price Index (CPI) to determine whether it accurately reflects changes in the cost of living for Social Security beneficiaries and whether revisions in the index are needed to avoid overstating increases in such living costs. The present indexing procedure, for example, appears to give undue emphasis to the increased cost of home ownership associated with rises in mortgage interest rates, since the bulk of the Social Security beneficiaries do not purchase new homes.

Moreover, there is a broad question whether the Nation can afford to completely insulate from inflation Social Security beneficiaries, or indeed any other large groups of individuals. One possibility would be to limit the annual increase in Social Security benefits under automatic indexing to a specified percentage of the increase indicated by the CPI. Another possibility would be to limit the annual increase in benefits to the increase in average wages for years when such wages increase less than the CPI.

We also support the Administration's proposal to moderate the increases in initial benefits provided for active workers when they retire. This would be done by increasing the "bend points" in the weighted benefit formula by 50 percent instead of 100 percent of increases in average wages in the years 1982-87. This change would provide benefit levels for new cohorts of beneficiaries which would be compatible with the financial position of the Social Security trust funds. It would restore replacement rates to the levels generally prevailing in the 1960s and would provide an initial replacement rate of 38 percent for the average worker.

Similarly, we endorse the Administration's proposal to place the automatic increases in benefits on a fiscal year basis by deferring the date for such increases from June to September, based on the changes in the CPI over the full year beginning in July and ending in June.

3. Increase the Retirement Age Under Social Security Gradually, After Sufficient Advance Notice

We believe it essential to provide now for a gradual increase in the retirement age under Social Security after giving individuals sufficient advance notice to adjust their retirement plans. Americans are now living significantly longer and are generally able to work until a later age than they did in 1935 when the earliest retirement age for the receipt of benefits was set at 65. As life expectancy becomes longer, it is appropriate to reapportion an individual's life span between years of work and years of employment. The Age Discrimination in Employment Act, as amended in 1979, recognizes this by generally prohibiting mandatory retirement prior to age 70.

Unless the retirement age under Social Security is increased, the future will see substantial increases in the relative size of the retired population and relatively smaller numbers of active workers to carry on the Nation's productive process. This change will be especially marked in the early part of the next century when the front end of the post-World War II baby boom will begin to reach 65. At present, there are about 20 persons age 65 or over for each 100 persons at the working ages, 20-64. According to the most recent intermediate estimates of the Social Security Administration, this "retirement-dependency ratio" will increase only moderately over the next 25 years, but will then climb sharply, reaching a high of 38 in 2030 and thereafter.

Social Security should recognize these important demographic and social developments. A gradual increase in the minimum retirement age for receipt of full benefits would help to stabilize the financial position of the Social Security system and would avoid placing undue financing burdens on the working population. For example, an increase in the normal retirement age under Social Security, which begins to take effect gradually after a long notification period to avoid any possible hardship, would greatly reduce the ratio of retirees to active workers in the next century and would eliminate about two-thirds of the long-term (75-year) average deficit projected on the basis of the intermediate assumptions of the 1981 Trustees Report.

We, therefore, suggest that the normal retirement age be kept at 65 until the year 2000 and that thereafter it be increased by one-fourth of a year annually until a retirement age of 68 is reached for 2012 and later years. At the same time, the early-retirement age, at which reduced Social Security benefits are payable (now 62) would be increased to 65 in corresponding gradual increments, again starting the upward movement at about the turn of the century. As an alternative, age 62 could be kept as the earliest retirement age with an actuarial adjustment in the size of the benefit for retirement prior to age 68, the new normal retirement age. This would give the public a long advance notice of the changes and yet have the new normal retirement age fully effective when most needed--when the members of the World War II baby boom population begin to retire, early in the next century.

We endorse the concept underlying the Administration's proposal to reduce the benefits of early retirees since it is consistent with a general increase in retirement age. However, we strongly believe that it would be preferable to put such a proposal into effect as part of an overall plan to raise the normal retirement age under Social Security to 68, as under our recommendation. Moreover, it is important that the proposed reduction in benefits for early retirement not be put into effect abruptly. Instead, it should be phased in gradually over a sufficiently long period of time to give future retirees sufficient advance notice to permit them to adjust their retirement plans. Such advance notice, in our opinion, is essential in order to avoid hardship and to gain public acceptance.

For similar reasons, we support two Administration proposals that are also designed to encourage later retirement under Social Security--namely a proposal to change the benefit computation point from age 62 to 65 and a proposal to eliminate childrens' benefits for retired workers age 62-64--again, provided that there is sufficient advance notice of the change to give individuals time to adjust their retirement plans.

4. Retain the Retirement Test for Social Security Benefits

While we sympathize with the objective of encouraging older individuals to work, we do not support the elimination of the retirement test, which would allow all otherwise eligible individuals to receive full Social Security benefits regardless of the amount of their earnings. This test is essential to the concept that the function of Social Security is to provide retirement benefits as a partial replacement of wages. Elimination of the retirement test would convert Social Security to a system which pays annuities to eligible individuals, regardless of whether they retire or continue to work. This would result in payment of benefits to individuals who do not need them as a replacement of earnings and would increase Social Security expenditures at a time when we should be considering every means of reducing them.

5. Eliminate Windfall Benefits and Move Toward Universal Coverage of Government Employees and Employees of Nonprofit Organizations

We support elimination of the windfall benefits received under Social Security by former government employees and employees of nonprofit institutions who have spent most of their working careers in noncovered employment but who acquire sufficient coverage to qualify for Social Security benefits. Present law gives such individuals unintended advantages in allowing them to receive the advantages of the heavy weighting in the present benefit computation formula which is intended for and should be confined to long-term low-income employees. Both equity and fiscal considerations strongly favor the elimination of the windfall elements in such benefits.

Moreover, eventual universal coverage under Social Security should be provided for all government employees and employees of nonprofit organizations in a way which assures that present employees who spend their entire careers in such employment do not have less overall benefit protection.

Finally, the option of State and local governments and nonprofit organizations to withdraw from coverage should be eliminated, after a grace period, during which the filing of notices of intent to withdraw would be permitted.

6. Extend the Family Cap Now Applicable to Disability Benefits to Retirement and Survivor Benefits

The Administration's proposal to extend the family maximum cap that is now applicable to disability cases to retirement and survivor cases merits support. The 1980 Disability Amendments limited the maximum family disability benefits to the lesser of 85 percent of the worker's average index earnings or 150 percent of the primary benefit, but not less than 100 percent of the primary benefits. Extending a similar maximum to old age and survivor family benefits would help assure that such family benefits will not exceed the worker's previous net take home pay and put the worker's family in a better financial position when he retires than when he worked.

7. Adopt the Administration's Disability Insurance Proposals

We support the Administration's recommendations to relate Disability Insurance (DI) more closely to an individual's work history and medical condition and to prevent excessive benefits. This includes:

a) Assuring that DI benefits will not be awarded to persons with temporary disabilities by requiring an individual's disability to have lasted or to be expected to last 24 full months;

b) Restoration of the six month waiting period requirement in effect prior to 1972, thus conforming to the terms of most private disability programs; and

c) Requiring individuals to have been in covered employment for a minimum of 6 out of the 13 quarters prior to disability and 30 out of the 40 quarters prior to disability in order to qualify for DI benefits. This change would make DI benefits more compatible with their role as a replacement for recently lost wages than the present requirement for coverage in 20 out of the past 40 quarters which makes it possible for a person to be out of covered employment for as long as five years and still qualify for DI benefits.

