THE FUTURE OF SOCIAL SECURITY FOR THIS GENERATION AND THE NEXT: PERSONAL SAVINGS ACCOUNTS AND INDIVIDUAL-OWNED INVESTMENTS

HEARING

BEFORE THE

SUBCOMMITTEE ON SOCIAL SECURITY

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

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CONTENTS

THE FUTURE OF SOCIAL SECURITY FOR THIS GENERATION AND THE NEXT: PERSONAL SAVINGS ACCOUNTS AND INDIVIDUAL-OWNED INVESTMENTS

JUNE 18, 1998

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON SOCIAL SECURITY,
Washington, DC.

The Subcommittee met, pursuant to notice, at 1:02 p.m., in room 1100, Longworth House Office Building, Hon. Jim Bunning (Chairman of the Subcommittee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON SOCIAL SECURITY

FOR IMMEDIATE RELEASE CONTACT: (202) 225–9263
June 8, 1998
No. SS–18

Bunning Announces Eleventh Hearing in Series on "The Future of Social Security for this Generation and the Next"

Congressman Jim Bunning (R–KY), Chairman, Subcommittee on Social Security of the Committee on Ways and Means, today announced that the Subcommittee will hold the eleventh in a series of hearings on "The Future of Social Security for this Generation and the Next." At this hearing, the Subcommittee will examine in detail the structure of personal savings accounts (PSAs) within the Social Security system and the effects individual-owned investments would have for retirees, financial markets, the investment community, PSA investors, and businesses, both large and small. The hearing will take place on Thursday, June 18, 1998, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 1:00 p.m.

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. Witnesses will include economic, investor, investment, and program experts, along with business representatives. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

BACKGROUND:

Possible establishment of PSA's as an element of Social Security modernization has added an additional level of debate regarding the system's solvency. Two of the three plans advanced by the 1997 report of the Advisory Council on Social Security proposed PSA's as a substitute for the shrinking resources available to traditional social insurance.

Since that time, Members of Congress of both parties, along with research and public interest groups have set forth plans containing PSA's as an integral part of Social Security reform. During the President's first forum on Social Security held in Kansas City, the President, Members of Congress, and social insurance experts agreed PSA's deserved further consideration.

Giving individuals investment choices not only would alter the role of participant workers, but also would incorporate a number of other institutions which currently have no or limited involvement in today's traditional Social Security system. Private capital markets, investment companies, employers, and certain Federal agencies would need to adapt to become stakeholders in the system.

To date, proposals have varied widely in structure and in recent months, more details have been reported for public examination. Several such proposals envision personal investments made through a centralized, quasi-government organization, similar to the Federal Employees Thrift Fund. The choice of such investments would be limited to "passive" vehicles, such as stock and bond indexes, to lessen the influence of government in the private capital markets and businesses. Other models propose investments more akin to the current Individual Retirement Accounts, where each investing worker would choose among a larger array of financial assets through private investment companies. Each model plan also varies in the way workers receive their funds upon retirement or disability.

The cost, operation, and regulation of these two diverse models vary considerably as do the opportunities and risks for the participants, both as workers and as retirees. In previous hearings, the Subcommittee has heard from authors of PSA plans. In the upcoming hearing, economic experts and representatives of institutions who could become vital components of a new system will discuss the implications for the economy and stakeholders.

In announcing the hearing, Chairman Bunning stated: ''Personal savings accounts may be an answer, especially for young people, to meet the challenge of providing for their own retirement. Someone once said, 'You cannot plough a field by turning it over in your own mind.' We need to have accurate and expert information about the important structural elements needed to ensure any new system would actually work.''

FOCUS OF THE HEARING:

The Subcommittee will receive the views of experts in the field of investments and capital markets and representatives of institutions that might become participants in a PSA system. Members of the Subcommittee would like to hear from each witness regarding: (1) the effect of Social Security PSA investments on the capital markets, (2) the cost and administration of PSA's, (3) needed investor education, and (4) the role of employers, both large and small, in a PSA system.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit six (6) single-spaced copies of their statement, along with an IBM compatible 3.5-inch diskette in WordPerfect 5.1 format, with their name, address, and hearing date noted on a label, by the close of business, Thursday, July 2, 1998, to A.L. Singleton, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Subcommittee on Social Security office, room B–316 Rayburn House Office Building, at least one hour before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be submitted on an IBM compatible 3.5-inch diskette in WordPerfect 5.1 format, typed in single space and may not exceed a total of 10 pages including attachments. Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, company, address, telephone and fax numbers where the witness or the designated representative may be reached. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press, and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are available on the World Wide Web at 'HTTP://WWW.HOUSE.GOV/WAYS__MEANS/'.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman BUNNING [presiding]. The Subcommittee will come to order.

Today marks our 11th hearing in a series on the future of Social Security for this generation and the next. At our last hearing, we heard from a number of those creators of PSAs, personal savings account, proposals who see the accounts as a key component in Social Security reform. Today, we'll hear from experts in the economy, the field of investments and capital markets, and representatives of institutions who would be key players in establishing a personal savings account system.

Personal savings account may be an answer, especially for young people, to meet the challenge of providing for their own retirement. Someone once said, "You cannot plow a field by turning it over in your own mind." We need to have accurate and expert information about the important design elements needed to ensure any new system would actually work.

While the structure for individual investment is critical, the success of any system will depend upon cost effective and responsive administration. Critical to that operation will be the institutions, many not involved in the Social Security system today, that would be the nexus between the participating worker and the government agency that administers the overall retirement systems.

To ensure a successful operation, the system of personal accounts must have minimal and equitable administrative cost, create no undue burden on employers, and make the operation of the system and the obligation of the investor easy to understand and use for the participants.

I look forward to hearing the advice of our witnesses today to help us determine the detailed and practical options that would be needed to resolve in designing a working of a personal savings account component as part of Social Security reform.

In the interest of time, it is our practice to dispense of opening statements, except for the Ranking Democrat Member. All Members are welcome to submit statements for the record. I yield to Congressman Kennelly for any statement she wishes to make.

Mrs. KENNELLY. Thank you, Chairman Bunning. And as you have noted, this is the 11th hearing on the future of Social Security that this Subcommittee has held. And we've held hearings on the broad issues related to Social Security, and on specific proposals to change the system.

In my view, our purposes need to be to strengthen Social Security for the future. We need to assure that future generations of workers, retirees, and their families continue to receive an adequate, guaranteed retirement benefit from Social Security. We need to assure individuals that they will receive a benefit that is protected against inflation and will last a lifetime.

Social Security provides an important protection for widows, orphans, and the disabled. We need to make sure that these protections are not eroded. We need to assure that we do not jeopardize benefits for women who have stayed home for part of their careers to raise children, or to take care of older parents.

And finally, we need to assure that any reforms we adopt do not benefit higher income individuals at the expense of middle- and low-income individuals. These are important principles that we have to keep in mind as we progress with our hearings. We must face up to the demographic challenges before us, but we must not undermine the protections afforded by the most efficient program of this century.

Our hearing today focuses on the effects of individual accounts. A study issued this week by CRS, Congressional Research Service, analyzes the impact that some individual account plans will have on Social Security benefits and protections. The study calculates the size of Social Security benefit cuts that will occur under three different Social Security reform plans. The study finds that under a plan in which 2 percentage points of Social Security revenue is diverted into individual accounts, Social Security benefits must be cut significantly.

Today's 38-year-old retiring at 65 in the year 2025 would have a 33-percent reduction in his Social Security benefit. Even if an individual account provided an extraordinary rate of return equal to the past performance of the Standard & Poor's index, the accumulation in the account would still leave the 38-year-old considerably worse off than he would be today.

Our witnesses today will discuss the impact of individual accounts on the economy and on individuals. We must take a careful look at all of these ramifications of these plans before we will act. I look forward to hearing the testimony of our witnesses. They will help us examine a wide variety of topics relating to the impact of individual investment accounts. We will have the opportunity to learn whether individual accounts can—in fact—create wealth for individuals and for the country; whether administrative costs will increase with the creation of 140 million individual investment accounts; and whether those administrative costs will reduce the level of retirement income for average Americans. Can a model like the Federal Thrift Savings Plan give us any incite into these issues? How would employers handle these accounts? Thank you, Mr. Chairman, very much.

Chairman BUNNING. Thank you very much. I would like to enter into the record, by unanimous consent, the Heritage Foundation paper—white paper—on the CRS Social Security study at this time.

[The information follows:]

Analyzing the CRS Social Security Study by William W. Beach and Gareth G. Davis

On June 18, 1998, the Congressional Research Service (CRS) released an analysis of major Social Security reform proposals.[1] The study, requested by Representative Charles Rangel (D–NY), purports to show that a Social Security reform plan proposed by Senators Daniel Patrick Moynihan (D–NY) and Robert Kerrey (D–NE), and a similar plan by Senators Judd Gregg (R–NH) and John Breaux (D–LA) and Representatives James Kolbe (R–AZ) and Charles Stenholm (D–TX) (based on a proposal by the National Commission on Retirement Policy [NCRP]), will result in large benefit cuts for future retirees. This study has been used to give the impression that under these two plans—which both allow for the investment of two percentage points of payroll taxes in private retirement accounts—workers would be left with lower retirement incomes. But in accordance with the instructions given by Representative Rangel, the CRS report looks only at Social Security benefit changes and ignores the offsetting retirement income that future retirees would receive from their private retirement accounts.

The report's author drew attention to these ''important omissions'' in the memorandum of transmission to Representative Rangel:

As your staff specified, the analysis is confined to the potential reductions in Social Security benefits prescribed by the various provisions of the three reform packages. Accordingly, the memorandum does not examine the impact of the changes in payroll taxes included in the packages, the potential benefits or annuities that may result from the ''personal savings'' components of the packages, nor...the elimination of the Social Security retirement earnings test.

Those using the report to suggest it ''proves'' privatization would hurt most retirees ignore this crucial omission from the analysis. In fact, if the study is adjusted for the omission of personal savings income, it shows the opposite.

A Statistical Analysis of the Report's Findings

To give a proper picture of the effects of these plans on the retirement income of workers, analysts from The Heritage Foundation's Center for Data Analysis calculated the amount that low-, average-, and maximum-wage workers would accumulate in their private accounts under those two plans. The results of the Heritage study, summarized in Tables 1 through 3, demonstrate that under both plans, workers would be likely to accumulate large amounts in their private accounts by retirement. These funds would be available as retirement income at age 65.

Table 1 shows the amount that low-, average-, and maximum-income 39-year-old workers would accumulate in their accounts by their retirement in 2025 at age 65. Under the Moynihan-Kerrey plan, a low-wage worker (earning 45 percent of the average) could expect to accumulate $31,260 ($12,874 in 1998 inflation-adjusted dollars) by retirement if he or she invested in an ultra-safe portfolio made up of 50 percent U.S. Treasury Bonds and 50 percent blue-chip stocks. With a similar portfolio, the Gregg-Breaux-Kolbe-Stenholm/NCRP plan would enable the same low-wage worker to accumulate $37,518 ($15,451 in 1998 inflation-adjusted dollars) by retirement. With a 50 percent bond/50 percent equity portfolio, an average-wage worker would accumulate $69,467 ($28,608 in 1998 dollars) by retirement under the Moynihan-Kerrey plan. This same worker would accumulate $83,373 ($34,335 in 1998 dollars) under the Gregg-Breaux-Kolbe-Stenholm/NCRP plan. A maximum-wage worker would accumulate $168,078 ($69,219 in 1998 dollars) under the Moynihan-Kerrey plan and $201,726 ($83,076 in 1998 dollars) under the Gregg-Breaux-Kolbe-Stenholm/NCRP proposal.

[1] David Koitz, ''Benefit Analysis of Three Recent Social Security Reform Proposals,'' Congressional Research Service Memorandum for Congress, June 16, 1998. The CRS examined three reform proposals, including one advanced by Robert M. Ball, a former commissioner of Social Security. The Center for Data Analysis examined only the proposals by Members of Congress: the Moynihan-Kerrey and the Gregg-Breaux-Kolbe-Stenholm/ NCRP proposals.

Table 1 CDA98-04

Accumulated Amounts and Benefit Reductions for Workers Retiring at Age 65 in 2025 by Wage Levels

			Private Retirement Account Accumulations		
			Low Wage	Average Wage	Maximum Taxable Wage
Moynihan Plan (S. 1792)					
	Treasury Bonds	Nominal	$24,647	$54,772	$132,523
		1998 Dollars	10,150	22,557	54,577
	50% Bonds, 50% Equities	Nominal	31,260	69,467	168,078
		1998 Dollars	12,874	28,608	69,219
	Equities	Nominal	40,021	88,935	215,182
		1998 Dollars	16,482	36,626	88,618
Gregg–Breaux/NCRP Plan					
	Treasury Bonds	Nominal	28,642	63,648	154,000
		1998 Dollars	11,795	26,212	63,421
	50% Bonds, 50% Equities	Nominal	37,518	83,373	201,726
		1998 Dollars	15,451	34,335	83,076
	Equities	Nominal	49,753	110,562	267,510
		1998 Dollars	20,490	45,532	110,168
			Annual Reduction in Social Security Benefits		
Moynihan Plan (S. 1792)		Nominal	$2,012	$3,323	$2,906
		1998 Dollars	829	1,368	1,197
Gregg–Breaux/NCRP Plan		Nominal	2,378	9,969	22,830
		1998 Dollars	979	4,105	7,916

Notes: Low-wage worker is assumed to earn 45% of average wage ($11,661in 1996), average-wage worker is assumed to earn 100% of average wage ($25,914 in 1996), and maximum-wage worker is assumed to earn $62,700 in 1996. The real value of the maximum wage is scheduled to increase under the Moynihan–Kerrey plan. However, worker is assumed to invest only 2 percent of current law maximum taxable amount in retirement and to take the remainder as salary increase. It should be noted that although Social Security benefit decrease for maximum wage worker under the Moynihan–Kerrey plan is smaller relative to average- and low-wage workers, this reflects a greater increase in payroll taxes for maximum-income worker as the maximum taxable threshold is substantially increased in the future above current law levels. Worker is assumed to earn 10% return on equity investment (6.5% after inflation), 8.15% return on mixed bond/equity investment (4.65% after inflation), and 6.3% (2.8% after inflation) on Treasury Bonds.

Source: Heritage Foundation Center for Data Analysis calculations based on projections of *1998 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.* Benefit reductions are calculated on the basis of Congressional Research Service Memorandum to Representative Charles Rangel, "Benefit Analysis of Three Recent Social Security Reform Proposals," June 16, 1998.

Table 2 shows the annual retirement income that would be likely to be generated by annuitizing these accumulations at retirement. Under the Moynihan-Kerrey plan and with a mixed portfolio of equities and bonds, the low-wage worker's portfolio could be expected to generate $2,909 ($1,198 in 1998 dollars) per annum; under the Gregg-Breaux-Kolbe-Stenholm/NCRP plan, it would generate $3,491 ($1,438 in 1998 dollars) in annual income. With a similar portfolio, the average-wage worker's account could be expected to earn $6,464 ($2,662 in 1998 dollars) per year under the Moynihan-Kerrey proposal and $7,758 ($3,195 in 1998 dollars) under the Gregg-Breaux-Kolbe-Stenholm/NCRP plan.

Table 2 CDA98-04

Annuity Amounts Generated by Private Accounts to Offset Reduction in Social Security Benefits

		Annuity from Private Retirement Account by 2025		
		Low Wage	Average Wage	Maximum Wage
Moynihan Plan (S. 1792)				
Treasury Bonds	Nominal	$2,293	$5,097	$12,331
	1998 Dollars	945	2,099	5,078
50% Bonds, 50% Equities	Nominal	2,909	6,464	15,640
	1998 Dollars	1,198	2,662	6,441
Equities	Nominal	3,724	8,275	20,023
	1998 Dollars	1,534	3,408	8,246
Gregg–Breaux/NCRP Plan				
Treasury Bonds	Nominal	2,665	5,922	14,330
	1998 Dollars	1,098	2,439	5,901
50% Bonds, 50% Equities	Nominal	3,491	7,758	18,771
	1998 Dollars	1,438	3,195	7,730
Equities	Nominal	4,629	10,288	24,892
	1998 Dollars	1,907	4,237	10,251
		Annual Reduction in Social Security Benefit for Worker Retiring at Age 65 in 2025		
Moynihan Plan (S. 1792)	Nominal	$2,012	$3,323	$2,906
	1998 Dollars	829	1,368	1,197
Gregg–Breaux/NCRP Plan	Nominal	2,378	9,969	18,403
	1998 Dollars	979	4,105	7,579

Notes: Low-wage worker is assumed to earn 45% of average wage ($11,661 in 1996), average wage worker is assumed to earn 100% of average wage ($25,914 in 1996), and maximum-wage worker is assumed to earn $62,700 in 1996. The real value of the maximum wage is scheduled to increase under the Moynihan–Kerrey plan. However, worker is assumed to invest only 2 percent of current law maximum taxable amount in retirement and to take the remainder as salary increase. It should be noted that although Social Security benefit decrease for maximum wage worker under the Moynihan–Kerrey plan is smaller relative to average- and low-wage workers, this reflects a greater increase in payroll taxes for maximum-income worker as the maximum taxable threshold is substantially increased in the future above current law levels.

Sources: Heritage Foundation Center for Data Analysis calculations based on projections of *1998 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* reductions are calculated on the basis of Congressional Research Service Memorandum to Representative Charles Rangel, "Benefit Analysis of Three Recent Social Security Reform Proposals," June 16, 1998.

Table 3 shows the net overall effect on annual retirement income after offsetting lower Social Security benefits with retirement income from private savings accounts. With a mixed portfolio and assuming annuitization of the retirement account, the retirement income received by a low-income worker would increase by 4.9 percent over what is promised by Social Security under the Moynihan-Kerrey plan and by 6 percent under the Gregg-Breaux-Kolbe-Stenholm/NCRP plan. Under the same assumptions, retirement income for an average-wage worker would increase by 10.4 percent over Social Security's benefits under the Moynihan-Kerrey plan but fall 7.3 percent under the Gregg-Breaux-Kolbe-Stenholm/NCRP plan. For a maximum-income worker, retirement income would increase by 26.3 percent under the Moynihan-Kerrey plan and by 0.8 percent under the Gregg-Breaux-Kolbe-Stenholm/NCRP plan.

Table 3 CDA98-04

Net Percentage Change in Annual Retirement Income for Worker Retiring at Age 65 in 2025 After Combining Income from Private Accounts with Reductions in Social Security Benefits

	Low Wage	Average Wage	Maximum Wage
	Moynihan Plan (S. 1792)		
CRS Estimates without Income from Private Account	*-11%*	*-11%*	*-6%*
Including Income from 100% Bond Portfolio	1.5	5.9	19.5
Including Income from 50% Bonds/50% Equity Portfolio	4.9	10.4	26.3
Including Income from 100% Equity Portfolio	9.4	16.4	35.3
	Gregg–Breaux/NCRP Plan		
CRS Estimates without Income from Private Account	*-13%*	*-33%*	*-38%*
Including Income from 100% Bond Portfolio	1.6	-13.4	-8.4
Including Income from 50% Bonds/50% Equity Portfolio	6.1	-7.3	0.8
Including Income from 100% Equity Portfolio	12.3	1.1	13.4

Notes: Low-wage worker is assumed to earn 45% of average wage ($11,661 in 1996), average-wage worker is assumed to earn 100% of average wage ($25,914 in 1996), and maximum-wage worker is assumed to earn $62,700 in 1996. The real value of the maximum wage is scheduled to increase under the Moynihan–Kerrey plan. However, worker is assumed to invest only 2 percent of current law maximum taxable amount in retirement and to take the remainder as salary increase. It should be noted that although Social Security benefit decrease for maximum wage worker under the Moynihan–Kerrey plan is smaller relative to average- and low-wage workers, this reflects a greater increase in payroll taxes for maximum-income worker as the maximum taxable threshold is substantially increased in the future above current law levels.
Sources: Heritage Foundation Center for Data Analysis calculations based on projections of *1998 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* reductions are calculated on the basis of Congressional Research Service Memorandum to Representative Charles Rangel, "Benefit Analysis of Three Recent Social Security Reform Proposals," June 16, 1998. Worker is assumed to earn 10% return on equity investment (6.5% after inflation), 8.15% return on mixed bond/equity investment (4.65% after inflation), and 6.3% (2.8% after inflation) on Treasury Bonds.

As this analysis shows, the retirement income of a low-wage worker would be higher than under current law under every investment portfolio when earnings from the worker's private account are included.

Under both the Moynihan-Kerrey and Gregg-Breaux-Kolbe-Stenholm/NCRP plans, a worker earning 45 percent of the average wage could expect to see his or her retirement income increase between 5 percent and 6 percent with a mixed portfolio of bonds and equities. Under the Moynihan-Kerrey proposal, the retirement income of an average-wage worker would be likely to increase by between 5.9 percent and 16.4 percent, depending on the investment options chosen.

Average workers would fare less well under the Gregg-Breaux-Kolbe-Stenholm/NCRP plan, with income falling by 13.4 percent if the worker invested entirely in Treasury Bonds and by 7.3 percent if the worker invested in a mixed bond-equity portfolio. If the worker invested entirely in equities, however, the income from the private account would more than offset the 33 percent reduction in benefits proposed by the plan.

Workers who have incomes above the maximum taxable threshold (which in 1998 is $68,400) would do well under the Moynihan-Kerrey plan. These workers generally are better off under the Gregg-Breaux-Kolbe-Stenholm/NCRP proposal, too, except for those who invest their payroll taxes entirely in Treasury Bonds; their net change in retirement income is a negative 8.4 percent.

NOTE ON RISK

It should be noted that advocates of the current system argue that Social Security provides "guaranteed" retirement benefits compared with the uncertain level of income that workers could receive from investing their payroll tax dollars privately. In no sense, however, can the benefits offered by the current system be held to be "safe, reliable or guaranteed."[2] The Social Security system, as it currently exists, is estimated by its own actuaries to be underfunded to the amount of $3.7 trillion and thus is financially incapable of delivering promised benefits.[3] Moreover, as the U.S. General Accounting Office has noted, if the rate of return on equities fell, then

[2] Democratic Staff of the House Committee on Ways and Means, "Response to the Heritage Report on CRS Study," June 18, 1998, p. 1.

[3] U.S. Department of the Treasury, 1997 Consolidated Financial Statement of the United States Government (Washington, DC: U.S. Government Printing Office, 1998), p. 63.

not only would private accounts deliver less retirement income, but a Social Security trust fund invested in equities would be unable to pay benefits.

Unlike individually held accounts, moreover, which are private property and thus constitutionally protected, the U.S. Supreme Court has ruled that Congress can alter Social Security benefits.[4] Workers also run the risk of dying prematurely, and thus collecting little or nothing in Social Security benefits. Considering today's demographic conditions, a worker alive in 1998 and planning to retire at age 65 in 2025 has been estimated by the National Center for Health Statistics to have a 16 percent chance of dying before even beginning to collect retirement benefits.[5] Only in a small minority of these cases will the families of these workers be able to collect Social Security benefits.

KEY ASSUMPTIONS [6]

- Rate of Return on Private Accounts: Heritage analysts calculated the rate of return from three investment strategies: a portfolio of 100 percent equities, a portfolio of 100 percent Treasury Bonds, and a portfolio made up of 50 percent equities and 50 percent Treasury Bonds. Workers are assumed to annuitize their accounts at age 65 at the rate of return prevailing on long-term Treasury Bonds A nominal rate of return of 6.3 percent (2.8 percent when adjusted for inflation) on Treasury Bonds was assumed. This is equal to the long-term interest rate on U.S. government bonds assumed in the 1998 Social Security Trustees' report. A nominal rate of return of 10 percent (6.5 percent after inflation) on equities was assumed. This rate is below the 7 percent post-inflation rate of return on equities found to exist by the 1994–1996 Social Security Advisory Council.[7] Heritage's assumptions also are lower than the long-term historical average yield on equities. Between 1926 and 1997 (a period that includes the Great Depression and World War II), the rate of return on large company equities averaged 11 percent, and the return on small company equities averaged 12.7 percent.[8]
- Reduction in benefits: The reduction in benefits payable to workers retiring at age 65 in 2025 under each of the plans was calculated directly from Table 3 of the CRS memorandum "Benefit Analysis of Three Recent Social Security Reform Proposals." The percentage reductions in this table were applied directly against the dollar benefits payable to low-, average-, and high-wage workers as published in Table III.B5 of the 1998 Annual Report of the Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.

—William W. Beach is John M. Olin Senior Fellow in Economics and Director of the Center for Data Analysis at The Heritage Foundation.

—Gareth G. Davis is a Research Assistant at The Heritage Foundation.

Chairman BUNNING. We will begin.

Mrs. KENNELLY. Mr. Chairman.

Chairman BUNNING. Yes.

Mrs. KENNELLY. Thank you. I meant to ask that the study that I referred to that was requested by Chairman Rangel be entered into the record. May I have that entered in?

Chairman BUNNING. Absolutely.

Mrs. KENNELLY. Thank you, Mr. Chairman.

[The information follows:]

[4] Fleming v. Nestor, 363 U.S. 603 [1960].

[5] Calculated from National Center for Health Statistics, Life Tables—Vital Statistics of the United States 1994 (1998).

[6] For details on Heritage's calculations of rates of return, see William W. Beach and Gareth G. Davis, "Social Security's Rate of Return," Heritage Foundation Center for Data Analysis Report No. CDA98–01, January 15, 1998.

[7] Report of the 1994–1996 Advisory Council on Social Security (January 1997).

[8] Stocks, Bonds and Bills and Inflation 1998 Yearbook (Chicago, IL: Ibbotson Associates,1998), p. 122.

Benefit Analysis of Three Social Security Reform Plans by David Koitz, Congressional Research Service, Specialist in Social Legislation, Education and Public Welfare Division

This memorandum is in response to a request for analysis of the potential effects on Social Security benefits of three recent proposals to reform the Social Security system. These proposals include: (1) S. 1792, the Social Security Solvency Act of 1998, introduced by Senators Moynihan and Kerrey on March 18, 1998, (2) a proposal recommended on May 19, 1998 by the National Commission on Retirement Policy (NCRP), a 24-member panel created under the auspices of the Center for Strategic and International Studies, and (3) a recent proposal by Robert M. Ball, former Commissioner of Social Security. All three proposals would make numerous changes to Social Security, on both the tax and benefit sides, and include other provisions either mandating or permitting the creation of new personal retirement savings accounts. As specified by the requester, the analysis is confined to the potential reductions in Social Security benefits prescribed by various provisions of the three reform packages. Accordingly, the memorandum does not examine the impact of the changes in payroll taxes included in the packages, the potential benefits or annuities that may result from the "personal savings" components of the packages, nor in the case of S. 1792 and the NCRP plan, the elimination of the Social Security retirement earnings test. Analysis of all of these would be necessary to gauge the full effects of the three plans on the national economy and individual retirement income. (A number of technical corrections to the memorandum sent to the original requester are reflected in this general distribution memorandum).

For the most part, the information provided in this memorandum is based on descriptions and estimates prepared by the Office of the Actuary of the Social Security Administration (SSA). The NCRP plan described here is one of four proposals priced by the actuaries, referred to as the Individual Savings Account (ISA) plus 2% plan. It is the one most closely resembling the NCRP plan released on May 19, 1998. The actuaries' estimates are contained in various memoranda summarizing aggregate trust fund impacts (i.e., on overall trust fund income and outgo) and illustrative benefit and annuity outcomes for workers with different lifetime earnings levels. Because the actuarial data are not necessarily consistent from one memorandum to another, the reader should be advised that this analysis required some interpolation of the actuaries' data and should be considered as approximations only.

Description of the Three Plans

All three plans include revenue increases and benefit reductions designed to bring the Social Security system into long-range actuarial balance. The SSA actuaries estimate that all would do so under the intermediate assumptions of the 1997 Social Security trustees' report. All three plans also include provisions either permitting or mandating the creation of new personal retirement savings accounts. A description of the plans as priced out by the actuaries follows.

S. 1792 reduces the Social Security tax rate by 2 percentage points of taxable payroll (it is currently 12.4% of pay) in the short run—1 percentage point on employee and employer each—and then raises it in the long run by 1 percentage point, bringing it to an ultimate rate 13.4% of pay in 2060 and later. Other measures to generate income for the Social Security system include: increasing the income taxation of Social Security benefits by requiring that benefits be taxed in the same fashion as private defined-benefit pension benefits (and would be fully effective in 1999); raising the maximum amount of earnings subject to Social Security taxation in steps to $97,500 in 2003 (under current law, it is estimated to rise to $81,900); and extending Social Security coverage to all State and local government employees hired after the year 2000. It reduces benefits by: gradually increasing the age for full Social Security retirement benefits to 68 by 2017 and eventually to age 70 by 2065 (under current law the full benefit age would rise to 67 by 2027); extending the period over which earnings are averaged for benefit computation purposes from 35 to 38 years by 2002; and permanently reducing Social Security cost-of-living adjustments (COLAs), as well as those of other indexed entitlement programs, by 1 percentage point per year beginning in 1998. This provision also would constrain the current indexing of income tax brackets (which would effectively increase income taxes). The bill also would eliminate the Social Security retirement earnings test for workers 62 and older. It further would permit workers to put 1% of pay into a new personal retirement savings account. Employers would be required to match these contributions.

The NCRP plan reduces the Social Security tax rate on workers by 2 percentage points and mandatorily redirects the proceeds into new personal retirement savings accounts (effective for workers under age 55). It raises the Social Security system's income by extending Social Security coverage to all State and local government employees hired after 1999 and crediting certain proceeds from the current income tax on benefits to the Social Security trust funds that now go to the Medicare Hospital Insurance (HI) trust fund. It reduces benefits by gradually increasing the age for full Social Security benefits to 70 by 2029 and the age for reduced benefits to 65 by 2017 (up from 62 under current law). After 2029, both would be increased by about 2 months every 3 years. It also: gradually reduces the top two (of the three) portions of the Social Security benefit formula from 32% and 15% respectively to 21.36% and 10.01% by 2020 (the first—90%—bracket would not be changed); gradually reduces the dependent spouse's benefit from 50% to 33% of the worker's primary benefit; extends the period over which earnings are averaged for benefit computation purposes from 35 to 40 years by 2010; and reduces Social Security COLAs by .5 percentage points per year beginning in 1998. The plan also would eliminate the Social Security earnings test for recipients at or above the full retirement age (effective in 2003), and create a new system of "minimum" Social Security benefits for workers with 80 or more Social Security "quarters of coverage."

The Ball plan increases income to the Social Security system by: requiring the investment of part of the Social Security trust funds in equities; increasing the income taxation of Social Security benefits by requiring that benefits be taxed in the same fashion as private defined-benefit pension benefits; raising the maximum amount of earnings subject to Social Security taxation (such that 87.3% of all earnings in covered employment would be taxable); and extending Social Security coverage to all state and local government employees hired after 1999. It reduces benefits by: extending the period over which earnings are averaged for benefit computation purposes from 35 to 38 years and permanently reducing Social Security cost-of-living adjustments (COLAs) by .3 percentage points per year. It also would allow workers to put 2% of pay (which would be over and above their Social Security taxes) into new personal retirement savings accounts.

THE IMPACT OF THE THREE PLANS ON BENEFIT EXPENDITURES OVERALL

The SSA actuaries prepared estimates of the average 75-year financial impact of the three proposals on the Social Security system overall based on the 1997 trustees' report so-called intermediate assumptions (shown in memoranda dated March 4, 1998 from SSA's actuaries, Alice Wade and Seung An, for the NCRP proposal; April 27, 1998 from Stephen C. Goss, SSA's Deputy Chief Actuary, and Alice Wade for the NCRP plan; and May 1998 from Robert M. Ball showing the actuaries' estimates of his plan). Traditionally, the trustees' intermediate assumptions are considered their best guess at any given time about the factors that will affect the future condition of the system. It should be noted that while the 1998 trustees' report was released after the preparation of the estimated impacts of these plans, the intermediate assumptions in the 1998 report do not noticeably differ from those in the 1997 report.

Traditionally, long-range Social Security income and expenditure estimates are shown as "percents of taxable payroll." Taxable payroll is the total amount of wages and salaries in the economy that are subject to Social Security taxation. In 1998, for instance, the Social Security system's costs are estimated to be equal to 11.18% of taxable payroll and its income, 12.65% of taxable payroll. The following table (Table 1) summarizes the average 75-year taxable payroll estimates of the impact of the three proposals under the 1997 trustees' report assumptions.

To summarize the data briefly, the NCRP plan would reduce projected 75-year average Social Security expenditures by 23%; S. 1792 would reduce them by 16%; and the Ball plan would reduce them by 6% (see, for instance, the S. 1792 column in Table 1—proposed benefit reductions of 2.46% of taxable payroll divided by projected total current law expenditures of 15.6% of taxable payroll = 16%). The reader should note that the estimated impact of the proposed changes shown in Table 1 includes the income taxation of Social Security benefits contained in S. 1792 and the Ball plan (since increasing the taxation of benefits results in lower after-tax Social Security benefits).

Table 1. Comparison of Projected 75-year Average Reductions of Social Security Expenditures Under S. 1792, NCRP, and Ball Plans

Proposal	S. 1792	NCRP (In % of taxable payroll)	Ball
Projected income under current law	13.37	13.37	13.37
Projected expenditures under current law	15.60	15.60	15.60
Projected 75-year average deficit	2.23	2.23	2.23
Proposed income changes	−0.21	−1.36	+1.44
Proposed (net) benefit reductions	−2.46	−3.59	−0.89
Impact on projected 75-year average deficit	+2.25	+2.23	+2.33
Proposed benefit reductions as a percent of the system's projected expenditures under current law	16%	23%	6%

Illustrative Social Security Benefit Reductions for Low, Average, and Maximum Earners

The actuaries' memoranda on the various plans contain illustrative "initial" benefit impacts for hypothetical low, average, and maximum earners who are assumed to work steadily at those levels throughout their working years (initial benefits are those paid at the point of retirement). However, their data are not consistently arrayed from one plan analysis to the next. With respect to S. 1792, for instance, the actuaries' memoranda provide benefit illustrations for retirement at ages 65 in 2025 and 2070. For the NCRP plan, they provide them for ages 65 and 67 in 5 year increments from 2000 to 2030. Illustrations for later years—out to 2070—are provided for retirement at age 67 only. Despite these inconsistencies, the relative magnitude of the reductions that the plans would make can be observed from the data. The following table (Table 2) summarizes these estimated benefit reductions (blank cells in the table indicate the data were not available from the actuaries' memoranda).

Table 2. Comparison of SSA Actuaries' Illustrative Reductions in Initial Social Security Benefits Projected to Result From S. 1792, NCRP, and Ball Plans

Year of retirement	Age of retirement	Benefit reduction as % of current law benefit		
		S. 1792	NCRP	Ball plan [a]
Low-wage earners [b]				
2010	65	...	7%	less than 1%
2020	65	...	12%	less than 1%
2025	65	11%	13%	less than 1%
2025	67	...	9%	between 1 and 2%
2030	65	...	19%	less than 1%
2030	67	...	14%	between 1 and 2%
2040	67	...	22%	between 1 and 2%
2050	67	...	25%	between 1 and 2%
2060	67	...	28%	between 1 and 2%
2070	65	22%		less than 1%
2070	67	...	31%	between 1 and 2%
Average-wage earners [b]				
2010	65	...	10%	less than 1%
2020	65	...	33%	less than 1%
2025	65	11%	33%	less than 1%
2025	67	...	29%	between 1 and 2%
2030	65	...	38%	less than 1%
2030	67	...	33%	between 1 and 2%
2040	67	...	39%	between 1 and 2%
2050	67	...	42%	between 1 and 2%
2060	67	...	44%	between 1 and 2%
2070	65	22%		less than 1%
2070	67	...	48%	between 1 and 2%
Maximum-wage earners [b]				
2010	65	...	17%	see footnote a
2020	65	...	38%	see footnote a
2025	65	6%	38%	see footnote a
2025	67	...	31%	see footnote a

Table 2. Comparison of SSA Actuaries' Illustrative Reductions in Initial Social Security Benefits Projected to Result From S. 1792, NCRP, and Ball Plans—Continued

Year of retirement	Age of retire-ment	Benefit reduction as % of current law benefit		
		S. 1792	NCRP	Ball plan [a]
2030	65	....	42%	see footnote a
2030	67	....	38%	see footnote a
2040	67	....	43%	see footnote a
2050	67	....	45%	see footnote a
2060	67	....	48%	see footnote a
2070	65	14%		see footnote a
2070	67	....	51%	see footnote a

[a] The figures in this column are CRS estimates of the impact of this plan's COLA changes on initial benefits (which assume BLS will alter the Consumer Price Index, CPI, to correct for an overstatement of inflation of 0.3 percentage points per annum). Although no estimates are reflected for the maximum-wage earner case, the potential impact of the plan's COLA reductions is the same as shown for the low-and average-wage earner cases. The impact of the increased wage bases proposed in this plan have not yet been calculated, but they would have the effect of raising benefits for maximum-wage earners, potentially offsetting the COLA reductions in whole or part, and in some cases causing higher benefits than payable under current law.

[b] A low-wage earner is assumed to be someone who always earned 45% of the average wage. An average-wage earner is assumed to be someone who always earned an amount equal to that incorporated in the average wage series determined and promulgated for Social Security indexing purposes. A maximum-wage earner is assumed to be someone who always earned an amount equal to the maximum level of earnings subject to Social Security taxation (e.g., $68,400 in 1998; this amount, referred to as the taxable earnings base, is indexed and rises annually at the same rate as average earnings in the economy).

Magnitude of illustrative benefit reductions: To highlight a number of the key outcomes shown by the actuaries' projections, the NCRP plan would make the largest reductions in "initial" Social Security benefits of the three plans. For instance, for average-wage earners retiring at age 65 in 2025, the NCRP plan would reduce current law benefits by 33%; S. 1792, by 11%, and the Ball plan, by less than 1%. In the long-run (see illustrations for 2070), the NCRP plan would reduce benefits in a range around 50% for average-and maximum-wage earners (less for low-wage earners). The following table shows compressed comparisons of the reductions resulting from the three plans using the estimated benefit impacts shown in Table 2 (blank cells in the table indicate the data were not available from the actuaries' memoranda).

