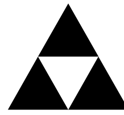

AMERICAN ACADEMY *of* ACTUARIES

Social Security Subcommittee
Committee on Ways and Means
U.S. House of Representatives

Hearing on
"The Future of Social Security for this Generation and the Next."

Testimony Presented
By

Ron Gebhardtsbauer, FSA
Senior Pension Fellow
American Academy of Actuaries

June 24, 1997

The American Academy of Actuaries is the public policy organization for actuaries of all specialties within the United States. In addition to setting qualification standards and standards of actuarial practice, a major purpose of the Academy is to act as the public information organization for the profession. The Academy is nonpartisan and assists the public policy process through the presentation of clear, objective analysis. The Academy regularly prepares testimony for Congress, provides information to federal elected officials and congressional staff, comments on proposed federal regulations, and works closely with state officials on issues related to insurance.

Chairman Bunning, committee members, staff, and fellow panelists, Good Morning. My name is Ron Gebhardtsbauer and I am the Senior Pension Fellow at the American Academy of Actuaries. The Academy is the non-partisan public policy organization for actuaries in the United States that analyzes, but does not endorse or propose legislation.

In order to save time, I have provided the subcommittee with copies of a more comprehensive presentation on this subject, so that I can focus on the four questions the subcommittee has asked the Academy to address regarding the Old-Age Survivors and Disability Insurance program, or Social Security.

The subcommittee's first question concerns **the degree to which Social Security reform is necessary**. To the extent that this nation wants to sustain the successes of the current Social Security program (e.g., alleviating poverty among the elderly), Social Security needs to be modified sooner rather than later. Without changes in the law, the government's actuarial predictions show that only 75% of benefits will be payable from income after the Trust Funds are exhausted in 2029, and as our country ages, this becomes 69%. This can be easily seen by looking at the demographics. Today there are about 3 workers for every beneficiary. In 2029, when virtually all the baby boom cohort will be retired, there will be about 2 workers for every beneficiary. This projection is quite accurate because it is based mostly on people already born.

There is also a U.S. budget concern which occurs <u>much sooner</u>, and this is responsive to the next question posed by the subcommittee, namely, **"How soon is Congressional action needed?"** At present, Social Security's tax income exceeds its outgo by $30 billion, which helps the U.S. deficit look lower than it actually is. This $30 billion annual surplus starts to decrease around the year 2008, which is exactly when the baby boom generation starts to retire. By 2012, Social Security's tax income will be less than what it pays out. Thus, if Congress balances the U.S. budget in 2002 using Social Security's surplus, then Social Security could put the U.S. budget out of balance in the year 2008. Therefore, if a balanced budget is a goal of Congress, then the Social Security **fix should be in effect by 2008**. But <u>action is needed even sooner</u> than that if Congress wants to:

- enable workers to plan ahead for the changes,
- have gradual implementation (i.e., less chance of notches)
- include more people in the solution,
- have a less drastic solution, and
- restore faith in the system again.

Congress should analyze the potential solutions carefully, which leads to the **third question: What is the Academy's assessment of the Advisory Council recommendations and other proposals?"** The attachment goes into the details about most provisions, so I will just discuss the more significant ones.

The advantages of the three Advisory Council options are clear. All three options solve the financial problems of Social Security for the upcoming 75 year period **and** maintain a stable Trust Fund at the end of that period. It is important to stress that second part. It is **not** sufficient to just put Social Security back in actuarial balance over the next 75 year period. If that is the only action Congress takes, then in 20 years there will be another crisis. This is because, as future deficit years get included in the 75 year period, the system gets thrown out of balance a little each year. The Maintain Benefits group solves this by increasing contributions by 1.6% of covered pay starting in the year 2045. The other two Advisory Group options solve this by increasing the Normal Retirement Age to 67 by 2011 and age 70 by 2083. This produces a more permanent solution. Unless, the Normal Retirement Age increases with longevity, the system will eventually go out of balance.

Each Advisory Council option also has disadvantages.

