S. HRG. 105–909

INVESTMENT-BASED ALTERNATIVES TO FINANCING SOCIAL SECURITY AND MEDICARE

JOINT HEARING

BEFORE THE

SUBCOMMITTEE ON HEALTH CARE

AND THE

SUBCOMMITTEE ON SOCIAL SECURITY AND FAMILY POLICY

OF THE

COMMITTEE ON FINANCE

AND THE

SUBCOMMITTEE ON SECURITIES

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

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INVESTMENT-BASED ALTERNATIVES TO THE CURRENT METHODS OF FINANCING SOCIAL SECURITY AND MEDICARE

TUESDAY, OCTOBER 7, 1997

U.S. SENATE,
SUBCOMMITTEE ON HEALTH CARE AND SUBCOMMITTEE ON SOCIAL SECURITY AND FAMILY POLICY, COMMITTEE ON FINANCE; AND THE SUBCOMMITTEE ON SECURITIES, COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:05 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Phil Gramm (chairman of the Finance Subcommittee on Health Care and the Banking Subcommittee on Securities) presiding.

Also present: Senators Grassley, Baucus, Breaux, and Kerrey.

Also present: Senators Allard, Faircloth, Johnson, and Grams.

OPENING STATEMENT OF HON. PHIL GRAMM, A U.S. SENATOR FROM TEXAS, CHAIRMAN, SUBCOMMITTEE ON HEALTH CARE, AND CHAIRMAN, SUBCOMMITTEE ON SECURITIES

Senator GRAMM. I have a statement from Senator Rod Grams, a member of the Securities Subcommittee, who will not be here this morning. He would like his statement put in the record. And so we will do that.

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

Senator GRAMM. This is something of a rare hearing in that we have brought together three subcommittees, two of them from the Finance Committee: the Health Care Subcommittee, and the Social Security Subcommittee; and the Securities Subcommittee from the Banking Committee, all of which have a jurisdiction that is relevant to the issues that we will be discussing today.

The reality of our situation today is that we know with virtual certainty that a continuation of the status quo in Medicare and Medicaid will require over the next 25 years, at a minimum, a doubling of the payroll tax. The payroll tax which today is slightly over 15 percent, will, unless we dramatically reform Medicare and Social Security, at a minimum grow to 30 percent, which means that the average working family in America will find itself with a marginal tax rate of 58 percent.

The impact of that on economic growth and job creation, and the impact of it on the purchasing power of working American families represent a burden that would be virtually unbearable by families and by the economy as a whole.

The alternative, if we maintain anything like the current status quo, would be a wholesale default on benefits that we have guaranteed under Social Security and Medicare.

It is an interesting fact to me, in fact almost paradoxical, that the debate about a tax cut, a flat tax, consumption tax, many other forms of reforming the tax system that are all based to some degree on lowering the tax burden, is occurring at a time when we know with certainty that we are looking at a substantial increase in taxes unless we reform the Social Security and Medicare programs.

Just to meet the unfunded liability of Medicare and Social Security would require us over the next 25 years to double the income tax burden on the American people, if we shifted to a broad-based tax to fund this deficit.

So this is a major problem. And I have tried since last November to begin to look at all the options that are available.

And it seems to me, having fairly thoroughly reviewed the options, that the only option that shows any real promise of allowing us to fulfill the commitments that we made to people under Medicare and Social Security and at the same time not drive up tax rates to such a level that we would destroy incentives for job creation, is the option that we will discuss today. It is an option that is based on changing the program from a government pay-as-you-go system to a system where individuals would save as they go.

It is interesting that the ideas that will be presented today, which at least to our ears are new and novel, are very close to the selling points that were used when Medicare and Social Security were first established. The problem is that the programs as they have actually been established vary greatly from the rhetoric of those who proposed them.

We have before us now an option to move from a tax-and-spend system to a save-and-invest system. And that is what we want to look at today. I believe that the only hope we have of preventing an explosion in the tax burden and a wholesale default on Medicare and Social Security benefits to the American people is to move to an investment-based system where we admit the unfunded liability in both Medicare and Social Security upfront, and where we begin to let younger workers transition into an investment-based system. We would have a mandatory program that would be supervised by the Federal Government for safety and soundness, but where individuals in their working lives, following a tradition that is as old as mankind, would set aside a portion of their earnings to protect themselves with pension benefits and health care benefits in retirement. We would in the process develop a transition mechanism that would allow us to pay the benefits to those who have paid into the system in the past and who are either in retirement already or quickly moving toward retirement.

I think it is clear that going to an investment-based system for Medicare and Social Security over a 50-year period is far cheaper than the status quo. The problem is a cash flow problem. And that is that in order to make the transition, you shift the huge unfunded liability, which is now off in the future and beginning to explode in 14 years, into the present. While you make it cheaper over a 50-year period, you create a near-term cash flow problem.

We will discuss that transition to some degree today. But primarily, this is a hearing that is about the long-term problems facing Medicare and Social Security.

We have with us today two premier academicians in the country. Most of the people here will know Martin Feldstein.

Martin Feldstein is President and Chief Executive Officer of the National Bureau of Economic Research, in Cambridge, Massachusetts.

Our other witness today is Thomas R. Saving, who is Director of the Private Enterprise Research Center at Texas A&M University, in College Station, Texas.

Dr. Feldstein's research concerns moving toward an investment-based Social Security system, but he has done some work on and some analysis of Medicare. Dr. Saving's work is primarily on an investment, savings-based Medicare. Both of these research projects fit together I think rather nicely.

Some members of the committee have asked: well, when are we going to hear from the other side? I plan to have a follow-up hearing to give those who believe there is no problem or that we can make the current system work an opportunity to present their views.

I would have to say that, based on what at least is out there in the literature, there are those who criticize an investment-based system, but I do not know of a coherent program to deal with the status quo by simply maintaining the current system. But I think it is important that we have a follow-on hearing to allow those who defend the current system, who believe that it can be made to work with some modest changes, to be heard.

I want to commit to members that we will hold a follow-up hearing as we identify people who want to come forward either to respond to something that is said today or to present an alternative program.

With that, let me stop and see if any of our colleagues would like to make an opening statement before we begin the testimony.

Senator Baucus.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA

Senator BAUCUS. Thank you, Mr. Chairman. I commend you for holding this hearing. Obviously, we have to think through very carefully what we do here.

Medicare and Social Security trust funds are in trouble. And looking at the demographics of our country, we can see that the problem is going to get worse, not better.

The ideas that you are expounding, as well as those of the witnesses, are very helpful. Certainly, they are provocative.

I also think they are helpful and will help guide us over the next year or two as we try to fashion a better, more solvent system.

I might warn some of us, however, that there are some people in this country who cannot save very much.

In my State of Montana, the people have lower incomes than do people in other States, other than is the average across America.

In my State, the median income level is 20 percent lower than the national average. So people just have a harder time saving to provide for their own futures.

In addition, we have a lot of seniors. One of eight Montanans is 65 years or older. We are higher than the national average.

And so as we fashion some kind of program here, we have to take into account both those parts of the country where there is a much higher incidence of senior citizens and second, those parts of the country where people just do not have the money to put into their private retirement accounts compared with some others. I only mention that as a warning.

My other observation is that there will be no solution to this problem unless it is bipartisan.

This committee, as you know, Mr. Chairman, passed out a budget resolution on a bipartisan basis.

And it passed the Congress on a bipartisan basis. But by and large, nothing of any consequence passes unless it is bipartisan.

And I urge us to approach this subject on that basis.

With that, Mr. Chairman, I again thank you for holding these hearings.

Senator GRAMM. Thank you, Senator Baucus.

I do not want to get into a debate here, but I would note that one of the advantages of the investment-based system is that under the current system, you get retirement based on 35 years of earnings.

That is that no matter what a person does between the time he or she enters the labor market and is 30 years of age, he or she gets no benefit for it under our current system. That is terribly unfair to unskilled workers who enter the labor market when they are 17 or 18 years of age, as compared to people who go to graduate school and law school and enter the labor market when they are 27 or 28. The current system only takes the last 35 years into account.

One of the great advantages of investment is that with low-income workers who start working early, they get the power of compound interest on those investments for a long period of time.

I think that ultimately, one of the strengths of the investment-based system is that it is a system which rewards people who have earnings early in their life.

Also, there are many other ways that we can deal with the problem you raised.

But I think it is clear that if we are going to do anything about this, the most significant of problems, in fact I think the greatest problem that we face in the next 25 years, it is going to have to be bipartisan in every way.

And I certainly appreciate your comments.

Chuck, did you have a statement?

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

Senator GRASSLEY. I just want to say to you thank you for having the hearing, not from the standpoint just of the subject matter, but it is related to an issue that is very politically sensitive.

And whenever we have a politically sensitive issue around this town and around this institution of the Congress, we tend to wait until a crisis period of time before Congress will deal with it.

And then, we tend to deal with it as we did in Medicare 4 months ago in a very less than bold fashion.

And yet, we beat our chests that we did something on Medicare. And we really extended the bankruptcy of it out six or seven years which really is not a very bold move.

But now, in 1997, is the time to talk about what to do about Medicare and Social Security so that Congress will be pushed into acting on it well before we get to a crisis period which is when babyboomers come into retirement at the year 2010.

And I do not think that we are ever going to be able to have the changes that are necessary to be made without a national consensus that those changes can be made.

And having a dialogue like we are having now years before a period of crisis has arrived is a necessary full step to getting to that point of getting a national consensus.

So it is that procedural move that you are making to bring this discussion about at this period of time that you want to compliment you on and why as chairman of the Senate Committee on Aging I feel responsibility to be here and help with this dialogue.

Senator GRAMM. Thank you, Senator Grassley.

Senator Faircloth.

OPENING STATEMENT OF HON. LAUCH FAIRCLOTH, A U.S. SENATOR FROM NORTH CAROLINA

Senator FAIRCLOTH. Thank you, Mr. Chairman. I want to echo what you just said about timing and moving at the right time to get started on this before the disaster strikes. And it is inevitable that it is going to. There is no question.

We cannot sustain ourselves as we are going with Social Security. I do not speak to any young people today that have any faith whatsoever that it will be there to sustain them.

We have to go to a save-and-investment approach to it. It is the only one. And we talk about the save-and-investment might not be a sure fire system, but certainly what we have is not.

And a save-and-investment program is the best possibility that we have to getting out of the inevitable fiasco that we are headed towards and which it would take unlimited amounts of money to sustain the system we have.

Whether it is a political popular issue or not, we are a Nation that is going to have to face up to the fact that something has to be done.

And I thank you for starting towards doing it.

Senator GRAMM. Thank you, Senator Faircloth.

Senator Johnson.

OPENING STATEMENT OF HON. TIM JOHNSON, A U.S. SENATOR FROM SOUTH DAKOTA

Senator JOHNSON. Thank you, Mr. Chairman. I appreciate again your holding this important hearing.

I want to associate myself with the remarks of Senator Baucus, relative to the need to examine options we understand.

I think everyone understands that there are demographic challenges facing the current Social Security structure.

I think we do need to look at alternative ways that may involve an investment-based kind of approach, if not to replace Social Security, to augment Social Security in any event.

But I also share Senator Baucus' concerns, one that there are a great many people in this Nation who frankly are not in a very good position to set aside significant private savings and, secondly, that the transition is a daunting challenge.

I think this hearing will be very beneficial for those of us who are very concerned about how that kind of transition could be implemented in a constructive way. So I think this is an important hearing.

I regret that I have some conflicting scheduling problems. And I am going to have to leave, but I take the testimony with me and will share it with my staff and look forward to working with you in a bipartisan fashion because as Senator Baucus noted, on an issue of this nature, we are simply not going to be able to move forward dealing with the demographic challenges of the coming generation without both parties holding hands and jumping off the cliff or jumping up the hill or whatever it involves together. And that is what will be involved.

And I look forward to working with you and others in crafting sensible and bipartisan adjustments as time goes on. Thank you.

Senator GRAMM. What I would like to do is to begin with you, Martin, if you would take about 15 minutes. If you have to go over a couple of minutes to make your point, do so. Our purpose today is to listen to you.

And then, Tom, if you would take about 15 minutes as well.

We will listen to both testimonies. And then, we will throw it open to questions.

STATEMENT OF MARTIN FELDSTEIN, PH.D., PRESIDENT AND CHIEF EXECUTIVE OFFICER, THE NATIONAL BUREAU OF ECONOMIC RESEARCH, CAMBRIDGE, MA

Dr. FELDSTEIN. Thank you very much, Senator.

I feel a little superfluous after your fine introduction. I think that you summarized very well what the issues are and what the options are. And all I can do is fill in some details and repeat the message once again.

In your original invitation, you asked me to talk specifically about the impact on national saving and national investment and therefore productivity of this kind of a substitution of a funded program.

And I will come back and do that briefly at the end because I have stated that at some length in the prepared testimony.

But what I thought I would do is to talk more generally about the reasons for fundamental reform of the current system, both Social Security and Medicare and also about the transition that is possible from our existing pay-as-you-go system to a system that would be based on individual accounts like 401–K and IRA accounts that more and more Americans every year are becoming familiar with and through which investments are made, and stocks and bonds.

Well, as you correctly said, our current pay-as-you-go system is in trouble. The trust funds that are there are relatively small in comparison to the obligations.

And those trust funds will soon be declining. Long before they run out of money, they are going to be shrinking. That is they are going to be selling bonds.

And selling bonds from a government trust fund in effect means that the trust fund is running a deficit.

It is contributing to the unified deficit in the budget as a whole and is dragging down our national savings rate.

And the only way to prevent that deficit which would start within a decade would be to increase taxes.

If there is no increase in taxes, the trust funds will be exhausted in the year 2030 or so for the Social Security trust fund and even earlier for the Medicare trust funds.

That is the situation we are in if we stay with the existing pay-as-you-go program.

And after that, the taxes—after those funds have been exhausted, the taxes would have to increase very sharply to pay the promised Social Security benefits and the Medicare costs that are currently projected.

And when I say very sharply, my numbers are not surprisingly very similar to yours that we are talking about an increase in the tax of about 50 percent from the current 12-plus percent to about 18 percent for Social Security alone and substantially more for Medicare.

And the key reason for that is the aging of the population. And people are aware of the aging, but often associate it with the baby-boom.

And while the baby-boom is going to accelerate this pace, the aging of the population is a permanent change.

It is not just a one-time thing, the pig and the python. That will pass through. We are going to be permanently older society because medical care and improved lifestyles are causing us all to live longer.

The Census Bureau estimates that the fraction of people over age 65 will increase from about 12 percent of the population now to about 20 percent of the population just 30 years from now.

And then, we will stay up there. So that there is no going back to the old demographics.

The group over age 75 which are even bigger consumers of medical care is increasing even more rapidly. That aging has a very big impact on the cost of Social Security and Medicare.

The CBO estimates that the current Social Security cost, now about 5 percent of GDP, in just 30 years will be up by 40 percent as a percentage of GDP. So we will go from 5 percent of GDP to 7 percent of GDP.

Or if you think about it in payroll tax terms, what is currently financiable by a 12 percent plus payroll tax will require a payroll tax of about 18 percent. That is just for the Social Security part.

Medicare is now about as expensive as the pension program. Of course, it is funded not just from the payroll tax, but from general revenue as well.

And the CBO estimates that over the next 30 years, it will double as a percentage of GDP. So it will go from 5 percent of GDP to 10 percent of GDP.

Well, if you think about that Medicare component, that 10 percent of GDP, that would require a payroll tax equivalent to 25 percent of payroll.

So when you combine the two, Social Security and Medicare, you are talking about a combined payroll tax of over 40 percent.

And that is why, as you said in your introductory remarks, the average family would, if we continue with a pay-as-you-go system, be facing a combined marginal tax rate somewhere over 60 percent, depending on their particular circumstances.

That would just be enormously destructive of the economy. There is another way of seeing the enormity of this demographic effect on our tax system if we stay with a pay-as-you-go system.

Now, Social Security and Medicare combined are about 10 percent of GDP. Thirty years from now according the CBO, it will be 17 percent of GDP.

Just the increase alone to finance that by the personal income tax would require doubling all the personal income tax rates.

So 15 percent would go to 30. Twenty-eight would go to 56 and so on.

Well, I do not have to tell members of this committee what serious adverse effects those kinds of tax rates would have.

It is rates at those levels that are really destroying our European economy that have created the permanent 12 percent unemployment rates that we are seeing in Europe.