Table 3. Illustrative Reductions in Initial Social Security Benefits Projected to Result From S. 1792, NCRP, and Ball Plans, for Retirements in 2025 and 2070 (Compressed Table 2)

Year of retirement	Age of retire-ment	Benefit reduction as % of current law benefit		
		S. 1792	NCRP	Ball plan [a]
Low-wage earners				
2025	65	11%	13%	less than 1%
2070	65	22%		less than 1%
2070	67	....	31%	between 1 and 2%
Average-wage earners				
2025	65	11%	33%	less than 1%
2070	65	22%		less than 1%
2070	67	....	48%	between 1 and 2%
Maximum-wage earners				
2025	65	6%	38%	
2070	65	14%		
2070	67	....	51%	

[a] The figures in this column are CRS estimates of the impact of this plan's COLA changes on initial benefits (which assume BLS will alter the Consumer Price Index, CPI, to correct for an overstatement of inflation of 0.3 percentage points per annum). Although "blank" cells are reflected for the maximum-wage earner case, the potential impact of the plan's COLA reductions is the same as that shown for the low-and average-wage earner cases. The impact of the increased taxable earnings bases proposed in this plan have not yet been calculated, but they would have the effect of raising benefits for maximum-wage earners, potentially offsetting the COLA reductions in whole or part, and in some cases causing higher benefits than payable under current law.

Distribution of benefit reductions between low, average, and maximum earners—S. 1792 looks to be relatively regressive in its benefit reductions compared to the other plans, i.e., it looks as if it makes a larger reduction in benefits, percentage-wise, for low- and average-age earners than it does for maximum-wage earners. However, this outcome is simply the result of requiring maximum-wage earners to pay taxes on more of their earnings than they would under current law. S. 1792 raises the taxable earnings base (the maximum amount of earnings subject to Social Security taxation) and this in turn requires not only more taxes to be paid by high earners, but also more earnings to be credited to their earnings records. This would give them a higher average monthly earnings level in the computation of their eventual Social Security benefits, and thus they would get higher benefits than under current law. As a result, this provision tends to mitigate the other benefit reductions contained in S. 1792. If this provision were ignored, the actuaries' analysis shows that the benefit cuts would be the same, percentage-wise, for low, average, and maximum-wage earners.

The NCRP plan would incur the largest benefit reductions of the three plans. However, the actuaries' analysis shows that the cuts would be relatively progressive, i.e., low-wage earners would incur a lower percentage reduction in benefits than maximum-wage earners.

As with S. 1792, the Ball plan would appear to be regressive in its benefit impact (although not reflected in the tables above—see the footnote at the bottom of Table 3) because of the higher benefits payable in the maximum-wage earner case. Like S. 1792, the Ball plan would increase the maximum amount of earnings subject to Social Security taxation and have the effect of raising benefits for the maximum earner. Ignoring this provision, the cuts would be very small and proportional on workers of different earnings levels.

Speed of implementation of benefit reductions—The NCRP plan would implement its benefit reductions much more rapidly than S. 1792. As reflected in Table 2, where S. 1792 would cause an initial benefit reduction of about 11% for an average wage earner retiring at age 65 in 2025, the NCRP plan would cause a 10% reduction for a comparable wage earner in 2010—in other words, it would have approximately the same impact about 15 years sooner. For a 2025 retiree, the NCRP plan would create a reduction of 33% (roughly three times the magnitude of that of S. 1792).

The Ball plan's reductions in "initial" benefits are marginal in both the short and long range (although the COLA reduction could have a noticeable impact on retirees' benefits late in life, e.g., age 80 or 95—see Table 4).

Important Omissions in Comparisons of "Initial" Benefit Reductions

It is important to recognize that the actuaries' projections of "initial" benefit impacts in the previous examples do not adequately reflect the impact of various features of the three plans. Specifically, they do not take into account (1) the proposed expansion of the taxation of benefits provided for under S. 1792 and the Ball plan, (2) the lifetime impact of the respective COLA constraints in the three plans, and (3) the lengthening of the earnings averaging period used to compute benefits that the three plans would make. The omission of these impacts is particularly relevant for the Ball plan, since without them, only very small reductions in benefits would appear to result from the plan.

Expansion of income taxation of Social Security benefits—Both S. 1792 and the Ball plan would expand the number of people affected by, and increase the amount of, income taxation of Social Security benefits by (1) eliminating the income thresholds below which recipients pay no tax on their benefits and (2) taxing benefits in the same fashion as private defined-benefit pension plans. S. 1792 would have the changes take effect immediately. The Ball plan would appear to phase them in (Mr. Ball's description of the proposal does not mention a phase in, but the estimated savings shown for the measure suggest that there would be such a feature). The NCRP plan makes no change in the taxation of benefits (although it would credit certain proceeds from the current tax on benefits to the Social Security trust funds that now go to the Medicare HI trust fund).

Currently, single retirees with incomes in excess of $25,000 (counting adjusted gross income and one-half of their Social Security benefits) pay income taxes on up to 85% of their benefits (up to 50%, if their incomes fall between $25,000 and $34,000). Couples with incomes in excess of $32,000 (again counting adjusted gross income and one-half of their Social Security benefits) pay income taxes on up to 85% of their benefits (up to 50%, if their incomes fall between $32,000 and $44,000). Today, approximately 75% of Social Security recipients pay no income taxes on their benefits, in large part because their incomes do not reach these thresholds. With elimination of the thresholds (or income exemptions) many more recipients would pay taxes on their benefits. In addition, the amount of benefits that would be taxable would rise in most instances. Estimates made by SSA's actuaries and the Congressional Budget Office (CBO) suggest that in a typical case 95% of benefits would be taxed using private pension rules (in lieu of the current maximums of 50% and 85%, depending on income).

The potential impact of these provisions of S. 1792 and the Ball plan is clearly illustrated by examining the case where recipients now pay no income tax on their benefits. These retirees could incur as much as a 14.25% reduction in benefits (or in the value thereof on an after-tax basis), or, although unlikely, as much as a 26.6% reduction in benefits depending on their other income and income tax bracket. The reduction of 14.25% would be the maximum impact if 95% of a recipient's benefits fell into the first income tax bracket (15% × 95% of benefits); the 26.6% reduction would occur if 95% of the benefits fell into the second income tax bracket (28% × 95% of benefits).

While the "zero bracket amount" (the combination of personal exemptions, regular standard deduction, and, if applicable, additional deductions for the elderly) would cause these proposals to have little or no impact on the lowest income retirees, those affected would not be exclusively high-income retirees. For example, if the proposal were fully effective in 1998, an age 65 retiree receiving an average Social Security benefit of $765 a month and having other annual income $8,000 would pay $1,308 in new income taxes. In other words, this person would go from paying no income taxes under current law to $1,308 under the proposal. Counting both the Social Security benefits and other income, his or her total income would be $17,180, which is considerably below the estimated average wage of $27,898 (under the trustees' intermediate assumptions).

This potential impact of S. 1792 and the Ball plan is not reflected in Tables 2 and 3 above, and its omission distorts the potential benefit reductions these plans would make relative to the NCRP plan. The fact that the current law income exemptions for the taxation of benefits (i.e., $25,000 for a single recipient and $32,000 for couples) are not indexed does mean that a greater proportion of future retirees will find that at least part of their benefits is taxable. However, it will take many years before inflation makes these exemptions meaningless. Assuming the trustees' projected inflation rates, the zero bracket amount for a single elderly retiree may reach $20,000 by the year 2025, but the annual benefit for an average-wage earner retiring at 65 in that year is projected to be $30,208. Under current law, if this retiree had $20,000 in other income, $5,438 of his or her Social Security benefit would be taxable at a 15% rate. The income tax paid on these benefits would be $816, which means the benefits would be 3% lower on an after-tax basis. Under S. 1792 and the Ball plan, $28,000 or more of the benefits would become taxable at a 15% rate, thereby reducing the value of the annual benefits by $4,200. This means that the benefits would be 14% lower on an after-tax basis.

Hence, taking the after-tax effects caused by the increased taxation of benefits into account narrows the difference in the size of the cuts between S. 1792 and the NCRP plan, and shows that the reductions under the Ball plan are not negligible (albeit still considerably smaller than the other two plans).

COLA reductions to adjust for perceived overstatements of inflation—All three plans would make reductions in Social Security COLAs to offset perceived overstatements of inflation as measured by the BLS's monthly Consumer Price Index (CPI). This is the index used to adjust Social Security benefits so that their purchasing power does not decline over the recipients' years on the benefit rolls. While all three plans appear to have the same motivation, they assume different degrees of inflation overstatement by the CPI. S. 1792 assumes the largest amount—1 percentage point annually. The trustees assume in their intermediate projections that the CPI will rise at an ultimate annual rate of 3.5%, and that COLAs of this amount would be paid annually. S. 1792 would reduce these COLAs by 1 percentage point annually, in essence, providing estimated COLAs of 2.5%, instead of 3.5%. The NCRP plan assumes the overstatement is 0.5 percentage point annually, and therefore it would provide estimated COLAs of 3%, instead of 3.5%. The Ball plan assumes the overstatement is 0.3 percentage point annually, and thus would provide estimated COLAs of 3.2%, instead of 3.5%.

The real impact of these proposals is not adequately reflected in measurements of "initial" benefit impacts, particularly when looking at retirements occurring near age 62. Under current law, "initial" Social Security benefits are adjusted to reflect COLAs granted in and after the year in which a worker reaches age 62, regardless of whether the worker joins the benefit rolls in that year (this keeps workers who delay retirement beyond age 62 in the same position with respect to inflation as workers who retire at age 62—simply put, they are not disadvantaged because they didn't retire early). A worker retiring at age 65, for instance, will have 3 years' worth of COLAs built into his or her "initial" benefits at age 65.

This aspect of the COLA reductions in the three plans is reflected in the actuaries' illustrations of "initial" benefit impacts, but the lifetime impacts of these cuts are not. For instance, under the Ball plan, as illustrated in Tables 2 and 3, the "initial" benefit reduction for an age 65 retiree is less than 1%. This is entirely the effect of reducing COLAs by 0.3 percentage points for 3 years. However, by age 80, this retiree's benefits would have been reduced by 0.3 percentage points for 18 years. With current law COLAs assumed to be 3.5%, this proposal would result in benefit levels at age 80 that would be 5.1% lower than under current law and at age 95, 9.1% lower. As reflected in the following table (Table 4), the late-life impacts of COLA cuts in S. 1792 and the NCRP plans would be considerably larger.

Table 4. Projected Impact on Social Security Benefit Levels From Proposed COLA Reductions Contained in S. 1792, NCRP, and Ball Plans

Impact on benefit level at age:	Benefit reduction at each age as % of current law benefit payable at that age[a]		
	S. 1792	NCRP	Ball plan
65	2.9%	1.4%	0.9%
67	4.7%	2.4%	1.4%
80	16.0%	8.3%	5.1%
95	27.4%	14.8%	9.1%

[a] Note that these estimates reflect only the late-life impact of the COLA reductions, not the late-life impact of the plans in their entirety. For instance, the actuaries' memorandum shows that the reductions in benefits taking all the benefit reduction provisions of S. 1792 into account are 32% and 41%, respectively, at ages 80 and 95.

The SSA actuaries estimate that the reduction in lifetime benefits is about 3% under the Ball plan, 5% under the NCRP plan, and 10% under S. 1792.

Taking these lifetime COLAs effects into account again narrows the difference in the size of the reductions made by S. 1792 and the NCRP plan, and better illustrates the reductions potentially arising from the Ball plan (although the Ball plan's reductions still would be much less than those caused by the other two plans).

The lengthening of the earnings "averaging period" for computing Social Security benefits—Under current law, Social Security benefits are computed from a worker's earnings record averaged over a 35-year period. The highest 35 earnings years are counted. All three plans would lengthen this averaging period. S. 1792 and the Ball plan would lengthen it to 38 years. The NCRP plan would lengthen it to 40 years. The impact of this change is not reflected in the actuaries' illustrations of "initial" benefit impacts largely because the illustrations reflect careers of steady earnings that exceed 35 years. However, the proposal's largest impact would be on workers with careers of erratic earnings, that may include significant periods of not working. For instance, a worker retiring at age 65 in 1998 with a 35-year career of average earnings would receive a monthly benefit of $938. If the averaging period were 38 years in length, this worker would have 3 years of zeros in his or her earnings record, and this would lower the average earnings level used to compute benefits. In this example, the worker would receive $885 in monthly benefits, representing a 6% reduction from the current law level. If the averaging period were 40 years, the monthly benefit would be $854, representing a 9% reduction.

Hence, this proposal, as with the proposals to increase the taxation of benefits and reduce annual COLAs, has the potential to reduce benefits further than that shown by the actuaries' illustrative "initial" benefit impacts. The actuaries point this out in their memoranda by stating that even though the provision would have a negligible impact in the examples they use, overall the provision would reduce the total benefit cost of the Social Security system by 3%. Obviously, the longer the averaging period, the greater the reduction in benefits. In this respect, the provision in NCRP plan would cause the largest reductions since it would lengthen the averaging period by 5 years, whereas S.1792 and the Ball plan would lengthen it by 3 years.

Conclusion

In summary, using the SSA actuaries' analyses of the impacts of S. 1792, NCRP, and the Ball plan, the NCRP plan would cause the largest reductions in benefits for the Social Security system in the aggregate and as well as in individual recipient cases generally. S. 1792, however, does make a larger reduction in annual COLAs and increases the taxation of benefits (the NCRP plan does not). Thus, it is highly probable that in many instances the benefit reductions caused by S. 1792 would approach or even exceed the size of those arising from the NCRP plan. The Ball plan would clearly make the least reductions of the three plans, but they are not necessarily negligible as one might deduce from looking only at the plan's impact on "initial" Social Security benefits.

Chairman BUNNING. Our first panel we will hear from today starts with Dr. Michael Boskin, senior fellow from the Hoover Institute, and Tully M. Friedman, Professor of Economics from Stanford University; Dr. Peter Diamond, Institute Professor from the Massachusetts Institute of Technology and, cochair of the National Academy on Social Security's Panel on Privatization of Social Security; Francis Cavanaugh, former Executive Director of the Federal Retirement Thrift Investment Board; and, Dr. Sylvester Schieber, vice president of Watson Wyatt Worldwide—that's a mouthful—Member of the Social Security Advisory Board and former Member of the 1994–96 Advisory Council on Social Security.

Dr. Boskin, if you would begin please.

STATEMENT OF HON. MICHAEL J. BOSKIN, TULLY M. FRIEDMAN PROFESSOR OF ECONOMICS, AND HOOVER SENIOR FELLOW, STANFORD UNIVERSITY; AND FORMER CHAIRMAN OF THE COUNCIL OF ECONOMIC ADVISERS

Mr. BOSKIN. Thank you, Chairman Bunning, Mrs. Kennelly, and other distinguished Members of the Subcommittee. It's always a pleasure to have the opportunity to appear before the Committee and any of it's Subcommittees. I've been doing this for two decades in formal sessions such as this, and informal retreats on trade, tax, and entitlement issues, and I've always found this Subcommittee to be an arena, despite the various political issues that arise, where people need to and take the time to understand the complexities of complex issues.

I want to commend you for your series of hearings. There's a lot of discussion and argumentation out in the public about what some programs would do—pro and con—that I think is overly simplistic. So I applaud your investing this much time and energy in exploring these important issues.

I want to make three big points and one little one, and leave much of the fleshing out of the smaller one to questions and answers. The first big point is to help set the context for why it's important to seriously consider the adoption of a personal account, or an individual account, component to Social Security.

There are those who would argue that Social Security is in very good shape, it's current operating surpluses demonstrate that current revenues are exceeding current outlays, that by the intermediate projections, all we'd have to do is raise taxes 2.25 percentage points today and we'd have 75-year actuarial balance. I think that's very misleading—that we'd still have a large actuarial balance. Thereafter, there is an enormous unfunded liability in the current projected Social Security benefit stream several times the current national debt.

If we wait and do nothing and act passively, or nibble around the edges and don't do something in the near future, the types of tax rates we will ultimately wind up with will be on the order of 50 percent higher than today. And we have a similar set of issues, not quite as severe, but a similar set of issues in Medicare. And that is likely to lead us to Western European style tax rates. The high tax rates in Western Europe relative to the United States are one of the major reasons why those several hundred million people have had a stagnant economy and no net private sector job growth in a quarter century. I would not like to see a similar fate await us.

There's also considerable evidence that the level and structure of Social Security are one of the reasons for the low personal saving rate in the United States and for the substantial reduction in the labor force participation of people 55 and over in the United States.

I say these things just to state that there's far more at stake than just the future of Social Security, as vitally important as that is. This program is so large and so important, affecting virtually every American now and in the future as a taxpayer and potential recipient, or actual recipient today, that how you deal with this can have major impacts on our overall economy.

So the impacts of any reforms you take will be direct through taxes and benefits, and structure of the system, and also will be spread widely among all Americans through the impact it has on the economy.

We all know the demographic trends. Most of the emphasis focuses on the coming of age and the impending retirement of the baby boom generation. There's also been an enormous increase in the life expectancy of the elderly. It's going up 1 month a year, every year. So it's like every year we live, we get a bonus month in expected value terms. That's unambiguously good news by the way, even though it imposes extra costs on Social Security.

But it does raise an issue, for example, about how you deal with people who are very old and whether the system that was set up at a time when there were very few old people, is the one we want 20 or 30 years from now.

So I think—and also I would add, that this demography suggests that if something isn't done now, in the next 1, 2, or 3 years, and we wait until the baby boomers start to retire, the fraction of voters who will be in the system or about to be in the system, and hence who will resist any change in their benefits and try to have any resolution of the long run actuarial problems be taxes on future workers will go up precipitously. So I think there's a political urgency of the problem that is not often appreciated.

I believe personal accounts are a very important, promising, and perhaps even vital component of an overall system of Social Security reform. Along with my Stanford colleague, John Shoven, and Laurence Kotlikoff of Boston University, at the time of the 1983 reforms, I proposed a system of personal accounts for some of the same reasons and some others in a different context than is discussed now.

But I think it is important to establish that the establishment of personal accounts done properly—and you'll hear much more of that from the rest of this panel and the next—has the capacity to increase the saving rate, particularly among low- and lower-middle-income people who are liquidity constrained. It is likely therefore to take some pressure off of Social Security in the long run, as well as to have some good effects directly on those people.

And, importantly, and I think this is a generic social comment, I believe it is tremendously important for us to extend the benefits of asset ownership to those who currently have or are likely to have very little assets at retirement. I would say it's analogous to avoid disenfranchising, as has occurred in Europe, tragically, a large part of the potential workers from the labor market.

The personal accounts obviously come in many forms. You've discussed some in previous hearings. There were different proposals from the advisory council. Most of the discussion recently limits them to the retirement component of Social Security, leaving disability, HI, hospital insurance survivors, and dependents components in the defined benefit system.

And there are many choices and combinations—mandatory or voluntary contributions made by or through individuals, employers, collected by the government; funds invested by the government or contracted out to private financial institutions, or directly from individuals or employers to private institutions.

The funding that has been proposed in some instances comes from an allocation of a part of the FICA tax, and others from refundable credits from current and projected future budget surpluses, that is, from general revenue.

Chairman BUNNING. I'm going to have to interrupt, because you have run out of time—if you would wrap up your testimony, I would appreciate it.

Mr. BOSKIN. Sure. I would just say that it is important, as you look at these, and as you decide which of the many possibilities for establishing personal accounts is the best system, that you take into account the entire Social Security system. Do not, as the recent CRS proposal analysis did, ignore the benefits from the individual accounts when you look at people's benefits. Do not assume that using the surpluses doesn't have an opportunity cost in terms of foregone tax cuts or other uses of those funds.

And in doing so, I believe that you'll come to the conclusion that personal accounts can be an important component of Social Security reform that strengthens the system, provides greater individual incentives, strengthens the economy, and dramatically reduces the need for very large future tax increases that would be very damaging for the economy.

Thank you very much.

[The prepared statement follows:]

Statement of Hon. Michael J. Boskin, Tully M. Friedman Professor of Economics and Hoover Senior Fellow, Stanford University; and Former Chairman of the Council of Economic Advisers

I. INTRODUCTION

Social Security is probably the nation's most popular social program. It is also one of the sources of the substantial reduction of the poverty rate among the elderly. Social Security annually collects hundreds of billions of dollars in taxes from more than 100 million workers, and pays benefits to over 40 million retirees, survivors, dependents and disabled persons. But Social Security also faces severe long-term challenges. The unfunded liabilities amount to over $10 trillion. If Social security continues on its current pay-as-you-go basis, it will have to reduce benefits substantially or raise taxes to a level that is likely to seriously impede the performance of the economy. For example, waiting passively for the deficits to occur in about 10 to 15 years, would mean that payroll tax rates would eventually have to rise to almost 19 percent of payroll. Alternatively, tax revenue would cover only ¾ of projected benefits. An additional large payroll tax increase would be necessary to cover the remaining unfunded liabilities in Medicare.

Increases in tax rates of this magnitude would move us close to Western European levels of taxation. Such high rates of taxation are a major reason why Western

Europe has stagnated in recent years. In fact, combined with the extremely generous social welfare payments, heavy handed regulation of business, and extensive labor mandates, European public policies have made it virtually impossible to create private sector jobs in Western Europe. Compared to 1970, there are 35 million more working age people in Western Europe, but no more private sector jobs, and vast increases in long-term unemployment. If we allow ourselves to wait passively and merely raise taxes to deal with the demographic transition in Social Security and Medicare, a similar fate may await us.

There is considerable evidence that the level and structure of Social Security taxes and benefits is also one of the reasons for the low personal saving rate, particularly for low income people, and for the substantial reduction in labor force participation among those over 55. Further, since the payroll tax comes on top of the income tax, it raises marginal tax rates which distort decisions even higher.

I raise these issues to reiterate that there is far more at stake than the future of Social Security in how we go about strengthening the program without worsening incentives for employment, saving and production in the private economy.

Demographic trends suggest that it is important to deal with these problems soon. We are transitioning from a relatively stable one retiree for every 3¼ workers to about one for every two. Some say that there's not much of a problem, a 2.25 percentage point increase in the payroll tax deals with the 75-year projected actuarial deficit and that is no big deal. This is both wrong and dangerous.

First, some perspective on the 2.25 percentage points. This is roughly double the short run temporary defense buildup in the Reagan years. That buildup, one of the major causes of the collapse of Communism, was enormously controversial. We have been overdoing the defense drawdown in the post-Cold War era. Comparing the two scenarios, something twice as large for 75 years as opposed to half as large and temporary for six or eight years, underscores how substantial the increase would be. Second, the 2.25 percentage points is disingenuous. While it is always difficult to forecast demographic trends in the distant future, the current projections would leave Social Security with only enough revenues to pay about three quarters of the projected benefits for the indefinite future including well after the 75 year projection horizon. The 2.25 percentage point payroll tax increase would have to be doubled about to 4.5 percentage points to deal with the problem on a sustained basis. That amounts to over a 33 percent increase in the Social Security payroll tax.

Third, as noted above, these figures reflect the gap if the large tax increase occurred *now*. If, instead, nothing is done in this period of short-term "operating surpluses," much larger tax increases or benefit cuts would have to be implemented once the Baby Boomers retire. The tax increases or benefits cuts would not just be much larger, but the political system would be biased toward tax increases if we wait. That is because the longer we wait, the larger the fraction of the voting population that will be receiving, or about to be receiving, benefits, and unlikely to vote to slow their growth, as opposed to raising taxes on the next generation to pay for them.

Finally, any major change in Social Security should be done gradually with a grace period so that those already retired, or about to retire, do not suffer any major discontinuity in what they have come to expect, and, correspondingly, those young and middle-aged workers can plan for a somewhat different system over enough years that they can adjust their private saving and future retirement planning behavior as necessary without any radical disruption. As can be seen from my remarks, I believe there is an economic and political urgency to reform, strengthen and improve the Social Security system.

II. Personal Accounts

As one of the first people to propose a system of personal accounts, (with my Stanford colleague John Shoven and Boston University economist Laurence Kotlikoff in the early 1980's) there are many reasons why I believe it is a good idea to have a private component of Social Security. These include, but are not limited to, the following: potential increases in private and national saving accompanying a likely increase in the private saving of low and middle income individuals who currently save very little and have historically arrived at retirement with very little liquid financial assets. The additional saving would be good for the economy in general, but just as important, this would take some pressure off of future Social Security finances. Perhaps most important, from my standpoint, are the tremendous societal benefits that could develop from extending the benefits of asset ownership to those who currently have, and are likely to have at retirement, little financial assets. Just as it is important not to disenfranchise a large segment of the population from the labor market, as has tragically occurred in Europe, I believe it is also important that virtually all Americans have some stake in the capital markets.

Personal savings accounts come in a variety of flavors, proposals and types. Most of the discussion recently limits them to part of the retirement component of Social Security, leaving the disability, hospital insurance, survivors and dependents components of Social Security in the current defined benefits system. Participation could be mandatory or voluntary. Contributions can be made by individuals, employers, or collected by the government. Funds can be invested by the government or contracted out to private financial institutions. This funding comes from dedicating a portion of the current or projected future payroll tax, or from general revenues including the projected future budget surpluses. This can be done by directly establishing individual accounts or by providing a refundable tax credit for individual contributions. Each of these characteristics of a personal saving accounts component of Social Security has pros and cons under different scenarios. These involve trade offs. For example, the takeup rate for refundable credits historically has been well under 100%. Importantly, the administrative costs of handling lots of small contributions might be substantial from the viewpoints of small businesses with few employees or private financial institutions administering such accounts. In order to prevent those with modest contributions because of low earnings or part-time employment from being priced out of the market or obtaining (net of fees) lower rates of return, the government might wish to require private financial institutions to take all comers with a uniform basis point fee. All current proposals maintain a defined benefit system, either quite similar to the current system, or at least sizable minimal benefit for those whose private accounts have, for whatever reasons, not accumulated enough to finance a minimal level of retirement consumption. Where to draw the appropriate tradeoff between what remains in a payroll tax financed defined benefit system and a however financed individual retirement defined contribution system is a question of economics, politics, and other considerations.

While I strongly favor the establishment of an individual defined contribution account, it is important not to mistake the important benefits of such a program with the still larger set of issues necessary to adequately reform Social Security.

Much of the current debate on establishing personal saving accounts suggests using the projected federal unified budget surplus in coming years to get them started (for example with refundable tax credits). While I believe the case for establishing individual accounts is strong, it is important to keep two things in mind: First, the projections of budget surpluses are exactly that, projections. Second, when comparisons are made of what is likely to be accomplished with individual accounts relative to the long run actuarial deficits in Social Security, or how differently situated individuals and groups fare with respect to such a program, that the measurement be done against an appropriate baseline projection. For example, one proposal establishes two percent individual accounts with refundable tax credits financed from projected budget surpluses. Assuming a continued equity premium along historic lines and a reasonably high fraction invested in equities, would be sufficient, combined with a high rate of reduction (say 75 percent) in future Social Security benefits for each dollar withdrawn from future individual accounts, it is argued, to finance future benefits without a tax increase. While I believe it is likely that such a proposal would make a sizable dent in the long term actuarial deficit, I do not believe it is certain that it will, and it is very likely that it will not cure the entire long term actuarial deficit. To do so, I believe, would require some additional slowdown in the growth of benefits and/or additional financing.

Third, use of surplus funds for establishing individual accounts may well be a good idea, but it does not come free. We should not fall into a trap of mathematical illusion by the number zero. Projected surpluses are coming from somewhere, namely tax revenues are exceeding outlays, and included in any calculation of who wins and loses by how much must be the opportunity costs of not using the budget surpluses to lower taxes. Lower taxes, especially lower tax rates, would strengthen the economy and, of course, are also part of what households would be giving up in terms of their own private saving and consumption, if personal accounts are financed by budget surpluses.

There are two additional concerns that should be kept in mind with the establishment of personal accounts. First, the impetus for establishing them has undoubtedly been given a booster shot by the recent strong performance of the stock market. This is certainly making the public much more willing to consider investments in equities themselves, and for Social Security trust funds and any individual component of Social Security. Again, it is likely that an equity premium will continue over long periods of time, but we should be aware that extrapolating the historical premium, may or may not prove reasonable.

Second, most younger workers seem to believe that Social Security is almost certain to go broke. While this is undoubtedly an exaggeration—see the discussion above—it is certainly true that the expected returns to each successive cohort of workers has been declining. The early cohorts of retirees received tremendous returns on their and their employers' contributions; large multiples of funds paid in plus interest. Those early windfalls are gradually dissipating and turning to returns that are likely to be considerably below what could be earned in private capital markets. Hence, many young workers are skeptical of receiving back much of a return, or even some of the principal, that they paid in on their Social Security taxes. On the other side of the age spectrum, however, are many millions of retirees, approximately one-third of which are not very well off. Any transition from the current pay-as-you-go financing of Social Security system to a privatized defined contribution system must account for continued payments for whatever benefits (I assume not radically different from current benefits) that current and about to retire workers will receive. Hence, one cannot immediately move to a system of defined contribution accounts, even a modest one of say two or three percentage points of payroll, without finding additional taxes somewhere. It may be additional taxes already scheduled or projected in budget surpluses, but they are additional revenues. For perspective, moving to a complete funding of the transition to full individual accounts would require ten trillion dollars in recognition bonds or massive tax hikes. While some believe that so-called recognition bonds have very little impact on the economy, I believe this is a risky assumption.

There are a number of substantive and practical issues raised by the many proposals to establish personal defined contribution accounts. Let me briefly mention several. Among the generic issues are the following:

1) What options should workers have about how to invest their contributions?

2) What rules govern withdrawals?

3) How should spouses be treated?

4) How can the administrative costs be minimized, especially those associated with small accounts?

Numerous tradeoffs exist in achieving desired goals. For example, the more choice afforded workers on their investments, the more likely that some will do relatively poorly, thereby increasing pressure to make up the difference later. Clearly, even minimal education knowledge of the principles of investing is not universally, or at least likely to be universely followed. While, in principle, I favor substantial choice, in practice some guidelines/regulations would have to be imposed. At the very least, an array of broadly diversified, perhaps index, fund choices should be available. Withdrawals should either be in the form of (joint survivor) annuities, or some minimum balance should be maintained. Care should be taken that benefits for surviving spouses not be jeopardized, with contributions sharing and/or some other vehicles.

Finally, I believe administrative costs especially for small accounts can be a serious problem for small businesses, low earners and/or private financial institutions. The record keeping, checking errors, accounting, trustee, legal and investing costs would be large relative to small periodic contributions from low earners or part time workers. I believe technology and financial innovations are driving these costs down, as the availability of no load mutual funds such as through Schwab's OneSource, demonstrates. However, I believe it will be necessary to require financial institutions administering such accounts to charge the same fees to all workers irrespective of account size. If the costs are deemed too high, I believe it is important that any government holding of the accounts be temporary, with legislated movement to the private market at a date certain.

CONCLUSION AND RECOMMENDATIONS

The long run actuarial problems of Social Security stem form two primary factors: changing demography and modest projected long term economic growth. The single best thing we can do for Social Security's future is to do everything we can to enhance long run economic growth. Every tax, regulatory, education, litigation, and trade policy issue that comes before this Congress has ramifications for the future of Social Security. We need lower tax rates, more market oriented education and training reforms, expanded rules based trade liberalization, serious tort reform and more flexible, less costly, regulation. Those types of reforms, together with sensible reforms that bring Social Security and Medicare into long term actuarial balance while at the very least preventing the large tax increases that worsen incentives in the economy, and at the best, actually strengthen incentives, are the most important thing that can be done to strengthen Social Security and beyond that the nation's long term economic prosperity.

Thus, while I strongly favor the establishment of individual accounts, or personal saving accounts, it is important not to overstate their many potential benefits and ignore the other financial and structural issues that will have to be dealt with as part of Social Security reform over time. I do believe that a sound system of personal security accounts can be established at a modest rate (perhaps 2 or 3 percentage points of payroll) and financed and administered in such a way that the benefits of the program vastly exceed its costs. I believe the primary benefits would be a modest increase in the saving rate due to an increase in the saving of low and low middle income households which are currently saving very little; taking some of the pressure off the defined benefits portion of the Social Security system in the future; reducing the need for future damaging tax increases; sharing the sizable benefits (but also the risks) of broader asset ownership to virtually the entire population; and improved intergenerational equity relative to the current system.

Chairman BUNNING. If you have long statements, past the 5 minutes, I would prefer that you enter into the record. Without objection, we'll enter them in.

Mr. BOSKIN. I'd ask for mine, please.

Chairman BUNNING. OK.

Dr. Diamond, if you would continue.

STATEMENT OF PETER A. DIAMOND, INSTITUTE PROFESSOR, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Mr. DIAMOND. Mr. Chairman, and Members of the Subcommittee, I'm pleased and honored to be here today. Some advocates look to individual accounts to substantially—individual accounts with equity investments, of course—to substantially increase the rate of return from Social Security, substantially increase national savings and economic growth. At the same time, some analysts have looked at investment in equities by the trust fund and have concluded that's not an improvement in our retirement income system.

My main message for today is that trust fund investment in equities and individual account investment in equities are very similar to each other. And understanding that similarity will help to understand the role of individual accounts in improving our retirement income system. They're similar, but not identical.

There are three important economic differences. One is the costs are obviously higher with any individual account system than with trust fund investment in equities. Second, the risk characteristics put more of the risk directly on those retiring, if you have individual accounts. And third, the ability to integrate the retirement income system with the disability system; the benefits for children who lose parents; the benefits for divorcees, and elderly divorced women are among the poorest of our elderly—that integration goes better in a fully defined benefit system.

But let me focus on the similarities, because that's the important message I'm trying to bring. Let's trace through what would happen if the trust fund were to buy equities. If the trust fund buys equities, it finances that by holding less in Treasury bonds. The Treasury then has to sell more bonds to the public.

Where does the public get the money to buy the bonds? That's easy—it gets the money from having sold the equities to the trust fund. In other words, this is an asset swap. The public ends up holding more Treasury bonds and fewer equities; the trust fund ends up holding more equities and fewer Treasury bonds. The fact that it's an asset swap means its first impact on the economy is very small. That doesn't mean there aren't important effects over time, but that first impact is very small.

Now let's trace through the same sequence for individual accounts. Assume that part of the payroll tax revenue goes into individual accounts, instead of going to the trust fund. What happens? The trust fund, having less revenue, will hold fewer Treasury bonds. The Treasury will have to sell more bonds to the public.

Where will the public get the money to buy those bonds? They'll get it from having sold equities to the individual accounts. Once again, it is simply an asset swap. And it has, to a first approximation, skipping the three elements I identified to begin with, the same effects.

Individual accounts have the same effects as trust fund investment in the same portfolio. So individual accounts by themselves don't increase national savings. And individual accounts by themselves don't increase a risk adjusted rate of return on Social Security.

To increase national savings, we need to put new revenue into the individual accounts. If we devote new revenue to individual accounts, then we can increase national savings. If we devote the same new revenue to building up the trust fund, we get the same increase in national savings. That new revenue will raise the long run rate of return on Social Security for our children and grandchildren coming down the road.

But in order to get the new revenue, some people have to be giving something up today, whether it's a payroll tax increase, or not getting some tax cut, or benefit from expenditure that might come from alternative uses of the surplus. And that means that the rate of return from Social Security goes down for the people who are financing the new revenue, at the same time that it goes up for future generations who will be benefiting from it.

And that analysis holds for individual accounts and holds for trust fund investment in equities. I could get into the cost differences and the risk differences, but the light's already yellow, and this is probably the right time to stop.

[The prepared statement follows:]

Statement of Peter A. Diamond, Institute Professor, Massachusetts Institute of Technology

Mr. Chairman and Members of the Committee, I am pleased and honored to have the opportunity to appear before you today to discuss the topic of individual accounts for Social Security.

My task for today is to discuss the economics of individual account investment in private securities—and I will focus particularly on equities. Some people favor individual accounts for philosophical or political reasons, but I will discuss only economics. Since equities have had a higher long-run rate of return than Treasury bonds, individual accounts are seen by some as a way to increase the rate-of-return from Social Security.

Social Security investment in equities can be done in three different ways. We can invest part of the Social Security Trust Fund in equities, we can set up government-held individual accounts, similar to the Federal Employees' Thrift Savings Plan (TSP), and we can set up individual accounts that are held by private financial institutions, similar to current Individual Retirement Accounts (IRAs). The three approaches are roughly similar in how they impact national savings and the rate-of-return from Social Security (including the individual accounts). But they differ in their administrative costs, sharing of market risks, need for worker education, and burden on employers.

Let me make three points that apply to all three approaches. First, with all three methods of investing, some increase in expected returns can be obtained, but only by taking on more risk. Second, by themselves, none of the methods directly increases national savings in the short run. Third, none of them has a large impact on the risk-adjusted rate-of-return from Social Security. These conclusions hold whether we create individual accounts or not.

But, there are also important differences among these approaches. First, Trust Fund investment costs less than government-held accounts, which, in turn, cost less than privately-held accounts. Second, workers have more choice with privately-held accounts than with government-held accounts, and no choice with Trust Fund investment. Third, stock market risk is a greater concern with privately-held accounts than with the narrower range of choice from government-held accounts, and stock market risk is a greater concern with any individual account plan than with Trust Fund investment in equities. Finally, privately-held accounts have a greater need for (and expense from) worker education than government-held accounts and both have more need than with Trust Fund investment.

