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To the Members of the President's Commission to Strengthen Social Security:

In your announcement in the Wednesday, August 8, 2001, issue of the Federal Register, you indicated that you were seeking ideas from the public about how to address the financing and financial problems facing Social Security. In this announcement, you indicated that you sought “a broad range of ideas” that would help you in crafting “recommendations to modernize and restore fiscal soundness to the Social Security system, as required by Presidential Executive Order 13210.”

In that August 8, 2001, announcement you also indicated that you welcomed “comment from any individual or organization regarding how best to preserve and strengthen Social Security,” and that your particular areas of interest are “How to financially sustain the Social Security system” and “How personal accounts, if they are part of your Social Security solution, should be financed, structured and administered.”

This testimony deals primarily with the first of these two issues, “how to financially sustain the Social Security system.” It does, however, in the course of discussing the financing of Social Security, touch on the second issue. On this latter point, as will be explained below in greater detail, if a system of private accounts is financed out of the current revenues of the Trust Funds, it will make it harder rather than easier to resolve the financing challenges that do face the Social Security system.. In fact, financing a system of private accounts in this way (referred to by some observers as a “carve out” approach) would take what is really a modest and manageable challenge and convert it into a substantially larger, and perhaps insurmaountable, challenge..

The context within which proposals for the strengthening of Social Security are being discussed is an unusual one. In 1998, for the first time in 30 years, the federal government had an overall budget surplus (i.e., total receipts exceeded total outlays.). And in 1999, for the first time in 39 years, it ran a surplus in its so-called "on-budget" accounts. It is also important to note that the on-budget accounts have only operated in the black during seven of the previous 60 federal fiscal years: 1947, 1948, 1949, 1951, 1956, 1957, and 1960. It should be mentioned, however, that from the end of World War II until the 1970s the annual on-budget deficits were relatively small and that they did not really grow to substantial proportions until the 1980s.

The federal government's "off-budget" accounts are comprised of the Social Security Trust Funds and the Postal Service. The Social Security Trust Funds have been running increasingly large budget surpluses since the early 1980s. This is the conscious result of the changes made in the Social Security system in the early 1980s to begin building up substantial reserves in the Social Security Trust Funds in anticipation of and preparation for the time when the “baby boom” Generation will begin retiring.
As of December 31, 2000, the balances in the Social Security Trust Funds were $1,049.5 billion (i.e., over one trillion dollars), up $153.4 billion from a year earlier. This is not by accident but represents, as indicated above, a conscious strategy designed to build up the balances in the trust

funds in anticipation of the baby boomers' retirements. One way to think about this effort (which is projected, under the Social Security Trustees' intermediate assumptions, to result in an accumulation of $6.5 trillion by 2024) is to see it as the baby boomers, who are currently in the prime earning ages of 37 through 55, in effect, collectively making a major contribution to the pre-funding of the old age and survivors benefits that their generation will be receiving in the future. For each of the next four year, for example, trust fund income without even including interest earnings will exceed outgo by over 21%. Once the baby boomers are all over 70, under the latest trustees' intermediate projections, trust fund income will account for between 73.2% and 74.4% of outgo over the next 20 years. If the indexing of the cap on earnings for payroll tax purposes were changes to ensure that the same share of earnings remained subject to taxation, then trust fund income would account for between 78.3% and 80.9% of outgo over the course of that same 20 year period (2035 to 2054) and for the subsequent 20 years as well. These coverage ratios would be even larger if the portion of earnings subject to taxation was returned to the level of the early 1980s.

The latest projections by the Trustees of the Social Security and Medicare Trust Funds are that Social Security contributions (i.e., the payroll taxes paid by employees and employers, including self-employed individuals) will exceed benefits each year through 2015 and that contributions, income from the taxation of benefits and interest income will exceed benefits each year through 2024. This means that the balances in the Social Security Trust Funds are projected to continue growing until the end of 2024, when they will peak at a projected $6.5 trillion. (Note: this is $6 trillion of 2024 dollars, not adjusted for inflation to be comparable to current 2000 dollars.)

