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GENERAL REVENUE FINANCING OF SOCIAL SECURITY

HEARING

BEFORE THE

COMMITTEE ON FINANCE UNITED STATES SENATE

ONE HUNDRED SIXTH CONGRESS

FIRST SESSION

FEBRUARY 9, 1999

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CONTENTS

OPENING STATEMENTS

	Page
Roth, Hon. William V., Jr., a U.S. Senator from Delaware, chairman, Committee on Finance	1
Moynihan, Hon. Daniel Patrick, a U.S. Senator from New York	2
Grassley, Hon. Charles E., a U.S. Senator from Iowa	2
Breaux, Hon. John, a U.S. Senator from Louisiana	3
Robb, Hon. Charles S., a U.S. Senator from Virginia	4
Conrad, Hon. Kent, a U.S. Senator from North Dakota	4

CONGRESSIONAL WITNESSES

Walker, Hon. David M., Comptroller General of the United States, General Accounting Office, Washington, DC	5
Koitz, David S., legislative specialist, Congressional Research Service, Washington, DC	22

PUBLIC WITNESSES

Gramlich, Hon. Edward M., Ph.D., governor, Federal Reserve System, and Chair, 1994–1996 Advisory Council on Social Security, Washington, DC	24
Greenstein, Robert, executive director, Center on Budget and Policy Priorities, Washington, DC	26
Steuerle, C. Eugene, Ph.D., senior fellow, The Urban Institute, Washington, DC	28

ALPHABETICAL LISTING AND APPENDIX MATERIAL

Breaux, Hon. John:	
Opening statement	3
Conrad, Hon. Kent:	
Opening statement	4
Gramlich, Hon. Edward M., Ph.D.:	
Testimony	24
Prepared statement	35
Grassley, Hon. Charles E.:	
Opening statement	2
Prepared statement	36
Greenstein, Robert:	
Testimony	26
Prepared statement	37
Koitz, David S.:	
Testimony	22
Prepared statement	40
Mack, Hon. Connie:	
Prepared statement	41
Moynihan, Hon. Daniel Patrick:	
Opening statement	2
Robb, Hon. Charles S.:	
Opening statement	4
Roth, Hon. William V., Jr.:	
Opening statement	1
Prepared statement	42

	Page
Steuerle, C. Eugene, Ph.D.:	
Testimony	28
Preapred statement	43
Walker, Hon. David M.:	
Testimony	5
Prepared statement	48

GENERAL REVENUE FINANCING OF SOCIAL SECURITY

TUESDAY, FEBRUARY 9, 1999

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:00 a.m., in room SD–215, Dirksen Senate Office Building, Hon. William V. Roth, Jr. (chairman of the committee) presiding.

Also present: Senators Grassley, Moynihan, Breaux, Conrad, Graham, Bryan, and Robb.

OPENING STATEMENT OF HON. WILLIAM V. ROTH, JR., A U.S. SENATOR FROM DELAWARE, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will please be in order. Today the committee will hear testimony about the President's proposal to improve Social Security's long term finance.

I am not going to read my full statement, Senator Moynihan, but, with your approval, will include it as if read.

[The prepared statement of Chairman Roth appears in the appendix.]

The CHAIRMAN. Let me make just a couple of observations. We all know that Social Security has some very, very serious financial problems. In about 14 years, the Social Security revenues will no longer cover benefit payments.

Now, last year the President did bring Social Security financial problems to the Nation's attention and promised to lead legislative action this year. On January 19, in his State of the Union, the President proposed transferring $2.8 trillion of the projected budget surplus over the next 15 years to fix Social Security financial problems through 2055. Of the $2.8 trillion, $2.1 trillion will be deposited in the Social Security trust fund, and will there lie until 2050.

The President's proposal would represent a major change in financial security financing. From the beginning, Social Security has been funded with a dedicated payroll tax.

Workers earned benefits based on payroll tax contributions, and general revenue has not been a source of financing. So, we are waiting to see the specifics of the President's proposal. But let me assure everyone that this committee intends to work with the President on a bipartisan basis to strengthen Social Security for the long term.

At this time I would call upon my good friend and colleague, Senator Moynihan.

OPENING STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM NEW YORK

Senator MOYNIHAN. Thank you, Mr. Chairman. Just to make a point that is sometimes overlooked as we talk about the moment when the Social Security system will run out of funds or the trust fund will begin to diminish. There is another, and equally singular fact, or perhaps more, which is, in 1977, we moved Social Security to a partially funded system from a pay-as-you-go system.

Very little note was taken of that decision, which was very much an inside decision of the great eminences who had run Social Security since the 1930's. I was a member of the committee on conference and I did not know we had done it. I found out about it later. It took Bob Meyers about 5 years to explain it to me.

But since that time we have been in surplus, and continue to be in surplus for some years to come. There is a question of what is owed the system in the aftermath of a good 20, 25 years of providing funds for general government in return for Treasury bonds.

But, having said that, I would just like to say that I know you would join me, sir, in welcoming our new Comptroller General, David Walker. We have not had many big ideas about government since 1787, but the Comptroller General was one. We welcome you. Not many of us will be here 15 years hence, but you will.

The CHAIRMAN. We all are very happy to have you here, Mr. Walker. It is your first appearance, I think, since becoming Comptroller General, a position of critical importance to government generally, but to Congress in particular.

Senator MOYNIHAN. Finance, in particular.

The CHAIRMAN. And finance, in particular. We are looking forward to hearing from you.

Any brief comments? Very brief comments from the Senator from Iowa.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA

Senator GRASSLEY. I just wonder, if you say I can make brief comments over any other Senator, I must have a very bad reputation. [Laughter.]

I want to put my statement in the record, Mr. Chairman.

The CHAIRMAN. Without objection.

[The prepared statement of Senator Grassley appears in the appendix.]

Senator GRASSLEY. And then explain that I am going to be leaving for our impeachment caucus that each party has before our court begins.

If I could just simply, in the brief fashion you have invited me to do it, explain that I have had an opportunity to be in touch with people in the White House about the President's proposal on Social Security.

On the complimentary side, I compliment the President for keeping the high visibility of an issue that would not otherwise be discussed if it were not done in a bipartisan way.

I would also applaud the President for setting aside surpluses for saving Social Security, but at the same time—and this was discussed in my office with people from the White House—whether you do it the way the President says to do it or whether you do it just the way we typically have done surpluses, just borrow less as a result of having surpluses, hence paying down the national debt and being in a position, after the year 2013, to meet our obligations under the trust fund IOUs when there's a shortfall of Social Security, or whether you set it aside, as the President has done, dedicated for Social Security. When the year 2013 comes, Mr. Chairman, you are still in the same boat of having to go to the marketplace for funds to meet our obligation for Social Security.

So I think that the best thing that could happen out of this debate is for the President, up front, to eliminate all of the smoke and mirrors and simply say that he has got one approach, that if you go his direction we still end up going to the money market, to the finance markets, in 2013 to borrow money, or if you do it the way we have traditionally done it, just use surpluses to pay down on the national debt, we are there in the year 2013 the same way.

There is no reason to, in a sense, try to muddy the waters and say we are doing something special when, in fact, we are not. I think that the place to start that debate is for the White House to say, whether you do it the way it has traditionally been done or whether the way you are doing it that way, you are still going to have to go to the point of borrowing or taxing by the year 2013.

The CHAIRMAN. Thank you, Senator Grassley.

It is my pleasure now to call on John Breaux. Let me just publicly thank you and compliment you for the leadership you are showing on Medicare. We think you are making a great contribution.

OPENING STATEMENT OF HON. JOHN BREAUX, A U.S. SENATOR FROM LOUISIANA

Senator BREAUX. Thank you very much, Mr. Chairman. I will just be very brief in the sense of stressing the importance of the committee doing something in this particular area.

In Washington, it seems that too many times too many people take the attitude of looking at solving difficult problems by arguing that someone else should do it first. It really amounts to, no, you go first, no, you go first, and as a result, no one goes first and nothing gets done.

I think that what we have from the administration is, in fact, a proposal on Social Security. It may not be one that members can agree with and have problems with, but it is a proposal. It is out there. We can argue about it, we can praise it, we can agree with it, we can dissect it, we can do all the things that we should do to it in a legislative process, but it is there. So I think that certainly is a starting point.

In addition to that, there are a significant number of members of this committee which have put out proposals on Social Security. Again, we may not agree with them and we may have problems with them, but they are there. The distinguished Ranking Member from New York, Senator Moynihan, has a proposed that he has worked on with Senator Kerrey.

I have a proposal that I have worked on with the Center for Strategic and International Studies, CSIS. We spent over a year in putting it together, Senator Judd Gregg and I, and we have introduced that proposal. Mr. Walker was part of that group that that helped us put it together. That is before the Congress. In addition, I think Senator Phil Gramm and Senator Domenici worked on a proposal in the last Congress.

So the point I would just make, is there are enough proposals that are out there from different philosophical viewpoints. I think it is now time that this committee, in particular, try and move forward with actually making a recommendation to the Congress, and doing it this year, and doing it before we get involved in the election process.

We cannot continue, I think, to use the argument, you go first, because there have been a lot of people who have, in fact, put something out there and we need to decide which is the best, or which combination is the best, and move forward so this committee can be involved in writing a Social Security reform bill that makes sense.

I know that the Chairman wants to move in that direction, and I would certainly support him in that effort. Thank you.

The CHAIRMAN. Thank you, Senator Breaux.

Senator Robb? We hope everybody will keep it very brief.

OPENING STATEMENT OF HON. CHARLES S. ROBB, A U.S. SENATOR FROM VIRGINIA

Senator ROBB. Thank you, Mr. Chairman. I will be very brief.

I was very much encouraged by the meeting that 12 members from each side of the aisle from each of the two houses had some time, I believe it was early December. I do not recall the exact date, but it was before the end of the year, in which most of the people agreed that, while there might not be a specific proposal at that point, that if the administration put forth a specific proposal that the leaders, particularly the chairman of the House Ways and Means Committee, and others, were prepared to, if not embrace it in its entirety, take it seriously and proceed from that point forward. I thought that was a good sign.

I shared the comments just made by my distinguished friend from Louisiana, that we ought to get beyond the stage of everyone asking for someone else to go first. I hope to see legislative language that we can look up, but we do have at least three circulating proposals at this point. I think that is a step in the right direction. And, as far as I am concerned, the need for finding a way to resolve this particular challenge is great. I thank the Chairman for holding this hearing.

The CHAIRMAN. Thank you, Senator Robb.

Senator Conrad?

OPENING STATEMENT OF HON. KENT CONRAD, A U.S. SENATOR FROM NORTH DAKOTA

Senator CONRAD. Thank you, Mr. Chairman. I will be very brief.

I would just say that we have an extraordinary opportunity this year to do something great. If we do not do it this year, this opportunity will slip from us. Next year will be an election year, then

we will be in the aftermath of the election. This is our opportunity and this is our chance. I hope very much that we do not allow this to slip from us.

It is going to require more than what has been so far offered by the White House. It is going to require more in terms of difficult decisions. I think everybody on this committee understands that.

The only way it is going to happen is if we reach across the aisle and work together. It will not happen if we stay behind our partisan barricades and simply hurl brickbats at each other.

So, Mr. Chairman, this committee has had a proud tradition of working together in bipartisan, and I hope this committee is able to lead the way and fashion a proposal that the rest of our colleagues can adopt. It has to start somewhere, and I think there is no better place than in this committee. I very much hope we do not lose this opportunity.

The CHAIRMAN. Well, thank you, Senator Conrad. I strongly agree that this committee is in a remarkable position to contribute and it must, and will, be done in a bipartisan way.

Let me now turn to our first speaker. I wrote Mr. Walker last week asking him to analyze the President's proposal. It is complicated. He is an expert in these areas. As I said, this is the first time Mr. Walker has appeared before our committee as Comptroller General, and we are looking forward very much to your comments.

Mr. Walker?

STATEMENT OF HON. DAVID M. WALKER, COMPTROLLER GENERAL OF THE UNITED STATES, GENERAL ACCOUNTING OFFICE, WASHINGTON, DC

Mr. WALKER. Thank you, Mr. Chairman and members of the committee. I would respectfully request that my full written statement be included in the record.

The CHAIRMAN. Without objection.

Mr. WALKER. And I would like to now go to summarize it. I realize that several members may have to leave in a few minutes, so what I am going to do first is to get to the proverbial bottom line, then I will end up expounding on it somewhat.

The President's proposal is complex, which makes it all the more important for us to focus our attention on what it does and what it does not do for our long-term future.

In summary, the President's proposal, first, reduces debt held by the public from current levels, thereby also reducing net interest costs, raising national saving, and contributing to future economic growth.

Second, it fundamentally changes Social Security financing in two ways. First, it promises general revenue funds in the future by trading publicly-held debt for debt held by the Social Security trust fund, and, second, it proposes to invest some of the trust fund in equities with the goal of capturing higher returns over the long term.

Number three, it does not have any effect on the projected cash flow imbalance in the Social Security programs, revenues versus expenditures, as was mentioned by Senator Grassley. Last, but not

least, it does not represent reform of the Social Security program itself.

It is important to look at the President's proposal in the context of the fiscal situation in which we find ourselves. After nearly 30 years of unified budget deficits, we look ahead to projections according to OMB and CBO of surpluses as far as the eye can see. At the same time, we know that we face a demographic tsunami in the future that poses significant challenges for the Social Security system and for our economy as a whole.

Although all projections are uncertain, they get more uncertain the farther out that you go. We have long held at GAO that the long-term perspective is important in formulating fiscal policy for our Nation.

Each generation is the custodian for the economy it hands to the next, and the Nation's long-term economic future depends, in large part, on today's budget decisions.

This perspective is particularly important because our model at the GAO, as well as the CBO's model, continue to show that, absent change in policy, our changing demographics will eventually lead to renewed deficits. This longer term problem provides the critical backdrop for making decisions about today's surpluses.

Let me briefly describe the President's proposal. The President proposes to use approximately two-thirds of the total projected unified budget surpluses over the next 15 years to reduce debt held by the public and to address Social Security's financing problem. I should say, to begin to address Social Security's financing problem.

His approach to this, however, is extremely complex and confusing. This complexity and the confusion associated with it may serve to undercut the public's understanding of, and confidence in, the government's approach to budgeting and Social Security reform.

The President proposes to transfer an amount equal to the portion of the projected surplus to the Social Security and Medicare trust funds. This transfer is projected to extend the solvency of the Social Security trust fund from 2032 until 2049. His proposal to permit the trust fund to invest in equities is expected to further extend the trust fund's solvency until 2055.

To understand and evaluate this proposal it is important to understand the nature of the Federal budget, how trust funds fit within that Federal budget, and the challenges and saving within our Federal budget.

First, can we save for the future in the Federal budget? The Federal budget is a vehicle for making choices about the allocation of scarce resources. It is different from State budgets, as Senator Graham and others would know, in several ways important to this discussion.

Most States use fund budgeting, in which pension funds might build up surpluses that are routinely invested in assets outside the government. These pension funds, in State situations, are separate and distinct legal entities that accumulate assets for the purpose of paying accrued obligations.

In contrast, the Federal Government's unified budget shows all governmental transactions and all funds that are available for all activities. As a result, Social Security is an accounting mechanism

by which government obligations have to ultimately be met in order to meet the cash flow needs.

The only way to save in the Federal budget is to run a surplus or to purchase a financial asset. When there is a cash surplus, it can be used to reduce debt held by the public. Therefore, importantly, under current law and past practice, to the extent that there is an actual cash surplus, debt held by the public would fall under the baseline scenario, absent any other action.

How does the President's proposal work? In order to "save the surplus" the President proposes to transfer to the trust fund additional amounts in the form of Treasury securities.

If I can, Mr. Chairman, I am going to deviate from this and try to use this chart. This is on page 5 of my statement. A couple of important points. On the left-hand side represents flows associated with Social Security alone. On the right-hand side represents flows associated with a general fund. The middle represents the flows between the two.

It is important to understand that you have to draw a circle around this entire chart because the circle represents the unified budget. So what we have here are accounting mechanisms. The left-hand side is the Social Security trust fund and the Social Security program, the right-hand side is the general fund. The consolidated portion is the unified budget.

Under Social Security, you have FICA taxes and certain other revenues that come in, and then you have distributions for benefits and program expenses. To the extent that you have an excess cash flow in any given year, that cash flow, that FICA surplus, is lent—is lent—to the Federal Government for the purpose of using for other purposes.

Special Treasury securities that are backed by the full faith and credit of the U.S. Government that carry prevailing market rates of interest are then provided to the trust fund to evidence that lending that has occurred and to provide a legal and moral commitment on behalf of the government equal to those securities.

On the right-hand side, you have other taxes coming in and then you have expenditures for discretionary spending that, today, represent about 30 percent of the Federal budget, whereas in JFK's time it was about 70 percent of the budget. Then you have mandatory spending, including entitlement programs, which today represent about 70 percent of the budget, whereas in JFK's time it was about 30 percent.

To the extent that, in combination, there is a balance, a positive balance, you then have a merged surplus, a unified surplus that would be available to pay down public debt. In the absence of any other action, that is what would happen.

In fact, for fiscal 1998, that is exactly what did happen. There was an approximate $50 billion reduction by debt held by the public attributable to the results of operations for fiscal 1998, largely, if not totally, due to surpluses that occurred on the Social Security side of this equation. If we can change, now.

This is what the President is proposing. It is exactly the same except for a couple of things. Number one, you will see down below, you had the transfer to the trust fund. This is the incremental securities that the President is proposing be transferred to the trust

fund equal to approximately 62 percent of the projected surpluses over the 15-year period that he is dealing with.

I would equate this to a grant. It is an additional grant that he is proposing to make to the Social Security trust funds above and beyond the securities that the Social Security trust fund will get because of lending the surplus cash flows that it has been doing for years to the Federal Government for other purposes.

I think, if you look at the proverbial bottom line, based upon the numbers that OMB has provided for the year 2000 to 2004, that 5-year period, you will see that two of the importance differences are that, under the President's proposal, in addition to the status quo, there would be $445 billion over the 5-year period in additional grants of securities to the Social Security trust fund above and beyond otherwise what it would get.

Second, there would be about $380 billion in reduction in the debt held by the public as compared to about $763 billion reduction of debt held by the public if the status quo was to prevail and if the President's proposal was not adopted.

Now, if I can, let us return to government financing and debt. But before I do, I think it is important to reemphasize my earlier comment. That is, this proposal represents a fundamental shift in the way the Social Security program is financed.

It moves away from payroll financing towards a formal legal commitment which has economic consequences to use general revenue sources to fund Social Security obligations in the future. This is unprecedented.

It is something that the Senate needs to carefully consider as to whether or not it is desirable and advisable, and to the extent that you use those resources for this, it obviously serves to squeeze out resources that are otherwise available for other entitlement programs or other discretionary spending that is there. Clearly, it has major legal and economic consequences that need to be addressed.

