



[COMMITTEE SCHEDULE](#)
[WHAT'S NEW](#)
[ABOUT THE COMMITTEE](#)
[NEWS](#)
[LEGISLATION](#)
[HEARING ARCHIVES](#)
[PUBLICATIONS](#)
[W&M COMMITTEES](#)
[LINKS](#)
[CONTACT](#)

★ [EMAIL SIGNUP](#)

★ [HEARING ARCHIVES](#)

[Printer Friendly Version](#)

★ [COMMITTEE ACTION - LIVE](#)

[Click Here to View Committee Proceedings Live](#)

Statement of Lawrence A. Hunter, Ph.D. Vice President and Chief Economist, Free Enterprise Fund and Senior Research Fellow, Institute for Policy Innovation

Testimony Before the House Committee on Ways and Means

May 12, 2005

★ [HOT TOPICS](#)

[Committee Resource Kits](#)

★ [SPECIAL FEATURES](#)



[President Signs Medicare Rx Bill Into Law](#)

President George W. Bush signs H. R. 1, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 on Dec. 8, 2003.



[Internship Opportunities Committee on Ways and Means Internship Opportunities](#)

Introduction

Thank you, Mr. Chairman for allowing me to express the views of the Free Enterprise Fund on ways to strengthen Social Security through personal retirement accounts.

The basic structure of Social Security has changed very little over the years but two things about the program have changed dramatically, both of them as a consequence of attempting to maintain the pay-as-you-go system in the face of a steeply declining worker-to-beneficiary ratio. First, contribution rates (FICA tax rates) now comprise a greater share of workers' income than financial analysts say is necessary to pre-fund an adequate retirement income if funds are invested in real assets. Second, the rate of return workers enjoy on the FICA taxes they and their employers pay has gone from hugely positive to barely greater than zero.

A seeming paradox arises. Everyone is coming to realize that Social Security is a very bad deal for today's workers at the same time many politicians who must confront Social Security's looming insolvency insist Social Security benefits are extravagant because they soon will exceed the revenue the system generates. It is disconcerting that politicians from both sides of the partisan divide propose making a bad deal worse for workers by cutting promised future benefits as a means of making Social Security "solvent," which is to say they are proposing what works for Washington rather than what works for workers.

When politicians are forced to reconcile their claim that Social Security currently makes extravagant promises with the painfully obvious reality that workers realize pitiful rates of return on their FICA contributions, they usually resort to a non sequitur. They point out that under the current benefits formula, which indexes future initial Social Security benefits to the rate of real wage growth in the economy, the level of initial Social Security benefits increases faster than inflation, as if that result somehow is unreasonable. Zero real growth in retirement benefits is a curious benchmark to set for a new pre-funded, market-based retirement system and an especially odd position for advocates of personal retirement accounts to take given that one would expect private investment income to increase over time at least as fast as private-sector wages. Moreover, this explanation fails to reconcile how benefits can be at the same time both a bad deal and extravagant.

I urge the Committee to critically examine the logic behind the argument that the initial level of retirement benefits should not increase faster than the rate of inflation. If you do, I believe you will discover that underlying this belief is an unwarranted presumption that workers should not expect a positive real rate of return of any magnitude on the FICA contributions they make throughout their working careers. To appreciate how odd this sounds to workers being urged to support market-based personal accounts, consider the reaction one would get if he made a

similar argument to investors in the private sector that they should not expect a rate of return on their investments greater than inflation. Such a suggestion would be met with incredulity. After all, dividends and capital gains are not welfare. Here, I suspect, is the crux of the matter. The only logical basis for concluding that Social Security retirement benefits should not increase faster than the rate of inflation is the premise that Social Security benefits are a form of welfare.

While characterizing Social Security as welfare may have been valid in earlier days, when benefits far outstripped what workers paid into the system, it no longer applies. Moreover, low- and many middle-income workers today pay so much of their income in FICA contributions that they find it difficult or impossible to save much more for their retirement outside Social Security.

American workers have a very keen sense of inconsistency on the part of politicians. They will become confused and then suspicious and eventually rebellious when they hear politicians on the one hand confirm their own sense that Social Security is a bad deal but then turn around and lecture them on the need to cut promised future benefits even more. In my opinion, a majority of the American people never will support a Social Security reform plan that is built on these contradictory notions.