The **Maintain Benefits (MB) option** requires future workers to contribute 1.6% of wages more into Social Security than current workers will ever pay. Furthermore, in order for their option to be in balance, the Social Security Administration would have to invest 40% of their surplus in passive equity indexes. This has advantages. For example, the additional savings from the MB option would really be saved if invested outside the government, and their long-term yields would improve. Indexes avoid the concern that Social Security would manipulate the market and proxy voting could be delegated to the money managers, like at PBGC and the Federal Thrift Savings Board, two other government agencies that have equity investments. However, with an estimated 5% to 10% of the domestic market, there are concerns that Congress could loosen these restrictions in the future. Other alternatives with less governance concerns (but also smaller returns) would be to invest in other indexes, such as those for mortgages (but that would entail competition with banks), municipal bonds (their lower returns would be supplemented by less tax expenditures), and corporate bonds (this would have an advantage of lower borrowing costs for industry).

The **Individual Account (IA) option** gradually reduces OASDI benefits by up to 20% for middle and upper income workers in order to keep costs within current contribution levels. The reason these reductions are so much more than the MB option, is because their Defined Benefit portion invests only in Treasuries and thus, has a lower return on investment, or a lower money's worth, for middle and upper-income Americans. However, when combined with annuities from their Individual Accounts, their money's worth ratios generally increase up to those of the MB plan. Eventually, as their savings in stocks exceeds those of the MB plan, their money's worth ratios could eventually be better for many people. This demonstrates the point that any transition from a DB-type plan toward a DC-type plan will take many years and one group must pay "twice". The Individual Account option does this by increasing contributions by 1.6% of covered pay.

The **Personal Security Account (PSA) option** has greater yields and benefits for most people, because this system invests the most money into the stock market. It must be noted, however, that it does this by increasing the U.S. deficit by over $1 trillion in the first 7 years. It is not a revenue-neutral bill. This could increase interest rates, borrowing costs, inflation, and taxes and, in fact, they pay for this transition cost through raising payroll taxes by 1.52% of pay. Another significant point is that the MB and IA options could achieve better yields and benefits than the PSA option if they also borrowed as much from the U.S. Treasury and invest in the stock market, and they would do it with less risk to the individual.

The PSA option places many more risks and responsibilities on the individual, such as investment risks, higher administrative expenses, longevity risks, leakage risks, and inflation risks. In the IA option, the risks on the individual are reduced by restrictions on investments, payroll deductions to a government clearinghouse (similar to the Federal Thrift Plan), requirements for inflation-indexed annuities, and restrictions on withdrawals before retirement. However, these restrictions increase the governance concerns and create a greater bureaucracy, so proponents of the PSA plan opted for risk over restrictions.

Another concern with the PSA option relates to the sustainability of this very different view of Social Security because of the following questions. Would Congress continue to mandate both low-income and high-income Americans to invest in their accounts, without allowing them access during difficult times? Would the flat $400 monthly benefit with its poor money's worth for middle and upper income workers succeed? Would a means test eventually be applied to it and thus turn it into welfare? Would tax avoidance occur? Under the current Social Security system, the more money you put in, the more money you get out. This would not be the case for the $400 benefit. Experience from other countries shows that tax avoidance occurs when one gets nothing for the additional taxes.

Finally, it is important to look outside the Social Security system and determine the **effects of the various proposals on an individual's total retirement income**. This would include employer pensions, personal savings, and possibly part-time work, sometimes referred to as the other legs of a retirement stool. Diversification can be helpful here. For example, when the stock market is down, traditional Defined Benefit employer pension plans can be more valuable than mandatory Individual Accounts. When low-income individuals have small savings and pensions, Social Security's adequacy element is more helpful. Thus, Congress should be aware of the consequences if one leg is saved by harming the other legs, and thus end up with a one-legged stool. For example, some fixes like means testing Social Security benefits and additional contribution mandates could reduce other legs of the stool, namely, personal savings and employer pensions. Congress should be careful not to eliminate the employer leg. Employer pension plans generally achieve better yields than individuals (by 150 to 250 basis points each year) and have been very helpful not only to individuals, but also to the national economy. Maybe there is a way to use employers. For example, if an employer has an adequate pension plan, then maybe the individual account mandate could be waived. Not much has been developed in this area, and the American Academy of Actuaries would be glad to discuss this further with the subcommittee.