8. Reduce Pressures on Social Security by Maintaining a Favorable Environment for Voluntary Pension Plans and Private Savings

Pressures for placing increased financial burdens on Social Security should be reduced by maintaining a favorable environment for the growth of voluntary pension plans and other private savings for retirement. As noted above, it is widely recognized that the historic purpose of Social Security is to provide a basic floor of protection and that voluntary private pension plans and other private savings have the job of supplementing this basic floor. To the extent that such private pension plans and other private retirement savings are encouraged through appropriate tax measures, demands for costly expansion of Social Security benefits are reduced. Accordingly, we are pleased that the Economic Recovery Tax Act of 1981 increased the tax deductible limits for contributions to IRAs (Individual Retirement Accounts) and H.R. 10 plans. This Act also encourages employees covered by pension plans to set aside retirement funds by allowing them to participate in IRAs on the same basis as other individuals. It also makes a start on the desirable objective of allowing employees to deduct their own pension contributions by granting employees tax deductions up to the IRA limits for voluntary contributions made to pension plans.

Unfortunately, the 1981 Act does not extend comparable tax deductions for mandatory employee pension contributions.*/ This should be remedied. The right of employees to deduct their own pension contributions should not be affected by whether their contributions are voluntary or mandatory under the terms of their plans. Extending the tax deductions for mandatory employee contributions, as well as for voluntary employee contributions, would provide more equitable tax treatment for the employees involved and would be more effective in encouraging retirement savings. It would provide more adequate financing for pension plans, making possible increased pension coverage and higher benefits. It would also increase savings and capital formation. This is especially significant in view of the fact that, in the second quarter of 1981, Americans saved only 5.3 percent of disposable income, which is significantly below the comparable savings rate in other industrial countries.

Finally, we strongly believe it would be most undesirable to mandate the adoption of pension plans providing specified benefits to employees. Because such mandatory plans would be

*/These are contributions that are required as a condition of employment, as a condition of plan participation, or as a condition of obtaining benefits (e.g., matching employer contributions).

imposed on very large numbers of employers in widely different economic circumstances, they would inevitably result in financial hardship for many employers who cannot afford them. This contrasts markedly with voluntary plans whose establishment and development tends to be closely correlated with financial ability. The costs involved in financing the mandatory plans could result in reduction of cash wages and other fringe benefits for employees. To the extent that the employees prefer the cash wages and other fringe benefits, their overall economic position is likely to be impaired rather than improved. Mandatory plans could also contribute to unemployment among the very people who are the intended beneficiaries of the proposal. The overall welfare of employees is likely to be improved if they, working together with their employers, are given as much choice as possible as to the relative importance of each of the components in their total compensation package, instead of having one component, namely pensions, mandated by the government.

This concludes our specific recommendations. Before closing my remarks, I want to emphasize again that, in view of Social Security's vital importance to our older people and the Nation, we cannot afford to risk weakening it by continuing expenditure patterns that substantially outrun receipts. We urge the Congress to take prompt action to bring these expenditures and receipts into balance and thereby place Social Security on a sound financial basis, both in the short run and over the long range.

Senator JEPSEN. Mr. Greenough, I welcome you and ask you to proceed in any manner you wish.

STATEMENT OF WILLIAM C. GREENOUGH, TRUSTEE, COMMITTEE FOR ECONOMIC DEVELOPMENT, WASHINGTON, D.C.

Mr. GREENOUGH. Thank you, sir. My name is William Greenough and almost all of my professional life has been in pensions with TIAA. Today I'm speaking for the Committee for Economic Development. I was chairman of its Subcommittee on Retirement Policy. CED is a group of about 200 chief executive officers of colleges and businesses, economists, academicians, and public officials. The recommendations that I bring to you were approved by that whole board after a very thoroughgoing process that included 2 years of study and discussion. We have chosen the date of your meeting today to announce the report.

I believe it is a very important study. It's responsive to so many of the questions that your preliminary material has shown Congress should study. These are important questions in this field. As a matter of fact, some economic and political questions that we are talking about now are multi-hundred-billion-dollar questions. This issue of retirement happens to be a multitrillion-dollar question. It's the biggest of all the questions that first in the financial world and entails the longest commitments that humans make to each other—until death do us part.

The CED report emphasizes the grave necessity of setting into place those decisions now that will have the most positive long-run effect as well as taking care of the near-term crunch.

You know the figures on the trust fund. We run out of money next year. One of the things I'd like to emphasize is the serious loss of confidence of those who are retired worrying that somebody is going to reduce their benefits. As Ken and others have said this morning, any really responsible discussion I have seen on the aged benefits is only a discussion of reduction of the increases and a question of whether the increase in benefits beyond the increases in wage rates are something that's acceptable to the American public.

But even more important than that there is a problem of the lack of confidence in the social security system's ability to provide retirement income. The Harris poll showed that half of our people under 35 don't think they are going to get social security. Another 35 percent have some confidence. This is an aspect I believe we have not taken a close enough look at.

If I may make a personal comment, I do find it incredible that a short-run and long-run crisis of this type has been kicked around in the newspapers in the last week as a political football. I really hope that we can all get together and agree on sensible solutions to some of the answers. Somebody is going to get blamed sometime for blocking social security correction. Policymakers fear they will get blamed for cutting back social security, but somebody is going to get blamed for messing up the system for millions and millions of Americans in the future by not taking action now.

Now I will bring before you our recommendations very quickly.

I would like the new report chosen to be released today and its supportive materials made a part of the hearing record.

Senator JEPSEN. They will be placed in the record.[1]

Mr. GREENOUGH. CED emphasizes that the Nation has a retirement problem, not just a social security financing problem. Of course, social security needs some important reforms, but focusing on it ignores the very great improvements that can be made by the pensions and private savings that cannot only help to shore up social security and take some of the burden from it but provide the very capital formation that supports both social security and private pensions as retirement in old age.

So the real message is that in the past 40 years we have given most of our attention to the transferred "to's" the person receiving social security. Politically now we will have to pay some real attention to the transferred "froms," the young people paying the taxes to support the benefits. We've got to be fair to both groups or the plan won't be politically successful, if we fail to avoid the inevitable confrontation between generations. It's not around the corner, but if the fund runs out of money next year and we don't do something, it might be around the corner.

CED recommends simultaneous action to help to shift over some of the burden—and it's a present burden—of financing good, solid old-age benefits for our elderly people to the private sector, private pensions, private savings.

So again, this does not require cutback in social security benefits; only in the rate of increase; and this can be offset by supplying good, solid retirement income under private pensions that so the elderly of the future are not hurt by a changed social security benefit structure.

The importance of the role of private pensions in capital formation is a key part of the CED study. As you also know, our savings rates in America are low. In fact it is among the lowest of the Western democracies. It shouldn't be. By strengthening private pensions and private savings and the tax treatment of them, we can help improve the savings rate. This will increase capital formation and by so doing increase productivity and by so doing take up at least some of the slack between all indexed benefits which are going up substantially faster than wage rates.

Our approach states there are three tiers to a sound retirement system in this country. The first is social security; the second, private pensions; the third, savings. On the issure of increase retirement age—we would start now. I think one of your witnesses today used 36 years. That's a bit long. We already have increased at least 3 years in life span since 1935. And as a result life we are supporting people under social security 3 more years during retirement than we were in the 1930's. Since people are retiring earlier, this is a huge shift in the number of years in retirement that we are supporting those people.

