

# INVESTING IN THE PRIVATE MARKET

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## HEARING

BEFORE THE  
SUBCOMMITTEE ON SOCIAL SECURITY  
OF THE  
COMMITTEE ON WAYS AND MEANS  
HOUSE OF REPRESENTATIVES  
ONE HUNDRED SIXTH CONGRESS

FIRST SESSION

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MARCH 3, 1999

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**Serial 106-13**

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Printed for the use of the Committee on Ways and Means



U.S. GOVERNMENT PRINTING OFFICE

57-507 CC

WASHINGTON : 1999

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## CONTENTS

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	Page
Advisories announcing the hearing .....	2
WITNESSES	
U.S. Department of the Treasury, Hon. Lawrence H. Summers, Ph.D., Deputy Secretary .....	7
-----	
Goldberg, Hon. Fred T., Jr., Skadden, Arps, Slate, Meagher & Flom, LLP .....	70
Investors Services of Hartford, Inc., Hon. Maureen M. Baronian .....	38
Lehrman Bell Mueller Cannon, Inc., John Mueller .....	87
National Committee Tto Preserve Social Security and Medicare, Martha A. McSteen .....	86
Reischauer, Robert D., Brookings Institution .....	48
Tanner, Michael, Cato Institute .....	41
Weaver, Carolyn L., American Enterprise Institute .....	66
White, Lawrence J., New York University .....	32
SUBMISSIONS FOR THE RECORD	
California State Teachers' Retirement System, Sacramento, CA, Emma Y. Zink, statement .....	110
Century Foundation, New York, NY, statements .....	111
Credit Union National Association, statement .....	127
Executive Intelligence Review News Service, Richard Freeman, and Marianna Wertz, statement .....	128
MFS Investment Management, Boston, MA, David Oliveri, statement .....	131
National Conference of State Legislatures, Gerri Madrid and Sheri Steisel; National Association of Counties, Neil Bomberg; National League of Cities, Doug Peterson; United States Conference of Mayors, Larry Jones; Government Finance Officers Association, Tom Owens; National Association of State Retirement Administrators, Jeannine Markoe Raymond; National Council on Teacher Retirement, Cindie Moore; National Conference on Public Employee Retirement Systems, Ed Braman, joint letter and attachment .....	146
National Taxpayers Union, Alexandria, VA, Peter J. Sepp, statement .....	147
Plan Sponsor, Greenwich, CT, Chris Tobe, statement .....	151

## **INVESTING IN THE PRIVATE MARKET**

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**WEDNESDAY, MARCH 3, 1999**

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

The Subcommittee met, pursuant to notice, at 10 a.m., in room 1100, Longworth House Office Building, Hon. E. Clay Shaw, Jr. (Chairman of the Subcommittee), presiding.  
[The advisories announcing the hearing follow:]

# ADVISORY

## FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE  
February 24, 1999  
No. FC-8

CONTACT: (202) 225-1721

### **Archer Announces Social Security Hearing on Investing in the Private Market**

Congressman Bill Archer (R-TX), Chairman of the Committee on Ways and Means, today announced that the Committee will hold a hearing on investing Social Security's Trust Funds in the stock market. The hearing will focus on the effects of government-directed and individually directed investments. The hearing will take place on Wednesday, March 3, 1999, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.

Oral testimony at this hearing will be from invited witnesses only. Witnesses will include experts in Social Security and investment policy. 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:**

Over the next 75 years, Social Security is expected to face a funding shortfall equal to 2.19 percent of taxable payroll. Traditionally, the gap between Social Security's income and costs has been filled by increasing payroll taxes, reducing benefits, and/or borrowing from the public. However, policy experts are now seeking new approaches to strengthen Social Security's finances. Leaders of both parties, including the President, have supported increasing the program's income by investing a portion of Social Security's excess tax receipts in the stock market. These surpluses are currently invested in special issue Treasury bonds, which earn an average annual yield of 2.8 percent. According to the President's 1994-96 Advisory Council on Social Security, stock investment would earn a real annual yield of 7 percent.

Although there is agreement that investing in stocks would help restore Social Security's long-term solvency, how the investments should be directed remains a key focus of debate. The President has proposed that a portion of the Trust Funds be invested directly by the Federal Government in the private sector. Some Members of Congress and other experts argue that investments should be directed by individuals through personal retirement accounts. While, in comparison with personal retirement accounts, investing a portion of the Social Security Trust Funds directly in the private market may reduce individual exposure to risk, some experts, including Federal Reserve Chairman Alan Greenspan, have warned it would lead to political interference in private financial markets and corporate decision making.

In announcing the hearing, Chairman Archer stated: "The President's proposal to invest in the private market as a solution to Social Security's problem is a breakthrough. While the White House and I may differ on who should own and control these investments, we need to carefully consider the benefits and risks of each approach as we move forward to save Social Security."

#### **FOCUS OF THE HEARING:**

The hearing will focus on the economic, political, and social effects of private market investing by the Federal Government and by individuals.

**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*, Wednesday, March 17, 1999, 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 Committee office, room 1102 Longworth House Office Building, by close of business the day before the hearing.

**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/](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.

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\*\*\*NOTICE—CHANGE IN HEARING STATUS\*\*\*

# **ADVISORY**

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE  
February 26, 1999  
No. FC-8-Revised

CONTACT: (202) 225-9263

## **Full Committee Hearing on Wednesday, March 3, 1999, on Investing Social Security in the Private Market to be Held at the Subcommittee Level**

Congressman Bill Archer (R-TX), Chairman of the Committee on Ways and Means, today announced that the full Committee hearing on investing Social Security in the private market, previously scheduled for Wednesday, March 3, 1999, at 10:00 a.m., in the main Committee hearing room, 1100 Longworth House Office Building, will now be a hearing of the Subcommittee on Social Security.

All other details for the hearing remain the same. (See full Committee press release No. FC-8, dated February 24, 1999.)

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Chairman SHAW. If the Members and guests would take their seats, we will convene this morning's hearing. We have a long agenda, and we would like to complete it giving adequate time to all our guest witnesses this morning.

Today, we will explore how market investments might improve Social Security for women, minorities, and all Americans. The benefits of investing are not lost on the American people. A new Congressional Research Service study I am releasing today estimates that 83.6 million Americans—that is about 1 in 3—will own stock in 1999. Last weekend, I noted on NBC a news story about the growing number of minority households saving and investing. In fact, women and hardworking families are increasingly recognizing the power of savings and investment as part of their retirement planning. Today, 1 in 3 households earning between \$25,000 and \$50,000 own mutual funds, and 53 percent of all mutual fund investment decisions are made entirely or in part by women, who are even more likely than men to see retirement as their investment goal.

As usual, the American people are way ahead of the Congress and ahead of the President. When asked last month, everyone—men, women, Republicans, Democrats, Independents—agreed that individuals could properly manage personal retirement accounts better than the government if created as part of a Social Security reform.

The numbers weren't even close. Women trusted individuals over government by a 2-to-1 margin, and even among Democrats, 52

percent favored personal savings versus only 35 percent who wanted the government to control those investments.

To his credit, the President proposed a framework for modernizing Social Security's financing. He supports market investments to boost Social Security returns and new savings accounts, and we agree with the President.

While we disagree with the President about who should own and control these investments, we need to carefully consider the benefits and risks of each approach as we move forward to save Social Security.

We should all ask ourselves several questions as we listen to witnesses today. What role does savings and investment have in Social Security's future? If we begin saving real assets, who should decide what investments are made, workers and families or the government? And, if we choose the investment route, what protections, if any, are needed to limit risk, prevent fraud, and maintain the security that has been the hallmark of Social Security for the past 60 years.

Getting the right answers to these questions will move us another step forward on the path to reform, so let us get to business, let us get down to work, and most of all, let us work together.

Mr. Matsui.

Mr. MATSUI. Thank you, Mr. Chairman. I appreciate your comments. I appreciate the fact that we are having this hearing today.

As all of us know, Social Security is probably the most fundamentally important program that the Federal Government has been involved in probably the whole history of our government. It provides the safety net for 260 million Americans, past and future. It takes care of not only the basic retirement benefits of all Americans when they reach 62 or 65 years old, but also provides survivors benefits when the breadwinner in the family dies. We had a witness that the Chairman was gracious to allow about 3 weeks ago who actually testified that without those survivors benefits when her father died, she would not have been able to attend college. And she is now proceeding to graduation. There are 1 million cases like hers.

It also provides disability benefits for many Americans, and in many families, the breadwinner might become permanently disabled at a very young age. Social Security takes care of that individual's family.

And so this is an issue of paramount concern I think to all of us as Americans and obviously as legislators. And so I appreciate the fact that we are finally getting down to the issue of how we are going to make sure that we protect the Social Security system as we know it.

We need to move away from the rhetoric and the attacks on the President's program and the countercharges, and we need to really get down to fundamental business. And it is my hope that now we can begin in earnest to talk about these issues.

And I might point out there was a study that was released by the General Accounting Office on Friday that talked about the Galveston, Texas, plan, one of the few communities in the United States which has its own privatized retirement system. I would

urge people to look at the GAO study, because it is very critical of the Galveston plan.

And just yesterday, the National Committee To Preserve Social Security and Medicare released a study by John Mueller. John Mueller is an economist who for the last decade has had his own accounting firm. Prior to that, for a number of years, he was the chief economist to the Republican Conference, and the head of the Republican Conference at the time was none other than former Representative Jack Kemp, not one of the most flaming liberals in America. And his study which was actually commissioned by Martha McSteen, who, as all of us know, was the Administrator of the Social Security Administration from 1983 to 1986, during which time we reformed the system, and who happened to have been appointed by none other than President Ronald Reagan.

So this is not a partisan issue. It is an issue I think all of us, whether Democrats, Republicans, conservative, liberals, or moderates, want to be involved in.

But I might just point out a couple points in the study commissioned by the National Committee To Preserve Social Security and Medicare.

One is that the study has discovered that there are no persons currently alive in America today who would benefit from privatizing Social Security. In fact, the only winners would be realized starting from the year 2025 on. And those winners would be single males.

We are only talking about male individuals born 25 years into the future who will benefit from individual accounts. Women are losers. Minorities, low-income people, are major losers if we should privatize Social Security. And one of the big problems, of course, is the fact that those people who are trying to make a determination about whether to privatize or go with the current system fail to take into consideration that when you consider the Social Security benefit structure, you do so over a 75-year period, and the growth rate is low over that period. Whereas, when it comes to considering investment in the equity markets, they use a more recent study of the equity markets.

But last and most importantly, I hope the witnesses, particularly in the first panel, will respond to the issue of who is going to pay for the transition costs—the \$8 trillion transition costs that are involved in making sure that current and future beneficiaries receive the same level of benefits.

I might just in closing point out that one witness who will testify has said that we need to privatize a significant part of the Social Security system. And then buried in the analysis there is a temporary tax on the payroll of 1.52 percent, a temporary 1.52-percent tax, that is not a major part of the program that is being discussed. The temporary tax is for 75 years. I wish that we in Congress could get by with calling a tax of 75 years a temporary tax, but that is a permanent tax. And no one is going to be able to convince me otherwise.

We need to discuss this issue in a rational, intelligent fashion. And I look forward to this, and hopefully, this will be the start of the kind of dialog that is so necessary if we want to protect the Social Security system as we know it. And I look forward, as the

Chairman said, to Secretary Summers' testimony and the two other panels as well.

Thank you, Mr. Chairman.

Chairman SHAW. Thank you, Mr. Matsui.

Our first witness is Hon. Lawrence Summers who is the Deputy Secretary of the U.S. Department of the Treasury.

Welcome. We are pleased to have you at this hearing. Your full testimony will be made a part of the record as all the witnesses' testimony, and we would welcome you to summarize as you see fit.

Mr. Summers.

**STATEMENT OF HON. LAWRENCE H. SUMMERS, PH.D., DEPUTY SECRETARY, U.S. DEPARTMENT OF THE TREASURY**

Mr. SUMMERS. Thank you very much, Mr. Chairman and Members of the Subcommittee, for this opportunity to testify on behalf of the administration's proposal and to share some of our thoughts on the crucial questions you raised in your opening statement, Mr. Chairman, regarding the benefits of investment of a portion of the trust funds.

We have a great opportunity in this country right now, with \$4.8 trillion in surpluses projected over the next 15 years. We have a great challenge with an aging society that will put much greater pressure on our Social Security and Medicare Programs.

It is the essence of the President's approach to use the opportunity to meet the challenge by contributing the surplus to the Social Security Investment Funds and modernizing the way in which the Social Security Trust Fund is invested.

This proposal has the crucial benefit of essentially eliminating the national debt sometime between 2010 and 2020. That is very important for the future of our country, because of what it means for the performance of our economy. The \$3½ trillion that would otherwise go into the sterile asset of government debt will be available to substitute for foreign borrowing and trade dislocations, to invest in tools for American workers, to invest in new homes for American families.

It is also very significant to the fiscal foundation of this country, because essentially eliminating that national debt reduces an amount equal to between 2½ and 3 percent of the GNP that we otherwise have to spend on interest. And that is an amount sufficient to meet the challenge of rising Social Security costs.

The President's proposal of contributing the benefits of debt reduction to the Social Security Trust Fund assures that that fiscal foundation we have laid for solvency turns into a legal commitment to meet the obligation to future Social Security beneficiaries. The President's proposal thus strengthens both our economy and the Social Security system by taking advantage of the opportunity of the surplus to meet the challenge of an aging society.

A particular focus of this hearing, Mr. Chairman, is on, as you made very clear, the question of the investment of Social Security Trust Funds and more generally the best way in which to take advantage of the returns that the stock market offers for future retirees.

The administration, as you know in its budget separate from its proposal for Social Security, has proposed a system of USA ac-

counts that would make universal private pension coverage, an insured investment vehicle to permit wealth accumulation for all Americans.

While this, along with other steps to promote pension portability and availability, is I think an important step in strengthening our overall national retirement security system, in the remainder of my opening statement, I want to concentrate on the question of investment in equities.

As Mr. Matsui noted, Social Security has been our most successful national social program. And it is very important that we preserve it in an effective and strong form.

Investments in equities can do that. If you look at essentially all defined benefit pension plans, whether in the private or in the public sector, they take advantage of the opportunities that equities offer. They do that because it makes possible providing larger benefits with smaller contributions.

The relatively limited proposal that the administration has put forward, to invest 15 percent of an augmented trust fund in equities, would itself be sufficient to obviate the need for what would otherwise be a 5-percent across-the-board benefit cut starting in 2030 or a year-and-a-half increase in the retirement age.

Is this something that can work? In terms of risks, we believe the risks are easily controlled. The trust fund—only 15 percent of the trust fund is to be invested in equities. In a year like 2030, 72 percent of benefits will come from the payroll tax stream. Only 28 percent will come from the trust fund. Of that 28 percent, only 15 percent, or about 4 percent of the total, will be related in any way to equity investments. So the system is secure.

Can this be done with integrity? We believe that a combination of an independent public board, whose only mandate is to choose private investment managers whose only freedom is to invest in market indices on a nondiscretionary autopilot basis, affords the possibility of investment with integrity and without interference.

There has, as you know, Mr. Chairman, been considerable discussion of the State and local experience in this regard. And I would only note that many of the State and local statutes prescribe economically targeted investing or other such practices. Whereas, we contemplate legislation that would proscribe this; and that the legislation we contemplate, unlike any in the State and local experiences, would provide for investment only along the lines of market indices with no discretion.

Finally, Mr. Chairman, you raised in your opening statement, this is something we can obviously get into more in the questions, the issue of collective investment versus investment by individuals as part of the Social Security system. And I would suggest that a collective investment approach has three important virtues relative to an individual one.

First, it is safer for individuals. In 1974, for example, the stock market declined by more than 50 percent in real terms. Somebody who retired at that moment would see half their benefit having eroded. With the defined benefit approach, the risks of the stock market would still be there but that would be spread over the long term and borne by the Federal Government rather than individual beneficiaries.

Second, administrative costs. Experience with mutual funds in the United States, with the private Social Security systems in Britain and in Chile, all suggests that the costs of an individual approach would be likely to eat up as much as 20 percent or more of account accumulations over a 40-year period. In contrast, Social Security with equity investments would continue to pay out 99 cents out of every dollar received in the form of benefits.

Third, a collective approach preserves the basic defined benefit progressive structure of Social Security, which has been so important in transforming the lot of the Nation's elderly, who were the group most frequently in poverty a generation ago; and today are the group in our population that is least frequently in poverty.

I might conclude with this thought, Mr. Chairman. The benefits of collective investment that I just described are often juxtaposed with concerns about the integrity of that collective investment. I have suggested that I believe those concerns can be addressed with independent management and indexing.

But it is important I think to recognize that any system of government-administered individual accounts that apply to millions of Americans would still carry with it many of the same risks of interference. There would still be the possibility of investment rules for the basic equity fund that would divert investments into less productive purposes or that would prescribe certain forms of investment holding. And so the opportunity for the political process to meddle would be there, whether it was a nationally run system of individual accounts or a collective investment scheme.

To be sure, I believe those risks can be controlled. But I do not believe those risks provide a strong basis for choosing between a collective and a more individual approach. Whereas, I do believe that the benefits of administrative simplicity, the benefits of progressivity, and the benefits of risk sharing do mean that in the Social Security pillar of our retirement security system, we are best off with an approach like the one that the President has put forward.

Thank you very much for this opportunity, Mr. Chairman.  
[The prepared statement follows:]

**Statement of Hon. Lawrence H. Summers, Ph.D., Deputy Secretary, U.S. Department of the Treasury**

Mr. Chairman, Members of the Committee, I appreciate the opportunity to appear today to discuss President Clinton's proposal to ensure the financial well-being of the Social Security and Medicare programs and improve the retirement security of all Americans.

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

Today I will first briefly describe the President's program. I will then devote the bulk of my remarks to the issue of the President's proposal to raise the rate of return earned by the Social Security trust funds by investing part of the surplus in equities.

THE PRESIDENT'S PROPOSAL

According to the Office of Management and Budget, the surpluses in the unified budget of the federal government will total more than \$4.8 trillion over the next 15 years. This presents us with a tremendous opportunity. At the same time, we are

also facing a tremendous challenge: the aging of the “babyboomers” is projected to put enormous strains on the Social Security and Medicare systems, on which so many retirees depend.

The natural approach would be to take advantage of this opportunity to meet the challenges facing us. This is the objective of the President’s plan.

The President’s framework devotes 62 percent of these projected budget surpluses to the Social Security system. Of the roughly \$2.8 trillion in surpluses that will go to Social Security, about four-fifths will be used to purchase Treasury securities, the same securities that the Social Security system has invested in since its inception. The remaining one-fifth will be invested in an index of private-sector equities. These two actions will reduce the 75-year actuarial gap from its current level of 2.19 percent of payroll by about two-thirds, to 0.75 percent of payroll. And they push back the date at which the Social Security trust funds are projected to be exhausted, from 2032 to 2055.

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

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

In addition to shoring up Social Security, the President’s plan would transfer an additional 15 percent of the surpluses to Medicare, extending the life of that trust funds to 2020. A bipartisan process will also be required to consider structural reforms in this program. The Medicare Commission is expected to report soon on these important issues.

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

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

#### BENEFITS OF THE PRESIDENT’S APPROACH

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

- First, it would greatly strengthen the financial position of the government. If we follow this plan, by 2014, we will have the lowest debt-to-GDP ratio since 1917 and will free up a tremendous amount of fiscal capacity. The reduction in publicly held debt will reduce net interest outlays from about 13 cents per dollar of outlays in FY99 to about 2 cents per dollar of outlays in 2014. Under the President’s pro-

gram, the decline in interest expense resulting from debt reduction will exceed the increase in Social Security expense through the middle of the next century.

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

- And third, it would substantially increase national saving, which must be a priority in advance of the coming demographic shift. By paying down debt held by the public and investing in equities, the President's program will create room for about \$3.5 trillion more investment in productive capital. In effect, this will be the reverse of the "crowding out" that occurred during the era of big deficits. With government taking a smaller share of total credit in the economy, interest rates will be lower than otherwise would be the case. The implications of lower interest rates will be profound. Not only will individuals be able to borrow for mortgages, school loans, and other purposes at lower rates, but importantly, businesses will be able to finance investments in productive plant and equipment at the lower rates. And the resulting larger private capital stock is the key to increasing productivity, incomes, and standards of living. Ultimately, one reason why this program is sound economically is that it will result in a more robust private economy, which will expand our capacity to make good on our Social Security and Medicare promises. This increase in public saving also has beneficial implications for our balance of payments side. Reduced government borrowing would lead to a reduced dependence on foreign financing, and an improvement in our status as a net debtor to the rest of the world.

#### BENEFITS OF USA ACCOUNTS

Social Security, strengthening employer-sponsored retirement plans, and creating USA accounts are key pillars of the President's proposal to provide financial security to retirees. We believe that USA accounts will provide a significant stimulus to private savings, by enabling millions of Americans to begin to set aside some money for retirement.

The President's proposal aims to deal more broadly with the challenges of an aging society by expanding individual access to retirement saving. As I noted earlier, the President proposes to devote 12 percent of the surpluses to establishing a new system of Universal Savings Accounts. These accounts would provide a tax credit to millions of American workers to help them save for their retirement. Workers would qualify for a progressive tax credit match against their own contributions. For example, a low-income worker may receive a dollar for dollar match up to a cap. In addition, low- and moderate-income workers will qualify for an additional tax credit, even if they make no contribution themselves.