I. National Savings and Rates-of-Return

As has been noted by many analysts, Trust Fund investment in equities rather than in Treasury bonds does not directly raise national savings. To directly raise national savings we need additional net revenue for Social Security, through a tax increase, benefit cut, coverage expansion, or new source of revenue. Without additional net revenue, the value of equities acquired by the Trust Fund is matched by a decrease in the value of Treasury bonds held by the Trust Fund. Similarly, without additional net revenue, diverting some payroll tax revenue into individual accounts leaves less revenue flowing into the Trust Fund. Without additional net revenue, the value of bonds and equities acquired by individual accounts is matched by a decrease in the value of Treasury bonds held by the Trust Fund. In both cases, the public ends up holding more Treasury bonds and less equities outside Social Security. Thus, creating individual accounts without additional net revenue does not directly increase national savings.

With or without individual accounts, a decrease in Social Security holdings of Treasury bonds that matches an increase in the holdings of equities is an "asset swap." That is, the aggregate effects of the creation of individual accounts is similar to the effects of a change in portfolio by the Trust Fund.

As has been noted by many analysts, Trust Fund investment in equities reduces the projected actuarial deficit and will increase the expected rate-of-return from Social Security for future workers. However, in our economy this increase in the expected rate-of-return comes with an increase in the riskiness of that return.

Moreover, the added expected return is not enough, by itself, to raise the future rate-of-return from Social Security up to the level of market returns. The reason that the rate-of-return remains below the market return is the presence of an unfunded liability. The unfunded liability exists because Congress voted to give retirees in the 1940's and 50's and 60's and 70's far more in benefits than could have been financed by the taxes each of these groups paid. On average, these retirees were much less well off than are current and future retirees. Most retirees prefer not to live with their children if they can afford to live separately. So current workers are benefiting from seeing that their elders have a better standard of living and that they are capable of living on their own. But current workers must receive a lower return from Social Security in order to pay for the higher returns received by earlier generations.

The same analysis holds for individual accounts. The creation of individual accounts does not change the history that leaves Social Security with unfunded liability. The rate-of-return from Social Security, including both individual accounts and the financing of the transition, is not increased by the creation of individual accounts per se.

An increase in the funds for Social Security, whether in individual accounts or in the Trust Fund, will increase the rate-of-return from Social Security for future generations. But this increase only comes at a cost of lowering the rate-of-return from Social Security for the generations who have to pay to provide increased funds for Social Security, whether they pay in the form of increased taxes, new mandated savings, decreased benefits, or the use of general revenues for Social Security rather than for tax cuts and other expenditures.

In short, individual accounts without an increase in funds for Social Security will not directly raise national savings or increase the risk-adjusted rate-of-return from Social Security. Increased funding will raise national savings and will eventually raise the rate-of-return from Social Security, but only by putting the cost of increased funding on current workers. Increased funding can be done with or without individual accounts.

II. Administrative Costs

Most proposals with individual accounts also continue some defined-benefit retirement program. They also keep Social Security in place to provide benefits to the disabled and to young children when a parent dies. Thus, the current administrative structure and cost of Social Security will continue into the future. Letting the Trust Fund invest in equities will add trivially to this cost. The 1994–1996 Advisory Council on Social Security estimated that the additional cost would be ½ of 1 basis point (½ of one one-hundredth of one percent) for the amount invested in private securities. That is, for each billion dollars invested in private securities, the annual cost would be roughly $50,000. This estimate seems roughly right.

Any creation of individual accounts will add to costs, because of the need for new institutions and because of duplication of administrative tasks with some proposals. The size of these additional costs depends on the structure of the accounts. The overwhelming bulk of the costs associated with accounts depends on the existence of the accounts, not the precise value of assets in the accounts. While it is common to state costs in terms of basis points charged annually on balances in accounts, I think it is better to think of costs as dollars per person per year. This cost can then be compared with the amounts going to the individual accounts. It is important to remember that the workers covered by Social Security average much lower earnings than do those covered by 401(k) plans. For example, in 1996, 58 percent of workers covered by Social Security had annual taxable earnings below $20,000, and 23 percent had earnings below $5,000.

The TSP cost roughly $23 to $24 per worker in 1997. A worker earning $27,000 per year (roughly mean earnings), would deposit $540 per year with 2% accounts. Thus the costs of the TSP would be 4.4% of the amount deposited. In the vocabulary of mutual funds, we can consider this a front-load of 4.4%. (TSP costs would be 2.9% of mean deposits with 3% accounts and 1.7% with 5% accounts.) Would government-held accounts cost more or less than TSP costs per worker? It is hard to say, since it depends on the details legislated—with a bare bones system some costs would be higher and some costs would be lower (including the provision of considerably less in services than TSP offers). This $23 figure strikes me as a reasonable ballpark number; but it is roughly twice what was assumed by the Advisory Council on Social Security for government-held accounts. Let me put this number into two contexts. First, it would more than double the administrative costs of Social Security. Second, this front load of 4.4% on a 2% account is equivalent to a 4.4% cut in this portion of benefits, compared to what could be financed with the same aggregate portfolio invested by the Trust Fund.

Privately-held accounts would cost more. How much more depends on how withheld funds get to financial institutions, what services are provided and what types of investments people choose. Taxes could be collected as they are now, with deposits by the government into the privately-held accounts once a year. Direct payment to financial institutions by employers or by the workers themselves would raise costs significantly on firms, on workers and on financial institutions. The cost of reconciliation of account deposits with taxes withheld is a particular problem. Moreover, setting up a system of reconciliation would duplicate what Social Security already does in reconciling W–2 forms with both taxes transmitted to the Treasury and Social Security records. Furthermore, direct payment to financial institutions would require additional enforcement efforts on the part of the Internal Revenue Service.

In thinking about how much private firms would charge workers for maintaining these accounts, we need to consider both the direct costs of handling the accounts and the marketing costs and profits of the firms. As with other markets, some firms will set low charges and others will set high charges. The charges will depend on the range of services provided by the firms, on whether they are allowed to charge workers when reallocating accounts after a divorce, and on the regulatory structure placed on these accounts.

It is difficult to know which existing accounts represent the closest approximation to what these accounts are likely to cost. Total costs for 401(k) plan administration vary greatly with the size of the firm and the services provided to workers. They also include the cost of providing information to comply with government regulations, some of which would not be present for Social Security accounts. On the other hand, reconciliation costs for financial institutions are held down since they receive all deposits together from the employer and generally electronically. IRA accounts also have little cost from reconciliation and they receive less regulation than is likely for mandatory accounts, since the government would be more concerned about protecting workers subject to a mandate. Consideration of either 401(k) or IRA accounts show higher costs on average than those of TSP, even with the lowest cost firms. Average charges would be considerably higher than the costs in the lowest cost firms. And charges would be higher (in percentage terms) on smaller accounts, unless the government required firms handling the accounts to offer the same opportunities to all workers.

A different approach to estimating charges is to consider foreign experience with privately-held accounts. Costs in Chile are roughly 20% of deposits each month, equivalent to a 20% front load. As discussed in the appendix, a 20% front load is roughly equivalent to a 1% annual maintenance fee for a full-career worker. A 20% front load or 1% annual maintenance fee seems to me a reasonable ballpark number for what accounts would cost in the US, on average, if they were as big as in Chile −10% of payroll. In Argentina and Mexico, with similar structures but smaller accounts, the charges are higher in percentage terms. In the UK, an advanced economy with privately-held individual accounts, costs are higher than in Chile. So I think that privately-held accounts would cost at least 4 times as much as accounts held by the government in a bare bones system. That is, the part of payroll tax payments that is used to finance benefits through privately-held accounts contains a 20% benefit cut compared with what could be financed by the same aggregate investment in equities by the Trust Fund.

It is common in discussing individual accounts to focus on the accounts and to ignore the additional costs that come with the provision of benefits from the accounts. But it is retirement income, not fund accumulation, that is the central purpose of Social Security. That means that accumulations need to be turned into streams of monthly payments. Annuitization adds to costs. If accounts are not annuitized, workers and their families risk outliving their money. So the costs of annuitization need to be added to the cost of maintaining individual accounts.

III. Market Risk

Estimates of the market risks associated with individual accounts depend on how the past is interpreted as a guide for the future. Estimates of the future performance of the stock market vary in their assumptions on the possibility of very low probability very bad events and on the extent to which the market is currently overvalued, both issues that are in dispute. What we can say is that a defined-benefit approach has the ability to spread the market risk across workers of different ages and different earnings in ways that are not done with individual accounts.

IV. Worker Choice

With Trust Fund investment, workers would have no individual choice on how the assets are invested. With government-held accounts, they would have choice among a small number of index funds. This allows workers to adjust their risk/return combinations by varying their relative holdings of bond and stock accounts. Having privately-held accounts opens up additional options, such as managed investment in equities, wider choice of investments abroad, bank CDs, and insurance company products. Some of this choice will help individual workers tailor their investments to their attitude toward risk. However, it is difficult to assess the investment abilities of different fund managers. And managed accounts have additional administrative costs and additional brokerage charges. Workers should be protected from the most risky choices by limiting investments to widely diversified portfolios or products guaranteed by sound financial institutions. However, limiting investment options requires another layer of regulation. Indeed, it is to be expected that any use of private firms for mandated accounts will involve additional government regulation.

V. Worker Education

The wider the array of choices for workers, the greater the need for worker education. Worker education that really impacts worker decisions is expensive, an issue that is particularly relevant when one is thinking about small accounts. It would be a large burden for firms that do not offer 401(k) plans to require employers to provide adequate education about investment to workers.

VI. Conclusion

Considering only the economics of investment policy, Trust Fund investment in equities can generate higher returns with lower risks than do individual accounts. It also avoids the need for additional regulation that would go with private holding of these accounts. It also represents a system where it is easier to protect lower-earning spouses and low earners generally. But it requires a carefully designed institutional structure for investing well.

Appendix

The wide variety of charges for fund management can be put into a common frame by comparing the ratio of the account accumulation available at retirement with a given set of charges to the account accumulation that would be available if there were no charges. The charge ratio is defined as the percentage decline in account value as a result of the charges. The charge ratio depends on the contribution history of the worker and the rate of return on the portfolio as well as the structure of charges. For a worker with a 40-year career, exponential real wage growth of 2.1 percent per year and a portfolio that earns a real return of 4 percent per year, a 1 percent management fee reduces the value of the account by 19.6%, roughly 20%. That is, for a worker with a 40-year career, the average deposit is charged a 1% annual fee roughly 20 times. Higher wage growth reduces the charge ratio slightly, since more contributions are made later in the worker's career and subject to fewer annual management fees. A lower management fee reduces the charge ratio roughly proportionally over the relevant range.

Charge Ratio

Interest Rate (%)	Wage Growth (%)	Career Length	Front Load (%)	Mgmt Fee (%)	Charge Ratio (%)
4	2.1	40	0	1	19.6
4	2.1	40	0	0.5	10.5
4	2.1	40	0	0.1	2.2
4	2.1	40	1	0	1
4	2.1	40	10	0	10
4	2.1	40	20	0	20

Chairman BUNNING. Thank you.

Mr. Cavanaugh, would you proceed.

STATEMENT OF FRANCIS X. CAVANAUGH, FORMER EXECUTIVE DIRECTOR AND CHIEF EXECUTIVE OFFICER, FEDERAL RETIREMENT THRIFT INVESTMENT BOARD

Mr. CAVANAUGH. Thank you, Mr. Chairman, I'm delighted to be here. I'll comment briefly on the four issues the Subcommittee asked me to address.

First, the effect of Social Security PSA investments on the capital markets would be slight and gradual increases in demand for corporate stocks and possibly other private investments and corresponding decreases in demands for U.S. Treasury securities. As funds are diverted from the Social Security Trust Fund, which is now invested solely in Treasury securities, the Treasury will increase it's borrowing in the private market.

Treasury borrowing costs might increase slightly, but such increases might be offset in part by savings to the Treasury from reducing issues to the trust fund on preferential terms. PSA investments in stock would probably never exceed 2 percent of the capitalization of the U.S. stock market.

Your second issue, the cost and administration of the PSAs, needs much more study. It just hasn't been done. This country has no experience with a mandatory system of individual accounts dependant upon the performance of very small employers and very low-income employees.

In 1994, 46 percent of workers for whom Social Security taxes were paid earned less than $15,000. Assuming 2 percent of a $15,000 income or $300, were invested annually in the PSA, the earnings in such a small account would generally be more than offset by the cost of servicing the account in the first several years of the plan.

The net earnings of the average PSA would probably never equal the net earnings of the funds invested in Treasury securities in the Social Security Trust Fund.

The administration of PSAs for the 140 million Social Security employees, if modeled after the 2.3 million member Federal Thrift Savings Plan, TSP, would require at least 10,000 highly trained Federal employees to man the telephones and answer employee questions.

PSAs would require the cooperation of 6.5 million private employers, most of whom could not meet TSP reporting standards. Federal agencies generally report payroll deductions and other employee data to the TSP on magnetic tape. But over 80 percent of private employers are still reporting to the Social Security Administration on paper, an extraordinarily costly and error prone process. The cost of error corrections, say for failure to make timely stock market investments, would be more than many small employers could bear.

Your third issue, investor education, is a statutory requirement of the TSP. The Office of Personnel Management has the primary responsibility for training, but the Thrift Investment Board itself conducts hundreds of training sessions each year throughout the country for personnel and payroll officers and individual plan participants.

These sessions, along with the TSP summary plan document, animated video, investment booklet, pamphlets, posters, and other materials, require extensive support from the Federal employing agencies. Such support could not be provided by most of the 6.5 million employers in the Social Security Program, given their lack of resources, the relatively low income of the average private employee, and the language difficulty. Meeting TSP standards, if possible at all, could be accomplished only at a price so high as to reduce net investment earnings to unacceptably low levels.

As to your fourth issue, the role of employers, large and small, in the PSA system, large employers with competent personnel, payroll, and systems experts could be expected to perform the functions now performed for the TSP by the Federal employing agencies. Yet most private employers have less than 10 employees. Also, household employers who hire part-time providers of cleaning and other domestic services are obviously ill-equipped to meet the employee information needs of a PSA system.

I believe it would be impossible to establish cost-effective TSP-type PSAs for the Social Security system. That is, the net investment earnings after administrative expenses of the PSAs would be less than the net earnings of Social Security Trust Fund investments in Treasury securities. Nor would the IRA-type alternative be cost effective, because of the relatively high administrative costs of small accounts.

The only feasible way for the Social Security system to benefit from the higher returns offered by the stock market, is to invest a portion of the trust fund in stocks, which is what virtually all large public and private pension and retirement funds have already done.

Thank you.

[The prepared statement follows:]

Statement of Francis X. Cavanaugh, Former Executive Director and Chief Executive Officer, Federal Retirement Thrift Investment Board

My name is Francis Cavanaugh. I was the first Executive Director and chief executive officer of the Federal Retirement Thrift Investment Board (1986–1994), the agency responsible for administering the Thrift Savings Plan for Federal employees. Before that, I served in the U.S. Treasury Department (1954–1986) as an economist and as director of the staff providing advice on Federal debt management and related Federal borrowing, lending, and investment policies. I am currently a writer and public finance consultant. I represent no clients and speak only for myself.

I am happy to participate in this hearing on the administrative costs and feasibility of establishing personal savings accounts (PSAs) within the Social Security system.

SUMMARY

I will comment briefly on the four issues your subcommittee asked me to address.

First, *the effect of Social Security PSA investments on the capital markets* would be slight and gradual increases in demand for corporate stocks and possibly other private investments and corresponding decreases in demand for U.S. Treasury securities. As funds are diverted from the Social Security trust fund, which is now invested solely in Treasury securities, Treasury will increase its borrowing in the private market. Treasury borrowing costs might increase slightly; such increases might be offset in part by savings to the Treasury from reducing issues to the trust fund on preferential terms. PSA investments in stocks would probably never exceed two percent of the capitalization of the U.S. stock market.

Your second issue, *the cost and administration of the PSAs* needs much more study. This country has no experience with a *mandatory* system of individual accounts dependent upon the performance of *very small employers* and *very low-income employees*. In 1994, 46 percent of workers for whom Social Security taxes were paid earned less than $15,000. Assuming two percent of a $15,000 income, or $300, were invested annually in a PSA, the earnings on such a small account would generally be more than offset by the cost of servicing the account in the first several years of the plan. The net earnings of the average PSA would probably never equal the net earnings of the funds invested in Treasury securities in the Social Security trust fund.

The administration of PSAs for the 140 million Social Security employees, if modelled after the 2.3 million member Federal Thrift Savings Plan (TSP), would require at least 10,000 highly trained Federal employees to man the telephones and answer employee questions. PSAs would require the cooperation of 6.5 million private employers, most of whom could not meet TSP reporting standards. Federal agencies generally report payroll deductions and other employee data to the TSP on magnetic tape, but over 80 percent of private employers are still reporting to the Social Security Administration *on paper,* an extraordinarily costly and error prone process. The cost of error correction, say for failure to make timely stock market investments, would be more than many small employers could bear.

Your third issue, *investor education,* is a statutory requirement for the TSP. The Office of Personnel Management has the primary statutory responsibility for TSP training, but the Thrift Investment Board conducts hundreds of training sessions each year throughout the country for personnel and payroll officers and for individual plan participants. These sessions, along with the TSP summary plan document, animated video, investment booklet, pamphlets, posters, and other materials, require extensive support from the Federal employing agencies. Such support could not be provided by most of the 6.5 million employers in the Social Security program, given their lack of resources, the relatively low income of the average private employee, and the language difficulties. Meeting TSP standards, if possible at all, could be accomplished only at a price so high as to reduce net investment earnings to unacceptably low levels.

As to your fourth issue, *the role of employers, large and small, in a PSA system*, large employers with competent personnel, payroll, and systems experts could be expected to perform the functions now performed for the TSP by Federal employing agencies. Yet most private employers have less than 10 employees. Also, household employers who hire part-time providers of cleaning and other domestic services are obviously ill equipped to meet the employee information needs of a PSA system.

I believe it would be impossible to establish cost-effective TSP-type PSAs for the Social Security system. That is, the net investment earnings (after administrative expenses) of the PSAs would be less than the net earnings of Social Security trust fund investments in Treasury securities. Nor would the IRA-type alternative be cost-effective, because of the relatively high administrative costs of small accounts.

The only feasible way for the Social Security system to benefit from the higher returns offered by the stock market is to invest a portion of the trust fund in stocks, which is what virtually all large public and private pension and retirement funds have already done.

I will now discuss these issues in more detail.

THE THRIFT SAVINGS PLAN OR 401(K) APPROACH

The TSP has 2.3 million accounts and is the largest defined contribution plan in the nation, although small compared to any plan for over 140 million Social Security workers. The TSP record keeper maintains a highly trained staff of 150 persons to respond to telephone questions from TSP participants. If the PSA structure were modelled after the TSP, a telephone staff of at least 10,000 would be necessary, especially since PSA participants would generally have less education, income, and employer support than TSP participants.

PSAs in fact could not be modelled after the TSP, which is structured much like the voluntary 401(k) defined contribution plans offered by most large corporate employers. The TSP requires a highly complex central record keeping system, and it depends on the Federal employing agencies and their expert personnel, payroll, and systems people to handle its "retail" operations throughout the world. This includes the distribution of TSP forms and other materials, employee education programs, and individual counselling. Each agency is required to provide employee counselling on all aspects of the retirement system, including the TSP, and the Office of Personnel Management is required under the TSP statute to provide training for the agency counsellors.

Employers are also responsible for the timely transmission of data to the TSP record keeper each payday for each employee's contributions, investment choices, interfund transfers, loans, loan repayments, withdrawals, and other essential information to ensure prompt and accurate investment and maintenance of employee accounts, including the restoration of employees' lost earnings because of delayed deposits or other employer error. While PSA proponents may not contemplate emergency loans or withdrawals, 401(k)s and the TSP permit them. I believe that it would be politically impossible to deny emergency access to funds once their ownership is vested in the names of individual account holders.

Private employers are now required to report individual Social Security tax information only once a year. Surely there would be millions of small employers who would be unwilling or unable to assume the additional administrative burden of PSAs and the corresponding financial liability, for example, to make up for lost stock market earnings resulting from employer failure to process an employee's interfund transfer request on time.

Even if the 401(k) approach were made workable for PSAs, perhaps by adopting (politically unpopular) measures such as exempting small employers or limiting the earnings or options of very small investors, net investment earnings would probably still be much less than would have been earned from Social Security fund investments in Treasury securities. According to the Social Security Administration, 46 percent of Social Security workers, including part-time and temporary workers, earned less than $15,000 a year in 1994. Servicing such small accounts would entail unacceptably high expense ratios.

A PSA deposit of two percent of a $15,000 income would produce contributions of $300 in the first year. Assuming the annual cost of servicing an account is $30[1] (or $4.2 billion for 140 million accounts), then the expense ratio would be ten percent, or 1000 basis points, compared to the TSP net expense ratio of 7 basis points in 1997.[2] That ratio would clearly exceed the real (after inflation) returns from PSA investments in a balanced portfolio of stocks, bonds, and other instruments in the first year of the plan. Moreover, since individuals with incomes below $15,000 tend to be risk averse and thus avoid stocks[3] in favor of lower yielding fixed-income investments, their net earnings (after expenses) would likely be negative for several of the early years of the plan.

By contrast, and contrary to popular belief, the Social Security trust fund now receives a relatively attractive net return on its investments in special issues of Treasury securities. The average annual interest rate on such issues over the past 30 years has been approximately 8.3% (about 3% after inflation). The trust fund is given preferential treatment, compared to private investors in Treasury securities: it is not required to pay any brokerage or security transaction costs, it receives the (higher) long-term interest rate on its short-term investments, and it is insulated from market interest rate risk by being guaranteed par value redemption on securities redeemed before maturity.[4] These securities are safer and more liquid than short-term market instruments such as Treasury bills or bank CDs which pay substantially lower rates.

THE IRA APPROACH

An alternative suggested by some PSA proponents is to require employees to set up IRA-type accounts at private financial institutions selected by the employees. Employers could then be required to send the prescribed percent of pay to the various financial institutions chosen by each of their employees. This IRA alternative has the advantage of being much less burdensome on small employers than the 401(k) approach. Yet IRAs are generally much less cost-effective than 401(k)s because the 401(k)s have the advantage of professional fund management, bargaining power in financial markets, and other economies of scale. The average annual expense ratio for stock mutual funds over the past decade has been estimated by Vanguard at approximately 200 basis points, including transaction costs,[5] and the PSA accounts would be much smaller and thus relatively more costly to maintain.

As indicated above, a typical PSA might have an expense ratio of about 10 percent in the first year of the account. It would take many years before such an account would earn a reasonable net return after administrative expenses. Over the past 30 years, the average annual real (after inflation in excess of 5 percent) return was approximately 3 percent for Treasury bonds, 6 percent for common stocks, and from 0 to a minus 1 percent for Treasury bills and various other short-term instruments, including bank CDs and money market accounts.

Yet many "risk averse" low-income PSA investors would undoubtedly seek the apparent safety and simplicity of a CD or money market account at their local bank or credit union, which would have provided over the past 30 years no net return after inflation (compared to a net 3% return from the Treasury bonds in the Social Security trust fund). Even under the very optimistic assumption that PSA investors would in time allocate their accounts on average one-third to stocks (at 6 percent), one-third to bonds (at 3 percent), and one-third to CDs (at 0 percent), for an average return of 3 percent after inflation (but before administrative expenses), those investments could never catch up with the 3 percent return of the Social Security trust fund.

The suggestion by some that competition would force financial institutions to lower costs substantially is doubtful. The market for personal savings and invest-

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[1] According to the "Report of the 1994–1996 Advisory Council on Social Security, Volume 1" (Washington, D.C.), 100, $30 per year is typical of charges levied for IRAs for flat dollar account maintenance fees.

[2] The net expense ratio is the gross expense ratio minus forfeitures and is the administrative charge to TSP participants. For example, in 1997 the gross expense ratio was .09, and the net expense ratio of .07 represented a charge to participants of $0.70 for each $1,000 of their TSP account balances. The expense ratios have declined steadily since 1988, when the gross ratio was .67 and the net ratio was .34.

[3] In 1995, only 6 percent of families with incomes less than $10,000 and only 25 percent of families with incomes from $10,000 to $25,000 had *any* direct or indirect stock holdings. Arthur B. Kennickell and Martha Starr-McCluer, "Family Finances in the U.S.: Recent Evidence from the Survey of Consumer Finances," excerpt from *Federal Reserve Bulletin*, January 1997, 12.

[4] Francis X. Cavanaugh, *The Truth about the National Debt: Five Myths and One Reality* (Boston: Harvard Business School Press 1996), 158.

[5] The Vanguard Group, "In the Vanguard," Summer 1996 (Valley Forge, PA), 10.

ments is already well established and highly competitive. More aggressive competition for small accounts would add substantial marketing, promotion, advertising, and high pressure sales costs.

Also, given the likely concerns about exploitation of small investors by the sharp practices of many financial advisers and investment managers, Congress would likely impose new regulatory burdens which would add to administrative costs.

Congress specifically rejected IRA-type proposals when it designed the TSP:[6]

Because of the many concerns raised, the conferees spent more time on this issue than any other. Proposals were made to decentralize the investment management and to give employees more choice by permitting them to choose their own financial institution in which to invest. While the conferees applaud the use of IRAs, they find such an approach for an employer-sponsored retirement program inappropriate.

The conferees concur with the resolution of this issue as discussed in the Senate report (99–166) on this legislation:

As an alternative the committee considered permitting any qualified institution to offer to employee[s] specific investment vehicles. However, the committee rejected that approach for a number of reasons. First, there are literally thousands of qualified institutions who would bombard employees with promotions for their services. The committee concluded that employees would not favor such an approach. Second, few, if any, private employers offer such an arrangement. Third, even qualified institutions go bankrupt occasionally and a substantial portion of an employee's retirement benefit could be wiped out. This is in contrast to the diversified fund approach which could easily survive a few bankruptcies. Fourth, it would be difficult to administer, Fifth, this "retail" or "voucher" approach would give up the economic advantage of this group's wholesale purchasing power derived from its large size, so that employees acting individually would get less for their money.

The conferees' concern about giving up "wholesale purchasing power" is very relevant here because investments by individual accounts, rather than by the Social Security trust fund, either in bonds or stocks, would be an enormous sacrifice of wholesale purchasing power.

Of course, the conferees' comments were from the perspective of the Federal government as an employer; it is not clear whether Congress would take a more or less paternal view in the case of Social Security.

The insurmountable problems with the PSA proposals are that (1) they shift Social Security from central financing to small individual accounts, thus losing economies of scale, and (2) they shift the investment risk from the group to the individual, thus violating the first principle of insurance.

Both economically and administratively, Social Security taxpayers would be much better off if any stock or other security investments were made by the collective Social Security fund, rather than by individual investments. Based on the assumptions in the 1997 report of the Advisory Council on Social Security, a gradual investment in stocks of up to 40 percent of the Social Security trust fund would produce a stock portfolio of an estimated $1 trillion (1996 dollars) in 2014. Yet the rapid development and growth of a variety of index funds in the United States and abroad should provide ample opportunities for substantial diversified investments of Social Security funds with minimal market impact. The capitalization of the U.S. stock market today is approximately $12 trillion, and at the Council's assumed growth rate it would be close to $40 trillion in 2014. The Council also contemplated investment in foreign stocks, which would reduce the estimated impact of Social Security stock investments on the U.S. stock market to less than 2 percent. (PSA investments of just two percent of incomes would of course have a much smaller impact on the stock market.) The Council's assumed 40 percent allocation to equities is quite modest—a 50 percent allocation would be more in line with the portfolio mix of other retirement funds. The TSP currently has 51 percent in equities, and *Pensions and Investments* (January 26, 1998) reports that the top thousand defined benefit plans hold 62 percent of assets in equities and that the top thousand defined contribution plans hold 65 percent in equities. Based on the Advisory Council's investment return assumptions, a 50 percent allocation to equities in the Social Security fund would slightly more than double the investment earnings of the fund.

To those who say that an individual account approach is needed to increase real savings in our economy I would say that such real savings would be significantly reduced by the high administrative expenses associated with small individual accounts—greater real savings would be realized by channeling any increased Social Security taxes into centralized investment in the Social Security trust fund. To those who say that an individual account approach is needed to change the income redistribution or generational effects of Social Security financing I would say the

[6] H.R. Rep. No. 99–606, at 137–38. *reprinted in* 1986 U.S.C.C.A.N. 1508, 1520–21.

first priority should be to enlarge the total Social Security pie, through more rational investment policies, so that we may better deal with any equity issues—a rising tide lifts all boats. Then those who would change the distribution of shares, by income or generation, could do more for some without hurting others so much.

Even if some sort of PSA is added to the Social Security system, a large portion (I would suggest up to 50 percent) of the remaining Social Security trust fund clearly should be invested in equities, which is what virtually all large public and private pension and retirement funds now do.

Chairman BUNNING. Thank you, Mr. Cavanaugh.

Dr. Schieber.

STATEMENT OF SYLVESTER J. SCHIEBER, PH.D., VICE PRESIDENT, WATSON WYATT WORLDWIDE; AND FORMER MEMBER, 1994–96 ADVISORY COUNCIL ON SOCIAL SECURITY

Mr. SCHIEBER. Thank you, Mr. Chairman. I'm also pleased to appear before the Subcommittee today to talk about this vitally important issue.

In my prepared remarks, I address each of the major questions that the Subcommittee put forward. The primary basis of my comments today will focus on the administrative issues, and if I have time, I'll speak a bit to the employer issues as well.

In establishing a PSA system, legislators will have to create an administrative system and regulatory structure that is efficient. Here there are two general approaches. First, we could create a centrally structured system along the lines that you just heard Mr. Cavanaugh advocate. The second would establish a regulatory framework for workers to create their own PSAs through a myriad of investment options available in the financial markets.

There are two fundamental issues at stake. One is the desire to minimize administrative costs. The other is the desire to minimize the intrusion of the Federal Government in the free operation of businesses and it's citizens in carrying out their economic activity. These two considerations pull in opposite directions.

There is no doubt that concentrating the administration of a personal account program within a single entity would render potential economies of scale. On the other side, the question is whether we can craft a system that allows workers' freedom in setting up their own accounts that have acceptable costs associated with them.

In my prepared testimony I explore ways to set up a system of accounts that would give workers more flexibility than a centrally managed system would. I cannot go into that fully here.

But to prove that such a system is achievable, we can look at Australia, which has established a national individual account system. Under their system, workers accounts tend to be organized at the employer or the union level. Under their system—the system is measured by the Australian Bureau of Statistics—the administrative costs run about 90 basis points a year, about nine-tenths of 1 percent.

A question raised by the added costs involved in a more flexible system is why we would to bear such costs, unless they were absolutely unavoidable. There are two parts to the answer.

The first is an assessment of whether the Federal Government can be an accumulator of a substantial share of our capital base. In my prepared remarks, I look at the historical debate and attempts at funding Social Security. Frankly, I do not believe that we can prefund these retirement obligations directly through government accumulation.

The second part of the answer relates to whether it is desirable to have the Federal Government be a substantial owner of our private capital base. Again, I do not believe that this Congress, or any future one, can create a firewall around a centrally managed fund that will insulate the fund from political manipulation. I think that's very important.

Undoubtedly, the establishment of a mandated system of individual retirement accounts will create the need for more education on investment than is now available. The research that I have done on 401(k) plans, however, is instructive of how people actually behave when they have retirement assets that they control themselves.

Our research indicate that workers in 401(k) plans invest in reasonable patterns. Older workers invest more conservatively than younger ones. Low-wage workers invest more conservatively than high-wage workers. We have found that women are as effective, if not more so, in their use of 401(k) plans than their male counterpart.

Our results do not mean that education to the public about investing will not be a challenge. It does suggest, however, that it's not an insurmountable one. Indeed, I believe it is not only doable, I think it is also highly desirable.

Employers' role will depend on the nature that reform takes. In Australia, the provision of individual accounts is generally implemented at the employer level. In Chile, employers have very little role.

One of the things that people are worried about, if we implement a reform of this sort, is that employers will cut back on their own commitment to their own plans. As I point out in my prepared testimony, that really depends on whether or not the reformed system becomes more generous than the current system. If it does, it is likely employers will curtail their plans. If it is not more generous, there is no reason for them to do so.

In closing though, I think there is one thing everybody should be aware of. There is some prospect that employer plans will be curtailed in the future, because they're facing the same kind of cost pressures that Social Security is facing. And so I think it makes Social Security reform an even more important that we figure out how to secure these benefits that we have been holding out to people. And I frankly believe a personal account option is a superior way to do that.

Thank you very much.

[The prepared statement follows:]

Statement of Sylvester J. Schieber,[1] Ph.D., Vice President, Watson Wyatt Worldwide; and Former Member, 1994–96 Advisory Council on Social Security

Mr. Chairman, I am pleased to appear before the Subcommittee on Social Security of the Committee on Ways and Means today. I am here to discuss the potential structure of personal security accounts (PSAs) as part of the Social Security system and the effect that such accounts would have for financial markets, workers and retirees, and business. As you are aware, Carolyn Weaver and I, as members of the 1994–1996 Social Security Advisory Council, authored the PSA proposal put forward by that Council. Thus, it should be clear that I come before you as a proponent of the type of Social Security reform this hearing is meant to explore.

In my testimony today I address a number of the issues you raised in your letter asking me to testify before you. First, I will address the potential effect of PSA investments on the capital markets. Second, I will comment on the potential cost and administration of PSAs; issue of administration and management of the accounts. Third, I will discuss the need for investor education if such a reform model were to be adopted. And finally, I will evaluate the potential role of employers in a PSA system.

Given that we are prognosticating about the prospects of a reform model that has not yet been implemented, I trust you understand that my testimony about the impacts of the model is based on observations about how the world as we know it works. To the extent that reform would change the world, the outcomes might be different than those I postulate here. However, I do not believe that they would be wildly so.

THE POTENTIAL EFFECTS OF PSAS ON CAPITAL MARKETS

The capital markets in the United States are the largest in the world and are among the most highly developed in the world. Despite their magnitude and state of development, it is likely that the adoption of a PSA-type policy would affect our financial markets leading some to voice concerns about the implications of a policy change of this sort.

One of the concerns often voiced by critics of individual accounts is that the creation of such accounts and the investment in them might lead to artificial inflation of asset prices. Put more directly, the concern is that we would have more money pouring into the markets driving up the prices of assets without adding to the underlying value of the assets themselves. While the adoption of a PSA proposal might have an effect on market prices at the time it was adopted, over the longer term the effects on asset prices will be determined by the productivity of the assets that are owned by the holders of PSA accounts.

One of the important goals of any Social Security reform should be the creation of additional saving in our national economy. To a certain extent, that was an underlying consideration in the development of each of the proposals put forward by the 1994–1996 Social Security Advisory Council, although the potential effects on national saving was highly varied among the three proposals. In order to understand the implications of greater national savings on capital markets, one has to begin by considering what households do with their income. Essentially, all of their income is allocated to do one of three things. Some of it is used to buy consumption goods and services, some is saved, and the remainder is used to pay taxes. Governments take the taxes and buy consumption or investment goods and services either directly—e.g., buying supplies for military operations, building roads, and so forth—or indirectly—e.g., providing food stamps to needy people to buy food. Producers and suppliers to the economy deliver the goods and services that people and institutions want.

If policymakers adopt a public policy that results in people saving more of their income, on average, than they had previously it will mean that they will reduce the amount of consumption they had been doing, at least for a period of time. The fundamentals of economics teaches us that as households reduce consumption and do more saving that it leads to higher levels of investment in the economy. The added investment, in turn, results in higher levels of productivity for workers. A simple example of a carpenter who saves a portion of his earnings for a period so he can replace his traditional hammer with an air hammer is but a graphic representation of the effects of added investment on our economy.

[1] The views in this statement are those of the author and do not necessarily reflect the views of Watson Wyatt Worldwide or any of its other associates.

The irony of this classic perception of how economies work is that as people save and invest more, the expected rates of return on capital are believed to decline. This is not simply the perception of some group of economists at one fringe of the Social Security reform debate. This is exactly the perception of economists like Barry Bosworth and Gary Burtless at the Brookings Institution who believe we should stay with the traditional form of Social Security we now have. It is also the perception of economists like Martin Feldstein and Andrew Samwick who have crafted a proposal to replace our current Social System completely with a system of individual accounts. Both of these pairs of economists have developed macroeconomic models that show the effects of increasing national savings under their perception of how Social Security should be reformed. Their results predict similar reductions in rates of return to capital as their proposed reforms are implemented.

More important than their consensus that added national saving would reduce rates of return to capital is their similar consensus that the improved productivity of labor that would result from such a policy will ultimately lead to higher levels of national output and consumption by households. The wealth of a nation is ultimately measured by the standard of living that it can provide its citizens. Standard of living in this context is nothing more than a measure of general consumption levels.

Another concern about the prospects of implementing a PSA-type proposal at the national level is that financial markets might be depressed as the baby boomers reach retirement and begin to sell off the assets they accumulate during their working career under such a system. On the surface of it, there is reason to expect that asset prices might be depressed as the baby boomers move from the asset acquisition phase of their lives to the liquidation phase. The problem here is quite similar to the problem facing Social Security, namely the ratio of retirees to workers. If workers in the future save at the same rate as current workers and retirees sell-off assets at the same rate as current retirees, the current ratio of savers to sellers will fall by roughly 45 percent between now and 2030. The concern in this area is that this 45 percent shift in relative demand for assets will result in significant reduction in asset prices.

For the sake of understanding the implications of this scenario, assume that asset prices are affected proportionately in response to this "hypothesized" demographic effect on demand. In other words, assume that asset prices by 2030 are reduced by 45 percent relative to what they would be if we could maintain the current demographic structure we now have. This 45 percent decline would not take place all at once, but rather would occur over a long period of time, perhaps in the twenty years 2010–30. Further, the 45 percent decline in asset prices assumed here is not an absolute decline in prices, but rather a cumulative 45 percent shortfall realized over a long period. If the expected total real return on equities over a normal 20-year interval is 395 percent (8 percent compounded for 20 years), then this factor might cause the total return to fall to 217 percent or roughly 5 percent per year. It is probably more reasonable to interpret the implication of the demographic trend in this manner (i.e. a couple of decades of subpar returns) than to predict actual absolute price declines. There are several reasons to doubt that even this reduction in the realized rate of return in financial markets will happen.