We would start restoring the balance at a rate of two months a year, until in 18 years, you would have arrived at the 68 for normal and 65 for early retirement benefits.

We believe that—considering how long it takes to develop an index—we should start now.

[1] The report and its supportive materials may be found in the subcommittee files.

Everybody agrees with the need for the new index. In our view either we link increases in benefits to that new index or to average wages of workers if they are to offset the real increase in security, which over the last 20 years, has greatly exceeded the the cost of living. Mr. Feldstein used the figure of 55 percent from 1970. Wages have stayed just level. So while retirees are being protected, the wage earners are getting clobbered.

Now a matter that will in the next 5 years become conventional wisdom—it's still highly controversial, but deserves very careful study and thought commencing now. And this is to tax benefits when received but not tax them when contributed. In 1937 the tax on the younger worker at the maximum was $30, 1 percent of $3,000. It's now $1,950 or essentially $2,000, which is 66 times what it was in 1937. It should be a good deal more, but 66 more times? The impact on the wage earner is considerable.

Not only has the maximum tax risen to $2,000, but it is also included in taxable income. A young couple trying to raise a family and buy a house and all that not only transfers up to $2,000 to current retirees; but then they are paying taxes on top of that, with no assurance they themselves will receive similar benefits in the future. We urge you to change this—although we realize it will take some time for this to become politically acceptable. On this point, there are those who say this is nothing more than a tax on those—namely the elderly, least able to pay. This is not so; because of exemptions and other exclusions, senior citizens do not begin being taxed until they earn over $18,000. This compares to $7,200 for the average wage earner.

The CED report believes all this is possible if we shift the burden to the other two tiers of the system: private savings and pensions many of which essentially are included in the recent tax laws. We do recommend higher limits, but let's live with these a while—they are quite good—and see how they work out, but keep in mind that that is an area for allowing individuals to help provide for themselves and provide the capital formation. But it satisfactory now.

The key to the whole strategy is the flexibility that using the private sector in addition to the public sector gives us. The third tier is private pensions. Our suggestions—which are too considerable to detail here—are included in our study.

So we hope this new report brought to you today will provide a workable, affordable, humane retirement system and help the economy break away from a vicious cycle of low savings, low productivity and high inflation, and move into a new era in which the long-term savings generated in our retirement system can help to bring about the capital formation that will enlarge the country's productive potential. I emphasize long term.

In the last few years, because of the surge of inflation, we have gone very short-term on our savings. Savings institutions are in trouble. Nobody ever bought a house or built a plant or bought machine tools on 30-day money. Pensions are long-term money and provide for the capital that the country needs. So we think these will produce decent income acceptable to all the people. The faith of the workers in their retired life in the Federal program will be restored and that faith is terribly important.

Senator JEPSEN. Thank you, Mr. Greenough.

[The prepared statement of Mr. Greenough follows:]

Prepared Statement of William C. Greenough

Mr. Chairman, my name is William C. Greenough. I am a board member of TIAA-CREF, Chairman of the CREF Finance Committee and I was a member of the President's Commission on Pension Policy.

But today I am speaking as Chairman of the Committee for Economic Development's Subcommittee on Retirement Policy which has completed a comprehensive statement on retirement after over two years of extremely hard work. I am pleased to have this opportunity today to introduce you to our thoughts on the important subject of retirement and reform, which I hope you will find useful to your deliberations. I realize there is a surfeit of recommendations being made by various groups. To facilitate matters we have prepared a brief comparison of several proposals, including ours, which I would be happy to provide the Committee.

Our CED trustees have concluded that the nation's retirement systems have an enormous impact on the future economic health of the nation. Inflation has made the cost of providing retirement benefits a substantial burden both on workers and on employers. Declining birth rates and increased longevity mean that proportionately fewer young people will be working to pay these higher costs. The report stresses that unless we curtail the growth of Social Security and strengthen employer pension plans and encourage individual saving for retirement, we will place an unbearable burden on future generations. We will also lose the opportunity to improve the capacity of the economy to provide growth in real income for the elderly and workers alike.

A Comprehensive Approach

First, and perhaps foremost, it is our conviction that the nation requires a comprehensive, broad-based retirement policy and that any piecemeal approach will not solve either the long-term problems facing our retirement system or contribute to a healthy economy.

In this regard, let me comment for a moment on the Administration's new proposals to reduce certain of the benefits and the scope of the Social Security system. The CED statement strongly endorses limiting the growth of Social Security. Indeed, CED's approach to changing Social Security policy is one that, if implemented, will avoid the short-term financing crisis facing the OASDI trust. While our recommendations for Social Security differ from those proposed by the Administration, I personally endorse the intent of these proposals. But singling out Social Security as the focus in the retirement reform is symptomatic of the same piecemeal approach that has consistently characterized years of decisions on retirement policy. Social Security is the most visible target but it is only one facet of the problems facing the entire U.S. retirement system. Reducing certain kinds of benefits, adjusting cost of living increases, and changing benefit formulas are major improvements, but CED urges the members of this Committee to seek and support additional changes for the entire retirement system.

In essence, the CED report recommends that any national system should be made up of three tiers--each building on the other--Social Security, employer pensions, and personal savings. The goal of this three-tier system, which we believe must be a balanced one, is to provide enough savings and productive capital formation to yield both a decent standard of living for retired workers and a permanent strengthening of the economy.

CED's Three-Tier Approach

Social Security is the first tier. We believe that the relative role of Social Security should be to provide a basic retirement benefit upon which an individual can build. However, to insure this basic level of support for future generations, we recommend a number of changes. We call for gradually raising the normal retirement age for Social Security to 68 and the early retirement age to 65. Again, as I have already stated, I commend the Administration's proposal to reduce early retirement benefits but do not believe that this goes far enough.

The CED statement also calls for revising the current system of indexing Social Security benefits to the Consumer Price Index. If possible, we should have an index which more accurately reflects consumption patterns of older Americans. We also recommend that any raising of Social Security benefits be linked to this newly developed index or the rise in average pre-tax wages for the working population, whichever is less. The CED trustees urge policymakers to consider partial indexing (at less than 100% of the CPI) of the Social Security annual automatic adjustment to benefits. This would reduce the past differential between Social Security increases and increases in average wages. It could also go a long way to solving the short-run financing crisis.

Perhaps the most sweeping change is the recommendation that we share with the President's Commission to exclude employee payments into retirement funds from current taxable income and instead make the ultimate benefit payments a part of taxable income when received. We would apply this principle to Social Security as well as to employer retirement plans. While the cost of this proposal is large, if introduced all at once, we believe that this could partially be offset by including such a tax change in any future proposals for personal tax reductions. Even given the necessary transition period, I believe that when combined with additional incentives for individual savings, this type of tax change could have real long-term advantages for the economy. We should start examining this concept so that we could eventually move the tax treatment of contributions and benefits in this direction.

It should be noted that if this policy were adopted, very few of those elderly who rely solely on small pensions or Social Security would have to pay any tax at all. In most of these cases, double exemptions and regular exclusions would exclude such elderly from paying taxes.

We also believe that excluding employee pension and Social Security contributions from taxable income and including the ultimate benefits in taxable income when received would make it possible to eliminate the controversial earnings test; otherwise it should be continued intact because Social Security was never designed to tax younger workers in order to transfer funds to untaxed older workers.