Well, what is the alternative? I think the clear alternative is to individual accounts like 401–K plans, mandatory accounts in which employers are required to withhold a certain amount from individual's pay, put it into those accounts.

And then, individuals are free to designate which of an approved list of investments they want to put that money into.

The primary reason for making that kind of shift on the current pay-as-you-go system to a system of mandatory individual accounts is that it could finance the same benefits in the future without very high tax rates.

And that really speaks to Senator Baucus' question before about maintaining the current benefits for existing retirees and for future retirees.

I think what I take as given in all this is that the transition that we are talking about is one that would maintain the same level of benefits for retirees under this hybrid system and ultimately under a funded system as is promised under the existing Social Security.

That could be done with much smaller, mandatory savings contributions than the level of payroll taxes that would be required in a pay-as-you-go system.

Just to indicate how big that saving would be, let me focus just on the Social Security part because it is the Social Security part that I have done extensive calculations on.

As I said a moment ago, Social Security 30 years from now would require an 18 percent payroll tax if we have a pay-as-you-go.

But if instead we had a fully-funded system with individual accounts, the required mandatory saving to produce the same level of benefits in retirement would be less than 5 percent of payroll.

So instead of 18 percent, we would be talking about some number less than 5 percent. In other words, less than a third of what would be required.

Indeed, under some calculations, depending on exactly how government policy operated, it could be as low as 3 percent.

Why? Because the investments in stocks and bonds, the investments in real capital produce a much higher rate of return than the rate of return that is implicit in the Social Security program.

The Social Security actuaries, as they look ahead, estimate that the implicit rate of return that participants would get in the Social Security program would be less than 2 percent.

Now, that is not the return on the bonds and the trust fund or anything like that. It is the implicit return that participants get because in a pay-as-you-go system, tax collections rise as real wages in the number of employees increase.

But looking ahead, the Social Security actuaries tell us that that implicit rate of return would be less than 2 percent.

Well, what is the comparable real rate of return, real meaning after inflation rate of return on a portfolio of stocks and bonds? Much greater.

The past few years, of course, have seen an incredible surge in stock and bond markets.

So let us set those aside and look back at the history of rates of return over a long period of time before 1995.

We look as far as I can get comparable data. From 1926 to 1994, the real rate of return that would be earned in an IRA, 401–K kind of plan, investing in a balanced mix of stocks and bonds would be about 5½ percent, 5½ percent cumulative real return over that long period.

Indeed, it turns out that if we looked just at the post-war period, the last 50 years through 1994, before the recent stock market surge, again that would real rate of return has been about 5½ percent.

In other words, it has been about three times as large as the Social Security actuaries forecast for the future.

And while there will be ups and downs from year to year in the rates of return in financial markets, over the long haul, I think there is every reason to expect that that rate of return would be as high as it has been in the past.

Well, that much higher rate of return would permit—instead of an 18 percent payroll tax would permit financing the same level of benefits with mandatory contributions of less than 5 percent.

What that means in effect is an enormous tax cute for average individuals.

And that goes back again to the point that Senator Baucus made about particularly middle and low-income individuals. This is an enormous advantage.

I cannot think of any other tax change, program change that you could make that looking ahead would produce as much increase in net income to the average American family.

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For a family with $40,000 of income, having a 5 percent mandatory saving instead of an 18 percent payroll tax to finance the same benefits, that is 13 percent of payroll. That is $5,000 for that family.

Now, of course, that is the long run. And the real question is, can we get from here to there? What does the transition look like?

A common misconception is that it is very hard to get from here to there, that the transition generation would somehow have to pay double.

They would have to pay the 12 percent payroll tax that we are paying now to finance retirement benefits.

And then, they would have to pay another 12 percent to take care of themselves. Fortunately, that is a misconception. It is wrong.

In the transition years, employees would have to pay something extra, but much, much less than double.

It would be possible, for example—and we have worked through very carefully the information based on census forecasts and Social Security actuarial assumptions.

It would be possible to have a transition over a long period of time that maintained the level of future benefits for retirees, but that only required employees and employers together to put in about 2½ percent of payroll into these personal retirement accounts.

In the beginning, they would be putting that in, in addition to the full 12 percent payroll tax. But soon, as retirees come to depend more and more on withdrawals from these funded accounts, from these personal retirement accounts, the cost of the pay-as-you-go system would come down.

And so over a period of years, roughly 20 years, we would see the combined rate going from the current 12½ plus, say, an additional 2½ percent or 15 down to 12½, and then beyond that getting lower and lower into the future until ultimately a fully privatized system could be financed with a contribution of just about 2½ percent of payroll.

Let me turn very briefly to the subject in which I was actually asked to prepare remarks. And that is the effect of this kind of privatization on national saving in capital accumulation.

I can summarize the calculations that we have done, again based on census projections and Social Security actuarial assumptions.

A small increase in direct saving, putting aside about 2 percent of wages plus the earnings on the resulting accumulation, that is really the magic that makes all of this work.

It is not the 2 percent that people put in. It is the return that the capital stock generates, the return that we get as a Nation on the increases in physical plant and equipment leads to a very substantial increase in the capital stock.

Within 30 years, the capital stock would be about one-fifth larger than it otherwise would be. And in the very long run, it would be up by about 35 percent.

And that, in turn, would, of course, mean a more productive work force, higher real incomes.

The combination of that increase in productivity and the rise in real wages go with it plus even more importantly the reduction in the payroll taxes.

That would be possible as we substitute this mandatory saving would mean that the disposable income that people would have to spend on consumption, net of the payroll tax and net of the mandatory savings, that disposable income 30 years from now would for the average Social Security participant be up 13 percent and in the long run would be up 35 percent.

It is really remarkable what a little bit of saving and the power of compound interest can do over the long run.

I hope that these comments are helpful. And I will look forward to the questions after you hear from Professor Saving.

Senator GRAMM. Thank you.

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

Senator GRAMM. Dr. Saving.

STATEMENT OF THOMAS R. SAVING, PH.D., DIRECTOR, PRIVATE ENTERPRISE RESEARCH CENTER, TEXAS A&M UNIVERSITY, COLLEGE STATION, TX

Dr. SAVING. Thank you, Senator, for inviting me back again.

We are all acutely aware, and I think Marty has made us even more aware, except his is primarily about Social Security, that the Medicare expenditures have outstripped current revenue sources. And if left unchecked, the problem will continue to worsen.

And I must say that one of the things that was indicated by someone here, that is that often we might wait until the crisis is here and to do something.

I want to say the crisis is really already here. The sort of the intergenerational ballistic missile has already been launched. And our job is to somehow shoot it down. And luckily for us, it is possible to do that.

The changes that we have implemented recently in the restructuring of Medicare with the Balanced Budget Act really only affects Medicare's cash flow problems and does not address at all the pending Medicare financial disaster that is going to result when retirement of the baby-boomers begins.

And as you can see from this chart which we have had up here before, and it is useful to kind of review it.

But what we propose is a complete change in the way Medicare is financed, from the current pay-as-you-go financing that pits one generation against another to cohort-based financing where each generation pays for its own Medicare.

The nice thing about this solution is it is immune to birth rate variations, and immune, as you will see from the way it is done, to the fact that the population itself may be aging which is a separate problem from birth rate variations.

And we are coupling that with a change to catastrophic insurance that gives both retirees and insurers an incentive to care about the price of medical care and thereby affecting the actual level of medical care expenditures.

I think there are two things to keep in mind from the outset here. And that is that, one, the risk associated with paying for medical care needs of the current and future retirees are going to exist.

And that does not matter what we do here in the next 10 years. Nothing is going to change the fact that what is going to happen in the future is uncertain.

And we do not know what that is necessarily and that these costs are going to really happen. And we cannot prevent them by putting our head in the sand.

And secondly, saving for retirement, and I think as Professor Feldstein has said, is not a radical idea.

But in fact, if it is not implemented soon, it is going to result in a disastrous Federal financial crisis.

Medicare's current problems simply bring into focus the need to reexamine how we ensure against and save for each member's retirement expenses.

And we are suggesting a plan that produces the right incentives, secures individual's ownership of their retirement medical insurance, and ultimately makes Medicare a sustainable program.

The fact that it dovetails very nicely with the whole issue of elderly entitlements I think is propitious. And that is the way this whole thing should be carried forward.

As a final bonus, by acting swiftly, and this is a point Professor Feldstein made, is we can use the years of plenty that are represented by the baby-boomers to help finance the cost of the switch.

In fact, by restoring the incentive to save, we can increase the Nation's capital stock and significantly increase the real resources available to pay for retirees' medical expenses.

And it is important to recognize that it takes real resources to do that. The retirees are going to require real resources when they take medical care.

And bonds or IOUs cannot provide those resources. Real doctors and hospitals and things have to be there. And those have to be produced by someone.

I think to see the extent of the problem, I should reflect briefly on how we came to this, what I would refer to as the brink of financial disaster.

At the time of Medicare's inception, several trends had converged that played a large part in the structure.

And I think Senator Gramm had mentioned a few things about what the original—the originators' ideas were about what was going to happen.

From 1946 to 1965, real wages were rising at 2.3 percent a year. The post-war baby-boom had produced a record number of bodies soon to enter the labor market.

And you can see them in this chart because the labor force, the young, 19 years and younger, back in 1965, that is what the 19 year and younger group looked like. This giant big bulge in the population was—that is what you were looking at in 1965.

In fact, they were 77 million individuals 19 years age and younger in 1965 and only 19 million retirees.

So there were almost four times as many young people as there were old people.

Third, the introduction of medical insurance in the way it was structured. It was a pre-tax idea that occurred really and accidentally because of price controls and wage controls during World War II has lead to the kind of medical crisis that we are facing.

At the inception of Medicare then, the medical cost of the relatively small number of retirees, the top of the pyramid, in a manner of speaking, could be paid with the small tax payments by an ever growing number of workers.

And that is what we are seeing. Growing wages and blossoming future work force were the ideal conditions for a pay-as-you-go program.

But baby-boomers' entry into the labor force was really a two-edged sword and can be likened to the 7 years of plenty in the biblical story of Joseph and the pharaoh.

The passage of the years of plenty really in the form of the baby-boomers moving through their life cycles provided a huge surge in tax revenues.

And that surge in tax revenues could have been used for a number of things. We will not go into what it was used for.

But just as in the story of Joseph and the pharaoh, there is good news and bad news. For the pharaoh, of course, the good news was 7 years of plenty. And the bad news was 7 years of famine.

In our case, the baby-boomers are both. They are the good news and the bad news.

And their coming retirement starting a near 14 years from now will mean a reduction in revenue as the boomers stop paying taxes—so that is a double whammy—and an increase in medical costs as they start consuming real resources.

So they stop putting anything into the system. And they start taking things out of the system.

For pharaoh, that was not a problem. Joseph convinced the pharaoh to put grain away during the years of plenty. So when the famine came, the grain silos were full. They did not have IOUs in them. They had real grain.

And if each member of the baby-boom generation behaved like pharaoh, they would have put away their savings for their own retirement and medical care.

These savings would have increased the capital stock of the Nation and actually increased our real capacity to provide the health care demanded by retirees.

Unfortunately, our current Medicare system discourages personal saving for retirement health care expenses in two ways.

One, it taxes the working population to provide medical service for the retired, thereby reduce their disposable income and their ability to save for their own retirement, health care expenses.

And second, the existing medical care system allowed workers to rely on the government to provide for their retirement medical expenses.

As a result, our silos are empty. And importantly, this emptiness is not affected by the trust fund.

It is a mistake to be concerned about the trust fund because it was never more than IOUs. It was never real factories or anything else that was actually going to provide doctors and hospitals and something to the retired population.

But the baby-boomer generation still forms a major part of the active labor force. We can by acting quickly let them prevent us from getting into a financial crisis.

And so the question really is, how can we change the future? What would a social insurance program designed to take care of the health care needs of the elderly look like if we started from a clean slate?

We can change it all. And we propose that for each age cohort, defined as all individuals born between January 1 and December 31 in any given, that it ensures itself against retirement medical expenses.

And at the end of every year, this cohort's contributions are distributed into what we refer to as personal retirement insurance for medical expenses, prime accounts.

And importantly, Senator Baucus' reference here to people who cannot afford to put money away is taken care of by this system because the amount of redistribution that goes on is within cohorts rather than between cohorts.

That is that the Social Security Administration can collect the entire collections in a given year from a cohort and distribute equally, if you like, to every person with a Social Security number that is in that age cohort into a privately managed account.

At the end of the year, anyone that died during the year, all their funds go back to the Social Security Administration, in addition to all of the new contributions by that cohort.

And all of that money is then redistributed to the remaining people in the cohort.

So by the time the cohort has reached 65, if that is the age in which we decide the retirement medical expenses are going to begin, their benefits, at that point, they purchase this insurance. And the money is in their account.

Every 5 years, you review what medical expenditures are like so that you can adjust the amount that people are putting into these accounts.

For various reasons, everyone has to be required to participate in such a system.

And the primary reason for that is the reason that we now have is that retirees—and in general, we are not going to allow people who do not put money away not to get medical care.

We have decided that everyone is going to have medical care. And as a result, everyone has to participate in the system.

No one can make a choice and say I will take care of myself. We cannot allow that to happen.

The insurance that we propose is in its simplest form a catastrophic type of insurance coverage. And perhaps, that is a bit of an over exaggeration of what we are referring to, but it is high deductible in the sense.

And the one we have priced here is the $2,500 deductible kind of policy.

Importantly, of course, we are proposing replacing both Part A and Part B of Medicare.

So the trust fund, as you know, is only Part A of Medicare and only part of that. We are replacing everything with a simpler thing.

And as you will see later on, it is actually cheaper than what we are now doing.

Senator GRAMM. And Medicaid for the elderly.

Dr. SAVING. And Medicaid for the elderly. It is all elderly payments. I am sorry I missed that part. It is Part A, Part B, and Medicaid for the elderly.

And moreover, those retirees with serious medical problems, and I think this is important, the actual out-of-pocket cost in the kind of insurance that we are talking about is very little different from those incurred by today's Medicare recipients. And I think that is important to see.

Under the current Medicare system, as we know, redistribution occurs across generation. What we are referring to is redistribution occurs among an individual's cohort.

So a cohort-based system can address both the problems. It redistributes income within the cohort rather than across generations.

So the cohort is small. It will have fewer workers, but it will need fewer dollars. If the cohort is large, it will need more dollars, but it will have more participants.

So we are going to be floating on a normal wave rather than sitting on the beach where we get swamped by a large wave.

If we act swiftly, we can accomplish all of the following. First, we can switch all the baby-boomers to a fully funded Medicare system before the years of famine begin. There is still time to put grain in the silos.

Secondly, the payments into the system will be invested into the economy which will result in an increase in our National saving rate and an increase in the Nation's capital stock.

Thereby, it will provide an increase in the gross domestic product and will really have something put away for the future rather than giving individuals incentives not to save.

We estimate that if we act soon, by the time the first baby-boomers retire in 2011, our Nation's capital stock will be 7 percent larger than if we do nothing.

And that is considering the Medicare is only 5 percent of gross domestic products.

Now, that 7 percent increase in gross domestic product will play a large part in the lull in actually providing the real resources that are required.

Third, the increased savings rate will increase the gross rate—the growth rate of gross domestic product significantly.

And fourth I think and lastly, this 100 percent coverage, health care policy, we suggest the high deductible will make retirees care what medical care costs, this first dollar part and will give us the benefit of increased competition as providers compete for the first dollars of those retirees' health expenditures.

But the real question is, what will such a dramatic change in financing Medicare cost? Our estimates indicate that using as a base the current 2.9 percent Medicare tax and switching all the baby-boomers into our proposed cohort financing will yield substantial long-run benefits at the cost of a short-run cash flow problem.

In these calculations, we are assuming that all the older cohorts, that is older the baby-boomers which are now 50 years old, are assumed to remain in the current Medicare system.

The older retirees' expenditures are financed by the excessive contributions from the switched population.

That is the baby-boomers and younger, and the contributions of the yet-to-retire people, and the remaining coming from general tax revenues.

If we assume a modes 3.5 percent real rate of return, we estimate the total cost of this transition at $734 billion. That is the present value cost.

And if you were to pay it over a 50-year period, it is an annual payment of something like $31 billion.

Once the last of the baby-boomers have left the system, that is they have died, the future generations are all self-funded.