First, there is the point that we now live in a world capital market. The elderly baby-boomers do not have to sell their assets to younger American workers, but rather they can sell them to any participants in the world capital market. This may reduce the price pressure on assets somewhat, but its force will be weakened by the fact that Europe and Japan are all aging societies just like the US. The only hope that the world capital market will help is if the developing countries in Asia (particularly China) become net exporters of capital within the next 25 years. The relative size of developed economies and the fact that all such economies are facing the same demographic problem is reason to be skeptical that the global capital market point will fully erase the downward pressure on prices in U.S. capital markets caused by the retirement of the baby-boomers.

Possibly the most plausible reason that the price pressure may be alleviated is rational expectations. After all, the demographic projections that our model is based on are not exactly private information. To the extent that these factors are predictable, they are already embedded in asset prices today. Rational expectations doesn't mean that the pressure for price declines will not occur, only that it will occur very gradually and perhaps long before the demographic factors actually come into play.

Yet another reason why the downward price pressure may not occur is probably the most important. Corporate assets are not fixed like land or gold, but rather are cash-generating, depreciable property. When retirees increase their demand for cash payouts, firms may respond by reducing investment, reducing retained earnings and increasing dividends and share repurchase programs. This means that some asset liquidation can be achieved without selling assets to the accumulating generation, but rather by simply paying out a higher fraction of corporate earnings to existing shareholders. This third factor could go a long way towards eliminating the downward pressure on asset prices. It seems quite likely that the net asset price effect will be rather modest and spread over at least twenty years.

One ameliorating consideration in all of this is that the two potential problems just discussed will actually be contrary forces within the financial markets. The way that added national savings will reduce rates of return to capital is by increasing the prices of assets relative to the stream of income that they generate. For example, a stock that yields $10 per year at a 10 percent rate of return will cost $100. If the yield is driven down to 5 percent, the price rises to $200—i.e., $200 x 0.05 = $100 x 0.10. So increases in national savings will raise the price of assets relative to their yield while the potential demographic effects on markets will tend to reduce the price of assets. If we can adopt policies that have a positive effect on our national savings rate during the period when baby boomers are going to be naturally selling off their assets, the two forces should be countervailing. Indeed, one of the reasons that I supported the Personal Security Account proposal developed by the 1994–1996 Social Security Advisory Council was that it had a larger projected net positive effect on wealth accumulation during the whole of the baby-boomers' retirement period than either of the other proposals.

Creating an Administrative Structure for PSA Operations

Another fundamental issue which legislators will face in establishing a system of individual accounts is in creating the administrative and regulatory structure that would allow such a system to operate efficiently. Here the popular thinking about this structure trends in two distinct directions. The first would create a centrally administered and managed system structured along the lines of the Thrift-Savings Plan (TSP) that is a 401(k)-type plan for federal civilian workers. The second would establish a regulatory environment that would define an operating framework for workers to create their own individual accounts through a myriad of investment options available in the financial markets.

As I see the evolution of the discussion on this matter, I believe there are two fundamental issues that will determine the relative position that various people will take regarding the two approaches. The first of these is a desire to minimize costs associated with the operation and administration of a defined contribution retirement system. The second of these is the desire to minimize the intrusion of the government in the free operations of business and citizens in carrying out their economic activities in accordance with their own individual interests. These two concerns will likely pull people in opposite directions in terms of forming their own conclusions about the best approach to take.

There is no doubt that concentrating the administration of a personal account program within a single entity or a relatively small number of entities would render economies of scale, at least up to a point. Creating and operating any administrative system results in a certain level of fixed costs. The larger the group that fixed costs can be spread across, the less the individual cost applied to any particular participant. While there is clearly value in minimizing administrative and investment management fees, the level of sophistication that exists in investment companies today suggests that the values of scale from moving to a single provider of administrative services might be overblown. For example, there are a number of retail mutual funds available to the general public today which charge 25 to 30 basis points per year in fees for managing and administering accounts.

The primary reason that some funds tend to charge significantly higher fees for investors than those mentioned typically relates to the degree of active management of the funds held in the fund. The funds with relatively low charges tend to be funds that minimize the amount of buying and selling of individual equities held by the fund. Those that "churn" their holdings regularly generally will have relatively high fees associated with brokerage charges assessed in the normal buying and selling of financial instruments. One way to deal with this churning phenomenon is to concentrate investment in a single managing entity with the contractual or legislated provision that funds not be churned on a regular basis. Requiring that all investing is in index funds would be one way to accomplish this. Another way would be to statutorily limit the administrative charges that fund managers could charge for managing the personal accounts. Those limits would essentially force fund managers to minimize the extent of churning in the funds that they manage by virtue of the fact that too much churning would eat up all the administration charges they could assess against the accounts.

If we were to go to a system of personal accounts that might be managed by multiple outside vendors, at least two problems would still have to be dealt with. The first of these is the general approach of getting contributions to designated managers on a timely basis. The second is dealing with small accounts.

Today, half the workforce is covered by an employer-sponsored retirement plan and the majority of them are now participating in defined contribution plans where regular contributions are being made to self-directed individual accounts. I believe that many workers would prefer to have some portion of their payroll tax go into 401(k) accounts or similar plans in which they are already participating. I believe that most of the vendors now providing self-directed plan administration would be willing to set up a segregated set of accounts to take PSA contributions.

While such a system might work for employers already sponsoring self-directed individual account plans, it probably would not work for employers without such plans, especially smaller ones. For such employers a central collection function would probably be required. Contributions could be collected throughout the year as payroll taxes are now. The money would be held in a pooled fund and invested in a reasonable short-term portfolio of financial instruments. At the point that W–2s are filed, the cumulative fund for the year could be allocated to individual accounts and the funds distributed to the managers designated by the individual worker. Minimal accounts—say less than $1,000—would be held in the pool until an appropriate threshold was achieved. Once that level was achieved, workers could designate that their assets be dispersed to an approved fund. For simplification purposes, workers would be restricted to one fund manager other than a current employer plan in which they might be participating. If they were not participating in an employer plan, their accumulated balance would be held by a single fund manager. Fund managers would have to offer investors multiple investment options in accordance with rules paralleling the ERISA section 404 (c) rules covering self-directed investment of tax-qualified defined contribution plan assets.

As noted earlier, allowing investment through an extended set of investment arrangements will add to the administrative costs of the system. It is impossible to give a precise estimate of what such costs might be in advance of the actual creation of such a system. However, there are cost estimates for systems that have characteristics somewhat similar to what is being proposed. Access Research, Inc. estimates that in mid-1987 asset levels in 401(k) plans stood at approximately $865 billion and that the annual administrative fees for both record keeping and asset management for the year were $6.7 billion, or 77 basis points—i.e., 0.77 percent.[2]

Possibly more pertinent than the case of our own voluntary 401(k) system is the national system of mandated personal accounts in operation in Australia. This system requires that employers make annual contributions to employee accounts. The funds themselves tend to be organized at the employer or union level. The Australian Bureau of Statistics surveys the plans with a minimum level of asset holdings quarterly—e.g., it surveyed all the plans holding assets over $10 million Australian—this is roughly $6 million in US currency at current exchange rates—in each of the quarters of 1997. For that whole year, total costs associated with the funds surveyed were 90 basis points. The costs include record administration, investment management, and other costs including education costs. While we do not yet have the detailed breakdown of costs based on size of plans, we know that there are economies of scale that can be realized by concentrating workers in larger plans. It is notable that nearly half of the plans surveyed—46 percent—by the Australian Bureau of Statistics during 1997 had fewer than 1,000 employees. The model that I envisage for the United States would have much greater concentration of participants than the majority of plans that now operate in Australia.

Throughout the development of the PSA proposal by the Social Security Advisory Council, all estimates were based on the assumption that the costs of running the PSAs would be 100 basis points per year. The reason that we chose that level was that people in the investment industry told us that a statutory limit of 50 or 75 basis points for administration and management fees was not unreasonable. They suggested that the imposition of such a limit would still result in substantial numbers of providers offering their services to manage the personal accounts under a PSA-type plan.

A question raised by these potential fees is why we would want to bear them if a large centrally managed system could substantially eliminate them. There are two parts to the answer. The first part is an assessment of whether the federal government can be an accumulator and holder of substantial share of the capital base in

[2] Speech by Robert G. Wuelfing, CEO, Access Research, Inc., at the 1997 SPARK National Conference, sponsored by the Society of Professional Administrators and Recordkeepers, Washington, D.C., June 23, 1997.

our economy. In the case of Social Security this is more than an academic question. The original Social Security Act passed in 1935 called for significant funding of the system in accordance with Franklin Roosevelt's strong feelings on the matter. For a variety of reasons, those provisions were gradually relaxed through repeated legislative measures adopted during the late 1930s and 1940s. Once again, the practical effect of the 1983 Amendments would have been to prefund a significant portion of the baby boomers' claim on Social Security by making a substantial addition to national savings. The net effect of the significant deficits run by the federal government throughout the 1980s and the first seven years of the 1990s was to largely dissipate the effect of the 1983 Amendments on national saving. I look at this long history and question whether any attempt to prefund these retirement obligations directly through government accumulation can succeed.

The second part of the answer relates to whether it is desirable to have the federal government be a substantial holder of ownership on the capital base of the economy. As we look around the world, there are national governments that have routinely used accumulated national retirement savings to finance "social" investment projects. In our own state and local public retirement plans, we have seen many cases of investment decisions being made on the basis of political considerations rather than the economic interests of the plan participants. I do not believe that this Congress or any other can create a firewall around a centrally managed fund that will insulate the fund from future political considerations. I believe the cost of dispersing these assets is in the long-term interest of our citizens individually and collectively.

NEEDED INVESTOR EDUCATION IN A PSA WORLD

Undoubtedly, the establishment of a mandated system of individual retirement accounts will create the need for more widespread education on investment than is now available. Large segments of the population are totally ignorant of how they would manage the money that might accumulate under a PSA plan. Much of this ignorance, however, follows from the simple fact that many people today have no personal assets to manage. I believe that it is imminently sensible that people who have no money and do not anticipate having any in the near future would spend very much time figuring out how they might invest such funds if they had them.

The research that I have done on 401(k) plans, however, is instructive of how people actually behave when they have retirement assets that they control themselves. We have recently analyzed plan administration data for a set of 401(k) plans that do not include company stock as an investment option. Using these data, we found that workers in their 20s and 30s held just under 60 percent of their assets in equity accounts at the end of 1995. For workers in their 40s and 50s, it was close to a 50–50 split, with the younger group having slightly more than half in equities, and those in their 50s having slightly more than half in fixed-income accounts. Workers in their 60s held roughly 60 percent of their accumulations in fixed-income assets.[3]

When we looked at variations in investment behavior based on workers' earnings levels we found that workers at low-earnings level invested more conservatively than those with higher earnings. Workers earning under $15,000 invested 45 percent of their assets in equities on average, those earning $45,000 to $60,000 held 60 percent of their funds in this form, and those earning over $100,000 held 70 percent this way. While the portfolio allocations described here might be a bit conservative in some investment advisors eyes, they are not wildly off base and the variations by earnings and age level follow a rational pattern that is consistent with the way educated investors would invest.

In addition to looking at investment patterns across the age and earnings spectrums, our recent work also looked at differences in investment behavior between men and women. Prior research has found that women demonstrate greater risk aversion in allocating assets within their self-directed defined contribution plans than men.[4] Our analysis of actual plan data, an advantage over prior research, found that women generally are not more conservative in their investment behavior

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[3] Robert L. Clark, Gordon P. Goodfellow, Sylvester J. Schieber, and Drew A. Warwick, "Making the Most of 401(k) Plans: Who's Choosing What and Why," paper presented at the 1998 Pension Research Council Symposium, Forecasting Retirement Needs and Retirement Wealth, April 27, 1997, The Wharton School, University of Pennsylvania, Philadelphia, Pennsylvania.

[4] For example, see Vickie A. Bajtelsmit and Jack A. Vanderhei, "Risk Aversion and Pension Investment Choices," and Richard P. Hinz, David D. McCarthy, and John A. Turner, "Are Women Conservative Investors?: Gender Differences in Participant-Directed Pension Investments," in Michael S. Gordon, Olivia S. Mitchell, and Marc M. Twinney, eds., Positioning Pensions for the Twenty-First Century (Philadelphia: University of Pennsylvania Press, 1997).

than men when controlling for earnings level, age, and other important determinants of investment behavior. In general, our results suggest that women are as effective in their use of 401(k) plans as their male counterparts. It would be hard to characterize their investment behavior within plans as inferior to men, and in certain regards, it appears to be more rational.

Our results do not mean that education of the public about investing will not be a challenge. It does suggest that it is not an insurmountable hurdle. Indeed, it is not only doable, in a larger context it is probably highly desirable.

THE ROLE OF EMPLOYERS IN A PSA SYSTEM

The role that employers will play in a PSA system will depend significantly on the nature of the reform that is adopted. In countries like Australia and the United Kingdom, the provision of individual accounts is generally implemented at the employer level. In a country like Chile, where the system is structured around the individual worker, employers have a much less significant role.

No matter what structure or approach to such reform might be adopted, employers will be required to remit the money collected to finance the system. They will also have to provide documented information on the covered earnings and level of contributions for each worker employed during any given year. For all practical purposes, providing such information is no different than what they do today.

If we go with a centrally administered system, all employers will have few obligations above and beyond those of compliance that is essentially the same as under current law. If we go with a system that allows employers the flexibility of allowing their own workers to make contributions directly into self-directed individual accounts, additional reporting requirements and administrative mechanisms will be required to assure that contributions are getting into accounts on a timely basis as required by law.

In terms of actually setting up and administering plans, my sense is that the existing section 401(k), section 403(b), and section 457 plans are a tremendous asset which could be adapted to meet the needs of nearly half the current workforce. I see no reason why I couldn't have payroll withholding for my PSA account into some of the same funds to which I now allocate 401(k) contributions. It would require separate accounting to keep the funds separate, but that should not be a significant challenge in this rapidly evolving technical age.

Onc concern that has been voiced about the adoption of PSA-type reform of Social Security is that some employers might curtail their own pension or savings plan offerings as individual accounts begin to develop under a reformed system. When most employers undertake their own plan designs, they typically structure them around Social Security so the combination of Social Security and their own plans give workers the opportunity to accumulate sufficient assets to maintain preretirement standards of living. This is accomplished by designing a set of plans that supplement Social Security at a level that the combined retirement income will equal some replacement rate target. The replacement rate is the percentage of preretirement earnings that is replaced by the various combined sources of retirement income. These replacement rate targets typically vary between 60 and 80 percent of preretirement earnings depending on earnings level, age at retirement and a host of similar variables.

The implications of Social Security reform for employer-plan design depends primarily on what happens to benefit levels from the first tier of our retirement system. In the context of the PSA proposals, I would characterize the combination of benefits actually provided through Social Security plus those provided through mandated individual accounts as coming from the first tier of the system. If the combination of PSA benefits and residual benefits provided through a modified centralized Social Security is roughly equal to current law benefits, there would be little reason for employers to significantly modify their own plans. If benefits under the first tier of the system are larger than current law benefits, I would expect employers to curtail their own plans. If the amended system provides lower benefits than the current system, there will be pressure to increase benefits at the employer level.

One thing that policymakers should keep in mind regarding the potential reaction of employers to public policy responses to an aging society is that the employers themselves are facing the same set of pressures. As the workforce ages, employer-based retirement systems are becoming more expensive. This is a natural phenomenon in the way we fund and account for defined benefit plans. It occurs naturally in 401(k)-type plans because older workers contribute at higher rates than younger ones and most of these plans have employer-matching provisions that increase sponsor costs as employee contributions rise. Health benefit programs become more expensive as workforces age. This is particularly true for health benefit plans that cover retirees.

CONCLUSION

The point of the immediately preceding paragraph is that I believe we are facing the prospect that some employer-sponsored retirement plans are going to be curtailed in coming years without regard for what we do on the Social Security front. Should that scenario come to pass, the securing of benefits provided through the first tier of our retirement system takes on even greater importance. I believe that first tier benefits can only be made more secure through a mechanism of greater funding that is associated with higher savings rates in the economy. I believe we can only accomplish such added funding through a system like the Personal Security Account system that I helped develop as a member of the 1994–1996 Social Security Advisory Council.

Chairman BUNNING. I would appreciate, for the first panel, if they would remain here. We have to go vote. We have two votes, and we will be back as soon as possible. So, we'll stand adjourned for the time that it will take us to vote and get back. Thank you.

[Recess.]

Chairman BUNNING. The Subcommittee will come to order.

Before we begin questioning the first panel, Congressman Jim Kolbe from Arizona would like to present his feelings on this, and we would like to accept them at this time.

STATEMENT OF HON. JIM KOLBE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ARIZONA

Mr. KOLBE. Thank you very much, Mr. Chairman. I appreciate the indulgence of the very distinguished panel that you have here, just to be able to make these remarks. I was meeting with the Speaker earlier when you began your testimony. So, I appreciate the opportunity to do this right now. I'll be very brief, if I might include my full statement in the record, I'd appreciate it, Mr. Chairman.

Chairman BUNNING. Without objection.

Mr. KOLBE. Mr. Chairman, I cochair, as I think you may know, along with Congressman Charlie Stenholm and Senators Judd Gregg and John Breaux, the National Commission on Retirement Policy. We have come up with a bipartisan middle-ground proposal that I think combines the very best features of the current Social Security system with innovative reforms, that I think will strengthen retirement security for all workers. I'm very pleased with the work that we have done.

Today I want to focus, however, on a recent study that was done—or analysis, would be perhaps a better word—that was done by the Congressional Research Service, at the direction of some Members of this Subcommittee, because I think it is so fraught with errors, not caused by CRS, but by the direction of the study itself, that I think it must be refuted or an answer must be placed on the table right away.

Chairman BUNNING. Just a moment—I just want you to know that we entered both the study and the analysis of the study by Heritage into the record prior to you being here.

Mr. KOLBE. Thank you. I appreciate that. I wasn't referring to the Heritage study at all. I was referring to the Congressional Research Service analysis that was done for the Ranking Member of this Subcommittee.

Just a word about our plan. As I said, it preserves much of the best features of the current system, but the main feature of it is the creation of an individual savings account, personal savings account, through a carve out of 2 percent of the current 12.4-percent payroll tax, to provide financial security for all disabled, low-income seniors, as well as for all other seniors.

Restoring the solvency of Social Security requires some very tough choices, as this Subcommittee knows very well. And it requires some tradeoffs. Those who extract specific components of our comprehensive plan for criticism have an obligation to suggest other benefit cuts or tax increases to replace them, without weakening the program solvency.

Now, Mr. Chairman, the CRS report that was released today, analyzes three Social Security reform proposals: The one done by the National Commission on Retirement Policy, the one I'm cochairing; Senators Moynihan and Kerrey's proposal; and the Social Security Advisory Council proposal prepared by Robert Ball.

But the restrictions that were placed on the analysis by the requestor suggests that the study was designed specifically to discourage or disparage any reform plan that contains a personal retirement component. What's most troubling to us from an analytical perspective, is that the request included design specifications that were concocted—seemed to be concocted—specifically to promote particular policy views.

Any fair analysis of a personal account policy would obviously include the income coming from those personal accounts, and yet, CRS was specifically directed to count income accruing from the investment of personal accounts as equal to zero. Whereas, if it was invested by the government in a government account, it was to be fully counted and funded.

Now, you're talking about starting with more than one hand tied behind your back when you start with that kind of analysis. It's a very odd value judgement—that investment in the private market generates income only when government controls the investment, but not when an individual does. But that's exactly what CRS was directed to do.

Putting market forces to work to improve retirement benefits for workers typically has been discussed as an either—or proposition—do we allow workers to invest for their own retirement, or do we entrust the government with that? Our plan allows individuals to determine their retirement future.

We believe that individual accounts have huge potential benefits, higher national savings rate, ultimately higher wages for workers, higher returns on contributions, and hence, higher benefits for retirees.

The government investment approach, whatever the scale of it, doesn't address the central concern behind the calls for personal ownership of the account. And that is namely that voters should have their own stake in the economy—that citizens should have their own stake in the economy and more control over their retirement benefit. The current system provides a mere statutory right to benefits, which Congress can cut at any time in the future. Thus, such security is really illusory.

Mr. Chairman, it's true that current law promises a benefit that is higher than does our plan for a low-income earner retiring in 2040. But under current law, the system would be insolvent before that point, or at best it would only have enough money to pay less than 75 percent of the benefit promises. That's a 25-percent decrease in Social Security benefit. So, by not taking that into account, of what is in current law, you have again, in another way, completely skewed the analysis that was done by the Congressional Research Service.

I mention this, Mr. Chairman, because we really need to have a comprehensive and honest and open dialog on this subject next year. And we're not going to be helped when we have this kind of thing going on—when people approach it from the very beginning with, from an ideological standpoint, to disparage one kind of provision or another. We need to be able to look at all the different provisions.

I'm pleased to say that the administration has kept an open mind on this. And I would hope that Members of the Congress would do that as well. Because this is going to be the single most important debate, as I think you know, next year, that this Congress is going to take up. And I want to commend you and your Subcommittee for having this hearing today.

The full testimony will go into some analysis of the CRS study. We have asked for a revision based on comparing apples to apples, so that you'll be comparing real things here when they revise it, and I think you'll find that it's a completely different study the next time it comes out.

And with that, Mr. Chairman, I thank you for your time.

[The prepared statement and attachments follow:]

THE HONORABLE JIM KOLBE
Ways and Means Social Security Subcommittee
Examining the Structure of Personal Savings Accounts Within the Social Security System Structure and the Effects Individual-Owned Investments Would Have for Retirees
June 18, 1998

As Congressional Co-Chairman of the National Commission on Retirement Policy, along with Congressman Charlie Stenholm and Senators Judd Gregg and John Breaux, we developed a bipartisan, middle-ground proposal that combines the best features of the current system with innovative reforms that will strengthen retirement security for all workers.

Our centrist plan preserves the best features of the current system while modernizing it for the 21st century. It demonstrates that it is possible to allocate two percentage points of the current 12.6-percent payroll tax into individual accounts, while continuing to provide financial security for disabled and low income seniors, all without increasing the regressive payroll tax or any other taxes.

Restoring the solvency of the Social Security system will require some tough choices and trade-offs. For example, we believe that increasing the retirement age gradually, over thirty years, to 70, is preferable to imposing higher payroll taxes on individuals during their working years or substantially reducing benefits during their retirement. **Those who extract specific components of our comprehensive plan for criticism have an obligation to suggest other benefit cuts or tax increases to replace them without weakening the program's solvency.**

CRS REPORT: Analysis of Individual Accounts vs. Government Investment of Trust Fund

It is important that a few clarifications are made regarding the CRS report which was released today analyzing three Social Security reform proposals: the NCRP proposal, Senators Moynihan and Kerrey's proposal, and the Social Security Advisory Council proposal prepared by Robert Ball. The restrictions placed on the analysis by the requester suggest that the study was designed specifically to disparage Social Security reform plans that contain a personal account component. What is most troubling to us from an analytical perspective is the fact that the request included design specifications that seem to have been concocted specifically to promote particular policy views. Any fair analysis of a personal account proposal should obviously include the income coming from personal accounts.

Specifically, CRS was requested to count income accruing from the investment of personal accounts to be equal to zero, whereas the income from similar investments, if controlled by the government, were to be counted fully in scoring an alternate plan. It is an odd value judgement that investment in the private market generates income only when the government controls that investment, but not when an individual does.

Putting market forces to work to improve retirement benefits for workers typically has been discussed as an either-or proposition -- do we allow (or mandate) workers to invest for their own retirement or do we entrust the government with that responsibility? Our plan allows individuals to determine their retirement future. We believe that Individual Accounts have huge potential benefits: A higher national savings rate, and hence ultimately higher wages for workers, and higher returns on contributions, and hence higher benefits for retirees.

The government investment approach (whatever the scale) doesn't address the central concern behind calls for personal ownership--namely, that voters should have their own stake in the economy and more control over their retirement benefits. The current system provides a mere statutory right to benefits, which Congress can cut at any time in the future. Thus, such "security" is illusory. Only personal accounts offer workers ownership of constitutionally protected property. Also, in government-controlled investments workers would not have the right to alter their investment choices if market returns were low. In an individual account system workers would be allowed to decide what level of risk they are willing to accept.

CRS REPORT: Current Law Reduces Social Security Benefits

While the most egregious flaws in the request pertain to comparisons between plans, comparisons with current law are likewise troubling. The bottom line is that the Social Security system is going broke. Current law projects insolvency for the Social Security system in the year 2032, and that solvency even through this date depends wholly on the general government's raising sufficient revenue from other taxation in order to pay trillions owed to the Social Security Trust Fund from 2013 to 2032.

Accordingly, it is not true that "current law" promises a benefit that is higher than does our plan for a low-income earner retiring in 2040. Under "current law" the system would be insolvent before that point, or at best there would only be enough money coming in annually to pay less **than 75% of benefit promises -- that is a 25% decrease in Social Security benefits.** Relative to "current law," our plan, even without the personal accounts, would increase the benefits that can be provided to this cohort of retirees

Mr. Chairman, we have submitted a request to CRS, and they have agreed to undertake a study that reflects the entire NCRP package and does not exclude the Individual Security Account component.

ADMINISTERING INDIVIDUAL ACCOUNTS:

Our plan has looked very closely at the mechanism needed to successfully administer Individual Security Account. We chose to model this mechanism after the successful Thrift Saving Plan for federal employees.

Administrative concerns argue strongly for working within the current payroll tax collection structure to direct contributions on behalf of covered workers into individual savings accounts. Currently, employers typically pay payroll taxes on behalf of each employee on a biweekly basis, and report total contributions to Social Security at the end of each year. In order to avoid a prohibitive increase in costs that would most harm small employers and the self-employed, this plan assumes that the responsibilities of employers should remain roughly the same as in current law.

The burden of record-keeping for each individual account would be assumed by an independent board created for, and dedicated to, this purpose. Administrative costs would be kept to a minimum. Because accounts of low-income employees would initially have small balances, it is essential that administrative costs not overwhelm the ability of any individual to receive a positive net rate of return from his or her investment. The TSP model creates a decentralized mechanism, in which all participants share the administrative burden.

Every worker would be able to choose from among a number of investment options, including stock index funds based on the Wiltshire 5000 or the S&P 500, a bond index fund, a blended index fund including both stocks and bonds, and a government securities fund. Individuals also would be allowed to make direct contributions to their ISA, up to $2,000 a year.

After a few years, the system permitting, the Commission envisions that an increased number of investment options would be provided to beneficiaries. For each type of portfolio, investors would have a choice between various government-approved companies to manage the funds within the TSP model. Firms would bid competitively for the right to manage these funds, with an eye to minimizing administrative costs.

Once the system is operational, the Commission recommends that additional voluntary contributions be permitted to the individual savings accounts, and that Congress consider providing incentives to enable individuals of all income levels to benefit from this option. Congress should also consider, once the system has matured to a point where administrative costs are predictable and manageable, allowing rollover contributions from these personal accounts into individual savings accounts with the same withdrawal rules as the ISAs, provided that these accounts are invested in broadly diversified low-administrative-cost funds.

Individual funds will be fully vested, and an individual will have a non-forfeitable property right in contributions to his or her account and in earnings accrued. No access would be allowed to said account until retirement and only within the guidelines prescribed by the program's rollover and distribution rules. Record-keeping for individual savings accounts must be explicit, and make clear to individuals that earnings posted to their accounts are direct market earnings, net of administrative expense, from direct investment of pooled account assets in financial instruments.

The fund managers will have a fiduciary responsibility for standards of management and investment of assets. The fiduciary provisions should recognize an "exclusive benefit" rule, which would assure each wage-earner that account contributions could be used only for the purpose of providing retirement savings for that individual: The government would have no ability to utilize account contributions or earnings. Additionally, the Commission recommends creation of a comprehensive regulatory program for oversight of asset managers, allowing for a reasonable self-regulation by the investment industry.

Social Security is intended as a safety net that provides a retiree with a monthly income for as long as the retiree lives. Individual savings accounts should not change the basic nature of the system. Combined with traditional Social Security, these accounts should provide retirees with income security for their remaining lives.

The Commission opposes withdrawal rules, such as pre-retirement or lump-sum distributions, that would expose individual beneficiaries to increased risk of poverty, relative to protections that would have existed had ISAs not been established. Therefore, the plan prohibits pre-retirement withdrawals, other than for death or disability.

Upon retirement, individuals would be required to annuitize that portion of their individual savings account balances which, when added to their traditional Social Security benefit, is necessary to provide an income comfortably above the poverty level. Individuals will be able to choose between a number of annuity plans that reflect the life needs of the individual. Individuals are not required to withdraw non-annuitized balances upon retirement.

The annuities would be similar to those required to be offered to plan participants under qualified defined benefit plans subject to Employee Retirement Income Security Act (ERISA) and would be indexed for inflation. Under ERISA, if the retiree is married, the normal benefit form is a joint and survivor annuity. In order to assure that the monthly payments keep pace with increases in the cost of living, the annuities could be adjusted for inflation annually, perhaps through the use of the Treasury Indexed Bonds. Individuals would be able to choose from a group of insurance companies that have been selected in a competitive bidding process for the right to manage these accounts. A government-provided standard option will also be available.

Concerns about shorter life expectancies among the poor can be addressed by requiring either a life annuity, period certain (income for life is promised but a minimum number of payments if guaranteed) or a refund annuity (monthly payments continue after death until the combined benefits have equaled the purchase price of the annuity).

MEDIA RELEASE

FOR IMMEDIATE RELEASE **June 18, 1998**

PARTIAL STUDY IGNORES PROFITS OF INDIVIDUAL SAVINGS ACCOUNTS

WASHINGTON (June 18) -- A bipartisan proposal advanced by Sens. Judd Gregg (R-N.H.) and John Breaux (D-La.), and Reps. Charles Stenholm (D-Texas) and Jim Kolbe (R-Ariz.) would save the Social Security program for future generations and increase retirement benefits for most Americans, despite a misleading report released at a House hearing today that does not factor in the benefits of new individual retirement accounts.

Last month, this bipartisan group, which served as the congressional co-chairs of the National Commission on Retirement Policy, released a Social Security reform proposal that has been hailed as one of the most comprehensive report offered so far in the growing social security reform debate.

To present the American people with a balanced analysis of their proposal, the four members have sent a letter to the Congressional Research Service (CRS) requesting an updated review of a report released today at a House Ways and Means Committee hearing, saying it is misleading and inaccurate regarding the Social Security benefits their reform plan will provide to future retirees.

In short, they said today's CRS report is inaccurate because:

* It ignores the two percent individual retirement accounts offered under the bipartisan plan to give Americans a higher rate of return and more control over their retirement finances. CRS was required to analyze only half a plan because it was instructed not to consider the personal account component.

* It does not compare their reform plan with the current system that will not have sufficient revenues to provide promised benefits. The Social Security Trustees themselves said with no changes in the current system, social security benefits will have to be reduced by 25 percent in the year 2032.

At a press conference yesterday, Sens. Bob Kerrey (D-Neb.) and Daniel Patrick Moynihan (D-N.Y.) expressed similar concerns about the validity of comparing their social security reform proposal with current law.

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(Attached is a copy of their letter requesting a new CRS report.)

JUDD GREGG
NEW HAMPSHIRE

CHIEF DEPUTY WHIP

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June 17, 1998

David Koitz
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Dear Mr. Koitz:

We have received a copy of your June 16 memorandum analyzing recent Social Security reform proposals, including the plan drafted by the National Commission on Retirement Policy, of which we were the Congressional cochairs. We fully recognize and appreciate the acknowledgment by CRS in the opening paragraph of its memorandum, to wit: ". . . the memorandum does not examine the impact of the changes in payroll taxes included in the packages, the potential benefits or annuities that may result from the 'personal savings' components of the proposals, nor in the case of S. 1792 and the NCRP plan, the elimination of the Social Security earnings test. Analysis of all of these would be necessary to gauge the full effects of the three plans on the national economy and individual retirement income." Although this highlights the limited utility of the numbers contained in the memorandum, we trust that you can appreciate why this study is, nonetheless, extremely troubling to us.

What is most troubling to us from an analytical perspective is the fact that the request included design specifications that seem to have been created specifically to promote particular policy views. Any fair analysis of a personal account proposal should obviously include the income coming from personal accounts.

Specifically, CRS was requested to count income accruing from the investment of personal accounts to be equal to zero, whereas the income from similar investments, if controlled by the government, were to be counted fully in scoring an alternate plan. This is a critical point because this alternate plan relies heavily on the returns from investment of Social Security contributions in the private market in order to achieve actuarial balance, something that the NCRP plan does not do. Were the Ball plan subjected to the same assumptions as the NCRP plan -- that zero income accrued from investment in the private market -- this plan would fail to achieve actuarial balance, in addition to failing to provide the benefits tabulated in the CRS memo. It cannot be the case that investment in the private market generates income only when the government controls that investment, but not when an individual does. While there are economic distinctions to be made between the two policy choices, it is equally clear that counting one and not the other is not meaningful.

We also would note, for the sake of updating CRS's information regarding the NCRP plan, that the NCRP report contained instructions to the Congressional cochairs to make certain modifications to the plan as then described, in order to increase retirement income to the extent permitted by the 1998 estimates of the Social Security Trustees. We hope that any future analysis by CRS will not, therefore, rely on data that was generated before the final modifications to the NCRP plan were made, but will review the most current version of the plan, as it will soon be introduced.

Although the most egregious flaws in the request pertain to comparisons between plans, comparisons with current law are likewise troubling. Neither CRS nor the requesters of the study need to be told that current law projects insolvency for the Social Security system in the year 2032 and that solvency even through this date depends wholly on the general government's raising sufficient revenue from other taxation to pay trillions owed to the Social Security Trust Fund from 2013 to 2032. Accordingly, it is not true that "current law" promises a benefit that is higher than does our plan for a low-income earner retiring in 2040. Under "current law" the system would be insolvent before that point or, at best, there would only be enough money coming in annually to pay less than 75% of benefit promises. Relative to "current law," our plan, even without the personal accounts, would increase the benefits that can be provided to this cohort of retirees.

Accordingly, we would request that CRS undertake a study that make the following modifications to more accurately represent how the NCRP plan compares with others as well as to current law:

1) The study should be repeated not on the basis of obsolete actuary tables that review an incomplete version of the NCRP plan, but including the effects of subsequent revisions that are incorporated in the draft of our bill.

2) The study should treat the returns accruing to each plan equivalently. Specifically, with respect to the Ball plan, if personal account investments are considered to vanish as in the previous study, the Ball plan's investment of the Trust Fund in the market should also vanish. We would request that CRS shows the benefits that Social Security would be able to pay on an annual basis, under the Ball plan, if cuts in outlays were made across-the-board after this amount of revenue were "lost" to private investment.

3) Comparisons to current law should take account of the extent that current-law benefits exist. Social Security does not have borrowing authority and, thus, cannot pay alleged "promised benefits" in the year 2033. All Social Security reform plan benefits should be compared to the level of benefits that Social Security can actually pay under current law during the years in question.

4) Benefits should be expressed in relation to total contributions, using a method that is internally self-consistent. For example, if the money directed to personal accounts in the NCRP plan is considered to not be funding benefits, then the remaining benefits should be portrayed as a function of the lower payroll tax rate paid of 10.4%. Plans that promise higher defined benefit levels also would require higher levels of taxation, both in payroll taxation and, in general, revenues used to redeem Social Security assets, and the analysis of what individuals get for their

Social Security investment should properly take this into account. We are working with the Social Security actuaries to produce updated figures on rates of return and replacement rates for our proposal as it is being refined, which we will be pleased to make available to you to assist with this portion of the analysis. Clearly, it is the rates of return in particular, as opposed to replacement rates, that take into account the level of taxation needed to fund benefits.

Again, we would repeat that we fully understand that CRS responds to requests for information to the best of its ability to do so, but we believe that, in this case, the specifications of the previous request, as well as the immediate circulation of CRS's memo to the Media, indicate clearly an intention to use CRS's data in order to portray personal account reform proposals in an incomplete and misleading way. We hope that CRS also will produce a study that makes a more complete accounting of all of the elements of Social Security reform proposals, relative to each other and to current law, in the manner that we have described above.

We greatly appreciate your prompt attention to this request.

Sincerely,

Judd Gregg
Senator Judd Gregg

John Breaux
Senator John Breaux

Jim Kolbe
Rep. Jim Kolbe

Charles Stenholm
Rep. Charles Stenholm

Chairman BUNNING. Thank you, Mr. Kolbe. I will tell you this: Before we are finished the hearings that we are having on these issues, we will have a total package to look at, and it won't be skewed one way or the other.

Mr. KOLBE. I thank you very much.

Chairman BUNNING. Now we'll get back to our first panel and our questions to our first panel. Let me address an open question to the first panel.

We have heard a lot about investment risk and rates of return. However, one very apparent, but not qualified, risk is political risk, which certainly exists in the taxpayer's mind. As we will hear later, we have taken the surplus FICA receipts, spent them on other parts of government, and given the trust funds an IOU that has a nice coupon rate, but can only be redeemed at the cost of increased taxes or Federal indebtedness.

Younger generations of workers who die early know other political risks from a system that may return very little to them through the current system structure. Therefore, this political risk exists and is real, as market risk are real.

Private investors have some control over their risk and cost in their portfolios, even when it is through a 401(k) plan. What controls over political risk does a FICA taxpayer or a retiree have in the system? All of you want to take a shot at that, or one person? If we eventually decide on some kind of private investment account.

Mr. DIAMOND. It seems to me that political risks come in two forms. One form is when the outside environment, whether it's economic or demographic changes, then existing institutions have to adapt to them. And exactly how that happens is going to depend on some future Congress and nobody today can predict what a future Congress is going to do. And so, that's some political risk.

The second form of political risk is that the legislation can put in train political forces that weren't there without the legislation that can then change the environment and result, as we have seen in the past, with slow or sometimes even rapid reversals by Congress, as Congress, as it were, unleashes the political forces and responds. Because Congress, of course, is responsive to the American public. And it's that responsiveness, of course, which is what makes Social Security not a wildly dangerous risk for people.