In addition to these major changes the report makes a number of other important recommendations on Social Security including, for example, gradually bringing in federal and other noncovered workers to make the system truly comprehensive.

<u>Employer pensions</u> make up the second tier. Since the vast growth of employer pension plans in the '50s, an increasing proportion of workers has become involved and is benefiting from such pension plans. But we believe that certain changes in pension policies and regulations

can improve funding, broaden coverage, help protect pensions from inflation, and increase private pension contributions to capital formation. In this latter regard, CED trustees believe that funded private pension plans, in addition to serving the retirement needs of the American people, can serve as a major source of capital for the economy. Consequently, the CED trustees recommended in the report a number of ways to encourage businesses voluntarily to broaden pension coverage. These include such means as simplifying certain ERISA rules, especially for small employers, and maintaining reasonable vesting periods.

Most importantly, we believe that employee contributions to private plans should not be currently taxed, but instead the ultimate benefits should be included in taxable income. This is a similar recommendation to that which we made for Social Security taxes. We believe this would go a long way toward encouraging greater use of private plans and would make such tax policy consistent in both public and private efforts.

We agree with the President's Commission report that ERISA should be amended to permit employer plans to increase their normal retirement ages to 65 and 68 in tandem with Social Security--on a strictly voluntary basis.

We favor an integration policy that will permit enough flexibility in benefit design to accomplish management and employee objectives.

<u>Personal saving</u> forms the third tier. We believe that not enough emphasis has been placed on encouraging personal saving and

investment to provide a significant portion of retirement income. As I am sure you are all too well aware, the United States has one of the lowest personal saving rates in the industrialized world. To repeat the disturbing litany, between 1973 and 1980, personal savings as a percent of disposable income declined from 8.6 percent to 5.7 percent. This is lower than the rates for Canada, Japan, and West Germany. While inflation is partly responsible for our low rate of saving, there is also a strong consumption bias built into the U.S. tax structure. In sum, there are inadequate incentives for an individual to save for retirement.

We agree with the Administration that policies to encourage greater personal saving and investment through an expansion of private pension programs and individual savings are one of the essential ingredients to the future health of U.S. retirement systems and to the economy as a whole. The enactment of the Economic Recovery Tax Act of 1981 includes a number of tax incentives to encourage saving for retirement. These incentives include raising the annual maximum contribution to IRAs and Keogh plans and permitting active participants in employer-sponsored plans to establish IRAs. Because these policy changes are precisely in the direction recommended by CED, we strongly endorse them. If as we expect, experience shows that these incentives produce significant net savings, we recommend that policymakers consider additional incentives to bring the maximum annual contribution levels under IRAs and Keoghs even closer to the level currently permitted for contributions to corporate plans.

The key to this strategy is the flexibility it gives individuals to plan for their own secure retirement, at the same time encouraging essential levels of savings and investment in capital formation required for a strong, growing economy. The CED report urges policymakers to develop a comprehensive and well-coordinated reform of U.S. retirement policies which will lead to a better balance among the major components of our retirement system. In strengthening the role of employer plans and personal savings, we do not mean to downgrade the absolutely essential role that Social Security and other government programs have played in the impressive development of the U.S. retirement system.

How then does this approach differ from that of the President's Commission? Let me mention again that I had the privilege of serving as a member of the Commission, and while the CED report may differ from the President's Commission recommendations in several important respects, we also share many similarities and our analysis supports several of their recommendations. For example, we agree with the Commission's findings on the exclusion of Social Secuirty taxes from taxable income and the raising of the retirement age to 68. But in several important respects we disagree. The fundamental difference between the CED paper and the President's Commission report is CED's very strong emphasis on encouraging the voluntary growth of private pensions and individual saving and investment for retirement. We believe that these private pension provisions are uniquely designed to create the capital formation necessary to assure a growing productive economy. The CED report stresses that the long-term health of all retirement systems, public and private, and of the economy in general, lies in encouraging such capital formation. And it is this particular point that we will continually stress in our future policy statements.

The CED report and the President's Commission differ on setting specific income goals for retirement and on the mandatory universal pension system, or MUPS as it is known.

As you know, the President's Commission recommended a national goal of providing retirement income equal to a worker's disposable income just before retirement. In my view, this is a pleasant goal to contemplate, but not a very realistic one. CED believes that American workers and their families are too diverse in their needs and circumstances for individuals to be well served by such a sweeping and costly national goal. While we believe that Social Security and other government programs should provide a floor of protection, we do not believe that it is appropriate for public policy to prescribe a specific standard of retirement living for all elderly Americans. However, public policy should provide an economic environment in which individuals have an incentive to set and meet their own reasonable retirement objectives beyond Social Security.

We also disagree with MUPS--the concept that each employer be required to establish a pension program for all of his or her employees. While the goal is well-intended, I do not believe that those who support MUPS sufficiently appreciate the cost of making private pensions mandatory. Nor do they comprehend the progress already made in extending private pension plans to individuals since their relatively recent broadscale introduction in the 1950s. The CED report makes a number of recommendations which would make it simpler and more attractive for employers voluntarily to establish new pension plans. A system of mandated private pensions is likely to resuot in an inflexible pension system which could be inappropriate for many employers and many workers. It could also have serious consequences for new and marginal businesses, causing many either to go out of business or severely restrict wages and employment.

In conclusion, the CED report stresses the following major themes:

- Failure to strengthen our retirement system now will lead to serious consequences for the elderly and for the economy generally.
- While it is absolutely necessary to address the serious problems facing Social Security, broad improvements can be made concurrently in coverage funding and benefits of employer pensions.
- This comprehensive approach should include three tiers which, in addition to Social Security changes now underway, include a balanced retirement system in which private pension plans and personal saving play a more important role than in the past.
- Such an approach should not require a specific retirement goal for all Americans through a mandated system of employer pension plans, but offer a flexible system that allows individuals to make personal decisions leading to secure retirement.

- Any such system should include incentives, in addition to those recently enacted, which will encourage individuals to save to meet their own retirement income goals, and provide a needed source of investment and capital so necessary for a growing and strong economy.

The policies CED recommends, I believe, will provide a workable, affordable and humane retirement system. At the same time we believe our policies will help the economy to break away from the current vicious cycle of low saving, low productivity and high inflation and move into an era in which the long-term saving generated in our retirement system can help to bring about the capital formation that will enlarge the country's productive potential. That in turn, is the only sound way in which our nation can raise the standards of living of both its retirees and its workers. We believe that if these policies are enacted we will achieve the common goal of providing a decent retirement income and a prosperous, sound economy for all Americans.

Senator JEPSEN. Congressman Richmond.

Representative RICHMOND. Thank you, Mr. Chairman.

Mr. Austin, how is your insurance company operating nowadays with the high interest rates and people borrowing back their premiuns at low interest rates? I suspect that does cut down your ability to help capitalize the Nation's insurance.

Mr. AUSTIN. Yes, it certainly does. Our net cash flow available for investment—I don't have the figures here—is probably 25 percent of what it was 5 years ago.

Representative RICHMOND. So many people are borrowing on their policies?

Mr. AUSTIN. It's a combination. We are talking about cash flow from insurance operations primarily here. Yes, it's a combination of borrowing, a combination of surrenders, purchase of more term insurance relatively. I think—and again. I'm just quoting from memory, but I'd say about 25 percent of what we consider a normal level.

Representative RICHMOND. It really cuts down your ability to help. As Mr. Greenough said, nobody can build a factory and buy major equipment on 30-day money. They have to come to you.

