TESTIMONY OF WENDELL PRIMUS
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before the Senate Special Committee on Aging
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Mr. Chairman and Members of the Committee on Aging:

I very much appreciate your invitation to testify on the subject of revenue options for financing Social Security. My name is Wendell Primus and I am Director of Income Security at the Center on Budget and Policy Priorities. The Center is a nonpartisan, nonprofit policy organization that conducts research and analysis on a wide range of issues affecting low- and moderate-income families. We are primarily funded by foundations and receive no federal funding.

INTRODUCTION

Any bipartisan solution that would restore solvency to Social Security over the next 75 years and restore confidence in the program, especially among our younger generations, is likely to involve increased revenues to the system. I would note at the outset that the current payroll tax is a fixed rate for the entire 75 year period. In light of increasing longevity, the increasing percentage of the population that is over age 65 and the decreasing amount of total compensation received as cash wages, it is unrealistic to expect that the amount of payroll tax revenues over this entire period to finance Social Security should decline as a percentage of GDP. But that is exactly what occurs under current law -about a 0.7 percentage point decline. That decline would be worth about $64 billion a year in today's dollars. Let me hasten to add that I also believe a bipartisan solution must necessarily involve some benefit reductions.

In your letter of invitation, you suggest that the hearing address four different types of revenue increases. The first type of revenue enhancement I will discuss is the Administration's proposal to obtain a higher rate of return through investment of a portion of the fund in equities. The second is the related proposal to increase general revenue financing of Social Security. The third is increases in the Social Security wage base or the payroll tax rate and the fourth is increased taxation of Social Security benefits. (While increasing revenues to the trust fund, this fourth proposal is in reality a progressive benefit cut.) To these types, I would add one more which I will discuss briefly- Social Security coverage of newly hired state and local workers.

I also would note that all of the major Social Security proposals currently being considered in Congress involve additional revenues of some kind. The President's proposal clearly involves significant new financing from general revenues. Based on papers authored by Senator Gramm, his approach also involves a significant amount of general revenues. The Breaux-Gregg bill provides for coverage of newly hired state and local employees not now covered by Social Security. If a bipartisan solution is to be found, it will involve revenues.

INCREASING THE RATE OF RETURN

Let me begin by discussing one option that almost everyone agrees about. Every policy maker would like to achieve a greater rate of return on investments. Doing so lessens the degree to which painful tax increases or benefit reductions may be needed. The difference is that some plans advocate investment of the Social Security trust funds themselves, like the President's approach, while other plans advocate investment in equities through individual accounts.

President Clinton has proposed investing about 15 percent of the Social Security reserves in the equities markets. Over the next 15 years, approximately $600 billion of budget surpluses would be invested in this manner on behalf of Social Security. The Center recently released a detailed analysis of the proposal which I will submit for the record.

The Administration has submitted a thoughtful and well-designed proposal on this matter. The proposal would remove management of a portion of the trust-fund reserves from the executive branch and Congress and transfer it to an independent, non-political, professional management board structured so the board would be beyond Administration and Congressional control. This independent board, the members of which would be expected to have substantial experience in pensions and investing, would in turn contract with private fund managers selected through competitive bidding. These managers -which would include entities such as Merrill Lynch, Vanguard, or State Street Bank - would do the investing of a modest portion of Social Security reserves in broad index funds in the equities markets.

To ensure the independence of the professional management board that would select the private fund managers, the board would be structured like the Federal Reserve Board or the Federal Retirement Thrift Investment Board, the entity that oversees the investment of the funds that federal employees deposit through the Thrift Savings Plan.

Since its creation in 1986, the Federal Retirement Thrift Investment Board has maintained its independence and not been subject to political meddling. As Francis X. Cavanaugh, the Board's first executive director, has noted, Congress designed the board to be insulated from both political interference and corporate decision-making, and this design has worked.

The Federal Retirement Thrift Investment Board also provides a model for how the Administration's proposal would work in another way. Equity investment by the Thrift Investment Board is limited to a stock index fund; the Board does not pick and choose among companies or sectors of the economy. The same would be true under the Administration's proposal. Equity investment would be limited to passive investment in very broad index funds, with neither the independent board nor the private-fund managers having authority to add or delete companies from the indices. The Administration's proposal is quite cautious in this regard, involving very modest holding of equities. When the proposal was fully in effect, 14.6 percent of Social Security reserves - about one dollar in every seven in the reserves -- would be invested in equities. By contrast, state and local public employee pension funds invest more than 60 percent of their assets in equities. The Federal Reserve Systems defined-benefit pension plan invests 65 of its assets in equities. Therefore, I support the Administration''s approach. I believe sound policy would allow up to 50 percent of Social Security's trust funds to be invested in equities.