It's called an entitlement program for a good reason. As long as the American people feel strongly entitled to it, Congress isn't going to take it away on a whim. But Congress will have to respond to a changing environment, changing demographic environment, changing economic environment.

Chairman BUNNING. That's why we're doing these hearings, and hopefully we'll get an answer out of them.

Mr. DIAMOND. And political risks are there with individual accounts, and they're there with a pure defined benefit system, and they're there with a mixed system.

Let's take a mixed system, because that's what's really on the table, such as the one that Congressman Kolbe talked about. If payroll tax revenue starts growing more slowly, and the Office of the Actuary comes in and says the residual defined benefit program is in actuarial imbalance, Congress will need to do something about it. What Congress will do will be different from what Congress would have done if the individual accounts hadn't been set up. But it may have exactly as big a problem anyway. So the same amount of risk may be there, concentrated on one part of the income distribution—benefit distribution—rather than the whole thing.

Chairman BUNNING. Dr. Diamond, I'd like to get some others. Thank you. Mike?

Mr. BOSKIN. Yes, Mr. Chairman, I think that there are three political risks that I think are very severe. One is I think it is very unlikely that very large surpluses can accumulate for a very long time without being spent on other things, as is happening currently with the short-run operating surpluses in Social Security. If we're contemplating building this to trillions of dollars, I believe that that will put great pressure to do something else and perhaps squander those resources. I think that is a history of what's gone on when States have tried to run surpluses for a span of time, they found it very difficult to do so.

Second, I believe that there is political risk that if this sort of thing is done inside the government, that there are corporate governance issues that would be very, very—potential very troubling if the government owned a sizeable fraction of equities, even if was limited in any individual firm. And when there was a fad, or an issue, or a sanction, or something going on, there would be tremendous pressure to do that. Now the TSP has some good procedures to resist that, and Mr. Cavanaugh is to be commended for his role in that.

The third thing is I think most people, ranging from my Stanford students to most people I've talked to in the general public about this, trust something being their own money, rather than something sitting in the government that they're going to get later. I think there's a big difference by generations. It's partly your generational experiences, it's partly most people realize that if they're already retired, there won't be radical changes in their Social Security. When you start to go down the age distribution, most people believe that if they keep on the current path that the system will be means tested, something will happen to it and they will get nothing. And I think they're probably right about that.

Chairman BUNNING. Thank you. Let's see.

Mr. SCHIEBER. One of the—can I speak to that?

Chairman BUNNING. Let me—I'll get in trouble with the rest of my panel if I go past my time. Mr. Christensen.

Mr. CHRISTENSEN. Thank you, Mr. Chairman. Dr. Boskin, I want to ask you about this testimony we heard from Dr. Diamond concerning the asset swap. The whole idea of there being new revenue, then there would be some advantages. This was kind of the first time I've heard this kind of direction in terms of not saying that there would be a benefit here for the American investor, for the retiree. Would you address specifically Dr. Diamond's testimony, where you disagree, if you do, and where he has erred.

Mr. BOSKIN. Well, I think as far as he had time to go, he is correct. I think he's partly correct. I think for some people, there will be an increase in saving and there will be an increase therefore in investment in the economy and other good things will happen. I think for some people, this will be rearranged. So I think he is partly correct.

Mr. CHRISTENSEN. When we're talking about assets——

Mr. BOSKIN. I think Chairman Greenspan has tried to make——

Mr. DIAMOND. There are two issues here. One issue is whether you put in new revenue and does all the new revenue show up as additional savings or do people, knowing that they have more, cut back on their own savings. If all you've done is shift some of the funds, and cut back on the defined benefits to match that, then people don't have additional amounts out there, it doesn't represent additional savings, and there isn't any effect at all. If we get the kind of increase in confidence that's been described here, then that would be a reason to cut back on savings. So unless there's new revenue, the creation of the individual accounts by themselves, as was said, as Alan Greenspan has pointed out, focusing on trust fund investment—but the same point holds with individual accounts—unless there's new revenue, it's an asset swap, whether it's individual accounts or not.

Mr. CHRISTENSEN. Dr. Schieber.

Mr. SCHIEBER. I think they both have summarized the issue.

Mr. CHRISTENSEN. For people who are liquidity constrained, low-income people who save nothing, of whom there are unfortunately there are too many. Their individual account—mandatory individual accounts—would change their behavior.

Mr. DIAMOND. Let me—again, we're not disagreeing. Mandatory individual accounts on top of everything else will change their behavior. That means a new revenue source. Individual accounts which are just a shift out of the defined benefits they would get, will not change their behavior.

Mr. BOSKIN. Let me try to be clear. The missing item is—compare two systems. One is where you allocated projected surpluses, which hopefully will materialize to establish individual accounts. So that's basically taking a tax cut, giving it to people, and saying, you now must save it. So it's going into savings.

Alternatively, suppose instead of that, you took 2 percentage points of the FICA tax and put it over there, there would be savings there, but unless you made up—and this is the new revenue Peter's talking about—the 2 percentage points in the FICA tax or cut the benefits somehow so there wasn't a 2 percentage point gap on the FICA side, then you'd get the saving here and the dissaving over here, and they match. That's what he's trying to say.

Is that clear?

Mr. CHRISTENSEN. So there's more agreement than disagreement here.

Mr. DIAMOND. Absolutely. We're the cochairs of the National Academy of Social Insurance Panel on Privatization of Social Security. We're hoping to have a report out in September, and we've yet to disagree on anything except whether there should be individual accounts. [Laughter.]

Mr. CHRISTENSEN. Thank you, Mr. Chairman.

Chairman BUNNING. Just a small difference of opinion. Mr. Collins will inquire.

Mr. COLLINS. Thank you, Mr. Chairman. Mr. Boskin, I'm one of those individuals who feels like the money that's been abducted from my payroll check all these years is my money too. I someday want a return on it. If I should cease before the time that I'm eligible, I feel like my estate should have that return. So I think it's time we took a real look at Social Security.

You mentioned that there's an unfunded liability out there of some $10 trillion. Explain where you get that figure please.

Mr. BOSKIN. There are many figures out there, and there are many different concepts. As a rough general approximation, if you take the projections of future benefits and discounted them back to the present based on the intermediate assumptions about wage growth, and so on, and the demography, and the projections of what current tax revenue would yield, and discounted that back to the present, there would be about a $10 trillion gap, or more, depending on how you dealt with—how far out you went on a variety of other——

Mr. COLLINS. I understand that. But there's one figure that you haven't laid out there. How long are you projecting that? What period of time?

Mr. BOSKIN. Well, most of these projections are either the—the different studies either look at the 75-year period of Social Security, which ignores the fact that there would be an additional large problem thereafter, with benefits able to be—only three-fourths benefits financeable by current taxes. Or, they have a specific reposal, for example, switched to—like Cato Institute, or somebody else—switch to individual account now. Maybe starting at a certain age, and phased in over a certain time profile. And we still have to pay the benefits to retirees or people soon to retire, and what's the difference. And so the number can be smaller or larger.

Mr. COLLINS. But you're talking about $10 trillion over a 75-year period. I mean, it sounds a lot more severe when you say $10 trillion unfunded liability, than it does if you say $10 trillion over 75 years. That's quite a difference in the concept of how you look at the $10 trillion. That difference in that concept can have a difference in how you determine what you're going to do about the generations behind my generation. I'm of the World War II generation. And how are you going to address their Social Security benefits in the future, as well as add deposits today? It could have a significant difference in how you approach this.

Mr. BOSKIN. That's fair enough. But the $10 trillion, which could be still larger, depending on how you define things, should be compared for example to the current explicit national debt, which is about half that size. So it's a stock that—so if we tried to finance this under these projections for the future, under many of these plans—full privatization plans—you'd have to issue $10 trillion worth of bonds.

Mr. COLLINS. $10 trillion is also close to the figure we just dealt with for a 5-year budget proposal, and where we carved out 1 percent savings. So, it's how you look at $10 trillion.

Mr. BOSKIN. It's certainly $10 trillion over an economy that will be vastly larger than that.

Mr. COLLINS. We won't debate that any further. Mr. Diamond, you mentioned that the unfunded liability exists because Congress voted to give retirees of the forties, fifties, sixties, and seventies, far more in benefits than could have been financed by the taxes each of these groups paid. Based on that range of beneficiaries, how long would it take them to actually get in return the funds that they had put into the trust fund, that have been deducted from their payroll checks.

Mr. DIAMOND. I don't have a figure on that cohort by cohort. That analysis, which is done by John Geanakopolos, Olivia Mitchell, and Steve Zeldes, will appear in a volume from the conference of the National Academy of Social Insurance, just to get another plug in.

Mr. COLLINS. So you don't really have a figure?

Mr. DIAMOND. It just accumulates up, but there is a graph that breaks it down separately, cohort by cohort—that is, the people who were born in a particular year. Look at the taxes they all paid—everyone born that year—and the benefits.

Mr. COLLINS. I have one more question. But you don't have any figures. You have a figure of speech, rather than figures. What about today. What about a young person entering the work force today. Say they pay the average—or pay the maximum—throughout their working lifetime. Based on maximum participation, how long would it take them to receive their benefits?

Mr. DIAMOND. I don't have that number, sir. You can get that.

Mr. COLLINS. Thank you, Mr. Chair.

Chairman BUNNING. Mr. Portman.

Mr. BOSKIN. I can give you the answer to that. Longer than their life expectancy. They expect to get back less than they pay in—they and their employers pay in.

Mr. COLLINS. That's right. That's kind of the way it was set up in 1935, was it not?

Mr. PORTMAN. Thank you, Mr. Chairman, and thanks for having these hearings. This is the second one of our hearings on individual accounts.

And it's interesting in the interim, since our last one, we had a meeting in my district of the Committee for Responsible Budget. This was an exercise in hard choices. Some of you may have been involved in that. Almost every group from AARP to the Concord Coalition was engaged in it. And in our little group, which was about 117 people, we broke out into 16 groups, 73 percent of the groups favored some form of personal individual accounts. And they were given information on what some of the choices would be if you went to individual accounts.

And I think the figures around the country are comparable to that. Maybe 73 percent is a little on the high side in my area, but it goes to what Michael Boskin was talking about earlier, which is, as folks look at this and begin to think about the alternatives, and particularly the alternative of the status quo, individual accounts, I think, are becoming more and more popular. This was a day long session where we actually went into some detail.

My question though is related to individual accounts and the current employer based pension system, rather retirement saving systems we have through our employers, which is really the third leg of the stool as we say. Social Security being one, and personal savings being another. The third, and one that I'm particularly concerned about because it's not growing as fast as it should, is employer based coverage.

I wonder whether an individual account could be part of someone's 401(k), or profit sharing plan, or simple plan for a small business, and how we could do that. I don't know if any of the gentleman here have spent any time looking at this issue. But the notion would be, I guess, to either set up a new form of account, which might have some more parameters than a current 401(k) might, or simply to allow rollover between the individual account and the 401(k). To maximize the return, to really take advantage of compound interest rates, and to simplify it, so you have one account, and to encourage more and more smaller businesses to have retirement savings plans.

Mr. SCHIEBER. There's a couple of issues there. One is if you're going to have these accounts, you're probably going to end up with a mandated savings program if you're replacing part of—you're carving out part of Social Security. The 401(k) system is still a voluntary system, and there's a question of whether you want to comingle voluntary money and mandatory money. Because, if you comingle the two types of money and somebody wants to withdraw some of their voluntary money as they're allowed to do so under current law, then you're going to create a very complex situation for figuring out which is apple and which is orange.

Mr. PORTMAN. Money being fungible.

Mr. SCHIEBER. Right. It seems to me though that there is some possibility that you could have a system where, in cases where employers do have 401(k) plans, that you could give employees access to the similar kinds of accounts through exactly the same vendors.

The vendors would have to keep track of these two sets of money separately. But you could actually run the administration of these quite together. So I think there is some prospect of doing that.

Mr. PORTMAN. Are there some efficiencies to be gained by running, as you say, the administration together?

Mr. SCHIEBER. Well certainly there would be. I mean, you've got communications programs built around it. You've already got withholding mechanisms built in, you've got reporting mechanisms for the employees. Most employees—we work with employers all the time—when they move from one employer to another, in most cases they want to move their 401(k) money from one plan into the next plan, because they don't want to run a half dozen different set of investment funds themselves. It's a convenience issue. I think there are some very significant prospects something like that might evolve. I do think you would have to keep the money segregated, at least for accounting purposes.

Mr. PORTMAN. Any other thoughts from the panelists?

Mr. BOSKIN. I think it's an interesting idea. I think that there are a couple of things to be aware of. One is that the takeup rate for 401(k)s has been under 100 percent, and many American companies, including ones that I am involved with, have had active education programs to boost the rates up, which have been successful. But they are still under 100 percent.

It may be we could build out from there and the prospect of having this mandatory system would—may, in fact, have the effect of making it easier for some people at the margin to graft on a private pension, where it doesn't exist now. That might offset the tendency that was mentioned earlier for the private sector to pull back if there was a mandatory government account.

Mr. DIAMOND. I'd like to add one small point on that. A major cost in running any system, current Social Security system, 401(k)s, any of them, is reconciliation. Making sure that the money that's withheld from a worker shows up in the right workers account, and the accumulations show up.

The way to hold down reconciliation costs in the aggregate is by using uniform systems. As soon as you start setting up different systems for different groups of workers, then you'll start to raise, I think, overall costs and you may raise them more because of the lack of uniformity than you gain from the synergism of having a single intermediary handling both of them. So I think one has to be very careful to look at the whole system.

Mr. PORTMAN. Just one quick point, Mr. Chairman, which is that we may argue for the simplification and the streamlining on the pension side, and more uniformity that many of us have been pushing for. And there might be a way to complement the two and get this synergism.

Thank you, Mr. Chairman.

Chairman BUNNING. We'll go around one more time, because I want to be able to submit to you all, questions in writing that we would like for you to respond to. Because, we do have another panel to follow you, and I don't want to go 6 o'clock this evening.

Dr. Boskin, in assessing the solutions to Social Security solvency problems, what pools in terms of analysis are important to Congress? What budgetary and economic questions must be answered at a very minimum to ensure that correct analysis is made?

Mr. BOSKIN. Well, I think that you need to have a comprehensive accounting of what's going on in all parts of the system. As was mentioned earlier when Congressman Kolbe was here, you can't just take a look at the current system and ignore the benefits that may accrue in the individual account system, and so on.

You have to take account as we move through time if there's a plausible—if there are additional revenues and additional national saving, there may be beneficial economic effects of that, that we have to figure how we're going to account for it which is not currently the norm in the way that the scoring agencies think about these things.

We're also going to have to reconcile the kind of procedures that are used at the CBO and Joint Tax Committee, which primarily looked at 5- and 10-year horizons, and the Social Security actuaries who are commonly looking at 75-year horizons. Although CBO has started to look at 20- and 30-year horizons now.

I think we need to reconcile demographic projections. The Census Bureau believes there will be a lot more 100-year-olds out there several decades from now than the Social Security Administration. I think it's important to know why.

All these things are important, and you need to be aware of the sensitivity when compounded for decades, only a small difference can make.

Mr. DIAMOND. Mr. Chairman, could I add just something quick on that. There's a tendency to focus on the main projection. But of course there are risks around—market risk and political risks. We're better at quantifying market risks than we are at political risks. And I think it's terribly important to use what the finance community calls risk adjustment to convert the expected value of returns into what it's worth to people when you correct it for the risks involved.

Chairman BUNNING. Thank you. Mr. Cavanaugh, you stated that PSA investment in the private market would probably never exceed 2 percent. What leads you to that conclusion?

Mr. CAVANAUGH. I was referring to the fact that the PSA investments would not exceed 2 percent of the capitalization of the U.S. stock market, because that was one of the questions that you raised. And that's based on, as I indicated at some length in my prepared statement, which I submitted for the record, a couple of different plans.

The one plan that would have the greatest impact on the stock market would be the one that involved investing up to 50 percent of the fund the Social Security Trust Fund in equities. That would come to around 2 percent of the total stock market in the year 2014, based on assumptions by the Advisory Council on Social Security. Given the fact that the capitalization of the U.S. stock market right now is about $12 trillion, if you use their assumptions and project out to 2014, it comes to almost $40 trillion. Their plans for investing the Social Security Trust Fund would have $1 trillion in stocks out of $40 trillion, or 2½ percent.

And the PSA proposal would be less than one-half of that, because presumably in the personal savings account we're assuming what most people propose, and that would be 2 percent of payroll going into it. So that's how you come to the less than 2 percent.

Chairman BUNNING. Is there anybody else that would—go ahead, Mr. Christensen.

Mr. CHRISTENSEN. Dr. Boskin, I wanted to ask you, how would you go about assessing a risk adjusted rate of return? Mr. Cavanaugh in his written testimony talked about an adjusted risk rate of return. What would your comments be on that, and then I want to ask also Mr. Cavanaugh?

Mr. BOSKIN. Well, the first thing is I think you'd have to specify all the classes of risk. All the investment options have risks in various forms, including Treasuries. Although we expect the government not to default, and in the short term, there's very little inflation risk. So there are standard procedures that are used.

If the investments are broadly diversified by supposition or by regulation, you can reduce that somewhat. But technically, what you're doing is you're looking at the covariance of the returns—and I don't want to get too technical here—there are ways to do that.

So I think another way of saying what Professor Diamond was saying is, if you took what might happen in the future under many or most scenarios, for example, investing in equities would do a lot better than investing in Treasuries or in bonds. But in some, in a smaller fraction, they might do worse. And so he wants that accounted for in some way.

Mr. CHISTENSEN. I think it was Dr. Diamond who talked about this adjusted also. Maybe you could comment on it, Dr. Diamond.

Mr. DIAMOND. No, I think that's fine. There are simulation models and Dr. Schieber has one of them, and EBRI has one, which project out returns on stocks and returns on bonds, based on the pattern of statistical variation in the past. And then you can calculate, if you have this portfolio, 90 percent of the time you'd do better than all bonds, and 10 percent of the time you'd do worse. Or if you have that portfolio, it's 50–50, and you get a spread, and you find out both the probability of doing better and the probability of doing worse, and you can compare any two different portfolios in that way.

Mr. CHRISTENSEN. I'm just trying to pick up some hints here, so when I can take some of this advice and take it into the market now. [Laughter.]

All these suggested risk on the equity markets, I want to make sure we try it out before we take it to the next step.

I want to ask Mr. Cavanaugh if there's a downturn in the stock market, will the investors in the Thrift Savings Plan be adversely affected so that there retirement is greatly reduced? If there is, how would you go about taking this in terms of moving on to the next step with this proposal, if there's a downturn in the stock market?

Mr. CAVANAUGH. If there's a downturn in the stock market, how would we go about doing what, sir?

Mr. CHRISTENSEN. Will the investors in the Thrift Savings Plan fund be adversely affected, so that their retirement is greatly reduced?

Mr. CAVANAUGH. Yes, of course that risk is there and you have great volatility in the stock market that you don't have in the bond market, and that goes to the previous matter you were discussing. There's no way that you can eliminate that risk.

But generally, what financial analysts or advisors would say, the way to minimize it is to make sure that you're not putting an awful lot of money into the market or taking an awful lot of money out at just the wrong time. And the way to avoid that is what they call dollar cost averaging. In other words, you put in a little bit every week or every month, and then when you're taking it out, you do the same. You spread it out and you're less likely to get caught.

Mr. CHRISTENSEN. Dr, Schieber, you shake your head on dollar cost averaging.

Mr. SCHIEBER. Well, people to a certain extent naturally insure themselves against the market. If you look at how people invest 401(k) money, and I think that's one place you can look to see how people behave, what we see is that younger people tend to invest far more aggressively than older people. For people in their twenties, typically they will have over 60 percent of their assets in equities. By the time they get into their sixties, it's down to 40 percent or less. They are insuring themselves against the market.

I think it also goes to the issue of how you design your reform. And there are ways, by establishing floor benefits and so forth, that you can keep people at the bottom end of the income spectrum from taking on too much financial market risk. In the final analysis though—FDR said it when he was signing the original Social Security Act in 1935 he said, we cannot insure all of the people in this country against all of the vicissitudes of life all of the time.

We've got tremendous political risk in this system right now. It's significantly underfunded. If you look at the kinds of bills that Senator Kerrey and Senator Moynihan have put forward, they are saying that there is some probability, maybe fairly significant, that benefits are going to be reduced—that's a risk.

Now the question is how we can diversify that in a reasonable fashion and protect people who are most vulnerable.

Mr. CHRISTENSEN. Thank you, Mr. Chairman.

Chairman BUNNING. Mr. Collins.

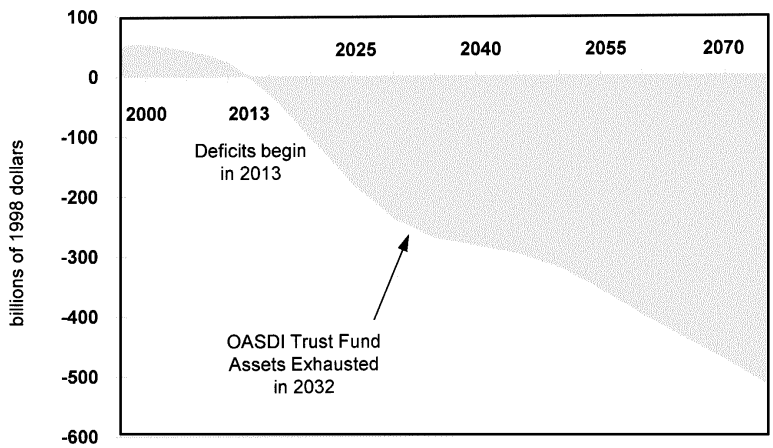
Mr. COLLINS. Thank you, Mr. Chairman. Mr. Boskin, I want to go back to you and this $10 trillion. You just blew my skirt up with that $10 trillion. [Laughter.]

Let me ask you my question first. Do you have a schedule of years that the liability becomes a liability, and each year thereafter, for that 75 years? Do you have such a schedule? I think it would be very helpful.

Mr. BOSKIN. Yes, and the Social Security Administration has it. What this does is it takes this year by year and then it discounts it back to the present. I may have a graph with me. If I do, I'm going to pass it up. I may—I did bring this with me—you'll be interested.

[The following was received:]

Projected Flows into OASDI Trust Fund
(excluding interest income)



Source: Data from OASDI Board of Trustees 1998 Annual Report

Estimated Balances of the OASDI Trust Fund: 1998-2075

	Nominal [$billion]			*CPI*		*Real [$billion, 1998 base]*		
Year	*Income Excl. Interest*	*Outgo*	*Balance*	*Percent Change*	*Adjusted Index*	*Income Excl. Interest*	*Outgo*	*Balance*
Initial balance								705
1998	435	383	52	-	100.00	435	383	52
1999	450	396	54	2.4%	102.38	440	387	53
2000	468	413	55	2.6%	105.01	446	393	52
2001	488	433	55	2.7%	107.82	453	402	51
2002	509	455	54	2.8%	110.89	459	410	49
2003	532	478	54	3.1%	114.33	465	418	47
2004	557	504	53	3.2%	118.02	472	427	45
2005	585	533	52	3.4%	122.03	479	437	43
2006	614	565	49	3.5%	126.28	486	447	39
2007	648	599	49	3.5%	130.73	496	458	37
2008	682	638	44	3.5%	135.30	504	472	33
2009	718	680	38	3.5%	140.04	513	485	27
2010	756	724	32	3.5%	144.94	522	500	22
2011	794	774	19	3.5%	150.01	529	516	13
2012	834	828	5	3.5%	155.26	537	534	3
2013	875	886	-11	3.5%	160.70	545	551	-7
2014	919	948	-29	3.5%	166.32	553	570	-17
2015	965	1,014	-49	3.5%	172.14	561	589	-28
2016	1,011	1,086	-75	3.5%	178.17	567	610	-42
2017	1,059	1,163	-105	3.5%	184.40	574	631	-57
2018	1,109	1,246	-137	3.5%	190.86	581	653	-72
2019	1,162	1,335	-173	3.5%	197.54	588	676	-88
2020	1,217	1,430	-213	3.5%	204.45	595	699	-104
2021	1,273	1,523	-250	3.5%	211.61	602	720	-118
2022	1,332	1,622	-290	3.5%	219.01	608	740	-132
2023	1,393	1,727	-333	3.5%	226.68	615	762	-147
2024	1,458	1,839	-381	3.5%	234.61	621	784	-162
2025	1,525	1,958	-433	3.5%	242.82	628	806	-178
2026	1,596	2,072	-476	3.5%	251.32	635	825	-189
2027	1,671	2,194	-522	3.5%	260.12	642	843	-201
2028	1,749	2,322	-572	3.5%	269.22	650	862	-213
2029	1,831	2,457	-626	3.5%	278.65	657	882	-225
2030	1,917	2,601	-684	3.5%	288.40	665	902	-237
2031	2,008	2,735	-727	3.5%	298.49	673	916	-243
2032	2,104	2,875	-772	3.5%	308.94	681	931	-250
2033	2,204	3,023	-820	3.5%	319.75	689	945	-256
2034	2,308	3,179	-870	3.5%	330.94	697	960	-263
2035	2,418	3,342	-924	3.5%	342.52	706	976	-270

Estimated Balances of the OASDI Trust Fund: 1998-2075

	Nominal [$billion]			CPI		Real [$billion, 1998 base]		
Year	Income Excl. Interest	Outgo	Balance	Percent Change	Adjusted Index	Income Excl. Interest	Outgo	Balance
2036	2,532	3,497	-965	3.5%	354.51	714	986	-272
2037	2,651	3,658	-1007	3.5%	366.92	722	997	-275
2038	2,776	3,828	-1052	3.5%	379.76	731	1,008	-277
2039	2,906	4,005	-1098	3.5%	393.05	739	1,019	-279
2040	3,043	4,190	-1147	3.5%	406.81	748	1,030	-282
2041	3,183	4,382	-1199	3.5%	421.05	756	1,041	-285
2042	3,330	4,583	-1253	3.5%	435.78	764	1,052	-287
2043	3,484	4,793	-1309	3.5%	451.04	772	1,063	-290
2044	3,645	5,013	-1368	3.5%	466.82	781	1,074	-293
2045	3,813	5,243	-1430	3.5%	483.16	789	1,085	-296
2046	3,987	5,490	-1503	3.5%	500.07	797	1,098	-300
2047	4,170	5,749	-1579	3.5%	517.58	806	1,111	-305
2048	4,360	6,019	-1659	3.5%	535.69	814	1,124	-310
2049	4,560	6,303	-1744	3.5%	554.44	822	1,137	-314
2050	4,768	6,600	-1832	3.5%	573.85	831	1,150	-319
2051	4,985	6,924	-1939	3.5%	593.93	839	1,166	-327
2052	5,212	7,265	-2053	3.5%	614.72	848	1,182	-334
2053	5,449	7,622	-2173	3.5%	636.24	857	1,198	-341
2054	5,698	7,997	-2299	3.5%	658.50	865	1,214	-349
2055	5,957	8,390	-2433	3.5%	681.55	874	1,231	-357
2056	6,228	8,804	-2575	3.5%	705.40	883	1,248	-365
2057	6,512	9,238	-2725	3.5%	730.09	892	1,265	-373
2058	6,809	9,693	-2884	3.5%	755.65	901	1,283	-382
2059	7,120	10,171	-3052	3.5%	782.10	910	1,301	-390
2060	7,444	10,673	-3229	3.5%	809.47	920	1,319	-399
2061	7,784	11,187	-3404	3.5%	837.80	929	1,335	-406
2062	8,139	11,727	-3588	3.5%	867.12	939	1,352	-414
2063	8,510	12,292	-3782	3.5%	897.47	948	1,370	-421
2064	8,898	12,884	-3986	3.5%	928.88	958	1,387	-429
2065	9,304	13,505	-4201	3.5%	961.39	968	1,405	-437
2066	9,727	14,147	-4420	3.5%	995.04	978	1,422	-444
2067	10,170	14,820	-4650	3.5%	1029.87	987	1,439	-452
2068	10,633	15,525	-4893	3.5%	1065.92	998	1,457	-459
2069	11,116	16,263	-5147	3.5%	1103.23	1,008	1,474	-467
2070	11,622	17,037	-5415	3.5%	1141.84	1,018	1,492	-474
2071	12,147	17,847	-5700	3.5%	1181.80	1,028	1,510	-482
2072	12,696	18,696	-6000	3.5%	1223.16	1,038	1,529	-491
2073	13,270	19,585	-6315	3.5%	1265.97	1,048	1,547	-499
2074	13,870	20,516	-6646	3.5%	1310.28	1,059	1,566	-507
2075	14,497	21,488	-6991	3.5%	1356.14	1,069	1,584	-516

Estimated Balances of the OASDI Trust Fund: 1998-2075

	Nominal [$billion]			*CPI*		*Real [$billion, 1998 base]*		
Year	*Income Excl. Interest*	*Outgo*	*Balance*	*Percent Change*	*Adjusted Index*	*Income Excl. Interest*	*Outgo*	*Balance*
1997-2010	-	-	-	-	-	6,169	5,619	1,255
1997-2030	-	-	-	-	-	18,122	19,774	-947
1997-2070	-	-	-	-	-	56,916	74,751	-17,130

Geometric interpolation used for 5-year intervals after 2005
source: 1998 OASDI Board of Trustees Report, Table III.B4
CPI Index from Table III.B1
[Intermediate Assumption Set]

Mr. COLLINS. We keep talking about investments. Investments worry me too, as an individual. It worries me from the standpoint that I may not have the best knowledge of how to invest, and I would say that probably runs concurrent with a lot of other people in the country.

However, I do have faith in accounts that are interest bearing. And if we stay focused on the generation behind us, and how we can solve this problem for them, we also look back at how we solve other problems in other areas of financial services, like the savings and loans, and we agree and confess that we have to belly up to the bar and pay that bill.

Then we can cover that liability, and yet ensure for young people, that they are going to actually get a return on the moneys that are deducted from their payroll checks. And if we do it right, I think we can reduce the amount of money that we are deducting, leaving them more of their income to direct in different type of investments.

Mr. BOSKIN. I agree with that.

Mr. COLLINS. Thank you. Thank you, Mr. Chairman.

Chairman BUNNING. Mr. Portman.

Mr. PORTMAN. Thank you, Mr. Chairman. I have a very general question and it may not be one where there will be a long answer here this afternoon, but perhaps those who are interested could get back to me. It goes to the basic approach one might want to take. And Dr. Boskin and I had a chance to talk about this recently.

But, looking at the Kolbe proposal, it's a percent of the payroll tax that would be taken out and invested as an individual account or a private savings account. Most of the payroll tax would continue to go to the government under the current system.

Another alternative being talked about, I think Mr. Ball's approach to this would be allowing the trust fund itself to invest in the private market, to a certain extent in the capital markets.

Another alternative that I just wanted to get your input on, if I could, would be to back up for a moment and say, in a sense, could you combine the two by allowing individual accounts, perhaps along the lines of some of the models we've seen in South America.

The notion is the highly regulated individual account where I, as a payroll taxpayer, would be paying into the system just as I am now, but it would go into my account. It would be highly regulated by the government in the sense I'd be very limited in terms of decisions I could make. But I could make decisions within certain parameters.

And the government would have it all. The government would hold it all, and money being fungible as we said earlier, the government would then be able to pay it's liabilities over this transition period. But I would have the personal decision to make as to how I would invest it in this kind of mutual fund or that kind of mutual and safer or more risky investment.

I just wondered if you could talk a little about that. It is, in a sense, a third way that I haven't heard much discussion about today. Dr. Schieber?

Mr. SCHIEBER. It certainly is a third way. I guess there is some skepticism as to whether or not the Federal Government, as this fund began to accumulate and build and get very large, and it would get extremely large, whether or not the Federal Government could hold the dam, because there's a lot of uses for money.

Mr. PORTMAN. Are you concerned about Congress allowing first time home buyers, or folks who are interested in education, IRAs, to use these funds? Is that the sort of concern?

Mr. SCHIEBER. It goes beyond that. It's problems like Medicare that need financing. We undoubtedly will go through periods where it looks like some people aren't getting enough in retirement income and maybe we can embellish those benefits. When we have a downturn in the economy, maybe we will need to give people some slack on payroll taxes. There's a long history of this having been done.

The original act called for the system to be significantly funded. All throughout the thirties and forties, we stepped back on that. If you look at the experience of the 1983 amendments, there are many analysts who believe that the exercise of building up the trust fund we have right now was not an act of national saving. There's a question of whether or not we can create saving in this economy in that kind of mechanism.

Mr. PORTMAN. I guess I want to hear from others if they have comments. But my response would be, in part, that even with individual accounts, as 2 percent as Mr. Kolbe is talking about, Congress can always go back and change the parameters of that. Also, the rest of it, whether you view it as 6.2 or 12.4 percent, remains in the government to be moved around as you say.

And finally, it would be different in kind from the way Social Security was initially established, because there would be an individual account where you would have the ability as an investor to be able to determine where it went, and you'd be getting a statement monthly, and so on. Rather than having it going into an amorphous trust fund.

Mr. SCHIEBER. As Michael Boskin indicated earlier, he put together a proposal several years ago that would have had individual account. My recollection was those were more notional, unfunded accounts than real accounts. I mean, you could convert the current system into an account based system without doing any funding.

Mr. PORTMAN. But you wouldn't have any investment.

Mr. SCHIEBER. You wouldn't have any investment.

Mr. PORTMAN. Any other comments?

Mr. BOSKIN. Two quick comments about that. One is, I've always thought one of the problems with Social Security is that we are not providing people with enough and accurate information. There have been some improvements made in the last few years—I want to say in the last decade or so.

But many people aren't aware that the benefit projections are projections and would assume current law plus massive tax increases to fund them. Many people aren't aware of the different types of things they're insured against with survivors, and disabilities, and so on, other than very generally. And the kinds of statements you get are not sufficient, in my opinion.

So that's something that I think ought to be done, and could be done, independent, even if there were no funding problems or any reforms being considered.

With respect to the point you made though, I view the tradeoff in the following way. I do believe there would be a very big difference in people's minds about having an account at a private financial institution, whether the money was sent by their employer, whether they put it in, whether it was done in some more cost effective way than a bunch of individuals trotting up with small amounts at Schwab, or Fidelity, or Vanguard, or many banks, or whatever it happened to be, then something that, even though their name was on it and was a separate part of the statement, was inside the government. I think people would have a different reaction to that.

I would favor the former, but it's going to be more costly to do, unless we figure out mechanisms to reduce the cost to a tolerable amount.

Mr. DIAMOND. In contrasting these——

Mr. PORTMAN. Dr. Diamond, I think I've exceeded my time here. We either can speak afterwards, or if you could give me your written comments, I'd appreciate it. Thank you.

Chairman BUNNING. I wouldn't tell Dr. Boskin that in the year 2000, everyone who has an account for Social Security over age 25, will be receiving an annual statement of how much they've put in, what their projected benefits will be.

Mr. BOSKIN. I think that's a major step forward. I proposed this 20 years ago in the 1982 Advisory Commission, which led to the 1983 amendments.

Chairman BUNNING. You weren't Chairman of the Social Security Subcommittee at the time, so it didn't take effect.

Mr. BOSKIN. No. I commend you for doing that. When it has your projected benefit, what will it say about the unfunded liabilities?

Chairman BUNNING. Probably nothing.

Mr. BOSKIN. That's a big concern of mine.

Chairman BUNNING. I understand that. But at least we're making the first step in the right direction.

Mr. BOSKIN. I commend you for that. It's very important.

Chairman BUNNING. We want to thank you all for being here. We appreciate your input. And we will ask for the second panel to take their seats. Thank you.

Dr. Lawrence White, professor of economics from the Stern School of Business at NYU; Dr. Gary Burtless, senior fellow from the Economics Study Program at the Brookings Institution; Ric Edelman, chairman and chief executive officer with Edelman Financial Services; Teresa Tritch, senior editor from Money Magazine; and Paul Huard, senior vice president of policy and communication at the National Association of Manufacturers.

Dr. White.

STATEMENT OF LAWRENCE J. WHITE, PH.D., PROFESSOR OF ECONOMICS, STERN SCHOOL OF BUSINESS, NEW YORK UNIVERSITY

Mr. WHITE. Thank you, Mr. Chairman. I am very pleased and honored to be here and to have been invited to address this Subcommittee.

As all of you know, the Social Security Program has been a valuable and popular program. It's been a valuable source of old age and disability support. But its structure has created serious financial problems. These problems have various manifestations. You've been talking about some of them: The unfunded liabilities; the negative expected discounted real returns of many of today's workers, or the equivalent unfavorable money's worth ratios; or, as yet another manifestation, the direct financing of the program as a self-contained entity faces serious future problems.

Those problems are going to arise at a much sooner date than many of the media reports would indicate. Since this is a pay-as-you-go program, the problems will manifest themselves in terms of the annual net cash flows of the program, and those will begin to be negative in the year 2013. That's the year in which the Congress will have to find alternative ways of supporting the program because the program itself will be running net negative on an annual basis.

2013: A mere 15 years away, which, for Social Security, is like an eye blink. This is the year in which either other taxes will have to be raised or other spending curtailed or other borrowing increased. This is much sooner than the year 2032, which is the year that the media focuses on. That's a meaningless year in terms of the real consequences for the program.

I believe that a PSA, a personal savings account component, is a very desirable part of the overall reform of the Social Security Program. Further, I am convinced that a broad choice PSA program, basically structured the way that the current investment retirement account, IRA, program is structured, is the direction to go. This broad choice direction would have a number of desirable features. First, it would give participants a wide range of opportunity to tailor their investments to their tolerances for risk, for their knowledge and information, their age and family status, and other personal considerations.

It would be especially valuable for the participants who are less financially sophisticated, less knowledgeable, perhaps quite risk averse. They could, as is possible in the IRA program, choose a bank account; a certificate of deposit; a credit union account; a savings institution account; or an insurance company's, similar vehicle for their investments. It is instructive that, as of 1996, over a quarter, 26.3 percent, of the funds in IRAs were invested in such funds. As recently as 1991, this figure was almost half, 47 percent.