Beginning in 2025, under these projections, the Trust Fund would begin using portions of the accumulated $6.5 trillion surplus to fund the difference between the benefits payable and current income. Recently, some members of the Social Security Commission have questioned the ability and/or the commitment of the U. S. government to redeem sufficient amounts of the certificates of indebtedness and the bonds held by the Trust Funds when such redemptions are necessary. This seems like a radical and counter productive strategy on the part of those commission members - calling into question the credibility of the federal government. It also seems like a direct attack on the efforts of the Congress over the last 20 years to ensure that the Trust Funds' balances would be secure for their intended future use. In the early 1980s the Congress placed the Trust Funds off budget and in recent budget resolutions it has stipulated that the Trust Funds' surpluses could not be used for any purpose other than the paying down of the publicly held debt. This latter approach serves to reduce the amount of general revenue that must go to servicing the debt and to ensure that the outstanding amount of publicly held debt will be at historically low levels if and when the treasury has to issue debt to the public to redeem bonds andor certificates of indebtedness held by the Trust Funds. And, under this approach, this can be done in 2025 without increasing the total amount of outstanding debt and without increasing the government's total interest expense.

It should also be noted that this approach is recognized as valid by the executive branch of the federal government. Review, for example, the chapter on "Federal Borrowing and Debt" in the ***Analytical Perspectives*** volume of President Bush's recent Executive Budget submission.

> The Federal Government issues debt securities for two principal purposes. First, it

borrows from the public to finance federal debt. Second, it issues debt to Government accounts, primarily trust funds, that accumulate surpluses. By law, trust fund surpluses must generally be invested in Federal securities. (page 228)

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Issuing debt securities to Government accounts performs an essential function in accounting for the operation of these funds. The balances of debt represent the cumulative surpluses of these funds due to the excess of their tax receipts, interest receipts, and other collections compared to their spending. The interest on the debt compensates these funds—and the members of the public who pay earmarked taxes or user fees into these funds—for spending some of the funds' collections at a later time than when they receive the money. The debt securities are a liability of the general fund to the fund that holds the securities and are a mechanism for that fund to accumulate interest on its balances. ***The fund can use these invested balances in later years to draw upon the U.S. Treasury to make future payments on its behalf to the public. Public policy may deliberately run surpluses and accumulate debt in trust funds and other Government accounts in anticipation of future spending*** (page 228, emphasis added)

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Trust funds, and some public enterprise revolving funds and special funds, accumulate cash in excess of current requirements in order to meet future obligations. These cash surpluses are invested mostly in Treasury debt and, to a very small extent, in agency debt.

Investment by trust funds and other Government accounts has risen greatly over the past two decades. It was $246 billion in 2000, as shown in table 12–5, and it is estimated to be $266 billion in 2002. The holdings of Federal securities by Government accounts are estimated to grow to $2.7 trillion billion by the end of 2002, or 48 percent of the gross Federal debt. This percentage is estimated to rise further in the following years as the budget surpluses reduce the debt held by the public and the trust funds continue to accumulate surpluses. By 2011, debt held by Government accounts is estimated to be 84 percent of the gross Federal debt. The large investment by Government accounts is concentrated among a few trust funds. The two social security trust funds—old-age and survivors insurance and disability insurance—have a large combined surplus and invest an increasing amount each year: a total of $486 billion during 2000–02, which is 65 percent of the total estimated investment by Government accounts.

The Social Security System is not in crisis. Improvements are necessary, but radical changes are not.

The Trustees' projections underscore the underlying strength of the Social Security system, but they also point out the long term problem that needs to be addressed. In doing so, it is important that the public not be taken in by exaggerations of the magnitude of the problem. In fact, the long-term solvency of the Social Security trust funds can be ensured by dedicating a modest percentage of the on-budget surplus to this cause and speeding up the rate at which we raise the cap on the amount of earnings subject to Social Security contributions. This would allow us to "save" Social Security without any increases in the retirement age over and above the increases that are already scheduled to take effect and without any benefit reductions. (Another option that should be considered is the investment of a portion of the Trust Funds' balances in government insured securities, such as Fannie Mae home mortgages.)