Mr. AUSTIN. That is correct, and the tragedy of inflation is it promotes short-term thinking instead of long-term thinking, and we need long-term thinking.

Representative RICHMOND. What is your borrowing rate?

Mr. AUSTIN. It's up markedly from what it used to be. I really don't like to think about the potential there that could be borrowed because it is demand money, as you can appreciate.

Representative RICHMOND. What interest rate are you charging?

Mr. AUSTIN. The contractual rate was 5 and went to 6 in 1972 or some such time and is 8 now in new issues, but most of the money is at 5 or 6 percent.

Representative RICHMOND. It makes it very difficult for the insurance companies of the United States to operate right now.

Mr. AUSTIN. It's not comforting. Yes, it's a difficult situation and, of course, the idea is being promoted by many people to borrow your cash values and go do something else with it.

Representative RICHMOND. The all-savers certificates won't help you people, will they?

Mr. AUSTIN. I'm sure, frankly, some of the interest in policy loans that we have seen in the last 6 weeks—and there has been a significant increase in the last 6 weeks or so—is the all-savers promotion. I trust that's a temporary sort of thing.

Representative RICHMOND. But it effectively drains the money out of the insurance companies who have historically been the basic source of capital for major projects?

Mr. AUSTIN. Yes. I'm not an economist, I assure you, and I don't want to act like I thought I was one, but one of our real problems at this point is that we aren't creating more savings. We're just churning what we already have. And that, of course, does nothing for the economy.

Representative RICHMOND. I suppose your premium volume goes on. People are still buying life insurance policies?

Mr. AUSTIN. Our new business is good. As we say on the street, business is good. There's some difference in the mix. We are selling more term insurance.

Representative RICHMOND. Mr. Greenough, I listened with great interest to your testimony. You obviously know social security better than most people. You want to increase the retirement age to 68 over a period of 18 years at a rate of 2 months a year. That sounds reasonable. You agree we ought to have a new index, and I assume your new index would be one that was more adaptable to retirees.

Mr. GREENOUGH. Yes, one which would reflect their costs.

Representative RICHMOND. Including rent and excluding new housing and that sort of thing?

Mr. GREENOUGH. Yes.

Representative RICHMOND. I didn't quite understand about your phasing in the lower costs for younger people in order to equalize their tax rate, your third item.

Mr. GREENOUGH. The third item? There were several items in the report.

Representative RICHMOND. Give me an example.

Mr. GREENOUGH. For instance, take a young professional couple, man and woman, working.

Representative RICHMOND. You said they used to pay $30?

Mr. GREENOUGH. They've got two kids now. Say they are at the maximum right now. Each of them is paying just under $2,000 in social security tax. Their employer is paying $2,000 in social security tax. They are both working at the maximum social security level. They earn in the 50-percent tax bracket so they are paying another $1,000 on their $2,000, or $5,000 first and $10,000 total to social security as taxes, and all of that goes away from them. They can't spend it currently, but they are taxed on their part of it currently. As you go down the income brackets, the tax is less.

Representative RICHMOND. How would you handle that?

Mr. GREENOUGH. I would defer the tax on the employee contributions to social security precisely as the tax is deferred on the employer contributions to social security. In fact, the employer part is never taxed. I would defer the tax on employee contributions to private pensions.

Mr. Austin alluded to that when he said that the new Revenue Act says if you voluntarily make a contribution to your existing pension plan you can defer the tax on it. But if your college or your business or whatever mandates that you make a contribution to the pension plan in order to get adequate benefits, then you're taxed currently on that. I would defer all those taxes to retirement.

Having done that, you include the benefits in taxable income. For all poorer people and middle income there would be no tax.

Representative RICHMOND. Have you got any idea of the numbers of all those, how much would it cost to put that into the system?

Mr. GREENOUGH. We can try to give you some figures on that or them from the Treasury.

Representative RICHMOND. What you say looks as though you would have an income loss to the social security system now.

Mr. GREENOUGH. That is correct.

Representative RICHMOND. I want to know how many dollars. As we all know, for the next 10 years we can't afford too many losses to the social security system. You would phase this in also?

Mr. GREENOUGH. Yes. If you would do it suddenly it would be $25 billion.

Representative RICHMOND. Over what period of time would you phase it in?

Mr. GREENOUGH. Various suggestions have been made—5 years, 10 years, 15 years. I see no reason to go very far.

Representative RICHMOND. You say phasing out now would be $25 billion?

Mr. GREENOUGH. $25 billion is the cost revenue loss.

Representative RICHMOND. What do you think of Mr. Feldstein's idea of a 2 percent index for all Federal pension plans?

Mr. GREENOUGH. That's a pretty good one too. Running ahead of the cost of living, a 20-percent increase has to be returned from some cutback or else we have to have an increase in taxes.

Representative RICHMOND. It's also inflationary.

Mr. GREENOUGH. It's inflationary. Another method is a percentage of the cost-of-living increase; 60 percent would bring us into balance over the next 7 or 8 years if that were the only cost change made. You would index only at 60 percent of increase for the next 5 years. That's one item.

Representative RICHMOND. Thank you.

Mr. GREENOUGH. Could I mention one thing on the tax? At the present time, that young professional couple——

Representative RICHMOND. Your children seem to be doing very well. They're both in the 50 percent bracket.

Mr. GREENOUGH. You know, I don't know whether they are or not.

Representative RICHMOND. That's what you said.

Mr. GREENOUGH. Well, I then said somebody at the maximum social security wage tax, and I think they both are above that and I'm going to hit them for some money one of these days. The young couple with two children start getting into taxable income at $7,400. The older couple doesn't get any taxable income now since social security benefits are not taxed until $19,180. The younger couple get taxed at $7,400; the older couple at $19,000. It happened accidentally back in the 1940's. While it is very hard on the emotions involved because it's so hard to explain, the message will start coming across now.

Representative RICHMOND. Thank you, Mr. Chairman.

Senator JEPSEN. Very briefly, could you expand on your opposition to the earnings limitation? You both have claimed it would raise payroll deductions and productivity, if I recall correctly, and you are both opposed to lifting the earnings limitation on social security.

Mr. GREENOUGH. I served on the President's Commission on Pensions. I served, and I dissented on HUPS. But both the President's Commission and CED urged that when the tax treatment for employee contributions in pension plans and the tax treatment of benefits and increase the retirement age, then a fair amount of the argument for the earnings test is gone. And at that point it's probably wise to get rid of it. It is controversial. Up until that time, absolutely no, because social security was not originally designed nor is it designed now to transfer money funds from young workers to older workers. That wasn't its design. Its design was to have persons go along until age 65 with a fair amount of their income being taken out for social security taxes and suddenly at 65 get a huge increase, untaxed, in their earnings. So until those other changes are made, we would strongly recommend keeping the earnings test.

Senator JEPSEN. Would you abolish the double-duty exemption at 65?

Mr. GREENOUGH. We did not consider it. I feel it is discriminatory.

Mr. AUSTIN. We are opposed to elimination of the earnings test on many of the same grounds that Mr. Greenough indicated. After all, there is a minimum of earnings permitted. We feel, in addition to everything else, it would be an undue burden on an already overextended system because then you would certainly be paying benefits to people who don't need them, a subject that's been discussed in this hearing on a number of occasions. We are opposed to that, although we realize the base should increase along with increases in inflation.