Second, a broad-based program would bring a regulated financial institution into the picture, since the regulated financial institution would be the place, the first point of contact, for the investment of such funds. And, with the regulated financial institution would come its fiduciary and advising obligations to the participants.

Third, it would bring the creative and competitive forces of the financial services sector into the picture to devise appropriate instruments and educate the program's participants.

Fourth, to the extent that participants do choose the bank accounts or similar instruments offered by financial intermediaries, this route will provide a financing channel for the millions of small enterprises in the U.S. economy that are not publicly traded, that would not benefit from the investments in index funds that would be a consequence of a more centralized financing mechanism. These are the millions of small enterprises that rely on bank finance or similar types of financial intermediary finance. There are only about 10,000 publicly traded companies in the U.S. economy. These are the larger enterprises; they are the ones who would benefit from investments in index funds. A broad-choice program would bring the other millions of enterprises into the picture as well.

A potential negative consequence is the transactions costs of broad based plan. I am convinced that there are ways of dealing with this problem. The competitive forces of the financial services sector will help deal with it. The IRA program manages to deal with it. The Federal Government could be an accumulator to help buildup sufficient balances.

In summary, Mr. Chairman, the problems are serious. Reform is necessary. A broad-choiced PSA component should be part of that reform. The time to act is now. Thank you very much; I'll be happy to answer questions.

[The prepared statement follows:]

Statement of Lawrence J. White,[1] Ph.D., Professor of Economics, Stern School of Business, New York University

Chairman Bunning, Members of the Subcommittee: I am pleased and honored to be invited to testify before your Subcommittee today.

SUMMARY

The future of the Social Security program is an important public policy issue for this Congress, and for the nation as a whole, to tackle. The program has been a valuable source of old-age and disability support for tens of millions of Americans. It has had a substantial and worthwhile redistributive component. But it has also evolved into a program with substantial problems.

As a pay-as-you-go system, it has not contributed to—and has probably subtracted from—the domestic savings available to finance investments in the U.S. economy. With its history of past policy changes and changing demographics, it has developed

[1] During 1995–1996 I was a consultant to the Investment Company Institute on the subject of Social Security reform.

serious financial problems. These problems have various manifestations: a net excess of discounted promised benefits less discounted taxes (net unfunded liability) of about $3 trillion; a declining expected real return or even negative return for many or most of today's workers, in terms of their expected discounted contributions and expected discounted benefits (equivalently, a decline in the "money's worth" ratios); and the projected direct financing problems of the program as a self-contained entity.

It is this last manifestation—the program's direct financing problems—that has attracted the most attention. But these problems will be reached at a much sooner date—2013—than most media reports have indicated. These difficulties will arise because the program has been on a pay-as-you-go basis, with no systematic investment of participants' contributions in real investment resources.

The solution to the Social Security programs financial problems must involve a widespread set of changes, including an expansion of the contribution base, an increase in retirement eligibility ages, modifications to the cost-of-living adjustments to benefits, and the institution of individual or personal savings accounts (PSAs). I believe that voluntary PSAs are an important part of that solution.

A PSA component that is modelled on the way that investment retirement accounts (IRAs) are currently handled would be a desirable direction for the program. A voluntary PSA component with a wide choice of investment vehicles and instruments, plus the involvement of regulated financial institutions with fiduciary obligations, reaches the proper tradeoff of choice, tolerances for and exposure to risk, and responsibility.

By allowing individuals to place their PSAs in FDIC-insured bank deposits or similar instruments (as is currently the case for IRAs), the PSA component would permit unsophisticated or extremely risk-averse individuals to participate in a way that would be comfortable for them. Equally important, the savings that would be channeled through such instruments would become a potential source of finance for the millions of small enterprises in the U.S. that are not publicly traded. These enterprises rely largely on debt finance through banks and other financial intermediaries. A program that restricted PSAs only to index funds would mean that, at best, only the 10,000 or so publicly traded companies in the U.S. would benefit from the finance made available through the program. The remaining millions of smaller enterprises in the U.S. would be deprived of this financial flow.

The problems of the Social Security program are serious and require serious attention. Because any changes in the program must be phased in gradually, the Congress must pass the appropriate legislation promptly. Delay can only increase the costs and the difficulties of making the eventually necessary reforms.

SOCIAL SECURITY'S FINANCIAL PROBLEMS

The financial problems of the Social Security program as a self-contained system are real. They will arise because it is a pay-as-you-go system. Today's workers' contributions are largely paid out to today's retirees. As the number of retirees continues to mount relative to the working population, the program will begin to experience annual net negative cash flows. The "intermediate" projection of the Board of Trustees of the Social Security program, in their 1998 Report, predicts that these annual net negative cash flows will begin to occur in 2013 and will grow ever larger in the following years. Even the "optimistic" projection of the Trustees predicts that these annual net negative cash flows will begin in 2018.

Under this pay-as-you-go program, there is no systematic investment of an individual's contributions in real investment resources. Any current surplus of cash intake over cash outflow—in 1997 this cash-flow surplus was about $45 billion—has been transferred to the Treasury and used to cover the other expenses of the U.S. Government. The funds have not been systematically invested in real resources. The so-called Trust Funds do not represent any claim on real resources. They are simply an accounting of the past cash-flow surpluses of the program, plus notional interest. Since the cash-flow surpluses have long ago been spent, the apparent accumulations in the Trust Funds simply represent the recognition of these past surpluses and the promise by the Congress that future appropriations will be made to cover future deficits in the program. But such promises are no stronger or weaker than the promises of the Congress generally to support the program. The presence of the Trust Funds adds nothing of real value to those promises.

Consequently, the year when the annual cash flows of the program become negative—2013—is the time when the real financing problems for the program will arise. It is the time when the program will no longer be making a net contribution to the other operations of the Federal Government but will instead will be a net drain and will require the Congress to curtail other spending, raise other taxes, or increase net borrowing. Indeed, one might argue that the effective financial "crunch" for the Federal Government will come sooner, around 2008, when the annual net cash-flow surplus of the Social Security program will begin to decline sharply and will offer less help in covering the other expenditures of the Federal Government.

In either case, whether the date is 2008 or 2013, this is much sooner than the year 2032, which is when the Trust Funds will be "exhausted" and is the year on which most media reports have focused as the date when the program will become "insolvent." Since there are no real resources in the Funds, the date of their "exhaustion" is a meaningless benchmark. It only indicates the point at which the accumulated net negative cash flows (after 2013) will have just equaled the earlier (pre 2013) accumulated net surpluses (plus notional interest). In 2032 the annual net negative cash flow of the Social Security program will be about $750 billion ($250 billion in constant 1998 dollars), or more than 1.8% of U.S. GDP in that year.

This same logic indicates why an often-advocated "easy fix" to the Social Security program—to increase the workers' and employers' wage contributions by about two percentage points (i.e., to raise the aggregate contribution rate to about 14.4% of the wage base from its current 12.4%)—would not solve the system's fundamental problems. Unless the extra contributions were invested in real resources, this "fix" would only delay the onset of the annual net negative cash flows by about five years, to 2018. And the additional tax on wages would make the hiring of labor more expensive, add to the distortion of labor markets, and drive more employment arrangements "off the books" and into the gray or underground economy.

Because the problems of the Social Security program are severe and because the program's self-contained financial problems will arise soon—within the next ten to fifteen years—and because gradual transitions are a necessary and legitimate part of any changes in the program (since it is fundamentally unfair to tell a 55 year old worker that his/her retirement benefits will be appreciably different from what he/she had earlier been promised), the time to begin making adjustments in the program is today.

PERSONAL SAVINGS ACCOUNTS

As was mentioned above, personal savings accounts (PSA) are just one component of the modifications that must be made to the Social Security program. But they are a vital part of those changes. They would represent the first step toward moving the program away from its defined-benefit structure, with that structure's attendant short- and long-run financial problems, and toward a defined contribution structure that would bring greater personal choice and responsibility, while maintaining an acceptable level of redistribution, and that could contribute toward national saving and real investment rather than detracting from them.

A PSA plan is far preferable to any plan that would simply have the Social Security Administration itself invest some or all of the cash-flow surpluses in private-sector securities. The latter plan would bring the Federal Government into far too much involvement in investment choices (only the S&P 500? all publicly traded companies? what about foreign companies? what about companies that have been convicted of criminal violations? what about tobacco companies? etc.) and potential conflicts of interest. Also, such investments would neglect the millions of enterprises in the U.S. that are not publicly traded. These problems are serious ones that the Federal Thrift Savings Plan, that applies to federal workers' pensions, do not adequately handle. They would be intolerable for the much larger sums that the Social Security Administration would be investing.

A number of PSA-type plans have been proposed. For a program that is as complicated as the Social Security program, truly "the devil is in the details." Instead of advocating any specific plan, I will set forth a set of principles that should guide any specific structure.

1. A PSA plan should be voluntary. Though many program participants would surely be eager to create and participate in a PSA component of their Social Security contribution, others will surely be reluctant and would prefer to stay with the program that they know and trust. So long as the choices are clear, this alternative should be available. This will help avoid the unfortunate political "poster" stories of the reluctant PSA participant who then invests in high-risk investments that subsequently prove worthless.

Though the preservation of this type of choice may make the program more complicated and could lead to problems of adverse selection and of maintaining the redistributive aspects of the program, I believe that the benefits would exceed the costs.

2. The PSAs should be patterned along the lines of the current investment retirement account (IRA) structure. That is, a wide choice of investment vehicles and in-

struments should be available to the program participants; and the PSA should be registered at a regulated financial institution, such as a bank, a savings institution, a credit union, an insurance company, a stock brokerage firm, or a mutual fund company.

This broad-choice structure would have many advantages. First, it would give participants a wide range of opportunity to tailor their investments to their tolerances for risk, knowledge and information, age and family status, and other personal considerations. This broad-choice structure would be especially valuable for the less sophisticated, less knowledgeable or very risk-averse participants who would prefer to keep their PSAs in a familiar FDIC-insured bank account or similar instrument. It is noteworthy that as of 1996, over a quarter (26.3%) of the funds in IRA plans were in deposits in banks, thrifts, or credit unions or in similar instruments in insurance companies; as recently as 1991 this percentage was 47%.

Second, it would bring a regulated financial institution, with fiduciary obligations and responsibilities, into the picture. Advising the customer as to the suitability of proposed investments with the customer's other circumstances is a major such responsibility. It is noteworthy that there have been no reported scandals or political calls for reform with respect to the way that the IRA program is structured.

Third, it would provide strong incentives for the creative and competitive forces of the financial services sector to develop appropriate investment instruments and to educate the program's participants as to the merits of those instruments.

Fourth, to the extent that individuals would choose to invest their funds in bank accounts or similar vehicles, this route would provide a financing channel for the millions of enterprises in the U.S. that are not publicly traded and that would not benefit from investments in any form of index fund that is restricted to purchasing the securities of publicly traded companies.

There are currently only about 10,000 companies in the U.S. that have publicly traded securities. An index fund would necessarily be restricted to their securities. But there are millions more of smaller enterprises in the U.S. that get their financing primarily through debt finance—i.e., through loans from banks and other financial intermediaries. In turn, it is deposits in banks and other financial intermediaries that provide the ultimate source of the debt financing. Indeed, it is this financing channel that has received extensive political and media attention in the recent past during periods of perceived "credit crunches."

A PSA structure that preserved bank accounts and similar vehicles as acceptable investments would keep this channel of finance available for smaller enterprises. By contrast, a PSA plan that was patterned along the Federal Thrift Savings Plan and that restricted participants to only a handful of index funds would have none of these desirable properties. A participant could not choose the familiar bank deposit. And the resulting flow of capital and finance would be distorted to favor the larger enterprises in the U.S. over all of the rest.

A potential drawback to a wide-choice PSA structure might be the transactions costs of maintaining these accounts. I am not convinced that this would be an insurmountable barrier. First, with a wide range of instruments and vehicles open to participants, there would be competition among providers to offer low-cost accounts, perhaps in return for agreed-upon restricted ability to move funds around, as is the case for bank certificates of deposit. The prospects for attracting these flows, present and future, should be an attractive one for many financial institutions. Second, as an interim measure for low income workers whose PSA contributions might initially be small, the Federal Government might stand ready to serve as the accumulator of, say, the first three years of PSA contributions, after which they would revert to the IRA-like structure described above.

THE TRANSITION

There are few free lunches to be had, and the financing of the Social Security program is certainly no exception. The diversion of participants' contributions into PSAs would leave a financing gap with respect to the current basic pay-as-you-go structure. The current federal overall budgetary situation, with projected surpluses for the consolidated budget, provides an excellent opportunity for making the necessary start on financing this transition.

A frequently stated fiscal goal in the current environment is that the projected budgetary surpluses should be used to "strengthen Social Security." Unfortunately, within the framework of the current pay-as-you-go structure, there is no direct way that the surpluses can be used to strengthen the finances of the Social Security program. But, with a PSA component to a reformed Social Security structure, the surpluses could be used to help finance the transition. Equivalently, as part of the overall reform of the program the budget surpluses could be used to finance the PSAs directly while workers' contributions continued to be used to cover the payouts to current retirees.

CONCLUSION

The Social Security program is a major feature of today's economy. Current retirees rely on it; future retirees expect it. But the program does have serious problems.

Reforming the program will not be easy. It is complex; there are many vested interests that will be affected by any changes. But reform is necessary.

A central component of any reform should be a system of voluntary personal savings accounts (PSA) accounts that are patterned on the current investment retirement accounts (IRAs), with a wide choice of instruments and vehicles and the involvement of a regulated financial institution. These PSAs would serve as the basis for bringing the Social Security program into a better funded position and for allowing the program to make a greater contribution to this country's saving, investment, and efficient use of resources.

Procrastination and delay in instituting reform of the Social Security program can only make the necessary eventual reforms more costly and more difficult. I urge the Congress to act quickly.

Thank you. I will be happy to answer questions.

Chairman BUNNING. Thank you, Dr. White.

Dr. Burtless.

STATEMENT OF GARY BURTLESS, PH.D., SENIOR FELLOW, ECONOMIC STUDIES PROGRAM, BROOKINGS INSTITUTION

Mr. BURTLESS. Thank you for the invitation. I'll confine my remarks to just a couple of points. First, the nation's interest in replacing part or all of traditional society security with a system of individual accounts is driven by a widespread recognition that rates of return on contributions to Social Security are going down and eventually may reach 1 or 1.5 percent for a typical worker. Americans compare this with a situation in which, in the last 15 years—the period ending in January of this year—they could have earned 13.3 percent after subtracting for the influence of inflation, on stock market investments.

Advocates of individual retirement accounts sometimes suggest that we can eliminate or reduce the traditional system in which workers' rate of return will be negative or very low with a new system in which they can get these high rates of return if we establish individual accounts. This beguiling invitation is based on a fundamental confusion. About 90 percent of the contributions we make for Social Security each year go directly to pay for benefits to our parents and grandparents, to our disabled relatives, and to the dependents of retirees and disabled people. We're going to have to make payments to these people for the next 40 or 50 years regardless of anything we do about establishing individual accounts. So there's no way we're going to earn 8 percent, 10 percent, or even 2 percent on this part of our contributions. They're going to pay for current benefits; they cannot be used for investments in stocks, bonds, real estate, or any other thing your stockbroker might want to sell you.

The only questions are: A. How can we invest the surplus of contributions over current benefit payments? And, B. How can we change things so the surplus gets bigger or lasts longer? The answer to question A is that we can certainly invest the surplus in assets that earn a higher expected rate of return. All we have to do is change the assets that we permit the Trustees to invest in, expand the menu of alternatives to include mortgage debt, corporate bonds, and equities.

The answer to question B, how can we increase the size of the surplus, is also obvious. We must either cut benefits or increase contributions and we must do so fairly soon. The crucial issue is: How much of each of these things should we do? Increase contributions or cut benefits?

My second point: The claim that individual accounts can yield workers a rate of return of 7 or 8 percent on their contributions must be assessed against the risk of investments in individual accounts. Bear in mind that the 13.3-percent real return we saw in the 15-year period ending January was far above the average 15-year return that U.S. equity markets have yielded over the last 130 years. In the 15-year period that ended in January 1982, for example, the annual real return on stock market investments held for 15 years was 0.7 percent. That's why in 1982, when Social Security faced a financing crisis, we didn't hear lots of discussion about how attractive the stock market looked as an alternative to Social Security. No one was going to talk about stock market investments when stock market returns had been negative over such a long period.

Since 1871, there have been 113 15-year periods over which we can calculate the real rate of return on $1.00 invested in U.S. equities. In six of those periods, the returns were negative. In eight, the return was 13 percent a year or higher. So clearly the recent return has been exceptional. The arithmetic average of the 15-year returns was 6.6 percent.

Many people mistakenly think that these ups and downs in the stock market average out over time, assuring that people who invest for long periods will be assured a high rate of return. But that's not true. If you happened to retire in 1931 or in 1975, your stock market assets would've purchased a lot less in the way of retirement consumption for you. That simply follows from the fact that the assets that you'd accumulated over your life fell substantially in value in a very short period of time—the last 2 or 3 years of your career.

The chart at the end of my table tries to perform calculations showing you what the replacement rate of a pension invested in stock market individual accounts would have been for workers retiring after a 40-year career ending in 1910, 1911, and so on up through 1997. The message of that chart is clear. These investments do not yield a highly secure retirement income. The average rate of return is good. It's just that in a 1- or 2-year period, the pension that you can accumulate if you invest in the stock market, or any other portfolio for that matter, can go up and down a lot. I don't think that the mandatory public pension system should force people to rely heavily on that kind of a system. Thank you.

[The prepared statement follows:]

Statement of Gary Burtless,[1] Ph.D., Senior Fellow, Economic Studies Program, Brookings Institution

SOCIAL SECURITY'S FINANCING PROBLEM

Most Americans recognize that Social Security faces a long-term financing problem. Many workers under 35 believe the problem is so severe they will never receive a Social Security check.

Young workers lack confidence in Social Security because they do not believe future workers will be willing to shoulder the higher payroll taxes that will be needed to keep the program solvent. I think they are wrong, but their fears are not unreasonable. For almost two decades many influential opinion leaders and elected officials have fiercely criticized any increase in taxes, even when it was plain that future Social Security revenues will fall far short of promised future benefits. If the Congress and public are opposed to boosting taxes today, when the tax increase required to eliminate Social Security's long-run deficit is relatively small, will they be willing to raise taxes after 2020, when the required tax increase would be far larger? Younger workers and many opinion leaders evidently do not think so.

The simplest and best solution to Social Security's financing problem is to trim promised benefits and increase payroll taxes one or two percentage points. It would be sensible if major steps along these lines were taken well in advance of 2010 when the Baby Boom generation begins to retire. Although it is not necessary that future benefits be reduced or taxes hiked immediately, it is desirable that decisions about future benefits and taxes be made as soon as possible. The OASDI Trustees' intermediate assumptions imply that the Trust Funds will be depleted shortly after 2030. The youngest Baby Boom workers will be in their middle 60s when that year arrives. If workers are to plan sensibly for their retirement, it is critical to inform them what combination of reduced benefits or higher taxes they will face over their careers.

The long-run threat to Social Security solvency has prompted many people to offer novel solutions to the financing problem. Some proposals are aimed at reducing or eliminating the role of Social Security in protecting the incomes of the disabled and retired elderly. Others have the simpler goal of improving the financial performance of the Social Security Trust Funds by permitting Trust Fund reserves to be invested in equities or other high-yielding assets.

INDIVIDUAL ACCOUNTS

One of the most widely discussed reform plans is to scale back traditional Social Security benefits and replace them fully or partially with a privately managed system of individual retirement accounts. Such accounts could be run independently of traditional Social Security or as an additional component of the existing system. Proponents of individual accounts offer three main arguments for moving toward individual pension accounts:

- It can lift the rate of return workers earn on their retirement contributions
- It can boost national saving and future economic growth
- It has practical political advantages in comparison with reforms in existing public programs that rely on higher payroll taxes or a bigger accumulation of public pension reserves

Moving to a system of large individual accounts must overcome a big financial hurdle, however. The existing Social Security system has already accumulated huge unfunded liabilities to workers who are already retired or who will retire in the next couple of decades. To make room for a new individual account system, the Nation must find public funds to pay for existing Social Security obligations while still leaving young workers enough money to deposit in new retirement accounts. This requires scaling back current obligations—by cutting benefits—or increasing total contributions from current workers. A large-scale individual account system would almost certainly require major new public borrowing. The country has struggled for the past decade to eliminate the federal deficit, so many voters will be angry to see that accomplishment thrown away in order to make room for a new system of individual accounts.

As noted, proponents of individual accounts claim both economic and political advantages for their favorite plans. In the remainder of my testimony, I focus on the economic aspects of such proposals.

[1] The views expressed are solely my own and should not be ascribed to the staff or trustees of the Brookings Institution.

Individual saving accounts can boost workers' rate of return by allowing their retirement contributions to be invested in private assets, such as equities, which yield a better return than the assets held by Social Security. Returns can be boosted still further if the U.S. government borrows on a massive scale to pay for past public pension liabilities, allowing workers to invest a larger percentage of their wages in high-yielding assets. Exactly the same rate of return can be obtained, however, if the existing Social Security system is changed to allow reserves to be invested in high-return private assets. Put simply, the rate-of-return advantage claimed for individual accounts could be duplicated by the present system if its investment options were expanded.

By shifting the retirement system away from pay-as-you-go financing and toward advance funding, a system of individual accounts could boost national saving. Such a move will require a consumption sacrifice, either through a cut in benefits or a hike in combined contributions to the old and new retirement plans. Individual account plans that do not impose a consumption sacrifice will not achieve a higher saving rate. Higher national saving can also be achieved by reforming the present Social Security system. The crucial change in policy is the move toward more advance funding, not the move to individual accounts. Thus, the claimed economic advantages of individual retirement accounts can be obtained in either a new individual account system or with a slight modification of the existing Social Security system.

In an individual account system workers would be free to decide how their contributions are invested, at least within broad limits. Some proponents of individual account plans suggest that contributions should be collected by a single public or semi-public agency and then invested in one or more of a limited number of investment funds. A worker might be given the option of investing in, say, five different funds—a money market fund, a stock market index fund, a real estate investment trust, a corporate bond fund, and a U.S. Treasury bond fund. By pooling the investments of all covered workers in a small number of funds and centralizing the collection of contributions and funds management, this approach minimizes administrative costs but it limits workers' investment choices. Another strategy is to allow mutual fund companies, private banks, insurance companies, and other investment companies to compete with one another to attract workers' contributions in hundreds or even thousands of qualified investment funds. This strategy would permit workers unparalleled freedom to invest as they choose, but the administrative, enforcement, and selling costs of such a system would be very high, substantially reducing the rate of return workers earn on their investments.

Transition to an Individual Account System

Individual account plans differ from traditional Social Security in two important ways. First, the worker's ultimate retirement benefit depends solely on the size of the worker's contributions and the success of the worker's investment plan. Workers who make larger contributions receive bigger pensions, other things equal. Workers whose investments earn better returns will get much larger pensions than workers who invest poorly. Second, in an individual account system pensions will be paid out of large accumulations of privately owned savings. In contrast, current Social Security pensions are financed mainly by the payroll taxes of active workers. This difference between the two kinds of system implies that the savings accumulation in an individual-account plan would be many times larger than the accumulation needed in pay-as-you-go Social Security.

Because the connection between individual contributions, investment returns, and pension benefits is very straightforward in a defined-contribution individual account program, the system offers less scope for redistribution in favor of low-wage workers. Pensions financed out of individual investment accounts are based solely on deposits into the accounts (which are strictly proportional to workers' earnings) and on the investment performance of the accounts. Redistribution in favor of low-wage or other kinds of workers must take place outside these accounts. In contrast, the Social Security pension formula explicitly favors low-wage workers and one-earner married couples in order to minimize poverty among elderly and disabled people who have worked for a full career. To duplicate Social Security's success in keeping down poverty among the elderly and disabled, an individual account system must supplement the pensions from the individual accounts with a minimum, tax-financed pension or with public assistance payments.

The United States cannot immediately scrap its public retirement system and replace it with a private system. At the end of 1997, almost 44 million Americans were collecting benefits under Social Security. About 2.3 million workers began to collect new retirement or disability benefits during the previous twelve months.

Even if the country adopted a new individual account system for workers under 45, people who are already collecting Social Security or who will begin collecting within the next few years will continue to receive Social Security checks for several decades. Public funds must be appropriated to pay for these pensions, regardless of the system established for workers who will retire in the distant future.

RISKS OF INDIVIDUAL ACCOUNTS

The deficit risk

The need to pay for the pensions of people who are already retired or near retirement age poses a challenge to all plans for establishing mandatory individual retirement accounts. Money must be found for existing pension liabilities at the same time workers will be asked to contribute to the new type of pension account. Because active workers will be required to finance pensions for retired workers and old workers nearing retirement, they may resent the obligation to pay for their own retirement pensions through contributions to new individual accounts.

Some individual account plans would fund new retirement accounts by diverting a small part of the present payroll tax into private retirement accounts. In 1997, Social Security tax revenues exceeded OASDI benefit payments by $44 billion, or a bit more than 1% of taxable earnings. Thus, 1% to 1½% of the 12.4% payroll tax could be invested in individual retirement accounts while still leaving enough taxes to pay for current pension payments. This source of financing for the new accounts will not last forever. Even if workers under age 45 were completely excluded from collecting Social Security pensions, benefit payments will exceed Social Security taxes by around 2015. In addition, workers must contribute much more than 1½% of their wages if they hope to accumulate enough private savings to enjoy a comfortable retirement. Thus, the strategy of diverting a small part of Social Security taxes can only work if current benefits are scaled back (yielding a surplus in Social Security long after 2015) or if private pension accounts provide only a modest supplement to Social Security pensions.

More ambitious individual account plans would require borrowing or new federal taxes to pay for existing Social Security liabilities. These plans would divert half or more of the present Social Security payroll tax into private retirement accounts. The Social Security benefits promised to young workers (for example, those under age 45) would be slashed. A high rate of contributions into the new private accounts would be needed to ensure that enough money is accumulated to pay for reasonable pensions. However, the diversion of payroll taxes would starve the Social Security system of revenue, forcing the program to run huge deficits. To cover these deficits Congress would be forced to raise taxes or borrow funds. The need for extra taxes or borrowing would shrink as pensioners collecting Social Security are eventually replaced by pensioners who receive benefits from the new private accounts, but this process would not be complete for several decades. In the interim, the federal government would need to impose extra taxes (temporarily replacing most of the lost Social Security taxes) or run large deficits in order to cover the shortfall in the remaining Social Security program.

Investment risk

The most frequently mentioned advantage of individual accounts is that they would permit workers to earn a much better rate of return than they are likely to achieve on their contributions to traditional Social Security. I have heard it claimed, for example, that workers will earn less than 0% real returns on their contributions to Social Security, while they could earn 8% to 10% on their contributions to an individual retirement account if it is invested in the U.S. stock market.

This comparison is highly misleading. First, the claimed return on Social Security contributions is too low. Some contributors will earn negative returns on their Social Security contributions, but on average future returns are expected to be between 1% and 1½%, even if taxes are increased and benefits reduced to restore long-term solvency.

Second, workers will not have an opportunity to earn the stock market rate of return on all of their retirement contributions, even if Congress establishes an individual account system in the near future. As noted above, more than nine-tenths of workers' contributions to Social Security are immediately used to pay benefits to disabled and retired workers and the dependents of deceased workers. Even if a new individual account system is established, workers (or other taxpayers) will be obliged to pay the cost of these promised benefits. Thus, the amount of surplus funds available to invest in the stock market is 1½% of a worker's pay rather than the full 12.4% of payroll that is deducted for Social Security contributions. Workers' overall rate of return on their contributions to the retirement system will be an average of the return obtained on their contributions to individual accounts and the return earned on their contributions to whatever remains of the traditional Social Security system. For most current workers, this overall rate of return will be much closer to the current return on Social Security contributions than it is to 8%.

Advocates of individual retirement accounts often overlook the investment risk inherent in these kinds of accounts. All financial market investments are subject to risk. Their returns, measured in constant, inflation-adjusted dollars, are not guaranteed. Over long periods of time, investments in the U.S. stock market have outperformed all other types of domestic U.S. financial investments, including Treasury bills, long-term Treasury bonds, and highly rated corporate bonds. But stock market returns are highly variable from one year to the next. In fact, they are more variable over short periods of time than are the returns on safer assets, like U.S. Treasury bills.

Many people mistakenly believe the annual ups and downs in stock market returns average out over time, assuring even the unluckiest investor of a high return if he or she invests steadily over a four- or five-decade period. A moment's reflection shows that this cannot be true. From January 1973 to January 1975 the Standard and Poor's composite stock market index fell 50% after adjusting for changes in the U.S. price level. The value of stock certificates purchased in 1972 and earlier years lost half their value in 24 months. The average real rate of return on a worker's lifetime investments in the stock market plunged more than 3 percentage points (from 8.6% to 5.3%) in a very short period of time. For a worker who planned on retiring in 1975, the drop in stock market prices between 1973 and 1975 would have required a very drastic reduction in consumption plans if the worker's sole source of retirement income depended on stock market investments.

I have made calculations of the pensions that workers could expect under an individual account plan using information about annual stock market performance, interest rates, and inflation dating back to 1871.[2] I start with the assumption that workers enter the workforce at age 22 and work for 40 years until reaching their 62nd birthdays. I also assume they contribute 2 percent of their wages each year to their individual retirement accounts. Workers' earnings typically rise throughout their careers until they reach their late 40s or early 50s, and then wages begin to fall. I assume that the age profile of earnings in a given year matches the age profile of earnings for American men in 1995 (as reported by the Census Bureau using tabulations from the March 1996 Current Population Survey). In addition, I assume that average earnings in the economy as a whole grow 1% a year.

While it would be interesting to see how workers' pensions would vary if they altered the percentage of contributions invested in different assets, in my calculations I assume that all contributions are invested in stocks represented in the Standard and Poor's composite stock index. Quarterly dividends from a worker's stock holdings are immediately invested in stocks, too. Optimistically, I assume that workers incur no expenses buying, selling, trading, or holding stocks. (The average mutual fund that holds a broadly diversified stock portfolio annually charges shareholders a little more than 1% of assets under management. Even the most efficient funds impose charges equivalent to 0.2% of assets under management.) When workers reach their 62nd birthdays they use their stock accumulations to purchase a single-life annuity for males. To determine the annuity company's charge for the annuity, I use the Social Security Actuary's projected life table for males reaching age 65 in 1995. To earn a secure return on its investments, the annuity company is assumed to invest in long-term U.S. government bonds. I assume that the annuity company sells a "fair" annuity: It does not earn a profit, incur administrative or selling costs, or impose extra charges to protect itself against the risk of adverse selection in its customer pool. (These assumptions are all unrealistic. Annuity companies typically charge an amount that is equivalent to 15% of the selling price of annuities to cover these items.) My assumptions therefore yield an overly optimistic estimate of the pension that each worker would receive.

The attached chart shows the replacement rate for workers retiring at the end of successive years from 1910 through 1997. The hypothetical experiences of 88 workers are reflected in this table. The worker who entered the workforce in 1871 and retired at the end of 1910, for example, would have accumulated enough savings in his individual retirement account to buy an annuity that replaced 19% of

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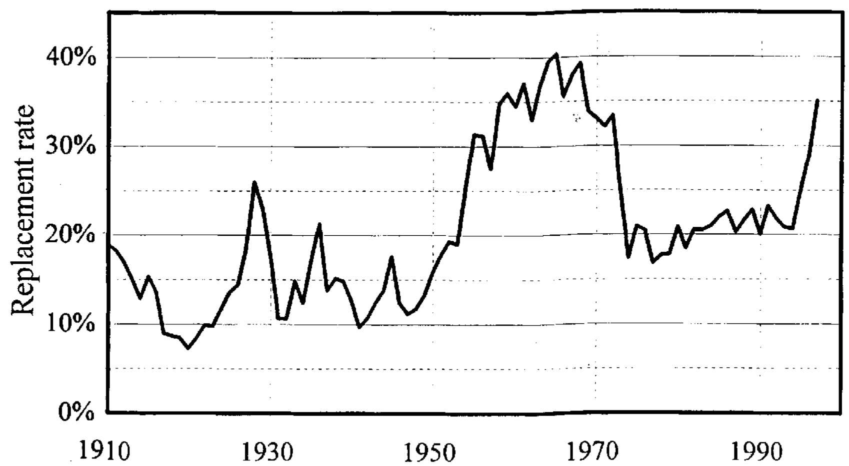
[2] Stock market data are taken from Robert J. Shiller, Market Volatility (Cambridge, MA: MIT Press, 1989), Chapter 26, with the data updated by Shiller. Inflation estimates are based on January producer price index data from 1871 through 1913 and January CPI–U data from 1913 through the present. Bond interest rates are derived using 1924 through 1997 estimates of the average long-bond yield for U.S. Treasury debt; yield estimates before 1924 are based on yields of high-grade railroad bonds.

his peak lifetime earnings (that is, his average annual earnings between ages 54 and 58). The worker who entered the workforce in 1958 and retired at the end of 1997 could purchase an annuity that replaced 35% of his peak earnings. The highest replacement rate (40%) was obtained by the worker who entered the workforce in 1926 and retired at the end of 1965. The lowest (7%) was obtained by the worker who entered work in 1881 and retired in 1920. Nine-tenths of the replacement rates shown in the chart fall in the range between 10% and 37%. The average replacement rate was 20.7%. (For workers retiring after 1945 the replacement rate averaged 25.3%.)

Chart: Male Replacement Rates under Individual Account Pensions, 1910-1997



Note: Replacement rates for workers retiring after a 40-year career completed at the end of the year shown. For example, the worker retiring at the end of 1910 began working at the beginning of 1871. Two percent of worker's earnings are deposited each year in individual retirement account and are entirely invested in U.S. equities. (For details of calculations, see text).

The principal lesson to be drawn from these calculations is that individual retirement accounts offer an uncertain basis for planning one's retirement. Workers fortunate enough to retire when financial markets are strong can obtain large pensions; workers with the misfortune to retire when asset prices are low can be left with little to retire on. The biggest pension shown in the chart is more than 5 times larger than the smallest one. Even in the period since the start of the Kennedy Administration, the experiences of retiring workers have differed widely. The biggest pension was 2.4 times the size of the smallest. In the six years from 1968 to 1974 the replacement rate fell 22 percentage points, plunging from 39% to 17%. In the three years from 1994 to 1997 it jumped 14 percentage points, rising from 21% to 35%. Social Security pensions have been far more predictable and have varied within a much narrower range. For that reason, traditional Social Security provides a much more solid basis for retirement planning and a much more reliable foundation for a publicly mandated basic pension.

The uncertainty of individual account pensions is understated in the chart, because it does not take account of the effects of inflation in years after a worker retires. In benign periods, such as the 1950s or the past few years, U.S. inflation has been low and fairly stable. In other periods, such as the 1970s and early 1980s, inflation has been high and erratic. Social Security has spared pensioners from the adverse effects of major jumps in inflation, because benefit payments are indexed. If workers were forced to buy annuities from private firms, this kind of inflation protection would be much harder to obtain. Workers could see big drops in the purchasing power of their annuities when prices started to rise rapidly.

Individual retirement risk

The calculations shown in the table refer to the experiences of workers who consistently invest 2% of their wages in an indexed portfolio of U.S. equities. This investment strategy on average has yielded the highest pension of the alternative investment strategies open to most U.S. workers. If instead the worker had invested a fixed percentage of contributions to corporate or U.S. Treasury bonds, the ultimate pension would have been lower, because the rate of return associated with the alternative strategy is lower than it is when all contributions are invested in equities. Of course, many workers, especially low-wage workers, are too risk averse to invest all their contributions in equities. They would instead invest some or all of their contributions in bonds or even short-term Treasury bills. Workers who selected a lower-return strategy would receive lower pensions than shown in the chart. Some workers might even earn negative returns if they withdrew their investments from stocks or long-term bonds at inopportune times.

The risk that workers might choose a particularly bad investment strategy does not arise under the present Social Security system. That system provides a minimally adequate pension for nearly all workers who make contributions over a full career, regardless of the individual worker's investment expertise. In my view, that is appropriate in a mandatory public pension. The mandatory pension should provide a secure and adequate retirement income regardless of a worker's investment expertise. If voters or taxpayers are concerned about the low rate of return earned under the present Social Security system, then the investment strategy of the Social Security Trust Funds should be changed to permit the funds to be invested in higher yielding assets. All of us should recognize, however, that this new investment strategy will expose the Trust Funds to greater short-run risk.

CONCLUSION

The debate about reforming Social Security should not begin with exaggerated fears about an impending financing "crisis" in the program, but with a reasoned view of the role played by Social Security in protecting the living standards of the old and disabled. For people who are (or expect to be) very well off, the role of Social Security may not be very important. For the great majority of old and disabled Americans, however, the program provides a large percentage of retirement income. Low-income American families containing a person over 64 derive more than three-quarters of their cash income from Social Security. Even among most nonpoor elderly families, more than half of income is derived from Social Security. A large percentage of nonpoor families would be poor were it not for Social Security pensions.

Social Security also provides workers a crucial protection against financial market risk. It is worth remembering that when the system was established in 1935, many industrial and trade union pension plans had collapsed as a result of the 1929 stock market crash and the Great Depression, leaving workers with no dependable source of income in old age. The private savings of many households was wiped out as well. Given these circumstances, it is hardly surprising that a public pension plan, backed by the taxing authority of the federal government, was found to be preferable to sole reliance on individual retirement plans. Financial market fluctuations continue to make private retirement incomes uncertain. As a result, the argument for a continued role for traditional Social Security is strong, even for workers who earn middle-class wages throughout their careers.