And they are self-funded at tax rates which are significantly lower, a point I am getting to right now.

The tax rate that will accomplish all of this is modest compared to even just the 2.9 percent Part A tax and is remarkably small when you compare it to the full 4.4 percent tax rate that is implied by Part A tax and the current Part B subsidy plus the Medicare for the—Medicaid for the elderly.

Assuming a modest 3.5 percent real rate of return, a 1.36 percent tax rate would suffice to provide medical care, retirement medical care coverage, fully funded retirement medical care coverage.

It will replace both Parts A and Part B of Medicare and the elderly Medicaid.

If we were to use one of Professor Feldstein's rates of 9 percent real return where you added in the taxes that corporations would have paid, you can fund this for two-tenths of 1 percent—two-tenths of 1 percent.

Moreover, at this rate of return, the unfunded liability would be $234 billion which could be paid off in 50 annual payments of $10 billion.

The fact that the transition to the cohort finance system can be done as cheaply as we imply may indicate that there is no hurry. We can take our time. This is cheap. And the solution can wait. But nothing could be further from the truth.

The cheapness of this in fact depends on the fact that you act rapidly. To succeed, our plan must capture the productivity of the baby-boomers.

Even taking the laziest scenario, that is the 9 percent rate of return, the cost of waiting 10 years to adopt our system increases the today's value of the cost more than five times.

If you wait 20 years to adopt it so that a lot of the baby-boomers are now already retired, the cost increases more than 20 times.

We cannot afford to wait if we are to solve this problem. We have to shoot down the intergenerational ballistic missile. And the only way to do it is to get after it now.

I think one final point is worth making. One of the great benefits of moving to a cohort-based financing for Medicare is that the reputation of the system can be restored, even before making any further reductions in benefits that must be enacted to keep the current system solvent.

Young people believe the system is not going to be there for them. This distrust of government has been exasperated by this year's changes.

And if further changes must be made, a clear—but if we give them further changes, if we move to cohort-based financing, we will send a clear message to young people.

That message is while we change the existing system, we have taken steps to ensure that the system will be there for the young people.

Moreover, we restore their confidence by giving them a property right in their Medicare. The Medicare is theirs.

It is not to be taken away for any other kind of use. It cannot be used to fund physicians' education at teaching hospitals because it will actually be in their accounts.

There is no way that anyone can get access to it. And I think that is an important thing.

The main thing is that in order to accomplish any of this, and this is also true of the Social Security reform, you have to act soon. You cannot wait. Waiting is expensive.

And this is a project that actually has—I believe if proper accounting is done has a positive benefit versus a cost to the country.

Thank you.

Senator GRAMM. Thank you. Let me thank both of you.

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

Senator GRAMM. Let me begin by trying to summarize both of your testimonies because you have covered what, for people that do not have the benefit of reading your statements, is very complicated material. And let me begin with you, Dr. Saving, and then go to Dr. Feldstein.

Basically, what you are both saying is that the power of compound interest really represents the foundation for the solution to both the Medicare problem and the Social Security problem. Throughout history, only a very small number of people have ever truly understood the power of compound interest. And very few people have ever been able to put it to work for them. They became very wealthy people as a result. The genius of both of the systems that you are talking about is that they put that power of compound interest to work in a program for average workers, a program to pay for their medical care when they retire and a program to fund the core of their retirement income.

Now, let me summarize, and you tell me if you agree, Dr. Saving. Basically, what you are saying is this, that with Medicare we have a program now where 2.9 percent of the payroll is funding only part of the program, Part A, and that the real tax is about 4.4 percent of payroll when you put Part A and Part B together. And that is not even counting elderly Medicaid.

Dr. SAVING. Right.

Senator GRAMM. If you added Medicaid, that would clearly drive the cost to over 5 percent of payroll. If we had an investment-funded system, even under the most conservative estimates, your average worker entering the labor market could fund their health care program for less than half of what they are currently paying.

In fact, if you had the real rate of return of the economy as a whole, which is being taxed several times before the investor gets it, then that actual number would fall from about 1.3 percent of payroll down to 0.2 percent of payroll. Is that right?

Dr. SAVING. That is correct, exactly.

Senator GRAMM. In Dr. Feldstein's investment-based Social Security program, obviously people get a retirement benefit based on what they put away. Under your system for Medicare, we do not want a program where people get more health care or get less health care.

To illustrate your program, let us look at a person who starts off, say, at 22, when he or she enters the labor market. At the age of 22, we do not really know who is going to be successful and who is not. We do not know who is going to get rich and who is not. We do not know who is going to live and who is not. We do not know with any degree of certainty who is going to be healthy and who is not.

What you call an age cohort, for example everybody 22 years of age, would start off paying into a mandatory program to provide for their health care and retirement. Let us just start with your number, 1.3 percent. Those funds would go into the Medicare Health Care Financing Administration, or whoever is administering the program. Everybody would be paying a fixed percentage of their wages. So obviously, high-wage people would be paying more. Low-wage people would be paying less.

And under your system, as I understand it, all the money would be put together and then would be, at the end of year, put into the individual investment accounts. These accounts would be regulated or supervised by the government on a safety and soundness basis. And these investments would then be made so that all the workers would have the same amount going into each of their accounts that year, based on the total amount that was paid in. Is that right?

Dr. SAVING. That is correct, yes.

Senator GRAMM. And then, every 5 years, you would conduct an assessment of what the value of their investments is relative to what the projected costs of their health care are. And then, you would adjust the numbers. The mandatory contribution could be lowered or raised, depending on what the estimate is of what the costs are going to be. And obviously, as they get close to retirement, that becomes important.

Dr. SAVING. That is correct. And I think the advantage of that, I might add, is that instead of this if you raised it or lowered it, it does not—it is not a change in taxes in a sense because it is actually going into their own account.

It is a different kind of a raise, even if you had to raise it.

Senator GRAMM. Well, one of the things that I do not think is understood enough is that workers respond to Medicare and Social Security payments today, when they are 22 years old, as though they are a tax. And they view them as a net reduction in their salaries. It affects their willingness to work. It represents from the point of view of the labor market almost a dead weight loss. It is being heavily discounted as being of any value.

But when people in an investment-based Social Security system get a passbook that every month says this is how much money you have in your account, that cannot be spent for anything else except your retirement, that it belongs to you, it is your wealth, and when they have a similar account that says this is the amount that is available from last year for your retirement health care, as people come to evaluate this as something that is of value to them, something they own, it is going to affect the labor market. It is going to affect the ability, the willingness of people to supply labor. I am not sure that is all factored in the debate.

Your approach on transition is that you calculate a break-even point, which is about 40 years of age with a lower rate of return on investment. And you say, let everybody who, from this point on, if they paid the 2.9 percent, if they could fund their health care, put them into the system, the new system, if they choose to get into it.

And then, for the people who are younger, they pay 2.9%, but only the amount that is needed to refund their program goes into the real investment. The difference goes to help pay off the unfunded liability cost of the current system.

You are saying in essence that if you calculated the present value of what B owed for the unfunded liability, to pay out the benefits we guaranteed, that is over $700 billion. If you paid that out with interest, over a 50-year period that would be about $31 billion a year.

That sounds big until you look at this huge growth in Medicare that we are facing. Very quickly, under your system, you are going to work out of being in the red to being in the black.

So, while $700 billion even in Washington is a lot of money, we have to look at the fact that in 10 years we will have an unfunded liability under the current Medicare system, without reform, of $1.1 trillion. Your point is that if you can get wealth created quickly, so that it can compound until the babyboomers retire, then that investment can do a lot of the heavy pulling.

Dr. Feldstein, let me turn to your presentation. I think people have thought about Social Security more than Medicare, but it is basically the same system.

You point out that the rates of return on the existing system are very, very low. And that is assuming that the government lives up to the commitments it has made. That is, there are no further changes, that we do not change the consumer price index to cut benefits, that we do not further raise the retirement age. Those are pretty optimistic assumptions in terms of the status quo, probably unrealizable.

Your findings are that even in paying out those benefits, we could begin a transition where, in the short run, workers would pay 2 percent more of payroll, but very quickly we would be back down to the current rate of contribution and then that rate would fall very rapidly thereafter.

Dr. FELDSTEIN. That is correct. For a young person, that is correct.

Senator GRAMM. Now, you could do it. There would be no reason, if it worked out better, that Dr. Saving could not do his program in the same way. You could take people who, say, your break-even age would be 45, where the current 12.4 percent if invested for 20 years would equal the current retirement benefits being provided by Medicare. There is no reason why you could not do your transition in that way if you chose to do it.

And then, for example, let me just make up some numbers. Let us say everybody 45 and younger, if we gave them the choice of putting their money into a real investment, could fund a retirement at least as great as the current system with the 12.4 percent of payroll. And let us say that you took the difference between the 12.4 and what the younger people had to pay in this transition period and you used it to fund the transition cost, part of it. You could calculate a number and come up with a 50-year pay-out by going ahead and in essence borrowing the money now to fund it and guarantee it, paying it out over, say, a 50-year period.

It would be interesting to see how big that number would be.

Dr. FELDSTEIN. You could do it by borrowing, but you would have to then think very hard about what that borrowing did to the capital stock.

And if it depressed the capital stock, if it crowded out other investment, then the real cost of that borrowing would be much higher than just the interest rate that the government pays on those bonds.

And that is why in the calculations that I and my colleagues have done, we have always avoided the borrowing.

We have just looked at a transition system which is feasible without the government doing any borrowing, other than using up the funds in the trust fund.

Senator GRAMM. As we know, there is not a real fund at all. The trust fund does not count as a debt of the Federal Government. The interest paid to it does not count as an outlay of the Federal Treasury. It is a phony trust fund in every respect.

But you could take that and use it not just to put off making a decision, but you could use it to fund part of the transition.

Dr. FELDSTEIN. But there is not enough there to do it.

Senator GRAMM. Well, I am just saying though that we are going to have to sell these bonds in the trust fund to buy time under the current status quo. If you went ahead and sold the bonds to fund the transition cost, you could lower the cost, not from an economic point of view, but from an accounting point of view.

I guess my point is that——

Dr. FELDSTEIN. That is exactly what happens in the transition that I just sketched very briefly that those bonds are sold. And that allows the tax rate to be less than it otherwise would have to be.

If you just sort of waved your hand and say we are going to forget that there is that trust fund, then you would need an even higher tax rate during the next 30 years. So we actually do have that as part of the calculations.

Senator GRAMM. Let me pose a couple of questions. And then, we will see if someone else comes back who wants to pose questions.

Let me go to the Baucus question about low-income people. I am told, but I do not know, and I think it would be interesting to check out, that Social Security is one of the few programs that reallocates wealth from the poor to the rich.

And if you think about it, it is easy to believe that this is true. Poor people, who start to work early in their lives, do not get any credit toward their Social Security benefits for the first 15 years they work or the first 10, depending on when they enter the labor market. So between 10 and 15 years that they are working when other people are going to school and graduate school and traveling to see Europe or whatever they do, working people are working for nothing in terms of building up their retirement because only the last 30 years of employment count.

Most blue-collar workers will pay into the system for 45 or 50 years. They get no benefit from having paid in early because there is no compounding effect. Working people, blue-collar workers also do not tend to live as long. So they do not get benefits for as long as others do.

It seems to me that while you are attempting to say, well, the current system redistributes wealth because you have these bin points in Social Security, you are ignoring that it tends to transfer wealth to the rich. This is not an argument against Dr. Saving's argument because what he is proposing to do is all upfront, and is contained within a generation and not between generations.

But under your system, Dr. Feldstein, it seems to me that if you worked it out, if you had the numbers, one might actually make a case that with real investment lower-income people who work longer periods of time might actually benefit from an investment-based system relative to the pay-as-you-go because time is rewarded by compound interest.

Dr. FELDSTEIN. Well, they would benefit enormously. Simply, everybody would benefit enormously because the tax rate would be so—the contribution rate would be so much lower than the contemplated tax rates.

So it is then a fine calculation to say whether people with incomes of $30,000 would do relatively better than people with income of $50,000.

But for all of them, it would be a substitution of a mandatory saving of something less than 5 percent for payroll for what would otherwise be an 18 percent payroll tax.

For the very high-income individual, Social Security is relatively unimportant. So the relative saving for the rich is clearly trivially small.

It is proportional to wages for everybody else. It has the extra advantage, as you said, that for people who work a longer period of time or situations where you have two earners who now in many cases, the second earner does not get any benefit, any economic benefit for her contribution.

Senator GRAMM. Again, that is a reallocation from low-income people to high-income people because high-income families are more likely to have one wage earner. Whereas, low-income couples are more likely to have both work.

Dr. FELDSTEIN. Yes.

Senator GRAMM. I do not know whether you have looked——

Dr. FELDSTEIN. I know in the case of Medicare that some calculations done by some colleagues of mine at the National Bureau of Economic Research showed that Medicare does redistribute to high-income individuals because they live longer, they consume more medical care.

And so there is a program which is rapidly becoming even more expensive than the pension program which is redistributing and in a way that people really had not taken into account.

Senator GRAMM. I do not know whether you have looked at the Chilean system, but one of the attractive things about their system is that they have a guaranteed minimum benefit. Now, interestingly enough, it has been a very inexpensive guarantee because what their system has done is really turn Marx on its head. Since 1980 working people have been accumulating wealth. And they have been benefitting from compound interest. And so you meet a taxicab driver or a house painter who has $70,000 or $80,000 U.S. dollar equivalent of wealth, real wealth.

Our system of Social Security and Chile's previous system are both based on the same pattern, and that is the Bismarck system that came from Germany. Chile started theirs 10 years before we did, in 1925. And when they started their system, they had 10 workers per retiree. And when it went broke, they had two workers per retiree, very similar to the kind of numbers that we are looking at, as we look 25 years into the future.

Chile allowed people to opt into a new investment-based system. Ninety-five percent of the people decided to do it. And they have a guarantee that says if you put into the system the required amount, then at the end of your working life, we guarantee a minimum pension. You maybe missed years. You may have had low income. You may have been sick. But we guarantee that at the end of your working life, if you have fallen short, then we are going to make up the difference so that you are going to get a minimum amount no matter what.

The interesting thing is that with the power of compound interest, that guarantee has cost them virtually nothing. But it gave people security to know that if they worked, no matter what happened to them, they would have a basic pension. It is like buying an insurance policy in a sense, a real insurance policy where if you live, you are going to be successful. It seems to me that something like that would be needed.

Dr. FELDSTEIN. I think we could do that in the following sense. We did calculations as part of this report that I know you have read of the risks that individuals would be exposed to.

If the average rate of return is 5½ percent and they save a certain amount, then the benefits that they will get if they actually get that 5½ percent, there is some given level.

And you could set the mandatory, the required saving to target the existing projected Social Security benefits.

But since there is uncertainty about that return, there is an even chance that retirees would come out ahead having more than the benefits that they needed and even chance that they would come out below.

What we did was to ask, well, maybe if you added a little bit more? So you upped your savings rate to build a cushion into that number. Then, you would reduce the risk of being below.

And you would increase the odds that you actually had more than the Social Security program provided.

The thing that I learned from that exercise is that you do not have to begin. Because of the magic of compound interest, you do not have to add a lot to your savings to build up a very big cushion against the fluctuations that would otherwise occur.

An extra percentage point in the mandatory savings makes it virtually certain.

Based on the ups and downs of the stock market over the last 50 years makes it virtually certain that individuals would be on the ups side, would have at least as much as they would have gotten from Social Security.

So I think the government could come along and say, we will provide a guarantee and that that would be, as you said, a costless guarantee that if in fact history surprises us and there really is a long draught in the financial markets, then the then-working generation would have to do on a pay-as-you-go basis that supplement.

But I think the risk of it if we require people to save just a little bit more than the face amount would be very, very small.

Senator GRAMM. Well, one other little wrinkle that I like about the Chilean system and the system that is now being put into place in Australia is that they require a minimum pension level for retirement.

You can do this when you have a system based on somebody's accumulated savings as compared to debt. In Chile, if someone, say, is 55 and decides, well, I would really like to retire when I am 60 and not 65, Chile has a minimum retirement that says you can retire any time that you can equal 50 percent of your current wages in your retirement program in perpetuity. What that allows workers to do is to put the information into a computer, and look at their account. They can find out almost instantaneously that at current rates of return, if they increase their contribution from 10 percent to, say, 13 percent, than they could in fact reach 50 percent of their projected earnings at 60 instead of 65 in which case, they can set their retirement age instead of the government doing it.