Senator JEPSEN. How do you respond to the fact that what you have said is not complete? To complete it you have to add that they will be paying social security taxes in full on whatever incremental earnings they have and yet won't be receiving any incremental benefits. Wouldn't that be kind of a boon to the social security system?

Mr. AUSTIN. Again, we have to look at the issue that's been discussed here of what we are trying to do. This is not an insurance system, as we all know. I think it's most unfortunate that that name was tagged on it in 1935 or 1936, although it may have been at that time. It's a transfer system. People—well, I think this has been mentioned this morning. Someone who retired at the beginning of this year would get back all the money in 17 months or some such amount. If you improve that with interest, it would be a little longer. But still, for people retiring today, the amount paid in versus potential benefits is peanuts. I haven't done a study on the basis of compound interest, but it's very, very small. So it's still not an insurance system. If in fact it were, it would be a different thing entirely.

Senator JEPSEN. Do you believe the social security system, as you just described it, can be made actuarially sound?

Mr. AUSTIN. Not by the terms which we insurance companies think of as actuarial. I don't know what the difference is. In one hearing I attended, a figure of $6 trillion was thrown out as the deficit. That sounded like a good round figure, but it's enormous.

Senator JEPSEN. Do you believe the social security system would work better if it were set up like the insurance companies in regard to use of funds and organization?

Mr. AUSTIN. The trouble is that the number of double-duty numbers is 13 weeks' social security payments. It's a tiny amount of money in the trust funds, so you can't get much leverage from them. The $6 trillion figure he mentioned is the unfunded liability. We shouldn't try to fund it. It's a social plan. But the earnings on the trust funds can never be very much of a support for social security, in my opinion.

Mr. GREENOUGH. No. As a matter of fact, I had some concern about them getting too large. As we all know, in 1970 when we were a year maybe or a year and a half in the trust funds, that's the sort of incentive it takes to do something rather spectacular to benefits, which we are now paying for. I would be very nervous.

Senator JEPSEN. You mean the surplus encourages the Government to find new benefits and spend the money on them.

Mr. GREENOUGH. Well, it's encouraging.

Senator JEPSEN. That is a good point. Both of you appear to agree with Secretary Schweiker that private sector initiative in retirement planning must be expanded. Would either of you like to express that point in more detail?

Mr. GREENOUGH. Yes, for several reasons. One is to take some of the pressure off social security without reducing benefits. If we leave things just as they are, and two younger people are supporting one person in retirement, that might be actuarially an unsound position for social security. There's just not enough funds in the economy to take care of it.

On the other hand, if a fair amount of the burden of taking care of income for the elderly is provided by funded pensions, individual savings, that will help materially.

I happen to be chairman of a mortgage committee of TIAA, unsalaried but still chairman of it. Tomorrow we are going to invest in White Plains, Stanford, Stephensville—these are investments that are productive and that are providing for college professors in their old age income—Quincy Market in Boston, downtown Minneapolis—those are direct investments that every 7 of 8 years double the money the professors in college put in that and quadruple it by the time of retirement. That's a fair amount of money in the funds to provide income, provide the capital during the interim time, and lift some of the burden off social security. That would be my explanation.

Senator JEPSEN. Some of those principles which you just describe—is there any room for them in the social security system at all? That is what I was referring to with the double duty dollars. Insurance companies take the premiums and invest them in the economy. The dollars provide good things like downtown Minneapolis and Stanford and so on. Everybody benefits. What do we do with the social security dollars? Haven't they been invested in or put back into some Treasury bills?

Mr. GREENOUGH. Yes. One, they all go into Government obligations of one sort or another. Two, if we were to try to fund the social security system even partially with $6 trillion out there, after funding less than one-sixth of that, you would have federalized all the stock on the New York Stock Exchange and the American Stock Exchange. That is, the Federal Government would own General Electric, General Motors, and General Telephone. It's an interesting way to get into socialism and I don't think it would help anything and we could put ourselves in a recession by oversaving. You can oversave if you put the Federal system of underpaying on a fully funded basis. So that would be very bad for the economy.

Mr. AUSTIN. Of course, the problem is worrying about getting enough revenue now to pay today's bills or next month's bills and the possibility or feasibility of a few mills is different and in the short run seems almost impractical. In other words, we're not really willing to increase the tax and we're not willing to lower the benefits and we're already out of balance. So the chance of accumulating significant funds is very small.

Senator JEPSEN. In closing, I would ask, as I have the other members today, a question. Do you believe that the social security system, as it stands as of now, is losing money? Is it in economic trouble?

Mr. GREENOUGH. The statistics would seem to demonstrate that. Last year, by $3 billion or some such amount, we spent more money than we took in, and it seems inevitable unless something is done that the trust fund will run out of money within the next year or two.

Some borrowing would probably go to 1984 or 1985, in which case not only the OASI fund but all the funds would then be out of money.

Yes, we have a serious short-range and long-range problems.

Senator JEPSEN. Mr. Austin.

Mr. AUSTIN. Short-range—when a company runs out of cash, it either goes broke or has to get some cash from somewhere. The same with social security. But the important question is the long-run question and the changing demographics and the burden of the groups in our population before us then retiring. Unless we do something about the escalation and the retirement age—we have been increasing benefits for 40 years unconscionably just by the increase in indexing. If we keep doing that for the next 40 years, then financially we presumably will reach a place where we simply cannot transfer that much money to the older from the younger and neither group would want it.

Senator JEPSEN. You have expanded and I believe I heard you say that it not only is in trouble today but the more crucial issue is that it will be in deep trouble in the long run if something is not done.

Mr. GREENOUGH. One way or another.

Senator JEPSEN. Let me be sure of this for the record. We have many folks who have constructively and honestly suggested that we need to strengthen social security because we have a problem that involves a number of things, and then there are those who say that is not so, that we do not have any problems. There is something economically wrong with social security and do I understand both of you to say that we do have a problem?

Mr. GREENOUGH. Yes.

Mr. AUSTIN. Yes.

Senator JEPSEN. As Secretary Schweiker said today, we have been losing money since 1974 and I would point out that the national polls indicate, as I have always known, that you cannot fool the American people about this for very long. They are, on an overwhelming basis, very concerned about this and believe that social security is in financial trouble. That is one of the reasons for the lack of faith and confidence which is shown by young people today. In fact, not just young people, but people coming up to retirement age are apprehensive.

I would ask if either of you have any closing comments that you would like to add or make for the record?

Mr. GREENOUGH. If I could have thought of them, I would have made your closing comments. You did them so well.

Mr. AUSTIN. Yes, sir. I'd just repeat what we've said. We have a short-range problem which we will no doubt muddle through in some fashion, but the long-range one has to be faced. And I would agree with someone who said here, I think it's really a moral issue to lay this thing on the next generation without making some provision of taking care of it. I just don't think it's conscionable.

Senator JEPSEN. I thank you. I know that you both have taken your valuable time to be here and I know Ken Austin has traveled a sizable distance because I travel it often. I appreciate you coming and thank you very much and have a safe journey.

The subcommittee is adjourned.

[Whereupon, at 12:30 p.m., the subcommittee adjourned, subject to the call of the Chair.]