If I can return to government financing and debt. The President's proposal would have the effect of reducing debt held by the public from the current 44 percent of GDP to 7 percent of GDP over the 15-year period.

Our previous work on the long-term effects of Federal fiscal policy has shown the substantial benefits of debt reduction. For the economy, lowering debt levels increases national saving and frees up resources for private investment.

The President's proposal trades debt held by the public for debt held by government accounts, but it also spends a portion of the projected surplus under the baseline. Debt held by the trust fund goes up more rapidly than debt held by the public fall, largely due to the additional securities transferred to the trust funds. Gross debt, therefore, increases.

I am sorry, we do not have a chart on that. We did not have time to do it. But if you can look on page 8, I think it is informative. Several comments on page 8.

If you look at the horizontal line, that's the debt limit. It is currently at $5.95 trillion. That is the current debt limit. If you look at the line that slopes upward, that is OMB's baseline projection of what will happen to total debt before the President's proposed

reforms. In other words, that is status quo, using all surpluses to pay down public debt.

Then if you look at the bars, that is what would happen to total debt if the President's proposal was adopted. One of the things that you will see is that, while publicly-held debt as a percentage of GDP goes down under the proposal, total debt goes up, largely attributable to these grants of additional Treasury securities that would be made to the Social Security trust fund, and also being proposed for Medicare as well.

So total debt would go up to the point where the debt ceiling actually would be exceeded in the year 2001 of the President's proposal, as opposed to in the out years under the status quo.

While reducing debt held by the public appears to be the centerpiece of the President's proposal and has significant benefits, as I noted before, the transfer of unified surpluses to Social Security is a separate issue. The transfer is not technically necessary.

Whenever revenue exceeds outlays and the cash needs of the Treasury, there is an actual surplus. Then debt held by the public should fall because those additional proceeds would be used to pay down debt held by the public.

The President's proposal appears to be premised on the belief that the only way to sustain surpluses is to tie them to Social Security or to hide them in Social Security.

He has merged two separate questions. First, how much of the surplus should be devoted to reducing the debt held by the public? Two, how should the Nation finance the Social Security program in the future?

The President proposes two changes in the financing of Social Security. First, a pledge of general funds in the future, and second, a modest amount of investment in equities.

Both of these represent major shifts in approach to financing the Social Security program. By trading debt held by the public for debt held by the trust funds, the President is committing future general revenues to the Social Security program.

This means that, for the first time, there will be an explicit and legal claim on the general fund for amounts in excess of the positive cash flow as attributable to payroll taxes. This is a major change in the underlying theoretical design of the Social Security program.

The question of bringing significant general revenues into the financing of Social Security is a question that deserves full and open debate. The debate should not be overshadowed by accounting complexities and budgetary confusions associated with the proposal, but rather to deal with the substance rather than the form of what is going on.

One discouraging aspect of the President's proposal is that the transfers to the trust funds would be made regardless of whether the expected budget surpluses actually are realized. The amounts to be transferred to Social Security would be written into law as a percent of taxable payroll rather than as a percent of the actual unified budget surplus in any given year.

These transfers would have a claim on the general fund, even if the actual surplus fell below the amount specified to be transferred to Social Security. And that does present a risk because, as we

know, projections are not always reality, and it gets tougher the further out you go.

It should be noted that any proposal to allocate surpluses, particularly over a long period of time, is vulnerable to the risks that those surpluses and those projected surpluses may not materialize. The history of forecast shows that we need to be cautious here.

I think it is important, Mr. Chairman and Senators, to note that this is not a unique dilemma to the United States, that there are many other countries around the world that have faced similar challenges. It is a nice challenge to have a surplus rather than a deficit, but there are many countries and many other democracies that have faced that.

We have looked at some of these democracies at GAO and what they have done to try to deal with it. Several nations have, in fact, succeeded in sustaining surpluses while meeting longer term obligations. In those nations, political leaders were able to articulate a compelling rationale to justify the need to set aside current resources for future needs.

For example, in Australia, New Zealand, the United Kingdom, these countries have come to the conclusion that the debt burden matters and they make it an explicit part of their fiscal decision-making process. In addition, in other countries such as Canada, they save for the future by separating their pension and Social Security-related assets from the rest of the government's budget.

It should be noted that other nations have attempted to directly address their debt and pension problems and have usually done so shortly after a fiscal or economic crisis. Fortunately, we do not have that problem.

At the same point in time, we do, as Senator Conrad said, have a unique opportunity to be able to use our good fortunate to meet the very real and known challenges of the future.

Finally, it is important to note that the President's proposal does not alter the cash flows associated with the Social Security program one nickel. There is no change in the cash flows.

If I can show you here, Senators. If you look at the dotted line, that represents the projected cash income for Social Security. If you look at the solid line, that represents the projected expenditures. You will see that the marks cross in 2013. 2013 is when there is a projected negative cash flow. At that point in time you either need to raise taxes, reduce benefits or cut spending, or refinance the obligations in order to meet the cash flow needs. There is no free lunch associated with it. The graph does not change at all.

So, therefore, while this proposal does represent a number of positive elements, including paying down debt held by the public and saving part of that for the future, it does not represent Social Security program reform.

In order to assure the solvency and sustainability of the Social Security program, we must engage in fundamental reform. These changes should be made sooner rather than later. The longer meaningful action is delayed, the more severe the actions will have to be in the future.

There is another reason to take action on Social Security now. Social Security is not the only entitlement program needing urgent attention. In fact, the issues surrounding the Medicare program are

much more urgent and complex. I recognize that Social Security is not easy. At the same point, in time on a relative basis, it is a lot easier than Medicare and possibly some of the other challenges that we face.

In my view, progress is likely to be greatest if we see the various choices as not either/or decisions, but rather as an array of possibilities along a continuum. Combining elements of different reform approaches may offer the best chance for this committee, for the Congress, and for the Nation to produce a package that addresses the problem comprehensively for the long term in a way that is meaningful and acceptable to the American people. I give several examples in my testimony.

Mr. Chairman, I also proposed five criteria on which I give more detail in my testimony that the Senate might wish to consider for evaluating proposals. Those are: sustainable solvency, equity, adequacy, feasibility, and, very important, transparency, so the American people understand what is being done and has confidence in what our government is doing in this regard, and supports it.

In conclusion, budget surpluses provide a valuable opportunity to capture significant long-term gains to both improve the Nation's capacity to address the looming fiscal challenges arising from our demographic changes, but also to aid in the transition to a solvent, secure, and sustainable Social Security program.

Under the President's proposal, a substantial share of the surpluses would be used to reduce publicly-held debt, providing demonstrable gains for our economic capacity to afford our future commitments.

However, the President's proposal does not include any Social Security program reforms to make the programs' commitments more affordable. There is no free lunch. We must move to assure the long-range solvency and sustainability of Social Security through fundamental program reform, which will involve tough decisions.

The transfer of surplus resources to the trust fund which the administration argues is necessary to lock up these surpluses for the future would, nonetheless, constitute a major shift in financing of the Social Security program. Moreover, the proposed transfer may well make it more difficult for the public to understand and support the savings goals that are articulated.

Several other nations have shown how debt reduction itself can be made to be publicly compelling, and only you can decide whether or not their approaches will work in the United States.

I am very concerned that enhancing the financial condition of the Social Security trust fund alone, without any comprehensive and meaningful program reforms, may, in fact, undermine the case for fundamental program changes.

Delay will only serve to make the necessary changes more painful down the road. The time has come for meaningful Social Security reform. After all, we have much bigger and more complex challenges to tackle.

Mr. Chairman, GAO stands ready to help this committee and the Congress address Social Security reform and other critical national challenges. We are here to fill the gaps and to try to provide clarity where there is confusion. We look forward to working with you to

try to make a positive and lasting difference for our country and the American people.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Walker appears in the appendix.]

The CHAIRMAN. Thank you, Mr. Comptroller General, for a very informative and effective statement.

Having said that, I have to say it is also very disturbing and very alarming because it seems to me what you are saying is that the President's proposal does nothing to really reduce the fiscal crisis or to make the kind of structural reforms that will help secure Social Security for the long term. That bothers me.

I think it was last year the President was at Georgetown and he said, "If we can develop a consensus as a country to act soon, we can take relatively modest steps that will keep Social Security's role in providing some retirement security to people without unfairly burdening your generation."

But this program, if I understand you, Mr. Walker, does not do that. Is that correct?

Mr. WALKER. It does not fundamentally reform the Social Security program. It does not change the cash flows associated with the Social Security program, which ultimately is going to need to be done. It does result in a significant pay-down on publicly-held debt which has positive economic consequences, which increases our flexibility and capacity in the future.

The CHAIRMAN. Correct.

Mr. WALKER. But that would happen anyway if these surpluses really were realized, and if the surpluses were used to pay down debt. In fact, it would happen to a greater extent than is being proposed under the proposal.

The CHAIRMAN. Let me ask you this. If we followed the President's plan, why could we not just recycle the surplus again, and again, and again and make Social Security solvent forever, on paper at least, and still pay off the debt?

Mr. WALKER. Well, ultimately, you have to pay off the debt. What you have is, to the extent that you have intragovernmental transactions, in the end you have to pay off the debt. You have got to be able to generate the incremental cash to pay off that debt. In the end, it means you either have to raise taxes or other revenues, cut spending, in order to get that done.

Let me give you an example, Mr. Chairman. If you look at several key dates, 2013 is when Social Security turns a negative cash flow, before or after this proposal. It does not change.

Those cash flows have to be made up. That has consequences. Overall, the government has to either raise taxes, cut spending, or try to refinance it. But if it refinances it, it is ultimately going to have to meet that burden down the road at some point in time; 2032 represents the date, without any reform, in which the amount of government securities that are in the trust fund are exhausted. After that date, Social Security only has 75 cents in revenue for every dollar in expenditures.

The President's proposal would extend that date to 2049 if you do not do the equity allocation, and 2055 if it does. But it does not change the fundamental imbalance in cash flows in Social Security which we have long stated needs to be addressed.

The CHAIRMAN. Let me go to what I consider to be a very major policy change of using general revenues for Social Security. As long as I can remember, there has been great pride taken on the part of senior citizens that this was an insurance program, that they were paying their way. But for the first time, in a significant way, we are talking about financing Social Security with general revenues. Would you spell out what the implications of that are?

Mr. WALKER. Well, historically, the Social Security program has been financed primarily by payroll taxes. It has been viewed as a social insurance program, where everybody pays for a portion of their benefits.

Now, as you know, Mr. Chairman, and the other Senators, there are different rates of return. The lower income individuals get a lot better rate of return than higher income individuals. People that retired back in the 1940's and 1950's got a lot better return than the people today, but it has been the concept of social insurance financed primarily by payroll taxes.

This would, to the extent that these additional Treasury securities would be granted or gifted to the Social Security trust fund, change that. It would mean that there is a pledge, a legal pledge, an explicit promise, that a portion of general revenues above and beyond the excess payroll tax surpluses would be pledged to meet Social Security obligations that otherwise could be used for other purposes.

The concern is, that fundamentally changes the financing of the program. It kind of moves you somewhat away from social insurance. It provides you less flexibility. The concern is, that is a major change that the Congress and the Senate needs to debate that we are trying to highlight here in our testimony.

The CHAIRMAN. Senator Moynihan?

Senator MOYNIHAN. Well, first of all, to agree with you completely that this is an extraordinary proposal which we have to look hard at.

To make one point. I am so pleased, Mr. Walker, that you began with the proposition that this whole proposal would reduce the debt held by the public at current levels. Would you agree, sir, given the surpluses, that will happen whether we have the Social Security fandango or not?

Mr. WALKER. Yes, Senator. If the projections are proved to be real.

Senator MOYNIHAN. Yes. We look up and find we went into enormous debt in the 1980's. At this point, 11 cents of every Federal dollar is spent on debt service, only 15 cents on national defense. But we never held hearings on debt service, because they are automatic. You have no choice.

But here is chance to get us back to the 1970's, or get us back to 1914, if you can believe it, to the point where it is not a major factor in our National life. We should do that no matter what we do. We have this chance, and it will not come again.

Second, on your point that the President's proposal, after all that talk last year, does not represent a Social Security reform plan. Indeed, it does not. It does not change one line in the statute as regards who pays and what you get back, and so forth.

Yet, the proposals we have in this committee, Mr. Chairman, do address those matters. I would like to just give one example of an archaic aspect of the present system that might surprise people. One-quarter of all the State and local employees in the United States do not pay Social Security taxes.

That hearkens back to the 1930's when it was not clear whether the Federal Government could tax the State government, and so forth. Now, almost all of these people managed to get Social Security on the side. But that is five million people not paying in their proper dues. There is no reason to allow that to go on.

Would you agree? I am not asking you to agree, but you will grant that that is an example of an archaic problem from the 1930's which we could resolve before the century is out.

Mr. WALKER. Many of the reform proposals that are out there propose to address that issue and to eliminate that imbalance.

Senator MOYNIHAN. And the fraction of wages, that they are taxed 88 percent, do we not? We normally taxed about 90 percent of wage income in the country, and we have dropped below that, have we not?

Mr. WALKER. We have.

Senator MOYNIHAN. Yes. So if we just kept to our traditional practice, we would be getting more revenue without changing any of the rules. That is true. So why not? You do not have to answer that.

Mr. WALKER. I will not, Senator. That is the Senate's job, the Congress.

Senator MOYNIHAN. Yes. But thank you very much for making those points. It was very clarifying and very helpful.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Moynihan.

Senator Robb?

Senator ROBB. Thank you, Mr. Chairman.

Mr. Walker, let me say that the one chart that you did not reproduce, for me, is the most edifying and the most valuable, and one that I have been trying to produce on my own for some period of time. I hope that you will reproduce this chart.

This is on page 8, for my colleagues and others who may have a copy of the Comptroller General's testimony. Because this is, at least as far as I am concerned, a candid presentation of what is actually happening and belies the concern or belies the optimism that creates a great deal of concern for me, that we feel that, by extending the date that we say that the real problem occurs with Social Security, we will just forget structural reform altogether and move on.

The chart that you still have displayed, and I do not know which page it is on, but it relates to the fact that there is no change whatever in the cash income and outgo, and I think reflects accurately the situation. But I suspect that there is widespread public belief that somehow that has been changed.

It seems to me that the point you make with respect to the fundamental change in law, whereby we accept as a responsibility of the general revenue flow, an obligation to make Social Security payments is going to come about in 2013 unless we do something

to change the dynamics of the system as it exists today. Would that not be correct?

Mr. WALKER. That is correct, Senator. Let me add that I agree with you about this chart on page 8. I would like to have had it here today, but this is something we came up with at the last minute, because it did help us. We will reproduce it for future use.

But you are correct. We need to deal with the fundamental imbalance in the cash flows. I am concerned about an expectation gap.

Senator ROBB. That is exactly what I am referring to.

Mr. WALKER. Because you are going to hit the debt ceiling. Total debt is going up, yet people are saying, we are paying down debt held by the public. Yes, we are, and that is good. But total debt matters, too.

Senator ROBB. You have produced the chart that I have been looking for, and I simply commend you for doing it. If it is possible, based on the figures that are available, it seems to me producing a chart that goes out 10 or 15 years based on the information that is available would be additionally useful because of the speculation about the 10- or 15-year date with respect to these numbers would, I believe, present an even more dramatic picture. If my calculations are correct, based on the current assumptions, which are considerably rosier than they were a year ago, and much rosier than they were two years ago, the total debt, the unified budget debt for the government, stays about level over a period, whereas the debt held by the public goes down to 7 percent of GDP at the end of 15 years, from the current 44 percent, I guess it is.

But, because of the increase in the obligation that is now transferred to Social Security as opposed to government-held debt, we have, if you do not put in the USA accounts a figure that is essentially an even line with the percentage of debt owed to the public and debt owed to the government, so to speak, the line changes but the large bar graph remains about constant. Is that a fair assumption?

Mr. WALKER. Senator, it is my understanding, it depends on how you look at it. First, as a percentage of GDP, as a percentage of our economy——

Senator ROBB. I was not even relating this to GDP, but please go on.

Mr. WALKER. But this might be helpful. Total debt does decline as a percentage of GDP. The debt held by the public declined significantly under this proposal. But the intragovernmental debt, the debt held by the trust funds, goes up significantly during the period.

But what is important, which you pointed out, Senator, is percent of GDP is one way to look at burden, but you also have to look at nominal dollars and you also have to look at total debt. You have to consider the debt ceiling which is in dollar terms rather than percentage of GDP.

Senator ROBB. Let me ask you one final question, because my time is about up. Is there any real difference between the dollars that are held in the two accounts in terms of what we have to assume are long-term government obligations?

Are the dollars fungible or beyond the ability to keep Congressional hands off of the projected surplus between now and the year 2013?

Is there any other significant impact of choosing this particular plan over proceeding on the status quo as far as Social Security is concerned?

Mr. WALKER. I guess the way I look at it, Senator, is the President seems to be saying that he believes the best way to ensure that the surplus will be preserved is to link it to Social Security and Medicare.

Senator ROBB. And that is the one aspect of the plan that I find myself in wholehearted agreement with the President. I am looking beyond that. Is there anything more than, in effect preserving that amount from the prying hands of Congress for either additional spending or tax cuts, whatever the case may be, that accrues from an obligation accounting point of view?

Mr. WALKER. Obviously, you could end up, just by doing nothing, if Congress had the discipline not to do something on taxes or spending, you could pay down debt even more than the President is talking about.

Ultimately, the obligations that our Nation faces with regard to Social Security is not affected by this. We have still got government financing challenges that have to be dealt with, because we have not dealt with the imbalance and the cash flows attributable to the Social Security program. I hope that is being responsive, Senator.

Senator ROBB. It is. Paying down the debt even faster would be my preference.

With that, Mr. Chairman, I thank you.

The CHAIRMAN. Thank you.

Senator Conrad?

Senator CONRAD. Thank you, Mr. Chairman.

Thank you for an excellent presentation, David. I thought it was right on the mark.

It is very hard to communicate, I think, to the American people, perhaps even to our own colleagues, what is going on here. I think it is very hard for people to understand, when you have these separate accounts, how they work together.

We have had testimony from virtually every economist. Alan Greenspan has told us this very clearly. The best single thing that we could do for the future of the economy of our country is to pay down debt, that that is preferable to a tax reduction, that is preferable to spending the money in new initiatives.

The reason that is preferable is because paying down the debt reduces pressure on interest rates. Reducing pressure on interest rates creates a better climate for investment, and means we will have a bigger economy for the future.

The question is, how do we accomplish that? As you indicated in your testimony, the President believes that if you just start paying down debt with surpluses, that that will become a honey pot. In Congress, people will move to spend it or they will move to give it back in tax cuts. But we will not accomplish what is, according to every economist I have heard, the single best thing we could do for the future of this country, which is to pay down debt.

Now, I do not know if he is right about that judgment. He has come up with something that is very complicated, transferring assets to the Social Security trust fund and in the meantime paying down publicly-held debt.