For blue-collar people who may be working at very physically demanding jobs and who might choose to retire early because they want to enjoy the benefit of retirement, that is a God-send expecially relative to the direction we are going in this country, which is raising the retirement age. To the three of us that might be pretty irrelevant because we intend to work until we die. But to a guy who is doing a job that is drudgery and who would like to retire early, this kind of option would be an absolute God-send, would raise his happiness level tremendously. That is something we cannot do with our system. In fact, we are going in the opposite direction.

We vote on raising the retirement age. And I was a leader in trying to raise eligibility ages for Medicare because we have to do it with the current system. But the reality is that for blue-collar people, that is a very, very heavy burden. Whereas, for white-collar people, it is relatively insignificant.

That is another strength of what you are saying. It lets us tailor our program to our own lives, not some imaginary life some politician visualizes as to what America is like.

Let me conclude so I can recognize my colleagues by just sharing the best analogy I have heard of our situation.

The best analogy that I have heard for Medicare and Social Security, says that we are on the Titanic. And we are heading toward an iceberg. And we cannot avoid it. We are going to hit it. Our challenge is to get people off the Titanic, to get them into these lifeboats. And the water is cold. And there is floating ice out there. And then, we must take them in those lifeboats to another ship that is not going to hit the iceberg.

The problem is the Titanic looks big. And it looks safe. And the water is cold. And also, there is a lot of fog and ice out there. There are some people who do not want to see the iceberg. They want to deny its existence.

Our challenge and why your work is so important, our challenge is to convince people that there is an iceberg, that we are going to hit it, that the ship is going to sink, and that we are going to have to get in these lifeboats anyway, only if we wait we are already going to be in the water.

It seems to me that to solve this problem, we have to convince people of the following. Number one, that we can pay people the benefits they have grown to expect if we make the transition. We cannot, if we do not.

Number two, that we can let the current working generation, especially young people, have retirement benefits at least as good as they have been promised now, and probably better, but we cannot do that if we stay with the current system.

It is always difficult to change things. And I am a firm believer that the burden of proof is always on people who want to change things.

And I want to thank both of you for your research. I think that it allows someone like me to be able to say in this debate, for the first time, something optimistic. It is like going to a doctor and the doctor says, well, I have bad news and good news. The bad news is you have a debilitating disease that is going to ruin your life. The good news is I can cure it, but you have to go on this diet.

In this case, there are not many bitter pills. The diet is not that stringent. But you have to start early. You cannot wait until you have had a heart attack and tell the doctor, well, wait a minute, I have to go play golf next Friday. And his answer is, well, you should have thought about that when you were 40 years old, when you were not doing exercise you were becoming overweight. Basically, your point is it is still early enough to make these changes and really improve the lifestyle rather than hurt it.

I think that is a very powerful idea.

Let me recognize Senator Grassley.

Senator GRASSLEY. First of all, I only have one question for Dr. Feldstein. But I want to apologize. I missed half of your presentation.

And I missed all of yours, Dr. Saving, because I was across the hall at the Judiciary Committee where I had a constituent who was testifying.

I would ask you, because presently Social Security has to be paid, the taxes, half paid by the employer and half paid by the employee, do you see, foresee a role for the employer and a mandate, his personal savings plan?

Dr. FELDSTEIN. Yes. I think the natural and the administratively efficient way of doing it is to have the employer withhold.

You could have the employer required to pay half and the employee required to pay half. I do not think that is really central.

But the employer would be the entity that collected the funds and then sent them off to a bank, an insurance company, a mutual fund or something like that.

The individual could then designate the particular kind of approved investment that the funds might go into.

Or if the individual does not make any choice, then the employers by sending it to that insurance company or that mutual fund would in effect have developed a default option, a background option that individuals would automatically be invested in.

But the employer would be the collecting agency because that would keep the cost of this much, much lower than they would be if individuals were required to send their funds off as they do in an IRA. It would be like a 401-K plan basically.

Senator GRASSLEY. Thank you, Mr. Chairman.

Senator GRAMM. Thank you.

Senator Baucus had about five questions, I think three to Dr. Saving and a couple to Dr. Feldstein. We will go ahead and send you these questions. And then, if you can give us the answers in writing.

Senator Baucus had to leave to go to another hearing.

Senator GRAMM. We have with us now Senator Rod Grams. Rod and I went to Chile and took a very close look at their system. We not only met with the economist, the sort of physicist who put the thing together, but we met with the engineers and the mechanics and the people who are actually making it work day by day. As a result of that experience, Rod and I have been very interested in this whole approach.

And, Rod, let me recognize you.

Senator GRAMS. Thank you very much, Mr. Chairman. And, gentlemen, thank you for being here.

Just a couple of brief questions. And I am sorry I am late. So I am not sure if they have all been covered, but I am assured they probably have been in some respects, maybe just a little more emphasis on some of our concerns, as well.

And one of my basic questions would be, first of all, what if we do nothing? What happens if nothing is done with the current system?

Dr. FELDSTEIN. If we do nothing, let me just focus on the Social Security pension part, not the Medicare part, but the situation is really analogous.

If we do nothing, the trust fund runs out. We can continue to meet benefits. Then, in the year 2030, we wake up and discover that we either have to raise taxes by about 50 percent. In other words, from 12½ to 18 percent suddenly. Or we have to cut benefits by a third.

Neither of those look like a very attractive choice, but that is what would happen in a pay-as-you-go system.

Senator GRAMS. Are we not basically going to have to raise taxes by like 2012 or 2013 to pay back the IOUs that are in the trust accounts?

So are we not facing a——

Dr. FELDSTEIN. Well, what I am really describing, what I did say in my prepared remarks is that around that date, the date you just mentioned, the trust funds would start shrinking.

Senator GRAMS. Right.

Dr. FELDSTEIN. And so in effect, the government would be running a deficit.

Senator GRAMS. Right.

Dr. FELDSTEIN. And if the government did not want to run a deficit, then, you would have to have higher taxes.

But if you just look at the Social Security system separate from everything else and you continue with the fiction of the trust funds, then you have another 18 years during which that trust fund shrinks.

And the combination of the shrinking trust fund and the taxes are enough to finance projected benefits.

But then, it runs out. And the day of reckoning really hits.

Senator GRAMS. So the unavoidable scenario is either raise taxes or cut benefits or both in the current system?

Dr. FELDSTEIN. Right. And in a very big way once the trust fund is empty.

Senator GRAMS. And we would see what will happen if people start talking about COLA adjustments.

Dr. FELDSTEIN. Right.

Senator GRAMS. Can you imagine the argument over slashing benefits by as much as you talked about?

Dr. FELDSTEIN. It is hard to think that either of those is a politically viable outcome. And the various suggestions for tampering with benefits, changing the indexing which I think there is good reason to do, but the ultimate saving on that would mean that instead of an 18 percent payroll tax, you would need a 16.2 percent payroll tax.

You do not really solve the problem that way. If you push the retirement age off another year or two, then you hit very hard people who find it difficult to go on working because ultimately they will retire earlier, but with lower benefits.

But again, you do not solve the very high tax rate problems. The only way you are going to deal with it I think is to start to build up some kind of funded option.

Dr. SAVING. And the real problem is that nothing real in either one of these systems has ever been put away.

I mean, there are no real resources to be taken. And the trust funds are fictions in that sense. And so that if you wait and never put any real resources away, then the increased level of use of the system is just—for Medicare, even if you wait 20 years, you increase the cost by a factor of 10.

Senator GRAMS. Dr. Saving, Professor Eisner from Northwestern University argues that if we increase productivity by just 1 percent by the year 2030, the economy will have enough to cover the trust fund deficit. Will that happen?

Dr. SAVING. Well, I think that it will happen if we convert over to the system that Professor Feldstein and I are talking about. In fact, more than that will happen, but that is the only way it is going to happen.

What Eisner is really discussing is exactly what we are talking about. That is real things have to happen.

And why should this increase of 1 percent in, say, productivity be used for this thing? Why should the rest of the people not enjoy it?

That is what I would say to Bob is that he is making a mistake in looking at this. And we can achieve exactly what he wants to do by simply changing the system. It is all the reason why we ought to change the system rather than a criticism of it.

Senator GRAMS. You mean that he would advocate that you take everything from the increased productivity just to go in and to fund the system rather than do the other thing.

Dr. FELDSTEIN. No, I do not think so. I mean, if we literally take his argument, it is that if the tooth fairy comes down and grants us this extra 1 percent, that is the big assumption. Somehow by some miracle, we are going to get an extra 1 percent.

Senator GRAMS. We have passed budgets like that.

Dr. FELDSTEIN. Well, one way to put that 1 percent in perspective is that the current projections of productivity gains over the next 30 years is about 1 percent.

So this is a doubling. It is a 100 percent increase relative to the base line. So that is miracle stuff.

But if that miracle happens, then 33 years from now, thanks to compound interest, the GDP would be about 40 percent higher. Payrolls would be about 40 percent higher.

And if you tax them at the 12.4 percent, you get just about enough revenue to keep the system going.

So if a big miracle happens, then we do not have to worry. The iceberg melts.

Dr. SAVING. Well, I think in addition to that though, what you have done is you have taken all of that gain away from the workers.

Dr. FELDSTEIN. No, it is not all of it. No, no, it is not all of it. It is just the 12.4. You would apply 12.4 percent of it.

But it is a miracle. That is the key thing for Professor Eisner to bear in mind.

Senator GRAMM. This miracle would have to occur with 60 percent tax rates, not for rich people, but for blue-collar workers. That is the problem when you are counting on this miracle growth solution.

Dr. FELDSTEIN. We would not actually get to the 60 percent tax rates because all this miracle is going to happen just before the iceberg.

Just before we hit the iceberg, the lightning comes down. And the iceberg melts. So we never actually have to have the 60 percent thing in the Eisner calculation. But it is a miracle.

Senator GRAMS. Just a couple of other brief comments, we will hear a lot of those who say, well, we have been able to tinker with the system.

Medicare, we have been able to make changes to keep it solvent. Social Security, we can do the same.

Can we tinker with the current system in any way over the next 30 years to keep it solvent and to have it as a meaningful retirement program?

Dr. FELDSTEIN. Well, you could tinker with it, meaning cut benefits. That is what tinkering means.

Senator GRAMS. Or raise taxes.

Dr. FELDSTEIN. Or raise taxes a little bit. But let us just look at the benefit side. You could tinker with it in a variety of ways, changing the age and changing the bend points and all of that, all of which would cut benefits.

But either you are going to cut benefits by a third or you are going to raise taxes by a corresponding amount.

To me, the point is that even if we did not have the demographic transition that focuses everybody's attention on that, even if we could keep going with the current 12.4 percent, it would just be a lousy deal. It would be a very poor rate of return.

It is the Social Security actuaries who tell us it is a less than 2 percent real rate of return that we are forcing people to take rather than giving them the opportunity to invest in real plant and equipment which for the economy as a whole earns about 9 percent.

So the demographic transition is attention getting. It tells us that something politically very unpleasant would have to happen one way or the other if we do not move to a funded system.

But even if we did not have that there, I would say I would want to make this transition to a much more favorable way of financing retirement incomes.

Senator GRAMS. What is the biggest concern that you would have or has been stated maybe as a generalization of the program of transforming Social Security from an instrument of investment or to an instrument of investment rather than the current pay-go system, like the crash of the market?

I mean, people's retirements would be wiped out. There are some concerns out there.

Dr. FELDSTEIN. There are a variety of concerns. I talked about the investment risks, the fluctuations.

And the fact that if the mandated savings was just a little bit higher, an extra percentage point of payroll, you could build up enough of a cushion that the chance that people would not get—given the historical fluctuations in the market, that people would not get the Social Security level of benefits would be really very, very, very small.

The government could in effect guarantee that and yet have very little exposure.

Administrative costs are another problem that people point to. And they usually point to it after they have come back from Chile or read something about Chile because Chile, while there are many wonderful things about what they have done, they do have a God awful expensive way of administering it.

They have made a lot of, quote, mistakes. They have in terms of their administrative structure and the fact that firms are—have an incentive to incur very large sales costs because they cannot compete on product quality because of the regulations in the Chilean system.

So I think that we have a very well developed mutual fund, banking, insurance industry. That would not be a big problem in the United States, especially if the way funds are collected and disbursed is through the employers rather than having the employees having to take their funds and send it and open accounts, that the employers would do it.

In the world of modern computers, the administrative costs would be very low. But that is a concern that people come back to me.

But when you start with a Social Security pay-as-you-go system that has got an explicit return of 2 percent and you say society on real investments earn just 9 percent, you have a lot of administrative waste and still come out a heck of a lot better with that 9 percent.

Dr. SAVING. And the other issue is that these disasters, financial disasters are economy-wide disasters that affect government revenues as well.

So you really—the risk does not change at all. It is still exactly the same risk.

If we went into a great depression, is it, are all the people who are unemployed going to say that retired people are living like kings? Should they be allowed to do that?

And I think that you would have exactly the same problem, just faced differently.

Senator GRAMS. The regulations in Chile, of course, are based on safety and soundness. They want to make it as safe and as sound as it can be.

And I imagine, we would have sort of regulations or maybe a tightening of those reins just to make sure that we would not come into a problem like that. So——

Dr. FELDSTEIN. Sure. There would have to be safety and soundness regulations.

But the way in which people are restricted or companies are restricted in the returns that they can offer in Chile means that they really cannot say, well, we have got a better performance record.

All they can say is, we will give you another toaster or a television set or a bicycle if you will bring your account to us.

And then, next year, there is another guy waiting to induce you to bring your account to him. So there are a lot of bicycle costs in this that are keeping up the administrative side of this.

Senator GRAMS. One final question, you know, I always talk about bipartisanship being that you can agree that there is a problem. You can debate very hard on the differences in approaching the answers.

But how can we, do you feel, conduct some debates like we are starting here with the chairman holding this hearing on the future of Social Security?

If we are going to have some out there, they are going to be resorting to scare tactics to keep this from moving forward.

So I think we need some honest debates. I think the public needs to know what is going on, needs to know the alternatives, and what are some of the scenarios so they can make a decent observation and decision.

But how do we conduct in an atmosphere where people are not going to use the scare tactics as you saw in Medicare and other things?

Can we hold some reasonable debates and hearings without that political involvement?

Dr. FELDSTEIN. You cannot squeeze the politics out of important policy decisions. So they are bound to be there.

What you can hope is that if you have enough hearings and you bring in people from both sides and if you bring them together rather than just separately and if the press takes a serious interest in this and begins to educate themselves about the numbers, that the public will understand it, will come to understand it because it certainly is an issue in which the public has a great deal of interest.

And I think one of the things that we have going for us is that 401–K plans and IRAs have now become much more widespread than they were in the past.

So people have an experience with something like that. It is not an alien concept to say instead of sending your contribution to a, quote, trust fund in Washington, you will put it into your 401–K plan.

And I think if people can begin to associate it with something that they understand more concretely, we will not have the scope for those kinds of scare tactics.

Senator GRAMS. Are you familiar with the PEBEs, the Public Employment Benefit, that is supposed to next year, I believe the Social Security Administration begin providing Americans with what their benefits are going to be under Social Security?

We have got an amendment in that says that they have got to provide even better information in current dollars, you know, or real dollars, not current dollars.

Dr. FELDSTEIN. Yes.

Senator GRAMS. Because if you are 25 today and going to retire in 2043, the statement you get next year will say you are going to have $98,989 in benefits.

Dr. FELDSTEIN. There is one other number that would be very nice to put in which the Social Security Administration could program in very easily. And that would be the rate of return implied in these numbers.

Senator GRAMS. That is what our bill asks for, rate of returns, status of the trust fund, real dollars, and then what your benefit—how much you are contributing, including the employer.

Dr. FELDSTEIN. Because I think if people look and they see that they are—here is the projected contributions. Here is the projected benefit.

And the Social Security actuary tells them that their expected real return is minus 0.2 percent or plus 1.3 percent, they are going to say wait a second. Wait a second. There has got to be something better.

Senator GRAMS. Is that a good step in the right direction?

Dr. FELDSTEIN. That is a great step in the right direction.

Senator GRAMS. If we get that approved so people can begin the debate.

Dr. FELDSTEIN. A great step. I hope there is bipartisan support for that bill and enough support to make it happen.

