TREASURY DEPUTY SECRETARY LAWRENCE H. SUMMERS
SENATE SPECIAL AGING COMMITTEE

Mr. Chairman, Members of the Committee, I appreciate the opportunity to appear today to discuss President Clinton's proposal to ensure the financial security of our aged population. The demographic challenge that we as a nation face today is a critical issue to all Americans and to the future of our economy. As you know, it is in direct response to this challenge that President Clinton has offered his framework for preserving the financial well-being of the Social Security and Medicare programs and improving the retirement security of all Americans. Let me applaud this Committee for its contribution in addressing and focusing attention on these issues.

The advent of an era of surpluses rather than deficits has radically transformed our national debate about entitlements. The terms of all of the earlier tradeoffs in the entitlements debate have been eased -- provided we seize the opportunities now available to us. The President's framework for Social Security both recognizes the brighter present reality, and moves us well along the road toward seizing the opportunities currently available, if we can work together on a bipartisan basis.

This afternoon, I will first briefly describe the President's program. Then, I will devote the bulk of my remarks to addressing some of the issues that have arisen about our approach to retirement security policy.

The President's Proposal

According to the Office of Management and Budget, the unified budget of the federal government is now projected to accumulate more than $4.5 trillion in surpluses over the next 15 years. The operational question now before us is how we should use these surpluses.

The President's framework devotes 62 percent of these surpluses to the Social Security system. Of the roughly $2.8 trillion in surpluses that will go to Social Security, about four-fifths will be used to purchase Treasury securities, the same securities that the Social Security system has invested in since its inception. The remaining one-fifth will be invested in an index of private-sector equities, which should on average yield a higher rate of return for the program's investments. These two actions will reduce the 75-year actuarial gap from its current level of 2.19 percent of payroll by about two-thirds, to 0.76 percent of payroll. And they push the date at which the Social Security trust fund is projected to be exhausted from 2032 back to 2055.

Substantial as that accomplishment would be, it is critical that we do more. Historically, the traditional standard for long-term solvency of the Social Security system has been the 75-year actuarial balance. A 75-year horizon makes sense because it is long enough to ensure that virtually everyone currently participating in the system can expect to receive full payment of current-law benefits. Attaining this objective will require additional tough choices. But the objective is both important and obtainable. To reach it, the President has called for a bipartisan process. We believe that the best way to achieve this type of common objective is to work together, eliminating the need for either side to "go first."

In the context of that process, we should also find room to eliminate the earnings test, which is widely misunderstood, difficult to administer, and perceived by many older citizens as providing a significant disincentive to work. In addition, it is critical that we not lose sight of the important role that Social Security plays as an insurance program for widows and children, and for the disabled. As President Clinton said last month: "We also have to plan for a future in which we recognize our shared responsibility to care for one another and to give each other the chance to do well, or as well as possible when accidents occur, when diseases develop, and when the unforeseen occurs." That is why the President has proposed that the eventual bipartisan agreement for saving Social Security should also take steps to reduce poverty among elderly women, particularly widows, who are more than one and one-half times as likely as all other retirement age beneficiaries to fall below the poverty line.

In addition to shoring up Social Security, the President's plan would transfer an additional 15 percent of the surpluses to Medicare, extending the life of that Trust Fund to 2020. A bipartisan process will also be required to consider structural reforms in this program. This process will be informed by the important work of Chairman Breaux and the other members of the Medicare Commission, and we look forward to their report.

Finally, the President would use 12 percent of the surpluses to create retirement savings accounts -- Universal Savings Accounts or USA accounts -- and the remaining 11 percent for defense, education, and other critical investments. The President will be announcing further details regarding the USAs soon.

Benefits of the President's Approach

In essence, the President is proposing that we use the Social Security and Medicare trust funds to lock away about three-quarters of the surpluses for debt reduction and equity purchase, and ensure that they are not used for other purposes. This would have three key effects:

1. First, it would greatly strengthen the financial position of the government. If we follow this plan, by 2014, we will have the lowest debt-to-GDP ratio since 1917 and will free up a tremendous amount of fiscal capacity. The reduction in publicly held debt will reduce net interest outlays from about 13 cents per dollar of outlays in FY99 to about 2 cents per dollar of outlays in 2014. Under the President's program, the reduction in interest due to debt reduction will exceed the increase in the Social Security burden through the middle of the next century.