Many critics would have you believe that investing the Social Security trust funds as the President has suggested is terrible policy but having funds invested in equities through individual accounts is wonderful policy. The National Commission on Retirement Policy (NCRP) plan is one well-thought out approach that allows individuals to invest a portion of their individual accounts in equities. The individual accounts that the legislation introduced by Senators Gregg and Breaux and Representatives Kolbe and Stenholm. would create would be administered centrally, with the funds in these accounts invested by a board or institution managed by federal appointees. The board would select private fund managers who would do the actual investment of the funds. *Its role and function would be virtually identical to those of the board the Administration has proposed.* In neither case does government do the investing. If the NCRP proposal protects the investment from political interference, so should the Administration's proposal since both plans use identical structures to do the investing.

<u>GENERAL REVENUES</u>

A strong case can be made for general revenue contributions to Social Security. Under current law, several types of general revenue contributions to Social Security have already been authorized. These are (1) contributions made by the Federal government as employer, (2) funds from general revenues to reflect the taxation of Social Security benefits, and (3) a small amount of general revenue contributions to cover the cost of the Prouty amendment.

Besides these already-authorized general revenue transfers, there are two other reasons that support use of general revenue contributions:

Compensating Social Security on a one-time, temporary basis for benefit payments well in excess of payroll contributions made for the first several generations of Social Security beneficiaries.

2. Compensating Social Security for lost earnings to the extent that certain restrictions continue on where Social Security may invest its monies.

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

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

The decision made 60 years ago to provide benefits to retirees of that era who had not paid much into the Social Security system provides a strong justification for a temporary general fund infusion revenue into Social Security today. It makes sense to "reimburse" the Social Security system today in some form for a limited period of time for bearing the costs of providing benefits to earlier generations of beneficiaries who had paid little into the system because the system was new.

Compensating Social Security for Lost Earnings

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

Workers currently paying Social Security payroll taxes should not be penalized by having all of their pension fund balances invested only in Treasury securities. The restriction barring the trust funds from investing in anything other than Treasury bonds is understandable, given the history and origins of the program, which was established in the 1930's not long after the stock market crash of 1929. But this restriction does not continue to make sense today.

To the extent that policymakers are not willing to invest up to 50 percent of trust fund reserves in equities, there is a strong case for a general revenue transfer to compensate the trust fund for the lost income. To the extent that Social Security is confined to lower returns by being restricted to investments in lower-yielding Treasury bonds - and private investors are able to secure higher returns because they can purchase fewer Treasury bonds and thus have more resources to place in equities - general revenue collections will be higher. These collections will be higher because investors win pay taxes on the higher returns that they are able to secure because Social Security is using its reserves to add to national saving and pay down publicly held debt. A strong case can be made for transferring a portion of these added general revenues to Social Security.

That leads me to the strongest economic feature of the Administration's proposal - the reduction in the amount of the public debt outstanding. The Administration projects unified budget surpluses of $4.85 trillion over the next 15 years. Under the Administration's plan, $2.87 trillion of these surpluses would be used to reduce the public debt, about $580 billion would be invested in equities and about $1.4 trillion would be spent. The interest savings alone from this proposal (as a percentage of GDP) would more than offset the increase in Social Security benefits over the first half of the next century.

This can best be illustrated in the following way. Over the last 10 years, the combined amount that we have spent on Social Security and net interest costs has averaged 7.7 percent of GDP. If we could reduce our net interest costs to zero and maintain them there, our combined Social Security and interest expenditures as a percent of GDP (and hence the burden that these expenditures will place on future generations) will not exceed the 7.7 percent level until about 2070 under the actuaries' intermediate assumptions. This proposal also would increase national saving and thus, over time, probably lead to somewhat higher levels of GDP.

Once-in-a-Generation Choice

The projected surpluses present policymakers with a once-in-a-generation choice. You can either spend those surpluses by cutting taxes or raising government spending and thus boosting current consumption. Or you can save those surpluses by strengthening Social Security and Medicare, paying down the debt held by the public, and raising national saving, investment and economic growth.

I believe the American public would much rather have you save the surplus and strengthen Social Security and Medicare. The Administration has proposed setting aside 35 percent of the on-budget surpluses to strengthen Medicare and Social Security over the next 15 years. The President has proposed crediting the Hospital Insurance Trust (Medicare) fund with 14 percent of the total surplus (and about a third of the on-budget surplus), which would result in Medicare holding $686 billion of additional Treasury securities and the public debt being paid down by that amount. In addition, $536 billion over 15 years would be used to create Universal Savings Accounts, which would, to a substantial degree, also raise national saving. To the extent that you do not accept the President's proposal to transfer monies to Medicare or to enact universal savings accounts, that money should be transferred to Social Security and saved, rather than being used to enact a larger tax cut or increase other spending.