In addition, he is doing more than that. Not only is he paying down debt, but he is also allowing resources for certain high-priority spending, including defense, including education, he is also putting money into Medicare to shore that up because that is in a tougher circumstance in the short term than is Social Security.

So it boils down to, fundamentally, a question of how do we use resources? Most of the resources in the short term, the surpluses, are coming because there is a surplus in Social Security.

But if we go back to the fundamental goal which the economists have told us ought to be our goal, which is to pay down debt, how would you propose that? Is there any thought that you have on how we could fence that money off so it is not either spent or given back in tax cuts so that it can actually be used to pay down debt to strengthen the economy for the future?

Mr. WALKER. Senator, there are other ways that you could accomplish this same objective. You could look at the budget treatment for Social Security. I think that one of the things that we could do, that we could provide for the record, if you would like, is what some other countries have done, some more detail.

I think it is important to recognize that, at GAO, our job is to give you the facts, to tell it like it is, and to help you be able to decide, since you are elected, what ought to be done. And I would be happy to provide you with some additional information, but I would hate to make a recommendation on what you ought to do.

Senator CONRAD. I understand. Let me just say this to you. I am part Swedish and part Norwegian, so I look at what they have done and am interested in what they have done to wall this money off.

I believe, clearly, the best thing we could do for this country is to pay down debt. That would put us in the strongest position to deal with the imbalances in Social Security in the future in addition to actual Social Security reform proposals.

Now, I would be very interested in what these other countries have done to segregate the trust funds. What mechanism have they used so that those of us in Congress and the executive branch would not be as, perhaps, open to spending it on new initiatives or giving it back in tax reduction? I can tell you, I would love to have a tax cut.

I look at what we spend in Federal taxes every year. It is a lot of money. Of course, most Americans pay more in payroll taxes than they pay in income taxes. The vast majority of the people in our country are paying more in payroll taxes than they are in income taxes.

But, still, if we are going to do what every economist tells us is the best thing for the future of this country, it is clearly to pay down debt, that that will strengthen the economic growth of this country and mean that there is more to share in the future than what we have now. So, I would be very interested in any models that you have of what other countries have done to assure that that happens.

Mr. WALKER. Senator, I would commend to you page 12, which provides an example of what Norway has done. We would be happy to provide you with additional information. But Norway faces the problem of declining oil revenues, because they get a significant percentage of their total tax receipts from oil revenues.

Second, an aging society, the demographic tsunami that we talked about before. So they have actually created a separate and distinct trust fund that is off budget, that is funded and dedicated solely for the purpose of meeting some of the future challenges associated with the aging population. But we can provide you further detail but, yourself being Scandinavian, I thought you would be interested in that.

Senator CONRAD. I would be very interested in that.

The CHAIRMAN. I would ask that you provide that information for the committee, because I think everybody would be very interested.

[The information appears in the appendix.]

The CHAIRMAN. Next, we have Senator Bryan.

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

I agree with the observation that Senator Conrad just made in terms of what we can achieve if we can reduce the amount of the debt. There is an additional benefit that we get as well, and that is the 11 percent that Senator Moynihan talked about.

That is, the percentage that we pay each year on the interest on the national debt would be reduced as well if the principal amount of that is reduced, and that would give us the opportunity to either provide tax relief or to enrich programs that we feel may need additional funding as well.

Most of us are going to have to explain this proposal, not to the American Institute of Certified Public Accountants, but ordinary folks at home, people who have focused on the debate in recent years. I think that is a positive byproduct of the discussion we have had.

There is a recognition that we are going to have to do something in Social Security. Not everybody may have that date of 2032 etched into the memory circuit, but people do recognize that there are some problems out there, and particularly younger people who are part of the work force in their 30's have this understanding that somehow the system is going to be different, many of them do not even believe that there will be a Social Security program for them. So it is going to be incumbent upon us to explain exactly what this involved, convoluted proposal means.

Some of us came to the Congress in the 1980's from a State perspective and we were, frankly, horrified at what we saw occur at the Federal level. I mean, in 1980, I think the numbers were something like, less than $1 trillion in national debt.

That represented the accumulated expenditure since the Federal Government assumed the Revolutionary War debt of the States, the Civil War, two World Wars, a Great Depression, Korea, Vietnam, and all of the intervening social programs of the 1930's.

All of a sudden, expenditure has exploded and this massive overhang of debt now confronts us. We do have a unique opportunity, it seems to me, to do something about that. Like Senator Conrad, I would be interested in what other thoughts that you might have in terms of options that are available to us.

Let me return to a pragmatic question. The national debt today is somewhere in the range of, what, $5 trillion plus? What numbers do you use?

Mr. WALKER. Let me see. Right now it is $5.4 trillion, $5.5 trillion, I believe.

Senator BRYAN. All right. So $5.5 trillion. That is the number that we use today. What number will we have based upon the President's proposal and the President's projections? How will that change in terms of using the number that we use today that we all know is somewhere in the $5 trillion range?

Mr. WALKER. On page 8, which is the chart that Senator Robb referred to, that will tell you total debt, which is what is subject to the debt ceiling. Public debt will go down significantly.

Senator BRYAN. I understand that.

Mr. WALKER. We have a line chart that we have done that shows what happens with total debt as a percentage of GDP, as well as gross numbers, what happens to debt held by the trust funds, what happens to publicly-held debt, because I think that would help shine some light on this.

Senator BRYAN. It would, indeed. But the point that I am trying to get is some apples to apples comparison. I mean, I realize that this is an innovative approach. We talk about debt held by the public, and institutional debt, and all of these terms. But, basically, what you are saying, for those of us that are going to have to explain this at home, that the total amount of the debt is going to go up.

Mr. WALKER. That is correct, Senator.

Senator BRYAN. And what will that be?

Mr. WALKER. The total debt in 2004, under the President's proposal, would be $6.743 trillion, which is up from about $5.4 trillion, $5.5 trillion today.

Senator BRYAN. Let me say in great respect, and I understand the differences between the two types of debt we are talking about, but that does not seem to be moving in the direction that a lot of us would like to see it go.

We do this under this proposal without achieving any real long-term Social Security reform. In effect, we kind of punt the ball and decide to work on that, presumably, at some later time.

The concern that I have is that we are in a most fortuitous circumstance right now. I do not think any of us who were elected in the late 1980's, as I was, ever believed in our lifetime that we would see the kinds of budget surpluses that we are seeing today. I mean, I do not think any of us thought that.

We hoped that we would be able to help to return to a more fiscally responsible Federal budget, but none of us saw that. This is not going to continue forever. Everybody knows, the business cycle has not been repealed. We are going to have downturns.

One last question. With these proposals that the President has advanced, what happens to those proposals if there is a revenue shortfall? That is to say that, because of economic circumstances unforeseen, the revenue stream disappears and, in any one given year, our expenditures exceed by a fairly substantial amount the revenues coming in. How does all of that then come into play in

terms of the obligation to the trust fund under these special Treasury certificates, or whatever they are?

Mr. WALKER. That is one of our concerns, Senator, because under the President's proposal the amounts that would be granted or transferred, incremental amounts would be transferred to the Social Security funds, would be based on a percentage of taxable payroll, not a percentage of the actual unified budget surplus. Therefore, there is a possibility that you would still be transferring these sums in a circumstance where the surpluses do not exist, they evaporate for some reason.

Senator BRYAN. So in order to finance that, and tell me if I am missing something here, you would have two options, either to reduce other expenditures, an amount that is represented by the obligation that you have got to transfer to the trust fund so that you keep, in effect, a balanced budget, or, dare I say it, the "T"-word, increase taxes in order to have the revenue stream increase to represent the amount of money necessary to address the outflow. Or the third option is to increase the debt level even further.

Mr. WALKER. Increase publicly-held debt, which ultimately further mortgages the future, obviously.

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

The CHAIRMAN. Thank you, Senator Bryan.

We, next, have Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman.

Thank you, Mr. Walker. I am pleased that we have a son of Florida here providing us with such clear analysis.

Let me ask a few questions. For the last year, one of the guiding principles of our fiscal policy has been to save Social Security first and not use the Social Security surplus for any purpose other than Social Security until we had reformed the Social Security system.

I hear you saying that we do not have in this plan a reform of Social Security, that the system stays the same way it is and we make certain accounting adjustments inside the unified budget.

Mr. WALKER. We have Social Security financing reform in that we have a situation where this additional grant of securities will, in effect, represent a pledging of general revenues above and beyond the excess payroll taxes. We have a proposal for a portion of the trust fund to be invested in equities, which is financing reform. We do not have program reform.

Senator GRAHAM. You emphasize the fact that these new Treasury securities will be a pledge of future general revenue to pay them off. What about the rest of the Social Security surplus, that which we have been accumulating and will continue to accumulate; what is the nature of the general revenue obligation to pay that off when those securities come due?

Mr. WALKER. They are similar. Let me try to explain this, Senator, because it is complicated. I think the complexity, frankly, serves to confuse the public and undermine public confidence.

Basically, what you have is the securities are the same. They are non-readily marketable Treasury securities, backed by the full faith and credit of the U.S. Government bearing prevailing rates of interest.

The difference is as follows. In the past, the way I look at it, what we have had is basically a loan. We have had a loan from one

element of the government to another part of the government because Social Security, on its own, that separate account, if you will, within the overall budget has been running a positive surplus.

So, therefore, the rest of the government has taken that cash flow, that positive cash flow, used it for other purposes, but given back a government security backed by the full faith and credit of the U.S. Government.

What is new here is, the securities are the same. You still have the issue that we talked about before, you have got to either raise taxes, reduce spending, or further mortgage the future through refinancing and increasing publicly-held debt in order to deal with Social Security's obligations.

What is different, is that for the first time, rather than these securities in the trust fund representing excess cash flows attributable to payroll taxes, plus interest, obviously, on past obligations, it is going to be a grant that does not have anything to do with Social Security that will be a legal and explicit promise to use future general revenues above and beyond what happened on Social Security on its own to shore up Social Security in future years.

Senator GRAHAM. But in terms of the commitment of general revenue to repay, it is the same commitment for the underlying of surplus generated by excess payroll taxes over benefits, as it will be on this new layer of, as you describe it, grant securities.

Mr. WALKER. The macroeconomics are the same.

Senator GRAHAM. One concern I have, is we have put a lot of focus on the number 62, that being the percentage of the unified surplus over the next 15 years which will be generated by Social Security. That then becomes the means by which that new grant is calculated.

Actually, that 62 percent number is a little deceptive. Using my elementary school long division capabilities, because I was without computer or hand calculator, and using the OMB budget estimates of the unified surplus, it appears that over 86 percent of the unified surplus during the first 5 years, that is 2000 and 2004, will be generated by the Social Security surplus, and over the first 10 years, 68.8 percent will be generated by the Social Security surplus.

It concerns me, therefore, that we are essentially putting the Social Security system at risk by saying, from year one, you are going to get the 62 percent that is based on a 15-year average, whereas, it is going to be deep into the latter periods of that before we begin to approach the allocation of the unified surplus that would cause Social Security to be only 62 percent.

Mr. WALKER. As you properly point out, Senator, that 62 percent is an average over a 15-year period of time.

Senator GRAHAM. The average is back loaded, i.e., the Social Security surplus is disproportionately high in the first 5, and even the first 10 years, and then it is only in the last 5 years that the non-Social Security surplus gets to the point that it reduces Social Security to just the 62 percent level.

Mr. WALKER. Correct. Social Security is providing most of the surplus in the early years, but, as we have talked about before, in 2013 Social Security has a negative cash flow, so it provides none of the surplus starting in 2013.

Senator GRAHAM. My conclusion of that is, we are putting the Social Security surplus, in terms of its use, at the risk that those prospects of surplus 10 and 15 years from now will, in fact, materialize.

The CHAIRMAN. Thank you, Senator Graham.

One conclusion that disturbs me, is you are saying that the current debt limit will have to be raised sooner under the President's proposal than currently. Is that not correct?

Mr. WALKER. That is correct, Senator. 2001, under the President's proposal, and a number of years later under the status quo.

The CHAIRMAN. Which, of course, in turn means that debt is increasing.

Mr. WALKER. That is correct, Senator.

The CHAIRMAN. Well, David, I want to thank you for being here today. I think your testimony has been extraordinarily helpful. We do want to continue working with you on this complex matter as a source of information and intelligence.

Thank you very much for being here.

Mr. WALKER. Thank you, Mr. Chairman.

The CHAIRMAN. It is now my pleasure to call the next panel. We will start out with a number of distinguished Social Security experts. David Koitz, from the Congressional Research Service, will briefly describe the operations of the Social Security trust funds.

Then we will hear from witnesses who will present their early look at the President's proposal to shore up the Social Security trust funds with general revenue.

We will take the witnesses in alphabetical order. We have with us Dr. Edward Gramlich, Mr. Robert Greenstein, and Dr. Eugene Steuerle. We will ask each witness to limit his or her testimony to 5 minutes.

Mr. Koitz, we will begin with you.

STATEMENT OF DAVID S. KOITZ, LEGISLATIVE SPECIALIST, CONGRESSIONAL RESEARCH SERVICE, WASHINGTON, DC

Mr. KOITZ. Chairman Roth, Senator Moynihan, members of the committee, I was asked to provide you with an overview of the nature and operations of the Social Security trust funds.

Mr. Walker has covered some of it, and it might be a little bit redundant. Maybe I will be a little bit more arcane, but maybe I will get a little more information across to you.

The cost of the Social Security program, both its benefits and administrative expenses, are largely financed by taxes on wages and self-employment income commonly referred to as FICA and SECA taxes.

Contrary to popular belief, these taxes are not deposited in the Social Security trust funds. They flow each day into thousands of depository accounts maintained by the government with financial institutions across the country. Along with many other forms of revenue, these taxes become part of the government's operating cash pool, or what is more commonly referred to as the U.S. Treasury.

In effect, once these taxes are received, they become indistinguishable from other monies the government takes in. They are accounted for separately through the issuance of Federal securities to

the Social Security trust funds, which basically involve a series of bookkeeping entries by the Treasury Department, but the trust funds themselves do not receive or hold money. They are simply accounts.

Similarly, benefits are not paid from the trust funds, but from the Treasury. As the checks are paid, securities of an equivalent value are removed from the trust funds.

When more Social Security taxes are received than spent, the money does not sit idle in the Treasury but is used to finance other operations of the government. The surplus is then reflected in a higher balance of Federal securities being posted to the trust funds.

These securities, like those sold to the public, are legal obligations of the government. Simply put, the balances of the Social Security trust funds represent what the government has borrowed from the Social Security system, plus interest.

Like those of a bank account, the balances represent a promise that, if needed to pay Social Security benefits, the government will obtain resources in the future equal to the value of the securities.

While generally the securities issued to the trust funds are not marketable—they are issued exclusively to the Social Security trust funds—they do earn interest at market rates, have specific maturity dates, and, by law, represent obligations of the U.S. Government.

What often confuses people, is that they see these securities as assets for the government. When an individual buys a government bond, he or she has established a financial claim against the government.

When the government issues a security to one of its own accounts, it has not purchased anything or established a claim against some other person or entity. It is simply creating an IOU from one of its accounts to another.

Hence, the building up of Federal securities in Federal trust funds, like those of Social Security, is not a means in and of itself for the government to accumulate assets.

It certainly establishes claims against the government for the Social Security system, but the Social Security system is part of the government. Those claims are not resources that the government has at its disposal to pay future Social Security benefits.

Generally speaking, the Federal securities issued to any Federal trust fund represent permission to spend. As long as a trust fund has a balance of securities posted to it, the Treasury Department has the legal authority to keep issuing checks for the program.

In a sense, the mechanics of a Federal trust fund are similar to those of a bank account. The bank takes in a depositor's money, credits the money to the depositor's account, and then loans it out. As long as the account shows a positive balance, the depositor can write checks that the bank must honor.

In Social Security's case, its taxes flow into the Treasury and its trust funds are credited with Federal securities. The government then uses the money to meet whatever expenses are pending at the time.

The fact that this money is not set aside for Social Security purposes does not dismiss the government's responsibility to honor the trust fund account balances. As long as those funds show balances,

the Treasury Department must continue to issue Social Security checks.

The key point is, the trust funds themselves do not hold financial resources to pay benefits. Rather, they provide authority for the Treasury Department to use whatever money it has on hand to pay them. If the Treasury lacks the resources to meet these claims it must borrow them or, alternatively, Congress would have to enact legislation to raise revenue or cut spending.

The significance of having trust funds for Social Security is that they represent a long-term commitment of the government to the program. While the funds do not hold resources that the government can call on to pay Social Security benefits, the balances of Federal securities posted to them represent and have served as financial claims against the government, claims on which the Treasury has never defaulted, nor used directly as a basis to finance anything but Social Security expenditures.

That concludes my statement, Mr. Chairman.

Senator MOYNIHAN. Just like that.

The CHAIRMAN. Thank you, Mr. Koitz.

[The prepared statement of Mr. Koitz appears in the appendix.]

The CHAIRMAN. Next, we would call on Dr. Gramlich.

STATEMENT OF HON. EDWARD M. GRAMLICH, PH.D., GOVERNOR, FEDERAL RESERVE SYSTEM, AND CHAIR, 1994–1996 ADVISORY COUNCIL ON SOCIAL SECURITY, WASHINGTON, DC

Dr. GRAMLICH. Mr. Chairman and members of the Committee, I appreciate the opportunity to appear before you today to discuss Social Security. I speak for myself, as past chair of the 1994-1996 Quadrennial Advisory Council on Social Security and not in my current status as a member of the Federal Reserve Board.

As you are all aware, the U.S. population is aging. Today there are 3.4 workers per retiree. By 2030, it is projected that there will be only two. This fundamental change in the demographics of our population poses a large challenge: how can we provide adequate health and retirement benefits to our retired population without imposing undue burdens on tomorrow's workers?

Clearly, the answer to this question is that we must act now to increase the total amount of resources to be available in the future. By increasing the size of our economy, we can devote a greater share of output to the retired population, without reducing the consumption of the working population. The only way to achieve this critical objective is for us to build up the stock of productive capital by increasing our rate of national saving. Indeed, in the current expansion, investment has expanded at a rapid clip without inducing a rise in interest rates. This investment boom and the accompanying step up in the growth of the capital stock is largely attributable to an increased rate of national saving.

The stellar performance of the economy over recent years provides the nation a unique opportunity to begin to tackle its long-run problems. In particular, the large budget surpluses that are projected over the next 15 years, if they are permitted to materialize, will significantly improve our fiscal and economic position as the baby boom begins to retire. From the government's perspec-

tive, using these surpluses to pay down the Federal debt will reduce future interest payments and free up future tax revenues. From a macroeconomic perspective, the increased national saving represented by the increase in government saving will lead to a larger capital stock, higher productivity, and an improved standard of living.

From this broad standpoint, the general objective of the Clinton administration's budget—that is, to preserve most of the projected surpluses—seems to me both responsible and appropriate.