Finally, the subcommittee asked for **specific recommendations for moving forward**. Some proponents of reform suggest passing some provisions now, such as reducing COLAs and mandating coverage to all state and local government employees. These changes will help reduce the U.S. deficit over the next 15 years, but will not help the financial stability of Social Security unless the money is really saved. This may be an appropriate reform if the policy objective is also to reduce U.S. deficits. However, if Congress wants the additional savings to help the Social Security program and not just the U.S. budget, then these provisions may need to be enacted in conjunction with private investment options (or the elimination of budget deficits). Since the concept of private investment entails a much different view of Social Security, we would suggest that Congress allow sufficient time to educate the public and consider all of the ramifications.

Once again we commend the subcommittee for taking a leading role in educating the Congress and public on a very complex, but important topic.

Supplemental Sheet

Social Security Subcommittee
Committee on Ways and Means

June 24, 1997 Hearing on: "The Future of Social Security for this Generation and the Next"

Testimony Presented By:
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Summary:
In my statement, I respond to your 4 concerns regarding::
(1) the degree to which Social Security reform is necessary - To the extent Congress wants to sustain Social Security's successes (e.g., elderly out of poverty), we need reform. Otherwise, only about 75% of benefits can be paid after about 2029.
(2) how soon is action needed? If Congress balances the U.S. budget using Social Security surpluses, then Social Security could put the U.S. Budget out of balance by 2008. Action is needed well in advance of 2008, if we want to avoid this and be able to plan for changes, have a less drastic solution, implement them gradually (i.e., avoid notches), include more people in the solution, and restore faith in the system.
(3) an assessment of the Advisory Council recommendations and other reform proposals - The Academy analyzes, but does not endorse or propose legislation. Thus, I provide the major advantages and disadvantages in my statement and more details in a prior speech of mine. All 3 Advisory Council options solve the Social Security financial problem using later retirement, higher taxes, and use of private-sector investment. This last item causes either governance concerns or puts much risk and responsibility on the individual. In addition, (1) the PSA option will cause large deficits in the near future, and (2) any option which increases contributions can hurt the other legs of the retirement stool, especially employer-sponsored pensions, which have been very beneficial to individuals, employers, and the nation. Maybe there is a way to not harm the other legs of the retirement stool by using employer plans. Not as much has been developed in this area, and the Academy would be glad to discuss this further with the Subcommittee.
(4) specific recommendations for Congress to consider as it moves forward - Any savings produced in the first 15 years only reduces the U.S. budget deficit and does not directly help Social Security, unless it is saved in a productive way, such as private sector investing. Congress needs to educate the public on this newer idea before legislation is passed. The Academy thanks the Subcommittee for its leadership in this area.

August 18, 1997

The Honorable Jim Bunning
Ways and Means Subcommittee on Social Security
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Bunning:

The American Academy of Actuaries appreciates your interest in our June 24 testimony before your subcommittee. The following are responses to questions (shown in italics) posed in your July 18, 1997 letter.

1. *In your testimony, you emphasized that it's not enough for Congress to just put Social Security back in actuarial balance over the next 75 year period, we must also maintain a stable Trust Fund at the end of that period to be sure we aren't dealing with this problem 20 years down the road (mostly due to the fact that individuals keep living longer.) The Maintain Benefits group solves this problem by increasing contributions by 1.6% of covered pay beginning in 2045. The other two Advisory Council proposals solve this by increasing the normal retirement age to 67 by 2011 and to age 70 by 2083. What are the disadvantages you see in raising the normal retirement age?*

As you suggest, there are advantages and disadvantages to any solution for putting Social Security in actuarial balance. The following are some disadvantages to raising the Normal Retirement Age (NRA).

- **Same as a benefit decrease:** Increasing the NRA by one year is the same as decreasing benefits by 7% (*except* it has the advantage of not decreasing disability benefits). For example, if the NRA is increased from age 67 to age 70, the benefit of someone who wants to retire at age 65 is reduced by almost 21%. This disadvantage (benefit decreases could adversely affect beneficiaries) can also be seen as an advantage (it corrects for the hidden benefit increase due to longer lifespans). Note that the age 70 normal retirement age is not reached until 2083 in the Individual Account (IA) and Personal Security Account (PSA) plans. Thus, the benefit decreases suggested are quite gradual (in order to reduce the effects of a notch).