Dr. SAVING. And I think on the Medicare front to raise this issue and I will say one last thing about it is that if the issue of bipartisanship is one of redistribution, you can have any level of redistribution.

I mean, that is what makes this Medicare thing not really a politically issue, if that is the issue is redistribution, taking care of the poor and all of those kinds of things because this is a system that does that.

Senator GRAMS. Thank you, Mr. Chairman. I appreciate it. And thanks again for holding this hearing.

Senator GRAMM. Thank you, Senator Grams.

I would say on the administrative structure, that there is no reason, if it is a superior system, that we could not use the same system of collecting the funds, the payroll deduction, the employer/employee contribution run through the existing Social Security system. The question is, what is done with the funds? Are they spent or are they invested? And I think that is the issue.

I think the criticism of Chile is basically unfair in two ways. Number one, they did not really have a capital market when they started. So they had to invent a capital market. Then, it was not big enough. And they had to develop a system to invest abroad.

In contrast, we have the largest, most developed capital market in the world. Of course the administrative cost of the system which takes your money and then spends it, giving it to somebody else, that system can be very cost effective. I mean, it is just like when people pick your pocket. It does not cost you anything. You do not have to pay them to do it. They do it for nothing. And the administrative cost may be low as compared to buying into a mutual fund. The problem is someone else has the money and not you.

So I think this is something we can deal with. But I agree with Senator Grams that I think what we have to do is give people the truth. It is clear that the Social Security Administration historically has not wanted to do that. The statement that they provide does not include how much your employer put in, which we all know is part of your wages. I think good reporting of what actually the benefits are, what the return is, how much you put in is very important.

I also agree with those who would say, as Alan Greenspan does, that another very therapeutic change we could make, which is only bookkeeping, but it would be revolutionary politically, is if we from time to time had to do our government books on an accrual basis. If we had to present Medicare and Social Security on an accrual basis of accounting like every business firm in America and every individual has to do in paying their taxes and keeping their books, people would then understand the magnitude of this problem. If people know the magnitude of this problem it would be like the old biblical admonition, you shall know the truth and the truth shall make you free.

I think that those who want to preserve the status quo will reject that option to let people know how big the problem is.

And the people who want to defend the status quo, we want to give them ample opportunity to do it before these Subcommittees.

Before we stop, are there any additional points that either one of you would like to make that may have arisen, anything you want to clarify?

Dr. FELDSTEIN. No, thank you.

Senator GRAMM. Well, let me thank you both very much.

We have written questions that we will provide to you. If in the next couple of weeks you will respond to them, we will put them in the record.

And again, I want to thank both of you very much for coming. The Subcommittees are adjourned.

[Whereupon, at 11:47 a.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted for the Record

Prepared Statement of Hon. Wayne Allard

Thank you, Mr. Chairman for holding this hearing on Social Security and Medicare. I believe we all realize the importance of Medicare and Social Security in helping our nation's senior citizens.

The budget bill did little to extend the solvency of Medicare. Congress will still need to tackle real entitlement reform in upcoming legislation. Similar to Medicare, Social Security also faces financial difficulties in the years to come, especially beyond 2015. I believe that Social Security funds should be invested in real assets that translate into real wealth for the Trust Funds.

The number of workers for each retiree has been dropping at an alarming rate recently. In 1990, there were almost five workers for each retiree. In 2030, there will be fewer than three workers for each retiree. The Social Security Trustees to project that Social Security will go bankrupt by 2029 unless changes are made.

One of the most serious criticisms of plans to reform Social Security is the high cost associated with the transition to a new system. Rather than having assets to back up the benefits of future retirees, the contributions of current workers are immediately paid out to current beneficiaries. Further complicating the financial situation of Social Security is the fact that the program maintains an alarming $9 trillion unfunded liability.

Given the enormous task ahead of us with regard to reforming and preserving our Social Security system for future generations, we need to begin to take steps today to improve the financial health of the system.

Congress has taken only the first step necessary to improve health care options for seniors and to save the Medicare program from financial ruin. We must put the Federal government's finances back on a sound footing and provide the Social Security system with real money rather than accounting entries on the government's balance sheet. My hope is that extensive entitlement reform will be forthcoming in subsequent years.

I appreciate the witnesses taking the time to come forth to discuss these issues and look forward to hearing the testimony of Dr. Saving and Dr. Feldstein as Congress continues to address entitlement reform.

Embargoed until
October 7, 1997
10:00 a.m. EST

The Effect of Prefunding Social Security and Medicare on National Saving and Capital Formation

Testimony of

Martin Feldstein
Professor of Economics, Harvard University

before subcommittees of the

U.S. Senate Committees on Finance and on Banking, Housing and Urban Affairs

October 7, 1997

Thank you, Mr. Chairman. I am pleased to appear before this committee to discuss the effect on national saving and capital formation of shifting from our existing pay-as-you-go method of financing Social Security and Medicare to a funded system based on individual accounts invested in private stocks and bonds.[1]

I strongly favor such a change in the financing of our Social Security and Medicare systems.

[1]My remarks are based on technical studies presented in Martin Feldstein and Andrew Samwick "The Transition Path in Privatizing Social Security," NBER Working Paper No. 5761, forthcoming in M. Feldstein, Privatizing Social Security (Chicago: University of Chicago Press) and Martin Feldstein and Andrew Samwick "The Economics of Prefunding Social Security and Medicare Benefits," NBER Working Paper No. 6055, forthcoming in The 1997 NBER Macro Annual. See also my less technical discussion in "Time to Privatize Benefits," Foreign Affairs, July-August 1997.

Doing so would greatly reduce the tax needed to finance the projected level of Social Security pensions and the increasing cost of the Medicare program that will otherwise result from the long-term ageing of the population. This reduction in future taxes would raise the spendable income of all employees and therefore substantially increase their standard of living. The lower tax rates would also avoid the increased distortions of economic incentives that would result from higher marginal tax rates. And this more efficient financing mechanism would make it unnecessary to diminish the future Social Security pension benefits or to scale back the health care of the retired population that is now projected for the future. These are important reasons for favoring prefunding Social Security and Medicare benefits through a system of individual accounts.

In addition, such a system of mandatory saving in individual accounts would also increase saving and capital formation, thereby raising economic growth, labor productivity and real wages. In the long-run, the capital stock and the national saving rate would rise by more than 30 percent. That would significantly raise real wages, further increasing the real income gains that result from lower tax rates. The higher rate of saving would also permit the United States to achieve a higher rate of investment in plant and equipment while reducing our dependence on foreign capital and the accompanying trade deficit.

I have done detailed calculations based on the demographic and actuarial projections of the Census Bureau and the Social Security Administration. These calculations are part of a larger study of the feasibility of gradually replacing the existing pay-as-you-go Social Security system with a fully funded system based on individual accounts.[2] The analysis shows that the existing system can be

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[2]That study is reported Martin Feldstein and Andrew Samwick "The Economics of Prefunding Social Security and Medicare Benefits," NBER Working Paper No. 6055, forthcoming in <u>The 1997 NBER Macro Annual</u>.

completely replaced by a funded system to which individuals eventually contribute only about 2 percent of their wages (up to the ceiling on the Social Security tax base). During the long phase-in period, individuals would contribute between 1.5 percent and 2.0 percent to their wages.[3]

These mandatory savings would provide the base for a substantial increase in national saving. The increased national saving and the greater capital stock that would result from prefunding social security would however not just be the accumulation of these mandatory savings. Even more important would be the investment return that would be earned on those accumulated funds and that would be retained in each individual's Personal Retirement Account until that individual retires. Detailed calculations show that the investment return is an even more important source of increased national saving than the small share of wages that the individuals save in their accounts.

The Rate of Return

How large is the rate of return on these funds? Because the past few years have seen such a remarkable boom in stock and bond prices, I will be very conservative and look at the experience before 1995. During the nearly 70 year period from 1926 to 1994 for which comparable data are available, the real rate of return on a portfolio of stocks and bonds was about 5.5 percent after adjusting for inflation.[4] The return during the postwar period from 1946 to 1994 was almost exactly

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[3]During the transition, individuals would also have to pay a payroll tax to support the existing pay-as-you-go benefits. The payroll tax rate would decrease over time as retirees come to depend more on their accumulated savings. Within 20 years the combination of the payroll tax and the required savings would be less than the initial payroll tax alone.

[4]I might just note in passing that this 5.5 percent real rate of return would be more than 3 times as great as the implicit rate of return that individuals would earn on the taxes that they would pay in the future to an unfunded pay-as-you-go system.

the same. While the future rate of return will fluctuate from year to year, there is good reason to believe that the average rate of return in the future will be similar to what it was in the past.

Even this relatively favorable rate of return on stocks and bonds understates the return to the nation on the funds that are saved and invested in stocks and bonds. Although the 5.5 percent return is calculated before any personal income tax, it is the return that portfolio investors earn after the taxes that corporations pay to the federal, state and local governments. The real return on additions to the capital stock before all taxes during these same years averaged slightly more than 9 percent.[5]

With this rate of return, the assets in the Personal Retirement Accounts would grow very rapidly. Even with contribution rates that are only between 1.5 percent and 2.0 percent of wages (up to the maximum amount covered by Social Security), the accumulated balances in the Personal Retirement Accounts would reach 25 percent of covered wages (about 10 percent of GDP) after only 10 years and about 80 percent of covered wages (more than 30 percent of GDP) after 25 years. Looking further ahead to a time 75 years from now when the gradual transition from the pay-as-you-go system to a fully funded system would be complete, the accumulated Personal Retirement Account balances (net of all the benefit payouts that have been made) would equal 2.3 times that year's total payroll or about 100 percent of the Gross Domestic Product. Stated differently, the extra saving

[5]With about 40 percent of that return to capital paid by companies as taxes to the various levels of government, the net return is about the 5.5 percent that shareholders and bondholders have received as interest, dividends and capital gains. The saving done in a prefunded system would thus earn the nine percent real return for the nation as a whole. The government could supplement the dividends, interest and capital gains that savers receive in their individual accounts by providing matching grants financed with the incremental tax revenue collected on the additional profits earned as a result of the additions to the nation's capital stock that result from the mandatory savings accounts. In that way, the accounts could earn the full 9 percent real rate of return without any net cost to the government or change in the budget deficit.

would be equivalent to a 34 percent rise in the capital stock.

Induced Changes in Other Private Saving

I have spoken about the accumulated assets in the Personal Retirement Accounts as if that corresponds to an equivalent increase in the nation's capital stock. Wouldn't the mandatory saving in the Personal Retirement Accounts induce some changes in other personal saving?

In my judgement, in the early years of the transition to a prefunded system there would be a very small offsetting effect while in the later years the induced changes in private saving would actually reinforce the mandatory saving. To understand why this is so, note that the shift to a mandatory prefunded system would not alter the benefits that individuals would receive in retirement. The feasible transition that I have studied is calibrated to keep the combination of the diminishing pay-as-you-go benefits and the increasing Personal Retirement Account benefits equal to what the pay-as-you-go benefits alone would be under current law. The shift to the prefunded system therefore would not induce individuals to reduce private saving because of an expected increase in retirement income. The primary reason for the change in other saving would be the effect of the transition on the level of disposable income during pre-retirement years.

Consider first how private saving would be expected to respond in the long-run when the combination of the mandatory saving and the pay-as-you-go tax are lower than the payroll tax would be in the existing pay-as-you-go system. [6] This implies that the disposable income of individuals in their preretirement years would increase while the disposable income during retirement would remain unchanged. Instead of increasing consumption only during their preretirement years, individuals

[6] In the transition that I have analyzed, that would happen in less than 20 years. After that date, the combination of mandatory savings and payroll tax would remain permanently less than the current payroll tax rate.

would generally want to spread the higher disposable income during their working years between higher consumption at that time and in retirement, i.e., they would save some of the higher disposable income that results from the lower payroll tax. The response of private voluntary saving would therefore be to increase the national saving rate. The rise in the capital stock would therefore be greater in the long-run that the increase that comes directly from the balances of the Personal Retirement Accounts.

During the early part of the transition, the extra mandatory saving (i.e., the combination of the mandatory Personal Retirement Account contributions and the pay-as-you-go tax) would exceed the baseline pay-as-you-go tax, causing a decline in disposable income. In the first year, for example, individuals would experience a decline of disposable income equal to 2 percent of wages up to the maximum tax base in the Social Security program. Individuals who experienced such a decline in disposable income during their working years (while their expected retirement benefits remained unchanged) would presumably want to reduce some of their existing saving in order to cushion the decline in consumption and spread the consumption decline between their working years and their retirement years. However, this effect is likely to be very small because most individuals have little or no saving that can be reduced in this way. Even at age 60, the median financial wealth of households in less than six months earnings. Moreover, these small saving balances are generally held as "emergency reserves" for uncertain events (e.g., uninsured medical bills, replacing consumer durables, etc.) and would therefore not be reduced to spread the income decline.

Thus the rise in saving during the early transition years would be somewhat less than the previous discussion implied and the rise in saving in the long run would be substantially greater. I have no doubt that the net effect of the transition from the pay-as-you-go system to the prefunded

Personal Retirement Account system would be a substantial rise in national saving and therefore a larger capital stock and a higher level of real national income.

Prefunding Medicare

Although I have focused my remarks on the idea of prefunding the Social Security pension system, the same logic applies to the Medicare program of health benefits for the aged. In both cases, the government is now using current tax receipts to provide benefits to a group of retirees that can no longer finance its spending out of current earnings. In both cases, the high level of current and even higher level of future taxes could be avoided by shifting to a mandatory funded plan based on individual accounts.

The total cost of Medicare (and of the portion of Medicaid that goes to the aged) is now approximately equal to the cost of the Social Security pensions but is scheduled to increase substantially faster in future years. The Congressional Budget Office estimates that by 2030 these health care costs of the aged will be nearly 50 percent greater than the cost of the Social Security pensions and that by the year 2050 they will be 70 percent higher. Continuing to fund Medicare and the related Medicaid expenditures on a pay-as-you-go basis would require a tax for this purpose alone that would be equivalent to a 30 percent payroll tax. If Congress chose to finance the increase in these health care costs with the personal income tax, it would require more than doubling all of the existing personal income tax rates. Even with substantial improvements in the efficiency of the Medicare program and restrictions on the services that are available, the tax increase required with the existing pay-as-you-go method of financing would be enormous. So there is a very powerful reason to switch from pay-as-you-go funding of Medicare to a prefunded system similar to the one that I have been describing for the Social Security pensions.

The funds accumulated in private Personal Retirement Health Accounts could be used at age 65 to buy a traditional indemnity policy similar to that provided by Medicare, or to pay for membership in some form of Health Maintenance Organization, or to finance a high copayment insurance plan like the Medical Savings Accounts. There are other issues about the operation of a prefunded system for Medicare that are different from prefunding Social Security but the implications for saving are similar.[7]

Because of the relative costs of the Medicare and Social Security programs, the private saving needed to prefund the Medicare outlays would be about 50 percent greater than the saving needed to prefund the Social Security pensions. The increase in national capital accumulation would therefore also be about 50 percent greater.

Conclusion

Let me conclude now by emphasizing the point that I made at the start of my testimony. Continuing with the pay-as-you-go method of financing Social Security and Medicare would require an unacceptable increase in tax rates. A shift to a funded system based on individual accounts invested in stocks and bonds would eventually permit replacing these high tax rates with a very much lower mandatory saving rate. This would substantially increase the after-tax income of all wage earners and reduce the distortions caused by high marginal tax rates. The favorable impact on the national saving rate would eventually produce a major increase in the nation's capital stock that would cause a correspondingly large rise in real incomes.

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[7]For a discussion of some of the issues involved in prefunding Medicare, see section 8 of Martin Feldstein and Andrew Samwick "The Economics of Prefunding Social Security and Medicare Benefits," NBER Working Paper No. 6055, forthcoming in The 1997 NBER Macro Annual.

Insuring Medicare's Future

Statement of
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UNITED STATES SENATE COMMITTEE ON FINANCE
SUBCOMMITTEE ON HEALTH CARE AND ON FAMILY POLICY

AND THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
SUBCOMMITTEE ON SECURITIES

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This statement represents the views of the authors and not necessarily those of Texas A&M University.