The administration would devote about $1.4 trillion of the projected $4.9 trillion current law surplus over the next 15 years to new spending, using the remainder to pay down our National debt. According to their calculations, the ratio of debt held by the public to GDP would fall from the current 44 percent to 7 percent by 2014. If such an outcome were to materialize, it would represent a dramatic improvement in the fiscal position of the Nation.

Under current law, Social Security revenues exceed outlays, creating the surpluses that are credited to the Social Security trust fund in the ways that you have talked about already. Without any legislative changes, the Social Security trust fund will continue to accumulate funds and these surpluses both reduce the national debt and improve the long-run fiscal condition of Social Security.

But, in addition to this accumulation already scheduled under current law, the administration is also proposing to transfer an additional $2.8 trillion of general revenues to the Social Security trust fund. While the administration's rationale for these transfers is to ensure that the surpluses actually materialize, the transfer of general revenue represents a major shift from past practice under which Social Security has been financed almost entirely from dedicated payroll taxes.

During our deliberations of our Advisory Commission, we considered whether general revenues should be used to help shore up the Social Security program. The idea was unanimously rejected, for a number of reasons. First, using general revenues to fund Social Security puts the Social Security system in competition with other spending programs during the budget cycle. But Social Security is a long-range program—people pay dedicated taxes today toward benefits that may be received 30 or 40 years later—and many feel that it should not be part of an annual budgetary allocation process.

Perhaps more importantly, using general revenues to fund Social Security undermines the fiscal discipline imposed by the need to ensure that income earmarked for Social Security is sufficient to meet the entire cost of the program in both the short and the long run. Without a long-range budget constraint on Social Security, it would be much more difficult to limit future benefit growth. Notwithstanding the large surpluses being projected, some reductions in benefits are almost certain to be necessary, as the U.S. population ages.

Thus, I find that there are serious drawbacks to relaxing Social Security's long-run budget constraints through general revenue transfers. I would prefer Social Security reforms that maintain the link between dedicated taxes and benefits and maintain the value of long-range actuarial analysis. This discipline is essential if we

are to limit the impending explosion of entitlement spending. The President's budget proposal, by preserving future surpluses and paying down our National debt, makes an important contribution to raising national saving, but to me the proposal looks even better without the general revenue transfer.

Thank you very much.

The CHAIRMAN. Thank you, Dr. Gramlich.

[The prepared statement of Dr. Gramlich appears in the appendix.]

The CHAIRMAN. Mr. Greenstein?

STATEMENT OF ROBERT GREENSTEIN, EXECUTIVE DIRECTOR, CENTER ON BUDGET AND POLICY PRIORITIES, WASHINGTON, DC

Mr. GREENSTEIN. Thank you, Mr. Chairman, Senator Moynihan.

I think there is some merit to the administration proposal to do temporary, time-limited general revenue transfers if—and I underscore if—they are tied to reforms to do the rest of the job to put us back in 75-year balance.

In fact, I think there is a thought I would like to share as using them as inducements, that in order to get the transfer one has to do the reform; for each dollar saved in reform, maybe then one could get some amount of transfer. Let me return to that in a minute.

But, first, I want to discuss two other issues, the question of double counting, and the debt question that several Senators raised earlier.

The proposed transfer has been called a double count by some. But what has been called double counting in the administration proposal is essentially unified budget accounting, a practice the budget has followed for many years under which Treasury takes the surplus payroll tax revenues, provides the trust fund with Treasury bonds, and then uses that borrowed cash for other government operations, so that the funds show up in the budget twice, once as Treasury bonds the trust fund gets, once as expenditures for other government programs.

The administration's proposal is similar, except that, instead of the borrowed funds being used for other government programs, they are put back in Social Security. In this case, the second use of the funds is Social Security rather than another government program does not really alter the basic nature of the transaction. If we want to call this double counting, every one of our budgets of the last 15 years then used double counting as well.

On the debt front, I did want to call attention to page 4 of Mr. Walker's testimony, in which he notes that, "Debt held by the public represents government competition with the private sector and the credit market that it raises interest rates and lowers private capital accumulation, and that it increases burdens on the taxpayers for those net interest payments in the budget."

He goes on to say that the other part of the debt, the debt owed to Social Security in this case, has none of these economic effects and does not compete with the private sector for funds in the credit markets.

So, to me, these are not the issues, but there are other serious issues. Let me, briefly, also note that I think there is a philosophical or analytic justification for a temporary general revenue transfer.

Two points. One, is one of the reasons we have an unfunded liability in Social Security today is that when the program started the designers humanely departed from the principle of linking payroll tax contributions to benefits. To let the early generations get benefits, it made it a pay-as-you-go system. It built up an unfunded liability. One can make a case for a temporary general revenue transfer to reimburse Social Security for part of that original burden.

Second, the justification is that, if we have this surplus in Social Security and we save it, that adds to national saving and gives us a bigger economy. If we use it to pay down debt, that means private investors do not need to hold as many Treasuries. Social Security will hold more, private investors invest more in the market and get higher rates of return.

The government makes money in corporate and personal income tax collections. Both add greater economic growth. You can make a case for a transfer to Social Security there, too.

However, there is a problem. The temptation could be to rely solely on transfers and not do the reforms. The point Mr. Walker just made, I share that concern. I share the concern of what would happen if Congress adopted only the transfers and did not do the rest of the job to close the long-term balance. If that occurred, we would have to do big burdens on the rest of the budget in the 2030's and 2040's, cashing in all of these Treasury bonds.

In my view, the administration's transfer makes sense in conjunction with structural changes to fully close the rest of the gap and put Social Security on a permanent, sound basis.

If those needed reforms were made, then the trust funds would not need to cash in as many bond in the 2030's and 2040's because the gap between payroll tax income and outgo would not be as great, the reforms would have narrowed the gap.

Also, helping us bear that burden would be reductions in interest payments on the debt. In 1998, Social Security benefits plus interest payments on the debt consumed 7.4 percent of GDP.

If we save most of the surplus, under the administration's plan interest costs will decline so much that the combined cost of Social Security and that interest will remain below 7.4 percent of GDP when the baby boom generation is retired.

So combining a temporary transfer with permanent structural changes and fully closing the gap, I think, strikes a reasonable balance.

In conclusion, therefore, what I suggest is closing a portion of the gap with these transfers, if they are accompanied by structural changes, and looking for a way to use them as incentives.

For example, for each dollar saved through reforms, the kinds of things Senator Moynihan and others have proposed in their bills, that one would get a certain amount of transfer. I emphasize, transfers should be temporary and in addition to structural changes, not instead of making structural changes.

Thank you.

The CHAIRMAN. Thank you, Mr. Greenstein.

[The prepared statement of Mr. Greenstein appears in the appendix.]

The CHAIRMAN. Dr. Steuerle, please.

Senator MOYNIHAN. May I say, Mr. Chairman, Dr. Steuerle has a challenge. Every one of these extremely articulate and informed persons has come in on the dot of the bell. [Laughter.]

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

Dr. STEUERLE. That is quite a task, Mr. Moynihan.

Senator MOYNIHAN. Yes.

Dr. STEUERLE. I should note, by the way, that in reflecting the dilemma facing this Congress, the Office of Management and Budget and the Council of Economic Advisors, two of the finest offices in the Federal Government, reflected the dilemma, I think, by first putting out a budget that you may note was purposely put in black. The Council of Economic Advisors, a week or so later, decided, reflecting perhaps on our long-term dilemmas, to put out an economic report that was again in the red.

As a member of the baby boom generation, I grew up with individuals who, whether they considered themselves liberal or conservative, considered themselves somewhat idealist when it came to the role of the Federal Government.

Today, this cohort has come into full power as members of the labor force, the business community, the White House, and the Congress itself. I find it somewhat ironic that the legacy the baby boomers would now bequeath is one in which almost the sole purposes of the Federal Government would be to care for their own consumption needs and retirement.

I do not believe this legacy was intended. Yet, it would come about under current law under the President's proposals and under most of the Republican and Democratic alternatives being considered in Congress.

It is largely the consequence of laws written decades ago that are determining almost all of the spending priorities for today, and for future generations. In particular, it is the consequence of particular design features in Social Security, as well as a number of health laws, so that they really are designed to grow forever faster than the economy without regard to changes in fertility and mortality. Or, if I may be so bold as to try to paraphrase one of Moynihan's laws, without regard to the law that all is demography. Correct me if I am wrong, Senator.

The greatest difficulty with today's budget policy is that the law itself would deny into posterity both the right and the privilege to decide for itself the priorities and the needs facing the Nation. The simple fact is that general revenue financing of benefits does not in any way change the scheduled growth and commitments to programs for the elderly and near-elderly.

General revenue financing, standing by itself, could even detract attention from the more important issue of how the structure of Social Security benefits should relate to the overall needs of society.

Now, general revenue financing is an issue more of political economy than pure economics. General revenue financing puts on the

table several very important questions, which I will only very briefly summarize.

First, would it add to real assets held by the government or simply to a pretense that Social Security holds on to real assets? My own assessment is that an additional transfer from the government's left hand, the Treasury Department, to its right hand, Social Security, over and above any surplus accruing between taxes and benefits, tends to ask too much.

The simple fact is, as so many of the previous speakers have noted, future taxpayers must cover the cost of interest and principal on any gift of bonds from Treasury to Social Security.

Second, do new sources of general revenue financing lay bare the fact that programs for the elderly, including Social Security, have always relied, in part, upon general revenue financing.

Programs for the elderly have often had general revenue financing fixes. These include the financing of Part B of Medicare out of general revenues, several other items I list in my testimony, and within Social Security, the transfer, indeed, of income taxes and Social Security benefits on the basis of what is a fairly generous formula. Considered as a whole, programs for the elderly have always run substantial deficits if benefits were to be compared only to Social Security taxes.

Third, and closely related, did or will the tie between taxes and benefits, as reflected in the concept of trust fund balances, act as a constraint on the system and prevent deficit financing?

It appears to me that the current willingness to tackle Social Security is based, in part, upon this concept of trust fund imbalances. These imbalances would appear less severe with a general revenue transfer.

Fourth, does general revenue financing break the relationship between benefits and taxes on earnings and thereby invite means testing, the more formal introduction of general revenue financing, which could shift public sentiment toward viewing the system as a transfer program?

In my view, means testing is highly inaccurate, given the ability to shift assets to children, or simply for the elderly to hide them. Means testing also really discourages saving for retirement.

Fifth, would general revenue financing open up consideration of the appropriate tax base to support old-age programs, wage taxes, income taxes, or consumption taxes? Certainly a case can be made for consumption taxation vis-a-vis wages taxation.

If it is projected, we continue on a path where larger and larger portions of Social Security and Medicare recipients consume at higher rates than many of the workers who are supporting them. By the same token, it is doubtful as a matter of simplicity—and yes, there are a few of us left who do care about tax simplicity—that one would want to add yet another tax system onto the ones we already have.

Sixth, would the transition to general revenue financing be done in a way that might encourage more short-run saving by government? This is really the principal argument used by the administration. In its own proposal, success depends upon the crafting of legislation to change accounting practices, really to constrain not this Congress, but future Congresses and future Presidents.

I have serious doubts, as a matter of accounting, that this hoped-for constraint can be achieved and, if achieved, that it really can be made as an accounting rule to constrain future politicians. The confusion that reigns over the administration proposal, however, does not mean that short-run saving might not be enhanced.

Finally, I believe that general revenue financing could be used to support transition to a new system, however, not necessarily through an accounting mechanism.

[The prepared statement of Dr. Steuerle appears in the appendix.]

The CHAIRMAN. Thank you, Dr. Steuerle.

Let me ask you, matter of fact, the first question. In your testimony, you make the statement that, given the way Social Security is designed today, benefits will grow faster than the economy, and that there is one little recognized reason for Social Security's financial problem.

In that regard, is the issue not the way the benefit formula provides real increases in initial benefits for new retirees each year based on wage growth? For example, according to Social Security actuaries, after inflation, initial benefits for the average wage earner will double over the next 70 years, from about $7,000 to $22,000. Would you discuss this point further, and if you have any recommendations?

Dr. STEUERLE. Mr. Chairman, what Social Security attempts to do is to have benefits, annual benefits, for the elderly to grow as fast as wages grow in the economy s that if I am 30 percent richer than my parents, I get annual benefits that are 30 percent higher. If my children are 50 percent richer than I am, or wages grow 50 percent, they get 50 percent higher benefits.

At one level, this might sound like a reasonable formula. However, on top of this, the system also has never adjusted for the fact that we live longer, and it never adjusts for the fact that fertility rates change and there would be fewer taxpayers to pay.

So Social Security, on net, is scheduled to always grow faster than the economy, thus always putting pressure eventually in the long run to figure out how you catch up. No matter how many tax increases you have, no matter how many other adjustments along these lines you have, you still always grow faster than the economy.

Again, as I say, it is not unreasonable to say, as wages grow, that future individuals might share in that wage growth. But we do not do it for education. We know that teachers' wages have to grow. We do not do it for military pay. That is the reason you are addressing military pay on a discretionary basis this year, is we do not do it automatically.

When you do things automatically, for this year going forward 10, 50, 100 years in the future, you box in, so to speak, the direction in which government can head. It does not mean you cannot change the formula, but I think doing everything automatically that far into the future adds to this problem of more and more entitlement spending, displacing more and more discretionary spending.

The CHAIRMAN. This question is for all members of the panel. Given all the confusion over the Social Security trust funds, would

it not be better to eliminate the trust fund build-up rather than increasing the build-up as the President proposes, and return Social Security, as I think my colleague proposes, to pay-as-you-go financing?

Dr. GRAMLICH. Well, I will take this one. I know I am going at cross purposes with Senator Moynihan here, but I actually think the build-up is a good thing. We have some bumpy demographics coming on. So what, in effect, was done back in 1983 was to prepare in advance for some of that by raising payroll taxes earlier than was strictly necessary on the benefit side. That did build up——

Senator MOYNIHAN. That was the 1977 decision to go to a partially funded system, when we had put those payroll taxes in place.

Dr. GRAMLICH. All right. I thought some of that was in the 1983 compromise.

Senator MOYNIHAN. Well, we advanced the date in which the previous agreement was made.

Dr. GRAMLICH. Well, in any case, in those years, taxes were raised in advance of benefit growth.

As Senator Moynihan said earlier, it may be that that was not recognized very much at the time, but I think it was a good thing because it did lead to Social Security accumulating assets. It did raise national saving, all the good things that we are all complimenting here.

So that was done in a small way back in the 1970's and 1980's and I think was a good thing. If that had not been done, we would be looking at much sharper payroll taxes now to pay for the benefits.

The CHAIRMAN. Mr. Greenstein?

Mr. GREENSTEIN. If I could add, and I hesitate to comment and possibly misstate some of the intention that Senator Moynihan is far more expert than any of the panel on, but my understanding is, part of the thinking in going to some partial advance funding was that we were supposed to build up national saving with this so that we could have a larger economy that could better afford to meet the boomers' retirement.

If I understand correctly, one of Senator Moynihan's criticisms, quite rightly, over the years was that we were not using the build up to promote national saving, we were spending it on other parts of government. I think he said for years, if we do not stop doing this, I am going to propose that we go to a pay-as-you-go system, and he has now done that.

I am hopeful that, after all these years, Senator, this time we might get it right. I am encouraged that both the administration in its own way, whether one agrees or disagrees with the transfer, and many members of Congress who do not agree with the administration's plan, in their own way are saying, I do not like the President's transfer, but I, too, want to wall off that money so it is only used for Social Security.

If we can really do partial advance funding so it does what it is supposed to do and we do not use the money for the rest of government, then I think that would be the best course to follow. I have some optimism, just in the debate of the last few weeks, that the debate is heading in that direction.

The CHAIRMAN. Mr. Koitz, if I might ask you. Was the trust fund build-up really planned to pay benefits for baby boomers only?

Mr. KOITZ. No. Back in 1983, we had a short-run problem of about $160 billion, 1983 to 1989 or 1990. We had a long-run deficit of about 2 percent of payroll. As Senator Moynihan will clearly recollect, there was a lot of controversy over how to view the problem, what the assumptions should be, how big the problem was. What I think it came down to was, let us deal with the short-run problem on a pessimistic basis. Use pessimistic assumptions to make sure it does not arise again in the next decade.

In the long run, we used average, 75-year estimates. In most of the proposals that were presented to this committee, the Ways and Means Committee, and to Congress in general dealt with how much of that average would be eliminated.

So if raising the retirement age to 67 produced 0.6 or 0.7 percent of payroll savings, it got rid of one-third of the average long-run problem. If taxing benefits generated 0.5 or 0.6, there was another 25 or 30 percent.

That all was done in a very tight schedule. The Greenspan Commission's report came out on January 15 or January 20, and by the end of March, we had a done deal. So a lot of things had to be done in a very short period of time, and the basic goal was to achieve these two objectives.

There was very little attention to the flow of funds, actuarially, on how much revenue we would get in in 2010, or 2030 vis-a-vis the expenditures. The goal was principally, how do we deal with this issue in the simplest way possible to get to a bottom line?

The CHAIRMAN. Senator Moynihan?

Senator MOYNIHAN. Well, first of all, that is exactly my recollection, although my recollection is increasingly decreasing. [Laughter.]

I was struck by a statement by Mr. Greenstein which notes, and I will just read it, "It may be noted that in FY 1998 the cost of Social Security benefits, plus interest payments on the debt, equalled 7.4 percent of GDP."

If you take all the administration projections and so forth and anticipate that the surplus will be saved, that when the baby boom is retired, call that 2030, something like that, the combined debt service and Social Security will still be 7.4.

Mr. GREENSTEIN. Actually, a little under.

Senator MOYNIHAN. A little under. Now, I do not think I have ever heard that.

Could I ask your colleagues how they see that as a possibility? Mr. Koitz?

Mr. KOITZ. Yes. If we got rid of the debt held by the public, there are 3 percentage points right there from where we are now, 3 percent of GDP.

Senator MOYNIHAN. Oh, yes.

Mr. KOITZ. One of the things that I do find troubling in looking at those numbers, however, is that once you get rid of debt held by the public, what do you do with the projected surpluses that the administration proposes or estimates will be there after the year 2013 to 2014? For analytical purposes, they show the government accumulating assets.

Now, I do not know how the government accumulates assets. I do not know what it buys, I do not know what the authority is to buy. But, as a result of accumulating the assets, there is a 2 percentage point of GDP eventual gain to the government, an offsetting receipt, so to speak, that causes a reduction in outlays.

So under their numbers, right there, we are looking at a 5 percent of GDP swing, going from a negative three percent to a positive 2 percent effect for interest.

Then on top of that, there is a long-run revenue gain projected basically raising us from about 19 percent of GDP, all government revenues, up to around 21 or 22, in part due to the built-in bracket creep from indexing the income tax to inflation only and not wages. So I can keep going, but there is 7 percent.

Senator MOYNIHAN. Well, so you agree.

Mr. KOITZ. Yes.

Senator MOYNIHAN. Could you give us——

Mr. KOITZ. I do not agree necessarily with the projections, but I see how they got there.

Senator MOYNIHAN. Yes.

