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I appreciate the invitation to testify here today. I am Robert Greenstein, executive director of the Center on Budget and Policy Priorities, a nonprofit policy institute here in Washington, D.C. Several years ago, I also had the privilege of serving on the Bipartisan Commission on Entitlement and Tax Reform, chaired by two individuals who were members of this Committee at the time, Senators Kerrey and Danforth.

As you know, the President's Commission to Strengthen Social Security completed work last December and proposed three Social Security plans. One of these plans (Model 1) would not restore long-term balance to Social Security. I focus on the other two plans today.

My comments will center primarily on issues related to the financing of these plans and their relationship to the rest of the budget. Because the financing of the plans rests upon massive general revenue transfers despite the presence of budget deficits outside Social Security as far as the eye can see — and fails to provide any way for the rest of the budget to come up with the revenues that are to be transferred — my assessment of the financing of the plans is necessarily a critical one. Before addressing these matters, however, I would like to discuss an area where I believe the Commission's report makes an important contribution to the Social Security debate.

The "Free Lunch" Fallacy

In recent years, some proponents of partly converting Social Security to private accounts have sought to portray such accounts as a painless way to restore Social Security solvency without having to institute any reductions in Social Security benefits, increases in payroll taxes, or budget cuts or tax increases elsewhere in the budget. Some have presented private accounts as a direct alternative to benefit cuts or payroll tax increases and have essentially described individual accounts as a third way that entails no painful sacrifices. In this portrayal, there are three approaches to restoring Social Security solvency — benefit cuts, payroll tax increases, and private accounts.

Careful analysts, whether or not they favor partially replacing Social Security with private accounts, have long recognized that such "free lunch" claims regarding private accounts are inaccurate and misleading. Nevertheless, such claims concerning private accounts have continued to be made.

The Commission's proposals should help put a halt to such claims. Both of the Commission plans that restore solvency are able to do so only through a combination of: 1) large reductions in traditional Social Security benefits, as compared to the benefits scheduled under the current-law benefit structure (benefit reductions that are sufficiently large that, for millions of

beneficiaries, the combined benefits from Social Security and private accounts would be below the benefits payable under the current-law benefit structure); and 2) extremely large general revenue transfers that would entail hefty budget cuts or tax increases or large-scale deficit financing. Given that a Presidential commission composed entirely of advocates of private accounts was unable after months of deliberation to find a way to restore solvency without these large benefit changes and general revenue transfers, I hope that we will see an end to spurious claims that private accounts are a panacea that can restore long-term solvency without other painful actions. As is true elsewhere in life, there is no "free lunch." The Commission report should be helpful in demonstrating that.

In this vein, I also would like to commend several members of this Committee who, along with Reps. Stenholm and Kolbe in the House, have put forth private-account proposals that do not shrink from hard choices or seek to hide or camouflage the choices they have made. I do not favor those plans, but I respect the fiscal and intellectual integrity on which they are based.

The Financing of the Commission Plans

Two of the three Commission plans succeed in restoring Social Security solvency, according to the estimates of the Social Security actuaries. *How* they restore solvency warrants close examination.

As Peter Diamond of M.I.T., widely regarded as one of the world's leading experts on retirement systems, and Peter Orszag of Brookings, a fellow panelist at today's hearing, have shown in their magisterial analysis of the Commission plans, the private accounts that would be established under the Commission proposals would make no contribution to restoring Social Security solvency. To the contrary, as the Commission report acknowledges, the private accounts themselves would worsen Social Security's balance over the next 75 years.[1] The accounts would have an adverse effect on Social Security's financial condition on a permanent basis, rather than just during a "transition period."

The private accounts would have this effect for a basic reason: under the Commission plans, these accounts would be subsidized with revenue from the Social Security Trust Funds, and these subsidies would be a permanent part of the new financing structure. As a result, the Social Security Trust Funds would lose more in revenue due to the private accounts than they would gain as a result of the reductions in Social Security benefits that would be tied to participation in the private accounts. The result would be a permanent worsening of the Trust Fund's financial condition.