Overall, the USA program would be considerably more progressive than the current tax subsidies for retirement savings—where higher bracket taxpayers get higher subsidies. This proposal would contribute significantly to national savings, because it will produce retirement savings for millions of low- and moderate-income people who do not have access to pensions. The tax credit match will provide a strong incentive for workers to add their own saving to accounts.

#### INVESTING PART OF THE SURPLUS IN EQUITIES WOULD RAISE THE RATE OF RETURN EARNED BY THE SOCIAL SECURITY TRUST FUNDS

As I have mentioned, the President has proposed transferring 62 percent of projected surpluses to Social Security, and investing a portion of these transferred surpluses in equities.

To date, the trust funds have been invested exclusively in U.S. Government bonds. While these bonds are essentially risk-free, they have the corresponding downside that they have historically paid a lower rate of return, on average, than other potential investments. Between 1959 and 1996, the average annual rate of return earned on stocks was 3.84% higher than the rate earned on bonds held by the trust funds.

Currently, the pension savings of many upper income Americans are invested in private plans that earn these higher equity returns. The higher equity returns can potentially make it possible for these Americans to have more upon retirement. We believe that it is important to give all Americans, even those of low and modest means, the opportunity to enjoy these potential benefits from stock market performance.

Raising the rate of return on the trust funds would mean that the Social Security system could be brought into long-term actuarial balance with smaller reductions in benefits, smaller increases in revenue, and/or less transfer of surplus. The Presi-

dent's plan for investing in equities will reduce the actuarial gap by an estimated 0.46 percent of taxable payroll—and thus will close roughly one-fifth of the problem we face over the next 75 years. If one were to try to achieve the same actuarial impact of equity investments through alternative measures, we would have to immediately reduce the COLA on Social Security benefits by 0.3 percentage points. The equity investment in the President's package achieves as much for the financial soundness of the system as would moving the normal retirement age up by about an extra year and one-half for participants who reach age 67 in 2022. If we delayed until 2030 to make the changes necessary to set Social Security back on a sound actuarial footing, the required across-the-board cut in benefits would be 5%.

Investing part of the trust funds in equities would also bring Social Security into line with the "best practice" of both private and public sector pension plans. Among large private-sector defined benefit plans (those with more than 100 participants), more than 40% of total assets were invested in equities in 1993; this number has risen significantly since then. Nearly all state pension plans also now invest in equities. In 1997, state and local government plans invested 64% of their portfolios in equities.

#### WOULD EQUITY INVESTMENTS ADD RISK TO THE TRUST FUNDS?

I see two broad concerns regarding trust fund investment in equities. These concerns are legitimate, but we believe they are manageable, and should not stop us from achieving the potential enhanced returns of equities.

First, stock returns are more volatile than the returns on the government bonds held by the trust funds. However, the trust funds are well-situated to bear equity risk, because they have long—or indefinite—time horizons. The trust funds would be capable of riding out the ups and downs of the market, because they receive the cash flow from payroll taxes, and because of the cushion provided by the trust funds' bond holdings.

More specifically, investing only 15 percent in equities seems to us to be a prudent balance between receiving the potentially greater return from equities and keeping the investment small enough so that the trust funds are not overly exposed. This 15 percent allocation to equities is much smaller than the customary allocation to equities in either public or private pension plans. Moreover, 85% of the trust funds will still be invested as before in risk-free Treasury securities.

In addition, the equity investments and disinvestments that we are proposing will be smoothed in incremental additions over 15 years. In any year, investments or disinvestments are projected to be less than 0.5% of the stock market. Incremental investments and disinvestments—rather than total divestiture at one time—will help to mitigate the risk from adverse price movements.

Finally, in the near term, all benefits will continue to be paid out of payroll and other taxes. Furthermore, under current law, even in 2032 payroll and other taxes will be sufficient to pay for the lion's share—about 72%—of Social Security benefits. The remaining 28% of benefits will be paid out using the assets of the trust funds. As only 15% of the trust funds' assets would be invested in equities, only about one sixth of this 28% would be backed by equities. In short, even in 2032, only about 4–5% of payments from the trust funds will be backed by private sector investments.

#### ENSURING THE INTEGRITY OF INVESTMENT DECISIONS

The second concern is that of political influence on trust fund investment decisions. Any system of collective investment can and must address these concerns. We believe that we can successfully work with Congress to design a system that is free from political influence. We need to strike the right balance, so that we can earn the higher potential returns to equities, by finding a way to take care of these legitimate concerns.

That is why we will work with Congress to design a system that observes *five core principles*. These five core principles will establish several levels of protection.

First, the share of trust fund assets invested in equities ought to be kept at a very *limited* level. We have proposed that equity investment be limited to 15 percent of trust fund balances. This will be important to limit the trust funds' exposure to price movements from equity investments, and to ensure that collective investments never account for more than a small fraction of the stock market. During the first years of the program, from 2001 to 2014, Social Security would own, on average, only 2% of the stock market. On average through 2030, Social Security would own approximately a 4% share of the total stock market.

Second, the investments should be *independently managed and non-political*. We suggest that trust fund managers be drawn from the private sector through com-

petitive bidding and that the trust fund managers be overseen by an independent board. There should be wholly independent oversight of investment, in order to shield the trust funds from political influence.

Third, the sole responsibility of the independent board would be to *select private sector managers through competitive bidding*. Private sector management will provide a further degree of political insulation. Moreover, Social Security beneficiaries deserve the same efficient management and market returns that people receive for their private pensions and personal savings.

Fourth, equity investments should be *broad-based, neutral and non-discretionary*. Assets should be invested proportionately in the broadest array of publicly listed equities, with no room for discretion in adding or deleting companies and no room for active involvement in corporate decisions. We have proposed that the funds be invested in a total market index, which would encompass a broad range of stocks. In addition, the managers should be on autopilot in investing the funds; they should have little or no discretion in the investment of trust fund assets, so they cannot "time the market" or pick individual stocks.

As a shareholder the trust funds should be entirely passive. One way to accomplish this might be to mandate that proxies be voted in the same proportions as other shareholders.

Fifth and finally, collective investment needs to be achieved at the *lowest cost* available. This will be important both to obtain the highest possible returns and to further enhance the system's transparency and independence. Indexed investment is less expensive than active management. In addition, given the large size of the potential equity investments by Social Security, we would expect to pay very low asset management fees.

Let me emphasize our belief that there should be zero government involvement in the investment. We will work with Congress to design a system that is completely insulated from political pressures.

#### THE EXPERIENCE OF STATE AND LOCAL GOVERNMENTS

As I mentioned earlier, virtually all state pension funds now invest in equities. In 1997, state and local government plans invested 64% of their portfolios in equities, up from 56% in 1996. State and local pension plans now hold fully 10 percent of the overall stock market. By contrast, the Social Security trust fund equity investments would total only 15% of the trust funds, and would represent, on average, about a 4% of the equity market.

Some have suggested that the trust funds might fall short of earning market returns, based on the experience of state and local pension plans. I would emphasize first that the experience of state plans is really not directly comparable to what we are proposing for Social Security. State plans do not generally operate under the kinds of restrictions that are envisioned under the President's proposal. That is, the statutes governing state plans do not generally require that investments be made only through indexed funds, with a clear prohibition against adding or subtracting equities from the index. Many state pension plans are actively managed, and some have explicit investment goals. As a result, the experience of these plans may not be relevant as a guide for what Social Security's experience would be.

Our preliminary analysis of the available data suggests that, over the period 1990-1995, public plans actually received returns that averaged two basis points higher than private plan returns (this difference is statistically indistinguishable from zero). Although in earlier periods (from 1968 to 1983) the performance of public pension funds was slightly inferior to that of private pension funds, this difference is also not statistically significant. More importantly, this very slight difference in performance during earlier periods can be explained by the fact that public pension funds generally allocated a far smaller portion of their portfolios to equities, and in some cases were statutorily prohibited from buying any equities.

The returns to trust fund investments to this date would not stack up well in this comparison of earnings of public and private pension funds. Because the trust funds have been invested exclusively in government securities until now, both public and private pension funds would likely have outperformed the rate of return earned on trust fund investments.

#### ADVANTAGES OF COLLECTIVE INVESTMENT OF SOCIAL SECURITY

There are three key advantages to having the trust funds invest collectively in equities for the American people. These advantages relate to the ability of defined benefit plans to bear market risk, minimize administrative costs, and achieve progressivity. Defined contribution plans, such as the proposals for individual accounts, are less able to realize these objectives. In addition, the potential political risk from

collective investment in equities through the trust funds is not very different from the political risk that could arise from investing in equities through defined contribution plans.

An advantage of collective investment in equities through the trust funds is that periods of poor equity performance could be spread over many generations of current and future Social Security participants. By contrast, during a market downturn, participants in a defined contribution system could be forced to choose between postponing retirement and a severely reduced retirement income. For example, for the year that ended with the third quarter of 1974, the S&P500 declined by 54 percent in real terms. By placing the risk of a market downturn in the trust funds, we can greatly reduce this risk to beneficiaries. Additionally, we have proposed limiting Social Security's equity holdings to 15% of the trust funds. As I noted earlier, this means that only 4% of benefits payments would be backed by the performance of equities.

The second advantage of collective investment in equities is that the returns to trust fund investments in equities would likely be higher than the returns to equities held in individual accounts. This is primarily because it would be much more costly to administer a defined contribution plan than it would be to administer a defined benefit plan. The trust funds would expect to pay very low asset management fees, because of the large size of the trust fund asset pool. These asset management fees could be comparable to, or lower, than the 1 basis point (0.01%) currently paid by the federal employees' TSP plan for private management of the equity-indexed "C Fund."

By contrast, administrative costs for a system of defined contribution plans held in the private sector could be comparable to the commissions and fees charged by equity mutual funds today. The average equity mutual fund currently charges between 100 and 150 basis points for administrative and investment management services. Costs of this magnitude could significantly reduce the balance that could be accumulated in an individual account. According to our estimates, administrative costs of 100 basis points would reduce by 20 percent the total account accumulations at the end of a 40-year career. Collective investment through the trust funds would avoid the need to pay the administrative costs associated with individual accounts.

The experience of individual accounts in Britain and Chile illustrates how significant these risks and costs can be. In Britain, many personal pension plans take more than 5 percent of contributions in administrative charges.

Chile also has had high administrative costs. According to the Congressional Budget Office (CBO), fees and commissions of the Chilean pension system amounted to 23.6 percent of contributions in 1995. As a result, according to the CBO, Chilean workers who invested their money in an individual account in 1981 received an internal real rate of return of 7.4 percent on that investment through 1995, despite average real returns of 12.7 percent to pension fund investments. Even in the best of circumstances, however, costs will be higher for a system of individual accounts than for collectively investing trust fund assets.

The third advantage of collective investment is that it is progressive. This is one of the most important features of Social Security: benefits are greater, as a percentage of wages, for low-income workers than high-income workers. By investing in equities, we are able to maintain this critical feature of progressivity and avail Americans of modest means of the higher returns that have historically accrued to equities.

In addition to these key advantages, one might note that, with regard to the concern about political influence, this concern also exists for individual accounts. Most individual account proposals have suggested some centralized plan structure, both in order to reduce administrative costs and to help familiarize tens of millions of Americans with the range of possible investment vehicles. These individual account plans would create a large pool of money under a single manager, or a handful of managers. This pool of money would not look very different from the Social Security trust funds. With any centralized pool of assets there is the potential for those pursuing a political agenda to try to influence it.

We can all be encouraged by the history of the Thrift Savings Plan (TSP), whose investments have not been subject to political influence. We believe that some of the features that have protected the TSP system so well are worth emulating. These include the TSP system's independent board, its private sector managers, and the rule that equity investments can only be made by tracking an index.

#### CONCLUSION

In conclusion, it will be critical to have the Administration and Congress work together to address the needs of future generations. We need to keep the promises

that we have made to retirees, without unduly burdening younger generations. We want to work with you, on a bipartisan basis, to implement the President's program. I believe that we can find a safe and prudent way to participate in the enhanced returns in equity markets.

Thank you. I would welcome any questions.

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Chairman SHAW. Thank you, Dr. Summers. I have just a few questions. You mentioned in your initial remarks that the President's plan would virtually eliminate the national debt. Does that include the part of the national debt held by the Social Security Trust Fund?

Mr. SUMMERS. I am sorry, Mr. Chairman. I should have spoken more precisely. It would eliminate the debt of the Federal Government to the public, which is the debt that potentially crowds out other investments and which is the debt that represents a fiscal burden on taxpayers.

The intra-Federal Government securities would still exist, but they would simply be there in recognition of a liability that is already there for the Federal Government, namely the liability to meet future benefits.

Chairman SHAW. So it is a liability to the general public, particularly the working people who have paid into Social Security. The debt is still there, and it is a debt to the public, is that correct?

Mr. SUMMERS. There would be no—the—whatever is done, the public has an obligation to meet future Social Security obligations.

Chairman SHAW. Yes.

Mr. SUMMERS. There is no new obligation incurred by the public, and the obligation that the public now has to meet a national debt, which comprises just under 50 percent of the GNP, would be, over time, eliminated, of course, assuming the projections came true in the context of the President's proposal.

Chairman SHAW. Dr. Summers, it can be argued that if you take the Social Security Trust Fund completely off of budget—if Congress did it—if the President did it—that we wouldn't be looking at a surplus, we would be looking at, indeed, a deficit. The math on that is very clear. We all agree that that is the case. So it can be argued that the surplus has already gone through the Social Security Trust Fund in the form of FICA taxes, because that goes into the unified budget. So the 62 percent that the President runs through the Social Security Trust Fund and then comes out the other end, and pays off the publicly held debt—in other words, exchanging government-held debt for publicly owned debt—that money has already been through the trust fund. So what would be the effect if you ran it through two or three times before you came to the end game of retiring the public debt? That would have the effect of putting more IOUs into the trust fund, is that not correct? That is a simple "yes" answer, I believe. So what we are—

Mr. SUMMERS. I don't think—I am not 100 percent certain I understood the whole question, Congressman, but I don't—

Chairman SHAW. Well, let me repeat it then.

Mr. SUMMERS. But I don't think the effects are as you describe. I think the effects of the President's proposal would be to reduce the interest burden that taxpayers would have to finance from its current—from what would have been a level of a few hundred bil-

lion dollars in 2015 to a number that would be a few tens of billion dollars at that time, while at the same time, which, in turn, would both provide the increased national savings and the increased government budget space to make room for meeting our Social Security obligations.

Chairman SHAW. Let me ask you a question. Let me you ask you for just a simple “yes” or “no” answer. When the 62 percent goes through the Social Security Trust Fund that has the effect of putting more Treasury bills, more IOUs, in the trust fund, is that correct?

Mr. SUMMERS. That is correct.

Chairman SHAW. And if you were to take that when it comes out the other side and run it through there again, it would have the same effect, is that not correct? And if you were to run it through again, it would have the same effect, is that not correct?

Mr. SUMMERS No, I don't—

Chairman SHAW. You don't think so. I am a CPA, not an economist, so maybe I am looking through more realistic glasses than you are. But the question is, I think, a very simple one, and one is if you have already double counting, why not triple count, if it is going to do any good? Or why not count four times if it is going to do any good? I am not trying to trash the President's plan. I think that he has opened the door toward investment in the private sector, and I compliment him for that. And he has come forward with a plan, even though we don't have it in the form of legislation. It is not a complete plan. I think that he has certainly has made a very material contribution to the process that we are going to try to go through. But the question of what happens in the year 2013 is what bothers me. And that is at the time, whether you say it is 2013 or 2016, whatever it is, that is the date in which we have to start calling in these IOUs, because that is the date that the FICA taxes can no longer take care of existing benefits. And when you get past that date, the taxpayers are going to have to chip in because those IOUs are being cashed in, and that is the situation that worries me. And I think when you talk about 2030 or 2050, down here at the base, the taxpayers have already been skinned by the time you get down to that point. At that point, you either have to increase the FICA tax or you have to tap into the general fund or you have to get more Treasury bills and more IOUs out there to borrow money in order to cash in the ones that are in the trust fund. That is what is troubling, and that is the problem that I see with the President's plan or the primary problem that I see with the President's plan.

Mr. SUMMERS. Congressman, I see and I think understand your concern, and let me just respond in this way. Take 2016, at the end of the 15-year contribution period that the President envisions. You are quite correct that the payroll tax stream in that year will not be sufficient to meet the benefits stream. And that is why it is contemplated, by the way in the current situation without the President's budget as well, that the benefits would, at that point, be financed from the trust fund, which does, indeed, as you suggest, hold Treasury bills.

And so you ask the question, well what is there really, because in some ultimate sense benefits in 2016 have to be financed nation-

ally from resources that we generate in 2016. What is important about the President's proposal is that by providing for the running down of the national debt, it provides an offsetting benefit to taxpayers. That offsetting benefit to taxpayers is the fact that they no longer have to meet the tax burden that is associated with what would otherwise be an interest bill of several hundred billion dollars.

And so the same level of tax effort will make it possible to meet the Social Security benefits and provide for the continuation of unified surplus. And it is that that is salient about the President's proposal. The benefits and the greater solvency of Social Security and ability to meet Social Security obligations derive from the running down of the national debt. Now, some will ask, well, why not run down the national debt and not do the business with putting the benefits of running down the national debt into the Social Security Trust Fund. And I think there are two important virtues of the President's approach: one, in a political sense. And I hesitate to give Members of this Subcommittee advice on anything political. I think it is generally—I think it is generally felt that by associating debt reduction with Social Security, we create a much stronger and more salient lockbox than would otherwise be available to assure the preservation of the surpluses.

Second, if we do succeed in scaling down very substantially our interest costs, there is a question as to where the benefits of that should go, and the President wants to make the decision now before other temptations tempt that that should go to Social Security. And that is what is accomplished by the political act, the administrative act of committing those surpluses to the Social Security Trust Fund.

There would be no possibility of triple or quadruple counting, because we only have this unified surplus once. We have the unified surplus. We make the contribution of the unified surplus to Social Security. We are not retiring the debt two, three, or four times. And so the only amount that can be contributed from the unified surplus to Social Security is what comes from the unified surplus and there—that is where the President has chosen the 62-percent figure.

Chairman SHAW. I would respectfully disagree with you that there is not double or triple counting here, because if you start out with the basic premise that the surplus is caused by the excess of FICA taxes over the amount of benefits, then you have to say that is where the surplus came from. And if you say that is where the surplus came from, then I think that the argument is easily made that is already gone through the Social Security Trust Fund, and we are just simply running it through a second time.

But let us move on, because there is one other part of your testimony that I do want to address. You made three comments with regard to an individual retirement or a private savings account or whatever you want to call it. Those are good points, and those are points that we are discussing; those are points that we are also concerned about. And I think those are points that we will be able to answer. And if we are able to answer, I would want the President and the Treasury to take another close look at additional proposals, which would safeguard those retirement accounts, and

would really hold them separate and guarantee the return which would be no less than what the beneficiaries are receiving today, adjusted for inflation. And if we can do that, and we can also permanently fix Social Security in the process, I would hope that the President would keep an open mind and take a very close look at this, and become an ally in our efforts to try to accomplish these goals.

I can tell you this Subcommittee desperately wants to work with the President in this area, and we will continue our efforts to communicate with the President. Anything the President sends down, I can tell you, will be received with respect and courtesy toward the President, certainly by this Subcommittee. We will have thorough hearings on it, as we are today, on the President's plan. And we would wish nothing more than to work with the President as partners in reforming Social Security.

That should be this President's legacy, and that should be the legacy of the 106th Congress.

Mr. Matsui.

Mr. MATSUI. Thank you, Mr. Chairman. I just want to say about you, Mr. Chairman, I have never heard you say anything really negative in the sense of the trashing the President's plan. I just wanted to acknowledge that, because I have concerns about some of our colleagues on your side of the aisle in particular, but you yourself have been very, very balanced in your approach. I just want to make that statement for the record and to you personally.

Do you support the President's plan?

Mr. SUMMERS. Yes.

Mr. MATSUI. Do you want to bring it up to the Congress?

Mr. SUMMERS. Out of—let me just say out of professional judgment—

Mr. MATSUI. Let me ask my question. Will you let me ask my question?

Mr. SUMMERS. Excuse me.

Mr. MATSUI. You support the President's plan. You said, "yes." Now, are you going to put it in legislative language? I know there's been some requests for that by some of our leadership just for the purpose of perhaps looking at it. Are you interested in going beyond the rhetoric or do you want to actually introduce it?

Mr. SUMMERS. I think the President and all of us in the administration are engaged in a very active process of discussion with Members of Congress in both parties, in both Houses, as to how best to take this forward, and whether we—

Mr. MATSUI. In other words, it is not your intent then to bring up specific language? I just want to get a sense of where you are—because I am getting tired of trying to find out whether you are interested or not interested, because we are going to start drafting our own plan if, in fact, you are not interested. We keep defending your plan, but I want to know what you are going to do?

Mr. SUMMERS. I don't think we have made a definite—I don't think we have made a definite—

Mr. MATSUI. Do you support your plan?

Mr. SUMMERS [continuing]. Decision on that.

Mr. MATSUI. Oh, do you support your plan?

Mr. SUMMERS. Yes.

Mr. MATSUI. Yes, but you still haven't decided anything definite.

Mr. SUMMERS. About what?

Mr. MATSUI. About how much support you are giving to your plan?