Dr. STEUERLE. May I add to that?

Senator MOYNIHAN. Yes, sir.

Dr. STEUERLE. In the administration's projections, once you move beyond 2010 and the baby boomers start retiring, and I can even show you a chart on this that I did not include in my testimony, but I have done elsewhere. They have discretionary spending essentially declining toward zero.

One way that those interest payments stay so low is not just the saving that they want you to achieve over the near term, when we had this baby bust population from World War II and the Depression era started entering the ranks of the elderly, but that this discretionary side of the budget sort of keeps going toward zero.

The second issue that is raised, and I think it is a fundamental one, is even if we do save adequately in the present, to be able to finance a better future, in terms of what we are doing in terms of the Federal budget, we are putting Social Security on sort of a path where it will sort of have to run a perpetual deficit. That is, when we think the of the debate over having saving today in the unified budget, we are saying, well, Social Security has been running a surplus and the rest of the government has been running a deficit.

But the way a lot of proposals go, we flipped that and we say, well, because we did such a good job of saving today, let us put Social Security, at least in unified budget accounting purposes, on a perpetual deficit financed by these interest payments, and principal payments, in some cases, that have to come in from the rest of the government that have to be collected from income tax payers.

So the one question is, can we afford it if we save more? But a second question is, should we afford it; is that really the type of budget we want to have in the future?

Mr. GREENSTEIN. Could I add a point of clarification?

Senator MOYNIHAN. Sure.

Mr. GREENSTEIN. David Koitz made a very important point. There is an assumption in the administration's calculations of income from interest after the debt is eliminated. I would share the view that that is not a realistic assumption of what I think the po-

litical system will do. But in the numbers we have done, we stopped the interest payments at zero. We did not assume in these.

Again, basically what you have is interest payments are now, I think, just over 2 percent of GDP. If the interest payments go down to about zero we eliminate the debt held by the public, if Social Security goes up by about 2 percent of GDP, the two balance each other. But I think, as everyone on the panel is saying, that is not good enough.

If we do some reforms in Social Security, then it need not go up as much as it would in the calculations that I did here. But even without the reform—again, I am not suggesting no reform—the interest payments in the Social Security about balance each other out, if we are wise enough to get rid of the national debt held by the public.

Senator MOYNIHAN. Dr. Gramlich, you may have the last word.

Dr. GRAMLICH. I agree with the calculations, and I actually agree with everybody's commentary. I have nothing to add.

Senator MOYNIHAN. Well, then I am a lot more cheerful. I think I will get my Social Security because, matter of fact, I am.

Dr. GRAMLICH. Well, before you get too cheerful, there is always the end-date problem with Social Security because we have an aging population that keeps on aging.

So, for example, we have a 75-year tradition in Social Security and one of the things that has been a problem in that is that, as soon as you get past the 75th year, the deficit gets bigger unless we have some reform. So whenever you look at it over a finite date, you are, in a way, understating the problem.

I think that calculation, which I agree with, also understates the problem because we do have to change the trajectory of benefits if we are going to deal with real Social Security reform.

Senator MOYNIHAN. Call it reform.

Dr. GRAMLICH. Real reform.

Senator MOYNIHAN. Yes. Could I just say one last thing? I could not more agree with Dr. Gramlich. But consider the apocalyptic projections with which we have been entertained over the last 15 years, that you cannot do it. You can.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Moynihan.

I want to thank the panel for their very helpful testimony. We will continue to call upon you as we proceed with reform.

The committee is in recess.

[Whereupon, at 12:01 p.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted for the Record

Prepared Statement of Edward M. Gramlich

Mr. Chairman and members of the Committee, I appreciate the opportunity to appear before you today to discuss Social Security reform. I speak for myself, as past chair of the 1994–1996 Quadrennial Advisory Council on Social Security, and not in my current status as a member of the Federal Reserve Board.

As you are all well aware, the U.S. population is aging. Today there are 3.4 workers per retiree; by 2030 it is projected that there will only be two. This fundamental change in the demographics of our population poses a large challenge: how can we provide adequate health and retirement benefits to our retired population, without imposing undue burdens on tomorrows workers?

Clearly, the answer to this question is that we must act now to increase the total amount of resources to be available in the future. By increasing the size of our economy, we can devote a greater share of output to the retired population, without reducing the consumption of the working population. The only way to achieve this critical objective is for us to build up the stock of productive capital by increasing our rate of national saving. Indeed, in the current expansion, investment has expanded at a rapid clip, without inducing a rise in interest rates. This investment boom, and the accompanying step-up in the growth of the capital stock, is partly attributable to an increased rate of national saving. Between 1992 and 1998, national saving increased from 3.7 percent to 7.5 percent of net national product. While private and state and local government saving actually dipped during this period, this decline was more than offset by increased saving by the federal government through deficit reduction.

The stellar performance of the economy over recent years provides the nation a unique opportunity to begin to tackle its long-run problems. In particular, the large budget surpluses that are projected over the next 15 years or so, if they are permitted to materialize, will significantly improve our fiscal and economic position as the baby boom starts to retire. From the governments perspective, using those surpluses to pay down the federal debt will reduce future interest payments and free up future tax revenue; from the macroeconomic perspective, the increase in national saving represented by the increase in government saving will lead to a larger capital stock, higher productivity, and an improved standard of living.

From this standpoint, the broad objective of the Clinton Administrations budget—that is, to preserve most of the projected surpluses—seems to me both responsible and appropriate. The Administration would devote about $1.4 trillion of the projected $4.9 trillion of current law surpluses over the next 15 years to new spending, and use the remainder to pay down our national debt. According to the Administration's calculations, the ratio of debt held by the public to GDP would fall from its current 44 percent to 7 percent by 2014. If such an outcome were to materialize, it would represent a dramatic improvement in the fiscal position of the nation.

Under current law, the Social Security revenues exceed outlays, creating surpluses that are credited to the Social Security trust fund. Without any legislative changes, the Social Security trust fund will continue to accumulate funds, reaching a peak in 2020 of $3.8 trillion, or almost 16 percent of GDP. These surpluses both reduce the national debt and improve the long run fiscal condition of Social Security. This claim does not stem from any accounting gimmickry: By reducing future interest payments, these surpluses do indeed free up future revenues.

In addition to this accumulation already scheduled under current law, the Administration is also proposing to transfer an additional $2.8 trillion of general revenues to the Social Security trust fund. While the Administration's rationale for these

transfers is to ensure that the surpluses actually materialize, the transfer of general revenues represents a major shift from past practice, under which Social Security has been financed almost entirely from dedicated payroll taxes.

During the deliberations of the 1994–1996 Social Security Advisory Commission, we considered whether general revenues should be used to help shore up the Social Security program. This idea was unanimously rejected, for a number of reasons. First, using general revenues to fund Social Security puts the Social Security system in competition with other spending programs during the budget cycle. But Social Security is a long-range program—people pay dedicated taxes today toward benefits that may not be received for 30 or 40 years—and many feel that it should not be part of an annual budgetary allocation process.

Perhaps more importantly, using general revenues to fund Social Security undermines the fiscal discipline imposed by the need to ensure that income earmarked for Social Security is sufficient to meet the entire cost of the program, both in the short run and long run. Without a long-range budget constraint on Social Security, it will be much more difficult to limit future benefit growth. And, notwithstanding the large surpluses being projected, some reductions in benefits are almost certain to be necessary as the U.S. population ages.

It is important to remember that the aging of the population will bring pressures to programs other than Social Security. The trustees of the Medicare trust fund project that Medicare expenditures as a share of GDP will more than double—from 2.7 percent today, to over 5.8 percent in 2030, and Medicaid spending on long-term care likely will face similar increases. Because under the current budget system, Medicare Part B and Medicaid are financed with general revenues, there is much less pressure to take measures now to improve their long-run financing. But these programs too will put significant demands on government resources in the future. If we use the projected surpluses as a rationale for not making hard choices in Social Security, finding the resources to provide Medicare and Medicaid to our aging population will prove that much harder.

Thus, there are serious drawbacks to relaxing Social Security's long run budget constraint through general revenue transfers. I would prefer Social Security reforms that maintain the link between dedicated taxes and benefits, and maintain the value of long-range actuarial analysis. This discipline is essential if we are to limit the impending explosion of entitlement spending. The President's budget proposal, by preserving future surpluses and paying down our national debt, makes an important contribution to raising national saving. But to me the proposal looks even better without the general revenue transfer.

PREPARED STATEMENT OF SENATOR CHARLES E. GRASSLEY

Thank you Mr. Chairman. I would like to thank you for convening this hearing so that the Finance Committee can gather the information we need to make sound decisions about the future of such an important program. The President's proposal is not easy to comprehend. That seems to be par for the course when it comes to Social Security financing. I can give a pretty good explanation of how trust fund accounting works when I hold meetings back in Iowa but my constituents still think that money is stolen from the trust fund. The President's proposal doesn't help matters at all.

Although you need to negotiate a couple of hairpin turns in the road to discover it, what is clear about the President's proposal is that he wants to use most of the off-budget surplus to pay down the debt. I like that part of the plan. So do many of my Republican colleagues. What I don't like is saying that the President's proposal to spend an additional $1.7 trillion on new programs is prudent, but a tax cut is not.

By focusing on the Social Security financing issues that are implicated by the President's proposal, I hope we will clarify a number of issues. First, I hope we can focus on the date of 2013—the date cash flow for Social Security goes negative, according to the 1998 Trustees report. While we may see an improvement in that date as our economy continues to perform well, this is the date general revenue financing becomes a very real possibility. Will our witnesses agree with the President that we should simply resort to increased government borrowing to meet our commitments?

Second, I think it's important that we put a historical context on the reason that Congress has avoided using general revenues to finance Social Security. Why? Because the program's benefits are tied to the earmarked payroll taxes that workers pay. We need to look at options which will build support for Social Security. Relying on general revenues for financing will further diminish one of the most important principles of Social Security.

I look forward to our witnesses' testimony and thank them for being here.

PREPARED STATEMENT OF ROBERT GREENSTEIN

I appreciate your invitation to testify on the subject of general revenue financing of Social Security. I am Robert Greenstein, executive director of the Center on Budget and Policy Priorities. The Center is a nonpartisan, nonprofit policy institute that conducts research and analysis on a wide range of issues with particular emphasis on fiscal policy and on issues affecting low- and moderate-income families. We are primarily funded by foundations and receive no federal funding.

The question of whether Social Security should be partly funded with general revenue contributions is an important one. Several types of general revenue contributions to Social Security already exist, including funds transferred from general revenues to reflect the partial taxation of Social Security benefits. So the issue is not entirely new. On the other hand, the President's budget proposes significantly larger general revenue transfers than have existed until now.

In the past 10 days, the issue of whether to make general revenue transfers has become enmeshed with a debate over whether the Administration's proposed revenue transfer rests on an illegitimate double-counting of funds. This is unfortunate, as it is diverting the debate from the serious policy issues the proposed general revenue transfers raise and leading to a focus on much less important technical accounting issues.

So, let me briefly try to set the double-counting issue to the side so as to get to the more serious issues. What has been called double-counting in the President's budget is essentially unified budget accounting, a practice the federal budget has followed for many years. Under unified budget accounting, the Treasury takes the surplus payroll tax revenues the Social Security trust fund is receiving each year and provides the trust fund with Treasury bonds in return. The Treasury then uses the borrowed cash to fund other government operations.

In a sense, these funds show up in the budget twice—once as Treasury bonds provided to the trust fund and a second time as expenditures for other government programs. (The tax bill that the House passed last summer followed a similar course, except that surplus Social Security revenues would have been used to finance a tax cut rather than other government operations.)

The Administration's proposal follows along similar lines. The Treasury would borrow the surplus Social Security payroll tax receipts and provide the trust fund with Treasury bonds in return. The only new element is that instead of using the borrowed money to fund other government programs or finance tax cuts, the funds would be put back in the Social Security trust fund and used primarily to buy more bonds for the fund.

All of these approaches entail borrowing funds from the Social Security surplus, crediting the trust fund for the borrowed funds by issuing Treasury bonds, and using the borrowed funds for a second purpose. That under the Administration's proposal the second use is Social Security rather than another government program or a tax cut does not alter the basic nature of the transaction. If one wants to consider this double-counting, then every budget passed for years—including budgets proposed and approved by Presidents and Congresses of both parties—have used "double-counting." In all of these budgets, Social Security surpluses were credited to Social Security and also borrowed and used to fund other government operations.

What has led to confusion regarding the Administration's proposal is that in this case, the "second use" of the funds is the same as the first use, namely Social Security. But borrowing funds from the Social Security trust fund in return for Treasury bonds and using the borrowed funds is essentially the same transaction regardless of how the borrowed funds are used and whether they are designated for support of Social Security, another program, or a tax cut. (In fact, placing the borrowed funds in Social Security reserves rather than spending them on other programs or tax cuts should be a more benign use of the borrowed funds, since it does not reduce national saving or prevent the borrowed funds from being used to pay down publicly-held debt, as such other uses of the borrowed funds would do.)

In short, the issue isn't double-counting. It is whether a substantial transfer of general income to the Social Security trust fund, such as that the Administration has proposed, represents good policy.

IS THERE JUSTIFICATION FOR GENERAL REVENUE TRANSFERS?

I believe the answer to this question is that there is justification for transfers, but not on an unlimited basis.

- In Social Security's early years, its designers faced a difficult question—should those already retired or nearing retirement age be able to receive benefits? Since the program was in its infancy, these individuals contributed little or nothing to Social Security during their working years. But many of them, including workers who had endured the Depression and fought for the nation in World War I would otherwise face poverty in old age.

Policymakers of that era made the humane decision; they decided to provide, rather than deny, Social Security to these individuals. That decision meant Social Security would primarily be a pay-as-you-go system, with current payroll tax revenues used to fund the benefits of current retirees, rather than a pre-funded system. The establishment of Social Security largely as a pay-as-you-go system also meant these would be an unfunded liability and that when a demographically large generation retired, such as the baby boom generation, financial pressures on the pay-as-you-go system would intensify.

The decision made 60 years ago to provide benefits to retirees of that era who had not paid much into the Social Security system provides a strong justification for a limited-duration infusion of general fund revenue into Social Security today. It makes sense to "reimburse" the Social Security system in some form for bearing the costs of providing benefits to earlier generations of beneficiaries who had paid little into the system because the system was new. That early decision is one of the reasons Social Security faces insolvency in the decades ahead. A general fund transfer of this nature would help reduce the unfunded liability.

- Social Security surpluses are now adding substantially to national saving. Because Social Security is able to purchase so many Treasury bonds, other investors can hold fewer bonds and invest more money in equities, securing the higher average rates of return that equities provide. Robert Reischauer and Henry Aaron of the Brookings Institution have suggested that because Social Security is adding to national saving in this manner, the trust fund should be able to receive its fair share of the higher rates of return that equities provide. They propose this be done by diversifying the trust fund's investments and ultimately placing up to half of trust-fund reserves in equities. This is roughly the same share of reserves as are placed in equities by corporate pension plans and state and local public employee pension funds. The Administration's proposal is much more cautious, placing about 15 percent of trust funds reserves in equities.

To the extent that policymakers are not willing to invest up to 50 percent of trust fund reserves in equities, there is a strong case for a general revenue transfers to compensate the trust fund for the lost income. To the extent that Social Security is artificially confined to lower returns by being restricted to investment in lower-yielding Treasury bonds—and private investors are able to secure higher returns—general revenue collections will be higher, since investors will pay taxes on the higher returns they secure. A case can be made for transferring a portion of these added general revenues to Social Security.

- If Social Security reserves are saved rather than borrowed and consumed, they will help pay down the debt and add substantially to national saving. Treasury estimates are that the national saving rate would rise significantly under the Administration's plan. That should promote somewhat stronger economic growth. Martin Feldstein and Senator Gramm have argued that the increased saving they estimate their Social Security plans would generate would result in increased corporate income tax revenues. If this is true for their plans, it also would be true for the Administration's. A case can be made that the Social Security trust funds should share, through a general revenue transfer, in the benefits of the stronger economic growth and increased tax revenues made possible by saving the Social Security surpluses.
- Finally, the Administration has said the general revenue transfer it is proposing would be structured in such a way as to "lock-up" budget surpluses so they are saved and used primarily to pay down debt, rather than being available to be consumed by program expansions or tax reductions. Accomplishing this requires a budget process change so the transfers are "scored" as expenditures and placed in a lock-box. (The details on this aspect of the Administration's proposal have not yet been provided.)

CONCERNS WITH GENERAL REVENUE TRANSFERS

Having said this, there also is a significant concern—there could be a temptation to rely largely or entirely on general revenue transfers to close Social Security's funding gap.

I believe this would be unwise. If little or no change is made in the Social Security benefits-and-tax structure to help close its long-term financing gap—and if the gap is closed solely through general fund transfers—the gap in future decades between benefit costs and payroll tax revenues will be too large. The consequent burden on the rest of the budget will be too great. This would not be a prudent course.

I also am concerned by what would occur if Congress were to adopt the part of the President's plan that calls for general fund transfers, but Congress and the President failed to close the other half of Social Security's long-term financing gap through changes in the Social Security benefit-and-tax structure, as the President proposed be done on a bipartisan basis. If we do only the transfer, the gap between benefits and payroll tax revenues will be too great in the 2030's and 2040's, and insolvency will hit in 2055. In my view, the Administration's proposed transfer makes sense in conjunction with structural changes to close the other half of the gap. If the needed structural changes are made, the trust funds will not need to cash in as many Treasury bonds in the 2030's, 2040's and beyond, and the burden on the rest of the government will be much more bearable, especially in light of the substantial anticipated budgetary savings on interest payments on the debt. (In FY 1998, the cost of Social Security benefits plus net interest payments on the debt equaled 7.4 percent of GDP. If we save most of the surplus, interest costs will decline to such a degree that under the Administration's plan, the combined costs of Social Security and net interest payments are projected to remain below 7.4 percent of GDP when the baby boom generation is retired.)

I would note that just as trying to close all of the gap through general fund transfers would be unwise and structural changes are needed, closing the gap mostly or entirely through benefits reductions appears too harsh. Aaron and Reischauer have noted that Social Security benefit levels are more modest than is sometimes appreciated. They note that "A worker retiring in 1996 after a lifetime of year-round work at the minimum wage received a [Social Security benefit] that was slightly under the poverty threshold for a single person; a minimum-wage married retiree received a benefit that was just above the poverty threshold for a couple. Benefits of average earners are less than 1.5 times the poverty threshold if they start drawing benefits at age 65, and are only 16 percent over the poverty threshold if they start benefits at age 62."[1] Aaron and Reischauer also note that for workers with average earnings, the portion of earnings that Social Security benefits replace is less than two-thirds the portion of earnings that is replaced in the French, Dutch, Belgian, Italian, German, and Spanish systems.

Combining a temporary general revenue transfer with structural changes to close the other half of the 75-year gap and keep Social Security solvent after that would strike an appropriate balance.