How then do the Commission plans succeed in restoring solvency? They are able to do so through rather massive infusions of general revenue from the rest of the budget. Indeed, in the absence of these general revenue transfers, the Commission plans actually would hasten the date of Social Security insolvency, despite the large reductions in traditional Social Security

[1] President's Commission to Strengthen Social Security, "Strengthening Social Security and Creating Personal Wealth to All Americans," p.127.

benefits they contain. For example, in the absence of general revenue transfers, Model 2 would hasten the date of insolvency by 13 years.

The Magnitude of the General Revenue Transfers

As Diamond and Orszag have demonstrated, the general revenue transfers that would be required under Model 2 would be *two-thirds as large as the entire Social Security shortfall over the next 75 years*. (This estimate assumes all eligible workers would participate in the plan's private accounts, as it would be to their advantage to do given the subsidies that would be provided to the accounts.) The transfers that would be required under the Commission plan known as Model 3 would be *three-fifths as large* as the entire Social Security shortfall. (This estimate for Model 3 assumes that two-thirds of eligible workers would participate in the private accounts under that plan; this is a reasonable participation estimate for Model 3, since participants would have to contribute some of their own money to participate in the plan's private accounts.) Transfers of this nature can only be described as massive.

The Problem of Disability Benefits

Moreover, these figures may significantly understate the magnitude of the transfers that would be needed. These figures assume that the deep cuts in traditional Social Security benefits that are part of Models 2 and 3 would be visited upon disabled Social Security beneficiaries. Yet those who become disabled at a relatively young age would have participated in the private accounts for only a short number of years and hence would receive little income from these accounts to offset the large loss of traditional Social Security benefits. Furthermore, under Models 2 and 3, no one — including disabled beneficiaries — would be able to receive any income from their private accounts until they reached retirement age.

I raise this issue here because the figures cited above for the magnitude of the general revenue transfers assume that the reductions in traditional Social Security benefits would apply in full to the disabled. That assumption is made because it is what the Commission assumes in its report when it describes the financing of the plans. It consequently also is what the Social Security actuaries assumed when they estimated the costs of the Commission plans and assessed whether those plans would restore solvency. Without these substantial reductions in disability benefits, either the Commission plans would fail to restore Social Security solvency or the general revenue transfers would have to be even larger.

The reductions in Social Security disability benefits would be large. Those who began to receive Social Security disability benefits in 2060 would be subject to a 39 percent reduction in these benefits under Model 2 (compared to the current-law benefit structure) and a 23 percent reduction under Model 3. Moreover, the reductions would grow deeper for each new cohort of disabled individuals. Those beginning to receive disability benefits in 2075 would be subject to a 48 percent reduction in Social Security disability benefits under Model 2 and a 29 percent reduction under Model 3.

Adding to the problems that these deep reductions in disability benefits would entail, these benefit reductions would disproportionately affect minority workers, since the proportion

of workers who are disabled is significantly higher among African-Americans than among the rest of the population. (These same reductions in benefits also would apply to young children of deceased workers. African-Americans would be disproportionately affected by those benefit reductions as well.)

Unfortunately, the Commission's treatment of this problem was less than straightforward. Throughout its report, the Commission counted the savings from these large reductions in disability benefits to help make its numbers add up. Until two pages from the end of its 151-page report, however, the Commission was silent about this important matter, failing to explain that its proposed reductions in traditional Social Security benefits would apply in full to Social Security disability benefits unless a change in the plans were made. Only at the end of its voluminous report did the Commission acknowledge that these reductions in traditional Social Security benefits would apply to disability benefits and that the disabled individuals affected would not have had the same opportunities as retirees to build private account balances. In essence, at the end of its report, the Commission acknowledged that application of these benefit changes to the disabled could cause significant hardship and accompanied this acknowledgement with a statement that disavowed the application of these benefit changes to Disability Insurance and asserted it was *not* proposing that these benefit reductions apply to DI.