Current Social Security Contribution Rate Is Higher than Necessary to Fund Full Blown Retirement Plan

We still think of Social Security as a supplemental, back-up retirement program—and the benefits it promises certainly are less than adequate as the sole source of retirement income. The reality is, however, the FICA tax burden the program imposes on workers substantially exceeds the contribution rate a full-blown retirement plan would require to generate higher retirement benefits. While many people continue to think of Social Security as “social insurance,” it has, in fact, evolved into a very poorly designed, inadequate government-operated defined benefits plan built on a mountain of government debt and teetering on the brink of bankruptcy. Protestations of scholars and politicians to the contrary, that is how the vast majority of American workers perceive Social Security today.

Workers have good reason to view Social Security this way. If the 12.4 percent of their income workers and their employers currently contribute to Social Security were invested through personal retirement accounts in real, productive assets, the investment income from the accounts would be more than adequate to provide workers a secure and prosperous retirement at a level substantially above what Social Security currently promises but can't pay. So much so, in fact, that a portion of that 12.4 percent could be reserved by the government as true “social insurance” against disability and other calamities that might make it impossible for a relatively small number of workers to accumulate sufficient assets by the end of their working careers to enjoy retirement benefits at least as generous as Social Security currently promises.

The personal retirement accounts plan introduced by Congressman Paul Ryan (H.R. 1776) and its Senate companion introduced by Senator John Sununu (S. 857) demonstrate this point conclusively. By allowing workers to invest between five and ten percent of their wages through personal retirement accounts—lower-wage workers would be able to save a larger share of their income—it is possible to generate sufficient investment income from the accounts to raise retirement benefits substantially above what Social Security currently promises but cannot pay. The Ryan/Sununu plan leaves in place more than enough of the current 12.4 percent FICA contributions (about four percentage points) to finance the disability program and a secure government safety net equal to the level of Social Security benefits currently promised while also reducing payroll taxes eventually about two percentage points.

The large personal accounts created under the Ryan/Sununu plan would be so powerful they would eliminate Social Security's long-term financial crisis and eliminate Social Security deficits completely over time without the benefit cuts or tax increases or hikes in the retirement age. That is because so much of Social Security's benefit obligations, ultimately 95 percent, are shifted to the accounts, thus reducing the federal government's need to pay Social Security benefits. As the Chief Actuary stated in his analysis of the Ryan/Sununu plan, “the Social Security program would be expected to be solvent and to meet its benefit obligations throughout the long-range period 2003 through 2077 and beyond.”

Social Security Is A Bad Deal for Today's Workers

For most workers in the work force today middle aged and younger, the real rate of return Social Security promises to pay them on the taxes they and their employers pay into the system would be one percent to 1.5 percent, or less. For many workers, it would be zero or negative.

Allowing workers to invest a substantial portion of their FICA contributions in real assets through personal retirement accounts is the only way to avoid forcing workers to labor their whole lives for a pittance of a handout from the government in retirement. Attempting to overcome the declining worker-to-beneficiary ratio by raising the cap on the payroll tax would reduce the currently pitiful rate of return from Social Security even more for higher income workers. Cutting future benefits through so-called "progressive price indexing" would reduce that rate of return for all but the lowest income workers. Even for the low-income workers it supposedly "protects," "progressive price indexing" would do nothing to improve their return. Raising the retirement age is just another way to reduce everyone's rate of return by making them work longer to receive the same level of benefits.

All three conventional attempts to outpace the declining worker-to-beneficiary ratio, i.e., to make Social Security as we know it "solvent" without introducing personal retirement accounts, simply make a bad deal worse for workers by asking them to pay more, work longer and get less. This is precisely what the Congress did in 1977 and again in 1983. It didn't work then, and it won't work now.

President Bill Clinton recognized this reality back in 1998 when he said, "We all know that there are basically only three options: We can raise taxes again, which no one wants to do. . . We can cut benefits. . . Or we can work together to try to find some way to increase the rate of return. . . Even after you take account of the stock market going down and maybe staying down for a few years, shouldn't we consider investing some of this money, because, otherwise, we'll have to either cut benefits or raise taxes to cover them, if we can't raise the rate of return."