Mr. SUMMERS. Oh, I think we are—I think our support for this approach is a total support—is total support for this approach, Congressman. And on the question of a specific bill, I will have to—we will have to—we will have to come back to you.

Mr. MATSUI. So you may change your bill? So I shouldn't be so supportive, because in case you pull the rug from under us I have to be a little careful, is that what you are saying?

Mr. SUMMERS. No, I think I am only—not at all—I think the commitment to this approach is complete. I think the only question is whether embodying it at this point before there has been more discussion in a specific legislative draft is something that the White House is or is not going to choose to do—

Mr. MATSUI. I really don't care, Larry, what you do, because whether you introduce your plan or not doesn't make any difference. But I wish you would be consistent. That is the only thing I am asking in terms of private discussions in these matters.

Let me turn to another subject—the concept of making sure that investments in the equity market by the government are protected. Undoubtedly, you are working on something there. Is that my understanding?

Mr. SUMMERS. Protecting the investments—absolutely.

Mr. MATSUI. Yes, in other words, so that you don't let a political interference occur?

Mr. SUMMERS. Certainly, we are.

Mr. MATSUI. And how far along are you?

Mr. SUMMERS. I think we have given a great deal of thought to that, and I think we have identified as crucial aspects the four protections that I mentioned in my testimony: investment on a limited scale; an independent board; a requirement that the investment take place by private managers; and that the private managers only be permitted to invest in large across-the-board indices, and not make selections with respect to individual securities. And I think those four protections embody our basic approach.

Mr. MATSUI. OK, I have no further questions.

Chairman SHAW. Mr. McCrery.

Mr. MCCREY. Thank you, Mr. Chairman. Mr. Summers, we are—I was interested in your dialog with the Chairman over the double counting and triple and quadruple counting, and I think the Chairman was correct in saying that you could if you wanted to just take the cash that you get from the Social Security Trust Fund, when it initially purchases government securities, and purchase another set of government securities, which you call for in your plan.

Then you get more cash, and in your plan you use it to buy down the debt, publicly held debt. But you could go ahead, reissue it to the trust fund again, if you wanted to. Now, you don't call for that, but I think the Chairman is correct in saying that you could just add more debt to the trust fund, and that would, on paper, solve the Social Security crisis.

The problem, of course, would come in the outyears, when you have to redeem those securities and pay the benefits with trust fund moneys. But one thing that I think you need to clarify for this Subcommittee, and I think I am right in saying this, if I am not, please correct me, but I think in your plan there is an explicit link between the amount of debt issued to the Social Security Trust Fund and the amount of public debt that is retired. Is that correct?

Mr. SUMMERS. Yes, in the sense that the President's plan proceeds by taking the currently projected retirements of Federal debt and assuring that 62 percent of those are transferred to the Social Security Trust Fund. And now, I may have—I may not have fully understood.

Mr. MCCRERY. I think it is 62 percent of the anticipated surplus.

Mr. SUMMERS. Of the anticipated surplus, but the surplus—

Mr. MCCRERY. That would be used to buy down the publicly held debt.

Mr. SUMMERS. If you don't do anything—if nothing happens, and the surplus just materializes, what happens is that because we have got a surplus, we—debt securities come due, we pay them off. And because we have a surplus, we don't issue new debt securities, and so the public debt falls.

Mr. MCCRERY. Right.

Mr. SUMMERS. So that sort of happens on autopilot, that the public debt falls when you run a surplus, almost by the definition of a surplus. What the administration proposes to do is to take 62 percent of that reduction in the debt, 62 percent of the debt that would no longer be outstanding, and make the transfer to the Social Security Trust Fund. Clearly, and perhaps this was the point I didn't appreciate sufficiently in the Chairman's question, clearly if you simply just made up new government bonds and placed them in the Social Security Trust Fund that would be some kind of accounting entry that wouldn't correspond to any economic reality. The reason the President's proposal has economic reality is that what is being put in the Social Security Trust Fund is not some figment of the imagination. It is a portion of the savings that are being realized by running down the debt that is held by the public.

Mr. MCCRERY. But is there no explicit link between the amount of money that is put into the trust fund and the amount of publicly held debt that is redeemed?

Mr. SUMMERS. Sixty-two percent of the publicly held debt that is redeemed is then put in the trust fund.

Mr. MCCRERY. Yes, but you said that there was—that you hated to advise this Subcommittee on the politics, but that it was—that it would be more difficult for us to use the money for anything other than reduction of the publicly held debt because it was linked to Social Security.

Mr. SUMMERS. Oh, yes.

Mr. MCCRERY. Oh, yes, well—

Mr. SUMMERS. Right now, what we say is that 62 percent of the reduction in publicly held debt goes to the trust fund. In, and so when you contemplate the maintenance of the surplus, not pursuing new spending policies that would dissipate the surplus, the argument can always be made that if you dissipate the surplus, then you are disadvantaging the trust fund. That money is no

longer available for the trust fund. It is no longer there for the trust fund.

On the other hand, if you don't have such a provision, then the argument is always there then why don't we just run down the national debt a little less and have a new spending program or have a new whatever-it-is program. So, in effect, you are using the Social Security as a kind of guarantor to assure what we would regard as prudent behavior in preserving the surplus in the future.

Mr. MCCRERY. Well, that is not clear to me at this point, at least not from your response. And I don't have time to follow up, but let me just point out to you that even though you do call for Congress to proscribe some sort of political targeting of investments, you obviously know that a law is just a law and any future Congress can change the law with a simple majority vote. Certainly, those of us who do have some reservations about the government investing directly in the stock market are not too assuaged by a law being passed, and it won't happen.

Mr. SUMMERS. I can appreciate the concern, and the only point I would add on that is as we do with respect to the caps in the budget process, there are a variety of kinds of procedural protections that can be put in place that would require much more than a simple majority. It would require extraordinary majorities and so forth to make any kinds of changes.

But I think one also has to rely on, and I think we have seen a lot of political experience to suggest this, that once one has a set of procedures the idea that Social Security funds are being tampered with is one that I suspect would be sufficiently politically explosive so as to discourage that tendency in the future.

Mr. MCCRERY. Thank you.

Chairman SHAW. Mr. Doggett.

Mr. DOGGETT. Thank you very much, Mr. Chairman. Will investing 15 percent of the trust fund in the private sector increase Social Security administrative costs, since Social Security has been so very efficient in the past?

Mr. SUMMERS. We believe that in contrast to an individual account approach that the effects would be very small. The costs of managing moneys of this size are in the range of a few basis a most; that is to say, less than one-tenth of 1 percent annually of the moneys that have been invested.

And so I think the basic economy, whereby Social Security pays out in the range of 99 cents out of every dollar that it receives is something that could be preserved.

In contrast, with even relatively efficient individual accounts, you could easily find yourself, and again, I don't mean to make a firm estimate because it depends on how it is done, in the range of as much as 20 percent of the account accumulation over 40 years going to pay various kinds of administrative costs. I think if you add the costs all in Britain and Chile, the figures are actually somewhat larger than 20 percent, although that is something that people argue about and no doubt with information technology, there will be some possibilities for improvement. But I think the costs could be rather large.

Mr. DOGGETT. A multitude of voices have expressed concern about the declining savings rate in the country. Do you believe that

the President's proposals for the USA accounts will address that concern?

Mr. SUMMERS. I certainly do believe that in an important sense, Congressman, savings, like life insurance, is sold, not bought. And you have to provide people with an incentive to save for the future. It's something that can be marketed as a savings vehicle. You know somewhere in the neighborhood, we are refining the estimate of 75 million Americans who have no pension, no 401(k), no IRA, and really are not part of that leg of that retirement security system. And I think by making these savings accounts universal, we can get a lot more people started on savings and correct what I think is a perhaps our Achilles' heel, along with education issues, in a period of remarkable prosperity. In the last quarter of last year, we actually had a negative personal savings rate in this country for the first time since the Depression. And there is a lot to disagree about here, but my guess is on a bipartisan way, we ought to be able to agree that that negative personal savings rate at a time of plenty is something that we should be working to address.

Mr. DOGGETT. How do you view the proposal to just take Social Security off budget in phases, leaving the trust fund interest available, at least on paper, for more spending and more tax cuts?

Mr. SUMMERS. With, to be honest, Congressman, considerable concern. I think compared to the approach that the President favors, it has at least two important disadvantages. One, it would result in less fiscal prudence, more room for dissipating the surplus, and as a consequence, leave us with a larger tax burden to pay interest bills in the future at the time when our society is challenged by aging.

Second, by not providing in any way for fortifying the trust fund with the benefits of debt reduction, it wouldn't do anything to strengthen the claim of future Social Security beneficiaries, and, therefore, it wouldn't really provide any of the kind of credibility and solvency that the system requires.

Mr. DOGGETT. Thank you very much.

Mr. SUMMERS. Thank you.

Chairman SHAW. Mr. Portman.

Mr. PORTMAN. Thank you, Mr. Chairman. Mr. Secretary, just following on to Mr. Doggett's question on personal savings and the USA accounts, I couldn't agree with you more, and I think this panel, on a bipartisan basis, shares your concern about the fact that many Americans do not have a 401(k), do not have an IRA, do not save adequately for their retirement, or have opportunities to do so. I would respectfully suggest that the USA accounts isn't the right way to do that, because I think you will find as you do your economic analysis, that will displace private savings, and, in fact, won't be leveraging those very private dollars about, which should be government policy. And we can aggressively go after this problem by reforming our pension system, by allowing people to contribute more, by offering tax credits, by allowing portability, by doing the catchup contributions that you have supported in the past. And so I would just say that there may be a better way to get at this, another way to skin the cat that is much more effective in terms of the taxpayers contribution here. Let us not bring the government into a position of taking the place of our employers

and, instead let us expand private savings. I hope you will take a look at that.

Mr. SUMMERS. Congressman, just on that.

Mr. PORTMAN. Yes.

Mr. SUMMERS. We certainly will take a look at all those proposals, and I think the vast majority of what you said with respect to the private pension system, we would certainly support. My only comment on that would be that, for the 73 million who are now out of the system, I think if anyone wants to reach them on a nearly universal basis, some supplement to the system is appropriate. But I think it is very important—and this is something we have been very much focused on—that, in the design of any supplement to the system for those people, that we not do anything that is other than strengthening the existing employer-based system. And that is certainly very much a focus of ours.

Mr. PORTMAN. I think we will find that difficult. And we have talked about this before with some of your folks and with the Secretary in his testimony here. But we would love to work with you on that. I would say also, along the lines of what Mr. Matsui said earlier, we would love to see the details on the USA account. If it indeed is only for retirement and only for an annuity, I think a lot of us would feel differently about it.

And I know there are still decisions to be made and we would love to see some legislative proposals on that and to work with you on it so it is not for first-time home buyers, it is not for education, it is not for other things that—although very important—don't help the solvency of the Social Security problem or backstop Social Security.

On your proposal, I think we should respect the ideas and I concur with my colleagues who said that, including the Chairman. We do have some concerns and one is, as you know and you have said and the President has stated many times, this does not solve the problem over the 75-year period. It is not a proposal to solve Social Security under the timeframe in which we have to work.

Second, the paying down of the debt issue. I have listened carefully and we have talked to some of your people about it. I have tried to understand this. I think the bottom line is this is a policy and a political decision, as you say. If we want to reduce debt, we can reduce debt, whether we do it with the trust fund or without. Linking it to Social Security may make it more likely that, indeed, the benefits of reducing the service and the debt go back to the trust fund. It may not.

These are tough decisions. I don't think it necessarily is an integral part of this proposal one way or the other, but I would just sort of leave that almost to the side and focus, instead, on how do we get to that 75 years.

On the higher rate of return, I commend the administration for doing that. And I think most of my colleagues do, on both sides of the aisle. Some of us believe that there are better ways to do it in terms of directing it by the individual, but I guess the question I would ask you with regard to individual accounts, and you have talked about the importance of the higher rate. You say there would otherwise have to be a 5-percent benefit cut, there would

otherwise have to be at least a year and a half rise in the age, just doing what you all do, which is the 15 percent.

If you indeed believe that the higher rate of return is so important, isn't there a way to have the same benefits you talk about with regard to the government investing, doing it through individuals making that decision, and bringing it back into the Social Security system?

Mr. SUMMERS. There may be. We are certainly opening to considering a variety of suggestions that may be put forward. I think the concerns that that has to address are that the proposal we make preserves the defined benefit structure. So that if the stock market goes down 50 percent in some year, it is not the retiree whose benefits are getting scaled back by one-half.

Mr. PORTMAN. Yes. I would just say, with regard to that, I suppose one could say the same thing about the government-direct investment, because the stock market will go up and down and there is a larger risk pool—

Mr. SUMMERS. Surely, but the—it is like—

Mr. PORTMAN [continuing]. But some of these same issues would have to be addressed.

Mr. SUMMERS. Well, I don't think quite, Congressman. It is like the difference in the private sector between having a defined benefit pension plan and having a defined contribution pension plan.

Mr. PORTMAN. Except that it depends how you set it up, of course. If you indeed have the individual making the decision, but bring it back into Social Security, taking, as the Chairman said earlier, into account a safety net or a floor. There may be a way to design it so that you minimize those risks, just as you would with investments.

Mr. SUMMERS. Those are—no. Those are—

Mr. PORTMAN. It would be directed by the government.

Mr. SUMMERS [continuing]. Those are obviously issues that would have to be considered. As I say, the focus—the virtues that we believe are achieved by the collective investment which have to be considered in the context of all approaches, are the virtues that the individuals not at immediate risk from the fluctuation, the administrative costs virtue, and the preservation of an overall progressive structure. And there is always the question of what other possible ways are there of preserving those things.

Mr. PORTMAN. OK, my time is up. I would just thank you all for keeping this on the table and suggest that, with regard to the studies that were referenced earlier, there are various ways to do individual accounts, including addressing all three of those concerns and I hope that we can work together on a bipartisan basis. Otherwise, I don't see us getting to a deal this year. I thank the Secretary.

Mr. SUMMERS. I think we can. I think we can all agree that any satisfactory resolution here has to be both bipartisan, bicameral, and, if you like, bibranch, involving both the executive and the Congress.

Mr. PORTMAN. Stop there with the "bi's."

Chairman SHAW. Bicameral may be a very hard thing to get over.

Mr. Weller.

Mr. WELLER. Thank you, Mr. Chairman, and Mr. Secretary, I want to congratulate you on what I saw is a very flattering article in a national magazine. It was a nice photo, as well. And I have always wanted to meet somebody who saved, so congratulations.

Mr. SUMMERS. Don't believe everything—with respect, don't believe everything you read in the papers, Congressman. [Laughter.]

Mr. WELLER. Well. And just building on some of the comments by Mr. Portman and some of my colleagues regarding savings, of course, as we are talking about Social Security, private savings as a supplement to Social Security, of course, I also share that concern and I hope, particularly when it comes to the idea of a catchup mechanism and IRAs and 401(k)s, particularly for working moms who are off a payroll while they are home taking care of the kids and have an opportunity to make up those contributions later on. I hope we can work together in a bipartisan way.

And I just want to better understand the President's proposal regarding Social Security. As I understand it, he wants to take 62 percent of the surplus, set that aside until we come up with some solution for saving Social Security. And then he wants to take 25 percent of the Social Security Trust Fund and invest that in corporate America. That is essentially the proposal as I understand it. And I am just trying to get a better understanding of what the President considers as part of the surplus.

I know my Governor and State legislators would want to ask this question. In the President's budget, it is my understanding that you want to essentially take about a \$5 billion tax on the States' share of the tobacco settlement. And is that part of the surplus?

Mr. SUMMERS. I am going to have—I apologize, Congressman. I am going to have to give you an answer in writing to that because I just don't—OK?

[The following was subsequently received:]

No, it wasn't part of the surplus. The Administration did not propose to collect the money. The basis of the state lawsuits against tobacco companies was to recover tobacco-related costs to the Medicaid program. Because Medicaid costs are shared between the Federal government and the state governments, the Administration had an obligation under Federal Medicaid law to "recoup" part of the state settlements. Having said that, we had hoped to work with the States and Congress to reach an agreement waiving Federal claims to these funds in exchange for a commitment by the States to use the tobacco settlement payments for certain activities including public health and children's programs.

The Administration was extremely disappointed that the Congress failed to require States to use even a portion of the funds collected from the tobacco companies to prevent youth smoking. Even though 3,000 young people become regular smokers every day and 1,000 will have their lives cut short as a result, most States still have no plans to use tobacco settlement funds to reduce youth smoking. This bill represented a missed opportunity by the Congress to protect our children from the death and disease caused by tobacco. The Administration will closely monitor State efforts in this area, and will continue to fight for a nationwide effort to reduce youth smoking through counter-advertising, prevention activities, and restrictions on youth access to tobacco products.

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Mr. WELLER. OK.

Mr. SUMMERS. The people at OMB handle the budgetary treatment on that and I just don't know the answer. I don't know the answer to your question. It is possible that a note will be handed to me with the answer to your question, but I don't know it.

Mr. WELLER. OK, well. I would like to know that because that \$5 billion tax on Illinois and other States—

Mr. SUMMERS. We will get back to you on that.

Mr. WELLER [continuing]. It is my understanding you may consider that part of the budget.

The second is the President proposes \$165 billion tax increase as part of his budget proposal. Is that tax increase part of the surplus?

Mr. SUMMERS. Well, certainly, all the elements in the President's proposal, both the revenue raisers that I think you may have been referring to and the targeted tax cuts contained in the President's budget all enter into the calculation of the unified surplus.

Of course, the President, just to clarify one point, the President's proposal was that he believed we could use 62 percent as part of a framework for resolving Social Security.

Mr. WELLER. Yes. I understand—excuse me.

Mr. SUMMERS. But his position continues to be that we shouldn't use any of the surplus—I think this is a crucial point—we shouldn't use any of the surplus until we are successful in finding a framework for resolving Social Security.

Mr. WELLER. Well, reclaiming my time, Mr. Secretary, but—so if Congress did not pass \$165 billion in tax hikes, essentially you are saying the surplus would be smaller. Because you are counting that \$165 billion in tax increases in the President's budget as part of the budget when you talk about the unified—

Mr. SUMMERS. I am not—I think, clearly, if you didn't pass other components, the surplus wouldn't materialize in the way you suggested.

Mr. WELLER. OK.

Mr. SUMMERS. I don't think by the—certainly by the definitions we would use, I don't think the President's budget contains anything like \$165 billion in tax increases. There may be differences in how we and you view certain of the items from the point of view of accounting, as to whether they are taxed or not.

Mr. WELLER. Mr. Secretary, the Joint Committee on Taxation has analyzed the President's budget and they said that there is \$165 billion in what you call revenue raisers, but most people call tax increases.

Mr. SUMMERS. Well, some of that goes, I think, to some of the moneys associated with the tobacco settlement, as you suggested.

Mr. WELLER. Yes. In trying to better understand the President's proposal on Social Security also, so far you have declined to actually offer any specifics on a proposal beyond its part of the surplus and the trust fund. As I understand it, some of the options that Congress and the President have looked at and talked about behind closed doors, does the administration support or oppose a tax increase as part of the Social Security solution? Just support or oppose?

Mr. SUMMERS. We don't think that is the primary way to go.

Mr. WELLER. OK. Benefit cuts?

Mr. SUMMERS. We think that it is necessary—we can even go a long way, out to 2055—

Mr. WELLER. Just support or oppose.

Mr. SUMMERS [continuing]. With the administration's proposal. The remainder has to be worked out in the bipartisan process.

Mr. WELLER. OK. Eligibility age. Do you support or oppose changes in that?

Mr. SUMMERS. All has to be addressed in the context of the bipartisan process.

Mr. WELLER. Raising the cap above the \$72,000?

Mr. SUMMERS. Bipartisan process.

Mr. WELLER. OK. So you are open to all these ideas, then, I take it? So you are open to cutting benefits—

Mr. SUMMERS. We believe the primary thrust—

Mr. WELLER [continuing]. You are open to raising taxes?

Mr. SUMMERS. Well.

Mr. WELLER. How about means testing? Are you open to that idea or do you support or oppose means testing?

Mr. SUMMERS. I think the President has indicated very great concerns in that area.

Mr. WELLER. OK.

Mr. SUMMERS. The remainder, most of the other things you have mentioned, I think, are things that could be looked at in a bipartisan process.

Mr. WELLER. OK.

Mr. SUMMERS. But we think the thing to do first is to set aside that surplus and get—

Mr. WELLER. To reclaim my time, there are some last couple options, Mr. Secretary. Personal accounts as part of Social Security. Not as a supplement to, but as part of. Do you support or oppose?

Mr. SUMMERS. Don't have a—not something that can be judged in the abstract without looking at whole proposals.

Mr. WELLER. You are open to that. So you are open to tax increases. You are open to benefit cuts. You are open to changing the eligibility age. Means testing—you don't seem to like that idea. You are open to personal accounts. Your response to the question.

Mr. SUMMERS. Open to. We believe the place to go with this is 50 years with the President's proposal and it can be a bipartisan process behind that. My guess is many, probably most of those items on the list would be things that neither nor—

Mr. WELLER. But you are not saying no to any of those ideas.

Mr. SUMMERS [continuing]. Neither we nor other participants in a bipartisan process would choose to go, but I don't think it is appropriate to start trying to prejudge that. I didn't mean to suggest—

Mr. WELLER. OK.

Mr. SUMMERS [continuing]. I did not mean in any way to suggest receptivity to any of those things in my answer, only a desire not to prejudge that bipartisan process.