Those who advocate increasing the retirement age as a way to close Social Security's projected shortfalls are in white collar jobs that they could easily continue to do through their late 60s or even into their early 70s, but they have their blinders on when they imply that most waitresses, nurses aides and carpenters can continue to ply their physically demanding trades at those ages.

It is also important to note that, in the last several years, the projections as to the future health of the Social Security system have been improving steadily. The public would clearly be able to make more informed decisions about alternative Social Security "reform" proposals if the Commission made sure that they knew that each of the last four annual reports by the Trustees of the Social Security and Medicare Trust Funds concluded that the system was in better shape than the prior year's report had projected. Since their 1996 report, the Trustees have revised from 2020 to 2025 their projection of the year in which payments are first likely to exceed income. Their projection of the year in which the trust fund surplus is projected to be depleted has been extended from 2029 to 2038. And, the projected overall funding shortfall (over the course of the 75-year period for which the Trustees are required to make their projections) has been reduced from 2.23% to 1.86%.

According to many independent observers, these rosier projections are still based on pessimistic assumptions about the future economy. According to an Economic Policy Institute analysis of the Trustees' 2000 annual report, for example, "Recent developments suggest higher real GDP and productivity growth than the trustees assume. Hence, real wage and payroll-tax revenue growth should be greater than predicted by the trustees' report, increasing the size of the trust fund. Given the report's improved forecast in spite of these pessimistic assumptions, there is even less need to cut benefits or to privatize the system."

Diverting a portion of Social Security revenues to private accounts makes it harder rather than easier to eliminate the budget shortfalls projected for 2038 and thereafter.

In reality, allocating a portion of Social Security contributions to private accounts would make it harder rather than easier to solve the Social Security problem that most Americans care about: ensuring the long term solvency and stability of the system without cutting benefits or increasing the retirement age.

Proposals to allow workers to divert a portion of their Social Security contributions to individual accounts would greatly increase the difficulty involved in balancing the system's revenues and expenditures over time. If, under the current rules, revenue increases and/or expenditure decreases of a given amount are necessary to ensure the system's solvency over time, then even greater revenue increases and/or expenditure decreases would be necessary if a portion of the current revenue stream were diverted to private accounts.

Under one proposal, for example, workers would be allowed to divert 2% of their 12.4% Social Security contributions to private accounts. This would mean that for those workers, a little more than 16% of their contributions would go to individual accounts rather than to the overall Social Security Trust Fund. This would create a particular challenge for the system's solvency since Social Security is a pay-as-you-go system in which current revenues are used to pay current benefits.

If half of all workers (or some smaller portion of workers with higher than average earnings and half of all taxable earnings) took this option, then about 8% of Social Security contributions would be diverted from the Trust Fund, with virtually no material reduction for many years in the amount of benefits to be paid. The result would be a reduction of about $40 billion in revenues in each of the next several years, growing to about $50 billion per year in current 2000 dollars over the course of the ensuing decade. By reducing the system's annual revenue, such a change would also be reducing the system's accumulated surpluses at the end of each year, by ever increasing amounts, given the power of interest compounding. This would put the system into the red sooner than under current law and increase the percentage by which revenues fall short over time of expenditures. (A more sophisticated analysis by Princeton University Economics Professor Alan Blinder, a former member of both the Council of Economic Advisors and the Board of Governors of the Federal Reserve Bank, and several other highly respected economists, concluded that if everyone who is younger than 55 in 2002 opted to have 2% of their earnings go into a private account, that the amount available to be spent on basic benefits over the ensuing 75 years would have to be reduced by 41%, over and above any benefit reductions necessary to cover the revenue shortfall, that is currently projected by the Trustees for this period. This analysis also concluded that the benefits from the private accounts, thus established, would only cover about half of the reduction in basic benefits.)

Many investment firms that want a piece of the individual or private accounts business have been obscuring these realities - either directly and/or through the funding of one of several advocacy organizations that have been established to advance this concept. A refreshing exception has been John Bogle, the founder of the Vanguard Group of mutual funds, who has emphasized the clear reality that, "Diverting part of the existing tax flow earmarked for Social Security . . . will only deplete the programs's reserves faster than the experts are predicting." (Prial, Dustin, "Vanguard founder offers another view on Social Security," Associated Press, August 29, 2000.)