[The following information was subsequently supplied for the record:]

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STATEMENT

WITH SUMMARY OF PRINCIPAL POINTS

ON

SOCIAL SECURITY: EMPLOYMENT, SAVINGS,

AND RETIREMENT

TO THE

JOINT ECONOMIC COMMITTEE

OF THE UNITED STATES CONGRESS

BY

DON A. EICHELBERGER, CLU

AND

ROBERT A. PIERCE, CLU

September 23, 1981

Summary of Principal Points In Statement of the National Association of Life Underwriters

1. The financial dilemma of Social Security can in a large part be attributed to prior overexpansion. To insure that the system's original purposes continue to be served certain programs must be pared down or eliminated.

SHORT RANGE PROPOSALS

2. The abolition of the minimum benefit and payments to students over 18 who continue their education is necessary. The real purpose of these programs can be better accommodated elsewhere.

3. The Consumer Price Index is seriously distorted when applied to Social Security beneficiaries. Benefits should rise with a revised Consumer Price Index or with the increase in average wages, whichever is lower.

4. Medicare should not be funded in whole or in part by general revenue. Such a fundamental need must not be subjected to budgetary football.

5. Interfund borrowing would add to the problem, not provide a solution. A permanent restructuring of the tax rate would build public confidence.

LONG RANGE PROPOSALS

6. Social Security must be extended to cover federal, state and local government workers. In addition to treating everyone equally it will alleviate public resentment of the windfall benefits phenomenon.

7. The full retirement age should be increased to 68.

8. An across the board lowering of replacement ratios should be instituted.

9. If, after making all the changes recommended above revenues are still inadequate to carry the system, the tax rate should be increased. The wage base should not be increased. It was never intended as the revenue raising mechanism of the system.

INTRODUCTION: Mr. Chairman and members of the Committee, my name is Don A. Eichelberger, CLU. I am a practicing life insurance agent from Waterloo, Iowa. Seated next to me is Robert A. Pierce, CLU, a life insurance agent from Tigard, Oregon. We are appearing here today as representatives of the National Association of Life Underwriters (NALU). NALU appreciates the opportunity to present its views on ways to preserve and strengthen the Old-Age, Survivors and Disability (OASI) System.

The National Association of Life Underwriters is a federation of approximately 1000 state and local associations which in turn have a combined individual membership of over 140,000 life and health insurance agents, general agents, and managers doing business in virtually every community in the United States. The individual members of the federation are called life underwriters. From the creation of the Social Security Program to the present time, life insurance agents have provided a primary source of information to individuals and families on what Social Security means to their financial security.

In their professional work, life underwriters counsel individuals and businesses on the means of providing financial security for themselves and employees through private life and health insurance. While it is probably safe to say that the Social Security Administration talks to more Social Security beneficiaries than anyone else, it may also be accurate to say that life underwriters talk to more Social Security tax-payers that anyone else. Taxpayer views and apprehensions over the status of Social Security are reflected in NALU's comments, today.

The kinds and amounts of insurance to be sold frequently are determined in part by the benefits provided by Social Security. Thus, Social Security plays a significant role in the financial security of most individuals. And it is high on their list of concerns.

Because of their daily encounter with Social Security life underwriters have developed expertise in the area. Lately, apprehension has crept into the minds of life underwriters who may view a Social Security system allowed to grow too large as a source of unwarranted competition. Then, too, life underwriters are well aware of Social Security's growing financial problems and burdens. Overall, however, life underwriters have been supportive of Social Security over the years and continue in that posture today.

THE NATURE OF THE CURRENT DILEMMA: As originally conceived and designed, the Social Security program is socially and economically desirable; but it is essential that the program be soundly maintained. Overexpansion of the program must be avoided, since such overexpansion would substantially increase the tremendous financial burden already facing present and future Social Security taxpayers, and poses a threat to the safety and continued existence of the program itself. Unfortunately, today's leaders are presented with painful choices because their predecessors ignored this principle.

The Administration projects, under pessimistic economic assumptions, that the deficit of the Social Security program will be $111 billion by 1986, and bankruptcy in 1982 if nothing is done to shore-up the program. The time for congressional action to bring the system back to financial stability is now.

The nature of the short-term financial problems besetting Social Security and the prospects for even more severe problems in the future have been ably explored and documented by the various experts who have already appeared before this distinguished Committee. It is not our purpose to go over this ground again and we will not attempt to do so here. In the balance of this statement, NALU will present its ideas on how these short and long-term problems might be solved.

SHORT-RANGE PROPOSALS

STUDENT AND MINIMUM BENEFITS: NALU views with great interest President Reagan's proposals to abolish the minimum benefit and payments to students over 18 who decide to continue their education. We believe that priority lines must be drawn. The basic needs addressed by Social Security at its inception were food, shelter and medical care which must continue to be served. The abolition of the minimum benefit and student payments would seem to be in line with Social Security's original intention.

The needs of persons who receive payments under these programs would be better accommodated by other appropriate federal assistance programs. For example, those truly dependent on the minimum benefit would probably qualify for Supplemental Security Income and students could draw upon federal and state grant and loan programs.

CONSUMER PRICE INDEXING: Distortions in Social Security's automatic cost of living adjustment mechanism must be cured. Government and private sector economists now agree that the Consumer Price Index is seriously distorted when applied to Social Security beneficiaries, particularly those on retirement. Runaway inflation in new housing, mortgage rates and energy do not impact as heavily on Social Security recipients as they do on the general working population.

Experts have already testified before this Committee that the 100% cost of living adjustment overstates the actual rate of inflation and overstates the true cost of housing to individuals.

Changes in the CPI factor need to be coupled with another change in the automatic cost of living mechanism in order to prevent future economic conditions from running away with future costs. Presently, there is no tie between the cost of living mechanism and the underlying financing structure based on wages and income from self-employment. But as economic forecasters have pointed out, the current cash flow problems of the OASI trust fund are being precipitated by two factors in tandem. Inflation is higher than expected, so benefits are automatically adjusted higher than expected. At the same time lower than expected employment and increases in wages have slowed contributions to Social Security. These two factors work together to cause the problem. Therefore, they should work together to solve it.

BENEFITS SHOULD RISE WITH THE CONSUMER PRICE INDEX, OR WAGE BASE, WHICHEVER IS LOWER: In the future, the system should be geared so that benefits can only be paid to the extent that increases in wages occur, presuming the Congress wishes to maintain the Social Security program on essentially a pay as you go system. No insurance system, public or private, can maintain its integrity without the ability to control income and outgo of the system. Steps must be taken now to tie the benefit structure to its underlying financing structure so that the two may go forward together.

GENERAL REVENUE FINANCING FOR MEDICARE: NALU opposes strongly the financing of the Social Security system through direct contributions from general revenues.

NALU is opposed to general revenue financing, even on the somewhat limited basis to fund hospital insurance. We believe that the program will be irreparably harmed by general revenue financing. In the short run general revenue contributions may provide relief from anxiety about the financial stability of Social Security, but we believe that such relief will be short lived.

The Social Security tax remains the best means to keep the Health Insurance Fund intact. If Medicare were to have to fight with MX missiles, for example, it might lose out. Such a spectacle would, in our view, be unconscionable.

Our experience has been that the tax paying public sees a direct correlation between general revenue financing and the creation of a needs test for the receipt of benefits. Tax paying Americans view their tax contributions as premiums which purchase future benefits. Though technically not correct, the public believes Social Security benefits are an earned right. General revenue financing is likely to be the last straw as far as public confidence is concerned. Without widespread worker support, we believe the system would be imperiled.