1

INTRODUCTION

In April of this year, Medicare's Trustees predicted that the Hospitalization Insurance (HI) Trust Fund would be depleted by 2001. The restructuring Medicare received with the passage of the Balanced Budget Act is expected to forestall the trust fund's depletion until 2007. The extension is accomplished largely by shifting home health expenditures to Part B and by reducing payments to providers. Even with this restructuring, however, Medicare's HI expenditures are expected to exceed payroll tax payments in every year between now and 2007 -- four years prior to the retirement of the oldest of the baby boomers.

We believe that Medicare can be improved in two fundamental ways. First, the current Medicare pay-as-you-go financing system has resulted in no one putting anything aside to pay for retirement medical care. Current Medicare recipients' medical expenditures are financed by taxes on current workers' wages. Social Security is financed in a similar manner. This kind of financing is problematic if there are peaks and valleys in birth rates or if workers' wages are stagnant. With the start of the baby boom generation's retirement looming in fourteen years, the ratio of workers per retiree will dramatically drop. In addition, wages, primarily those of male workers, have been relatively stagnant in inflation adjusted dollars for the last twenty years. Both of these trends do not bode well for a financing system that requires growth in both workers and their wages for real growth in benefits to occur.

Second, because Medicare recipients care little about the price of the medical services they consume, Medicare expenditures have risen faster than Gross Domestic Product (GDP). Medicare shares this problem with most prepaid medical "insurance" programs. When individuals do not face the full price of a service or product, they consume more than they would if they were to pay the full price. The growth rates in per beneficiary expenditures actually experienced over the life of the program have far outpaced Medicare's financing mechanism.

A Medicare reform plan that confronts pay-as-you-go financing's inherent problems and reestablishes prices as the mechanism that allocates health care is offered in the following sections. We propose a solution that addresses the more enduring problems associated with pay-as-you-go financing by suggesting a financing method that is immune to birth rate variations and that gives both retirees and insurers an incentive to care about the price of medical care. Two things to keep in mind from the outset are: (1) the risks associated with paying for the medical care needs of current and future retirees exist regardless of whether the financing plan is tweaked or fundamentally changed and (2) saving for retirement is not a radical idea. Medicare's current problems simply bring into focus the need to reexamine how, as a society, we insure against and save for each member's retirement medical expenses. We offer a plan that produces the right incentives and secures individuals' ownership of their retirement medical insurance.

A BRIEF HISTORY

Medicare: 1965

On July 30, 1965, President Lyndon B. Johnson signed the bill that established the Medicare program. Several trends converged during the early 1960s that helped facilitate the passage of Medicare. From 1946 to 1965 the average real manufacturing wage rose 2.3% per year. Just as importantly, by 1965 there were almost 77 million children and teenagers between zero and nineteen years of age. Growing wages and a blossoming future workforce were the ideal conditions for a social insurance program that relied on pay-as-you-go financing. Medicare was not the only government sponsored health insurance program passed during 1965; it shares its birth year with Medicaid. These two health insurance programs are Titles 18 and 19 of the Social Security Act, respectively.

The genesis of these programs also owes much to the wage and price controls in effect during World War II, some 20 years earlier. Prior to the war, employer provided health insurance was rare as was health insurance in general. But the combination of wage controls and a wartime increase in the demand for labor resulted in employers searching for other ways to raise workers' compensation. Paying workers in the form of health insurance was one way to accomplish that goal. Employer-based health insurance purchases were also tax exempt. Because of their special tax status, they became a fixture in the employment relationship. Between 1940 and 1965, health insurance premiums grew as a proportion of workers' compensation. During that same time period, the proportion of the population covered by a health insurance plan grew from 9% to 80%.[1]

Medicare: 1966-1996

Since its start, Medicare has grown substantially. From 1966 to 1996, the number of enrollees grew from 19 to 38 million. The average Part A benefits per retiree grew at an annual rate of 11.34% from 1967 to 1995. Per retiree Part B benefits have increased 12 07% per year over the same period. These growth rates compare to a 5.6% annual growth in the consumer price index and a 7.6% annual growth in the medical care component. In 1972, disabled persons who met Social Security's eligibility requirements and individuals with end-stage renal disease were added to the program.

To keep pace with Medicare growth, the payroll tax has been increased numerous times, starting at 0.7% in 1966 and reaching its current level of 2.9% in 1986. Besides the growth in the tax rate, the maximum tax base rose from $6,600 in 1966 to its current unlimited level in 1994.[2]

Medicare: 1997 and Beyond

Since 1992, the Trustees of Medicare's Hospital Insurance Trust Fund have reported that the fund does not meet the Trustees' short-range test of financial adequacy. In their 1997 report, the Trustees warned that, *"without corrective legislation soon, the fund would be exhausted shortly after the turn of the century - initially producing payment delays, but very quickly leading to a curtailment of health care services to beneficiaries."*[3] They go on to state that to bring the HI program into actuarial balance over the next 25 years would require an immediate 69.66% increase in the tax rate from 2.9% to 4.92%. To adequately fund Medicare's HI program under the intermediate assumptions over a 75-year horizon, the tax rate would have to be increased immediately to 7.22%.[4]

Because Supplemental Medical Insurance (SMI) is not financed by a dedicated payroll tax, the Trustees discuss it in a separate report. In 1996, premium payments represented 22% and general revenues represented 76% of SMI expenditures. The remaining 2% of expenditures was primarily financed through drawing down the SMI trust fund.[5] The Trustees reported that under their intermediate assumptions, SMI expenditures as a percent of GDP are expected to grow to 1.80% in 2010 and 3.13% in 2030 from their 1996 level of 0.94%.[6] In their concluding comments on the future status of the SMI program, the Trustees note: *"As in past years, we note with great concern that the program costs have been growing faster than GDP and that this trend is expected to continue under present law."* The Trustees continue by stating, *"Of additional concern is the fact that the premium income after 1998 is projected to cover a progressively smaller fraction of SMI expenditures, shifting a greater share of the program financing from beneficiaries to the general public."* They call on Congress to address the increased costs of both SMI and HI associated with the baby boomers' retirement and conclude by stating that *"prompt, effective and decisive action is necessary."*[7]

The Balanced Budget Act is a start on *"prompt, effective and decisive action,"* but it is important to consider going further. The recently passed changes do not adequately address the burden that the retirement

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[1] *Economic Report of the President 1966*, p. 106.
[2] 1997 HI Trust Fund Report, p. 18.
[3] 1997 HI Trust Fund Report, p. 15.
[4] 1997 HI Trust Fund Report, pp. 14-15.
[5] 1997 SMI Trust Fund Report, p. 4.
[6] 1997 HI Trust Fund Report, p. 70.
[7] 1997 SMI Trust Fund Report, p. 14.

of the baby boomers will place on the system. In what follows, we outline our proposal to move to a fully-funded system of retirement medical insurance.

A COHORT BASED SOLUTION

We propose that each age cohort, defined as all individuals born between January 1 and December 31 in any given year, insure itself against retirement medical expenses. Each worker within an age cohort pays a premium that insures against the medical expenses that arise during retirement. If the insured event does not happen, the insurance does not pay. As a cohort ages, the required premium is adjusted as more information about the cohort's future medical care needs is revealed. This kind of financing establishes a link between the purchasers and the consumers of medical care that is absent with a pay-as-you-go financing system. Another benefit of cohort based financing is that it eliminates cohort size risk of the form we are now facing with the pending retirement of the baby boom generation. If the population age distribution experiences a bulge because of larger than normal fertility or immigration, the aggregate contribution to retirement medical insurance of these cohorts will rise, maintaining the same per-capita value as smaller cohorts. The discussion of the feasibility of such a system must address the issues of the insurance itself, participation, and redistribution.

We are proposing catastrophic retirement health insurance coverage that is comparable to today's high deductible policies. Insurance is purchased during a worker's years in the labor force and comes into play only if an individual reaches the age of 65 and has medical expenditures that exceed the policy's annual deductible. This type of coverage requires smaller contributions than would a medical IRA. Plus this insurance, like Medicare currently, pays no death benefits to survivors should an individual die before reaching 65 years of age. A medical IRA implies a transferable property right to a survivor and is thus more costly.

For various reasons, all individuals are required to participate in the insurance program we are proposing. The primary reason for mandatory participation is a result of individuals' incentives to under-insure themselves against medical care expenses that arise during retirement. In the past, family units, through implicit inter-generational contracts, provided this insurance function. With today's increased mobility and the changing dynamics of family units, a new means of insurance is required. Cohort based insurance in which, at the minimum, all working individuals in a cohort pay into the system insures that a sufficient level of assets will be set aside as the cohort ages. Mandatory participation also solves the problem that arises when individuals choose to join the system only when they expect large medical expenses, adverse selection, by forming age cohort risk pools. Additionally, during the transition to the new system, all individuals will continue to pay the taxes required to finance the current and future retired population who remain in the current system.

Any universal program must address redistribution. Under the current Medicare system, redistribution occurs across generations — workers are expected to pay for the medical care of retirees and receive medical care (upon retirement) from the next generation of workers. This system functions well when the number of workers per retiree is high but poorly when the number of workers per retiree is low. Since birth rates have been steadily declining in America and life expectancy has been steadily lengthening, the current Medicare system relies upon an ever-shrinking pool of workers to fund an ever-growing pool of retirees. This is both unfair to younger workers and unsustainable for the health of the Medicare system.

While simple privatization solves the issue of inter-generational redistribution, it does not ensure that the medical needs of the less fortunate will be met. A cohort based Medicare system can address both of these problems by redistributing income within rather than across generations — workers in a particular cohort would subsidize nonworkers in their cohort, and high wage earners would subsidize low wage earners in their cohort. Since age cohorts are independent, the size of an individual cohort is irrelevant. If a cohort is small, it will have fewer workers but it will also need fewer dollars to help the less fortunate in its cohort; if a cohort is large, a relatively high amount of money will be needed to help the less fortunate but a relatively high number of workers will be present to provide it. Thus, the relevant fact is that a cohort based health insurance system protects the Medicare benefits of the less fortunate and fortunate alike while preserving the earnings of younger generations from the hands of a pay-as-you-go financing system.

The actual implementation of the within cohort redistribution could be set up in the following way. The cumulative funds collected from each cohort could be held by the Social Security Administration until the end of the year and then divided equally to each member of the cohort. Distributions would then be deposited to each individual's Personal Retirement Insurance for Medical Expenses (PRIME) account to grow until retirement. All insurance account providers would be subject to reasonable requirements on the soundness of their portfolios and would be required to take all applicants.

THE THEORETICAL CONTRIBUTION RATE

From the pay-as-you-go accounting identity we can derive the formula for a cohort based financing equation. The pay-as-you-go accounting identity can be written as

$$T \cdot N_w \cdot Y = N_b \cdot B \tag{1}$$

where T is the tax rate, N_w is the number of workers, Y is the mean annual wage, N_b is the number of beneficiaries, and B is the average benefit. The left-hand side identifies tax revenues and the right-hand side identifies the gross benefits. If the tax rate is held constant then the gross benefits can grow at a rate that is equal to the tax base growth.[8]

Rearranging (1) we can also identify the relation of the pay-as-you-go tax rate to the relative sizes of benefits and income and the relative sizes of the retirement and working populations,

$$T = \frac{N_b}{N_w} \cdot \frac{B}{Y}. \tag{2}$$

The sensitivity of the required tax rate to the relative size of the retirement population and the benefit-income ratio are well known and form the basis of the current crisis. In 1995, the ratio of beneficiaries per worker, N_b/N_w, was 0.256, but by 2030 the ratio is expected to rise to 0.454. The 1996 HI Trust Fund report also indicates that in 1995 the ratio of total benefits to available taxable income, $(N_b \cdot B)/(N_w \cdot Y)$, was 3.40% and that by 2030 it is expected to be 8.52% under the intermediate assumptions. Thus, average Part A benefits as a percent of an average worker's income are expected to rise from the 1995 level of 13.3% to 18.7% by 2030. Under the current pay-as-you-go financing system the effects of the pending retirement of the baby boomers and the expected rapid growth of average benefits relative to average earnings will require higher tax rates or a substantial reduction in benefits.

In contrast to pay-as-you-go financing, consider the problem of an age cohort entering the labor force where we want to provide for the cohort's retirement medical expenses upon reaching age 65. Thus, we have defined an age cohort as the relevant group for the provision of retirement medical care. We can simplify the problem by considering a representative individual in the cohort. For this case, N_b and N_w are both equal to unity (the one representative individual) who at some point will be retired and the required "tax" rate is the ratio of the present value of future expected medical costs, B, to the present value of expected earned income, Y, all adjusted for the probability of survival, which yields

$$C_{a_0} = \frac{\displaystyle\sum_{t=65-a_0}^{119-a_0} \frac{p_{a_0,t}\, b_{a_0,t}(1+g_m)^t}{(1+r)^t}}{\displaystyle\sum_{t=0}^{64-a_0} \frac{p_{a_0,t}\, y_{a_0,t}(1+g_y)^t}{(1+r)^t}}. \tag{3}$$

[8] Schieber and Shoven, *American Economic Review*, May 1996, p. 373.

where a_0 = age of cohort entering the program, C_{a_0} = percent of lifetime earnings that must be saved to purchase retirement medical insurance given entering age of a_0, $y_{a_0,t}$ = mean cohort a_0 income in year t, r = real interest rate, g_{md} = real medical expenditures growth rate, g_r = real income growth rate, $b_{a_0,t}$ = estimated retirement medical care cost in year t for cohort a_0, $p_{a_0,t}$ = probability of living to time period t for cohort a_0, and $p_{a_0,t} = \prod_{i=a_0}^{t} s_i$, (where s_i = probability of surviving to year i+1, given a_0). In effect, C_{a_0} is the tax rate that must be applied to mean cohort a_0 income in order to fund the retirement medical benefits of cohort a_0.

The numerator of (3) is the expected present value of the retirement medical insurance benefits for members of cohort a_0 and the denominator of (3) is the expected present value of cohort a_0 income. The ratio of the expected present value of benefits to the expected present value of income yields the appropriate tax rate to fund all members of cohort a_0. This simple idea represents a replacement for the current pay-as-you-go financing for Medicare.

DATA SOURCES

Earnings Data

Age cohort contribution rates depend on a cohort's future life-cycle earnings. One estimate of life-cycle earnings is the current cross-sectional age earnings profiles. However, current earnings profiles are not a good indication of the real earnings that today's 25 year old worker will have 25 years from now; especially for females because of the rise in female labor force participation, human capital investment, and length of labor force continuity.

As a result of the changes in women's labor market behavior, we assume that younger female cohorts' life cycle earnings will be higher than exist in a current cross-section. Specifically, we assume that female full-time workers will have lifetime earnings that reach 84.5% of men's lifetime earnings by the time today's younger workers complete their careers.[9] We also assume that the women's ratio of the full-time profile to the profile for all individuals will approach the ratio that exists among men. Finally, the average earnings across all women at ages 50 to 64 drop dramatically. Women's rates of not working or working part-time due to retirement are quite similar to the rates reported by males.

To account for changes in both the male and female life-cycle earnings, earnings across all men of a given age are averaged up to the age of 50. For ages 50 to 64 projected earnings that follow a profile estimated from the full-time cross section are used. We make a similar adjustment to the average earnings for all women 50 years of age and above. We also assume that as the younger female cohorts age, their earnings profile approaches the cross-sectional shape of the men's profile.

Retirement Medical Insurance

Because almost all individuals 65 and above have Medicare coverage, we must estimate the price of a catastrophic care policy for each retirement age. We calculate two sets of premiums based on different estimation techniques. The first set of premiums we estimate are based on the experience of a private carrier of a $2,500 deductible policy. We predicted the price of a policy of this type for ages 65 to 119. The out-of-sample estimates are based on a regression of premium prices on a cubic in age for ages 25 to 64. The actual and predicted premiums are presented in Figure 1 along with a series tied to the 1997 Health Care Financing Administration (HCFA) Revised Demographic Cost Factors for the Aged. The cost factors are used to adjust HCFA's county by county per capita rates of payment to HMOs by age groups. As seen in Figure 1, our projections are quite similar to the growth implied by Medicare's experience. Using the estimated shape of the benefit profile beyond 64 as a guide, we can calculate the premium price by age under different assumptions

[9] We assume that the younger cohorts' life-time earnings profile approaches the shape of the current cross-sectional profile for men. Though the shape of the profiles approach each other, the ratio of women's to men's life-time earnings does not reach unity because we implicitly assume that the difference in the intercepts that exist at age 22 in the 1995 survey data persist into the future.

about the price of a policy at age 64. The national weighted average price for a policy of this type is approximately $150 per month for a qualifying 64 year old.