2. Second, it would strengthen significantly the financial condition of the Social Security and Medicare Trust Funds. Indeed, it would extend the life of the Social Security Trust fund by more than 20 years, to 2055, and extend the life of the Medicare Hospital Insurance Trust Fund to 2020. Meeting our obligation to the next generation of seniors should be the number one priority in allocating the surpluses.

3. And third, it would substantially increase national saving, which must be a priority in advance of the coming demographic shift. By paying down debt held by the public and investing in equities, the President's program will create $3.5 trillion more room in private portfolios for productive capital in place of the sterile asset of government paper. In effect, this will be the reverse of the "crowding out" that occurred during the era of big deficits. With government taking a smaller share of total credit in the economy, interest rates will be lower than otherwise would be the case. The implications of lower interest rates will be profound. Not only will individuals be able to borrow for mortgages, school loans, and other purposes at lower rates, but importantly, businesses will be able to finance investments in productive plant and equipment at the lower rates. And the resulting larger private capital stock is the key to increasing productivity, incomes, and standards of living. Ultimately, one reason why this program is sound economically is that it will result in a more robust private economy, which will expand our capacity to make good on our Social Security and Medicare promises.

The President's proposal also specifically aims to deal more broadly with the challenges of an aging society by expanding individual access to retirement saving. As I noted earlier, the President proposes to devote 12 percent of the surpluses to establishing a new system of Universal Savings Accounts. These accounts would provide a tax credit to millions of American workers to help them save for their retirement. A majority of workers would receive an automatic contribution structured as a flat dollar amount regardless of income. In addition, many of those who make voluntary contributions would receive a matching contribution from the government to their USA account. Overall, the program would be considerably more progressive than the current tax subsidies for retirement savings -- where higher bracket taxpayers get higher subsidies.

At the same time, the President proposes to strengthen employer-sponsored retirement plans in a variety of ways. The President's budget addresses the low rate of pension coverage among the 40 million Americans who work for employers with fewer than 100 employees by proposing a tax credit for start-up administrative and educational costs of establishing a retirement plan and proposing a new simplified defined benefit-type plan for small businesses. Workers who change jobs would benefit from the budget proposals to improve vesting and to facilitate portability of pensions. In addition, the retirement security of surviving spouses would be enhanced by the President's proposal to give pension participants the right to elect a form of annuity that provides a larger continuing benefit to a surviving spouse and to improve the disclosure of spousal rights under the pension law.

Additional revenues

Mr. Chairman, in your letter of invitation, you asked that I address the merits of various possible ways of bringing additional revenues into the system. A wide variety of such options have been included in the plans that have been put forward in the last few months. As you know, the President has expressed his belief and determination that we should be able to put Social Security on a sound long-term financial foundation without increasing the payroll tax rate. The payroll tax hits all workers and it hits the low and middle of the earning scale proportionately harder than more affluent individuals. Partly because of this, the President believes that other ways of closing the gap are preferable.

With regard to most other ways of increasing the revenues of the system, the Administration has striven to maintain an open mind. We have emphasized that individual proposals should not be judged in isolation, but rather in the context of complete plans. And the President strongly believes, as I noted before, that the way to achieve final agreement is for both parties to work together, avoiding in the meantime actions that would polarize the debate. For that very reason, it would be counterproductive for me to discuss specific alternatives -- regardless of their merits or demerits. The time for us to exchange such views will come, but, in my judgement, is not here today.

Investing in Equities

As I noted above, an important element of the President's framework is the proposal to invest part of the transferred surpluses in equities. Historically, the Trust Fund has been invested exclusively in government bonds. While these bonds are essentially risk-free, they have the corresponding downside that they have historically earned a lower rate of return, on average, than other potential investments. Between 1959 and 1996, the average annual rate of return earned on stocks was 3.84 percent higher than the rate earned on bonds held by the Trust Fund.

Raising the rate of return on the Trust Fund would substantially alleviate the need to bring additional revenues into the system. Even in the President's program, in which the proposed equity investment is modest, the impact on the actuarial balance is significant: It would reduce the actuarial gap by an estimated 0.45 percent of taxable payroll -- roughly one-fifth of the overall problem we face today. Put another way, the proposed investment in equities achieves as much, in terms of improving the 75-year actuarial balance as a 5 percent across-the-board cut in benefits beginning in 2030. Or, to put it still another way, the equity investment in the President's package achieves as much for the financial soundness of the system as would moving the normal retirement age up by an extra year-and-a-half. Given the magnitude of what the equity investment will accomplish, I believe that the President's proposal should receive serious consideration as a means of, in effect, bringing new resources into the system.

Addressing Issues

Since the President unveiled his plan in the State of the Union Address, a number of important issues have been raised. Let me briefly address a few of them here.