- **Benefits at 62 might not be adequate:** If the current benefit structure was designed to provide the appropriate minimal benefit, then this decreased benefit will not be adequate. This is of particular concern at the youngest eligibility age 62. When the NRA reaches age 70, the age 62 benefit will be 55% of the NRA benefit, and thus, probably inadequate. In order to avoid this problem, the earliest retirement age of 62 could be increased to age 65 gradually. However, this would be a disadvantage for those who wanted to retire earlier, but would now be ineligible for a retirement benefit (unless they could qualify for disability retirement).

- **Working until age 70:** Just because Americans are living longer, does not mean the population is healthier or can work longer. However, recent studies are showing that the elderly are healthier. Employing them would increase national productivity. In addition, many people worked beyond 65 in the past, before Social Security was available.

- **Employer concerns:** Social Security does not exist in a vacuum. Private sector retirement systems will be affected. Employers who do not want an aging workforce may need to increase benefits for their pension plans in order to make up for the decrease in Social Security benefits (caused by the increased NRA). Aging workforces can also lead to increased unemployment, health, and disability costs for employers. On the other hand, it appears that large numbers of retirements of healthy baby-boom workers starting in 2008 may prompt employers to rethink their retirement strategies. Employers may not want their workers to retire in such large numbers. Retirement plans can encourage this strategy if retirement ages are increased in tandem with Social Security. This could reduce employer pension costs also.

- **Some citizens not affected:** The retirement age change in the IA and PSA options affect covered workers who reach age 62 on or after 2005 (i.e., those born in 1943 and later) and not those born earlier. Age 67 would apply to those born in 1949 (1960 and later under current law). Thus, this change affects baby boomers and younger workers, but not the retired or near-retired. This can be seen as a disadvantage (older workers and retirees are not sharing in this particular solution) or as an advantage (no sudden changes for those near or in retirement who can not change their plans easily). A summary of the IA and PSA retirement age changes are enclosed.

2. *You mentioned that experience from other countries shows that tax avoidance occurs when one gets nothing for additional taxes. Would you provide more detail as to which other countries have this experience and what actually happened?*

A paper presented by Joyce Manchester (Visiting Fellow - World Bank) at the 1997 Pension Research Council at Wharton names countries where under-reporting of taxable income occurs when people get little additional benefit from paying additional contributions. In her speech she also cited Italy as an example. She stated that people under-report income when:

- Benefits are not linked to contributions
- Benefits are only based on the last 5 years of income
- Low returns on contributions make the value of the additional benefits worth much less than the amount contributed.

Even in the United States, many self-employed women with lower wages than their husbands under-report their income, since they get little or no improvement in their Social Security benefits if they do report their income (see pages 13 and 14).

3. *Of what importance are cost-of-living adjustments and should they be preserved?*

If COLA's are eliminated, the effects will be most felt by the very elderly of the future. For example, if inflation is 4% over the next 30 years, someone age 95 then will have fallen behind by 4% for each of the next 30 years. Thus, their purchasing power at age 95 will be only 31% (=1/1.04^30) of what it was at age 65. This is quite a concern, since:

- Employer pensions often don't have COLA's,
- Medical and long-term-care expenses are higher in the last couple years of life, and
- Poverty rates are higher at the most elderly ages, especially among women, who are more likely to be widows living alone. (See attached chart on poverty rates.) Poverty rates assume it costs widows about 75% of the amount before widowed – to maintain the same standard of living.

Social Security's loss of purchasing power was a concern for Congress before COLA's were automatic, so they occasionally passed ad hoc COLA's which ended up being more expensive than CPI increases would have been. Automatic COLA's were introduced as a way to reduce costs. Thus, eliminating them could also increase outlays.