Chairman SHAW. The time of the gentleman has expired.

Mr. WELLER. Thank you, Mr. Chairman.

Chairman SHAW. Mr. Tanner.

Mr. TANNER. Thank you, Mr. Chairman. Mr. Secretary, thank you for being here, and I want to follow up on just a couple of things and see if we can put it in some sort of perspective. You mentioned the two types of debt that comprise the "national debt." One is interagency debt, that debt that the Treasury owes to the

Social Security Trust Fund because the Social Security Trust Fund transferred FICA taxes to the Treasury that were used for some public purpose, consistent with the law.

The other \$3.56 trillion is debt that is owed to nongovernmental agencies, to people, to banks, to institutions, a third of which is owned by foreign interests. Now, as you were talking about paying down the debt, I hope you were talking about paying down this debt that actually is real, that we pay interest on every year; last year to the tune of \$246 billion. That is the debt that is real.

Now, in terms of this interagency debt. Call it what you will. You could call it a certificate, an interest-bearing certificate, whatever. What I characterize that as is basically a call on future tax dollars that says we are going to honor these obligations. You can quantify them with certificates or bonds or notes or bills. They could have an interest rate of 20 percent or an interest rate of 1 percent. It doesn't really matter because it is—you can quantify it any way you like, but it is a call on future tax dollars to the extent that we have Social Security defined benefits in the law, given a person reaches a certain age.

Would you take issue with anything that I have said?

Mr. SUMMERS. No, I would entirely agree and I thought you put it very accurately. And, frankly, Congressman, the next time I have occasion to try to explain this, I will steal some of what you just said.

Mr. TANNER. Well. This is homespun logic from my point of view because I have to simplify things, I think, so that I can understand them and, more importantly, explain to people.

Now, when we talk about saving Social Security, however one characterizes it, if we use the surplus, whether it comes in from Social Security FICA taxes, whether it comes in through increased income taxes because of the great economy, or whatever, there is this finite amount of money coming to the U.S. Treasury. If we retire this \$3.56 trillion debt, we not only are in a better position at some future date when the Social Security bubble hits to borrow to pay it and we plus have the benefit of whatever interest payments we are then saving at that later date because we have paid or redeemed or retired this outstanding debt that we have to pay interest on every year.

Now, as it relates to that idea, I want to commend the President's plan. I would just simply say, I don't think that we go far enough. I realize the political realities, but I would like to go much farther and to say all surpluses that are being paid into the Social Security Trust Fund now would be used to retire this \$3.5 or \$3.6 trillion debt. That would—you don't have to get into double or triple accounting. You just say everything that comes in that we don't need, we will begin to retire this outstanding indebtedness.

We will be in a much better position in the future if we do that, in my opinion, than if we have an across-the-board tax cut. Nobody ever talks about using the surplus, whether it be in Social Security or on the budget to pay back some of what we have borrowed in the last 20 years. Nobody talks about that, but that is what ought to be done. It is what a business would do.

But we have all of these ideas about what we are going to do with this great projected surplus, but you very seldom hear some-

body say, you know what? We ought not to leave this debt to our kids. What we really ought to do is pay down some of this so we will be in a position to either, one, borrow the money at that time in the future when we owe the Social Security Trust Fund or we can use the moneys that we have saved on interest to do it.

I wanted to ask one other question about individual accounts and about the so-called clawback provision that I have read about. I don't understand it. But we can get into that at a later time, because I see my time has expired. Thank you for being here.

Mr. SUMMERS. Thank you.

Chairman SHAW. Mr. Hulshof.

Mr. HULSHOF. Thank you, Mr. Chairman. Mr. Secretary, welcome. Following up on my friend from Tennessee's question, in his homespun way, which was a good way to define it, you are not suggesting, are you sir, that the internal government debt is not real? I mean, the fact is that the full faith and credit of the U.S. Government supports that internal government debt, does it not?

Mr. SUMMERS. It is a commitment that will surely be honored. It is not a commitment that has impacts on the real economy in the same way because it is purely intragovernmental, just as, for example, there is a big thing about General Motors. There is a big difference between debt that General Motors shareholders owe the public and debt that Buick owes Chevrolet, both of which are internal to General Motors. And that is the kind of distinction that I think Mr. Tanner was trying to draw in his comments and that I had drawn in my earlier comments.

Mr. HULSHOF. And, certainly, recognized that a man of your intelligence and expertise in this area and even some Members on this Subcommittee that understand that, but back home, when people talk about paying down the debt, they don't understand sometimes the nuances that we speak of.

In fact, let me ask you. Last week we had the head of the General Accounting Office who testified, perhaps sitting in the same seat you are, Mr. Walker, who said that if Congress did nothing and allowed current law to operate that the Federal debt would be paid down more than if we adopted the President's plan. Do you agree or disagree with Mr. Walker's statement?

Mr. SUMMERS. If Congress did nothing for the next 15 years, chose no new spending programs, chose no new tax cut programs, indeed, I suspect, the debt would be reduced more rapidly. I would, again, defer to others on the political question, but would respectfully suggest the possibility that the likelihood of Congress doing nothing in the face of multihundred billion dollar surpluses is perhaps not so great. And that is why the precommitment of the contributions to Social Security that the President envisions seem to us to be so very important, both in terms of prudent fiscal policy, running down the debt, and in terms of what it means to the future of the Social Security system.

Mr. HULSHOF. Mr. Secretary, let me follow up on a point that you made in your testimony and then my friend from Texas made, Mr. Doggett, who has raised some concerns with other witnesses and other panels about the administrative costs. You mentioned that—and others have pointed out—that the administrative costs for per-

sonal accounts can be as high as 15 to 20 percent or you said possibly even higher.

But is this not the case that back in 1940—and clearly we understand now from the trustee's report that the administrative costs that the Social Security Administration has now is around 1 percent and you mentioned that as well. But back in 1940, it is my understanding that the Social Security administrative costs were equal to 74 percent of the benefit outlays. In fact, a short 5 years after that, these costs had fallen—the administrative costs had fallen to about 10 percent. Do those numbers ring true with you? And I see some staff—I thought I saw a head nodding behind you. You may want to confer with your staff.

Mr. SUMMERS. I am not familiar with the 1940 experience, but I am familiar with the argument that the costs will come down over time. And no doubt there would be some tendency in that direction. The system in Chile has been in place for some 15 years and the costs there are in the range of 20 percent.

The mutual fund industry has been in place for nearly 50 years and it continues to be the case that the typical mutual fund in the United States involves costs on the order of 100 to 150 basis points. If you work that out over the 20 years over a 40-year lifetime, it would represent about 20 percent of a lifetime's costs. But, no doubt, there would be some improvements and that is something that should be factored in. There would also be startup costs that actually aren't reflected in the 20-percent figure.

Mr. HULSHOF. OK. With all due regard to the Ranking Member who, I think, has been very forceful and has been working on this many years, those of us who may ask questions about the President's plan not necessarily are trashing or being critical, and yet I think there are legitimate questions.

And probably my final question to you would be this. Social Security has always been self-financed. Payroll taxes are sacred. And yet it is my understanding—and please correct me if I am wrong—that, were the President's plan to be implemented, that we would then be using general revenue funds, that is income taxes, and no longer would we have this firewall or distinction. Is that true? And what are your views regarding using general revenue funds to save Social Security?

Mr. SUMMERS. I think the President's plan with its use of unified surpluses does represent an innovation in financing Social Security, but one that is very different from general revenue financing as it has historically been contemplated. Very different because one is not envisioning taking on a new set of obligations. Very different because the financial contribution is temporary rather than some commitment to the tax stream permanently. And very different because what is being contributed is a surplus that is being used to directly pay for itself, that is it is directly paying for the contributions by reducing future interest burdens.

So, yes, I think it does represent a departure, but I would argue an appropriate departure in light of the opportunity that is presented by the very large surpluses that we will have, not forever, but that we now appear likely to have for some number of years going forward.

Mr. HULSHOF. Thank you.

Chairman SHAW. OK. Dr. Summers, I have one question on an area that we haven't covered. In the President's budget, I believe he talked about the elimination of the earnings limit on Social Security. You have been quoted as to raising the earnings limit. What is the position of the administration or is the administration open on both areas?

Mr. SUMMERS. I haven't seen myself quoted. My understanding was that our position was that the earning's limit should be eliminated.

Chairman SHAW. OK. I thank you. And I want to thank you for your testimony. If there is one thing that I have really gotten out of it is that the administration is not drawing lines in the sand. And I think that is terribly important that none of us draw lines in the sand at this particular point. Your openness and frankness to this Subcommittee is appreciated. We appreciate your testimony.

Mr. SUMMERS. Thank you very much, Mr. Chairman. And let me just say that I appreciated this opportunity to testify, and I neglected in my opening comments to thank Mr. Matsui for his role in ensuring that the administration had an opportunity to raise many of its concerns in this context. And to look forward very much to, as I think we have all emphasized, working on a bipartisan basis with you, along with Mr. Matsui and his colleagues on these very critical issues. And I think there is a lot that we can agree on on a bipartisan basis, but I think there are also some very real issues that we are going to have to resolve where, at this point, there do appear to be some differences in perspective.

Thank you very much.

Chairman SHAW. Dr. Summers, if the administration shares the goals of Chairman Archer and me as Chairman of this Subcommittee, the determination to solve the Social Security problem and solve it today, I am convinced that we will do so.

Thank you very much.

Mr. SUMMERS. Thank you.

Chairman SHAW. Next, we have a panel of witnesses. We have Lawrence White. Dr. Lawrence White is professor of economics at Stern School of Business at New York University; Hon. Maureen Baronian, who is vice president and principal of Investors Services of Hartford, Inc., Hartford, Connecticut, and is former State representative in the Connecticut General Assembly and former trustee, Investment Advisory Council in the State of Connecticut; Michael Tanner, director, Health and Welfare Studies, the Cato Institute; Dr. Robert Reischauer, who is the senior fellow, economic studies, at the Brookings Institution, a former Director of the Congressional Budget Office; Dr. Carolyn Weaver, director of Social Security and Pension Studies, the American Enterprise Institute and a former member of the Advisory Council on Social Security; and Hon. Fred Goldberg, Skadden, Arps, Slate—I am having trouble with this—Meagher and Flom, former Commissioner for the Internal Revenue Service and former Assistant Secretary for Tax Policy of the U.S. Department of the Treasury.

We have all of your written testimony, which will be made a part of the permanent record, without objection, and we would ask you to proceed as you see fit.

I would like to make an announcement at this time that this Subcommittee will recess at 12 and then reconvene again at 1. I hope that doesn't inconvenience any of our witnesses.

Dr. White.

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

Mr. WHITE. Thank you, Chairman Shaw, Members of the Subcommittee. I am pleased and honored to be invited to testify before your Subcommittee today.

The future of the Social Security Program is one of the most important public policy issues that currently face our Nation. 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 is also burdened with latent financial problems that threaten its future. Further, the basic structure of the Social Security Program remains widely misunderstood.

In my written testimony, I have offered a 12-step plan for understanding Social Security, its problems, and some real and not-so-real solutions. I will try to summarize that testimony this morning.

First, as Deputy Secretary Summers repeatedly said, Social Security is a defined benefit plan. The benefits of a worker are linked through a complicated formula to his or her income during his or her working life. The structure of this defined benefit and strength of this defined benefit program is in the Congress' promise to pay those benefits.

Second, the program, as we all know, is financed through wage taxes. It is a pay-as-you-go program. There is no direct link between what a worker pays in and what he or she receives in benefits. There are no canned goods piling up as resources as a result of a worker's contributions. In this context, it is the net annual cash flow of the program that is the crucial concept. Currently, this net annual cash flow is positive. It is running about \$80 billion a year. But as Chairman Shaw indicated, around the year 2013, that cash flow will start to become negative. That is the crucial crunch-point for the Social Security Program. Not the year 2032, which is when what one often reads, but the year 2013. And for Social Security, this is an eyeblink.

Next, the presence of Treasury bonds in the so-called trust fund adds absolutely nothing to the strength of the program. They are not canned goods. For this defined benefit program, the strength of the Social Security Program is the promise of the Congress to make good on promised benefits. In this context, as Deputy Secretary Summers indicated, President Clinton's proposal to use 2 trillion dollars' worth of future surpluses to buy back public debt, debt that is held in the hands of the public, is clearly going to provide the kinds of beneficial consequences for the U.S. economy that Deputy Secretary Summers indicated. It is basically a good idea.

But then placing those repurchased Treasury bonds in the Social Security Trust Funds does absolutely nothing. It does not add to the strength of the fund. It is window dressing, at best. As Deputy

Secretary Summers indicated, it is a marker indicating that the repurchasing of the debt is going on.

Now the plan to purchase about 700 billion dollars' worth of private sector securities at least does provide real resources for the program. But I think there are real and substantial problems to having the Social Security Administration do the investing of these \$700 billion. There are huge problems of choice as to what they should invest in, how should they invest. And I think these decisions are subject to potential abuse. This worries me greatly.

Also, and this is an area that has received much less attention, to the extent that the Social Security Administration would do the investing, they would be limited to the 10,000 largest publicly traded companies in the U.S. economy. The millions of other smaller enterprises in the country that are not publicly traded would see none of this investment flow.

There is another way. It is a personal savings account approach that I think would be valuable as a component of the Social Security Program. The devil is in the details. I am not going to propose a specific plan, but there are two important principles that should be observed. First, a PSA Program should be voluntary. Second, it should be structured along the lines of the current IRA Programs. That means a wide choice of investment vehicles and bringing a regulated financial institution with fiduciary obligations into the picture.

This PSA component would allow individuals, families, to tailor their choices to their knowledge, their information, their age, their family status, their tolerance for risk, and other personal considerations. For the less sophisticated, less knowledgeable, for risk-averse individuals, there would be the familiar FDIC-insured bank account. As of 1991, almost half of IRA funds were invested in bank accounts or similar type instruments.

The stock market is not for everyone and an IRA-type approach recognizes that. And it would have the advantage that these types of investments would be rechanneled by the banks and other financial institutions to those millions of smaller enterprises that are not going to see a penny out of any Social Security Administration-directed investments.

A potential objection to the PSAs are their transactions costs. I do not believe this is a real objection. I am greatly impressed with the ability of the private sector financial institutions to structure low-cost accounts, perhaps with some limitations to deal with the transactions costs problem.

In summary, Mr. Chairman, 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 for this opportunity.  
I'll be happy to answer questions.  
[The prepared statement follows:]

**Statement of Lawrence J. White, Ph.D.\* Professor of Economics, Stern  
School of Business, New York University**

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

The future of the Social Security program is one of the most important public policy issues that currently face our nation. 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 is also burdened with latent financial problems that threaten its future. Further, the basic structure of the Social Security program remains widely misunderstood.

In the interests of advancing the debate, let me offer:

**A TWELVE-STEP PLAN FOR UNDERSTANDING SOCIAL SECURITY, ITS  
PROBLEMS, AND SOME REAL AND NOT-SO-REAL SOLUTIONS**

ONE To understand what Social Security is, it is useful to start by explaining what Social Security isn't. Imagine an extremely simple "retirement plan": A worker saves 10% of her income during each year of her working life and with those savings consistently buys canned goods, accumulating them in a large closet. Then, during her retirement, she eats the canned goods.

This is clearly a metaphorical retirement plan, with many practical drawbacks. But it has two important features: The worker has *invested* in *real resources* (the canned goods). And there is a direct connection between what she has contributed to her retirement plan and what she eventually receives from it. In the terms of modern pension phraseology, hers is a *defined contribution* pension plan.

TWO To make the above example slightly more realistic, let us instead imagine that the worker, so as to avoid the inconvenience of piling up 40 years of canned goods herself, pays that same 10% of her income each year to her local grocer, who in turn hands her an "I.O.U." for the sum and promises to deliver the appropriate amounts of canned goods upon her retirement. So long as the grocer remains honest and economically viable, this retirement plan is essentially the same as the previous one. The worker is still investing in real resources, only one step removed: She has *claims* on real resources. And she still has a defined contribution plan.

THREE It is only a modest modification of step two to have the worker instead invest that 10% of her annual income in corporate stocks and bonds, which again are *claims* on real resources; or to have her invest in mutual funds, which purchase those claims on her behalf; or to have her place her annual 10% of her income in a bank, which then lends it out in the form of business loans. We have now virtually replicated a modern IRA or 401(k) retirement plan, with claims on real resources and a defined contribution retirement plan.

FOUR Contrary to much popular perception, the Social Security program bears absolutely no resemblance to the retirement plans described in steps one, two, or three. Instead, the retirement benefits that a worker is statutorily promised are linked loosely, through a quite complicated formula, to the wages that she receives during her working life. In this important sense, Social Security is a *defined benefit* program.

FIVE The financing for the Social Security program comes from broadly based tax on wages: 6.2% of a worker's annual wages (up to a maximum wage base of \$72,600, as of 1999) is paid by the worker, and another 6.2% is paid by the worker's employer. But there is no direct link between what a worker and her employer pay into the program and the benefits that she receives when she retires. The money that current workers pay into the Social Security system is mostly paid directly out to current retirees. It is a *pay-as-you-go* system. There is no piling up of canned goods, or (more realistically) of claims on real resources for any worker, as a consequence of that worker's Social Security contributions.

SIX In this pay-as-you-go framework, the "net" annual aggregate cash flow of the Social Security program—the annual wage tax payments into the program, minus the annual payments to retirees—is the crucial concept. In recent decades this net annual aggregate cash flow has been positive: Workers (and their employers) have been paying more into the program than retirees have been pulling out. This cash-flow surplus has been "transferred" to the U.S. Treasury and has been used as just another source of revenue to support the other spending activities of the Federal Government (e.g., defense spending, farm subsidies, interest payments on the national debt, etc.); in essence, the Social Security cash-flow surplus has been used to

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

offset partially the net deficit that the U.S. Government has been running on the remainder of its activities. That cash-flow surplus has *not* been invested in real resources that would be the equivalent of the canned goods of step one or the claims on real resources of steps two or three.

In recognition of these transfers, the Treasury has duly created appropriate amounts of special bonds and credited them to the Social Security "Trust Funds." The bonds even "pay" interest (which just involves the creation of still more Treasury securities and the crediting of them to the Trust Fund account). But the presence of these Treasury securities in the Social Security Trust Funds does not add anything real to the basic financial position of the Social Security program. The statutory promise by the Congress to pay benefits to retirees (current and future) is already present. The presence of these Treasury securities does not provide the Social Security program with any additional real resources that can be used to make benefit payments. The Treasury securities are not canned goods or claims on real resources; they are just another set of promises-to-pay by the Congress.

Further, even if one thought that the presence of the Treasury securities in the Trust Funds did somehow represent a stronger commitment by the Congress to make good on its promises to retirees, the amounts of Treasury securities in the Trust Funds are far short of the sums necessary to fulfill all promises to retirees. (This shortfall is due, of course, to the pay-as-you-go structure of Social Security: The Treasury securities have been created only when the program has run aggregate annual surpluses, rather than when the statutory obligations to future retirees have been created.)

SEVEN For this pay-as-you-go structured program, the true fiscal "crunch" will occur in the year 2013, when the net annual aggregate cash flow becomes negative; i.e., when the annual payments by workers and their employers fall short of the annual payments to retirees. This fiscal pattern will arise because of the longer lives of retirees and other demographic and economic characteristics of the American population. It is at this point that the Social Security program will cease being a net surplus program, and fiscal transfers *into* the program will be required. If the statutory promises to retirees are to be honored, taxes will have to be raised, or other Federal Government spending will have to be reduced, or more Treasury debt will have to be issued to the general public (or less debt will be bought back from the general public, depending on the Federal Government's overall budgetary position at that time). Or the promises will have to be modified (e.g., later retirement ages, or reduced payment benefits, etc.)

The presence or absence of the Treasury securities in the Trust Funds at this point will make absolutely no difference to the true fiscal position of the program or the necessary actions that will have to be taken in order to continue to honor the statutory promises to retirees.

This point in time—2013—is only fourteen years away, which is a mere "eyeblink" for the Social Security program, since fundamental fairness requires that any changes to the program (e.g., a delay in retirement ages) should be gradually phased in, over a long period of time. Also, it is far sooner than the year 2032, which is the date on which most media accounts of Social Security's problems have focused. This latter year is the date when the Trust Fund's Treasury securities will be "exhausted" (in "cover" the net negative annual cash flows of the previous two decades). But, again, the presence of the Treasury securities will have made absolutely no difference with respect to the necessary fiscal actions of those previous two decades; and, as of 2032, the net negative annual cash flow of the Social Security program will be about \$750 billion (\$250 billion in constant 1998 dollars), or over 1.8% of U.S. GDP in that year.

EIGHT An understanding of the Social Security's pay-as-you-go structure also helps focus attention on what actions actually do provide real improvements in the program's finances and what actions constitute mere window dressing. For example, the Clinton Administration has proposed to use \$2.7 trillion of federal budgetary surpluses over the next 15 years to support Social Security. Of this sum, about \$700 billion is to be used by the Social Security Administration directly to buy private-sector securities. The remaining \$2 trillion would be used to repurchase Treasury securities from the general public, with the bonds then being "deposited" in the Social Security Trust Funds.

Let us analyze the latter actions first. The use of \$2 trillion to repurchase outstanding Treasury securities is a sensible policy action. It will add to the U.S. economy's saving rate and encourage greater private sector investment, thereby leading to higher levels of productivity, income, and wealth. But the placement of the repurchased bonds in the Trust Funds is pure window dressing. The presence of extra bonds in the Trust Funds will make no difference with respect to the actions that must be taken after 2013.