Is the President's framework based on sound accounting?

One issue is whether the President's framework is based on sound accounting methods. In this regard, the framework is grounded in two essential ideas:

- First, the framework should speak to the disposition of the whole of the *unified* surplus, which encompasses both the Social Security and non-Social Security portions of the budget. As I outlined earlier, the President proposes to reserve the bulk of the unified surplus for the purpose of paying down the debt held by the public and for acquisition of assets. Some have criticized the framework for proposing a disposition of the whole of the unified surplus, but in doing so the framework follows squarely in the tradition of Republican and Democratic administrations alike for each of the past 30 years. Moreover, any time a competing proposal is cast in terms of how it would use the unified surplus, the validity of our fundamental approach is reinforced.

- Second, the framework should ensure, to the greatest extent possible, that the surpluses that have been transferred to the Social Security and Medicare Trust Funds may not be used for any purpose other than to pay down the debt held by the public or to acquire assets. In short, these transfers must constitute a *full use* of those resources. It is clear to us that current budgetary methods are inadequate in this regard because they would not sufficiently wall off the transferred amounts and protect them from being used either to finance additional spending or tax reductions. We are looking forward to working with the members of this Committee and the rest of the Congress to devise new methods for achieving this fundamentally important objective.

Debate about accounting arcana threatens to obscure one crucial point: that -- as Secretary Rubin stated in his budget testimony -- at the core of this budget is fiscal discipline. We must not lose sight of the fact that this budget is possibly most notable for the fact that it lays the groundwork for paying off the debt held by the public. That is the most prudent budget accounting of all.

Can equity investment in the Trust Fund be undertaken in a sound, prudent manner?

Another issue concerns the potential for political interference in the investment of a portion of the transferred surpluses in equities. We take this issue seriously. Accordingly, we have devoted a good deal of effort to developing an institutional framework aimed at isolating these investment decisions from political pressures. With this framework -- or one like it -- we are confident that the concerns that have been expressed can be overcome.

Under the President's plan, an apolitical, independent board would select private-sector investment managers through a competitive bidding process similar to the one used by the Federal Retirement Thrift

Investment Board. Investments would be limited to broad-based, widely-used index funds, eliminating the possibility of individual stock picking. Purchases and sales will be dictated by the cash needs of the Social Security system and by the requirement to maintain equities as 15 percent of the Trust Fund, eliminating the possibility of investment decisions based on market timing. In addition, our proposal limits the share of Trust Fund assets that could be invested in equities, so as to ensure that these funds never account for more than a small fraction of the stock market.

Why does the President's plan cause gross federal debt to rise faster than it otherwise would?

A third issue concerns the fact that, under the President's framework, gross Federal debt would rise by more than otherwise would occur, even as debt held by the public is being paid down. Doesn't this signal an *expansion* of the obligations of the Federal government?

Debt held by the public and debt held by the Trust Funds do have equal legal standing. Both are obligations of the United States Treasury. But there are important distinctions that must be recognized. It is debt held by the public that best captures the Federal government's pressure on credit markets, and hence this measure of the debt that is most relevant for determining whether interest rates are high or low, whether private investment in productive capital is strong or weak, and whether we have to borrow much or little from abroad.

While the debt held by the Trust Funds is a liability of one part of the government, it is at the same time an asset of another part of the government. On a consolidated basis, then, it is a wash. By contrast, the debt held by the public is a liability of the *entire* government; it is, therefore, the better measure of the fiscal burden we are passing on to future generations. The Congressional Budget Office has long held this view, and reiterated it in their testimony before the Senate Budget Committee on February 23rd of this year.

Looking at the situation from the perspective of the non-Social Security portion of the government only, the President's program in effect converts an *implicit* commitment (in the form of promised future Social Security and Medicare benefits) into an *explicit* one (in the form of the Special-issue securities, or "Specials", held by the Trust Funds). Putting Specials into the Trust Funds does not increase the amount that we will owe in the future for Social Security benefits and debt. Again, this point was made clear in CBO's February 23rd testimony.

What if the projected surpluses do not materialize?