Finally, we need to maintain the trust fund aspect of Social Security, with a dedicated funding mechanism. Trust fund accounting is important. If we did not have the actuarial estimates projecting an imbalance between trust fund income and trust fund expenditures 33 years from now, we probably would not be having this debate today.

COURSES OF ACTION

This suggests several courses of action.

- Consider closing up to half of the current long-term financing gap through general revenue transfers, but not much more than that. It would be preferable if these transfers are temporary, rather than permanent.
- General revenue transfers ought to be accompanied by structural changes and perhaps used as incentives or inducements to get agreement on structural changes (e.g., you get a dollar or some other amount in transfers for each dollar in structural change). I would like to see transfers used in a way that enhances the political system's ability also to make structural changes. Transfers should be in addition to structural changes, not instead of making any structural changes.
- General rules should probably be developed to set parameters on the size of general fund transfers allowed. For example, to the extent that such transfers do not come from on-budget surpluses, they might be limited to the amounts needed to compensate the trust fund for losses due to the investment of less than 50 percent of Social Security reserves in equities. An exception to this limitation is that if and when sufficient progress is made in restoring Medicare solvency, it would be appropriate to transfer to the Social Security trust fund the

[1] Henry J. Aaron and Robert D. Reischauer, *Countdown to Reform: The Great Social Security Debate*, pp. 93–94.

portion of revenues from the taxation of Social Security benefits that is currently deposited in the Medicare trust fund.

- To enhance fiscal discipline and apply pressure for necessary Social Security reforms, the current pay-as-you-go rules should be maintained until Social Security is in long-term (i.e., 75-year) balance. These rules should be lifted when 75-year balance is secured to the extent there is an on-budget surplus.

We also would like to see the Senate adopt section 13302 of the Budget Act, which now applies only to the House. This rule says that any bill or amendment that weakens the solvency of the Social Security trust fund on a 5-year or 25-year basis should not be considered. (The Senate has an alternative procedure that makes this rule operative for 10 years, but not 75 years.) This rule could be designed to create a point of order against legislation that would violate the rule, with the votes of 60 Senators required to waive the point of order.

CONCLUSION

The goals of saving rather than consuming most of the surplus, paying down the debt, building national saving, and shoring up Social Security for the long term are the most important domestic policy goals we can pursue. The Administration has designed a plan that uses general revenue transfers as an integral part of advancing these goals; these transfers would be used as part of a plan designed to help ensure surpluses are saved rather than spent and to help shore up Social Security. Overall, the plan would use 77 percent of the unified budget surplus to pay down the debt held by the public or otherwise improve the government's assets-and-liabilities position. It would devote more than 80 percent of the unified budget surplus to building saving rather than for current consumption.

I believe this is a sound course to follow. If we follow this course, we will need to place appropriate limits on the use of general fund transfers so we do not rely on them excessively, and we will need to marry general revenue transfers to structural changes.

PREPARED STATEMENT OF DAVID KOITZ

Chairman Roth and Members of the Committee, I was asked to provide you with an overview of the nature and operations of the Social Security trust funds.

WHERE DO SURPLUS SOCIAL SECURITY TAXES GO?

The costs of the Social Security program, both its benefits and administrative expenses, are largely financed by taxes on wages and self-employment income, commonly referred to as FICA and SECA taxes. Contrary to popular belief, these taxes are not deposited into the Social Security trust funds. They flow each day into thousands of depository accounts maintained by the government with financial institutions across the country. Along with many other forms of revenues, these taxes become part of the government's operating cash pool, or what is more commonly referred to as the U.S. treasury. In effect, once these taxes are received, they become indistinguishable from other monies the government takes in. They are accounted for separately through the issuance of federal securities to the Social Security trust funds—which basically involves a series of bookkeeping entries by the Treasury Department—but the trust funds themselves do not receive or hold money.[1] They are simply accounts. Similarly, benefits are not paid from the trust funds, but from the treasury. As the checks are paid, securities of an equivalent value are removed from the trust funds.

DOES THIS MEAN THAT THE GOVERNMENT BORROWS SURPLUS SOCIAL SECURITY TAXES?

Yes. When more Social Security taxes are received than spent, the money does not sit idle in the treasury, but is used to finance other operations of the government. The surplus is then reflected in a higher balance of federal securities being posted to the trust funds. These securities, like those sold to the public, are legal obligations of the government. Simply put, the balances of the Social Security trust funds represent what the government has borrowed from the Social Security system (plus interest). Like those of a bank account, the balances represent a promise that if needed to pay Social Security benefits, the government will obtain resources in the future equal to the value of the securities.

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[1] P.L. 103-296 requires the Secretary of the Treasury to issue "physical documents in the form of bonds, notes, or certificates of indebtedness for all outstanding Social Security Trust Fund obligations." Under prior practice, trust fund securities were recorded electronically.

ARE THE FEDERAL SECURITIES ISSUED TO THE TRUST FUNDS THE SAME SORT OF FINANCIAL ASSETS THAT INDIVIDUALS AND OTHER ENTITIES BUY?

Yes. While generally the securities issued to the trust funds are not marketable, i.e., they are issued exclusively to the trust funds, they do earn interest at market rates, have specific maturity dates, and by law represent obligations of the U.S. government. What often confuses people is that they see these securities as assets for the government. When an individual buys a government bond, he or she has established a financial claim against the government. When the government issues a security to one of its own accounts, it hasn't purchased anything or established a claim against some other person or entity. It is simply creating an IOU from one of its accounts to another. Hence, the building up of federal securities in federal trust funds—like those of Social Security—is not a means in and of itself for the government to accumulate assets. It certainly establishes claims against the government for the Social Security system, but the Social Security system is part of the government. Those claims are not resources that the government has at its disposal to pay future Social Security benefits.

WHAT THEN IS THE PURPOSE OF THE TRUST FUNDS?

Generally speaking, the federal securities issued to any federal trust fund represent "permission to spend." As long as a trust fund has a balance of securities posted to it, the Treasury Department has legal authority to keep issuing checks for the program. In a sense, the mechanics of a federal trust fund are similar to those of a bank account. The bank takes in a depositor's money, credits the amount to the depositor's account, and then loans it out. As long as the account shows a positive balance, the depositor can write checks that the bank must honor. In Social Security's case, its taxes flow into the treasury, and its trust funds are credited with federal securities. The government then uses the money to meet whatever expenses are pending at the time. The fact that this money is not set aside for Social Security purposes does not dismiss the government's responsibility to honor the trust funds' account balances. As long as those funds show balances, the Treasury Department must continue to issue Social Security checks. The key point is that the trust funds themselves do not hold financial resources to pay benefits—rather, they provide authority for the Treasury Department to use whatever money it has on hand to pay them. If the Treasury lacks the resources to meet these claims, it must borrow them, or alternatively, Congress would have to enact legislation to raise revenue or cut spending.

The significance of having trust funds for Social Security is that they represent a long-term commitment of the government to the program. While the funds do not hold "resources" that the government can call on to pay Social Security benefits, the balances of federal securities posted to them represent and have served as financial claims against the government—claims on which the Treasury has never defaulted, nor used directly as a basis to finance anything but Social Security expenditures.

PREPARED STATEMENT OF SENATOR CONNIE MACK

Mr. Chairman, I want to thank you for holding this hearing. I'm particularly pleased to see Mr. Watkins before us today. I've known David for a number of years now and am completely confident that he will do an excellent job as comptroller general of the GAO.

Social Security is an extremely important issue for Congress to tackle in a serious, thoughtful, and bipartisan manner. We need to strengthen and secure Social Security so that our children and our grandchildren can enjoy the same retirement security that we have. That means putting aside the chance to score partisan political points and focusing on changes that would make a real difference in people's lives.

I was disappointed to see that the President's budget offered no specific plan to make sure Social Security is around for future generations. Instead, in my view, the Administration has given us an accounting gimmick that shirks the need to make tough choices.

This is how I understand the President's plan.

- He starts out with a unified surplus of 4.5 trillion dollars over the next 15 years—2.3 trillion of which is already part of the Social Security surplus.
- He takes the 4.5 trillion and spends 1.2 trillion. That leaves us with 3.3 trillion.
- He takes another 500 billion and says he would start USA retirement accounts. That leaves us with 2.8 trillion dollars.
- He then says he would take all of this 2.8 trillion and dedicate it to the Social Security trust fund.

But there's one big problem: 2.3 trillion of this is already supposed to be going to the trust fund. Basically, the President seems to be promising to pay Social Security with money that already belongs to Social Security.

We all know that a big part of future surpluses should be used to help fix Social Security. But using accounting gimmicks doesn't fix anything. It still leaves future taxpayers having to bear a burden they did not create. Polls show that many Americans think they're never going to get any Social Security paychecks. The President's gimmick isn't going to help.

On the other hand, I was glad to see the President leave the door open to using personal retirement accounts. Personal accounts would be real and tangible and would give all working Americans a greater sense of financial security. Hopefully we can work with the administration to craft a solution to Social Security that would ensure future generations get a system they can all have faith in.

I am pleased to see that we have a number of knowledgeable witnesses here today. I'm very interested in hearing their views on this critical issue and whether there is any merit to the President's plan.

PREPARED STATEMENT OF HON. WILLIAM V. ROTH, JR.

Today the Committee will hear testimony about the President's proposals to improve Social Security long-term finances.

Social Security is a vitally important program for most Americans. Over 44 million of our fellow citizens receive monthly benefits—retired and disabled workers and their families, and the families of workers who have died. Indeed, at some point in their lives, most Americans will receive a check from Social Security.

But, as is well known, Social Security has serious financial problems in the future. In about 14 years—in 2013—annual Social Security revenues will no longer cover benefit payments, and the program will need to call upon its Trust Funds.

Last year, the President brought Social Security's financial problems to the nation's attention, and promised to lead legislative action this year. On January 19th, in his State of the Union Address, the President proposed transferring $2.8 trillion of the projected budget surplus over the next 15 years to fix Social Security's financial problems through 2055. Of the $2.8 trillion, $2.1 trillion would be deposited in Social Security's Trust Funds, extending their life to 2050.

The President's proposals are very complex, and link paying off the current public debt to enabling the Federal government to pay Social Security benefits through 2050.

The President's proposals would represent a major change in Social Security financing. From the beginning, Social Security has been funded with a dedicated payroll tax. Workers "earn" benefits based on payroll tax contributions. General revenues have not been a significant source of financing. The Committee will need to understand the implications of this proposed change in financing policy.

Although the President has not yet submitted a bill that would permit a definitive analysis of his proposals, today's hearing expresses the Committee's commitment to act both thoughtfully and expeditiously. Saving Social Security is a big job, and the sooner we start, the better.

Let me also note that this Committee intends to work with the President on a bipartisan basis to strengthen Social Security for the long term. It is all of our responsibility to preserve and protect Social Security for our children and grandchildren.

Because the President's proposals are complicated, last week I wrote to David Walker, head of the General Accounting Office, asking that GAO analyze the President's proposals and that Mr. Walker testify before the Committee today.

In addition to providing an overall evaluation, GAO was asked to address two specific issues. First, GAO was requested to clarify the President's accounting methods in using budget surpluses for Social Security. A number of analysts, including Harvard Professor Martin Feldstein, who is also a former head of the White House Council of Economic Advisors, believe the President "double counts" or uses the Social Security surplus twice. Mr. Walker will describe this issue further.

Second, accounting methods aside, does the President's proposal actually help solve Social Security's long-term financial challenges? According to Secretary Rubin, who recently testified before this Committee, the President's proposal would give Social Security first claim on Federal budgets through 2055. What does this mean for Social Security and for the rest of the government?

Senator Moynihan, would you like to make a statement before we turn to this morning's witnesses?

[MOYNIHAN STATEMENT]

Thank you, Senator Moynihan. I encourage other members to submit their testimony for the record.

PREPARED STATEMENT OF C. EUGENE STEUERLE

Mr. Chairman and Members of the Committee:

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

I do not believe this legacy is intended. Yet it would come about under current law, under the President's proposals, and under many of the Republican and Democratic budget alternatives now being considered in Congress. It is largely the consequence of laws written decades ago that are determining almost all of the spending priorities of future generations. In particular, it is the consequence of designing Social Security benefits (as well as health benefits for the elderly) so that they forever grow faster than the economy, without regard to changes in fertility and mortality rates that determine the numbers of taxpayers and beneficiaries (see figure). In the presence of such unsustainable growth, the greatest difficulty with today's budget policy is not whether either the surplus or revenues are too large or too small in the short or intermediate term, but that the law itself would deny to posterity both the right and the privilege to decide for itself the priorities and needs facing the nation.

The simple fact is that general revenue financing of benefits does not in any way change the scheduled growth in commitments to programs for the elderly and near-elderly. General revenue financing, standing by itself, can even detract attention from the more important issue of how the structure of Social Security benefits relates to the true needs of society.

ISSUES RAISED BY GENERAL REVENUE FINANCING

In theory, general revenue financing is an issue more of political economy than pure economics. General revenue financing puts on the table several very important questions:

- First, would it add to real assets held by the government or simply to a pretense that Social Security holds onto real assets? Would it hide how obligations still must be covered by future taxpayers? Would that make reform easier or harder?

  My own assessment is an additional transfer from the government's left hand (Treasury) to its right hand (Social Security)—over and above any surplus accruing between taxes and benefits—tends to mask too much. The simple fact is that future taxpayers must cover the cost of the interest and principal on any gift of bonds from Treasury to Social Security.
- Second, do new sources of general revenue financing lay bare the fact that programs for the elderly, including Social Security, have always relied in part upon general revenue financing? If so, what does it mean when trust funds temporarily run surpluses?

  Programs for the elderly have often had general revenue fixes. These include: the financing of Part B of Medicare out of general revenues; the transfer at times of benefits from Medicare Part A to Part B so that Part A appears more solvent; the expansion of long-term care for the elderly within Medicaid (or, as the President proposes, with income tax credits) rather than as part of a broader reform of the health care benefit package offered as a whole to the elderly; the use of SSI to pay for some transfers to low-income retirees even though other large transfers occur within Social Security; the income tax exemption for one-half of Social Security taxes paid; and the simultaneous transfer to Social Security of income taxes paid on benefits on the basis of a very generous formula. Considered as a whole, programs for the elderly have always run substantial deficits if benefits were to be compared to Social Security taxes paid.

- Third, and closely related, did the tie between taxes and benefits, as reflected in the concept of trust fund balances, act as a constraint on the system and prevent deficit financing? Whether or not it acted as a break in the past, would severance of this break reduce or eliminate one of mechanisms that tends to force elected officials to deal with imbalances between benefits and taxes?

  In general the tie between taxes and benefits has acted as a modest past constraint on growth, sometimes forcing action, as in 1983. It has also kept taxes and benefits somewhat in balance. On the other hand, the expansion in general revenue financing of elderly programs as a whole probably has forced wage earners on average to pay something like 20 percent of wages to support elderly programs, rather than the supposed 15.3 percent Social Security tax rate. As for the future, it appears that the current willingness to tackle Social Security's problems is based in part on trust fund imbalances projected under current law; these imbalances would appear less severe with a general revenue transfer.

- Fourth, does general revenue financing break the relationship between benefits and taxes on earnings, so that the public comes to view Social Security more as a transfer program than a social insurance program? Would such a change invite means testing and would that be a good thing for elderly programs?

  The more formal introduction of general revenue financing could shift public sentiment toward viewing the system as a transfer program. Already the Administration is saying that some of the remaining imbalances in Social Security (and Medicare) could be met by further gifts of bonds from Treasury beyond what they have proposed. Hence it suggests that the general revenue financing door can be opened even further by this or later Congresses. Although I have written elsewhere that one might easily justify flattening the benefit structure in Social Security, especially in exchange for subsidies for saving, means testing is another matter. Means testing of a substantial portion of the elderly population could be considered degrading, and means testing is highly inaccurate given the ability to shift assets to children or simply hide them. Means testing also severely discourages saving for retirement.

- Fifth, would general revenue financing open up consideration of the appropriate tax base to support old age programs—wage taxes, income taxes, or consumption taxes? Would the outcome of that debate lead to a better or worse Social Security system? A better or worse tax system?

  This is an open question. Certainly a case can be made for consumption taxation vis-a-vis wage taxation if, as projected, we continue on a path where larger and larger portions of Social Security and Medicare recipients consume at higher rates than many of the workers who pay for those benefits. By the same token, it is doubtful as a matter of simplicity—yes, there are a few of us left who care about simplicity—that one would want to add yet another tax system onto the ones we already have.

- Sixth, would the transition to general revenue financing be done in a way that might encourage more short-run saving by government?

  This is the principal argument used by the Administration. In its own proposal, success depends upon the crafting of legislation that somehow would count transfers of bonds and interest to Social Security as an outflow for purposes of some new unified budget deficit accounting, but then turn around and not count the inflow of bonds to Social Security as income for the same set of books. I have serious doubts as a matter of accounting practice that this hoped-for constraint can be achieved, and, if achieved, that it can be made to constrain future politicians. Nothing stops someone from looking at the current unified budget deficit, which is useful for a variety of purposes, not the least of which is to understand the flow of demand for borrowing from the public.

  The confusion that reigns over the Administration proposal, however, does not mean that short-run saving still might not be enhanced. In fact, the Administration has made a good case not to deplete very much of the current surplus. Its proposal to subsidize USA accounts also attempts to encourage some saving relative to alternative budget uses.

  We must also distinguish between the short-run political fight over what this Congress might do with the longer-run issue of how future Presidents and Congresses might be constrained. The Administration really doesn't propose to save the non-Social Security surplus over the short-run, but rather somehow to put future Presidents and Congresses under a new pay-as-you-go rule where they have few choices as to how to spend the additional revenues that taxpayers will be paying and the temporary surpluses that they would see under today's unified budget accounts. In fairness, a number of tax cut proposals would also tend to lock in future elected representatives as well.

- Finally, would general revenue financing be used to finance the transition to a new system? That is, would it be one means of dealing with the political pain (not necessarily the economic pain) borne by those sometimes identified as the "transition" generation—the ones who would be called upon both the save more to cover their own benefits and to cover the benefits of those whose Social Security taxes have already been spent.

 The Administration does not really come up with a structural reform that might achieve this purpose. But it has thrown on the table the possibility of using general revenues to meet these ends. This is reflected partly in the amount of the non-Social Security surplus that it would try to make future Congresses save. It is also reflected partly in the USA account proposal, although no structural offset of any type is suggested—even a modest cutback in Social Security benefits for non-poor recipients in exchange for their new USA account subsidy.