To the extent Congress saves the on-budget surplus and reduces the public debt, it is entirely appropriate to credit the Medicare and Social Security trust funds with those savings. Room will have been created in the budget for these transfers, and the dollars transferred will not be able to be used for tax cuts or expenditure increases. For every dollar of the on-budget surplus saved, you have contributed to strengthening the solvency of the Medicare and Social Security trust funds and also have reduced the public debt.

My generation - those born after World War II - are entering their peak earning years, and we know there will be budgetary pressures as the baby-boom generation retires. The choice you face is whether to give my generation a tax break for the next 10 to 15 years and let some future Congresses raise taxes on my children and grandchildren to meet Social Security and Medicare promises. I strongly urge that you save the surplus, including a significant portion of the on-budget surplus, to strengthen Medicare and Social Security.

Having said this, I do have concerns with aspects of the Administration's proposal for transfers to the Social Security trust fund. If not tied to structural reforms in Social Security, up-front crediting of $2.8 trillion over the next 15 years might encourage policy-makers to avoid needed structural changes in Social Security (i.e., reductions in benefits and increases in revenues). Indeed, the crediting the Administration has proposed, coupled with a higher level of trust-fund investment in equities than the Administration has proposed, could make Social Security solvent over 75 years (or nearly so) without any structural changes to the program.

In addition, transferring large amounts of general revenue without making clearer the policy basis for the transfer, and without tying the transfer more tightly to the policy basis for it, could reduce public confidence in the program. Transfers from general funds need to be limited rather than open-ended and need to have a clear policy basis, with the amount transferred corresponding to the policy basis.

SPECIFIC SUGGESTIONS

I would therefore suggest that Congress consider the following guidelines for general revenue transfers.

- Transfers to Social Security or Medicare from on-budget surpluses, which would result in further reductions in the publicly held debt, are appropriate.

- In addition to any transfers from the on-budget surplus, further transfers are appropriate to the extent that Congress is unwilling to grant the authority to invest up to 50 percent of the OASDI reserves in equities (a smaller percentage than state and local pension funds invest in equities) under the management of an independent board. To the extent that such authority is not granted, general revenue transfers to compensate the trust fund for this lost income are appropriate. This policy (or better yet the actual investment of 50 percent of the trust fund in equities) would close slightly more than 50 percent of the 75-year financing gap.

- Explicit linkage of these transfers to other structural changes in the Social Security program should be considered (if this were done, approval of the transfers would be tied to approval of structural changes). Under this approach, the transfers could be used as an incentive to make structural changes. (I also would note that if Congress were to make the structural changes, program surpluses would grow larger, and either more monies could be invested in equities or larger transfers to Social Security from general funds would be justified.)

The guidelines I have just outlined would allow for general fund transfers, but the authority would be limited rather than open-ended, would have a clear policy basis, and would be tied to (and reward) structural changes.

(The Administration's plan also envisions that the half of the shortfall not closed by general-fund transfers be closed, in whole or large part, through more traditional methods. The President has called for the specific changes to be identified and agreed upon through bipartisan negotiations. To reinforce this strategy, the Administration wants to "Save Social Security First"; it proposes that the increased discretionary spending and the USA accounts contained in its proposal not be created until Social Security solvency is restored. I assume this to mean that 75-year solvency must be restored, which in turn means that structural Social Security changes would have to be identified and enacted.)

- In addition, if Medicare is given sufficient transfers from on-budget surpluses, transferring back from the Medicare trust fund to Social Security the Social Security-related revenue that the Medicare trust fund now receives is appropriate. This would close about 15 percent of the 75-year financing gap. Social Security benefits for individuals above $34,000 and married couples above $44,000 are essentially taxed like private pensions. The revenue is placed in the Medicare trust fund, rather than the Social Security trust funds. (Some have suggested reducing this tax. I would urge you to reject that option, as it would increase the financing gap you would have to close and is unfair from an intergenerational equity point of view.)

- Finally, it is extremely important that all of the Social Security surpluses be walled off in a manner that precludes their being used for tax reductions or spending increases. These surpluses should be used solely for Social Security solvency. In addition, the pay-as-you-go rule should continue to apply until Social Security is solvent for 75 years. After that date, the pay-as-you-go rule should be modified so on-budget surpluses that remain after any transfers to Social Security and Medicare are made may be used for mandatory spending increases and revenue reductions. This rule should be enforced with a both a sequester and a 60-vote point of order. Other methods of enforcement such as counting public debt reductions as outlays also should be considered.