This perspective also clarifies an often-suggested “solution” to Social Security’s problems: raising the combined employee/employer tax rate to about 14.4% of the wage base (as compared to the 12.4% combined rate today). Contrary to the claims of the advocates of this action, this wage-tax increase would not permanently solve Social Security’s problems. It would simply delay by about five years (to 2018) the “crunch” point at which the net annual aggregate cash flows would become negative. This action would achieve nothing real for Social Security between now and 2013 (it would just increase the net annual aggregate cash-flow surplus of the program and add Treasury securities to the Trust Funds). The added tax revenues coming into the program would sustain cash-flow surpluses between 2013 and 2018. But the cash outflows after 2018 would then overwhelm this somewhat larger stream of cash inflows. 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.

NINE The proposal to channel \$700 billion into stocks and bonds is slightly more promising. At least this action would channel claims on real resources into the Social Security program. But it would not alter the fundamental “defined benefit” structure of the program.

Further, as many other commentators have pointed out, having the Social Security Administration invest the funds (which could eventually total about 4% of U.S. corporate value) could potentially open the door to political influence as to the choice of companies in which Social Security invests. Should the program invest in just the S&P 500? Or in all publicly traded companies? What about overseas-based companies? What about companies that have been convicted of criminal violations? What about tobacco companies? etc. Unfortunately, the record of a number of the states in their investment policies and actions with respect to state employees’ pension funds is not reassuring. Perhaps the Federal Government’s record would be better; but perhaps not.

Further, should Social Security also invest part of its funds in debt securities? What kinds of debt securities? Only corporate debt? What about state and local government debt obligations? What about securitized home mortgages? Securitized commercial real estate mortgages? Securitized credit card debt? Securitized auto loans? The varieties of debt securities are many, and the advocates of each kind will surely not hide their enthusiasm for their variety.

Another important and unavoidable drawback to this route, and one that has gained much less attention, would be the restricted investment focus of such a program. Even if the Social Security program were somehow able to invest in a broad index of all publicly traded companies in the U.S., this focus would still restrict the program’s investment flows to the 10,000 or so largest companies in the U.S. Neglected would be the millions of smaller enterprises in the U.S. that are not publicly traded and that get their financing primarily through debt finance—i.e., through loans from banks and other financial intermediaries. Until such loans become regularly securitized (the way that home mortgage-based securities are easily bought and sold today), these millions of smaller enterprises will be cut off from the Social Security investment flows. And even with securitization, it seems likely that an index-fund orientation for Social Security would largely or entirely bypass this sector.

TEN There is another way. A system of personal savings accounts (PSAs), as a component of the Social Security program, would be a valuable step toward moving the program in the direction of a defined-contribution structure that would bring greater personal choice and responsibility, while maintaining an acceptable level of redistribution.

A large number of PSA variants have been proposed, and for a program as complex as Social Security truly “the devil is in the details.” Rather than advocate a specific plan, I will set forth two important principles that should guide any structure.

First, a PSA plan should be voluntary. Though many Social Security participants will be eager to embrace PSAs, others will be reluctant. That choice should be available.

Second, the PSAs should be structured along the lines of the current investment retirement account (IRA) program. That is, a wide choice of investment vehicles and instruments, *including bank accounts and similar depository instruments*, should be available to PSA 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.

ELEVEN This broad-choice structure would have many advantages. First, it would give participants a wide range of opportunity to tailor their investments to their knowledge and information, their age and family status, their tolerances for

risk, 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 those 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. This strong advantage would not be present if the Social Security Administration directly invested the funds or if PSA participants were limited to a handful of index-fund products (as is true for the Thrift Savings Plan that serves as the retirement plan for employees of the Federal Government).

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.

TWELVE In summary, 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 latent problems.

Reforming the program will not be easy. Social Security is complex, and its basic structure is widely misunderstood. 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.

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Chairman SHAW. Thank you, Dr. White.  
Ms. Baronian.

**STATEMENT OF HON. MAUREEN M. BARONIAN, VICE PRESIDENT AND PRINCIPAL, INVESTORS SERVICES OF HARTFORD, INC., HARTFORD, CONNECTICUT; FORMER STATE REPRESENTATIVE, CONNECTICUT GENERAL ASSEMBLY; AND FORMER TRUSTEE, INVESTMENT ADVISORY COUNCIL, STATE OF CONNECTICUT**

Ms. BARONIAN. Thank you. Chairman Shaw, Ranking Member Matsui, and Members of the Subcommittee, thank you for inviting me to be here today. As a member of the Investment Advisory Council for the State of Connecticut from 1987 to 1995, I have seen firsthand the results of allowing governments to invest directly in private equity markets. I can only hope that my experiences will help enlighten this Subcommittee as it considers President Clinton's proposal to invest a portion of the Federal Social Security surplus in private markets.

Almost 10 years ago, on March 22, 1990, the State of Connecticut retirement and trust funds joined with members of the United Autoworkers, some existing members of Colt management, and a few other private investors to complete a buyout of the Colt Firearms division of Colt Industries, Inc. In all, the State placed \$25 million in State pension funds into this buyout: \$17.5 million in CF Holding and \$7.5 million in CF Intellectual Properties which owns the Colt trademark. This investment gave the State of Connecticut a 47-percent share of Colt Manufacturing.

Unfortunately, in less than 2 years, on March 18, 1992, CF Holding Corp. filed for chapter 11 bankruptcy. Fortunately, the State pensions loss was "limited to only" \$21 million, after the Colt trademark was sold to the Economic Development Authority of Connecticut 2 years later.

While it is not uncommon for pension funds to lose money on the investments they make, the case of Connecticut's investment in Colt is an example where politics, not prudence, led to the failed investment.

For months leading up to the investment, Connecticut newspapers were filled with editorials and news reports on the financial crisis facing Colt Manufacturing, a company that employed 950 people. Colt finances were in disarray, it lacked positive cash flow, it had low reserves, and it was suffering from a bitter 4-year strike by its labor union which had resulted in a \$10 million fine by the National Labor Relations Board.

Not only was Colt in trouble, industry analysts pointed to a shrinking market for firearms, growing international competition, and an increasing threat of liability claims against firearm manufacturers. Colt was clearly a failing company in a shrinking industry—not exactly the type of company a pension manager would normally seek to invest \$25 million.

Colt's financial problems were well-known to the State and to the Investment Advisory Council. In fact, the State Economic Development Authority had been trying to find a buyer or investor for Colt Manufacturing for years. Unfortunately, no venture capitalists or private money managers would touch Colt Manufacturing with a 10-foot pole. So why did a majority, 7 out of 10, of the Investment Advisory Council, vote in favor of investing in Colt Manufacturing? Politics.

While the supporters of the IAC and the State Treasurer wrapped this investment in rhetoric of “prudence,” “due diligence,” and “careful consideration,” there was no question that the primary reason for this investment was political, for example, to save the 950 UAW workers from certain unemployment.

Shortly after the State buyout of Colt, the Hartford Courant ran an editorial noting that the State Treasurer, Francisco Borges, had told the editors that the Colt investment was not, “to make money for the State, but to save jobs.” Upon announcement of Colt’s bankruptcy, Mr. Borges issued a press release that bemoaned the bankruptcy of Colt, “despite our best efforts in saving the company from demise or dismantling 2 years ago.”

These two statements are very enlightening—the State’s investment in Colt was not about higher returns for the State pension funds, it was not about sound investment practices, it was about saving a company from certain “demise.” Like I said, it was politics over prudence.

As a former member of the State of Connecticut’s House of Representatives and as a firsthand witness of the hearings and deliberations of the Investment Advisory Council, I am well aware of the difficulty in shielding State investment funds from political influence. The failed investment in Colt is only the starkest and most dramatic example of the effect of politics on investment decisions.

During my tenure on the IAC, our investment decisions were limited by legislative action, by the State of Connecticut limiting our investment in companies located in Northern Ireland and South Africa, and by rules requiring us to consider the “environmental records” of companies in which we invest.

Even more troubling, the influence of State investment funds is not limited to the investment decisions of the State, but also is affected by the active role of the State in the governance of the companies in which the State invests. In fact, the State used to have a person in charge of voting the State’s proxies at shareholder meetings, thus ensuring that the State’s restrictions on investing in various foreign countries or the State’s concerns over environmental or other matters were heard at such meetings.

My experience with the State of Connecticut pales in comparison to the meddling politics could ultimately play were the Federal Government to invest Social Security surpluses in private markets. Connecticut’s pension was equal to approximately \$8 billion at the time we invested in Colt—a paltry sum compared to the trillions that could ultimately be invested by the Federal Government.

Would the Federal Government be able to resist the temptation to invest in suffering steel companies to save jobs? Would the government be able to resist the temptation to limit its investment to “union-friendly” companies? Would the government be tempted to meddle in the pay scales of the companies it invests in to lower wage disparities between management and labor? Would the Federal Government be able to add weight to its antitrust cases by threatening to divest in companies it files cases against? Or, worse yet, would the Federal Government pursue antitrust cases against companies it owns share of? I fear not, and for that reason, I strongly oppose allowing the Federal Government to invest surplus funds in private markets.

Mr. Chairman, the United States has been a shining example of the benefits of the free enterprise system to the rest of the world. As a result of the success of our system, countries around the world have divested their government's ownership in private companies. France is exiting Renault, England has sold British Airways, and Germany is divesting in Lufthansa. And there are many other examples.

I am baffled that the President would now move our government in the opposite direction and follow the disastrous and the discredited example of foreign governments by buying shares of private corporations.

I thank you, Mr. Chairman, and Members of the Subcommittee for listening to my testimony.

Thank you.

[The prepared statement follows:]

**Statement of Hon. Maureen M. Baronian, Vice President and Principal, Investors Services of Hartford, Inc., Hartford, Connecticut; Former State Representative, Connecticut General Assembly; and Former Trustee, Investment Advisory Council, State of Connecticut**

Chairman Shaw, Ranking Member Matsui and Members of the Subcommittee, thank you for inviting me to be here today. As a member of the Investment Advisory Council (IAC) for the State of Connecticut from 1987 to 1995, I have seen first hand the results of allowing governments to invest directly in private equity markets. I can only hope that my experiences will help enlighten this Committee as it considers President Clinton's proposal to invest a portion of the federal Social Security surplus in private markets.

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Unfortunately, in less than two years, on March 18, 1992, CF Holding Corporation filed for Chapter 11 Bankruptcy. Fortunately, the State Pension's loss was "limited" to "only" \$21 million—after the Colt trademark was sold to the Economic Development Authority of Connecticut two years later. While it is not uncommon for Pension funds to lose money on the investments they make, the case of Connecticut's investment in Colt is an example where politics, not prudence led to the failed investment.

For months leading up to this investment, Connecticut newspapers were filled with editorials and news reports on the financial crisis facing Colt Manufacturing—a company that employed 950 people. Colt finances were in disarray, it lacked positive cash flow, it had low reserves, and it was suffering from a bitter four-year strike by its labor union which had resulted in a \$10 million fine by the National Labor Relations Board (NLRB).

Not only was Colt in trouble, industry analysts pointed to a shrinking market for firearms, growing international competition and an increasing threat of liability claims against firearms manufacturers. Colt was clearly a failing company in a shrinking industry—not exactly the type of company a pension manager would normally seek to invest \$25 million.

Colt's financial problems were well known to the State and to the Investment Advisory Council. In fact, the State Economic Development Authority had been trying to find a buyer or investor for Colt Manufacturing for years. Unfortunately, no venture capitalists or private money managers would touch Colt Manufacturing with a ten-foot pole. So why did a majority (7 of 10) of the Investment Advisory Council vote in favor of investing in Colt Manufacturing? *Politics*

While the supporters in the IAC and the State Treasurer wrapped this investment in the rhetoric of "prudence," "due diligence," and "careful consideration," there was no question that the primary reason for this investment was political—i.e., to save 950 UAW workers from certain unemployment.

Shortly after the State buyout of Colt, the Hartford Courant ran an editorial noting that the State Treasurer, Francisco Borges, had told the editors that the Colt

investment was not “to make money for the state but to save jobs.” Upon announcement of Colt’s bankruptcy Mr. Borges issued a press release that bemoaned the bankruptcy of Colt “despite our best efforts in saving the company from demise or dismantling two years ago.” These two statements are very enlightening—the States investment in Colt was not about higher returns for state pension funds, it was not about sound investment practices, it was about saving a company from certain “demise.” Like I said, it was politics over prudence.

As a former member of the State of Connecticut’s House of Representatives and as a first hand witness of the hearings and deliberations of the Investment Advisory Council, I am well aware of the difficulty in shielding state investment funds from political influence. The failed investment in Colt is only the starkest and most dramatic example of the effect of politics on investment decisions. During my tenure on the IAC, our investment decisions were limited by legislative action by the State of Connecticut limiting our investment in companies located in Northern Ireland and South Africa, and by rules requiring us to consider the “environmental records” of the companies in which we invest.

Even more troubling, the influence of state investment funds is not limited to the investment decisions of the State, but also is effected by the active role of the State in the governance of the companies in which the State invests. In fact, the State used to have a person in charge of voting the States proxies at shareholder meetings, thus ensuring that the States restrictions on investing in various foreign countries or the States concerns over environmental matters were heard at such meetings.

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Mr. Chairman, the United States has been a shining example of the benefits of the free enterprise system to the rest of the world. As a result of the success of our system, countries around the world have divested their government’s ownership in private companies: France is exiting Renault, England has sold British Airways, and Germany is divesting in Lufthansa. I am baffled that the President would now move our government in the opposite direction and follow the disastrous and discredited example of foreign governments by buying shares of private corporations.

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Chairman SHAW. Thank you, Ms. Baronian.  
Mr. Tanner.

**STATEMENT OF MICHAEL TANNER, DIRECTOR, HEALTH AND WELFARE STUDIES, CATO INSTITUTE**

Mr. MICHAEL TANNER. Thank you, Mr. Chairman, Mr. Matsui, and distinguished Members of the Subcommittee. I want to start off by saying how pleased I am to have the opportunity today to talk to you about Social Security reform and how particularly pleased I am that the Clinton administration has had the courage to bring this issue forward, to touch the third rail of American politics and engender a real debate about the future of Social Security. I am also very pleased that the Clinton administration has recognized that investment in private capital markets must be part of any Social Security reform. That said, I must disagree with the details of how the President would go about this and that, rather

than allowing individuals to invest, the President would allow the Federal Government to do the investing.

Allowing the Federal Government to purchase stocks would give it the ability to obtain a significant, if not a controlling, share of virtually every major company in America. Experience has shown that even a 2- or 3-percent block of shares can give an activist shareholder influence over the policies of publicly traded companies. The result could potentially be a Federal Government that intervenes in how corporations conduct their affairs, making those decisions on the basis of political passions, rather than on the best interests of the company, the economy, or the shareholders.

The experience of State employee pension funds suggests that governments have difficulty resisting the temptation to meddle in corporate affairs. For example, in the late eighties, State employee pension plans in California and New York were primarily responsible for the election of a new board chairman for General Motors. And according to a 1990 report by the U.S. House of Representatives Committee on Labor, State employee pension plans were increasingly using their clout and voting their shares to influence the corporate role in environmental improvement, humanitarian problems, and economic development.

But even if the government could remain passive, its very ownership of large blocks of stock would, in effect, create situations favoring certain stockholders and corporate managers.

As the General Accounting Office has pointed out, if the government did not exercise its voting rights, other stockholders would find their own voting power enhanced and could take advantage of government passivity. The GAO also warns that regardless of whatever stock voting rules are adopted when the program begins, Congress can always change the rules in the future. Experience with various budget agreements and caps should indicate that no Congress can bind future Congresses as to what they may do.

The second problem is the whole question of social investing, which is the question of even if the government can avoid directly using its equity ownership to influence corporate governance, there is likely to be an enormous temptation to allow political considerations to influence the type of investments the government makes. I think you have just heard an example of that.

The whole idea of this can best be summed up in a task force on social investing convened by Mario Cuomo—then-Governor Mario Cuomo—of New York, who held that public employees were merely one stakeholder in their pensions, along with the rest of society and therefore, the trustees of public pensions were entitled to balance the interest of society against the interests of the public employee.

Using that criterion, they rejected the idea that investments should be made solely on the basis of maximizing immediate returns, and instead, should focus on ways to maximize the direct and indirect returns to all stakeholders, including the larger society and the economy.

Other States have taken that to heart, and today approximately 42 percent of State, county and municipal pension systems have restrictions targeting some portion of investments to projects designed to stimulate the local economy or create jobs. In addition,

23 percent of pension systems have prohibitions against specific types of investments, such as companies that failed to meet the MacBride Principals in Northern Ireland; companies that do business in Libya or other Arab countries; companies that are accused of pollution, unfair labor practices, failing equal employment opportunity guidelines; alcohol, tobacco and defense industries; and even companies that market infant baby formula in the Third World.

In the few moments I have left, I just want to caution against one misunderstanding. And that is that the Federal Thrift Savings Program can be in any way compared to the idea of government investment of Social Security Trust Funds. The Thrift Savings Program is a defined contribution program with individually owned accounts. Workers have a property right in their account, which is not true of Social Security.

There is the case of *Fleming v. Nester* in 1960. The U.S. Supreme Court held that individuals have no legal right to their Social Security benefits. And allowing the government to invest a portion of Social Security revenues in capital markets would do nothing to change this. Therefore, a government-invested Social Security Program would be far more akin to the defined benefit State employee pension systems that I have been describing in which the individual is not the sole interest of the investors.

Because workers have no ownership rights to their pension funds, the government has no fiduciary duty to those workers. The situation may be even worse than the Social Security system, since the exclusive benefit rule, which the IRS imposes on State employee systems, would not be applicable to the Social Security system.

Finally, I would just mention that the Thrift Savings Program is transparent as a defined contribution program. Individual workers can see the result directly of any change in government investment. That would not be the case under Social Security, where the costs of social investing would be hidden within the entire system.

I thank you very much.

[The prepared statement follows:]

**Statement of Michael Tanner, Director, Health and Welfare Studies, Cato Institute**

Mr. Chairman, Distinguished Members of the Committee:

My name is Michael Tanner and I am the Director of Health and Welfare Studies at the Cato Institute, as well as Director of Cato's Project on Social Security Privatization. I very much appreciate the opportunity to appear before you today and discuss the problems inherent in any attempt to allow the government to invest Social Security funds in private capital markets.

First, let me begin by saying that I appreciate President Clinton's proposal for Social Security reform. The president deserves enormous credit for having the courage to tackle this most contentious of political issues. I also commend the president for recognizing that private capital investment must be central to any reform of Social Security. That recognition could form the basis for moving forward in a bipartisan way to ensure that future retirees will be able to retire with the same security as their parents and grandparents.

That said, however, as currently formulated, there are serious problems with the president's proposal and with the entire concept of allowing the federal government to invest directly in private capital markets. Superficially, that approach offers some attraction. It promises the advantages of higher returns through private capital investment, while spreading individual risk and minimizing administrative costs. In reality, allowing the government to control such an enormous amount of private investment, in the words of Federal Reserve Chairman Alan Greenspan, "has very far

reaching potential dangers for a free American economy and a free American society.”<sup>1</sup>

#### THE CURRENT SYSTEM

Social Security is currently running a surplus. In 1996, for example, Social Security taxes—both payroll taxes and income taxes on benefits—amounted to \$385.7 billion. Benefit payments and administrative expenses totaled only \$353.6 billion, resulting in a surplus of \$70.8 billion.<sup>2</sup> Under current law, that money must be invested solely in U.S. government securities. The securities can be any of three types: government securities purchased on the open market; securities bought at issue, as part of a new offering to the public; or special-issue securities, not traded publicly. In actual practice, virtually all the securities purchased have been special-issue securities,<sup>3</sup> which earn an interest rate equal to the average market rate yield on all U.S. government securities with at least four years remaining until maturity, rounded to the nearest one-eighth percent—an average of approximately 2.3 percent above inflation.

By contrast, equities have earned an average 7.56 percent real rate of return over the past 60 years. Some have suggested that the government should be allowed to invest a portion of the Social Security surplus in equities rather than government securities, allowing the Social Security system to reap the benefits of the higher rate of return.<sup>4</sup>

#### PROPOSALS FOR GOVERNMENT INVESTING

The idea of allowing the government to invest excess Social Security funds in private capital markets is not a new one. As early as the 1930s, fiscal conservatives warned that unless private securities were included in the government's portfolio, the trust fund would earn less than market returns. But they also realized that if the government invested in private securities, it would lead to large-scale government ownership of capital and interference in American business. Sen. Arthur Vandenberg (R-Mich.) warned that “it is scarcely conceivable that rational men should propose such an unmanageable accumulation of funds in one place in a democracy.”<sup>5</sup> In the end, Congress rejected not only government investing but any system of full funding, establishing a pay-as-you-go program in which nearly all the taxes paid by current workers are not saved or invested in any way but used to pay benefits to current retirees.

Two factors brought the concept of government investing back into public debate. First, following a series of Social Security reforms in 1983, the Social Security system began to run a modest surplus. Second, demographic trends made it clear that the program's pay-as-you-go structure was not sustainable.