SUMMARY

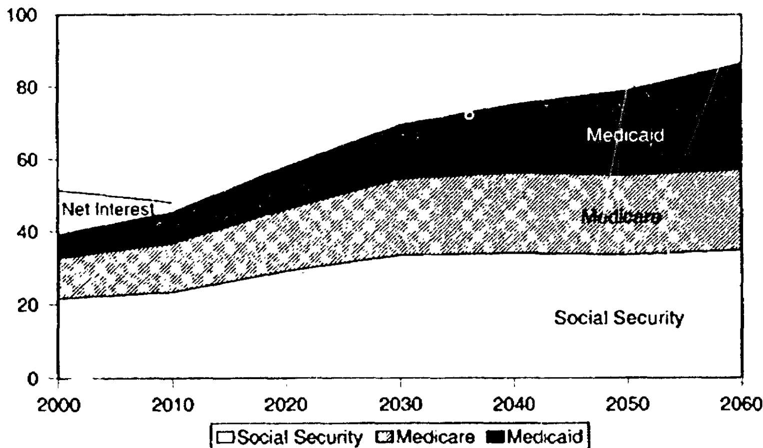
In summary, we have only begun our journey toward a domestic policy in which our children are allowed some choice as to what their government will do to meet their own needs and those of their children. Getting our budget into surplus after years of large deficits has been a positive development. However, obligating the children of today to pay almost all of their future federal taxes as transfers to support the consumption of their parents is a recipe neither for citizen-led government nor for economic growth. The size of the deficit or surplus has never been more than a symptom of the disease from which we suffer, and excessive attention to that number has detracted from dealing with the longer-term direction of policy.

Done the right way, the infusion of some general revenues into a Social Security reform package might help deal with some of the political pain. Certainly more saving by government—or limited reduction in projected surpluses—is a prudent move. Development of the USA account, just like other individual account proposals, offers the prospect of addressing the very poor distribution of private pension wealth in society.

Nonetheless, direct general revenue financing of Social Security might reduce the willingness to deal with our long-term problems and could raise a whole series of other debates such as whether to means-test Social Security benefits. It is also unclear how an obscure form of budget accounting, even if it passed this Congress, could be placed off-bounds for re-consideration by future Presidents and Congresses.

Federal Expenditures as a Percentage of Revenue

Long-Run Budget Projections of Clinton's 2000 Budget Policy



Source. The Urban Institute, 1999 Based on the Budget of the United States Government, FY 2000.
Note: Net interest not shown after 2010.

APPENDIX 1

The Nature of Future Obligations

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

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

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

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

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

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

APPENDIX 2

economic perspective

by Gene Steuerle

'Spending' the Surplus: Counting the Ways

In his State of the Union address, President Clinton proposed that "62 percent" of the surplus be spent on social security, that another share be allocated to Medicare, and that the remaining share be spent on other items, including a subsidy for new private pension accounts. When the administration subsequently tried to translate those portions into numbers, confusion reigned. Almost no one outside the administration initially could figure out how to get the numbers to add up. It takes a complete set of accounts to reconcile the various statements that are being made and why they are so confusing (see table on the next page).

The bottom line is that the president's proposals allocate more than 100 percent of the total unified budget surplus — a surplus that encompasses both the social security and the non-social security budgets. Never stated explicitly by the administration is that its suggestion would convert the non-social security budget from a surplus into a deficit. Yet because so much of that new non-social security deficit would be caused by an internal governmental transfer to social security, the proposal still would retain close to three-fourths of the unified budget surplus.

> ***Still confused? Join the crowd! What complicates matters is that social security itself is scheduled to run a surplus.***

Still confused? Join the crowd! What complicates matters is that social security itself is scheduled to run a surplus. Its own surplus is already about 56 percent of the total unified budget surplus expected over the next 15 years. That is, under current law social security would run a surplus of about $2.7 trillion over the next 15 years, while the combined unified budget surplus would be $4.8 trillion (see "current law" column of the table). If social security merely held onto its own surplus, then, it would seem as if the president's goal could almost be reached. Perhaps another $100 million to $300 million or so would be needed to achieve the 62 percent target, but that is all. Right? No, wrong! The president suggested making an *additional* transfer from Treasury to the Social Security Administration of $2.8 trillion or $2.7 trillion (the administration has used both numbers, but, while confusing matters further, it makes little difference to our story).

Now think about it. If social security already has about three-fifths of the combined surplus, and if it is allocated another three-fifths of the surplus, then doesn't the total add up to about 120 percent of the entire surplus — social security and non-social security together? That is correct, and that helps explain the confusion.

How, then, can one reconcile the accounts? Essentially, the administration has proposed to run a non-social security deficit of about $2 trillion to be able to finance both the additional transfer to social security and its other spending and tax proposals. Put another way, the non-social security surplus over the next 15 years would be about $2.1 trillion under current law. The administration has proposed allocating $2.8 trillion to social security and $1.3 trillion to other spending and tax proposals. That $4.1 trillion debit to Treasury's non-social security accounts would require that they run a $2 trillion deficit.

Now return to the unified budget measure that counts both the social security and the non-social security accounts together. In that broader set of accounts, all of the accounting transfers are a wash. Social security gets a credit, the rest of government gets a debit. Medicare also gets a credit, which is matched by a recording of additional debt on Treasury's books. The total surplus is reduced only by actual changes in spending and taxes, suggested by the administration to equal $1.3 trillion. Hence the unified budget surplus would still be reduced from only $4.8 trillion to $3.5 trillion.

From the administration's perspective, these various accounting shifts — and the claim of having "spent" the surplus on social security and Medicare — would help it maintain the surplus and prevent even more rampant spending and tax cutting by Congress. Why, however, didn't it simply try to preserve the social security surplus that is already being recorded in its own set of books? On net, the administration's proposal isn't much different from suggesting that the social security surplus be maintained and that the majority of the non-social security surplus be available for other purposes. (The Medicare transfer merely adds support for current spending promises rather than increases in Medicare spending per se, so technically the administration suggests spending only $1.3 trillion out of the $2.1 trillion non-social security surplus.)

The problem for the administration is that if it recorded the changes in this simpler way and didn't

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make the additional transfer, it couldn't claim to have done anything to "solve" the social security problem. Think of its proposal with respect to social security as totally separate from the rest of what happens in the budget. Its recommendation is to have the Treasury Department issue an additional $2.8 trillion worth of bonds to social security for free. Treasury would book the new liability; social security would book the new asset. Of course, the interest and principal on the debt must now be covered by the income taxpayer rather than the social security taxpayer. However, when the actuaries run numbers on social security's own books, it will appear to have more money (due to obligations imposed on future taxpayers to pay off this formal Treasury debt).

> ***Why didn't the administration simply try to preserve the social security surplus that is already being recorded in its own set of books?***

When all the accounts are fully reconciled, the administration's proposal involves converting the non-social security surplus into a significant deficit. Running a non-social security deficit is likely to be the Achilles heel of the proposal. Add to that problem the total confusion that arises because the administration really tries to "spend" more than 100 percent of the unified budget surplus without saying that it has done so, and it becomes clear that this is a policy a long way from enactment. There really isn't a social security or a Medicare proposal anyway, merely a suggestion to try to save some of today's temporary surplus for the future so that reduced interest payments on the debt held directly by the public can now be made by income taxpayers to meet the obligations of Medicare and social security.

Nonetheless, the president's suggestions do give us some hints as to the broad boundaries that are likely to be set on budget policy this year. It is unlikely that Congress would spend down the social security surplus already projected (hence violating the "62 percent" standard, no matter how measured). Meanwhile, bargaining over additional spending and tax cuts between the administration and Congress is liable to fa[ll] somewhere between the $1.3 trillion suggested by the administration and the $2.1 trillion in non-social security surplus now projected. Whether any of this will make sense as a matter of budget, social security, Medicare, tax, or expenditure policy is another matter.

Gene Steuerle is a senior fellow at the Urban Institute and an economic consultant to *Tax Notes*.

Summary of President's Budget & Social Security Proposal

	Current Law	Proposal
Social Security Accounts		
A Social Security -- Own Sources	2.7	2.7
B Transfer of Obligations to Be Financed From General Revenues	—	2.8
C *Subtotal:* Total Recorded Social Security Surplus	2.7	5.5
Non-Social Security Accounts		
D Non-Social Security — Own Sources/Old Law	2.1	2.1
E Transfer of Obligations to Social Security (= -B)	—	-2.8
F Addition to Medicare Assets	—	+0.7
G New Treasury Debt to Medicare	—	-0.7
H New Spending and Tax Cuts	—	-1.3
I *Subtotal:* Total Recorded Non-Social Security Surplus	2.1	-2.0
Reconciliation		
Unified Budget Surplus (=C + I)	4.8	3.5
Change in Unified Budget Surplus (also = H)		-1.3

Note. Numbers are based on early administration figures, which are changing daily. The claim that 62 percent of surpluses would be spent to shore up social security is achieved roughly by dividing the $2.8 trillion to social security by the $4.8 trillion estimated surplus under current law. The administration has also used $2.7 trillion as the size of the new transfer to social security and $4.4 trillion as the unified budget surplus under current law.

Prepared Statement of David M. Walker

Mr. Chairman and Members of the Committee:

It is a pleasure to be here today to discuss the President's recent proposal for addressing Social Security and use of the budget surplus. These proposals address some of the most important issues facing the nation, both now and over the longer term. The proposals have stimulated much controversy and dialogue in the past few weeks.

The President's proposal is complex, which makes it all the more important for us to focus our attention on what it does—and what it does not do—for our long-term future. In summary, the President's proposal:

- Reduces debt held by the public from current levels, thereby also reducing net interest costs, raising national saving, and contributing to future economic growth

- It fundamentally changes Social Security financing in two ways:
- It promises general funds in the future by, in effect, trading publicly held debt for debt held by the Social Security Trust Fund (SSTF)
- It invests some of the trust fund in equities with the goal of capturing higher returns over the long term
- It does not have any effect on the projected cash flow imbalance in the Social Security program's taxes and benefits
- It does not represent a Social Security reform plan.

CONTEXT: LONG-TERM OUTLOOK IS IMPORTANT

It is important to look at the President's proposal in the context of the fiscal situation in which we find ourselves. After nearly 30 years of unified budget deficits, we look ahead to projections for "surpluses as far as the eye can see." At the same time, we know that we face a demographic tsunami in the future that poses significant challenges for the Social Security system and our economy as a whole. In this context, we should recognize that the President uses a longer-term framework for resource allocation than has been customary in federal budgeting.

Although all projections are uncertain—and they get more uncertain the farther out they go—we have long held that a long-term perspective is important in formulating fiscal policy for the nation. Each generation is in part the custodian for the economy it hands the next and the nation's long-term economic future depends in large part on today's budget decisions. This perspective is particularly important because our model and that of the Congressional Budget Office (CBO) continue to show that absent a change in policy, the changing demographics to which I referred above will lead to renewed deficits. This longer-term problem provides the critical backdrop for making decisions about today's surpluses.

Surpluses are the result of a good economy and difficult policy decisions. They also provide a unique opportunity to put our nation on a more sustainable path for the long term, both for fiscal policy and the Social Security program itself. Current decisions can help in several important respects: (1) current fiscal policy decisions can help expand the future capacity of our economy by increasing national savings and investment, (2) engaging in substantive reforms of retirement and health programs can reduce future claims, (3) by acting now, we have the opportunity of phasing in changes to Social Security and health programs over a sufficient period of time to enable our citizens to adjust, and (4) failure to achieve needed reforms in the Social Security and Medicare programs will drive future spending to unsustainable levels.

THE PROPOSAL

Let me first briefly describe the President's proposal. The President proposes to use approximately two-thirds of the total projected unified budget surpluses over the next 15 years to reduce debt held by the public and to address Social Security's financing problem. His approach to this, however, is extremely complex and confusing. The President proposes to "transfer" an amount equal to a portion of the projected surplus to the Social Security and Medicare trust funds.[1] This transfer is projected to extend the solvency of Social Security from 2032 to 2049. His proposal to permit the trust fund to invest in equities is expected to further extend trust fund solvency to 2055.

To understand and evaluate this proposal it is important to understand the nature of the federal budget, how trust funds fit into that budget, and the challenges of "saving" within the federal budget.

Can we save for the future in the federal budget?

The federal budget is a vehicle for making choices about the allocation of scarce resources. It is different from state budgets in ways important to this discussion. Most states use "fund budgeting" in which pension funds build up surpluses that are routinely invested in assets outside the government. In contrast, the federal government's unified budget shows all governmental transactions and all funds are available for current activities. We cannot park our surplus in a cookie jar. The only way to save in the federal budget is to run a surplus or purchase a financial asset. When there is a cash surplus it is used to reduce debt held by the public. Therefore, to the extent that there is an actual cash surplus, debt held by the public falls.

This presents a problem for any attempt to "advance fund" all or part of future Social Security benefits. Advance funding within the current program would mean

[1] In this testimony I will address only the Social Security portion of this transfer. The issues are similar but not identical for the Medicare trust fund transfer.

increasing the flows to the SSTF. Although it is officially "off budget," the fact remains that the SSTF is a governmental fund. In the federal budget, trust funds are not like private trust funds. They are simply budget accounts used to record receipts and expenditures earmarked for specific purposes. A private trust fund can set aside money for the future by increasing its assets. However, under current law, when the SSTF receipts increase, they are invested in Treasury securities and used to meet current cash needs of the government. The increase in assets to the SSTF is an equal increase in claims on the Treasury. One government fund is lending to another. These net out on the government's books. Any increase in the trust fund balances would only become an increase in saving if this increment were to add to the unified budget surplus (or decrease the unified budget deficit) and thereby reduce the debt held by the public.

How do these transactions affect the government's debt? Gross federal debt is the sum of debt held by the public and debt held by governmental accounts—largely trust funds. This means that increases in the trust fund surplus will increase gross debt unless debt held by the public declines by at least the same amount. Any reform of Social Security that increases the annual SSTF surplus would increase debt held by government accounts since under current law any excess of revenues over benefit payments is loaned to Treasury for current needs. As a result, total government debt would go up unless these surpluses were used to reduce debt held by the public by an equivalent amount.

Debt held by the public and debt held by trust funds represent very different concepts. Debt held by the public approximates the federal government's competition with other sectors in the credit markets. This affects interest rates and private capital accumulation. Further, interest on debt held by the public is a current burden on taxpayers. In contrast, debt held by trust funds performs an accounting function and represents the cumulative annual surpluses of these funds (i.e., excess of receipts over disbursements plus accrued interest). It provides the account with a claim on the U.S. Treasury for the future, but it does not represent an estimate of the size of the account's future transactions with the public. In particular, debt held by the SSTF does not represent the actuarial present value of expected future benefits for either current or future participants. Nor does it have any of the economic effects of borrowing from the public. It is not a current transaction of the government with the public; it does not compete with the private sector for available funds in the credit market.

How does the President's Proposal Work?

This information is important to an understanding of the President's proposal because in large part he proposes to, in effect, trade debt held by the public for debt held by the SSTF. By running a cash surplus over the next 15 years, debt held by the public falls. To "save" this surplus, the President proposes to "transfer" it to the trust fund in the form of increased Treasury securities. Under his proposal, debt held by the public falls, but debt held by the trust funds increases. Because he shows the transfer as a subtraction from the surplus—a new budgetary concept—he shows no surplus. As a result, he attempts to save it by hiding it.

The mechanics of the proposed transfer of surpluses to the SSTF are complex and difficult to follow. Few details have been made available, and there is conflicting information on exactly how it would work. Figures 1 and 2 are flow charts representing our best understanding of the Social Security portion of this transfer. Since it is impossible to understand the changes proposed by the President without understanding the present system, Figure 1 shows the flows under the current system. Under current law, annual cash flow surpluses (largely attributable to excess payroll taxes over benefits payments and program expenses) are invested in Treasury securities.[2] This excess "cash" is commingled with other revenues and used to finance other governmental activities. In this way, SSTF surpluses have helped and continue to help finance the rest of the government. This year, the SSTF surplus is expected to exceed the general fund deficit so there is also a surplus in the unified budget. Over the entire 15-year period, more than half of the projected unified surplus is composed of Social Security surpluses. Absent any change in policy, these unified surpluses will be used to reduce the debt held by the public.

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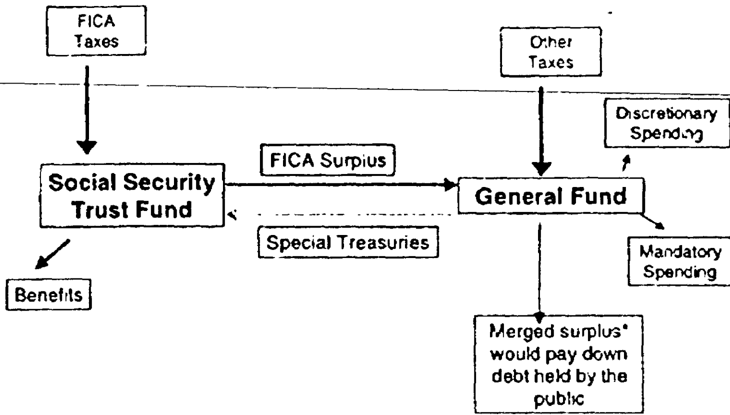
[2] This presentation is somewhat simplified. In reality, FICA taxes are collected with income and corporate taxes by the Treasury and then allocated by the Treasury to Social Security, medicare, or the general fund.

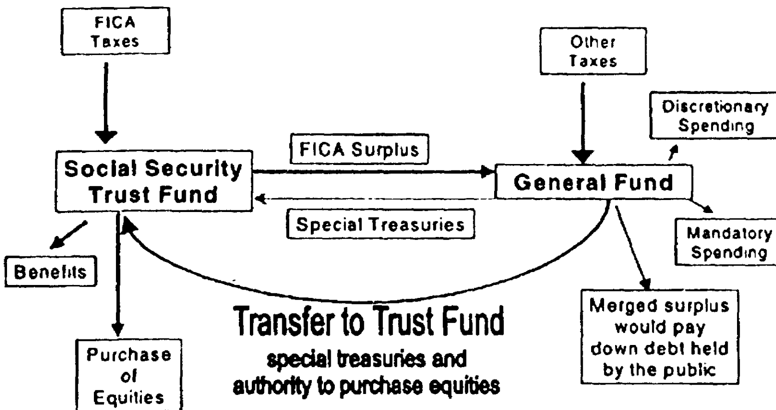
Figure 1: Current Social Security Flows



*Merged surplus=FICA surplus + General Fund Surplus

Under the President's proposal, this would continue. However, as shown in Figure 2, at the point where total tax receipts are allocated to pay for government activities, a new financing step would be added to "transfer" a portion of the unified budget surpluses to the Social Security and Medicare trust funds. The unified budget would do this by providing a new set of securities for these trust funds. However, the excess cash would still be used to reduce the debt held by the public.

Figure 2: Social Security Flows Under President's Proposal



In essence this swaps debt held by the public for debt held by the trust funds. While there are many benefits to reducing publicly held debt, it is important to recognize that under the current law baseline—i.e. with no changes in tax or spending policy—this would happen without crediting additional securities to the trust funds.

The Administration has defended this approach as a way of assuring both a reduction in debt held by the public and giving Social Security first claim on what they call the "debt-reduction dividend" to pay future benefits.