I would urge that the Senate also adopt section 13302 of the Budget Act, which now applies only to the House. Conceptually, this rule says that any bill or amendment which weakens the solvency of the Social Security trust fund on a five- or 75-year basis should not be considered. The Senate has an alternative procedure that essentially makes this rule operative for 10 years, but not for 75 years. I recommend that you consider adopting this rule on a 25- and 75-year basis, with the point of order able to be waived only by a vote of 60 Senators.

CURRENT PROPOSALS UNDER CONSIDERATION IN THE CONGRESS

Contrast these suggestions to some of the approaches being considered in Congress. I have serious reservations about approaches that would use on-budget surpluses to provide tax cuts and use a large, portion of the Social Security surpluses to establish Individual accounts. These plans will not reduce the publicly held debt very much, forcing Americans to pay higher interest bills than under a plan that does largely reduce or eliminate the publicly held debt.

For example, the Feldstein approach would *increase* our retirement-income promises to the elderly, since it guarantees all of the elderly's Social Security benefits plus a portion of the retirement income they would receive from government-funded individual accounts. Under this plan, government funds would have to be deposited in individual accounts on an ongoing basis, not just for 15 years. Yet federal interest costs would not have been appreciably reduced to help make room for these costs. The fiscal burden on future generations would increase. While we should, to the best of our ability, fund the promises we have made to the baby-boom and succeeding generations, the last thing we should do is to increase those cash retirement promises, particularly to the more affluent elderly, as the Feldstein plan does. (To be sure, there is a need to target some benefit improvements on widows, as the President has suggested, but such improvements should be offset with other benefit reductions.) In addition, these individual accounts are likely to undermine the long-run viability of the Social Security system as we know it today.

THE MAXIMUM TAXABLE WAGE AND THE PAYROLL TAX

The remainder of my testimony describes a menu of revenue options. Each of them has policy advantages and disadvantages. I am not suggesting you should adopt an of them. But none of them should be dismissed out-of-hand at this early point. They warrant review and consideration.

The Social Security payroll tax is not applied to all earnings. Only wages up to a limit called the maximum taxable wage are taxed, which in 1999 is $72,600. Wages exceeding this limit are not taxed. When the Social Security program began, the maximum wage base was set such that the payroll tax was applied to approximately 92 percent of wages for covered employees. Over time, the percentage of earning subject to the tax has declined.

In recent years, the distribution of earnings has become more unequal, with the earnings of high-paid workers increasing faster than average earnings. The maximum taxable wage is updated each year by the percentage increase in average earnings. Therefore, because the maximum taxable wage rises more slowly than the wages of high-paid workers, each year a smaller proportion of earnings fall under the maximum taxable wage. The ratio of taxable earnings to total earnings has fallen from around 90 percent in the early 1980s to 87.1 percent in 1997 and is projected to decline to 85 percent b 2007.

There is a limit to the amount of redistribution of income that should occur in a social insurance program. I would recommend raising and indexing the taxable wage base so it covers 87 percent of all earnings. This increase in the wage base should be phased in over a number of years. That would increase the total amount of earnings subject to the Social Security tax for workers at high earnings levels. It would have no effect on workers with earnings below the current level of $72,600 in 1999. This would close about 11 percent of the 75-year financing gap. An alternative proposal would insure that the percentage of earnings that are subject to the payroll tax declines no farther in the future than the level to which it has already fallen by 1999.

Taxing a higher level of earnings is justified not only because earnings at high levels have been increasing faster than average earnings, but also because cash earnings are becoming a smaller proportion of total compensation. Non-cash benefits, which are not subject to Social Security tax, have been rising both in actual amounts and as a proportion of total compensation. According to a study by the Pierce Brooks of the Bureau of Labor Statistics, benefits made up 27 percent of total compensation in 1986, rising to 28.1 percent in 1996.

The same study found the gap between total compensation costs of high-paying and low-paying industries was greater than the gap in wages and salaries alone. This indicates that workers in high-paying industries tend to have proportionately larger benefit packages than workers in low-paying industries. Since benefit packages are not subject to payroll tax, the proportion of total compensation on which workers contribute payroll tax is declining more for high-income earners than for low-income earners. Raising the maximum wage base will make the payroll tax more progressive with respect to both cash compensation and total compensation.