INTERFUND BORROWING/RATE REALLOCATION: As pointed out by the Administration, Congressional Budget Office, and other concerned groups, the OASI Trust Fund will experience severe cash flow inadequacies in the very near future and must stop paying benefits unless action is taken. Obviously, the specter of a depleted OASI Trust Fund is viewed with great alarm by individuals currently on, or soon to be on, the retirement rolls. Bad news travels quickly when someone's financial security is at stake. It should come as no suprise that the retired population is seriously concerned about its benefits.

The tax paying public, however, is just as concerned. Ever more frequently, life underwriters hear this general concern expressed by relatively young workers who ask whether there will be any Social Security benefits at all for them when they retire. Public confidence in the system, in our opinion, is eroding quickly and once lost will be difficult to recapture.

Interfund borrowing would, in our view, only exacerbate these concerns. Interfund borrowing is widely perceived as a first step toward general revenue financing. Last year Congress legislated a reallocation of the tax rate. If further steps need be taken to redistribute the funds flowing into the Social Security System, a permanent restructuring of the tax rate should be undertaken again.

The discipline necessary to implement a rate restructuring can provide the basis for real improvement in public attitude towards Social Security. News of the oversight function will reaffirm the notion that a responsible Congress is making judgments that will guarantee the continuation of the Social Security System into the twenty-first century. While a restructuring of the tax rate is less flexible than a simple interfund borrowing proposal, there is a certain comfort in a permanent solution.

LONG RANGE PROPOSALS

UNIVERSAL SOCIAL SECURITY COVERAGE: It is a basic

NALU policy that Social Security be extended to cover the entire working population. Therefore, we endorse in general the concept of universal Social Security coverage.

We support universal Social Security with some reservations, however. First, individuals who have already retired without having been covered by Social Security should not have benefits reduced. Second, once extended to all workers, newly covered workers should not have their combined benefits lowered. Third, employee contributions under the new system should be no higher in the aggregate than the worker is now paying, at least for a transitory period. Depending on what benefits are wanted in the future, however, contribution rates may have to go up or down.

REASONS FOR SUPPORTING UNIVERSAL COVERAGE: On balance, NALU believes that universal Social Security coverage would have salutory benefits. These may be summarized as follows:

1. PSYCHOLOGICAL: The lack of coverage of a large group of individuals, principally federal, state and local government workers, is creating a significant morale problem. There is a growing resentment among the general population about sizable increases in the Social Security tax rates and wage base. This resentment is heightened because people in the private sector know that there are many individuals, chiefly government workers, who do not share in the experience. Universal coverage would lessen this resentment and foster an attitude of unity.

Coverage of federal government workers in particular may bring a new perspective to Social Security by the people who run it. It is inconceivable to NALU that the individuals who make the decisions on Social Security, namely Members of Congress and employees of the federal government, are not themselves covered by the system. Instead, they are covered by what is generally regarded as a rather plush retirement system. Many people do not believe it is possible for Members of Congress and civil servants to make the best decisions possible about Social Security when they themselves have no stake in it. We agree.

2. ELIMINATE WINDFALL BENEFITS. One of the most disturbing aspects of Social Security today is the ability of some workers to take advantage of the minimum benefit provision. The minimum benefit provision was adopted by the Congress to help individuals who work at low wages for a long period of time. As adopted, this provision has a worthwhile goal, but many workers who are not low paid have become its beneficiary.

This occurs when a worker not covered by Social Security either moonlights or retires from government service at a relatively young age, goes to work in covered work, and becomes eligible for the minimum Social Security benefit, a benefit much higher than that which would be purchased on an actuarial basis by his contribution.

There seems to be a widespread belief that government workers in particular have placed themselves in a superior position vis-à-vis the private sector. Government workers are widely perceived as enjoying pension programs that are superior to those that are available to the private sector, and have manipulated the Social Security system so as to take advantage of the minimum benefit law. Lifelong coverage under Social Security would put an end to all windfall benefits problems, and should be adopted for that reason.

3. FLOOR OF PROTECTION. For our mobile work forces, universal coverage would guarantee that a basic floor of protection would be placed under the entire work force. Individuals moving in and out of covered work may lose some or all Social Security benefits by doing so. These benefits may not be made up elsewhere.

All workers should be guaranteed a basic minimum floor of protection even if they move from job to job. This security is available to most private sector workers now and should be made available to the entire work force.

4. EQUALIZE SOCIAL INSURANCE ASPECT OF SOCIAL SECURITY. The weighted benefit formula built into Social Security benefits provides that a worker with a lower average income receives a higher proportion of that income in benefits than does a higher paid person. Higher paid persons pay for the weighted benefits through lower replacement ratios. This welfare aspect of Social Security is not shared by workers not covered by Social Security.

RETIREMENT AGE: Several alternatives to the current full retirement age and the early retirement age have been recommended by individuals and groups. The most often mentioned is age 68 for full retirement and age 65 for early retirement. NALU believes that there is no inherently correct age, but ages 68 and 65 respectively for the following reasons seem about right.

Life expectancy is increasing. While this is good news personally, it is bad news financially. Benefits must be paid longer, thereby increasing the burden on the system.

Today our older citizens are more vigorous and are leading more productive lives and a significant number could work longer if required. NALU believes that this need should be addressed now. While we would prefer to immediately implement age changes, prudence dictates it be phased in over a relatively long period of time starting in the future.

REPLACEMENT RATIOS: Even after increasing the age of retirement, one more painful step is likely to be necessary. NALU believes that an across-the-board lowering of replacement ratios should also be instituted. Difficult as this may be, it is necessary in order to return the system to its proper position as the basic floor protection. The private sector can then build on a more solid, though admittedly smaller Social Security base.

TAX RATE VS. WAGE BASE: If after implementation of the changes we have outlined there remains a deficit, it should be financed with a tax rate increase, not a wage base increase. Our objection to financing benefits via the wage base rests on the precept that the tax base was never intended to be the revenue raising mechanism for the system; neither is it a very efficient means of doing so. Rather, the wage base was intended to delimit the extent of benefits to those workers within the system. And, over the years, the equalization of the wage base between employers and employees was intended to underscore the principle that employers and employees are both responsible to the same extent for the financing of the system.

An increase in the wage base would have a deleterious effect on the private sector. The higher the wage base goes, the higher the benefits and taxes go, and the less net income remains for private investment or savings as employers and employees see fit. The insurance industry, securities, banking and thrift markets would all be adversely affected, as each represents a traditional place where workers can save for their own financial security. Increasing the wage base means increasing the number of people who will leave more of their income with the government and have less of it for their own use. This loss of discretion on the part of workers has an immediate impact on such private sector investments as insurance, but we believe that it has a long-term effect on the ability of people to make judgments about their lives.

SUMMARY: Mr. Chairman and Members of the Joint Economic Committee, NALU shares your deep concern over the future of the Social Security System. These hearings are a tribute to your commitment that its noble purpose continue to be served. We urge that you:

1) Eliminate the minimum benefit;
2) Phase out adult student payments:
3) Restructure OASI/HI tax rates to reflect reality;
4) Deflate the Consumer Price Index to the extent that current market conditions do not impact on benefit recipients;
5) Tie benefit increases to wages;
6) Avoid interfund borrowing and general revenue financing.

For the long term, a basic restructuring of the whole system is needed. Work should begin today on scaling back replacement ratios which would permit a lowering, or perhaps just no further increase, in the wage base and tax rate. Other steps such as an increase in retirement age to 68 should be adopted as may be necessary to guarantee the long-term financial soundness of the program. And Social Security should be extended to federal, state and local government workers.

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