An alternative to these estimates are estimates based on the Health Care Administration's Annual Person Summary (APS) data. This data summarizes Part A and Part B reimbursements by age. Adjusting 1994 APS data to reflect claims, we can calculate the average claims by age in excess of a stated deductible. After adjusting for growth in per capita costs, the required monthly premium for a $2,500 deductible policy was $210 in 1996 for Medicare beneficiaries ages 65 or 66, assuming the deductible had no effect on expenditures. Using the results from the Rand Corporation's Health Insurance Experiment, which indicates that higher deductibles reduce expenditures, we estimate that the premium at ages 65 and 66 would fall in a range between $155 and $187 per month. Table 1 presents results based on the estimates from the private carrier's experience and from those derived from the APS data.

Mortality and Population Data

The mortality estimates are based on predicted life expectancies from the Census Bureau's middle series. The 1995, 2005, and 2050 life tables are used along with linear interpolations by age for the intervening years and for the years beyond 2050. The population estimates used in our discussion of the transition are from the Census Bureau's intermediate population projections for the years 1995 to 2050.

REQUIRED CONTRIBUTION RATE ESTIMATES

The contribution rate at age 22, presented in Table 1, is the tax rate that a new labor force entrant would face over his or her lifetime. We also present the age at which the required contribution rate is equal to 2.9%. This defines the oldest cohort that could switch to the new system at a contribution rate of 2.9% or less.[10] By definition then, cohorts younger than the feasible switch age can pay for their retirement medical accounts at rates that are less than 2.9% of their remaining lifetime earnings.

The contribution rates for new labor force entrants and the age at which the required contribution rate is equal to 2.9%, presented in Table 1, are based on four real rates of return, two real earnings growth rates, and two real medical price growth rates. The first three real return assumptions of 3%, 3.5%, and 4.0% reflect conservative estimates of the rate of return a cohort could expect to receive over the years that it insures against future medical care expenses. These rates of return fall between the 2.3% rate assumed in the Trust Fund intermediate projections and the historical 6% to 7% real after corporate income tax return on the S&P 500 (including dividend reinvestment since nothing is withdrawn until retirement age is reached). The last set of estimates in the Table are based on the 9% real return Felstein and Samwick (1997) use.

The two real earnings growth rates of 0% and 1% also reflect conservative assumptions regarding real productivity growth. The Trust Fund's intermediate forecasts assume a 1% real earning growth rate.[11] The real medical expenditures growth rates used to calculate the contribution rates in Table 1 are also 0% and 1%. By way of comparison, the Medicare Trustees' report assumes that Medicare's cost per unit of service during

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[10]Because men and women have different life-cycle earnings and life expectancy, the contribution rates for each sex are estimated separately. The single tax rate and switch age presented in Table 1 are averages weighted by life-time earnings and population. The 1996 HI Trust Fund Report indicates that HI costs as a percent of taxable payroll were expected to be 3.54% of taxable income in 1996. Including SMI costs, net of premium payments, produces an implied tax rate that is equal to 4.99% of taxable payroll. Aged beneficiaries' Part A and B expenditures, net of premium payments, were equal to 4.39% of taxable payroll in 1996.

[11]However, real wages for men have been relatively stagnant in recent years. Kevin Murphy and Finis Welch in Real Wages 1963-1990, (1992) Table 1c, p. 9, suggest that real productivity growth, measured at the hourly wage, has been closer to -0.09.

the first 25 years of their 75 year projections will decline gradually from the current level to the same growth rate that is projected for average hourly earnings and then to continue at that rate for the following 50 years.[12]

As the estimates in Table 1 indicate, it is feasible for new labor force entrants to fund their retirement medical care at tax rates that are less than the current 2.9% rate. The first three sets of assumptions concerning income growth, rate of return, and health care expenditure growth produce new labor force entrant tax rate estimates that range from 0.95% to 2.85% for the premiums based on the private carrier's experience. The tax rate estimates range from 1.28% to 3.89% for the premiums based on the APS data. With a 9% rate of real return, cohorts in their late forties and early fifties could fund their retirement medical insurance with less than 2.9% of their remaining lifetime earnings. Our discussion of the transition is based on the private carrier's experience and a real rate of return of 3.5%, real earnings growth rate of 0%, and real medical expenditures growth rate of 0%.

ESTIMATING THE TRANSITION COST

Since we are replacing both Parts A and B of the current system, the saving in Part B federal expenditures are the equivalent of a revenue to our system. As cohorts in the new system retire, the implied reduction in federal Part B expenditures are considered as a reduction in costs to the new system, where the cost reductions are valued for a fixed number of years (25 years in the calculations presented below).[13] In this method, the tax rate remains at the current 2.9% for 50 years after the cohort financing system is adopted, at which point the tax rate reverts to the rate facing new labor force entrants.

Revenues

We begin by identifying the age at which the required contribution rate is equal to 2.9%. All individuals less than or equal to this age, 39 in this example, will be in the new system. Each cohort in this group contributes the difference between 2.9% and the rate required to fund its own insurance to help fund the Medicare expenses of individuals above 50. Individuals between 40 and 50 years of age will also be switched to the new system, thus capturing all of the baby boomers in the new system. Individuals between 40 and 50 will require contributions in excess of their 2.9% payment. These contributions will be made from general revenues. Members of cohorts above age of 50 will remain in the current Medicare system and will continue to pay the 2.9% tax. The savings that result from eliminating Part B expenditures are counted as revenues for 25 years after the first cohort in the new system retires.

Expenditures

Real expenditures during the transition are the annual cost per aged enrollee, adjusted for real growth, times the number of individuals who remain in Medicare. The aged Medicare population is equal to the number of individuals in any future year that are at least 65 years of age and who were older than 50 in the first year of the transition. Assuming all individuals 50 and below are in the new system, Medicare's unfunded liability is eliminated as the last individual born in 1945 leaves the system. Because the switch age is defined in conjunction with the 2.9% payroll tax, Part A expenditures are identified and Part B expenditures continue to be funded through general revenues.

Transition Costs

Table 2 summarizes the simulation results under three different scenarios. The first column presents the results if the transition towards cohort-funded retirement medical insurance begins in 1996. As presented in Table 2, the unfunded Medicare liability is equal to the present value of the difference between the total Part

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[12] 1997 HI Trustee's Report, p. 8.

[13] The reduction in the current Part A subsidy, if it continues, could also be considered as a revenue to our system, however, for purposes of our calculations we have only considered the Part B subsidy reduction.

A costs and the sum of the three revenue sources. If the transition had started in 1996 this unfunded liability would have been $734.36 billion. Paying the debt off over the next 50 years would require annual payments of $31 billion. The last row presents the present value of the liability assuming that the only revenues used to offset the Part A debt are the taxes paid by the individuals above the switch age. That debt amounts to $2,069 billion.

The next two columns in Table 2 present the transition costs if 10 or 20 years pass before the transition to the new system is made. During the years between 1996 and the beginning of the transition, the real growth rate in per retiree benefits is assumed to grow at the real growth rate experienced over the last 10 years in per retiree expenditures. The present value of the unfunded Medicare Part A liability grows to $1,736 billion if 10 years pass and to $3,776 billion if 20 years pass before the transition is made. The annual payment that would be required to retire the unfunded liability grows in similar proportions. Finally, the Part A debt, assuming that tax revenues are only collected from individuals who remain in the old system, is equal to $2.9 trillion and $4.9 trillion under the 10 and 20 year wait scenarios.

EFFECTS ON GROWTH AND CAPITAL STOCK ACCUMULATION

During the first fifteen years of a transition to a fully funded system, funds are accumulating, without withdrawals, in the accounts of all individuals born in 1946 or later. An amount equal to approximately 2.2% of labor earnings is being directed into the capital market during this phase-in period. Over time, the percent of labor income which ends up in the capital market will decline to 1.36%, but a higher contribution rate is required of cohorts born between 1946 to 1974. Given that labor earnings are 46% of Gross Domestic Product, the contributions to retirement insurance accounts are equal to 1% of GDP. In 1996, the private savings rate would have increased from 13.3% to 14.3% of GDP, as a result to the switch of cohort financing.

To identify the effect of increased savings on per capita GDP growth we estimated an econometric model which indicated that the increase in the savings rate will raise the real per capita growth rate to 4.1%. The longer run effects of the increased savings on the capital stock are presented in Table 3. The baseline capital stock is estimated in a manner similar to that used by Feldstein and Samwick (1997). The baseline estimates assume that capital stock remains a fixed multiple of GDP which grows at the same rate as aggregate labor earnings. Using this baseline, we can measure the relative impact of the added savings. The years 1996 to 2011 reflect the period over which funds are accumulating, with no withdrawals, in PRIME accounts. In 2011 the oldest group in the new system retires and begins drawing funds. As indicated in Table 3, by 2011 the assets in the cohort members' accounts represented a 7% increase in the base capital stock. This implies that the new financing method raises the capital stock by 7% relative to the stock that would have existed under pay-as-you financing.

SUMMARY

We have placed ourselves in the position of allowing the surge in population, generally referred to as the baby boom, to lull us into a sense of security that a pay-as-you-go system of financing Medicare would work. As a result, nothing has been set aside to provide the extra resources that will be required to fund the medical care costs of the surge in the retired population that is almost upon us. We are in a situation like that of a homeowner who is facing an imminent balloon payment with nothing in the bank.

How different the situation would be if the original planners of Medicare had recognized that the large group they foresaw entering the labor force was similar to the seven years of plenty Joseph predicted for Pharaoh. Joseph also predicted that these seven years of plenty would be followed by seven years of famine. He convinced Pharaoh to put grain aside during the years of plenty in order to feed his subjects during the seven years of famine.

In our case, the equivalent of the seven years of famine will begin when the baby boom population surge begins to leave the labor force. Have we put anything aside to prepare for these years? The answer is no. We have lulled the population surge to sleep by promising them retirement medical care so that they did not put anything aside. Thus, we are facing an impending famine with IOUs in our silos rather than grain.

But it is not too late. While we cannot turn back the clock, we can rescue the situation and insure that we are never again caught in a cohort or generation size caused crisis. Converting our current pay-as-you-go system of financing Medicare to a cohort based system can be accomplished if we act quickly. We can replace both Parts A and B of Medicare with fully funded cohort based real investment. Such investment will increase the nation's capital stock by 7% during the phase-in period. The additional savings will provide the resources necessary to fund the retirement medical care of the baby boomers while at the same time protecting the rights of older generations to retirement medical care.

The problem of the retirement population surge, that will occur as the baby boomers leave the labor force, is compounded by the fact that real per capita health care expenditures have been rising faster for the Medicare population than for the population as a whole. Our ability to cope with the unfunded medicare liability depends on our willingness to control health care expenditures by the Medicare-covered population. The approach we have suggested is the conversion of the current Parts A and B of Medicare into health insurance consisting of a high deductible and then 100% coverage. This type of health coverage makes consumers care what health care costs and will play a major role in restoring competition to the industry.

Our transition estimates are based on moving cohorts of age 50 and younger into a cohort based financing system. Older cohorts will remain in the amended Medicare system. Their expenditures will be financed by the excess of contributions from the switched population, the contributions of the yet to retire population and the remaining coming from general tax revenues. We estimate the total cost of this transition at $734 billion to be paid for over a period of fifty years. Once the last of the over 50 group has left the system all future generations are self funded. Thus, we will never be caught unprepared for a population surge again.

One of the great benefits of moving to cohort based financing for Medicare is that the reputation of the system can be restored. Even before the reductions in benefits that must be enacted to keep the current system solvent are enacted, young people believe that the system will not be there for them. This distrust of government will be exacerbated when this year's changes in the Medicare system are enacted. If the changes that must be made in the system are coupled with a movement to cohort based financing a clear message will be sent to the young. That message is that while we have changed the existing system we have simultaneously taken steps that insure that the system will be there for the young. We have restored their confidence in government by giving them a property right in their Medicare.

TABLES

Table 1
Contribution Rate and Switch Age Estimates

	$2,500 Deductible Policy			
	Out of Sample Estimates Based on a Private Carrier's Experience		Estimates Based on HCFA's Annual Person Summary Data	
r, g_y, g_m	Tax at Age 22	Age at which Contribution rate is 2.9%	Tax at Age 22	Age at which Contribution rate is 2.9%
3,1,0	1.34%	38.89	1.82%	33.48
3,0,0	1.63%	36.93	2.21%	30.65
3,1,1	2.34%	30.30	3.19%	N/A
3,0,1	2.85%	26.01	3.89%	N/A
3.5,1,0	1.13%	40.80	1.53%	35.78
3.5,0,0	1.36%	39.25	1.85%	33.81
3.5,1,1	1.96%	33.80	2.67%	26.78
3.5,0,1	2.37%	30.66	3.23%	N/A
4,1,0	0.95%	42.48	1.28%	38.06
4,0,0	1.14%	41.29	1.54%	36.27
4,1,1	1.64%	36.68	2.24%	30.47
4,0,1	1.98%	34.40	2.69%	27.16
9,1,0	0.17%	51.85	0.22%	49.74
9,0,0	0.19%	51.51	0.25%	49.33
9,1,1	0.28%	50.15	0.37%	47.74
9,0,1	0.32%	49.71	0.43%	47.16

r is the real rate of return, g_y is the real earnings growth rate, g_m is the real growth rate in medical prices. The tax at age 22 is the contribution rate that is necessary to fund the retirement medical benefits under each set of assumptions. The feasible switch age is the age at which the contribution rate is equal to the stated tax rate.

Table 2
Transition Cost Estimates (Billions)

	Transition in 1996	Wait 10 years	Wait 20 years
Switch age	50	50	50
Present value of unfunded Medicare liability	$734.36	$1,735.95	$3,775.55
Required 50 year annual payment	$31.31	$73.58	$160.97
Present value of total Medicare liability	$2,069.13	$2,961.88	$4,919.29

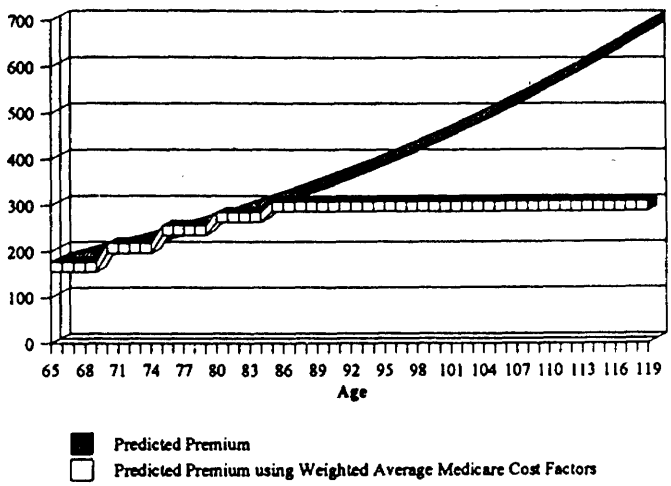
Transition Cost Estimates if $r = 3.5$, $g_y = 0$, $g_m = 0$, and the tax rate = 2.9 for 50 years. During the waiting period, real Medicare per capita costs are assumed to grow at the 10 year real historical rate.

Table 3
Change in the Capital Stock

Year	Cohort Contributions as a Percent of Capital Stock
1996	0.37%
2001	2.34%
2006	4.54%
2011	7.00%

Note: Base GDP and Capital Stock are based on the exogenous simulation real income per worker growth rate of 0%. GDP is assumed to remain 2.18 times labor income, the ratio in 1996. Capital stock is assumed to remain at a fixed multiple of GDP, 2.80, which was the ratio in 1994. The years 1996 to 2011 reflect the period over which funds are accumulating, with no withdrawals, in PRIME accounts. In 2011, the oldest group in this simulation, birth cohort 1946, retires and begins drawing funds.

FIGURE 1
Predicted Monthly Premium Age 65 to 119



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Opening Statement

by Senator Rod Grams

October 7, 1997

Mr. Chairman, first, I want to thank you for holding this important hearing. I'd also like to commend you for your leadership in what I believe is the most serious challenge facing this nation: preserving and strengthening Social Security and Medicare for today and tomorrow.