Small add-on accounts won't solve the problem either. Supplemental add-on accounts that attempt to fill in for cuts in guaranteed Social Security benefits (such as progressive price indexing) may succeed in maintaining the overall level of a worker's retirement income but will do so by raising workers' combined contribution rate and lowering the overall rate of return. With add-on accounts, workers would end up contributing even more than the already excessive 12.4 percent or not using the accounts and exposing themselves to the benefit cuts under price indexing. If small add-on accounts are accompanied by tax increases as well, the contribution burden increases yet again, and the rate of return falls commensurately. Add-on accounts, therefore, are just another way to force workers to pay more for the same level of benefits with an added element of risk.

Another idea under consideration, I know, is to give workers greater incentives to save more for their retirement by reforming the tax code, expanding IRAs, 401(k)s and so forth. These are all good ideas but should not, in my opinion, be enacted as a substitute for fixing Social Security the right way, namely allowing workers to save a portion of the payroll taxes in personal retirement accounts. Eliminating the tax bias against saving and investing should be undertaken independently of Social Security, on efficiency grounds to make the tax code as neutral as possible between saving and consumption. In my opinion though, this tax reform should not be conceived as a means of offsetting cuts to promised future Social Security benefits. As I observed above, too many workers already find it difficult to impossible to save much beyond the 12.4 percent they are forced to pay into Social Security.

Two Persistent Myths about Social Security

Just as the outdated image of Social Security as "social insurance" lingers on, so does the image of Social Security as some kind of welfare program. This image, contrary to current economic reality, has been reinforced by the legal status of the program over the years. Clearly, in the early days of the program, when workers received rates of return in excess of 15 percent, 25 percent, and even 35 percent for the earliest cohort of beneficiaries born before the turn of the century, Social Security could be considered a "welfare" program, i.e., people were getting from government far more than they contributed to it.

Today, I believe the willingness, indeed the enthusiasm, of some folks to cut promised future Social Security benefits arises from failing to take into account the reality that Social Security has evolved from “social insurance” (i.e., “welfare”) into a very poorly designed, inadequate government-operated defined benefits plan perched on a mountain of debt and teetering on the brink of bankruptcy. If Social Security is viewed as welfare, workers’ payroll taxes are not considered retirement contributions but rather as coerced tax payments that are used to pay welfare benefits to people who did not earn them. Thus, the welfare recipient (i.e., the Social Security beneficiary) should have no contractual right to the benefits. Neither should there be a moral, legal or political right for current workers to expect future workers to pay them welfare payments (i.e., Social Security benefits) when they retire even though they spent their entire working careers paying taxes to finance welfare (i.e., Social Security) benefits to their parents’ and grandparents’ generations.

By definition, then, if Social Security is viewed as welfare, benefits promised in the future that cannot be financed by payroll taxes are ipso facto “extravagant,” “unsustainable,” and, therefore, legitimately can be reduced since workers have no moral, legal or political claim to them.

Failing to recognize the changed reality of the situation—Social Security has evolved into a very poorly designed, inadequate government-operated defined benefit’s plan built on a mountain of government debt obligations to future retirees—also leads to confusion about what actually transpires if and when the government attempts to stop the bleeding by transforming the system into a financially sound pre-funded retirement system.

There is a widespread misconception that every dollar of payroll tax revenue “re-directed” or “diverted” into personal retirement accounts to begin pre-funding retirement benefits generates a new “transition” cost because it “siphons away” a dollar from Social Security that otherwise would be available to pay current retirement benefits. If personal accounts are created, that revenue must be generated from some other source (higher taxes, existing revenue reallocated away from other spending, borrowing). This formulation of the so-called “transition problem” fails to recognize that every payroll-tax dollar directed into personal retirement accounts is actually a dollar less indebtedness incurred by the federal government. Every payroll-tax dollar not “diverted” into paying current retirement benefits (the real “diversion” is the current diversion of FICA contributions to pay current benefits) is actually a dollar that can be devoted to pre-funding future benefits, which in turn reduces a future liability of the federal government.

There are no transition costs; there are only changes in cash flow, and compared to the size of the overall economy, those cash-flow changes are small.