A legitimate argument also can be made for a small increase in the payroll tax rate at some point well in the future. Under the intermediate assumptions, taxable payroll as a percent of GDP declines from 41 percent today to 35 percent by 2075. Therefore as a percent of GDP, total FICA taxes are declining. Raising the payroll tax rate a small amount 30 or even 50 years from now to maintain FICA taxes at a constant percentage of GDP seems worthy of consideration. In the shorter term, however, consideration of changes in the payroll tax rate should probably be reserved for Medicare, where the financing needs are much greater.

ONE COULD TAX SOCIAL SECURITY BENEFITS LIKE PENSION BENEFITS

Under current law, beneficiaries with incomes over the $25,000/ $32,000 threshold pay income tax on up to 50 percent of their benefits. Up to 85 percent of benefits are taxed for individuals with incomes above $34,000 and married couples with income above $44,000. Beneficiaries with incomes below the $25,000/ $32,000 threshold are not taxed. An argument can be made for taxing Social Security benefits like pension benefits. Taxing benefits in this way would meet two objectives. First, the method of taxation would make the treatment of Social Security benefits consistent with the tax treatment of other contributory, defined-benefit pension plans. That is, all benefits in excess of the contributions a worker paid in would be subject to income tax. Second, taxing benefits of current recipients gives some of the responsibility for bringing the Social Security system into long-term balance to current beneficiaries. Keeping the thresholds of $25,000/ $32,000 and taxing Social Security benefits as private defined pension plans would close about six percent of the 75-year gap.

EXPAND SOCIAL SECURITY COVERAGE

Currently, 95 percent of all jobs are covered by Social Security. The largest group of uncovered jobs are positions in state and local government In 1994, some 5.5 million state and local government jobs - one quarter of all jobs at the state and local level did not have Social Security coverage. All state and local employees who are not covered by Social Security are covered by a state or local pension program. State and local employees hired after March 1, 1986 are covered by the Medicare Program and must pay the Hospital Insurance payroll tax.

Over time, more and more of the employees of state and local governments have been brought under Social Security. One proposal that would complete this process would require all *new* state and local government employees to be covered by Social Security. This would increase the equity of the system by treating new state and local government employees just like other employees. The contributions of new state and local employees would be added to the trust fund for many years before most of them became eligible to receive benefits. This proposal would close about nine percent of the financing gap.

The provision covering all new state and local government employees should not take effect for a number of years - perhaps 10 years - in order to give state and local governments time to adjust to this change. In other words, it should apply only to new state and local government employees hired after some date such as January 1, 2010.

Extending Social Security coverage to all state and local workers is desirable for a number of reasons. For example, extending coverage would eliminate gaps in disability and survivor protection and provide for more inflation-proof pensions.

Some state and local governments would need to modify their pension systems to account for the fact that new workers would be entitled to additional retirement benefits. These governmental entities also would need to modify their budgets to include expenditures covering the employer's share of the Social Security tax. Many of the major Social Security proposals - including all three plans advanced by the Social Security Advisory Council in 1997 and the NCRP and Moynihan bills - contain this provision.

CONCLUSION

In conclusion, I want to express general support for the Administration's framework. One of the two major issues surrounding the Social Security and Medicare debate this year is the extent to which we should use the unified budget surpluses to save Social Security by reducing the publicly held debt rather than spending the surpluses for either reductions in taxes or increases in spending. The other major issue is whether we should set up mandatory individual private accounts that would compete with Social Security.

On both of these issues I believe the Administration has followed the best course. The President has proposed that 77 percent of the unified budget surpluses be used to retire debt or be invested in equities. (While investment in equities would not reduce the amount of public debt, it is analogous in that it builds government assets.) Those monies would not be available for tax cuts or spending increases. As a result, the debt held by the public would fall from 50 percent of gross domestic product (GDP) in the 1993-to-1995 period to seven percent of GDP costs in 2014. Our net interest costs would fall from $243 billion (14.7 percent of the federal budget) in 1998 to about 2 percent in 2014 and be completely eliminated by 2018. This reduction in interests costs would make a very large difference in our ability to meet our Social Security promises.

In my view, the Administration also has made the right decision about privatization. It has not proposed individual accounts that use part of the existing payroll tax structure or accounts of which the proceeds are used to reduce Social Security benefits. It has suggested instead that a modest amount of the Social Security trust-fund balances be invested in equities. Other Center analyses explain why I believe these to be wise decisions.

Congress, working with the President, needs very much to supplement the President's framework by making structural changes to the Social Security program, including both benefit reductions and some of the revenue options discussed above.

Thank you for allowing me to testify on this very important issue.