However, issuing these additional securities to the SSTF is a discretionary act with major legal and economic consequences for the future. Some could view this as double counting. Importantly, to the extent it appears that way to the public, it could undermine confidence in a system that is already difficult to explain. However, the debate over double counting focuses on the form of the proposal rather than its substance. Although form is important when it interferes with our ability to understand the substance—and I think this proposal falls into that trap—the important debate must be on the substance of the proposal.

This proposal represents a fundamental shift in the way the Social Security program is financed. It moves it away from payroll financing toward a formal commitment of future general fund resources for the program. This is unprecedented. Later in my statement, I will discuss the implications of this proposal for overall fiscal policy and for the Social Security program.

GOVERNMENT FINANCING AND DEBT

The President's proposals would have the effect of reducing debt held by the public from the current level of 44 percent of Gross Domestic Product (GDP) to 7 percent over the 15-year period. Nearly two-thirds of the projected unified budget surplus would be used to reduce debt held by the public. Because the surplus is also to be used for other governmental activities, the amount of debt reduction achieved would be less than the baseline, but nonetheless the outcome would confer significant benefits to the budget and the economy.

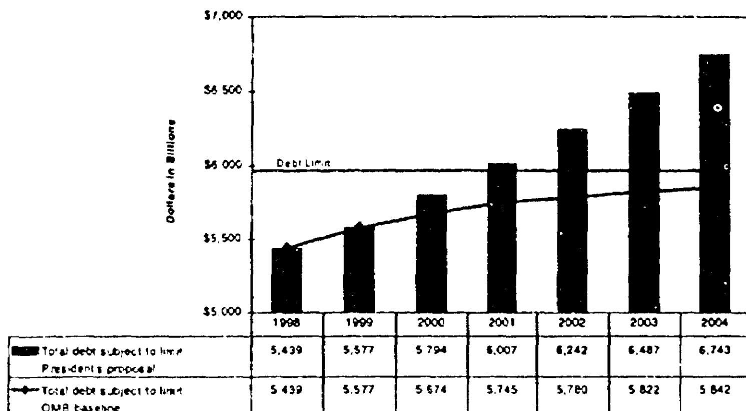
Our previous work on the long-term effects of federal fiscal policy has shown the substantial benefits of debt reduction.[3] Reducing publicly held debt reduces payments on net interest within the budget. For example, CBO estimates that the difference between spending the surplus and saving the surplus is $123 billion in annual interest payments by 2009. Lower interest payments lead to larger surpluses, which in turn reduce debt: the miracle of compound interest produces a virtuous circle. The result—future decision-makers gain significant budgetary flexibility to address other needs in the future.

For the economy, lowering debt levels increases national saving and frees up resources for private investment. This in turn leads to increased productivity and stronger economic growth over the long term. Over the last several years, we and CBO have both simulated the long-term economic results from various fiscal policy paths. These projections consistently show that reducing debt held by the public increases national income over the next 50 years, thereby making it easier for the nation to meet future needs and commitments. As Treasury Secretary Rubin has noted, reduced debt now helps the federal government increase its capacity to handle borrowing in the future.

The President's proposal, in effect, trades debt held by the public for debt held by government accounts, but he also spends part of the surplus. Debt held by trust funds goes up more rapidly than debt held by the public falls, largely due to the additional securities transferred to the trust funds. Gross debt, therefore, increases. It is gross debt—with minor exceptions—that is the measure that is subject to the debt limit. The current limit is $5.95 trillion. Under the President's plan, the limit would need to be raised sometime during 2001. Under either the CBO or OMB baseline (i.e. save the entire surplus), the limit would not need to be raised during at least the next 5 years. This is shown in Figure 3 below.

[3] *Budget Issues: Analysis of Long-Term Fiscal Outlook* (GAO/AIMD/OCE-98-19, October 1997).

Figure 3: Debt Subject to Limit under Baseline and President's Proposal



	1998	1999	2000	2001	2002	2003	2004
Total debt subject to limit President's proposal	5,439	5,577	5 794	6,007	6,242	6,487	6,743
Total debt subject to limit OMB baseline	5 439	5,577	5 674	5,745	5,780	5 822	5 842

Source: Budget of the United States Government, Fiscal Year 2000.

While reducing debt held by the public appears to be a centerpiece of the proposal—and has significant benefits—as I noted above the transfer of unified surpluses to Social Security is a separate issue. The transfer is not technically necessary: whenever revenue exceeds outlays and the cash needs of the Treasury—whenever there is an actual surplus—debt held by the public falls. The President's proposal appears to be premised on the belief that the only the way to sustain surpluses is to tie them to Social Security. He has merged two separate questions: (1) how much of the surplus should be devoted to reducing debt held by the public; and, (2) how should the nation finance the Social Security program in the future.

Let me turn now to the question of Social Security financing.

SOCIAL SECURITY FINANCING

The President proposes two changes in the financing of Social Security: a pledge of general funds in the future and a modest amount of investment in equities. Both of these represent major shifts in approach to financing the program.

General Fund Financing

By, in effect, trading debt held by the public for debt held by the trust funds, the President is committing future general revenues to the Social Security program. This is true because the newly transferred securities would be in addition to any buildup of payroll tax surpluses. Securities held by the SSTF have always represented annual cash flows in excess of benefits and expenses, plus interest.[4] Under the President's proposal this would no longer continue to be true. The value of the securities held by the SSTF would be greater than the amount by which annual revenues exceed annual benefits and expenditures.

This means that for the first time there is an explicit and legal claim on the general fund. This is a major change in the underlying theoretical design of this program. Whether you believe it is a major change in reality depends on what you as-

[4] Cash flow into the SSTF is composed of payroll taxes and a portion of the income taxes paid on Social Security benefits. Income taxes made up a relatively small component of the surplus. Interest paid to Social Security is analogous to interest paid on publicly held debt. Both come from the general fund. Interest on publicly held debt is paid in cash while interest to the trust fund is credited in the form of additional treasury securities.

sume about the likely future use of general revenues under the current circumstances. For example, current projections are that in 2032 the fund will lack sufficient resources to pay the full promised benefits. If you believe that this shortfall would—when the time came—be made up with general fund monies, then the shift embedded in the President's proposal merely makes that explicit. If, however, you believe that there would be changes in the benefit or tax structure of the fund instead, then the President's proposal represents a very big change. In either case, the question of bringing significant general revenues into the financing of Social Security is a question that deserves full and open debate. The debate should not be overshadowed by the accounting complexity and budgetary confusion of the proposal.

One disconcerting aspect of the President's proposal is that it appears that the transfers to the trust fund would be made regardless of whether the expected budget surpluses are actually realized. The amounts to be transferred to Social Security apparently would be written into law as either a fixed dollar amount or as a percent of taxable payroll rather than as a percent of the actual unified surplus in any given year. These transfers would have a claim on the general fund even if the actual surplus fell below the amount specified for transfer to Social Security—and that does present a risk.[5]

It should be noted that any proposal to allocate surpluses—particularly over a long period of time—is vulnerable to the risk that those projected surpluses may not materialize. The history of budget forecasts should remind us not to be complacent about the certainty of these large projected surpluses. Accordingly, we should consider carefully any permanent commitments that are dependent on the realization of a long-term forecast.

Investment in Equities

Under current law, the SSTF is required to invest in securities that are issued or backed by the Treasury. The President proposes changing current law to allow the SSTF to invest a portion of its assets in equities. His proposal calls for the fund to gradually invest 15 percent of its total assets in the equity market. According to the Administration's estimates, the SSTF's equity holdings would represent only a small portion—about 4%—of the total equity market. To insulate investment decisions from political considerations, the Administration proposes investing passively in a broad-based stock index and creating an independent board to oversee the portfolio.

Last year, we reported on the implications of allowing the SSTF to invest in equities.[6] In that report, we concluded that stock investing offers the prospect of higher returns in exchange for greater risk. We found that, by itself, stock investing was unlikely to solve Social Security's long-term financing imbalance but that it could reduce the size of other reforms needed to restore the program's solvency. We also concluded that investing in a broad-based index would help reduce, but not eliminate, the possibility of political influence over stock selections. However, the issue of how to handle stock voting rights could prove more difficult to resolve. If the government voted its shares, it would raise concerns about potential federal involvement in corporate affairs. If the government chose not to vote, it would affect corporate decision-making by enhancing the voting power of other shareholders or investment managers. The model applicable to passive private sector investment managers under the Employee Retirement Income Security Act (ERISA) may be relevant to the resolution of this issue.

From an economic standpoint stock investing would not have a significant impact on national saving compared to the alternative of using the surpluses to further reduce debt held by the public. Both approaches would add about the same amount of funds to private capital markets, meaning that national saving would essentially be unchanged. From a budget accounting standpoint they are not the same. Under current scoring rules the purchase of equities would be counted as an outlay, but the proposal apparently would change that. Equity purchases would not be scored as an outlay since they would be made out of the amount transferred to social security, which is already scored as reducing the surplus.

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[5] It is worth noting that something like this happens now. Treasury does not track how much of the revenues it collects are for Social Security and how much for income taxes. It credits the SSTF with fund equal to the appropriate tax rate applied to the taxable wage base—whether or not those FICA taxes were actually paid.

[6] *Social Security Financing: Implications of Government Stock Investing for the Trust Fund, the Federal Budget, and the Economy* (GAO/AIMD/HEHS-98-74, April 1998)

HAVE OTHER COUNTRIES TACKLED THESE PROBLEMS?

I should note that although the dilemma we are facing of whether and how to save for the future is a very difficult one, it is not unique. A look at other democracies shows that surpluses are difficult to sustain. However, several nations have succeeded in sustaining surpluses. In those nations, political leaders were able to articulate a compelling rationale to justify the need to set aside current resources for future needs.

For example, those countries that have come to the conclusion that the debt burden matters make it an explicit part of their fiscal decision making process. Australia, New Zealand, and the United Kingdom all attempt to define prudent debt levels as a national goal to strive for. These debt goals can prove important in times of surplus. New Zealand, for example, used its debt goals as justification for maintaining spending restraint and attempting to run sustained surpluses. They promised that once they met their initial debt target they would give a tax cut. Importantly, when they hit that specified debt target, they delivered on their promise of tax cuts.

Other countries have saved for the future by separating their pension or Social Security-related assets from the rest of the government's budget. For example, the Canadian Pension Plan (CPP) is completely separate from both federal and provincial budgets. When the fund earns surplus cash, it is invested in provincial debt securities and, starting this year, in the stock market. Sweden also maintains a pension fund outside the government's budget and invests assets in stocks and bonds.

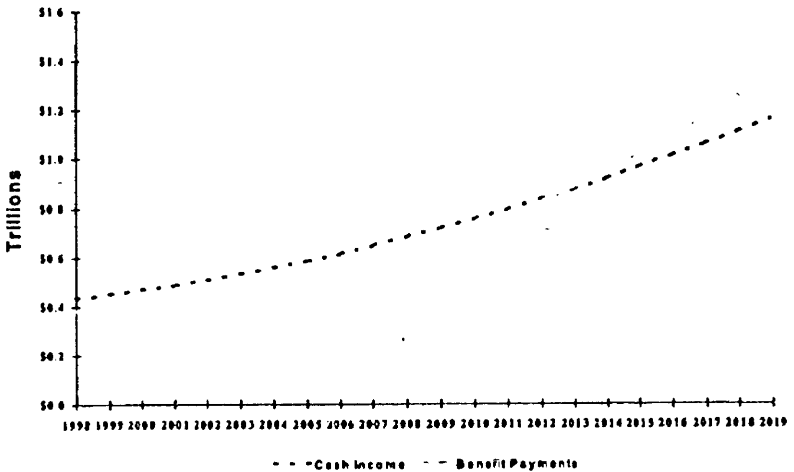
Norway may be the most dramatic example of setting aside current surpluses to address long-term fiscal and economic concerns. Norway faces the two-edged problem of a rapidly aging population and declining oil revenues—a significant source of current government revenue. To address these long-term concerns, Norway started setting aside year-end budget surpluses in 1996 to be invested in foreign stocks and bonds. Their express intention is to draw down these assets to pay for the retirement costs for their baby boomers.

It should be noted that other nations that have attempted to directly address their debt and pension problems have usually done so during or shortly after a fiscal or economic crisis. Fortunately, we do not have that problem. Instead, we have a unique opportunity to use our current good fortune to meet the challenges of the future.

SOCIAL SECURITY REFORM IS STILL NEEDED

Finally, it is important to note that the President's proposal does not alter the projected cash flow imbalances in the Social Security program. Benefit costs and revenues currently associated with the program will not be affected by even one cent. Figure 4, which shows Social Security's payroll tax receipts and benefit payments, illustrates this point. Without the President's proposal, payroll tax receipts will fall short of benefit payments in 2013; with the President's proposal, payroll tax receipts also fall short of benefit payments in 2013—the graph doesn't change at all. Under the President's proposal, expected stock market returns would be used to fill part of this gap, but from 2013 on the trust funds will be reliant on cash from redeemed securities, whether or not the President's proposal is adopted. The changes to the Social Security program will thus be more perceived than real: although the trust funds will appear to have more resources as a result of the proposal, in reality nothing about the program has changed. The proposal does not represent Social Security reform, but rather it represents a different means to finance the current program. One of the risks of the proposal is that the additional years of financing may very well diminish the urgency to achieve meaningful changes in the program. This would not be in the overall best interests of the nation.

Figure 4: SSTF Projected Cash Income and Outflow through 2019



Source: Social Security Trustees 1998 Report, Intermediate Assumptions.

To achieve long-term solvency and sustainability, the Social Security program itself must be reformed. The demographic trends that are driving the program's financial problems affect the program well into the future. The impending retirement of the baby boom generation is the most well-known of these trends, but is not the only challenge the system faces. If this were so, perhaps a one-time financing strategy could be sufficient. But people are retiring earlier, birth rates have fallen, and life expectancies are increasing—all these factors suggest that Social Security's financial problems will outlive the baby boom generation and continue far into the future. These problems cannot be addressed without changes to the Social Security program itself.

These changes should be made sooner rather than later. The longer meaningful action is delayed, the more severe such actions will have to be in the future. Changes made today would be relatively minor compared to what could be necessary years from now, with less time for the fiscal effects of those changes to build. Moreover, acting now would allow any benefit changes to be phased in gradually so that participants would have time to adjust their saving or retirement goals accordingly. It would be tragic indeed if this proposal, through its budgetary accounting complexity, masked the urgency of the Social Security solvency problem and served to delay much-needed action.

There is another reason to take action on Social Security now. Social Security is not the only entitlement program needing urgent attention. In fact, the issues surrounding the Medicare program are much more urgent and complex. Furthermore, the many variables associated with health care consumption and Medicare costs and the personal emotions associated with health decisions make reform in this program particularly difficult. Let us address Social Security for the long term today so that the nation can turn its attention to these other more pressing and difficult issues early in the new millennium. Much remains to be done in reforming entitlement programs, and engaging in meaningful Social Security reform would represent an important and significant first step. The Congress and the Administration, working together, can find a comprehensive and sustainable solution to this important challenge.

I recognize, though, that restoring Social Security solvency is not easy. Ultimately, any reforms to Social Security will address not only the relatively narrow question of how to restore solvency and assure sustainability but will also go to the larger question of what role Social Security and the federal government should play

in providing retirement income. There are many proposals being made to address these questions; choosing among them will involve difficult and complex choices, choices that will be critically important to nearly every American's retirement income.

In my view, progress is likely to be greatest if we see these choices not as "either/or" decisions but rather as an array of possibilities along a continuum. Combining elements of different approaches may offer the best chance to produce a package that addresses the problem comprehensively for the long term in a way that is meaningful and acceptable to the American people. For example, such a continuum may identify individual accounts that could serve as a voluntary or mandatory supplement to a financially sound and sustainable base defined benefit structure. In addition, master trust principles can be used to provide for collective investment of base defined benefit and individual account funds in ways that would serve to prevent political manipulation of investments.

In order to help structure these choices, I would suggest five criteria for evaluating possible Social Security proposals:

Sustainable solvency: A proposal should eliminate the gap between trust fund resources and expenditures over 75 years, and have the ability to sustain a stable system beyond that time period.

Equity: A proposal should create no "big winners" or "big losers." Those who are most reliant on Social Security for retirement and disability income should continue to receive adequate support; those who contribute the most would also benefit from participation in the system, and intergenerational equity would improve.

Adequacy: Consistent with Social Security's social insurance feature, a proposal should provide for a certain and secure defined benefit promise that is geared to providing higher replacement rates for lower-income workers and reasonable minimum benefits to minimize poverty among the elderly.

Feasibility: A proposal should be structured so that it could be implemented within a reasonable time period, it could be readily administered, and the administrative costs associated with it would be reasonable.

Transparency: A proposal should be readily understandable to the general public, and, as a result, generate broad support.

Applying such criteria will require a detailed understanding of the possible outcomes and issues associated with the various elements of proposals. We are working to provide the data, information, and analysis needed to help policymakers evaluate the relative merits of various proposals and move toward agreement on a comprehensive Social Security reform proposal.

CONCLUSIONS

Budget surpluses provide a valuable opportunity to capture significant long-term gains to both improve the nation's capacity to address the looming fiscal challenges arising from demographic change and aid in the transition to a more sustainable Social Security program. The President's proposal offers a valuable opportunity for us to address both how much of our current resources we want to save for the future and how we can best do so. The President's proposal is both wide ranging and complex, and it behooves us to clarify the consequences for both our national economy and the Social Security program.

A substantial share of the surpluses would be used to reduce publicly held debt, providing demonstrable gains for our economic capacity to afford our future commitments. In this way, the proposal would help us, in effect, prefund these commitments by using today's wealth earned by current workers to enhance the resources for the next generations.

However, the President's proposal does not include any Social Security program reforms to make the program's commitments more affordable. The transfer of surplus resources to the trust fund, which the Administration argues is necessary to lock in surpluses for the future, would nonetheless constitute a major shift in financing for the Social Security program. Moreover, the proposed transfer may very well make it more difficult for the public to understand and support the savings goals articulated. Several other nations have shown how debt reduction itself can be made to be publicly compelling, but only you can decide whether such an approach will work here.

I am very concerned that enhancing the financial condition of the trust fund alone without any comprehensive and meaningful program reforms may in fact undermine the case for fundamental program changes. Delay will only serve to make the necessary changes more painful down the road. The time has come for meaningful Social Security reform. After all, we have much larger and more complex challenges

to tackle. Explicitly pledging federal general revenues to Social Security will limit the options for dealing with other national issues.

As you consider various proposals, you might focus on the following questions:

- How much of the unified budget surplus should go to debt reduction vs. other priorities?
- If we are to use some portion of the surplus to reduce publicly held debt, is the President's proposed approach the way to do this?
- Should Social Security be financed in part by general revenues?
- Should the SSTF invest in the stock market?
- How can we best assure the solvency, sustainability, equity and integrity of the Social Security program for current and future generations of Americans?
- How can we best assure the public's understanding of and support for any comprehensive Social Security reform proposal?

We at GAO stand ready to help you address both Social Security reform and other critical national challenges. Working together, we can make a positive and lasting difference for our country and the American people.