A fourth issue concerns the prudence of committing today to transfers for as long as 15 years into the future, given the huge uncertainty surrounding budgetary projections. To be clear, the President is proposing that we make the specified transfers into the Trust Funds regardless of whether our current forecast of the budgetary outcome proves accurate. We did not make this policy choice ignoring forecast uncertainty. On the contrary, we fully recognize and appreciate the extent of uncertainty surrounding any economic projection, much less one purporting to peer out 15 years into the future. Indeed, that uncertainty is a primary reason why we believe that a more prudent way to run our fiscal affairs is to substantially pay off the debt held by the public over the next 15 years and, rather than commit today to the consumption of those surpluses over the next 15 years rather than commit today to reduce taxes or raise spending. Under our approach, the real uncertainty concerns whether the debt reduction we actually achieve will be less or more than we currently project. Under an alternative approach, in which government saving is reduced by spending increases or tax cuts, the remaining uncertainty would not concern how much debt reduction occurs in the future, but rather whether there is debt reduction in the future.

Do the bonds we propose placing in the Trust Funds make real provision for the future of Social Security and Medicare?

A fifth issue concerns the question of whether we have made real provision for the future of Social Security and Medicare by placing additional assets in their respective Trust Funds. We believe that we have, in two respects.

- First, we have ensured that a corresponding amount of debt held by the public is taken out of circulation. This is a crucial step toward creating the fiscal capacity to meet our benefit obligations to Social Security and Medicare beneficiaries. Given that we take this step, long-term projections by the Office of Management and Budget illustrate this fiscal capacity by showing unified budget surpluses into the middle of the next century. The overwhelming consensus of economists recommends paying down the debt held by the public as one of the most important contributions the government can make in advance of the retirement of the babyboom generation.

- Second, having created new *fiscal* capacity to meet our obligations, the President's framework provides new *legal* capacity, by assigning the proceeds of the debt reduction to the Social Security and Medicare programs. Absent this action, Social Security would be unable to pay current-law benefits beyond 2032, notwithstanding that we would have the fiscal capacity to do so. Medicare also would become insolvent early in the next century. To be clear, the assignment of the debt-reduction dividend to Social Security and Medicare does not expand our obligations under those two programs -- it merely expands our capacity to meet existing obligations in a timely manner.

Is it desirable to commit general revenues to Social Security?

Finally, a sixth issue concerns the desirability of committing general revenues to Social Security and Medicare. From the beginning, Social Security has been mainly financed out of a dedicated payroll tax, and a substantial body of opinion has held that the long-term integrity and durability of the programs would best be upheld by severely limiting, if not prohibiting, the use of general revenues.

The President's framework proposes something quite different from general revenue financing as it has historically been contemplated. The framework proposes to tap, for a limited time only, the unprecedented surpluses now in prospect. Importantly, the President's framework is a mechanism for ensuring that the surplus general revenue is used to pay down the national debt, and thus is a vehicle for ensuring fiscal discipline, not fiscal laxity. Such a temporary use of the surplus can be justified by the need for help in the transition of the retirement of the baby boom generation. This is far different from any approach that would either use general revenues in perpetuity, or that would expand benefit obligations.

Concluding Remarks

Mr. Chairman, it is difficult to overemphasize the significance of the changes achieved through the fiscal responsibility of the past six years. It is indeed remarkable that we can sit here today and debate how best to use budget surpluses. I believe it is worthwhile to take a minute to consider how recent economic changes have lifted the weight of an era of deficits off the nation's shoulders to make a new era of surpluses possible.

During the 1980s, the nation's fiscal status quo pointed only to a future of growing budget deficits. As deficits expanded throughout that decade, the volume of our nation's debt grew, meaning that the government's interest payment obligations were put on a path of continued growth. At the same time, health care costs of the federal government were rising relative to the size of the economy.

Today, by contrast, the situation has been reversed, and the basic momentum is toward improved budgetary performance. Important legislative steps toward deficit reduction were taken in the 1993 Omnibus Budget Reconciliation Act and the 1997 Balanced Budget Act. And over the past several years, health care costs have been rising more slowly. As a result, today's basic fiscal setting involves large and rising unified surpluses, which -- provided they are preserved -- will allow us to pay down the debt held by the public.

When President Clinton took office, the fiscal trajectory our nation was on suggested that by 2014, the government would be devoting 27 cents of every dollar it spent to interest payments on the federal debt. Instead, as a result of the course we have charted, only 2 cents of every dollar of outlays will be needed to cover interest expenses 15 years from now -- a savings of about $1 trillion in that year alone. The challenge we face in allocating the surpluses to the best possible use is to ensure that the underlying momentum toward fiscal control is maintained. By devoting the lion's share of the surpluses to debt reduction and preserving Social Security and Medicare, the President is ensuring that we devote the surpluses to the best possible use to help cushion the impact on future budgets as the population ages. Thank you. I would now welcome any questions.