The Commission cannot, however, have it both ways. Either it *is* proposing that these benefit reductions apply to disabled beneficiaries — in which case, hardship would ensue but the resulting savings could be used to help restore Social Security solvency — or it is *not* proposing that the benefit reductions apply, in which case the savings would not be realized and cannot be counted. Instead, the Commission has tried to claim that it is not recommending that these benefit reductions be applied to disabled beneficiaries, while still counting the substantial savings that would result from doing exactly that.

If these benefit changes do *not* apply to the disabled, the general revenue transfers would have to be even larger than the figures cited above (if Social Security solvency is to be achieved). Diamond and Orszag calculate that in this circumstance, the transfers under Model 2 would equal *four-fifths* of the 75-year Social Security shortfall that the actuaries currently project. Under Model 3, the transfers would equal 70 percent of the Social Security shortfall.

Where Would the Money for the Transfers Come From?

This raises the question of where the large amounts to be transferred would be found. This is a crucial question, as surpluses outside Social Security no longer remain. No money is available for such transfers, unless action is taken to secure such funds through major cuts elsewhere in the budget or substantial tax increases.

Nor is this lack of surplus revenues available for transfer a short-term problem only. To the contrary, long-term budget projections that have been issued by the General Accounting Office and the Congressional Budget Office, as well as the long-term projections made by independent analysts, show very large *long-term* budget shortfalls outside Social Security. The retirement of the baby-boom generation will lead to substantial increases in costs for Medicare and the long-term-care component of Medicaid, while the aging of the population will slow labor-force growth and hence the growth of the economy. Recent estimates suggest that the

long-term budgetary shortfall outside Social Security is at least *twice as large* as the long-term Social Security shortfall itself.

In short, no funds are available in the budget to make the very large transfers the Commission plan entails. Where the funds would be found is entirely unclear. Policymakers would essentially face three choices in finding the trillions of dollars to transfer to the private accounts. They could impose deep cuts on the rest of the budget. They could impose large tax increases. Or they could run even larger deficits outside Social Security than those currently projected, with such deficits continuing for decades.

In one of its less admirable aspects, the Commission report ducks these questions. It simply assumes that these large general revenue transfers will be made, while providing no indication of how or where the money for the transfers could be secured. If the Commission proposals were enacted, the general revenue transfers it would require would represent a "magic asterisk" of historic proportions.

By assuming such large transfers and then failing to pay for them, the Commission report itself becomes a "free lunch" proposal of sorts after all. Looked at another way, the large, unspecified transfers included in the Commission plans essentially mask the adverse financial impact that the subsidized private accounts the Commission has proposed would have on Social Security solvency.

I would hope that policymakers of both parties — whether or not they favor partial conversion of Social Security to private accounts — would adopt a basic principle from now on for Social Security reform: If general revenue transfers are to be part of proposals to restore long-term Social Security solvency and the non-Social Security budget is projected to be in deficit, the transfers should be "paid for." Henceforth, Social Security plans should not simply assume such transfers without financing them. Plans should specify the changes that would be made elsewhere in the budget to produce the revenue that would be transferred.

Two Risk Factors Could Aggravate the Financing of the Commission Plans

Finally, two risk factors that could add to the financing problems of the Commission plans. First, for the reasons just described, there is a possibility that the assumed transfers would not fully materialize. If they did not, Social Security benefits could have to be reduced to a greater degree to adapt the system to the available level of funds.

The second risk is a risk to the rest of the budget. Imagine what would happen if one of the Commission plans were in effect and the stock market plunged as it has in recent months, wiping out a significant share of the assets in the accounts. If balances plummeted in accounts that had been presented to the public as being a key part of the Social Security system and a substitute for a significant share of their Social Security benefits, the political pressures on the federal government to make up for these losses could be tremendous. One can see how this easily could become a political football, with possible bidding wars erupting in election years. The threats to the rest of the budget to produce even larger transfers could be substantial.