Proposals for government investment first appeared in legislation in the early 1990. The idea received widespread public attention when 6 of the 13 members of the 1994–96 Advisory Council on Social Security recommended the investment of up to 40 percent of the Social Security Trust Fund in private capital markets.<sup>6</sup> As Robert Ball, author of the proposal, put it, “Why should the trust fund earn one third as much as common stocks?”<sup>7</sup>

However, this approach is fraught with peril.

#### CORPORATE GOVERNANCE

Allowing the federal government to purchase stocks would give it the ability to obtain a significant, if not a controlling, share of virtually every major company in America. Experience has shown that even a 2 or 3 percent block of shares can give an activist shareholder substantial influence over the policies of publicly traded companies.<sup>8</sup>

The result could potentially be a government bureaucrat sitting on every corporate board, a prospect that has divided advocates of government investing. Some have claimed that the government would be a “passive” investor—that is, it would refuse to vote its shares or take positions on issues affecting corporate operations. Others, such as the AFL–CIO's Gerald Shea, have suggested that the government should exercise its new influence over the American economy, claiming that government involvement would “have a good effect on how corporate America operates.”<sup>9</sup>

The experience of state employee pension funds suggests that governments may not be able to resist the temptation to meddle in corporate affairs. For example, in the late 1980s, state employee pension plans in California and New York actively attempted to influence the election of a new board chairman for General Motors.<sup>10</sup> According to a report by the U.S. House of Representatives, state employee pension

plans are increasingly using their clout to influence “the corporate role in environmental improvement, humanitarian problems, and economic development.”<sup>11</sup>

Supporters of government investment claim that the government would remain a passive investor, refusing to vote its shares. However, that would require an extraordinary degree of restraint by future presidents and congresses. Imagine the pressure faced by a congress if the government were to own a significant interest in a company that was threatening to close its plants and move them overseas at the cost of thousands of jobs. Could politicians really remain passive in the face of such political pressure?

Even if the government remained passive, its very ownership of large blocks of stock would, in effect, create a situation favoring certain stockholders and corporate managers. As the General Accounting Office has pointed out, if the government did not exercise its voting rights, other stockholders would find their own voting power enhanced and could take advantage of government passivity.<sup>12</sup>

The GAO also warns that regardless of what stock voting rules are adopted when the program begins, Congress can always change the rules in the future.<sup>13</sup>

#### SOCIAL INVESTING

Even if the government avoids directly using its equity ownership to influence corporate governance, there is likely to be an enormous temptation to allow political considerations to influence the type of investments that the government makes. In short, should the government invest solely to earn the highest possible return on investments, or should the government consider larger political and societal questions?

The theory behind social investing was perhaps best explained in a 1989 report by a task force established by then Governor Mario Cuomo to consider how New York public employee pension funds were being invested. The task force concluded that state employee pension funds should not be operated solely for the benefit of state employees and retirees. In the opinion of the task force, those employees and retirees were only one among several groups of “stakeholders” in state employee pension programs, others being “the plan sponsor; corporations seeking investment capital from the pension fund; taxpayers who support the compensation of public employees, including contributions to the pension fund; and *the public, whose well being may be affected by the investment choice of fund managers*” (emphasis added).<sup>14</sup> Using that criterion, the task force rejected the idea that investments should be made solely on the basis of maximizing the immediate return to the pension trust. Instead, pensions should be invested in a way that maximizes “both direct and indirect returns” to all stakeholders, including “the larger society and economy.” Therefore, the task force concluded, state employee pension funds should be guided into economic development projects beneficial to the state of New York.

Most state employee pension funds are subject to such social investing. Alaska may have been the first state to require social investing, with a requirement in the early 1970s that a portion of state pension funds be used to finance home mortgages in the state.<sup>15</sup> The Alaska example also illustrates the dangers of social investing. A downturn in the local real estate market cost the fund millions of dollars that had to be made up through other revenue sources.

Throughout the 1970s and 80s, social investment increasingly came to be a part of state pension programs.<sup>16</sup> It became a subject of widespread public debate in the mid-1980s with the question of South African divestment. Eventually, 30 states prohibited the investment of pension funds in companies that did business in South Africa. Today, approximately 42 percent of state, county, and municipal pension systems have restrictions targeting some portion of investment to projects designed to stimulate the local economy or create jobs. This includes investment in local infrastructure and public works projects as well as investment in in-state businesses and local real estate development.<sup>17</sup> In addition, 23 percent of the pension systems had prohibitions against investment in specific types of companies, including restrictions on investment in companies that fail to meet the “MacBride Principles” for doing business in Northern Ireland, companies doing business in Libya and other Arab countries; companies that are accused of pollution, unfair labor practices, or failing to meet equal opportunity guidelines; the alcohol, tobacco, and defense industries; and even companies that market infant formula to Third World countries.<sup>18</sup>

A nearly infinite list of current political controversies would be ripe for such restrictions if the federal government began investing Social Security funds. Both liberals and conservatives would have their own investment agendas. Should Social Security invest in nonunion companies? Companies that make nuclear weapons? Companies that pay high corporate salaries or do not offer health benefits? Companies that do business in Burma or Cuba? Companies that extend benefits to the

partners of gay employees? Companies that pollute? Companies that donate to Planned Parenthood? Investment in companies ranging from Microsoft to Nike, from Texaco to Walt Disney, would be sure to engender controversy.

Supporters of government investment suggest two ways to avoid the problem of social investing. First, they propose the creation of an independent board to manage the system's investment, a board that would operate free of any political interference. However, Alan Greenspan, who should be in a position to know about board independence, has said that he believes it would be impossible to insulate such a board from politics. Testifying before Congress on proposals for government investment, Greenspan warned:

I don't know of any way that you can essentially insulate government decisionmakers from having access to what will amount to very large investments in American private industry. . . . I know there are those who believe it can be insulated from the political process, they go a long way to try to do that. I have been around long enough to realize that that is just not credible and not possible. Somewhere along the line, that breach will be broken.<sup>19</sup>

Indeed, the difficulty of shielding investment decisions from political considerations was illustrated, unintentionally, by one of the supporters of government investment, Jonathan Cohn, writing in *The New Republic*. "It would be easy to prohibit manipulation of the market for political reasons," Cohn wrote. "All you would have to do is assign responsibility for the investments to a quasi-independent body, then carefully limit how it can make investment decisions."<sup>20</sup> In other words, the new agency would be independent except that Congress would set restrictions on its investment decisions.

Supporters of government investment suggest a second means of avoiding social investment: the investment would be made only in index funds, eliminating the choice of individual stocks. However, that does not eliminate social investment questions, since there would remain the issue of what stocks should be included in the index, whether an existing index or a new one created just for Social Security.

#### THE FEDERAL THRIFT SAVINGS PROGRAM: AN IMPERFECT ANALOGY

Supporters of government investing often cite the federal thrift savings program as an example to show that government pension funds can avoid politicization. It is true that, so far, the TSP has avoided social investment and interference with corporate governance. However, there are several important differences between the TSP and a government-invested Social Security program.

Perhaps most importantly, the TSP is a defined-contribution program with individually owned accounts. Workers do have a property right in their account, which is not true of Social Security. In the case of *Fleming v. Nestor* (1960), the U.S. Supreme Court held that individuals have no property right in Social Security. Allowing the government to invest a portion of Social Security revenues in capital markets would do nothing to alter that.

Therefore, a government-invested Social Security program would be far more akin to defined-benefit state employee pension plans. A 1990 congressional report concluded that while workers acquire an interest in pension funds once they are vested, they have no legal ownership rights. The report went on to note that it would be equally incorrect to say that government "owned" the funds because the government's discretion in spending or disposing of the funds is limited under state trust law and the Internal Revenue Code.<sup>21</sup> The report concludes that there is no exclusive ownership by either party,<sup>22</sup> and that ownership, in any case, may be unimportant because "public defined benefit pensions are entitlements granted by governments that can be modified or taken away."<sup>23</sup>

Because workers have no ownership right to their pension funds, the government has no fiduciary duty to the workers. The situation may be even worse for a government-invested Social Security system. For all the social investment practices discussed above, state employee pension funds have been somewhat restrained by the "exclusive benefit rule," an Internal Revenue Service ruling that requires tax-exempt trusts to operate solely for the benefit of the trustees.<sup>24</sup> The applicability of that rule to government pension funds is extremely limited, however, since the tax exemption status of the trust is irrelevant. The employer—being the government—is already tax exempt. Therefore, the only potential enforcement mechanism is for the IRS to disqualify the plan, meaning that workers would be taxed on the employer's contribution. Because such a penalty would fall on innocent third parties, the threat is seldom invoked. It is even more unlikely to be invoked in the case of a government-invested Social Security system. It would certainly be unfair to do

so—to impose a huge new tax on every American worker because the government mismanages the investment of its funds. Of course, that assumes an IRS independent enough to take action against the federal government's own investment decisions. As a result, unlike the TSP, there appears to be no legal barrier to social investing under a government-invested Social Security program.

Second, as a defined-contribution program, the TSP is transparent. Benefits are dependent on the return to their investment, not on an arbitrary benefit formula. Therefore, the workers have a direct interest in ensuring that investments are made solely to maximize their returns. Workers can see exactly how an investment decision impacts their retirement benefits. Under a government-invested Social Security program, benefits would be defined by law and would be only indirectly affected by individual investment decisions. Therefore, workers would have little incentive to resist social investing. They would have no direct interest in whether investments are made solely to maximize returns or for other purposes.

Finally, the TSP is a voluntary program. If workers are dissatisfied with investment practices under the program, they can refuse to participate. Therefore, fund managers have an incentive to maximize returns. Failure to do so will result in a loss of business. In contrast, a government-invested Social Security system would be mandatory. Workers would be forced to continue contributing 12.4 percent of their income to the system, no matter how dissatisfied they were.

Clearly, then, there are both legal and market restraints on the TSP that would not exist under a government-invested Social Security system. Indeed, the TSP model would seem to argue for exactly the opposite, a system of individually owned, privately invested accounts. Only such a system would replicate the TSP's safeguards—property rights, a fiduciary responsibility, transparency, and an ability to remove funds from a nonperforming investor.

#### A NONSOLUTION

Finally, it is important to recognize that allowing the government to invest Social Security funds in private capital markets will do nothing to solve most of Social Security's problems. Yes, it will help preserve Social Security's solvency. But it will do nothing to increase the near zero or negative rate of return that can be expected by today's young workers. It will do nothing to redress the inequities of the current system that penalize working women, the poor, and minorities. It will do nothing to give low income workers the opportunity to accumulate real wealth. And, it will do nothing to give Americans ownership over their retirement benefits.

The president is right: we need to take advantage of the higher rates of return available through investment in private capital markets. But that should be done not through government investment, but through individual accounts.

Thank you.

#### FOOTNOTES

1. Testimony of Alan Greenspan before the Senate Committee on Banking, July 21, 1998.
2. 1998 Report of the Board of Trustees of the Federal Old-Age Survivors and Disability Insurance Program (Washington: Government Printing Office, 1998).
3. Robert Myers, *Social Security* (Philadelphia: University of Pennsylvania Press, 1993), p. 142.
4. Supporters of government investing may actually be understating the difference in returns. Under the current system, the interest attributed to the government securities does not actually represent a cash transfer but is attributed to the Social Security Trust Fund, which makes the interest more notional than real. When the time comes that payments must be made from the trust fund, the federal government will have to appropriate the attributed interest from general revenues. Thus, like the government securities themselves, the interest payments do not represent real current wealth, merely a promise by the government to tax future generations of workers. In contrast, if the government invested in equities or other assets outside the government, any return would result in a real increase in the system's assets.
5. *Congressional Record*, Vol. 81, Part 2, 75th Congress (March 17, 1937), p. 2324.
6. *Report of the 1994-1996 Advisory Council on Social Security, Volume I: Findings and Recommendations* (Washington: Government Printing Office, 1997), pp. 25-28.
7. Peter Passell, "Can Retirees' Safety Net be Saved?" *New York Times*, February 18, 1997.
8. Theodore Angelis, "Investing Public Money in Private Markets: What Are the Right Questions?" Presentation to a conference on "Framing the Social Security Debate: Values, Politics, and Economics," National Academy of Social Insurance, Washington, D.C., January 29, 1998.
9. "Quoted in Michael Eisenscher and Peter Donohue, "The Fate of Social Security," *Z Magazine*, March 1997.
10. U.S. House of Representatives, Committee on Education and Labor, Subcommittee on Labor-Management Relations, "Public Pension Plans: The Issues Raised over Control of Plan Assets," Committee Print, June 25, 1990; U.S. House of Representatives, Committee on Education and Labor, *Public Pension Plans: The Issues Raised over Control of Plan Assets*, p.49.
11. *Ibid.*

12. General Accounting Office, "Social Security Financing: Implications of Government Stock Investing for the Trust Fund, the Federal Budget, and the Economy," Report to the U.S. Senate Special Committee on Aging, April 1998, p. 62.
13. Ibid.
14. *Our Money's Worth: Report of the Governor's Task Force on Pension Fund Investment* (Albany: New York State Industrial Cooperation Council, June 1989), p. 20.
15. Jennifer Harris, "From Broad to Specific: The Evolution of Public Pension Investment Restrictions," Public Retirement Institute, Arlington, Va., July 1998.
16. For a thorough discussion of state employee pension systems and their investment policies, see Carolyn Peterson, *State Employee Retirement Systems: A Decade of Change* (Washington: American Legislative Exchange Council, 1987).
17. James Packard Love, *Economically Targeted Investing: A Reference for Public Pension Funds* (Sacramento: Institute for Fiduciary Education, 1989).
18. Love, *Economically Targeted Investing*; Peterson, *State Employee Retirement Systems*.
19. Testimony of Alan Greenspan.
20. Jonathan Cohn, "Profit Motives," *New Republic*, July 13, 1998.
21. U.S. House of Representatives, Committee on Education and Labor, *Public Pension Plans: The Issues Raised over Control of Plan Assets*, pp. 44-46.
22. Ibid., p. 52.
23. Ibid., p. 50.
24. Internal Revenue Manual, Examination Guidelines Handbook, Sec. 711.1.

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Chairman SHAW. Thank you, Mr. Tanner.  
Dr. Reischauer.

**STATEMENT OF ROBERT D. REISCHAUER, SENIOR FELLOW,  
ECONOMIC STUDIES, BROOKINGS INSTITUTION**

Mr. REISCHAUER. Thank you, Mr. Chairman. I appreciate the opportunity to participate in this hearing.

During the past few weeks, the President's framework for dealing with the surpluses project for the next 15 years has generated a good deal of controversy and even more confusion. For this reason, I have attached to my prepared statement my analysis of his proposal, and I ask that this analysis be included in the record of this hearing along with the paper that my Brookings colleague Shanna Rose has prepared that describes how Canada has gone about investing its Social Security reserves in equities.

Overall, I think the President's framework is a prudent approach. He would reserve 59 percent of the surpluses projected for the next 15 years for debt reduction, or, looked at another way, he would channel 71 percent into an improvement in the net financial position of the Federal Government. That larger estimate adds in the equities purchased for Social Security. Looked at still another way, the President would reserve 82 percent of the projected surpluses to boost national savings.

Given the inherent uncertainty of budget projections, I think the President has been wise to refrain from devoting more than a small portion of the projected surpluses to commitments, such as tax cuts or spending increases, that from a practical standpoint may be politically irrevocable.

It is an unpleasant yet inescapable reality that there are three, and only three, ways to close Social Security's long-run deficit: taxes can be raised, benefits can be reduced, or the return on the trust fund's reserves can be increased. Given this reality, it's important to compare proposals to invest a portion of Social Security's reserve in private securities with the realistic alternatives.

While there are legitimate concerns with this option, which I will discuss in 1 minute, there are also problems with the alternatives, whether they be raising payroll taxes, increasing the wage base, in-

creasing the age at which unreduced or initial benefits are paid, or reducing the size of the annual cost-of-living adjustments.

There are two good reasons why it makes sense to invest a portion of the trust fund's reserves in private securities. First, such a policy would boost the earnings on the reserves and thereby reduce the benefit cuts and payroll-tax increases that will be required to deal with Social Security's long-run problem.

Second, easing the restriction that requires Social Security to invest its reserves exclusively in government securities would provide workers with a fairer return on their payroll-tax contributions, one that was closer to the benefits that these contributions make to the Nation's economy. To the extent that the reserve accumulation adds to national savings, it generates total returns for the Nation equal to the average return from private investment, which runs about 6 percent above the rate of inflation. By paying Social Security a lower return, a return that is projected to average about 2.8 percentage points over the next 75 years, the system denies workers a fair return on their contributions.

However, some legitimate concerns have been raised about investing trust fund reserves in private securities. Many fear that such investments could disrupt financial markets. Others, as you have heard from my colleagues here, are worried that politicians in both the executive and legislative branches will be tempted to use reserve investment policy to interfere with markets or to meddle in the activities of private companies.

If there were no ways to reduce the risk of political interference, to a de minimis level, it would be imprudent to propose private investment of a portion of the trust fund's reserves. And I would be a strong opponent of such a policy. But fortunately, institutional safeguards can be created to provide the necessary protections. Such an institutional framework should have five elements.

First, an independent agency, modeled after the Federal Reserve Board, should be created and charged with the task of managing the trust fund's investments. Second, this agency should be required to select, through competitive bids, several private-sector fund managers, each of whom would be entrusted with investing only a portion of the trust fund's reserves. Third, these managers should be authorized only to make passive investments, that is, investments in securities of companies chosen to represent the broadest of market indexes.

In other words, there would be no picking and choosing of individual stock, and the index would not reflect just a portion of the market, such as the Dow Jones or the Standard & Poor's 500, but rather, the entire range of stocks that are traded on the major exchanges.

Fourth, Social Security investments should be comingled with the funds that private accountholders have invested in the same index funds that the managers, chosen by the board, would offer to the public.

And finally, the fund managers should be required to vote Social Security's shares solely to enhance the economic interest of future Social Security beneficiaries. All of these elements should be established in legislation. Of course, any law that Congress enacts it can change. But the President would have to sign that bill. And I be-

lieve that a powerful constituency would develop to support a hands-off policy toward trust fund investment.

I believe that this set of institutional arrangements should be sufficient to insulate trust fund investment decisions from political interference. There are those who disagree with this judgment and who think the only way to achieve higher returns on Social Security's reserves is to place these reserves in the hands of individuals who would invest them through personal accounts.

But that approach raises some very difficult questions, such as: Would individual accounts place an unacceptable amount of risk on individuals who are ill prepared to bear that risk? What would happen to the social assistance now provided through Social Security under a system of individual accounts? After all, Social Security is the most effective and the least controversial antipoverty program that the Nation has. Would administrative costs eat up a large portion of the returns in a system of personal accounts? The numbers that Secretary Summers discussed actually were low compared to the Chilean and British experiences. Could the system avoid excessive complexity, and would such a system be politically sustainable?

I think the answers to these questions make personal accounts an inappropriate way to provide American workers with a secure, predictable, and inflation-protected foundation upon which their other retirement income should be built.

Thank you, and I'll be happy to answer any questions at the end of this panel.

[The prepared statement and attachments follow:]

**Statement of Robert D. Reischauer,\* Senior Fellow, Economic Studies,  
Brookings Institution**

Mr. Chairman and Members of the Subcommittee, I appreciate this opportunity to discuss with you the issues raised by proposals to invest a portion of Social Security's reserves in private securities. My statement addresses three questions:

- Why do the Administration and others believe it would be helpful to diversify the portfolio of assets held by the Social Security trust fund?
- What legitimate concerns are raised by investing trust fund reserves in private securities? and
- Are there ways to address these concerns?

WHY INVEST IN PRIVATE SECURITIES?

It is an unpleasant yet inescapable reality that there are three, and only three, ways to close Social Security's long run fiscal deficit. Taxes can be raised, benefits can be reduced, or the return on the trust fund's reserves can be increased. Recently, some have suggested that a fourth way exists, one that avoids unpleasant choices. This route would be to devote a portion of the projected budget surpluses to Social Security. However, transferring resources from the government's general accounts to Social Security would only shift the locus of the inevitable adjustments. Rather than boosting payroll taxes or cutting Social Security benefits sometime in the future, income taxes would have to be higher or non-Social Security spending lower than otherwise would be the case.

Because neither the public nor lawmakers have greeted the prospect of higher taxes or reduced spending with any enthusiasm, the option of boosting the returns on Social Security's reserves is worth close examination. While higher returns can not solve the program's long run financing problem alone, they can make the remaining problem more manageable.

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\* This statement draws on *Countdown to Reform: the Great Social Security Debate*, by Henry J. Aaron and Robert D. Reischauer (The Century Foundation Press, 1998). The views expressed in this statement should not be attributed to the staff, officers, or trustees of the Brookings Institution.

Since the program's inception, the law has required that Social Security reserves be invested exclusively in securities guaranteed as to principal and interest by the federal government. Most trust fund holdings consist of special nonmarketable Treasury securities that carry the average interest rate of government notes and bonds that mature in four or more years and are outstanding at the time the special securities are issued. In addition to their low risk, these special issues have one clear advantage. They can be sold back to the Treasury at par at any time—a feature not available on publicly held notes or bonds, whose market prices fluctuate from day to day. They also have one big disadvantage—they yield relatively low rates of return.

It is not surprising that, when the Social Security law was enacted, policymakers viewed government securities as the only appropriate investment for workers' retirement funds. They were in the midst of the Great Depression. The stock market collapse and widespread corporate bond defaults were vivid in people's memories. Many believed that a mattress or a cookie jar was the safest place for their savings.