Second, I would like to join you in welcoming our distinguished witnesses Dr. Martin Feldstein (Feldstein) and Dr. Thomas Saving. We are pleased you are willing to join us. Your expertise in Social Security and Medicare reform will greatly help Congress understand the dimensions of the problems and explore workable solutions to them.

Mr. Chairman, Social Security's future is being challenged by a massive demographic shift now underway that will continue for the next 33 years. In 1941, there were approximately 100 workers for every retiree. Today there are only three workers for every retiree; that ratio will soon drop to two workers per retiree. Even though Congress has increased the payroll tax 51 times since Social Security's creation, the program is clearly headed for insolvency and the future tax burden on workers will be overwhelming.

The Congressional Budget Office warns that if these problems are not fixed, federal deficits could shatter our future economy, placing a heavy burden on our children and grandchildren. The federal deficit would increase from $107 billion in 1996 to $11 trillion in 2035. The debt held by the public would increase $3.9 trillion in 1996 to $91 trillion in 2035. Such rapid growth of federal debt and deficit would bankrupt this nation, making any bailout impossible.

The fundamental problem with the Social Security and Medicare programs is that they are funded on a pay-as-you-go basis. The Social Security payroll taxes are not directly invested in assets and retirees' benefits are not paid from the sale of earlier invested assets. Instead, the current payroll taxes are largely paid directly to current retirees, and the remainder is used by the Federal government to fund other programs. The Social Security's trust-fund "assets" consist of nothing but Treasury IOUs, that can only be redeemed if Congress cuts other spending, raises taxes, or borrows from the public to raise the cash.

Mr. Chairman, several recent polls have indicated Americans are increasingly concerned about funding in the current Social Security and Medicare programs. A USA Weekend poll showed that one out of two Americans says that they feared they would have inadequate Social Security benefits.

In a survey conducted during a Social Security conference I hosted recently in my home state Minnesota, we found that 73 percent participants fear they may not achieve a secure retirement from Social Security. 85 percent believe America's young people will be facing a major financial crisis and significantly higher taxes because of current and future spending on older generations. 80 percent believe most people could make more money investing their retirement funds in the private sector than they get from Social Security. 79 percent would support conversion of the current paygo system to a prefunded system.

Clearly, the American people want reforms to ensure that any retirement benefits will continue to be available to Americans. I believe we should look at possible Social Security reforms that would provide a better retirement safety net for all Americans by allowing compounding interest to work.

Mr. Chairman, shifting from the paygo system to a prefunded system will preserve and strengthen our Social Security and Medicare. It will significantly increase national savings; it will encourage work and reward families; it will stimulate a real economic boom and produce more jobs and higher tax revenues. Most importantly, it will protect our children's future.

With that, Mr. Chairman, I look forward to hearing our distinguished witnesses' testimonies. Thank you, Mr. Chairman.

COMMUNICATIONS

STATEMENT OF MARK PRICE

"I wonder whether we really understand either our Constitution or the volumes on the Social Security System; for, if we understood the former, would the latter even exist?"

Mr. Chairman and Honorable Senators, thank you for holding hearings on Social Security and asking for citizen input. I live, with my family (wife Holly and three children) in Greenville, Texas. I have an undergraduate degree in Engineering from LeTourneau University and a Masters in Computer Science from Texas A&M, Commerce. I've been active in grassroots politics, being a precinct chairman, and also having served as a Delegate to 1996 National Republican Convention in San Diego.

I would like to provide my own perspective, that of a common citizen, on the Social Security System and offer several arguments that question its very existence. Those present today have studied this topic much more than I have, so I'll not review the historical settings of how Social Security came to be or its current fiscal difficulties. Instead, the arguments I would like to submit span the time from our Founding Fathers to the present date.

When this nation was birthed into freedom after eight grueling years of war with England, all of the Declaration's signers had their wealth reduced substantially; their estates were trashed and many had their families taken as prisoners. Why were those signers so willing to be stripped of their lives for the glorious vision of freedom from English rule? Wasn't it all about control... control over their money, their possessions, and control over their very lives by a distant and unfeeling, unknowing monstrosity called "bureaucracy"? They wanted to be their own masters of life and liberty and to pursue happiness without the iron chains of English bureaucracy about their necks. From all the writings our Founding Fathers left to us, as a heritage to continue their experiment, our Founders would not be pleased with this Social Security system and I would like to illustrate this by their own recorded words.

It is no secret that our government has a spending problem, and that part of the cost is "paid" for by the massive influx of funds from common citizens into the Social Security System. Citizens, in essence, are given "IOU's" so that their money, meant for their own future retirement, is misdirected and spent for governmental projects. It concerns me that if government cannot keep its own fiscal house in order, how can it justify caring for and administrating over retirement money of its citizens? I argue that it cannot, and to be true to the American spirit and its principles, it must not. Assuredly, the Social Security Administration officials will state that the citizens' money is a sacred trust, but it hasn't been treated that way in a long time.

It is clear from the readings on our nation's founding that the responsibility of taking money for the citizens' futures is not that of government. Social Security is only a guise of government control under the pretense of caring for us. Most citizens I've spoken with believe our government is not the example of economy and liberty our founders sought. Thomas Jefferson said, "to preserve their independence, we must not let our rulers load on us with perpetual debt. We must make our election between economy and liberty, or profusion [waste] and servitude. If we run into such debts, as that we must be taxed in our meat and in our drink, in our necessaries and our comforts, in our labors and in our amusements, for our callings and our creeds, as the people of England are. our people, like them, must come to labor sixteen hours in the twenty-four, give the earnings of fifteen of these to the government for their debts and daily expenses; and the sixteenth being insufficient to afford us bread, we must live, as they now do, on oatmeal and potatoes; have no time to think, no means of calling the mismanagers to account... private fortunes are destroyed by public as well as by private extravagance. And this is the tendency of all human governments. A departure from principle in one instance becomes a precedent for a second; that second for a third; and so on, till the bulk of society is reduced to be mere automatons of misery.... and we shall go on, as other nations are doing, in the endless circle of oppression, rebellion, reformation; and oppression, rebellion, reformation, again; and so on forever."[1] Mr. Jefferson understood the principle of preserving the citizen's independence: a prevention of perpetual debt. If you look at the number of Americans with second jobs and wives working to make ends meet, I think you can see a repeat of history, as Thomas Jefferson conjectured in his writings. Today, I fault not only elected leaders, but also the citizenry of our nation for our debt. We have not been careful stewards of our money, money intended for our future years of retirement. We have not been careful or attentive to the motives of those we elect. Citizens must realize that their duty to country includes preserving liberty. And as President John C. Calhoun stated in 1848, "It is harder to preserve than to obtain liberty."[2] I ask myself, 'How can preservation of liberty be more difficult than eight grueling years of war with England?' The answer can be found in the words of Daniel Webster, "Having destroyed one despotism, nations generally create another; having rejected the dominion of one tyrant, they make another for themselves."[3] After seeing the testimonies offered earlier this year regarding the abuses of the IRS, it is abundantly clear to me that we have the makings of a despotism in our own backyard. How can a despotism emerge out of a Representative Republic?

Daniel Webster indicated how this transition is accomplished; it is effected by a series of changes and modifications to the Constitution we live under. By changing the Constitution to a broad authority-granting document, the resulting mechanistic monstrosity may resemble the original precepts of good government on the surface, but it does not have the life and vitality of the original freedoms granted in that Constitution. "A succession of small changes, a perpetual tampering with minute parts [of the Constitution] steal away the breath though they leave the body; for it is true that a government may lose all its real character -- its genius and its temper -- without losing its appearance. You may have a despotism under the name of a republic. You may look on a government and see it possess all the external essential modes of freedom, and yet see nothing of the essence, the vitality, of freedom in it: just as you may behold [George] Washington or [Benjamin] Franklin in wax-work, -- the form is perfect, but the spirit, the life, is not there." [4] When I look at this spiritless machinery we have formed called Social Security, and while we continue feeding our government's maverick appetite with more money, I ask myself, 'is this what Daniel Webster, Thomas Jefferson and others envisioned for our country?' I hardly think so.

I do not know how many volumes of books it would take to contain all the legislation on Social Security, or the regulations, policy, and operational procedures of the Social Security Administration, but I reflect on what Daniel Webster stated about our Constitution: It is not "so dark and complicated that it is the labor of one's life to investigate and understand it. All are capable of comprehending its principles and its operations."[5] He said ALL are capable of comprehending its operations. Yet, wouldn't you agree that it would take "the labor of one's life to investigate and understand" our Social Security System? I wonder whether we really understand either our Constitution or the volumes on the Social Security System; for, if we understood the former, would the latter even exist?

A frequent argument heard from advocates of Social Security is that 'the common citizen is not smart enough to save for his future... he's too busy.' I grant the second premise: we are too busy.... too busy with second jobs and sending our wives into the labor forces to feed that hungry entity called government. But regarding the former premise, Thomas Jefferson wrote "I know no safe depository of the ultimate powers of the society but the people themselves; and if we think them not enlightened enough to exercise their control with a wholesome discretion, the remedy is not to take it from them, but to inform their discretion by education. This is the true corrective of abuses of constitutional power."[6]

We, as citizens, want to be in control of our lives, and not simply puppets of an unfeeling and overburdening bureaucracy. This is the premise of our Great Revolution. Freedom means choice. Mr. Jefferson stated that "Freedom is the right to choose, the right to create for oneself the alternatives of choice. Without the possibility of choice, and the exercise of choice, a man is not a man, but a member, an instrument, a thing." [7] One could easily replace the word "thing" Jefferson used with "Social Security Number". It would read: "... A man is not a man, but an instrument, a member, a Social Security Number". Congress, knowingly or not, has taken the very power Mr. Jefferson spoke about. Congress has taken power from society for a reason that I do not recognize, for it does not appear to come from the fabric or embodiment of our Founding Fathers. Please don't tell us we have no choice and then give us the invoice for what you have decided for our future, and robbing from that (our future's money) to fund the maverick appetite of government.

Some might argue that 'to not take care of those less fortunate in their older years is anti-American and unChristian, and thus we have Social Security' [8]. This is a noble sentiment, but not substantial reasoning to justify contorting our Constitution to have government dispense charity. Our citizens have the benefit of countless charities to assist those who have fallen on rough times. We Americans are not a mob of heartless and cruel desparados, seeking ways to steal from the poor [9]. We have hearts to provide for those in our communities, and we do it with much less "executive expense" (i.e., waste) than any government program could boast. But we MUST understand the vital and eternal truth of personal responsibility, and that the average citizen, like myself, would gain much more wealth for retirement by investment in mutual funds or a pension plan instead of building the coffers of a government that few citizens trust, and many call wasteful. By investing in private mutual funds, one is constantly reminded of the accumulated money by the quarterly statements that are mailed out showing interest earned or dividends reinvested. But has ANYONE received such quarterly statements like that from the Social Security office regarding the growth of their savings? None have and none will. The office will send out statements, but only by requesting one, and one is all they will send; there does not appear to be a subscription service. Furthermore, the statement's content is lacking in substance.

What our government needs to adopt is a biblical precept, found in II Thessalonians 3:10 that states "He who does not work, neither let him eat." And for those who think that our government shouldn't be so closely associated with biblical principles, they need to argue with Theodore Roosevelt who stated that, "Every thinking man, when he thinks, realizes that the teachings of the Bible are so interwoven and entwined with our whole civic and social life that it would be literally --I do not mean figuratively, but literally -- impossible for us to figure what that loss would be if these teachings were removed. We would lose almost all the standards by which we now judge both public and private morals, all the standards towards which we, with more or less of resolution, strive to raise ourselves." [10] That statement was made before we had a Social Security System and his was not a "lone voice" on biblical standards for conduct. One immediately realizes this in the opinions of the U.S. Supreme Court in *Rector, etc., of Holy Trinity Church v. U.S.* and others [11].

Proponents of Social Security may point to their concern for the quality of American life. However, their concern befits not a governmental but a charitable cause, which is not within the reasonable and Constitutional scope and breadth of our representative system. I cannot help but think of William Buckley when he suggests that government involvement in quality of life "is something very new in the political theory of free nations. The quality of life has heretofore depended on the quality of the human beings who gave tone to that life, and they were its priests and its poets, not its bureaucrats." [12] Don't you believe that our Founding Fathers would agree with that sentiment?

In a scholarly and thorough review of the Social Security system from an economic perspective, the American Institute for Economic Research states that "Social Security represents a very poor investment for young workers, compared to what they could obtain privately on a mixed portfolio of stocks and bonds" [13]. This is an important statement, as it illustrates that our college graduates would be better served investing in AMERICA rather than investing in the United States Government for their retirement. Indeed, I think that our government would be better served as well, don't you think?

Like the IRS, reform is simply not enough. Instead of Social Security, we need privatized alternatives to this faulty system, very quickly. It is obvious from the president's own commission on Social Security that some radical changes must be made very soon or more difficult options will be made necessary. You have likely read and heard opinions expressed from some groups, like the AARP, that we cannot risk jeopardizing the money saved for years by those close to retirement now. I can understand that, so let me divest myself of all my money accrued in the Social Security system. Cut me out of Social Security and let me save, as I've been doing, via IRA's and a 401K plan since I was age 28. That way, all the money that has been taken from me since I was 16 by the government (through no choice of my own) can be applied to others' retirements. Just let me be FREE to save for myself from here on. Is that too much to ask? And it pains me to HAVE to ask.... How many people living today were responsible for electing those that implemented this faulty Social Security System? I venture that it's hardly a majority of Americans living today. That being the case, how can you fault people for not wanting to be part of a failed and unConstitutional system? Do you honestly think that founders like Patrick Henry, Thomas Jefferson and the many others would have signed up for Social Security?

Many, if not most, Senators and Representatives might call the Social Security system a "sacred cow". It appears that our Founding Fathers might not call it a sacred cow but a sacred sow. I'd have to agree with them.

In closing, thank you for your time and your commitment to realizing we must allow Americans to freely save for their own futures outside the limitations of a government-run system (like congressmen are able to). Please do your part to prevent our government from wasting the labor of the people, under the pretense of caring for us.

With kind regards,

Mark Rice
Greenville, Texas

p.s. If I get audited by the IRS for the above testimony, I'll be in contact with you very quickly.

Footnotes:

[1] Thomas Jefferson's Letter to Samuel Kercheval, July 12, 1816.

[2] John C. Calhoun in a speech before the U.S. Senate, 1848.

[3] Oration by Daniel Webster delivered on July 4, 1802 in Fryeburg, Maine. As reprinted in The Foundations of Liberty, published by the Mac Arthur Institute, East Moline, Ill.

[4] Ibid.

[5] Ibid.

[6] Thomas Jefferson's Letter to William C. Jarvis, 1820.

[7] Thomas Jefferson's statement on freedom has been difficult to find, but the source that I'm quoting from stated that they are quite sure he wrote it. I will continue to ferret it out.

[8] If this premise is true, then we have violated the separation of church and state.

[9] "Individual U-S donations to charity climbed more than nine percent in the last two years, totaling more than 130 billion dollars last year." Voice of America News Story by Linda Cashdan, "New Philanthropists", (10/9/97, 1:26 PM, NEB/LC/MMK NUMBER=5-37744, Washington, D.C.)

[10] From a speech entitled, "The Influence of the Bible" delivered by Theodore Roosevelt to the Long Island Bible Society in 1901, as quoted from pg. 306, Christian F. Reisner, "Roosevelt's Religion", New York, 1922.

[11] Rector, etc., of Holy Trinity Church v. U.S. [143 U.S. 457]; Reynolds v. U.S [98 U S 145]; And from a State Supreme Court ruling of more recent vintage, Church et al. v. Bullock et al., [Supreme Court of Texas, April 8, 1908, Southwestern Reporter, Texas, pgs 115-118, Justice J. Brown delivering the Court's Opinion] "Christianity is so interwoven with the web and woof of the state government that to sustain the contention that the Constitution prohibits reading the Bible, offering prayers, or singing songs of a religious character in any public building of the government would produce a condition bordering upon moral anarchy. The absurd and hurtful consequences furnish a strong argument against the soundness of the proposition... This would be to starve the moral and spiritual natures of the many out of deference to the few."

[12] William F. Buckley, Jr.; 8/7/65

[13] Marietta Constantinides, "What Will Social Security Mean to You?" pg. 63, Economic Education Bulletin Vol. XXIX No. 9, Sept. 1989. Published by the American Institute for Economic Research, Great Barrington, Mass. (ISSN 0424-2769)(USPS 167-360)

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