4. *What are your views regarding adjusting the Consumer Price Index as an option to consider as part of Social Security reform?*

The American Academy of Actuaries does not endorse legislative proposals, but rather provides analysis of advantages and disadvantages. Therefore, while we do not recommend arbitrarily reducing the COLA, we do note that the Chief Actuary of Social Security has estimated that subtracting 1.1% from the CPI (and no other changes) would lower Social Security's long-range actuarial deficit by about two-thirds.[1] Coupled with an increase in the normal retirement age to 70, it would solve Social Security's current long-range actuarial deficit.

However, if the COLA is reduced by 1.1%, the problems noted in the last question will arise if this reduction sets a COLA that is lower than the actual increases in the cost-of-living. The purchasing power of retirees will fall behind each year. Thus, the very elderly of the future will be hurt the most. Currently, changes in the CPI, being reputedly higher than the actual increases in costs-of-living, helps the very elderly the most.

Finally, the Bureau of Labor Statistics has made changes to the CPI that are expected to reduce the annual COLAs by 0.2% and suggests that it might make further changes that would lower the annual COLAs by another 0.3% in 1999. If Congress lowered the 1998 COLA by 0.3%, it would reduce outlays by 0.3% in 1998, with reduced outlays in future years gradually reducing to zero over current retirees' lives.

5. *How do we restore younger workers' confidence in Social Security?*

Robert Friedland of the National Academy of Social Insurance made a presentation before the 1994-1996 Advisory Council entitled "Public Confidence in Social Security". In it, he discussed their focus groups, supplemented by Gallup polls in 1994. They found that most people get their lack of confidence in Social Security from experts and media saying Social Security has financial problems. Young people "wanted someone with authority to walk in the room and say" Social Security will be fixed. (See page 295 of Volume II.) Thus, fixing Social Security's financial problems would probably help restore the people's confidence in the system. The presentation also suggested that annual benefit statements might help those people that do not trust the government or its ability to manage (page 297). Private sector pension plans must furnish benefits statements upon a participant's request.

[1] If the 1.1% decrease is done through BLS corrections to the CPI, the savings is not as great, because nominal wages and interest rates may also come down.

6. *I'd like to know your views on the Advisory Council's recommendation to study the investing of up to 40% of the Trust Funds. How would the market be affected by such a large infusion of money?*

   What percentage of private industry would the government own? Shouldn't the government stay out of private industry? How would this be done?

   Wouldn't the government wind up taking an active role in the direction of the companies whose assets it owns? Might this role for government have a depressing effect on stock yields and therefore on the yields for seniors?

   Since the government would control the investment of the Trust Funds, how do you avoid the risk that the government might ultimately influence the selection of stocks for political purposes unrelated to the best interests of the workers contributing to the plan?

Effects on U.S.: Most studies suggest that investing Social Security funds in private markets would probably drive up stock prices, and consequently lower their returns in the future. (The initial appreciation in stock prices would be a windfall for those already in the stock market.) Unless amounts invested in the private sector are found from reduced U.S. expenditures or additional contributions, the U.S. Treasury would have to find another source for its borrowing. In order to attract more funds, the U.S. Treasury would have to offer higher interest rates. This would increase the deficit and eventually taxes. Thus, Social Security becomes a better deal to covered workers at the expense of U.S. taxpayers.

Other Consequences: If lower market yields result, it would also affect pension plans and others that are heavily invested in the stock market. Funds in Defined Contribution plans would yield smaller benefits and Defined Benefit contributions would have to increase in order to fund the same benefits. Corporations might have higher borrowing costs to compete with the U.S. Treasury for funds. Higher corporate bond yields then might offset the lower equity yields in pension plans that had them.

Investment Risk: The Social Security Funds would be subject to market volatility risk. Since they are closer to pay-as-you-go than advance-funded pension plans, this risk should be analyzed carefully, to see how much funds can safely be invested in equities. On the other hand, Social Security does not allow lump sums (which some pension plans do offer) and contributions each year will greatly offset the amount needed for distribution each year. This would reduce the risk that large amounts of funds would need to be withdrawn when stock prices are down. However, when the baby boomers start to retire (from 2008 to 2030), the stock market might fall dramatically when retirement funds are pulled out to pay benefits to the large baby boomer cohort. This could lower equity returns dramatically.