For many years, the restriction placed on trust fund investment made little difference because Congress decided, before the first benefits were paid, to forgo the accumulation of large reserves that were anticipated under the 1935 law. Instead, Congress voted in 1939 to begin paying benefits in 1940 rather than 1942, boost the pensions of early cohorts of retirees, and add spouse and survivor benefits. The system was to operate on a pay-as-you-go basis.

Legislation enacted in 1977 called for moving from pay-as-you-go financing to "partial reserve financing" with the accumulation of significant reserves. These reserves failed to materialize because the economy performed poorly. Further legislation in 1983, together with improved economic performance, subsequently led to the steady growth of reserves. By the end of 1998, the program had built up reserves of \$741 billion, roughly twice annual benefits. Under current policy, these reserves are projected to grow to more than \$2.5 trillion—about 3.4 times annual benefits—by 2010. As reserves have grown, the loss of income to Social Security from restricting its investment to relatively low-yielding special Treasury issues also has increased.

The restriction that has been placed on Social Security's investments is unfair to program participants, both workers paying payroll taxes and beneficiaries. To the extent that trust fund reserve accumulation adds to national saving, it generates total returns for the nation equal to the average return on private investment, which runs about 6 percent more than the rate of inflation. By paying Social Security a lower return—a return projected to be only 2.8 percent more than inflation over the next 75 years—the system denies workers a fair return on their investment. As a consequence, either the payroll tax rate has to be set higher than necessary to sustain any given level of benefits or pensions have to be lower than would be the case if the program's reserves received the full returns they generate for the economy.

The restriction placed on the trust fund's investments has had another unfortunate consequence. It has added considerable confusion to the debate over alternative approaches to addressing Social Security's long-run fiscal problem. Advocates of various privatization plans argue that their approaches are superior to Social Security because they provide better returns to workers. In reality, the returns offered by these structures look better only because the balances they build up are invested not in low-yielding Treasury securities but rather in a diversified portfolio of private securities. If Social Security were unshackled, its returns would not just match, but almost certainly exceed, those realized by the various reform proposals.

There exists a very simple mechanism for compensating Social Security for the restrictions that are placed on its investment decisions. Each year, Congress could transfer sums to the trust fund to make up the difference between the estimated total return to investment financed by trust fund saving and the yield on government bonds. This could be accomplished with a lump sum transfer or by agreeing to pay a higher interest rate—say 3 percentage points higher—on the Treasury securities held by the trust fund. The transfer required to make up the shortfall in 1998, when the average trust fund balance was approximately \$700 billion, would have been about \$23 billion, more than two and one-half times the amount that is transferred to the trust fund from income taxes on benefits.<sup>1</sup>

<sup>1</sup>This estimate is based on the difference between the estimated long-run returns on government securities and private assets, not on the actual differences during 1998.

While general revenue transfers to social insurance plans are commonplace around the world, they have been controversial in the United States.<sup>2</sup> Some would oppose such a transfer, arguing that general revenue financing would weaken the program's social insurance rationale through which payroll tax contributions entitle workers to benefits. Others would object to the tax increases or spending cuts needed to finance the general revenue transfer. Still others would question the permanence of such transfers, especially if the budget debate begins to focus on maintaining balance in the non-Social Security portion of the budget, out of which the transfers would have to be made.

An alternative approach would be to relax the investment restrictions on Social Security and allow the trust fund to invest a portion of its reserves in private stocks and bonds. Such investments would increase the return earned by the reserves and reduce the size of future benefit cuts and payroll tax increases. Shifting trust fund investments from government securities to private assets, however, would have no direct or immediate effect on national saving, investment, the capital stock, or production. Private savers would earn somewhat lower returns because their portfolios would contain fewer common stocks and more government bonds—those that the trust funds no longer purchased. Furthermore, government borrowing rates might have to rise a bit to induce private investors to buy the bonds that the trust funds no longer held.<sup>3</sup> Nevertheless, the Social Security system would enjoy the higher returns that all other public and private sector pension funds with diversified portfolios realize.

#### CONCERNS ABOUT INVESTMENT OF TRUST FUND RESERVES IN PRIVATE SECURITIES

In 1935, Congress ruled out trust fund investments in private stocks and bonds for good reasons. First, policymakers were concerned that the fund's managers might, on occasion, have to sell the assets at a loss, a move that would engender public criticism. Second, they feared that if the fund had to liquidate significant amounts of securities, these sales might destabilize markets, depressing the value of assets held in private portfolios and upsetting individual investors. An even more important consideration was that they feared that politicians—like themselves—might be tempted to use reserve investment policy to interfere with markets or meddle in the activities of private businesses.

The concerns that Congress had in 1935 were certainly legitimate ones. But conditions have changed over the past 64 years in ways that reduce their saliency. Stock and bond markets are far larger, less volatile, and more efficient now than they were in the 1930s. Trust fund investment activities, therefore, are less likely to disrupt markets. Moreover, the trust fund is unlikely to be forced to sell assets at a loss because the fund has significant and growing reserves, most of which under the various proposals that call for trust fund investment in private securities would continue to be held in special Treasury securities. The trustees would almost certainly sell the fund's government securities to get past any short-run gap between benefit expenses and revenues.

On the other hand, the pressures special interests place on lawmakers and the stresses imposed by reelection are probably greater now than they were in the past. For these reasons, many justifiably continue to be concerned about possible political interference in trust fund investment activities. Chairman Greenspan of the Federal Reserve Board has stated that he does not "believe that it is politically feasible to insulate such huge funds from government direction." Others have been less judicious, charging that equity investment by the trust fund "amounts to nationalization of American industry" and "would threaten our freedom."

Those who oppose trust fund investment in private securities point to the record of some private and state government pension funds that have chosen to use social, as well as economic, criteria to guide their investment policies. In addition, some of these pension funds have voted the shares of companies whose stock they own to further social objectives, ones that might sacrifice some short- or long-run profits. The fear is that the Social Security trustees might be subject to similar pressures. Congress could force them to sell, or not buy, shares in companies that produce products some people regard as noxious, such as cigarettes, alcoholic beverages, or napalm. Similarly, Congress could preclude investments in firms that engage in

<sup>2</sup> General revenues have been used in Social Security in limited ways. The allocation of revenues from income taxation of Social Security benefits is an application of general revenues. So were payments made to provide Social Security earnings credits for the military. In addition, when minimum Social Security benefits were eliminated in 1981, they were preserved for those born before 1920 and financed through a general revenue transfer.

<sup>3</sup> With \$3.7 trillion in outstanding debt, an increase in borrowing costs of ten basis points (0.1 percentage points) would raise annual federal debt service costs by \$3.7 billion.

business practices some regard as objectionable, such as hiring children or paying very low wages in the company's foreign factories, polluting the environment, or not providing health insurance for their workers. Critics also fear that the trust fund might retain shares in such companies and use stockholder voting power to try to exercise control over these firms.

#### SAFEGUARDS TO PROTECT TRUST FUND INVESTMENT DECISIONS FROM POLITICAL PRESSURES

If there were no effective way to shield trust fund investment decisions from political pressures, the advantage of higher returns that a diversified investment strategy would yield would not be worth the price that would have to be paid. However, experience suggests both that concerns about political interference are exaggerated and that institutional safeguards can be constructed that would reduce the risk of interference to a *de minimis* level.

A number of federal government pension funds now invest in private securities. They include the Thrift Saving Plan for government workers and the pension plans of the Federal Reserve Board, the U.S. Air Force and the Tennessee Valley Authority. The managers of these pension funds have not been subject to political pressures. They have pursued only financial objectives in selecting their portfolios and have not tried to exercise any control over the companies in which they have invested.

Of course, the fact that the managers of smaller government pension funds have not been subject to political pressures provides no guarantee that the much larger and more visible Social Security system would enjoy a similar fate. Special interests might seek Congressional sponsors for resolutions restricting investments more for the publicity such limits would provide their cause than for any economic impact the directive might have if carried out. In addition, some Members might feel obliged to propose restrictions against investing in corporations that have been found to violate anti trust laws, trade restrictions, workplace health and safety regulations, or other federal limits. Political pressures might cause others to pressure the trustees to exclude investments in companies that have closed a plant in their district and moved their production facilities and jobs abroad.

For these reasons, it would be essential to enact legislation that would create a multi-tiered firewall to protect trust fund investment decisions from political pressures, one that would forestall efforts by Members of Congress or the executive branch from using trust fund investments to influence corporate policy. The first tier of such an institutional structure should be the creation of an independent agency charged with managing the trust fund's investments. This board—which could be called the Social Security Reserve Board (SSRB)—could be modeled after the Federal Reserve Board, which for over eight decades has successfully performed two politically charged tasks—controlling growth of the money supply and regulating private banks—without succumbing to political pressures. Like the governors of the Federal Reserve, the members of the SSRB should be appointed by the president and confirmed by the Senate. To ensure their independence, they should serve staggered terms of at least ten years in length. Congress should be empowered to remove a board member from office only if that member was convicted of a serious offense or failed to uphold their oath of office, not because Congress disliked the positions taken by the member. As is the case with the Federal Reserve Board, the SSRB should be given financial independence. This could be ensured by allowing it to meet its budget by imposing a tiny charge on the earnings of its investments. Under such an arrangement, neither Congress nor the executive branch could exercise influence by threatening to withhold resources.

A second tier of protection should be provided by limiting the discretion given to the SSRB. The primary responsibility of the board should be to select, through competitive bids, several private sector fund managers, each of whom would be entrusted with investing a portion of the fund's reserves. Depending on the amount invested, somewhere between three and ten fund managers might be chosen. Contracts with the fund managers would be rebid periodically and the board would monitor the managers' performance.

A third tier of insulation from political pressures should be provided by authorizing fund managers only to make passive investments. They would be charged with investing in securities—bonds or stocks—of companies chosen to represent the broadest of market indexes, indexes that reflect all of the shares sold on the three major exchanges. In other words, the trust fund's investment would be in a total stock market index such as the Wilshire 5,000 or Wilshire 7,000 index. If bonds were included in the investment mix, the appropriate guide might be the Lehman Brothers Aggregate (LBA) index. Unlike actively managed mutual funds, there

would be no discretion to pick and choose individual stocks and, therefore, no window through which political or social considerations could enter.

A fourth layer of defense should be provided by requiring that Social Security's investments be commingled with the funds that private account holders have invested in index funds offered by the managers chosen by the SSRB. These private investors would object strenuously if politicians made any attempt to interfere with the composition of the holdings of their mutual fund.

Fifth, to prevent the SSRB from exercising any voice in the management of private companies, Congress should insist that the several fund managers selected by the SSRB vote Social Security's shares solely to enhance the economic interest of future Social Security beneficiaries.

To summarize, this set of five institutional restraints would effectively insulate fund management from political control by elected officials. Long-term appointments and security of tenure would protect the SSRB from political interference. Limitation of investments to passively managed funds and pooling with private accounts would prevent the SSRB from exercising power by selecting shares. The diffusion of voting rights among several independent fund managers and the requirement that the managers consider economic criteria alone would prevent the SSRB from using voting power to influence company management. In short, Congress and the president would have no effective way to influence private companies through the trust fund unless they revamped the SSRB structure. That would require legislation which would precipitate a national debate over the extent to which government, in its role as custodian of the assets of the nation's mandatory pension system, should interfere in the private economy. Framed this way, there would be strong opposition to such legislation.

While nothing, other than a constitutional amendment, can prevent Congress from repealing a previously enacted law, the political costs of doing so would be high. Furthermore, if Congress is disposed to influence the policies of private businesses, it has many far more powerful and direct instruments to accomplish those ends than through management of the Social Security trust funds. The federal government can tax, regulate, or subsidize private companies in order to encourage or force them to engage in or desist from particular policies. No private company or lower level of government has similar powers.

#### CONCLUSION

Allowing the Social Security system to invest a portion of its growing reserves in private assets will increase the returns on the trust fund balances and reduce the size of the unavoidable payroll tax increases and benefit reductions that will be needed to eliminate the program's long-run deficit. Concerns that political interests might attempt to influence trust fund investment decisions are legitimate but institutional safeguards can be enacted into law that would reduce the possibility of such interference to a *de minimis* level.

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### **The President's Framework for the Budget Surplus: What Is It and How Should It Be Evaluated?**

The federal budget registered a surplus in fiscal year 1998, the first in 29 years.<sup>1</sup> The budget for the current fiscal year, 1999, will also end in surplus, producing the first back-to-back surpluses since 1956-57. OMB projects that, if tax and spending policies remain unchanged (the baseline projection), significant surpluses will persist for several decades. To ensure that this unexpectedly favorable fiscal outlook is neither squandered nor frittered away, President Clinton laid out in his fiscal year 2000 budget proposal a framework for dealing with the projected surpluses of the next 15 years. The president's framework, which is multi-faceted and complex, has proven difficult for even seasoned budget analysts to explain.

#### THE PRESIDENT'S FRAMEWORK

Assuming the economy performs as the Administration projects, that OMB's estimates of future mandatory spending are correct, and that tax and spending policies are not changed, budget surpluses totaling \$4.854 trillion will be realized over the

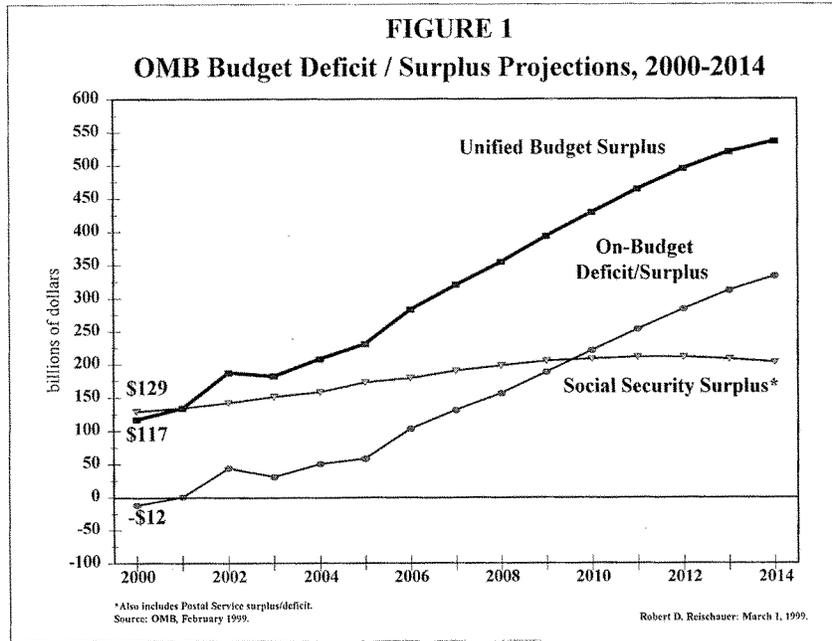
<sup>1</sup>This note uses the terms "surplus" and "total surplus" in place of the more cumbersome "baseline unified budget surplus." They refer to the sum of the Social Security surplus and the surplus in the government's other accounts. All of the figures are from OMB.

fiscal 2000 to 2014 period (Table 1). Both Social Security and the government's non-Social Security accounts will register sizeable surpluses over this period (Figure 1).

Table 1.—The Baseline Surplus and the President's Framework  
(fiscal years 2000–2014)

Baseline Surplus	\$ billions	President's Framework	\$ billions	Percent
Total .....	\$4,854	Total .....	\$4,854	100
Non-Social Security.	(2,153)	Debt reduction .....	(2,870)	59
Social Security.	(2,701) *	Increased discretionary spending	(481)	10
		USA accounts .....	(536)	11
		Equity investments for Social Security.	(580)	12
		Added financing costs .....	(387)	8
		Addendum: .....		
		Additional Treasury securities for Social Security.	\$2,184	
		Additional Treasury securities for Medicare HL.	\$686	

\* Includes \$5 billion from the Postal Service.



Under the president's framework, 59 percent of this projected baseline surplus would be reserved to reduce debt held by the public.<sup>2</sup> The remaining 41 percent would be available to commit now to current and future needs. The president's budget proposes using this portion of the surplus to increase discretionary spending, contribute to new personal retirement accounts for workers (USA accounts), and buy equities for the Social Security trust fund. Other policymakers have suggested that all of the surplus not devoted to debt reduction be used to cut taxes or expand discretionary and entitlement spending. This would be inconsistent with the allocation in the president's framework because the portion of the surplus used to buy equities for the Social Security trust fund is equivalent to debt reduction. The equities would be liquid assets that could easily be sold, and the proceeds used to redeem debt. Thus, under the president's framework, only 29 percent of the surplus is available for such initiatives.

Under the president's framework, special Treasury securities equal in value to the amount by which debt held by the public is expected to be reduced over the 15 year period would be credited to the Social Security and Medicare HI trust funds (addendum, Table 1). These bonds would be in addition to the special Treasury securities the trust funds receive when Social Security and Medicare remit their annual surpluses to the Treasury. The additional securities credited to the trust funds would be registered as budget outlays under a change the president proposes to make in current budget accounting rules.<sup>3</sup> The exact amounts that will be credited to the trust funds each year will be specified in legislation enacted in 1999. Therefore, the actual reduction in debt held by the public under the president's framework may end up being more or less than the value of the securities added to the trust funds. If the economy proves to be weaker than expected or policymakers boost spending or cut taxes more than the president has proposed, the reduction in debt held by the public could be considerably smaller than the transfers made to the trust funds.

#### THE GOALS OF THE PRESIDENT'S FRAMEWORK

The president's framework has at least four different broad objectives.<sup>4</sup>

First, it is an effort to ensure that a large fraction—roughly 82 percent—of the baseline surplus projected for the next 15 years contributes to national saving by paying down debt held by the public, purchasing equities for the Social Security trust fund, and boosting the retirement saving of workers (USA accounts).

Second, it is an attempt to establish a budgetary environment in which debt reduction is politically sustainable. Many believe that, without some restraints, lawmakers will enact tax cuts and spending increases that dissipate the projected surpluses. To thwart this, the president has wrapped his policy of debt reduction in the protective armor of initiatives to strengthen Social Security and Medicare.

Third, the president's framework is an initiative that shifts some of the burden for supporting future Social Security and Medicare benefits to the government's general funds. This is accomplished by crediting the Social Security and Medicare HI trust funds with more Treasury securities than the funds—surpluses warrant. These infusions of obligations mean that less of the long-run imbalances between future benefit costs and payroll tax receipts in Social Security and Medicare will be closed through payroll tax hikes and benefit cuts in those programs and more will be financed through slower growth in other program spending and higher levels of general taxes than otherwise would occur.<sup>5</sup> The equities purchased for the Social Security trust fund will reduce the adjustments that Social Security and the balance of government together will have to make in the future.

Fourth, the president's framework is an effort to improve the prospect that Congress and the president can reach agreements on measures that address the long-run solvency problems facing Social Security and Medicare. It does this by reducing the programs' funding shortfalls through the provision of additional bonds to the

<sup>2</sup>The percentages used in this note are percents of the baseline surplus. The Administration's descriptions of the framework calculate percentages of the surplus excluding the added financing costs that arise when a portion of the surplus is not used to reduce debt.

<sup>3</sup>This change is necessary to ensure that the projected unified budget balance is reduced by the transfers and the resources can not be spent again. Under current accounting rules, a transfer from the general accounts to the trust funds would not affect the balance in the unified budget because it would be an outlay from one account and an offsetting receipt in another.

<sup>4</sup>In addition to these broad objectives, the president's framework has objectives that are more tactical in nature such as to free up resources for increased discretionary spending after fiscal year 2000 and to check the impetus for large across-the-board tax cuts.

<sup>5</sup>In the short run, increased borrowing from the public represents a third alternative. Such borrowing, however, would lead to higher debt service outlays which eventually would require higher taxes or spending cuts.

trust funds. Because the shortfalls will be smaller, fewer painful measures—payroll tax increases and benefit reductions—will be needed to close the remaining imbalances. For example, without the president's infusion of extra bonds into the Social Security trust fund, benefit cuts and payroll tax increases equivalent to 2.19 percent of taxable payroll—a politically undigestible mouthful—would be required to close the program's estimated 75 year imbalance. With his policy, the adjustments would shrink to a size that lawmakers might more readily swallow—about one percent of payroll.

Some critics have suggested that, by reducing the long-run shortfall, the president's framework could undercut the pressure on policymakers to act. But the president has not claimed that his framework represents a full response to Social Security's long-run financial problem. It buys time but does nothing to lower future Social Security benefit promises. The higher returns earned by equity investments and the interest earnings on the additional bonds will boost the program's revenues modestly. But, as the president has acknowledged, other measures will be needed to complete the package.

#### THE IMPACT OF THE PRESIDENT'S FRAMEWORK ON PUBLIC DEBT AND SOCIAL SECURITY RESERVES

Under the president's proposal, the level of the debt held by the public would fall from an estimated \$3.670 trillion at the end of fiscal 1999 to \$1.168 trillion at the end of 2014, or from 41.9 percent of GDP to 7.1 percent of GDP, the lowest share of GDP since 1917 (Table 2). Whether this represents a major or modest reduction depends critically on what one thinks would happen to the budget surpluses if the president's framework were not adopted. Of the many possibilities, the following three scenarios encompass the range of plausible alternatives:

- *Save Total Surplus.* Under this scenario, all of the budget surplus would be "saved," that is, used to pay down debt held by the public. If this happened, all of the debt held by the public would be retired by 2013.
- *Save Social Security Surplus.* Under this scenario, the surpluses in the Social Security accounts would be used to pay down debt held by the public.<sup>6</sup> The surpluses in the non-Social Security accounts would be devoted to tax cuts and spending increases. Debt held by the public would amount to \$1.149 trillion or about 7 percent of GDP by the end of fiscal 2014 under this scenario.
- *Dissipate Surplus.* Under this scenario, all of the unified budget surplus would be dissipated through tax cuts and spending increases. Debt held by the public would not decline, but rather would rise a bit to \$3.849 trillion for reasons that relate to the way credit programs are treated under current budget accounting rules.