Allowing workers to place a share of their payroll taxes into personal accounts sufficiently large enough to pre-fund currently promised benefits actually reduces federal indebtedness. The temporary cash-flow crunch that results—the short-fall in available funds to pay all currently promised Social Security benefits—arises because the government would be borrowing less. Therefore, if the Congress turns around and decides to borrow funds to cover the cash-flow shortage, it would be simply substituting one form of debt with another. The net level of borrowing is unchanged. However, the federal government’s long-run, off-balance-sheet liability that must be paid out of the federal treasury to pay future retirement benefits is dramatically reduced. Devoting current payroll tax revenue to pre-funding future retirement benefits will produce greater investment income in the personal retirement accounts than the government could count on in future payroll tax revenues at current tax rates. This gain will relieve government of the obligation to spend so much on retirement benefits in the future, eventually covering virtually all future retirement benefits out of the personal accounts and eliminating the federal unfunded liability altogether.

In other words, contrary to conventional wisdom, sufficiently large personal retirement accounts do indeed solve the problem. It is only insufficiently large accounts—i.e., accounts not large enough to generate enough investment income to cover all promised Social Security benefits—that fail to solve the problem. Indeed, insufficiently large accounts leave a residual problem, which can only be covered by higher taxes, lower benefits or truly new borrowing.

The irony is that an aversion to borrowing (which results from a misunderstanding of the role borrowing plays in the current program and the role it reasonably could play in creating personal

accounts) has led many proponents of personal accounts in the name of "fiscal prudence" to reject large accounts and embrace small accounts, which only exacerbate rather than solving the solvency problem.

This welter of confusion and disorientation has produced a fallacious chain of reasoning by even some proponents of personal retirement accounts:

- False Premise: Social Security is a welfare program so promised benefits legitimately can be cut without breaching any moral, legal or political obligation;
- False Premise: Allowing workers to place a substantial portion of their payroll tax contributions into personal retirement accounts creates a net new cost that cannot be financed by borrowing without adding to national indebtedness;
- False Conclusion: Personal Accounts, therefore, do nothing to solve Social Security's financing problem;
- False Corollary: Consequently, large cuts in promised future benefits, tax increases and/or new borrowing are required to restore solvency to the system;

A real solution can be outlined as follows:

- Create sufficiently large accounts, which will solve the solvency problem;
- Address the cash-flow crunch created when workers are allowed to invest a sufficient amount of their payroll tax contributions through large accounts by:
 - Restraining spending growth in the rest of the budget and reallocating the savings to help pay all promised Social Security benefits in full and on time;
 - Enacting tax reforms to raise the after-tax returns to work, saving and investing, which will generate a dynamic revenue feedback effect to help pay all promised Social security benefits in full and on time;
 - Refinance part of the outstanding Social Security liability by borrowing whatever is required after tax reforms and spending restraint are enacted to alleviate any remaining cash-flow crunch:
 - Borrowing first from the funds workers save in their personal retirement accounts (i.e., issuing to the accounts new inflation-protected federal bonds backed by the full faith and credit of the United States Government with no restrictions on resale in the secondary bond market), and
 - Borrowing outside the accounts in financial markets only as necessary to complete the refinancing.

Make a Down Payment on Solvency: Stop the Raid and Start the Accounts

Let me conclude by moving from the theoretically desirable to the politically practical given the current political environment. In my opinion, the time is not yet ripe to enact a comprehensive reform. Instead, I encourage you to tackle the one issue on which there is near unanimous agreement on both sides of the partisan divide, ceasing to squander the Social Security surpluses, and instead allowing workers to save the excess payroll tax revenues in personal retirement accounts.

For decades now, the Federal government has been raiding the Social Security trust fund to finance other government spending. The Federal government takes the Social Security surplus each year and uses that money to help finance all of its other programs, from foreign aid to welfare. The time has come to stop this inexcusable raid and return the surplus instead to workers to start their own, individual, personal accounts.

Indeed, the new version of the Ryan/Sununu bill introduced a couple of weeks ago phases in the accounts so that over the first 10 years the account option is half of its full size. The Ryan/Sununu phase-in allows workers on average to shift about 3.2 percentage points of the full 12.4 percent payroll tax to the accounts. The total annual Social Security surpluses projected over the next 10 years, counting tax revenues and interest on the trust fund bonds, is more than

sufficient to finance this Ryan/Sununu option during that period. (See Appendix)

Congress should stop the raid on the Social Security trust funds and use that money to finance the first 10 years of Ryan/Sununu. The surplus money would then go to finance the future retirement benefits of today's workers, rather than for other government spending. As Fed Chairman Alan Greenspan has observed, personal accounts are the only way to enact a true lockbox where the government can't get its hands on the money to fuel further runaway spending on other programs.