The only practical way to reduce the burden on future workers of paying for retirement benefits is to raise future national income. This can be accomplished within the context of retirement policy by increasing national saving, either in the private sector or in the public sector. Many proposals to "fix" the Social Security financing problem by introducing individual retirement accounts boost private sector saving but simultaneously increase the federal deficit by an equivalent amount, leaving national saving unchanged. Some advocates of private pensions have suggested that part of the current Social Security payroll tax be diverted to private pension accounts, thus boosting private saving. Unless federal spending is cut sharply at the same time, this strategy will simply increase the size of the federal deficit, reducing government saving.

The best way to improve the welfare of both young workers and future retirees is to boost national saving so that there will be more future income to divide between future workers and retirees. Some individual retirement account plans can accomplish that goal, but most would not—and many would actually reduce aggregate saving. I cannot see how elimination or sharp curtailment of Social Security pensions could ever improve the prospects of today's younger workers. Their welfare and confidence in the system could be improved if pensions and contribution rates were promptly adjusted to keep Social Security's promises in line with its future revenues.

Chairman BUNNING. Mr. Edelman, go ahead.

STATEMENT OF RIC EDELMAN, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, EDELMAN FINANCIAL SERVICES, INC., FAIRFAX, VIRGINIA

Mr. EDELMAN. Mr. Chairman, thank you very much for allowing me to testify today. I'm honored to be here.

My perspective comes as one who practices in the financial planning environment. I'm also one of the most active financial educators in the field between two radio and two television shows, teaching at Georgetown, and doing seminars across the country, and two bestselling books. I spend a lot of time with ordinary consumers in addition to my financial planning practice.

My perspective is a little bit different. The benefits are obvious, and I don't think we need to belabor the point terribly much, but I do want to specifically cite five particular groups that are going to benefit dramatically from the concept of establishing PSAs with the Social Security system. The first, obviously, is the money management industry overall which gets to manage and invest all that money and earn asset management fees. Financial advisors such as myself will have a field day. I mean, you'll make me rich, so thank you very much in advance.

The financial education field will also do extraordinarily well in terms of teaching consumers how to handle this money in books and tapes and seminars and all of the activities from that industry. The financial media will also do extremely well. They'll have tons to write about for years to come. And the advertising industry will also do extraordinarily well as they do all of the printing and buying all the ad time and the advertisement placements in magazines, radio, and television, and so on. So the trickle-down theory at its best, I think, can be well suggested from establishing PSAs.

Unfortunately, there's a major flaw in the effort. The vast majority of Americans do not know how to invest. When I first came upon the concept of privatizing the Social Security system, it seemed that the original notion was to take *x* percentage of the FICA contributions, and put them into the stock market in order to get a higher rate of return—which may or may not exist in the first place. Well, how did we go from the notion of putting some of the Social Security Trust Fund into stocks to the notion of, well, let's let individual consumers make the decision of how that money is to be invested, which is what the PSA concept does?

If we allow consumers to have control over their own decisions, two things are going to happen. Number one, they're going to make the wrong investment choices in a great majority of the time, just as they do currently with their IRAs and as they do currently with their 401(k)s. And, second, they will change their investment decisions at precisely the wrong period of time, such as immediately following a stock market crash, or immediately on the bad news of something that has happened in the marketplace. Take a look at the topsy-turvy aspects going on in the markets right now.

In fact, it raises one question I have in my mind which has been suggested earlier. If we weren't experiencing an 18-year bull market that we have been currently enjoying since the early eighties, would we even be talking about the idea of putting some of the money into the stock market?

The question was asked earlier: What are the political risks associated with this decision? Well, there are none, as long as the stock market performs very nicely. But what happens if the stock market drops 3,000 points because of something happening in Japan, with Alan Greenspan rushing to the White House to confer with the President about what to do next and consumers who are placing their Social Security money into the stock market suddenly want to withdraw that money as quickly as they had been so happily ready to add it? The sudden decrease or the outflow of money from the stock market would have a tremendously detrimental effect on the overall stock market and, as a result, the economy as a net effect.

Therefore, I would like to suggest an alternative proposal that I think might allow us to have our good news and avoid the bad news. And that is to establish a system that is similar to that used by the Federal Campaign Contributions. We currently allow taxpayers every year when they do their tax return to choose whether or not they want to put $3 of their tax payment into a segregated fund that the Federal Government controls. The Federal Election Commission, FEC, takes those $3 and allocates them to the candidates under a system established by the government. Consumers have no say over how the $3 is spent after they decide to put in the $3.

We could do the same thing with a different system. Allow workers on their W–9 every year to determine how much of their money they want to put into stocks, up to a limit set by Congress, such as 2 percentage points of the FICA payment. Once the consumer makes that election, it's then up to the government, through a system similar to the FEC, to make the decision of how that money is going to be invested. Don't leave it up to individual consumers. As much as I personally and professionally would enjoy that decision, I don't think it's in the best interests of consumers.

This would be extremely easy to administer. The systems are already in place on the W–9. And we need to do one final thing: Make it a one-way trip. Once money is going into the stock market, the ability to remove it because of fears over current or future market conditions must not occur or we will be contributing to a topsy-turvy marketplace that will cause significant problems in the future. Thank you very much.

[The prepared statement follows:]

Statement of Ric Edelman, Chairman and Chief Executive Officer, Edelman Financial Services, Inc., Fairfax, Virginia

I am honored to be appearing before you and the Subcommittee today. The issue you are considering today—whether to place a portion of the Social Security Trust Fund's assets into the stock market—is both an exciting and a sobering one, and I am both pleased and relieved that the Congress has sought input from someone like me who is so intimately involved in the field of personal finance.

My perspective comes from my activities both as a provider of financial services and as one of the nation's best-known educators in the field of personal finance. By way of background, I am the author of two New York Times bestsellers, The New Rules of Money and The Truth About Money. My award-winning radio program, "The Ric Edelman Show," is heard on WMAL in Washington, DC and WLS in Chicago. I also host the national television show "Money University" on America's Voice cable network, write a syndicated column, publish a newsletter, and run a major advice area for America Online. I am on the faculty of Georgetown University, and my company, Edelman Financial Services, Inc., manages $900 million in client assets, establishing my firm as one of the largest financial planning companies in the nation.

Because of my background, it might at first appear that I would be strongly in favor of placing a portion of the money collected from Social Security taxes into the stock market. And, of course, to a large extent this is correct. However, I am also extremely concerned about several of the proposed ways this might be enacted, for as much as there is opportunity offered by the proposals, there is substantial risk for America embedded in those proposals as well. Please allow me to elaborate on these opportunities and risks, and offer a proposal that can best take advantage of the former while minimizing the latter.

To anyone working in the financial services industry, the opportunities are very real, and it is easy to see why I and others in my field would jump at the chance to manage these retirement assets. The advantages are clear:

- Billions of dollars would flow into the stock market. This can only cause stock prices to rise—and rise dramatically.
- The inflows would be based on periodic investments from payroll reductions. Referred to in financial circles as Dollar Cost Averaging, this is widely regarded as perhaps the most effective long-term investment strategy known. Therefore, sustained higher stock prices over the long run are virtually certain.
- If these massive investments are handled on an individual level, five major industry sectors will enjoy tremendous profits, which will serve as a huge catalyst for supporting the entire American economy:

—First, the money management industry will earn enormous fees by investing and managing these assets. I am referring to mutual funds, annuities, institutional money managers, clearing firms, banks, insurance companies and brokerage firms. My esteemed colleague from Charles Schwab, who joins me today on this panel before you, would be counted in this group. Make no mistake: placing a portion of Social Security's assets in stocks would be the biggest payday in Wall Street history.

—Financial advisors would become the nation's hottest new profession (if it isn't already). There will be incredible fee and commission income from advising consumers on how to invest their Social Security assets, and whereas I placed Schwab in the first group, I place myself solidly in this group. If you enact this proposal, let me be the first to thank you in advance for helping me and all financial advisors to become rich, or rather, even richer.

—The burgeoning financial education field, of which I am a part, and which currently is a small cottage industry, would become a major metropolis. Tens of millions of workers would be new targets for educational products and services.

—The financial media, which is very well represented today by Money Magazine, would find a treasure chest of new information to convey to its readers. They'll have plenty to write about for a long time.

—The advertising industry would receive its biggest bonus since prescription drug advertising hit television. Whereas currently Wall Street attempts to reach only the affluent, who have assets to invest, this proposal would place investable assets into the hands of virtually every working American. Wall Street will want to reach those consumers, and this means unmatched spending on advertising, marketing, promotional and public relations campaigns. This represents the trickle-down theory at its best.

As exciting as all of these benefits appear, the total result is even more exciting. Individual Americans would become more educated about investing. They would become more involved in their own financial future—a fundamental principle on which this great nation was founded. American entrepreneurial and business opportunity would be greatly expanded. And the overall U.S. economy would strongly benefit.

Of course, there is no such thing as reward without risk, and I would like to caution the Subcommittee of the three predominant dangers of this proposal.

First, the majority of Americans—again, the majority of Americans—do not know the proper way to invest, nor do they know how to hire and work with a financial advisor. They do not understand such fundamental investment basics as the power of compounding, or diversification. Consequently, many would be exposed to fraud and abuse—and the nation simply cannot afford to take these risks with the Social Security Trust Fund. Furthermore, I can tell you from experience that most Americans tend to emphasize risk over performance when it comes to investing. This means that, left to their own discretion, far too many Americans would invest their assets in the wrong asset classes, defeating the goal of improved performance that this privatization issue seeks to achieve.

Second, just as the great inflow of dollars in the stock market would be beneficial, great, sudden outflows would be disastrous. And if you give individual consumers the opportunity to withdraw their Social Security assets from stocks, such outflows would be certain to occur, for consumers tend to act emotionally with their investments.

On this point, I am very concerned that this proposal has surfaced at this time. Is it a coincidence that the stock market has been enjoying its biggest gain in history? Over the past 16 years, the Dow Jones Industrial Average has grown ten-fold, and aside from three very short-lived declines, consumers would be hard-pressed to recall the last time that stocks failed to rise dramatically in value.

My concern is that much of the fuel driving the proposal to place a portion of the Social Security Trust Fund's assets into stocks stems from consumer attitude. Consumers have been watching stocks and mutual funds rise sharply, while bonds and bank accounts have been languishing due to sharply decreasing interest rates. Indeed, during the same period of time that the Dow has risen from 800 to 9000, CD interest rates have fallen from 16% to 4%. Thus, stock investors have been richly rewarded while conservative savers have been left behind.

Today, too many consumers believe that stock prices only rise. What will be the sentiment when stocks fall? What happens when—not if—the nation enters a true bear market—something that hasn't happened for nearly 30 years? If the Congress is going to permit Social Security assets to be invested into stocks, then it must make this a one-way trip. Investor sentiment must not drive this decision today, nor should changing attitudes because of the current condition of the economy cause a change in our commitment in the future. Otherwise, the proposal you are considering today will cause great damage to this nation in decades to come.

And third, there would be massive inefficiencies and conflicts of advice as each organization strives to capture the attention—and the assets—of American workers. The contradictory advice that will emanate from the financial community will create confusion among consumers, and too many of them will consequently make the wrong investment decision—with disastrous results. The goals of the Congress can be achieved just as effectively without the activities of these various special interest groups.

Therefore, as much as I personally and professionally would like to see Congress turn over a portion of the Social Security assets to individuals for them to manage as they see fit, I cannot ethically and morally support such a position. Instead, I propose the following to Congress:

Without question, do allow a portion of the Social Security Trust Fund to be invested into the equity markets. The economic realities of today demand this. However, do not allow individual consumers to decide how to their portion is to be invested, for Americans have proved time after time that they do not know how to properly manage their money. Still, because I firmly believe in the individual rights of Americans, their individual participation in this matter is critical. I thus propose the following:

- Prior and existing Trust Fund assets should not be invested into equities.
- A portion of new contributions to the Trust Fund should be directed toward equities. Congress should determine the maximum percentage. I recommend no more than 25% of future contributions.
- Each American worker should declare what portion of their current Social Security contributions they wish to be invested into stocks, up to the maximum percentage determined by Congress. This election would be made annually on each worker's W–9 form.
- Each annual election must be irrevocable, meaning that workers will not be able to rescind their previous W–9 declaration, and such designated monies must not be withdrawn from the stock market until the assets are needed to make pay-

ments to Social Security beneficiaries. Withdrawals or redemptions for any reason—and especially because of concerns over current market conditions—must be strictly prohibited.

• The Federal Government, in a manner established by Congress, would be responsible for investing the equity portion of the Trust Fund into a broadly-based equalization (unweighted) index comprising at least 2,500 U.S. stocks. A capitalization-weighted index must not be used. As explained in my book, The New Rules of Money, index funds that mimic the S&P 500 Stock Index are poor investments, for the following reasons:

—In a capitalization-weighted index, like the S&P 500, the biggest companies have the biggest effect on the index, instead of each stock having an equal effect. For example, a 10% gain by the #1 company would have a much bigger impact on the index than a 10% gain by the smallest company. It also means that the index would buy more of the biggest stocks than the smallest stocks. And the higher a company's stock price gets, the more the index fund would buy it. It sounds bizarre, but it's true: Index funds buy more of a given stock merely because the stock has already risen in value.

—Because index funds tend to hold disproportionate amounts of stock—holding much more stock of big companies than it holds of little ones—it's impossible to maintain a balanced portfolio. If a stock grew in price, a typical money manager might want to sell some of it. But in a capitalization index fund, you can't. Instead, the fund will buy even more—at the new higher prices. This explains why S&P Index funds have as much money invested in the 50 biggest stocks as in the other 450 combined. The result is that such index funds make money only if the biggest stocks make money, because big gains in little stocks don't make much difference. Thus, index investors were lucky in 1996: six of the S&P 500's biggest stocks collectively produced 26% of the index's total gain. Put another way, just 1.2% of the holdings produced 26% of the profits, while the other 494 stocks in the index earned the rest. The Congress must not create an investment whose results are so dependent on such lopsided performance.

The format I propose here is similar to that currently used by the Federal Election Commission:

• Previously-received federal revenue is not used for federal matching contributions.
• Congress determines the maximum annual allowable contribution by each taxpayer; currently set at $3.
• Each taxpayer chooses whether or not to make this contribution.
• Once the election is made, taxpayers cannot change their mind.
• The Government determines how the assets are to be "invested," or distributed, among the candidates. The individual consumer plays no role in this decision.

The Campaign Contribution program is very efficient and effective, and a similar program can be created as easily by the Social Security Trust Fund.

Thank you very much for this opportunity to participate in this important process.

Chairman BUNNING. Thank you.

We are going to recess to go vote. I apologize, Ms. Tritch, but we have to go to the floor and we'll be back as soon as possible. We stand in recess.

[Recess.]

Chairman BUNNING. The Subcommittee will come to order.

We were about to hear from Ms. Tritch.

STATEMENT OF TERESA TRITCH, SENIOR EDITOR, MONEY MAGAZINE, NEW YORK, NEW YORK

Ms. TRITCH. Mr. Chairman, thank you for the opportunity to appear before you today to discuss personal savings accounts within Social Security. I've been asked to address two related issues. First, whether Americans in general are currently knowledgeable enough about financial markets to make sound investing decisions and, if not, what would be required to raise American's financial IQ to a level at which they could be reasonably secure about investing their tax dollars on their own?

Much of the survey data and anecdotal evidence on investor preparedness points to one conclusion: That is, overall, individuals are ill-equipped to make fundamental decisions about investing. A case in point. In 1996 and, again, in 1998, Money magazine and the Vanguard Funds Group tested the basic investing knowledge of roughly 1,500 people who own mutual funds directly or through a retirement plan at work. In 1996, the average test score was 49 out of 100; in 1998, investors averaged 51 out of 100, performances that deserve an F even by today's liberal grading standards. Clearly, if individuals who have money in mutual funds fail a test on investing basics, one can only assume that the roughly 60 percent of Americans who have no such investments are even less informed.

The negligible improvement in test scores from 1996 to 1998 is especially dismaying when you consider that during that time, investors poured more than $700 billion into mutual funds. Many proponents of Social Security privatization have equated individual's increased participation in the market with increased financial sophistication, but as the Money-Vanguard data shows, increasing participation in the markets does not necessarily correlate to investor savvy. Rather, individuals may be fooled by the long-running bull market into believing they possess an investing prowess that has, in fact, never been tested by adverse market and economic conditions.

Worse, investing experience that is confined to boom times can actually engender or reinforce faulty investing beliefs. The top four wrongheaded attitudes I've encountered are the notions that stocks, particularly U.S. blue chips, are the only place to be invested; that market downturns are rare, brief, and relatively painless; that fees and expenses are unimportant in determining one's investment return; and that inflation is not a threat. Unfortunately, misperceptions like these are fueling, at least in part, the current enthusiasm for individual Social Security accounts.

That said, I believe the task of turning each American worker into a savvy investor would be unduly burdensome for the individual and for the government. So, if individual accounts become part of Social Security, I believe that Americans would be best served by embedding sound investing basics in the rules of the program itself.

For example, participation in individual accounts would have to be mandatory, thus circumventing the need to convince people to participation. Investing options would have to be limited to those that have easily explainable risk-reward profiles and low fees, such as a stock index fund, a government bond fund, and a money market fund. There would also need to be a prohibition against early withdrawals, since tapping one's account before retirement defeats the compounding on which the success of the account depends. The government should make no guarantee against loss, but could seek to provide a cushion by requiring employers to match employees contributions.

By structuring individual accounts this way, the government will mirror much of the investor education that private companies have already undertaken. Thank you again for your time and attention.

[The prepared statement follows. Attachments are being retained in the Committee files.]

Statement of Teresa Tritch, Senior Editor, Money Magazine, New York, New York

Mr. Chairman and Members of the Committee,

Thank you for the opportunity to appear before you today to discuss the topic of personal savings accounts within Social Security. I have been asked to address two related issues:

First, whether Americans, in general, are currently knowledgeable enough about financial markets to make sound investing decisions

And, if not, what would be required to raise Americans' financial IQ to a level at which they could be reasonably secure about investing their Social Security tax dollars on their own.

INVESTOR PREPAREDNESS

Much of the survey data and anecdotal evidence on investor preparedness points to one conclusion. That is, overall, individuals are ill-equipped to make fundamental decisions about investing. A case in point:

In 1996 and again in 1998, Money magazine and the Vanguard Funds Group tested the basic investing knowledge of roughly 1,500 people who own mutual funds directly or through a retirement plan at work. In 1996, the average test score was 49 out of 100; in 1998, investors averaged 51 out of 100—performances that deserve an F even by today's liberal grading standards. I'll offer some details later. But clearly, if individuals who have money in mutual funds fail a test on investing basics, one can only assume that the roughly 60% of Americans who have no such investments are even less well-informed.

The low test scores—and their negligible improvement from 1996 to 1998—are especially dismaying when you consider that during that time, investors poured more than $700 billion into mutual funds—and for the first time in a generation, Americans had more of their assets invested in stocks than in their houses. Many proponents of Social Security privatization have equated individuals' increased participation in the markets with increased investor savvy. But as the Money/Vanguard data show: Increasing participation in the markets does not necessarily correlate to financial sophistication. Rather, individuals may be fooled by the long-running bull market into believing they possess an investing prowess that has, in fact, never been tested by adverse market and economic conditions. This sentiment was echoed last May by Securities and Exchange Commission chairman Arthur Levitt. He told a group of equity portfolio managers—quote—"The financial literacy of Americans has not kept pace with the growth of the fund investments or investor satisfaction."

Worse, investing experience that is confined to boom times can actually engender or reinforce faulty investing beliefs: The top four wrongheaded attitudes I've encountered are the notions that stocks—particularly U.S. blue chips—are the only place in which to be invested; that market downturns are rare, brief and relatively painless; that fees and expenses are unimportant in determining one's investment return; and that inflation is not a threat. Unfortunately, misperceptions like these are fueling, at least in part, the current enthusiasm for individual Social Security accounts—especially among young and surely untested investors who are among the greatest proponents of privatization.

A few of the specific areas in which participants in the Money/Vanguard survey exhibited surprising ignorance shed light on the question of whether individuals really grasp what they are being asked to give up in the current system by undertaking private accounts.

For example, the test found widespread confusion about how to calculate basic performance gauges, such as total return and real return. Such ignorance could lead individuals astray as they weigh the pros and cons of individual accounts. That's because one of the main arguments for individual accounts has been the relatively poor return that Social Security offers younger workers on their tax dollars. Those calculations generally fail to include the value of disability and survivor benefits under Social Security or the savings to workers due to the fact that Social Security spares them from having to contribute to their own parents' support.

On a related matter, 40% of testakers were unaware of the effect of a fund's operating costs on their returns, namely, that every cent a fund charges comes right out of their investment. (This finding echoes a similar result in a joint study conducted in 1995 for the SEC and the Office of the Comptroller of the Currency, which found that more than 80% of fund investors could not give an estimate of expenses for their largest mutual fund; and of them, only 43% even knew their largest fund's expenses at the time they first invested in the fund.) Without that understanding, investors are in no position to evaluate the potential returns in an individual account—let alone compare that account with the current system. This is especially true if, as has been estimated, administrative costs for individual accounts amount to a minimum of one percentage point a year. According to Peter Diamond at MIT, that alone would total a 20% hit against one's savings over a 40-year work life.

Finally, almost half of investors mistakenly believed that diversification guarantees that their portfolio won't suffer if the market falls. It's crucial that investors understand that nothing can guarantee against loss in the stock market and that their return depends on what they buy, when they buy it and when they sell it—and the fees they pay along the way.

INVESTOR EDUCATION

That said, I believe the task of turning each American worker into a savvy investor would be unduly burdensome for both individuals and the government. Thus, if individual accounts become part of Social Security, I believe that Americans would be best served by embedding sound investing basics in the rules of the program itself. For example, participation in individual accounts should be mandatory, thus circumventing the need to convince people to participate. Investing options should be limited to those that have easily explainable risk/reward profiles and low fees, such as a stock index fund, a government bond fund and a money market fund. There would also need to be a prohibition against early withdrawals, since tapping one's account before retirement defeats the compounding on which the success of the accounts depends. The government should make no guarantee against loss, but could seek to provide a cushion by requiring employers to match employees' contributions.

By structuring individual accounts this way, the government will mirror much of the investor education that private companies have already undertaken. These initiatives have centered on encouraging employee participation in employer-provided retirement savings plans; explaining the relationship between risk and reward, with an eye toward increasing employees' comfort with investing in stocks while stressing the need for asset allocation; and warning about the dangers of tapping one's savings before retirement.

Thank you for your time and attention.

Chairman BUNNING. Thank you very much.

Mr. Huard.

STATEMENT OF PAUL R. HUARD, SENIOR VICE PRESIDENT, POLICY AND COMMUNICATIONS, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. HUARD. Thank you, Mr. Chairman, on behalf of the National Association of Manufacturers, its 14,000 members and 18 million people, employed in manufacturing. We appreciate this opportunity to express our views.

We do not believe that the Social Security system as presently constituted is demographically sustainable. We believe that people who think so are indulging in a large number of rosy scenarios. We think the truth is that people will live longer than is currently being estimated, because medical science will continue to prolong life. We think that taxes will have to be raised more than is being projected in order to keep the system viable. Ultimately, if the Social Security system is not transformed from its present format, it will eat the U.S. economy alive. That being the case, the entire incoming tax receipts of the Federal Government will have to be used to pay out entitlements whether it's Social Security retirement, Social Security Medicare, or Medicaid.

We believe that the Social Security system should be transformed into a two-part system which continues to provide, as it presently does, a tax financed safety net of minimum benefits. The portion of tax receipts currently being put into the so-called Social Security Trust Fund should, in fact, be contributed to a system of personal retirement accounts. We believe such retirement accounts should be owned by their beneficiaries. Title to those funds should not be in the government nor should the government manage the funds. We believe collection remittance and reporting of allocations for these accounts should be based as much as possible on the current payroll tax mechanisms which are well-known to employers and which could be handled with a minimum of administrative expense.

And, finally, we believe that a robust system of private employer-sponsored retirement plans should continue to be encouraged by Federal tax policy. With that, I would submit the balance of my testimony for the record and, in the interests of time, be glad to answer any questions.

[The prepared statement follows:]

Statement of Paul R. Huard, Senior Vice President, Policy and Communications, National Association of Manufacturers

SUMMARY

Social Security reform is a necessity. Under a reformed system, a safety net will remain, as protection against poverty in old age. However, the safety net should emphasize its role as social insurance, not a source of defined benefits. Reform presupposes contributions of funds currently, for accumulation as necessary to provide retirement income. The defined contribution model for employer plans under ERISA provides the appropriate means of pre-funding. Accordingly, Social Security reform requires creation of a system of personal retirement savings accounts. Under such accounts, employees would enjoy an ownership interest in a pool of assets invested directly in publicly traded securities, specifically identifiable to the accounts of individuals. Personal accounts would exist separately from the current system of employer-sponsored retirement plans. Social Security reform is in large measure dependent on private plans, and federal policy should encourage expansion of the qualified-plan system. The payroll tax provides the appropriate platform for employer compliance with the requirements for contributions to personal accounts.

Thank you Chairman Bunning. I am Paul Huard, Senior Vice President for Policy and Communications of the National Association of Manufacturers. I am pleased to represent the NAM today in testifying before this subcommittee.

This afternoon I shall make observations with respect to the following issues:

- The attitude of employers toward Social Security reform, and the necessity that sources of retirement income be funded in advance;
- Employer support for a system of employee-owned personal savings accounts;
- Continuing employer commitment to the existing system of employer-sponsored retirement plans; and,
- Mechanical and practical considerations incident to a personal account system, and the requirement that employer obligations under such a system be based on the existing rules for collection, deposit, and reporting of payroll taxes.

THE NAM

The National Association of Manufacturers is the oldest broad-based trade association in the nation. Founded over a hundred years ago, the NAM encompasses 14,000 member companies which account for 85-percent of goods manufactured in the United States. NAM members range in size from companies with fewer than 50 employees to those with more than 100,000.

NAM members consider the reform of Social Security a top priority. Members recognize unreformed federal entitlement programs as the greatest threat to the economic health of American businesses. Absent entitlement reform, the unfunded obligations of the government will tax the growth out of the economy; tax the jobs out of the economy; and finally, make it extremely difficult for U.S. employers to compete in both domestic and foreign markets.

Because of the importance of the issue to member companies, the NAM became a leader among trade associations in addressing Social Security reform. In 1995, the NAM formed a task force to examine the dimensions of the Social Security issue and to consider potential remedies. Last year, the task force presented its recommendations to the NAM Board of Directors, which approved a "Statement of Principles for Social Security Reform." To the best of our knowledge, the NAM was the first employer group in the country to reach such a consensus on the fundamental aspects of reform.

In testimony before this subcommittee in July of last year, then NAM Chairman Warren Batts discussed the "Principles," and the salutary effect of Social Security reform on U.S. economic growth.

This afternoon, I represent American manufacturers in making comments on Social Security reform with a focus on personal retirement savings accounts.

EMPLOYERS AND SOCIAL INSURANCE

NAM member companies recognize the role of a "safety net" against poverty in old age. And while such a federal program should continue, it should emphasize the New Deal concept of "social insurance" against poverty in retirement, purchased through payroll taxes.

In the decades since the New Deal, Social Security has come to represent not insurance protection, but a system of "benefits," to which virtually all persons in the workforce are entitled, regardless of need. However, as amply demonstrated by students of the issue, demographic factors will not allow the current schedule of benefits to continue. If the safety net is to remain viable, we must "decouple" social insurance from accrual of retirement income.

To do so will strengthen the safety net dramatically, by reducing the insurance risk that the federal government assumes. Whether the safety net were needs based, or provided through a "first tier" of defined benefits, the ability of the federal government to satisfy its promise is greatly enhanced by a system of personal accounts through which retirement income needs are pre-funded.

REFORM MEANS A FUNDED SYSTEM

Anyone who operates a business enterprise recognizes the necessity of accumulating resources of current worth in order to satisfy projected needs—a future liability is offset by assets currently in hand. In the same manner, individuals and families recognize the necessity of saving now, for cash needs in the future.

With respect to Social Security reform, current accumulation of assets is not enough. The experience of employers in providing pension benefits to employees has shown the insufficiency of mere accumulation in view of future liabilities. In this regard, the promises made to employees for their retirement income presuppose not only the creation of reserves, but segregation of the funds that will provide such income. The Employee Retirement Income Security Act of 1974 made fund segregation a federal mandate, by requiring not only pre-funding, but creation of a trust to hold the assets.

Social Security reform requires an equivalent mandate. We must accumulate funds currently, segregate those funds, and provide for growth of the funds through investment returns.

In dealing with funding, a caveat is in order.

As noted, "reform" implies a funded system. But a system remains unfunded if the only assets dedicated to future needs are projected surpluses in the federal budget. To this effect, one well might ask, "What assets?" Projected federal surpluses simply aren't assets. "Reform" based on unrealized improvements in the federal balance sheet is less a promise of retirement income to individuals than it is a plea by the federal government for an expanded line of credit.

PERSONAL RETIREMENT SAVINGS ACCOUNTS

NAM member companies endorse Social Security reform based upon a system of "personal retirement savings accounts." In this regard, the term means vested rights of ownership by an individual in specified assets, accumulated through periodic contributions and investment earnings. While the assets attributable to each account would be pooled for investment purposes, an account would represent the individual's legal right to specific marketable securities that are identifiable to the account.

Start-up of a system of personal accounts might require that the federal government temporarily hold assets in gross, unallocated to the accounts of individuals. In a similar manner, continuing administration of a system of personal accounts might of necessity involve a federal escrow or sub-account to hold periodic contributions pending allocation. In any event, the operation of a functioning personal account system would require that the government transfer the contributions as quickly as possible to private-sector asset managers. Such managers would hold and invest the assets, as fiduciaries, for the benefit of the specific individuals on whose behalf contributions were made. Individuals would possess a legal right to assets held on their behalf, NOT a right to assets held legally by the federal government.

The obvious model for a personal account system is a defined contribution retirement plan (such as a 401(k) plan), sponsored by an employer, and subject to ERISA. In this regard, a plan sponsor is required to segregate contributions from its own funds as quickly as possible, and to forward the assets to an investment manager. The manager invests the assets in publicly traded securities, and simultaneously allocates the amount of the employer's contribution to the accounts of individual employees.

The NAM and others in the business community would vigorously oppose asset management subject to discretionary authority of an agency of the federal government.

The Role of Employer-Sponsored Retirement Plans

Employers endorse Social Security reform that emphasizes and strengthens current federal policy in favor of employer-sponsored retirement plans. Savings for retirement through qualified plans has proven highly successful, with approximately half the U.S. workforce participating in such arrangements. That such individuals are less dependent on Social Security and less likely to need a safety net is obvious. Accordingly, federal policy should encourage even greater coverage by employer-sponsored plans. Creation of new plans and increased savings under existing plans can only reduce financial pressure on the Social Security system and ease implementation of reforms.

Practical Concerns of Employers under Social Security Reform

Employers endorse Social Security reform that recognizes the necessity of a limited role for employers.

Common to virtually all the reform proposals currently under consideration is creation of personal savings accounts for employees, administered apart from employer-sponsored retirement plans or individual retirement accounts. But such proposals, of necessity, rely upon employers as agents for collecting and transmitting funds subsequently allocated to individuals' accounts.

In order to implement a personal-account system quickly and efficiently, the administrative aspects of reform should be attached to the existing system for payroll tax collection, deposit and reporting. Employers and employees alike understand the procedures for withholding and reporting FICA taxes. Most importantly, it appears that existing accounting and computer systems used by employers for payroll tax compliance could accommodate the additional requirements for personal retirement savings accounts fairly easily. Employers would withhold employee contributions to accounts no differently than employee FICA is withheld. Likewise, no new procedure is required for employer contribution to such accounts or for deposit of taxes. Indeed, the efficiency of the present system for collection of payroll taxes is among the principal reasons that personal accounts are administratively feasible.

Employees could receive documentation of amounts contributed to their accounts by means of a slightly revised Form W–2. If a reformed system allowed additional voluntary employee contributions, it appears that employees could make elections in this regard through a revised Form W–4. Such changes, accomplishing in large measure the mechanical requirements for personal accounts, would seem to impose only modest alterations upon the present payroll tax compliance system.

Existing civil penalties and criminal sanctions for payroll tax non-compliance would assure persons in the workforce, no less than federal regulators, that employers made contributions to personal accounts as specified. Enforcement of such proscriptions by the Internal Revenue Service is automated and highly efficient.

ADDITIONAL THOUGHTS ON THE MECHANICS OF A SYSTEM OF PERSONAL ACCOUNTS

Although employers endorse personal accounts as a means of achieving Social Security reform, they recognize significant practical issues that the Congress must address.

- The technology necessary to management of personal accounts is already in wide use. However, the capacity of such technology would have to be expanded enormously in order to accommodate a personal account for each individual in the U.S. workforce.
- Management of data with respect to contributions and earnings is an accounting function, separate and apart from asset management, which constitutes an investment function. Costs for accounting are separable from costs for investing. It seems a virtual certainty that accounting for individual accounts would remain with an agency of the federal government. As noted above, employers would support Social Security reform only if asset management and investment were performed by private-sector financial institutions, subject to rules governing fiduciaries.
- Use of the existing payroll tax system for collection of contributions to personal accounts presupposes that employers would remit amounts to depositary banks as under the current system. Such deposits would continue to be made in gross and without allocation. Subsequent allocation to individual accounts would be preformed by the government agency specified in the statute.
- In the first few years of a personal account system, the investment choices available to individuals would be limited, with reports of contributions and earnings made infrequently. Greater investment choice and more frequent reporting would become common as the system matured. Employer experience with 401(k) plans is highly analogous.

Chairman BUNNING. Thank you very much. I'm going to ask one question and I'd like a yes or a no answer from each of the panelists. Do you favor retaining the status quo on Social Security without any options for taxpayers to invest part of their contributions?

Mr. WHITE. No, Mr. Chairman.

Mr. BURTLESS. It depends.

Chairman BUNNING. It's a pretty obvious, easy question. We have to do it, every day. Next, Mr. Edelman.

Mr. EDELMAN. No, Mr. Chairman.

Ms. TRITCH. No.

Mr. HUARD. No.

Chairman BUNNING. OK. If you're opposed to personal accounts, how should the system be changed to ensure its survival? Or should it? Dr. White.

Mr. WHITE. If I'm opposed? I just indicated in my testimony——

Chairman BUNNING. That's you're not opposed.

Mr. WHITE. I am not opposed.

Chairman BUNNING. So all of you think——

Mr. EDELMAN. I am opposed to private savings accounts because I do not believe that ordinary consumers can make the right decisions.

Chairman BUNNING. OK. What system would you replace it with in order for its survival?

Mr. EDELMAN. What I would suggest is that the money—that *x* percentage of the contributions be segregated and diverted into an equities fund. Let Congress choose what that percentage ought to be. The number I hear most often is 2 percent—2 percentage points. But that money should be placed into an index fund, not a cap-weighted index fund, but an equalization-weighted fund, and managed by an organization established by Congress so that the individual decisions of where that money is to be invested is up to the individual consumer.

Chairman BUNNING. OK. Then, since you are the only one who opposed, the same question goes to you again. What events or policies would you possibly change—would possibly change your position as far as personal investment accounts?

Mr. EDELMAN. In order for me to change my position, I would want to see dramatic improvements in consumer education on personal finance. We need to begin teaching personal finance in schools on a mandatory basis. We need to have competency testing, just as we do on reading and writing and math skills. So that once we are convinced and assured that the ordinary general population is able to make intelligent, long-term investment decisions, I would feel much more comfortable giving them PSA accounts for Social Security.

Chairman BUNNING. Let me ask you the question, because it's going to become a reality very shortly: There's going to be some bills dropped in the hopper that will say to us, take part of the surplus and add it onto the Social Security system as we know it now and start a personal savings account for each individual that's in the Social Security system. Give me your thoughts on that. All right. Mr. Huard.

Mr. HUARD. I think that's the wrong approach. I think, as Dr. Burtless pointed out, what we have currently is a system of intergenerational wealth transfer. I think a far better use for the surplus is to fund the transition. If you divert *x* percent of the current payroll tax in the private savings accounts, you are not going to have enough to pay current benefits. It seems to me that what you need to do is divert the surplus to finance the transition and pay the current beneficiaries who are entitled to what the system has promised them.

Because that's the real problem here in going to a system of personal accounts. You're going from a system where each retiring generation is riding on the backs of the succeeding generations to a system where generations are paying or prefunding their own retirement. Well, you've left the stranded generation in the middle, and I think you need to use the surplus to finance their benefits.

Chairman BUNNING. Anybody else want to—go ahead, Ms. Tritch.

Ms. TRITCH. I think that the idea of starting a newborn out with a retirement account of $1,000 and $500 a year as you go along until the child is 5 sounds good because you get a very graphic example of what compounding can do to a relatively small sum of money, but is that really the way that we want to be spending our money? Is that really where the priorities should be?

I don't think that, by severing somehow the retirement savings from what someone earns during their working life, is necessarily going to help people in the long-run or make the system more understandable. So I would be opposed to starting out a savings account at an age that's far before someone even joins the work force. I also wanted to clarify my position on one thing. I'm not opposed to individual accounts at this point because I think this is a very healthy debate. As I think I indicated in my testimony, I don't think that individuals, by and large, are ready to take on this responsibility.

Chairman BUNNING. Mr. Collins to inquire.

Mr. COLLINS. Thank you, Mr. Chairman. A lot has been said about individual accounts. Maybe I've just been mislead all my working life, but I thought I had an individual account at the Social Security Administration. I have an individual Social Security number and I hope somebody over there has been crediting my account with the moneys deducted from my payroll check over the last 40 years. So I'm under the assumption I do have an individual account.

And Mr. Huard, I like what you talk about with the surplus and how to address the uses of that surplus and the shortfall and the liability. But I disagree with you that the problem is because people are living longer. That's not the problem with the Social Security system.