Governance Concerns: The above comments also apply to the IA and PSA options. However, the Maintain Benefits (MB) option also has the governance concern that you mentioned because the government holds the equity funds (while it avoids placing the many serious risks on individuals of a more privatized system). It is very difficult to determine what percent of the market would be held by the government. Thomas Stanton's presentation to the Advisory Council (pages 423 of Volume II) compares equity amounts in 2020 with total corporate equities in 1994 by deflating the equities at 5.5% per year. Under his method, the MB equities in 2020 of $3.2 trillion (as projected on page 196 of Volume I) would deflate to $0.8 trillion in 1994 or 13% of corporate equities. He states that this amount would probably be manageable by current equity managers. However, the Advisory Council projected stocks to yield 11% annually. If the size of the stock market were to increase commensurate with this assumption, the above 13% would be much lower. Finally, we note that stocks in the IA and PSA options will eventually far exceed amounts in the MB option (but they of course are held by individuals, not Social Security). One way to decrease these percentages is to allow investments in corporate bonds, mortgages, and mutual funds. This could cut the above percentage in half, since these additional markets are just as big as the domestic equity market. Foreign markets could further reduce these percentages. These other investments would have their governance concerns too, however.

Two agencies in the federal government (the Federal Thrift Savings Plan and the Pension Benefit Guaranty Corporation) reduce the governance concern by delegating voting rights to the investment managers. The PBGC has done this successfully for over 20 years. In addition, the Federal TSP only invests in indexes. This reduces the concern that they could manipulate companies with their huge amounts of money. In addition, they are by law fiduciaries investing money in the sole interest of their beneficiaries. This keeps investment managers from having other reasons for investment decisions. However, laws can be changed by a future Congress. For example, Florida's legislature just mandated the state retirement fund to eliminate investments in tobacco.

7. *Could you suggest a way that employers and employees together could opt to replace a personal savings account or individual account with an employer plan that would spread the risk more and yield a higher return?*

If reform legislation mandates additional employee contributions to individual accounts, it may harm their employer retirement benefits and personal savings. Many lower-paid employees could take their contribution from their 401(k) deferrals and lose the employer match. Higher-paid employees would then be prohibited from making their full contribution to the 401(k) plan, due to non-discrimination rules. If the mandate is for additional employer contributions, then employers may reduce contributions to their pension plans.

Papers from the World Bank laud the fact that retirement income in the U.S. comes from more than one source (i.e., the 3-legged retirement stool). Diversification of the sources of retirement income is very important. However, if the Social Security leg is strengthened by harming the other legs (private pensions and personal savings), the result could be an unbalanced retirement stool.

There are ways to preserve the employer pension leg. For example, if a mandatory contribution is required, employer pension plans could be one of the options for the mandate. The government might require some special rules for the pension plan to qualify, such as:

- A minimum benefit or contribution,
- A minimum vesting schedule, or
- A minimum cash-balance-type benefit in a Defined Benefit plan, that is vested within the first year.

Employer plans (including Defined Benefit plans) with 401(k) features could qualify as an option for all employees that made a minimum contribution. Section 414(h) pickup plans could be expanded to all employer types and also qualify as an option. The private and public pension sectors already exist for over 80 million employees and would be able to handle the imposition of reform legislation much easier than if the mandate is placed on each individual. Congress may want to consider this option if it decides to go forward with mandatory individual accounts.

In addition, simplification of pension laws is still needed to encourage more plans. Most small employers still do not have pension plans (therefore it would be difficult for small employers to find the money for any IA mandatory contribution). The tax advantage of employer pension plans (over other investment possibilities, such as savings accounts, IRAs, and stocks eligible for capital gains treatment) is also necessary to preserve them. Some forms of tax restructuring would remove the tax advantages of employer-sponsored pension plans. We have attached a report which discusses how this could negatively affect individuals, employers, and the nation.

8. *In light of the fact that the Trustees' long-range "intermediate" projections made in 1983 now appear to have been optimistic, if one were to ask you to design a package of reforms today, would you use the "intermediate" assumptions or the "high cost" assumptions? Said another way, should we build a financing cushion in the next set of changes we make to Social Security in the event the most recent intermediate forecast proves to be optimistic?*

The Academy uses the intermediate assumptions for its monograph and issue briefs (also enclosed). Social Security's 1990 Technical Panel assumptions were practically all implemented. In addition, the 1994 - 1996 Advisory Council, reflecting some outside criticism, suggested assuming longer lifespans and higher fertility rates. However, their suggested assumptions approximately offset each other. As stated in the Advisory Council report, they find the assumptions reasonable in the aggregate.