To free up the surpluses for the accounts, Congress must reduce its spending by an amount equal to at least the surplus of Social Security taxes over expenditures each year. That money belongs to the future retirement of working people, and Congress should never have been spending it in the first place.

The government currently pays the interest on the Social Security trust fund bonds by issuing new bonds to the trust funds each year. To the extent needed to finance the Ryan/Sununu accounts for the next 10 years, those bonds would be issued instead to the accounts of each worker across the country. Those bonds would be backed by the full faith and credit of the United States and be marketable. Workers, consequently, would be free to choose to sell those bonds on secondary markets and invest the proceeds in broader mutual funds if they desire. These bonds, of course, would not represent new debt, but, rather money the government already would owe to the trust fund under the current system.

It also would be highly desirable to phase in the Ryan/Sununu budget process reforms over the next 10 years, including the spending limitation, which would reduce the rate of growth of Federal spending by one percentage point a year for eight years. This would produce net surpluses from the reform during the first 10 years and provide the foundation for expanding to the full Ryan/Sununu accounts subsequently.

This reform would provide better benefits for working people from day one as the market returns earned by the accounts would be so much more than Social Security has even promised, let alone what it can pay. It would provide personal ownership and control for workers over their retirement funds, stopping the longstanding raid of the trust funds under the current system.

It would empower low and moderate income workers to accumulate substantial personal savings and wealth for the first time, which they can leave in whole or in part to their families through inheritance. It would greatly boost the economy through lower effective tax rates and higher saving and investment.

Finally, even the smaller accounts adopted for the first 10 years would make a substantial down payment on solvency by reducing the long-term deficits of Social Security as the benefit obligations borne by the old Social Security framework would be substantially reduced and taken up by the personal accounts instead. If the accounts were expanded after 10 years to the full Ryan/Sununu level of 6.4 percentage points on average, the long-term deficits would be eliminated entirely through this effect, achieving permanent solvency for Social Security. The Chief Actuary of Social Security has scored the Ryan/Sununu bill as achieving exactly this result.

This result, moreover, is achieved without cuts in future promised benefits or the tax increases that inevitably would accompany them. Since better benefits are going to be provided in the future by the accounts in place of benefits financed through the old Social Security framework, there no longer is any need to think about eliminating that old system's deficits through tax increases and benefit cuts.

It's time for Congress to focus on what Social Security reform should be about, providing a better deal for working people. It's time for Congress to stop the raid on Social Security and use the surpluses to start personal retirement accounts.

Thank you, Mr. Chairman.

Appendix

**Financing the First 10 Years of Ryan/Sununu
With the Social Security Surpluses
(All figures in billions of constant 2005 dollars)**

Year	Social Security Cash Flow Surplus (Taxes Minus Expenditures)	Total Social Security Surplus (Includes Interest Incomes on Trust Funds)	Annual Transition Financing Needed For Ryan/Sununu
2006	84.9	183.6	124.7
2007	88.7	194.7	137.5
2008	90.2	204.3	143.1
2009	84	206.3	148.5
2010	80.2	210.9	153.9
2011	75.6	215.1	159.0
2012	65.3	213.2	164.2
2013	52.9	209	168.9
2014	38.5	202.5	173.7
2015	24.3	196.3	178.4

★ SEARCH

Source: 2005 Annual Report of the Board of Trustees of the Old-Age and Survivors Insurance and Disability Insurance Trust Funds, March 23, 2005, Table VI.F.7; Office of the Actuary, Social Security Administration, Estimated Financial Effects of the "Social Security Personal Savings Guarantee and Prosperity Act of 2005," April 20, 2005, Table 1b.c

COMMITTEE SCHEDULE WHAT'S NEW ABOUT THE COMMITTEE NEWS LEGISLATION HEARING ARCHIVES PUBLICATIONS SUBCOMMITTEES LINKS CONTACT

Committee on Ways & Means
U.S. House of Representatives | 1102 Longworth House Office Building | Washington D.C. 20515
Phone: (202) 225-3625 | Fax: (202) 225-2610

[Privacy](#)
[Statement](#)
[Home](#)
[Adobe Acrobat
Reader](#)