The problem goes back to what was pointed out in the earlier panel. A lot of the liability is caused by the fact that retirees in the forties, fifties, sixties, and the seventies are receiving more benefits than they paid for. That's the flaw in the system—beneficiaries receiving or received more in benefits than they paid in. Now that's a transfer of money and under the Constitution of the United States, I don't believe the Congress really has the legality to transfer money from one individual to another. But that's what has happened over the years and that's the reason we need to straighten out these individual accounts to make sure that each individual understands how much they have in there and, if you're going to have safety nets as this was extolled under as a safety net, then that safety net—those funds should come from the General Fund, not from other people's investment into their Social Security account.

That's what's wrong with the Social Security system. It's not that people are living longer. That's great that people are living longer. Many of them stay productive for years and years after the retirement age.

But the problem goes back to how Congress has handled this in the past with the benefit program and Congress has got to deal with the benefit program in the future. And you have to deal with it from two funds: The funds that are paid by the individual into the Social Security accounts that are accredited to their account. You also have to deal with it with surplus General Funds, or you're going to have to cut some other spending somewhere else to have the General Fund because these promises have been made to these people. Those benefits have been created and established and they're going to have to be paid. Thank you, Mr. Chairman.

Chairman BUNNING. Thank you, Mr. Collins. I have introduced a bill to take the surplus and wall it off in a special account, and not do anything with it until we have a final settlement on what we want to do on Social Security.

That does a couple of things. Now we just recycle excess FICA taxes out and pay for other things. We have an IOU with the Treasury. But if you put it in a special Treasury account that would be available to lower the liability and lower the debt, which is good, when we come up with a solution, long-term solution, to the Social Security system.

Tell me what you think of that. It's not going anywhere, but, I mean, I put it in, but the leadership doesn't like it.

Mr. HUARD. Well, I think as a temporary, transitional solution, it has a lot to recommend it. One of the concerns we have is that the surplus is available while we're trying to move toward a solution of the Social Security problem and a reform system. As you know, we hope the reformed system will ultimately include personal accounts. Unfortunately, these surpluses are out there and Congress is tempted to use them for something else: Fixing the marriage penalty or spending more on Medicare.

Chairman BUNNING. If it's laying around, we might use it.

Mr. HUARD. Yes. So I'd certainly prefer that these surpluses, as you suggest, be walled off so that they are available. Because there is going to be a significant transition problem if you move to a system of personal accounts. I will give Dr. Burtless credit, he is quite right: The current money coming into the system is going right back out again, by and large, maybe 10 percent of it isn't. And if you start to divert some of that money into personal accounts, you've got to have another source of money to pay the promised benefits. I think using the surplus for that, walling it off, would be a fine idea.

Chairman BUNNING. Well, I look to have a solution within the next 2 years, so it wouldn't be a long term. It would be a total of about $200 billion over the next 2 years is just about what the surplus is going to be. But the fact of the matter is, there's an awful lot of people that want to spend it and do other things with it.

Go ahead, Dr. White.

Mr. WHITE. Mr. Chairman, first, with respect to your statement that you hope to have a solution within 2 years: As my grandmother would have said, from your lips to God's ear. I certainly hope that is the case. However, though, in your terms, walling off the surplus would be a fiscally responsible thing to do, since it would benefit the U.S. economy by raising national saving, it wouldn't help fix the problems of the Social Security system. It doesn't do anything for the system because it doesn't address the pay-as-you-go nature of the system. When you go to fix the system in 2 years, the fact that you will have piled up some extra IOUs from the Treasury won't provide you with any extra real resources.

Chairman BUNNING. No, no, no. You missed the point. You can't——

Mr. WHITE. The economy will be a little richer——

Chairman BUNNING. You can recycle it out in new IOUs.

Mr. WHITE. But you're not collecting bushels of wheat or barrels of oil.

Chairman BUNNING. No, but you're collecting interest on the money.

Mr. WHITE. You're only getting more IOUs from the Treasury, Mr. Chairman.

Chairman BUNNING. OK.

Mr. BURTLESS. I don't understand the proposal, because what you just said suggests that you would not hold this surplus in a form that is interest bearing.

Chairman BUNNING. You would hold it in government bonds, real government bonds, that are interest bearing.

Mr. BURTLESS. But if the government has got bonds, then it has also obtained cash in exchange for those bonds. If you were—you're not proposing, I take it, that the Social Security Trust Funds just give up the interest on——

Chairman BUNNING. No, no.

Mr. BURTLESS. OK. So the proposal, then, is that the government cannot do anything but retire outstanding public debt with it.

Chairman BUNNING. That's the exact——

Mr. BURTLESS. I think that there is one—I agree that that would add to national saving and in that respect it would be a good thing to do. I don't think we should just try to do it in 1 year, however. I think we should phase it in.

Chairman BUNNING. No, I think it should be until we finally get a settlement.

Mr. BURTLESS. But there is one confusion that a lot of people have and that is, somehow, if they buy another kind of assets, like a corporate bond, the corporation is not somehow spending that money. But the corporation is not putting it in a safety deposit box. The corporation is doing something with any money you lend to it, too.

Chairman BUNNING. Generally, reinvesting it, yes.

Mr. BURTLESS. We hope what the corporation does is a good thing with its money; and similarly, we hope the Federal Government does good things with its money. It spends it in a good way.

Chairman BUNNING. Anyone else?

Mr. EDELMAN. Mr. Chairman, I like the idea of anything that provides for long-term savings that is for retirement purposes, which is why I have concerns over new easings of IRA withdrawal provisions for some home ownership or for paying for college and hardship withdrawals and such. Anything we do that would divert money from the future into today's needs is something that will haunt us in the future. So your notion of walling it off and leaving it specifically for future need can only be healthy. Unfortunately, it's going to take another generation to enjoy your benefit and does the Congress and administration have that vision?

Chairman BUNNING. You know, I was in the investment business for 25 years before I came to Congress. There is a great concern on the cost-to-benefit ratio in personal or private investment accounts. What do you think would be the interest rate that we'd have to arrive at to offset whatever costs are involved if, in fact, we pulled it completely out of government. In other words, into, Mr. Edelman, you'd handle all of the accounts for Social Security.

Mr. EDELMAN. Can I? Great.

Chairman BUNNING. Yes. [Laughter.]

What would be the cost per individual? What is your cost factors now?

Mr. EDELMAN. Right now, it's typical to say that consumers are spending, on average, 1.5 percent per year in asset management fees.

Chairman BUNNING. One to 1.5?

Mr. EDELMAN. Right, so you need to make 1 to 1.5 percent a year to break even. And then you've got to factor in inflation. That you have to do whatever inflation's doing to break even. And then, on a net tax environment—that's not typically an issue on the taxdeferred vehicle such as Social Security Trust Funds, but you would then have to overcome the tax liability as a third break even. In the private sector, it typically works out to 3, 4, or 5 percent, depending on the inflationary environment.

Chairman BUNNING. Do any of you know what it costs right now in a thrift savings accounts?

Mr. EDELMAN. It's about $25 or $30 per worker.

Chairman BUNNING. Per year.

Mr. EDELMAN. Per year. Per year. Now you divide that number into the amount of money the typical worker is putting into the account, and it works out to about a 4- or 4.5-percent cost.

Chairman BUNNING. Four to 4.5, so it's——

Mr. EDELMAN. It depends—if you were to aggregate——

Chairman BUNNING. I'm sure it's higher than a private investment——

Mr. EDELMAN. As a share of new contributions, not on the total value, but as a share of the money going in. Call it like a front-end load in a mutual fund, 4 or 4.5 percent.

Chairman BUNNING. Generally, thrift savings money that we in the Federal Government or most people put in is nontaxed going in but only taxed coming out. So there would be no cost going in, it would be only on the back end of it that you would pay taxes.

Mr. EDELMAN. And you have inflation to deal with.

Chairman BUNNING. I want to thank you all for being here. We want to submit other questions to you for your written response. Thank you. We appreciate your testimony.

Mr. WHITE. Thank you, Mr. Chairman.

Mr. EDELMAN. Thank you.

Chairman BUNNING. The Subcommittee stands adjourned.

[Whereupon, at 3:35 p.m., the hearing was adjourned, subject to the call of the Chair.]

[Submissions for the record follow:]

Statement of Stephen J. Entin, Executive Director and Chief Economist, Institute for Research on the Economics of Taxation

DISTORTED PICTURE OF THREE SOCIAL SECURITY REFORM PLANS

At the request of Representative Charles Rangel (D–NY), the Congressional Research Service prepared and released a narrowly-targeted study comparing reductions in Social Security benefit outlays that would occur under three proposals to reform the Social Security System. ("Benefit Analysis of Three Recent Social Security Reform Proposals," David Koitz, June 16, 1998.) The Congressman's staff specified that the study examine only the benefit reductions, omitting other features of the plans from the analysis. This has led to a distorted picture of the relative impact of the plans on workers and retirees.

The Ball plan, recommended by part of the 1995 Social Security Advisory Council, would trim benefits modestly. It would avoid deeper benefit cuts by increasing income taxation of benefits (another form of benefit cut), raising the amount of income subject to the payroll tax, and investing some of the trust fund in the stock market. The Moynihan-Kerrey bill would trim benefits more deeply; it would initially cut the payroll tax 2 percentage points (although raising it in distant decades) and encourage people to save up to 2 percent of payroll, which they could then invest in the securities of their choice. The National Commission on Retirement Policy would cut the payroll tax by 2 percentage points and mandate that the money be placed in personal saving accounts in exchange for deeper cuts in Social Security benefits; the expected returns on the accounts would more than offset the additional reductions in direct benefit payments under any sensible projection, and leave retirees better off than patching the current system.

Comparing the effects of the Ball plan and the two plans with personal saving accounts requires looking, in each case, at all the taxes individuals must pay and the combined retirement benefits they would receive from Social Security and the personal savings. Looking only at the change in the level of benefits paid by the government and ignoring the replacement income provided by the personal saving accounts presents a highly distorted and one-sided picture of the outcome of the reforms for individuals. In effect, it is a half-truth, a cost-benefit analysis that looks only at the costs and ignores the benefits.

CRS complied with the specification of the request, but took great pains to warn, in the first paragraph, that it results in a partial analysis:

"As your staff specified, the analysis is confined to the potential reductions in Social Security benefits prescribed by various provisions of the three reform packages. Accordingly, the memorandum does not examine the impact of the changes in payroll taxes included in the packages, the potential benefits or annuities that may result from the "personal savings" components of the packages, nor ... [where applicable] ... the elimination of the Social Security retirement earnings test. Analysis of all of these would be necessary to gauge the full effects of the three plans on the national economy and individual retirement income."

The aging population will guarantee that workers will get extremely low yields on the pay-as-you-go Social Security System in the future. By contrast, there has been no extended period of time in the Nation's economic history when returns on private sector saving and investment did not exceed these projected Social Security System returns. Other things equal, plans with personal saving accounts can provide higher retirement incomes at less cost to future workers than any mere patch job to the current system.

The Moynihan-Kerrey bill and the NCRP plans have their own strengths and weaknesses, and neither goes far enough to take advantage of the full benefits of personal saving. Nonetheless, to judge the relative merits of these plans vis-a-vis the Ball proposal solely on the basis of the amount of Social Security benefit reductions they provide is not fair and not informative.

MILLIMAN & ROBERTSON, INC.
ACTUARIES AND CONSULTANTS, NEW YORK, NY
June 15, 1998

A. L. Singleton
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Mr. Singleton:

Milliman & Robertson, Inc. (M&R) hereby submits the enclosed as our written statement for the printed record of the June 18, 1998 hearing of the Subcommittee on Social Security.

M&R conducted an analysis of a Social Security personal savings account proposal on our own behalf and we are pleased to share our findings with the Subcommittee, other Members of Congress, and the public. In conducting our study, we developed a computer simulation model that can be modified to analyze other options.

Our study examined the Social Security Advisory Council's proposal to partially privatize Social Security through personal savings accounts (PSAs). We used a stochastic model to show the probability of various results vis-a-vis current Social Security. We found that there is great variability in potential results under PSAs compared with the benefits that would be paid under the current Social Security program. Typical wage earners, in particular, have a significant chance of receiving less than current Social Security, and conservative investors are likely to do much worse than the current system.

For your information, M&R is a national firm of actuaries and consultants, with offices in 26 U.S. cities and in Bermuda and Japan, serving the full spectrum of business, governmental, and financial organizations. Internationally, M&R is the U.S. and Japanese member of the Woodrow Milliman network, a formal alliance of leading independent actuarial and consulting firms operating in more than 100 offices in 31 countries throughout the world.

Please do not hesitate to contact me if you have any questions about our study or if we can be of any assistance in your efforts to study Social Security reform options.

Sincerely,

MICHAEL J. MAHONEY, F.S.A.

Privatizing Social Security: Expected Benefits Come with Uncertainty

by Gerald Cole,[1] LL.B., Peter R. Hardcastle, F.I.A., and Stephen A. White, F.S.A.

The national debate on how best to "save" Social Security has begun in earnest. President Clinton is holding town meetings throughout the U.S., key congressional leaders have expressed their desire for Congress to tackle the issue now, and numerous bills have been introduced. The debate centers around two competing approaches to the problem. One would partially or fully privatize Social Security by creating individual accounts, while the other would modify the present system to restore actuarial soundness. The results of the debate will profoundly affect how future generations achieve retirement security.

Social Security needs to be "saved" because of changes in the make-up of the U.S. population. Under the current system, retiree benefits are funded directly from payroll taxes, on a pay-as-you-go basis. While each retiree under the system is supported by three workers today, by the middle of the next century, each retiree will be supported by about two workers.

There are two main premises to the individual account argument. First, the system should be prefunded, with contributions invested in financial assets that produce a higher rate of return than that inherent in the current system. Second, the government should not invest in equities, which are the primary source of greater investment returns. Therefore, the only way to take advantage of the greater rates of return offered by equities is to create individual accounts.

To contribute to the discussion, we analyzed the effects the individual account approach would have on different workers. We specifically examined the personal security account (PSA) proposal advocated by several members of the most recent Social Security Advisory Council (SSAC). Issues raised by this PSA proposal also apply to other privatization options.

Our analysis shows that moving from the current Social Security system to individual accounts under the PSA proposal is likely to improve retirement benefits for many workers. Such a system, however, entails the risk of considerable variability in the level of potential retirement benefits. We found that in many cases, the retirement benefits of typical workers would be worse under the PSA option than under the current system. Not surprisingly, high-paid workers fare better than typical-wage workers. Single workers and two-earner households also fare better than single-earner households do.

The PSA proposal also brings risk to the economy as a whole as vast sums of money are borrowed to finance the transition to a funded retirement system. The end result could be positive if most workers are better off at retirement and if the final system is less influenced by political considerations and demographic trends. Policymakers must recognize at the outset, however, that results for individuals and for our economy are far from certain.

THE SOCIAL SECURITY PROBLEM

The most recent projections show the Social Security trust fund exhausted by the year 2032, with payroll taxes beyond that point sufficient to pay only about 75% of the benefits promised under the current system. The importance of Social Security as the bedrock of retirement security is not in doubt. For nearly 60% of the country's current retirees, Social Security is a major source of income. Even among current workers, who expect to receive less than their parents and grandparents under Social Security, 22% believe the program will provide a major source of their retirement income and another 52% believe it will be a source.

The nation's demographics will make providing current-program benefits over the long term unaffordable at today's contribution rates. The demographic time bomb

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is caused by three significant factors: increased life expectancy, the large cohort of aging baby boomers, and the reduction in U.S. birth rates.

This dramatic demographic shift means that there is a critical economic fact underlying the Social Security debate. The increase in the retiree population will trigger a shift of consumption from the working population to the retired population. Regardless of how this is funded by individual accounts or by increased taxes the result is a zero-sum game unless the reforms chosen for Social Security or changes elsewhere in government policy increase the rate of economic growth.

THE PSA OPTION

The PSA proposal supported by five of the 13 SSAC members would change the current system from one in which each worker receives a guaranteed lifetime benefit with automatic cost-of-living increases to a new system in which each worker would have an individual account. Five percent of each worker's pay would be redirected from Social Security taxes (under the Federal Insurance Contributions Act, or FICA) into the new accounts. Ultimately, retirement income would consist of a guaranteed base benefit of $410 (in 1996 dollars) plus the amount accumulated in the individual account.

The transition to the PSA plan will require additional financing because current Social Security obligations must be funded from another source if 5% of current FICA taxes is diverted to individual accounts. The PSA plan thus calls for a 1.52% increase in payroll taxes over a 72-year period to meet this transition cost. In the short term, this increase will still be insufficient to meet current obligations, so the proposal requires additional federal borrowing that will peak at $1.9 trillion (in 1995 dollars). Initially, the additional borrowing is equal to a 3.5% payroll tax (5% minus 1.52%). The annual borrowing declines over time, and the debt is retired in the latter part of the 72-year period.

The selling point of the PSA proposal is the assumption that it improves the rate of return on workers' contributions to the system, thereby making Social Security a "better deal." In its analysis, the SSAC assumed that the accounts annually earned the historical average rate of return on their investments. Thus, the portion of the portfolio invested in equities was assumed to earn a steady 7% real rate of return (i.e., after taking into account the effects of inflation reducing the worth of money) each and every year. But this type of analysis does not measure the probability of investments actually earning the stipulated rate of return. First, returns that average 7% might not produce equivalent results due to the timing of the returns. Four years of 15% returns followed by one year of a 25% loss does not yield the same balance as five years of 7% returns, even though both accounts can be said to have averaged 7% over the five-year period. Second, there is no guarantee that equity real returns will average 7% in the future, particularly for any specific period of time.

M&R'S ANALYSIS

To quantify the potential variability of benefits under the PSA proposal, we calculated and compared probability distributions for total PSA benefits and for current Social Security benefits. Exhibit 1 is a compilation of our study's results. In our analysis, the PSA benefits are fully phased in; that is, the transition period is not considered. Benefits are compared with the current Social Security program without changes. Because the current program is not balanced over the long term, we recognized that today's payroll taxes would have to be raised by roughly 2% to make this a valid comparison.

Our analysis took into account the following factors:

Income Level

Typical-wage earner—one who at age 23 earns 73% of the average wage of worker covered by Social Security and whose earnings rise to 106% of average wages at age 39 and continue at that level until retirement.

High-wage earner—one who always earns more than the Social Security taxable wage base.

Family Status

Single (unmarried) worker.

Worker with a nonworking spouse (or a spouse whose work history is sporadic).

Two-working spouse family. In the case of the typical-wage two-worker family, we assumed that one earned 80% of the primary wage earner.

Asset Allocation

100% equities.
100% bonds.
50% equities and 50% bonds.

Expected Financial Returns

Projected returns for stocks and bonds were generated from historical expected returns and standard deviations. We also modeled the returns on equities under the following two assumptions:

Investment expenses reduce the gross real rate of return by 1%. This is in line with the 401(k) plan experience.

Expected returns are reduced by an additional 1%, so that the expected net real rates of return are 2% lower than the gross historical rates. This scenario illustrates how results might change if future equity returns are lower over time than historical averages.

Our analysis compares the value of the benefits at normal retirement age. For this purpose, the value of the PSA account balance is simply the accumulated balance at retirement. To calculate the value of monthly Social Security benefits from the current system, as well as the flat PSA monthly benefit, we used an annuity factor based on a realized interest rate (or rate in excess of inflation and expenses of paying annuities) of 2.75%. A real rate is appropriate because benefits are increased with inflation and the rate used is consistent with historical averages of real returns on bonds.

Other assumptions we made are explained with Exhibit 1. For each sample worker, results are stated for five percentiles, ranging from the 10th to the 90th percentile. The 50th percentile represents the median: half of the time the worker/family would receive more, and half of the time less, than the amount shown.

SUMMARY OF RESULTS

The Typical-Wage Worker

In our most optimistic scenario, a typical-wage two-worker family that invested entirely in equities and that realized returns consistent with historical returns has a 50% chance of receiving at least 50% more in benefits under the PSA arrangement than under the current Social Security program. This same family has less than a 25% chance of receiving less than the current Social Security benefit and a 25% chance of receiving 235% or more than the current Social Security benefit.

On the other hand, if this same family invests solely in bonds, the expected results are shockingly different. The median benefit is only 86% of current Social Security, with a 25% chance of receiving 78% or less and a 25% chance of receiving 97% or more of the current Social Security benefit. Investing half of the account in equities improves the results to a median of 113% of Social Security using historical assumptions, with a 25% chance of receiving less than 95% and a 25% chance of receiving at least 142%. If the spouse is nonworking, the results are much worse. If the account of the worker with a nonworking spouse is invested 50% in bonds and 50% in equities, the median is 89% of current Social Security.

The High-Wage Worker

For the high-wage earner, the PSA proposal yields better results, but again the expected benefits will be less than under current Social Security if the PSA is invested only in fixed-income instruments. The median result for a family of two high-wage earners invested 100% in equities is approximately twice the level of current Social Security benefits. If the allocation is 50% equities and 50% bonds, the median benefit is 36% greater than Social Security.

Winners, Losers, and Uncertainty

Not surprisingly, PSA comparisons look better for high-wage earners than typical-wage earners. The results also illustrate the following:

The allocation to equities is a critical factor in the comparison. Projected PSA benefits are much better with a 100% equity allocation, but are generally worse than the current system with a 100% bond allocation.

Projected PSA benefits for single workers are very consistent with those for two-earner families, particularly in the typical-wage category.

Projected PSA benefits for one-earner families are less favorable than results for single workers and two-earner families because of the subsidy in the current Social Security system for nonworking spouses.

For accounts fully invested in equities, an additional 1% reduction in the expected equity return has a significant effect on projected benefits, with median results roughly 10% 20% lower than without the reduction.

More than anything, however, the projections illustrate the variability in expected results under the PSA system. Under a 50/50 stock/bond allocation, projected results for the typical-wage two-earner family range from 84% of the current system at the 10th percentile to 190% at the 90th percentile. Relative to the current system, the volatility in this scenario is mostly positive. But even upside volatility has some disadvantages. Generally, a retiree who receives 25% more than under the current system would gladly accept the change; however, that same retiree would still be disappointed if he or she had anticipated even higher benefits five years earlier and then experienced a market downturn.

Experience with employer-sponsored defined contribution retirement plans tells us that individual accounts have unpredictable benefits. Although this variability is a concern with such plans, the problem becomes magnified for Social Security. For participants in 401(k) plans, the individual account provides a retirement benefit on top of the Social Security foundation. Many employees also are covered by a defined benefit pension plan. Having a Social Security base allows workers to take more risks and accept more variability in their individual accounts. If a large part of the Social Security benefit is provided through individual accounts, the variability in total retirement benefits becomes much greater. And for the large part of the population that retires with nothing but Social Security, variability in account balances will be very unsettling.

The other big risk, and one that is not reflected in our analysis, is individual mortality risk. Under the current system, Social Security benefits are guaranteed for life, but under an individual account system, individuals run the risk that they will outlive their account balance. This risk can be managed by requiring individuals to purchase an annuity at retirement or by restricting the rate at which retirees can withdraw money from their individual accounts, but these will not be popular options. Both the mortality risk and the investment risk point to potential disadvantages of the PSA option relative to the defined benefit nature of the current system.

Our analysis illustrates the individual risks incorporated in the PSA option. Nonetheless, projected benefit comparisons look favorable for most cases, and many workers would trade some amount of risk for higher expected benefits. Our numerical analysis tells only part of the story, though. A complete analysis must also address macroeconomic issues that relate to the underlying investment return assumptions, as well as the impact of Social Security privatization on the economy as a whole.

THE DRIVERS OF HIGHER RETURNS

There is a basic concept at the core of all privatization proposals: fund Social Security obligations in advance and invest the contributions privately in stocks and bonds to earn higher rates of return than those implicit in the current Social Security system. In a pure pay-as-you-go system, in which a portion of workers' pay is transferred to retirees each month, the aggregate real rate of return on contributions over time will equal the real growth in wages. The SSAC assumed real wages will grow at 1.5% per year. This rate, combined with the oncoming demographic changes, results in a low aggregate rate of return for the current system. Add to this the fact that the current Social Security benefit formula favors lower-paid workers, it is not surprising that projected real return rates for higher-paid workers are negative.

Financial assets, on the other hand, have historically produced much higher returns. The SSAC assumed future real returns for invested assets would be 7% for equities and 2.3% for fixed income, assumptions that are consistent with historical returns. Using these assumptions, the path to increasing returns for Social Security appears clear. Projected returns will be higher as prefunding increases, particularly as more of this prefunding is invested in equities.

A BIGGER PICTURE TO CONSIDER

If Social Security is considered in the same terms as a private pension plan, the case for prefunding and investing in equities seems obvious. Prefunding has certainly lowered the long-term costs of private pension plans, and aggressive allocation of the assets in equities has resulted in lower costs and/or higher benefits in the long run. But because Social Security is not a private pension plan, nor was it designed to be one, there is a need to step back and look at the big picture.

The central problem facing the current system is the aging of the population. Prefunding or investing in equities will not prevent the population from aging. Regardless of how much people save or invest in equities, more of society's resources will be dedicated to retirees. Prefunding merely dictates how assets are transferred to retirees (e.g., dividends instead of taxes); there will still be one group that is working and one that is not.

In this aggregate sense, changes in Social Security can help to meet the retirement needs of society as a whole only to the extent they expand the economy and thereby enlarge the amount of total resources available for everyone, including the aged population. Thus, prefunding Social Security can be beneficial only if it increases the overall rate of national savings and only if the higher savings lead to economic growth.

Increased Savings

There is no magic to increasing savings. For society as a whole, just like for individuals, savings require sacrifices. For Social Security, this means taxes must be increased and/or benefits must be reduced and these actions must not be offset elsewhere in the economy (i.e., additional contributions to Social Security must not lead to reduced savings outside of Social Security).

The PSA proposal incorporates a plan for "additional savings," but on a fairly limited basis. On the surface, the 5% contribution to individual PSAs appears to be additional savings, but this is a redirection of contributions that is partially funded by the additional borrowing by the federal government. The actual increase to savings in the short term is equal to the 1.5% net increase in taxes.

The call for this small "additional savings" increase under the PSA proposal is not surprising. Contribution increases and benefit decreases are difficult political issues. These are the only options, however, if the nation wants to move toward a more prefunded Social Security that can generate better returns.

Economic Growth

Most economists agree that additional savings will increase economic growth by increasing investment. Having more resources can lead to business creation and expansion. One way of increasing savings available for investment is to reduce government borrowing to finance current operations. The Congressional Budget Office, for example, projects that balancing the budget and keeping it in balance, thereby increasing the availability of capital to the private sectors, would result in a 12% increase in per capita gross national product (GNP) by 2030. Simply maintaining the ratio of the deficit to GNP would still yield a 10% increase in per capita GNP.

Even with increased savings, however, there is no guarantee of economic growth. Moreover, there is no guarantee that the additional investments will be used as efficiently as current investments are. To the extent that additional savings merely serve to bid up the prices of current stocks, nothing will have been accomplished except to increase the rates of returns on equities in the short term and set them up for disappointing long-term returns when the savings are withdrawn to pay for retirement. The additional savings also might be used to fund marginal business enterprises that would otherwise not receive capital and would very likely be less profitable than other businesses.

Allocation in Equities

In all privatization proposals, estimated rates of returns are higher as the proportion of savings allocated to equities increases. Certainly this is borne out in our analysis. Based on historical returns for equities, this is a reasonable conclusion. The cumulative result is less obvious, however, when looking at the big picture.

In the PSA proposal, the money to invest in equities is financed in large part through increased government borrowing. This leveraging may produce higher Social Security rates of returns at the expense of returns on other investments. More borrowing will likely drive up interest rates, increasing the cost of government and business investment. The end result could be improvements for the Social Security system but a zero = sum gain for society as a whole.

We must also consider whether equity returns will suffer if the supply of investment options cannot keep up with the demand from investors. Mutual fund money continues to pour into equities, and pension fund allocations to equities are increasing rather than decreasing. If Social Security contributions are added to the mix, will we have too much of a good thing, particularly when the baby boomers start to sell retirement assets? If the answer is no, then the projected benefits of the PSA proposal would likely come to pass. But if the answer is yes, then the result could be disappointment for individuals counting on their PSAs to provide them a secure retirement.

RISK, RETURNS, AND SACRIFICE

If the nation commits to the additional taxes and borrowing in the PSA proposal, if historical return assumptions are borne out over time, and if the changes do not adversely affect other areas, then the PSA proposal can provide advantages over the current system. In the long term, funding retirement benefits at a lower cost level may be possible under the PSA option if individuals make a major commitment to equities. Even then, if the economy experiences a prolonged bear market, such as that which occurred during the 1970s, some participants may end up worse off at retirement than under the current Social Security system.

Policymakers need to remember that Social Security privatization cannot be done in isolation. There is a need to study the implications on larger and more complex questions:

What are the economic effects of the additional government debt that will be required to fund the transition?

How will long-term equity returns be affected by a large influx of money generated by Social Security privatization?

How will the demographic changes ahead (more retirees, fewer workers) affect financial investment returns?

These questions cannot be answered definitively, but they illustrate the fact that privatization brings added economic riskas well as potential rewardsand that these risks have implications beyond the Social Security system alone.

CONCLUSION

Privatizing Social Security may be a success for many people, but is not the panacea some have made it out to be. Average-wage earners, who have historically had a low tolerance for risky investments, may well end up worse off than under the current system. As Social Security is moved from a pay-as-you-go to a prefunded system, one generation must "pay twice" to fund the benefits for the prior generation as well as its own. Whether the sacrifice is worthwhile will depend on whether additional growth is generated. Mere asset price inflation, while satisfying for the present, does not mean that true gains in GDP wealth are realized. In time, such asset price inflation may spill over into general inflation, undoing the benefits of buying capital assets in the first place. Only production can be consumed, investment does not cure the demographic problem.

We studied the PSA proposal as one of many privatization approaches still to come. The PSA option calls for a mild direct sacrifice, reflected in the additional payroll tax of 1.52%. By incorporating government borrowing, the 1.52% tax extends for 72 years, effectively spreading the transition period over two working generations. But the effect of the massive additional federal borrowing is not reflected under the PSA proposal. Will this additional debt retard economic growth? If so, then the PSA proposal will not achieve its goals.

Other proposed privatization changes include no tax increases. Higher levels of federal debt and more money invested in equities are postulated to solve the imbalance. But the result will be less sacrifice and more risk. The complex questions raised above become magnified.

We can recognize these tradeoffs in all privatization proposals. Proposals with less risk must entail large tax increases to pay for the transition. By contrast, proposals with little or no transition pain must assume greater risks, particularly if they are centered on a large scale borrowing to invest in the equity market.

Perhaps the best solution for Social Security is to increase economic output so that the nation can allocate more to retirees and still maintain workers' standards of living. Even this result, however, might not eliminate the intergenerational battles as workers resist having the productivity gains of their generation devoted to maintaining the standard of living for a growing retiree population. Clearly, Social Security is headed for major problems if we do nothing. There will be no easy solutions.

PSAs Risky for the Average Joe and Josephine

To measure the investment variability of the PSA proposal, we created a computer model that generated rates of return for equities and bonds using historical probabilities. Our model can be adapted to analyze other reform proposals. The computer ran the model 1,000 times (that's like throwing dice 1,000 times and keeping track of each result). The results were then ranked from lowest to highest. This allowed us to determine what percentage of the time a given return would be realized. We then expressed the results as a percentage of the benefit the participant would have received under the current Social Security program.

We tested the effect of a fully phased-in PSA proposal so that none of the benefits would be based on the current system. We then looked at two different wage earners, a typical-wage earner and a high-wage earner. We also studied situations in which the wage earner was single and situations in which the wage earner was married with a nonworking spouse or married with a working spouse. We analyzed the results for three different investment portfolios: 100% equities; 100% fixed income; and 50% equities and 50% fixed income.

As Exhibit 1 illustrates, we found that married workers with nonworking spouses with typical earnings patterns have only a 25% chance of receiving slightly more than they would get from current Social Security if they were invested equally in stocks and bonds. The median result for this couple was 89% of current Social Security. If we further assume that the average real rate of return on stocks is 1% lower than the historical average, these families have a 50% chance of receiving 85% or less of the current Social Security benefit. If that couple invested very conservatively and kept all its money in bonds, expected benefits ranged from a low of 62% of current Social Security to a high of 86% of current Social Security. This demonstrates the critical importance of substantial exposure to equities to have even a chance of financially coming out ahead.

By contrast, under the more conservative assumptions about returns on equities, the two-earner family that invested equally in equities and bonds had a 75% chance of receiving at least 90% of current Social Security benefits and a 50% chance of receiving 106% or more than current Social Security benefits. Once again though, if the two-earner family kept all of its investments in bonds, it had 75% chance of receiving less than current Social Security. As expected, the high-wage earner group did even better because of the current Social Security system's bias toward benefits for lower-wage earners.

Exhibit 1: Expected Returns under the PSA Proposal vs. Social Security

	Percentile	Asset Allocation [1]					
		Equities	Bonds	Equities & Bonds	Equities [2]	Bonds	Equities [2] & Bonds
	....	100%	100%	50%/ 50%	100%	100%	50%/ 50%
PSA Returns as a percentage of Current Social Security Benefits							
Typical-Wage Earner							
Single	10%	86%	71%	84%	79%	71%	81%
	25%	[3] 108%	78%	96%	95%	78%	91%
	[4] 50%	[3,4] 156%	[4] 86%	[3,4] 116%	[3,4] 131%	[4] 86%	[3,4] 108%
	75%	[3] 251%	98%	[3] 148%	[3] 206%	98%	[3] 136%
	90%	[3] 444%	[3] 111%	[3] 199%	[3] 342%	[3] 111%	[3] 181%
Married, with Nonworking Spouse	10%	71%	62%	70%	66%	62%	67%
	25%	85%	66%	77%	77%	66%	74%
	[4] 50%	[3,4] 114%	[4] 71%	[4] 89%	[4] 98%	[4] 71%	[4] 85%
	75%	[3] 172%	78%	[3] 109%	[3] 144%	78%	[3] 102%
	90%	[3] 290%	86%	[3] 140%	[3] 227%	86%	[3] 129%
Married, Both Working	10%	85%	72%	84%	78%	72%	80%
	25%	[3] 105%	78%	95%	94%	78%	90%
	[4] 50%	[3,4] 149%	[4] 86%	[3,4] 113%	[3,4] 127%	[4] 86%	[3,4] 106%
	75%	[3] 237%	97%	[3] 142%	[3] 194%	97%	[3] 132%
	90%	[3] 412%	[3] 109%	[3] 190%	[3] 317%	[3] 109%	[3] 173%
High-Wage Earner							
Single	10%	91%	67%	88%	79%	67%	82%

Exhibit 1: Expected Returns under the PSA Proposal vs. Social Security—Continued

	Percentile	Asset Allocation [1]					
		Equities	Bonds	Equities & Bonds	Equities [2]	Bonds	Equities [2] & Bonds
	25%	[3] 128%	77%	[3] 109%	[3] 107%	77%	[3] 100%
	[4] 50%	[3,4] 207%	[4] 90%	[3,4] 141%	[3,4] 165%	[4] 90%	[3,4] 128%
	75%	[3] 363%	[3] 110%	[3] 192%	[3] 282%	[3] 110%	[3] 172%
	90%	[3] 700%	[3] 132%	[3] 276%	[3] 527%	[3] 132%	[3] 245%
Married, with Nonworking Spouse	10%	68%	53%	66%	60%	53%	62%
	25%	90%	59%	78%	77%	59%	73%
	[4] 50%	[3,4] 138%	[4] 67%	[4] 98%	[3,4] 113%	[4] 67%	[4] 90%
	75%	[3] 234%	79%	[3] 129%	[3] 184%	79%	[3] 117%
	90%	[3] 440%	92%	[3] 181%	[3] 334%	92%	[3] 162%
Married, Both Working	10%	88%	65%	85%	76%	65%	79%
	25%	[3] 123%	75%	[3] 105%	[3] 102%	75%	97%
	[4] 50%	[3,4] 198%	[4] 87%	[3,4] 136%	[3,4] 159%	[4] 87%	[3,4] 123%
	75%	[3] 348%	[3] 106%	[3] 183%	[3] 271%	[3] 106%	[3] 165%
	90%	[3] 675%	[3] 126%	[3] 265%	[3] 501%	[3] 126%	[3] 235%

[1] Assumes expenses of 1.0% for equity investments and 0.5% for bond investments.
[2] Assumes average equity returns are 1% lower than the historical average.
[3] Wage earners who can be expected to receive benefits under the PSA proposal that are equal to or greater than under an unchanged Social Security program.
[4] Median.

PSA Projection Assumptions

Sample Participants

- Born in 1976, entering workforce in 1998, with PSA changes fully phased-in in 1998
- Typical-wage earner

—Earnings at age 22 equal 70% of national average wage, increasing gradually to 100% of national average wage at age 33 and 106% of national average wage at age 39; earnings remain at 106% of national average wage until retirement
—Spouse earnings equal to 80% of earnings for primary wage-earner

- High-wage earner

—Earnings at or above Social Security wage base for all years
—Spouse earnings at or above Social Security wage base for all years

Unemployment

- Probability of unemployment reflected each year, with average unemployment of 6.0%
- Additional maternity unemployment of 5.0% for spouse earnings up to age 35

Gross Investment Returns

- Equity real returns:

—expected return 6.0% and 7.0%
—standard deviation 19.7%

- Fixed real returns:

—expected return 2.3%
—standard deviation 9.5%

- Correlation coefficient between equity real returns and fixed real returns: .31

Investment Expenses

- Equities: 1.0%
- Fixed: .5%

Inflation

- Mean: 3.6%
- Standard deviation: 4.1%
- Serial correlation: .54

Wage Increases

- Annual increase in national average wages: 1.5%

Annuity Conversion to Compare PSA Balances with Annual Annuities

- Real interest rate: 2.75%
- Mortality: UP94 mortality table developed by the Society of Actuaries, projected forward with projection scale AA. (Note: This mortality table projects longer lifetimes than the Social Security "best estimate" mortality assumption, which many actuaries view as overly optimistic. Using the Social Security assumption increases the relative value of PSA benefits by about 5%.)

[Additional attachments are being retained in the Committee files.]

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