In addition, as discussed in our testimony, it is not sufficient to just put the Social Security system in actuarial balance. The legislation must also create a stable fund balance at the end of the 75-year period. For example, the IA and PSA options create a stable fund balance by increasing the Normal Retirement Age.

9. *Given that the entitlement spending overall has been projected by the Congressional Budget Office and others to grow dramatically as a percent of GDP in the future (when the baby boomers are in retirement), do you think it would be wise to build tax increases into any Social Security plan?*

Whether or not to increase taxes (and how much) is a policy decision for Congress. If the solution is entirely on the tax side, and benefits are not reduced, the 1997 Trustee Reports of Social Security and Medicare Programs show that taxes would have to double from 7.38% of GDP today to 15.08% of GDP in 2071. This is about 40% of taxable payroll in 2071.

	1997	2071	% Increase
OASDI	4.65%	6.68%	44%
HI	1.76	4.98	183%
SMI	0.97	3.42	253%
Total	7.38%	15.08%	104%

Congress should consider how much they will need to increase taxes for Medicare (if any), before they decide to increase taxes for Social Security. It may greatly affect the thinking on this issue.

10. *Do you think the public wants, or is expecting, at least some market investment to underpin the Social Security system in the future, whether it is through personal accounts or collectively through the Trust Funds?*

As a result my participation in Social Security symposiums sponsored around the country by members of Congress, I have heard many attendees say who they think should invest the stocks. In general, these conversations have revealed that younger people, men, and higher-paid people may be more likely to be in favor of individual accounts, while older people, women, and the lower-paid may be more likely to not favor them. It is interesting to note that this latter category is also the same group that invests in a more conservative basis in their IRAs and 401(k)s. This is probably due to the fact that they have less future earning power to offset any possible investment losses that could occur.

11. *While the Advisory Council was not able to agree on everything, they did agree that any sacrifices in bringing the system into balance should be widely shared and not borne entirely by current and future workers and their employers. The council's suggestion was to apply appropriate income taxation to Social Security benefits. Do you believe the burden should be shared by all?*

The Academy does not take policy positions. However, we do note that taxing Social Security benefits like pension benefits by eliminating the thresholds would be a big simplification for retirees calculating their taxes. One might be concerned that very low-income retirees would then be stuck with a large tax increase. However, as pointed out in the Advisory Council report, 30% would still not be taxed. For example, exemptions and deductions for an elderly couple are $13,400 (= $2,550 x 2 + $8,300). This could easily be more than their Social Security benefit, so it would not be taxed anyway. In addition, middle income people will not be affected as much due to the progressive nature of our tax system.

However, pension tax law also requires a determination of the portion paid by the employer. This portion is taxed at distribution. We note that determining the portion of Social Security benefits not taxed yet would be a detailed calculation and difficult for retirees to verify. Thus, Congress might stay with the 85% imputation rule that already exists. This 85% is quite accurate for workers at the wage base and above. For middle and low-income people, however, the untaxed portion is closer to 90 or 95%. Thus, a more exact calculation would increase their taxes. Thus, the imputation is simpler and it has the added advantage of not affecting middle and low-income people more than higher income people.

In response to your question about whether current retirees should share in the solution, we note that further taxation and COLA reductions are two ways in which current retirees could be affected. Many current retirees have received or will receive more from Social Security than they contributed. They have had a good return on their contributions. On the other hand, they are also responsible for preserving our democracy in the 1940's, caring for their parents in earlier years before some were fully covered by Social Security, and creating a very productive nation in the 1950's. They may have paid in other non-financial ways.

We want to thank you again for holding the hearing and inviting us to testify. We are more than happy to answer further questions or meet with you to discuss these and other items at any time.

Sincerely,

Ronald Gebhardtsbauer, FSA, MAAA
Senior Pension Fellow