Most analysts who are familiar with the pressures facing lawmakers consider the "Dissipate Surplus" scenario to be the most likely. In other words, they believe that most, if not all, of the projected budget surplus will be dissipated if some enforceable framework for protecting the surplus is not enacted. Compared to this situation, the president's framework is a model of fiscal prudence. Over the next five, ten, and fifteen years, the president's plan would reduce the levels of public debt by \$464 billion, \$1.341 trillion and \$2.681 trillion, respectively, compared to the levels that would exist if all of the surplus was dissipated on tax cuts and spending increases.

The president's framework would reduce the level of debt held by the public marginally less than would be the case under the scenario in which all of the Social Security surpluses were devoted to debt reduction. Specifically, public debt in 2004, 2009, and 2014 would be higher by roughly \$249 billion, \$317 billion, and \$19 billion, respectively, under the president's framework. However, the equity investments provided to the Social Security trust fund under the president's framework, which are functionally equivalent to debt reduction, would amount to \$768 billion by the end of 2014.<sup>7</sup> Counting these assets, the net liabilities of the government under the president's framework would be lower after 2008 than those under the scenario in which the Social Security surplus was devoted exclusively to debt reduction.

<sup>6</sup>This would net out the \$12 billion deficit that the Administration projects the non-Social Security accounts will register in fiscal year 2000.

<sup>7</sup>This includes investments of \$580 billion plus reinvested earnings of \$188 billion.

Table 2: Debt Held by the Public and Social Security Trust Fund Balances  
End of Year 1999, 2004, 2009, and 2014

Public Debt	Save Total Surplus		President's Framework		Save Social Security Surplus		Dissipate Surplus	
	\$ billions	% GDP	\$ billions	% GDP	\$ billions	% GDP	\$ billions	% GDP
1999	\$3,670	41.9%	\$3,670	41.9%	3,670	41.9%	\$3,670	41.9%
2004	2,926	27.1	3,290	30.4	3,041	28.1	3,754	34.7
2009	1,398	10.4	2,466	18.3	2,149	15.9	3,807	28.2
2014	0	0	1,168	7.1	1,149	7.0	3,849	23.5
<b>Net Financial Liabilities (public debt less equities)</b>								
1999	\$3,670	41.9%	\$3,670	41.9%	\$3,670	41.9%	\$3,670	41.9%
2004	2,926	27.1	3,185	29.4	3,041	28.1	3,754	34.7
2009	1,398	10.4	2,126	15.8	2,149	15.9	3,807	28.2
2014	0	0	400	2.4	1,149	7.0	3,849	23.5
<b>Social Security Trust Fund Balances (special Treasury securities and equities)</b>								
	\$ billions		\$ billions		\$ billions		\$ billions	
1999	\$ 852		\$ 852		\$ 852		\$ 852	
2004	1,571		2,075		1,571		1,571	
2009	2,512		4,157		2,512		2,512	
2014	3,547		7,299		3,547		3,547	
<b>Social Security Equity Holdings</b>								
1999	\$ 0		\$ 0		\$ 0		\$ 0	
2004	0		105		0		0	
2009	0		340		0		0	
2014	0		769		0		0	

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The president's proposal would reduce the debt held by the public over the next five, ten, and fifteen years by about \$364 billion, \$1,068 billion and \$1,168 billion less than would be the case if all of the total budget surplus were devoted to paying down federal debt.

Reserves in the Social Security trust fund would be larger under the president's framework than under any of the alternative scenarios because additional Treasury securities and equities would be credited to the trust fund and these new assets would generate interest, dividends, and capital gains. By 2014, the trust fund balance would be augmented by about \$3.752 trillion.

#### GENERAL FUND SUPPORT FOR SOCIAL SECURITY AND MEDICARE UNDER THE PRESIDENT'S FRAMEWORK

Some have argued that the president's framework—which will credit the Social Security trust fund with equities and the Social Security and Medicare HI trust funds with special Treasury securities in excess of those due them in return for their annual surpluses—represents a sharp break with past policy, which they interpret as requiring that these programs be financed exclusively through payroll tax receipts and interest earnings on the trust fund reserves that accumulate when payroll tax receipts exceed benefit costs.<sup>8</sup> The additional securities and the equity investments that the trust funds will receive represent general fund support for these social insurance programs. They will postpone the dates at which the trust funds become insolvent. The additional Treasury securities will not, however, reduce the size of the adjustments that the government will have to make in the future, nor will they affect the timing of these adjustments. Rather than forcing adjustments—tax increases or spending cuts—within the Social Security and Medicare programs, the trust funds will redeem their added securities; the Treasury will have to come up with the resources by increasing general revenues, reducing the growth of non-Social Security, non-Medicare spending, or borrowing from the public, which would push up debt service costs.

<sup>8</sup>In fact, general revenues have been and are used for Social Security and Medicare HI in limited ways. A portion of the income tax receipts that derive from including Social Security benefits in the taxable income of upper-income recipients is transferred to each trust fund. Payments made to provide Social Security earnings credits for the military were taken from general revenues. In addition, when minimum Social Security benefits were eliminated in 1981, they were preserved for those born before 1920 and financed through a general revenue transfer.

There are political, historical, and economic justifications for the president's proposal to shift some of the burden for supporting future Social Security and Medicare benefits to general revenues. The political arguments were alluded to previously. One is that the transfer of securities to the trust funds, which creates a future general fund obligation, when combined with the proposed budget accounting change, will make a policy of debt reduction politically sustainable. A second argument is that by shifting some of the burden for adjustments onto the general funds the dimensions of the long run problems facing these two programs will be reduced to magnitudes that politicians may find more manageable.<sup>9</sup>

The historical justification is that an infusion of general revenues represents compensation for the fact that, during the early years, Social Security and Medicare payroll taxes were used to support benefits that more appropriately should have been paid for out of general revenues because these benefits were more social welfare than social insurance.

The 1935 Social Security Act set pensions for those retiring during the program's first few decades at very meager levels—ones that were commensurate with the modest payroll tax contributions the first cohorts of retirees were expected to make. The initial beneficiaries in 1942 would have received a maximum monthly pension of \$25 (in 1998 dollars); the first workers to receive full pensions under the 1935 law—those turning 65 in 1979—would have received pensions of less than \$250 a month (in 1998 dollars). Under this parsimonious approach, large trust fund balances would have accumulated and these reserves would have generated interest income that would have helped pay future pensions.

In 1939, Congress decided to begin paying benefits in 1940 rather than 1942, raise pensions, and add spouse and survivor benefits to the worker pensions established in the 1935 law. Benefits for these early cohorts were boosted periodically thereafter. These decisions were made to ameliorate a broad social problem—widespread poverty among the elderly whose earnings and savings had been decimated by the Great Depression. The 1939 and subsequent reforms reduced the amount of general revenues needed to support the welfare program for the aged. They provided income support to millions without the stigma of welfare or the inequities associated with the inter-state differences in welfare payment levels that characterized the Old Age Assistance program.<sup>10</sup> While the arguments for providing more generous pensions than the original Social Security Act called for to those turning 65 during the four decades after 1940 was certainly defensible, it imposed a burden on the Social Security system that would have been more appropriately placed on general revenues.

The implementation of Medicare followed a similar pattern. Starting in 1966, those age 65 and older who were eligible for Social Security benefits—and their spouses, if they were age 65 or older—became eligible for Medicare benefits even though they had not contributed a penny in Medicare payroll taxes to the HI trust fund. The first cohorts of workers who will have paid HI payroll taxes for their entire careers will become eligible for benefits only after 2005.

An economic justification for some general revenue contribution to the Social Security program arises from the difference between the benefit Social Security's surpluses provide to the nation's economy and the return that is earned by the trust fund on its reserves.<sup>11</sup> Additions to national saving generate a real return to the economy of at least 6 percent. Social Security surpluses, however, earn less because the trust fund is required to hold its reserves exclusively in special Treasury securities that, over the long run, are projected to pay an average real return that is under 3 percent. To provide workers with a fair return on the portion of their payroll taxes that bolsters the trust fund reserves, policymakers could allow Social Security to invest its reserves in higher yielding assets, agree to pay a higher rate of interest on the special Treasury securities held by the trust fund, or credit the trust

<sup>9</sup>An alternative way of trying to protect Social Security surpluses for debt reduction would be to exclude the Social Security accounts from all budget discussions and presentations, as former Representative Livingston and others have proposed, and focus the debate on the on-budget surplus.

<sup>10</sup>Old Age Assistance (OAA)—which was replaced by the Supplemental Security Income (SSI) program in 1974—was an open ended federal grant that reimbursed states for a share of their welfare expenditures for the indigent aged. Even with the expansion of Social Security, OAA provided benefits to more elderly than did Social Security until 1949 and distributed more money than the pension system did until 1951.

<sup>11</sup>This justification is irrelevant for Medicare, both because roughly 30 percent of the program is supported through general revenues and because the trust fund balances are small and not expected to grow significantly in the future.

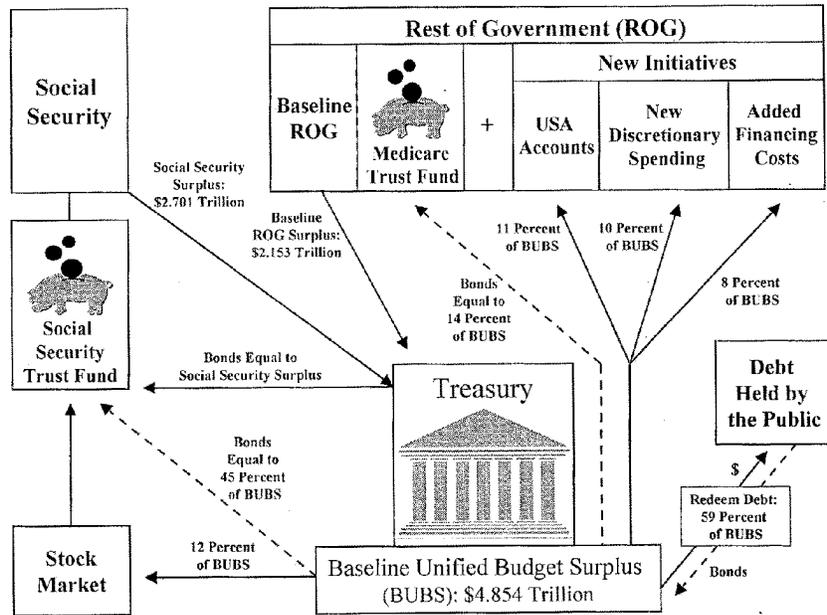
fund with additional bonds. The president's framework represents a mixture of the first and third of these alternatives.

THE "DOUBLE COUNTING" ISSUE

Many lawmakers and some analysts have criticized the president's framework not only for its complexity but also because it engages in what they consider to be "double counting." Specifically, they object to the fact that the president's plan seems to commit 159 percent of the budget surplus—59 percent to pay down debt held by the public; 12 percent to buy equities for the Social Security trust fund; 29 percent for USA accounts, new discretionary spending, and associated debt service costs; and 59 percent to provide additional Treasury securities to the Social Security and Medicare HI trust funds (Figure 2). They charge that it is budget legerdemain to use the same dollar to both pay down debt and boost reserves in the Social Security and Medicare HI trust funds, as appears to be the case under the president's framework.

But using budget surplus dollars to redeem debt is fundamentally different from devoting these surpluses to tax cuts or increased spending. In the latter situations, the benefit of the use is external—it flows to taxpayers or program beneficiaries. In the case of debt reduction, the government is reducing its external liabilities. In effect, it is strengthening its balance sheet by buying assets (government bonds held by the public). By crediting the trust funds with these assets, as is done under the president's framework, the benefit of the improvement in the government's balance sheet is directed towards preventing future payroll tax increases and benefit cuts rather than towards general tax cuts or spending increases for other government programs. The exchange, however, is not a wash—that is, the increase in the total liabilities of the non-Social Security, non-Medicare portion of the budget would be modestly larger than the reduction in the program adjustments necessary to meet future Social Security and Medicare benefit commitments.<sup>12</sup>

FIGURE 2



Revised by Helmsinger March 1, 1995.

<sup>12</sup>The liabilities would be higher because interest earned on the added securities will boost the trust fund's reserves by about \$800 billion over the period. This increase in reserves will not be offset by a reduction in public debt.

## CONCLUSION

The prospect of growing budget surpluses over the next several decades, together with the expiration of the discretionary spending caps and pay-as-you-go rules after fiscal year 2002, has created a need to establish some framework for dealing with the nation's fiscal good fortune. Absent such a framework, fiscal discipline could break down and a feeding frenzy of tax cuts and spending increases could erupt. If so, the surpluses could be dissipated by addressing immediate needs that, in retrospect, could appear trivial when compared to the priorities that emerge over the next two decades.

The president has proposed one framework for dealing with the projected surpluses; other policy makers have put forward alternatives. Senator Domenici (R-NM), chair of the Senate Committee on the Budget, has recommended that all of the Social Security surpluses be reserved for debt reduction and that only the projected surpluses in the non-Social Security accounts be available for current commitment. Representative Kasich (R-OH), chair of the House Committee on the Budget, has suggested that commitments can be made now to cut taxes (or increase spending) as long as those initiatives (and the resultant financing costs) do not absorb more than 43 percent of the projected budget surplus for any year.<sup>13</sup> This percentage is the fraction of the aggregate fifteen year surplus that would remain, under the president's framework, if the additional Treasury securities credited to the Social Security trust fund and the equity investments were excluded.

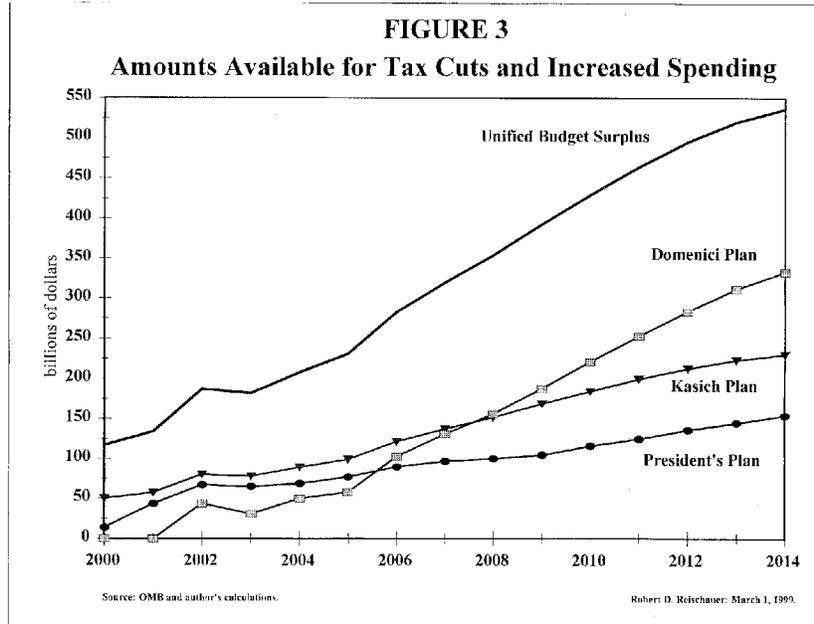
Over the next five years, the framework suggested by Senator Domenici would make much less available for current commitment than would the approaches of the president or Representative Kasich. This is because little of the expected surplus over the next few years is contributed by the non-Social Security portion of the budget (Table 3 and Figure 3). Over the 2009 to 2014 period, the Domenici framework is the most generous because well over half of the projected surpluses for that period arise from the non-Social Security accounts. In fact, Social Security surpluses peak in 2012 and decline thereafter. The president's framework is the most restrictive over the entire 15 year period because it commits 71 percent of the projected surpluses to debt reduction and equity investments for Social Security.

Table 3.—Resources Available for Current Commitments under Alternative Frameworks for the Surplus  
[fiscal years 2000 to 2014 (\$ billions)]

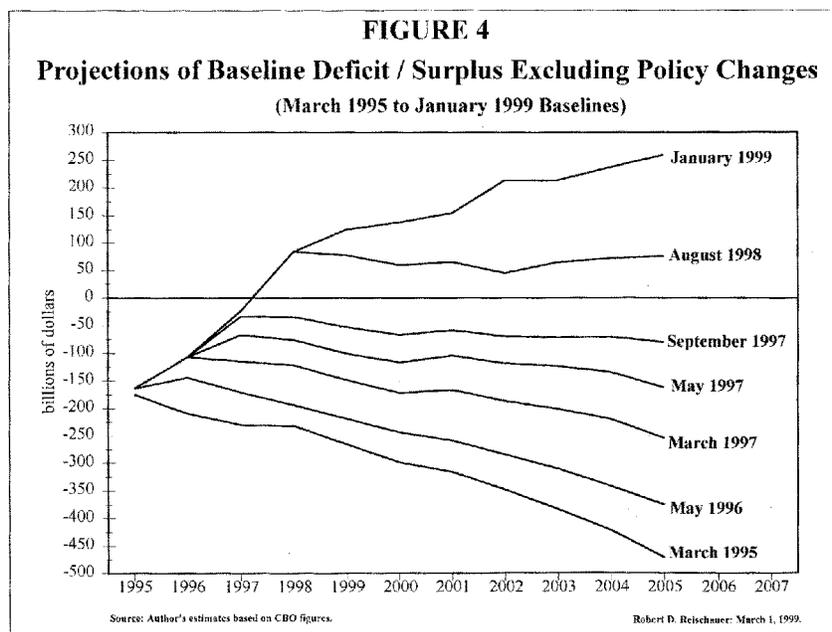
	2000-04	2005-09	2010-14	2000-14
Save entire surplus .....	\$ 0	\$ 0	\$ 0	\$ 0
President's framework* .....	259	469	676	1,404
Domenici's framework .....	125	636	1,403	2,164
Kasich's framework .....	356	680	1,051	2,087

\* Excludes debt reduction and equity investment.

<sup>13</sup> After their initial statements, Senator Domenici and Representative Kasich have been less specific about the parameters of their proposals.



Projections of federal revenues and spending, even under unchanged policy, are notoriously inaccurate. The economy can perform significantly better or worse than expected. The fraction of economic output represented by tax revenues can trend up or down for reasons that are difficult to predict. Similarly, spending on entitlement programs such as Medicare and Medicaid can speed up or slow down for reasons that are hard to explain even in retrospect. Figure 4, which illustrates the changes that have occurred over the last four years in the Congressional Budget Office's baseline projections, after subtracting out the effects of policy changes, underscores this reality. While on balance the unexpected shocks of the past four years have acted to improve the fiscal outlook, the opposite was the case during the 1980s and early 1990s. That less fortunate pattern could be repeated in the future. Given this uncertainty, the economic benefits of debt reduction, and the challenges that the babyboomers' retirement will pose for the nation, a framework like the president's represents a prudent approach to fiscal policy for the first two decades of the 21st century.



## Legislated Changes to the Canada Pension Plan

Shanna Rose \*

### CANADA'S RETIREMENT INCOME SYSTEM

Canada's retirement income system has two main components: the Old Age Security Program and the Pension Plans. In 1997, each program provided approximately \$22 billion in retirement income.<sup>1</sup> The government also offers tax-assisted private savings in Registered Pension and Retirement Savings Plans.

The Old Age Security Program, which guarantees Canadian seniors a basic level of retirement income, was established in 1952, replacing a provincial, means-tested benefit system that had existed since 1929. The program consists of Old Age Security (OAS), a flat benefit for all Canadians age 65 and over who meet residence requirements; the Guaranteed Income Supplement, a means-tested benefit for low-income seniors; and the Spouse's Allowance, a means-tested benefit for low-income spouses of OAS recipients and widows/widowers age 60 to 64.<sup>2</sup> The Old Age Security Program is financed from general revenues.

The other main component of Canada's retirement income system consists of two parallel public pension plans, the Canada Pension Plan (CPP) and the Quebec Pension Plan (QPP). Both are mandatory, earnings-related social insurance programs financed on a pay-as-you-go basis. The CPP applies to all of Canada except those living in the province of Quebec. The two plans have the same contribution rates and benefit formulas. Quebec recently amended its pension plan so as to conform to the changes made to the CPP's benefits and contribution rates mentioned below. The following discussion of the newly created Investment Board, however, applies only to the CPP.

\* Research Assistant, Economic Studies, The Brookings Institution.

<sup>1</sup> All monetary figures are expressed in Canadian dollars.

<sup>2</sup> In 2001, the OAS and GIS will be consolidated into one benefit, called the Seniors Benefit, with stricter means-testing.

## THE CANADA PENSION PLAN

Approximately ten million Canadians currently pay into the CPP and 3.7 million receive benefits. The early, normal, and late retirement ages are 60, 65, and 70, respectively.<sup>3</sup> The CPP provides a pension of 25 percent of the average of the contributor's highest monthly pensionable earnings, adjusted for growth in wages. The formula for calculating average earnings "drops out" the years in which the worker earned the least (15 percent of all years up to seven years) to account for unemployment, school attendance, etc. The formula also excludes years of absence from the labor force due to disability and child-rearing.

Until now, CPP fund reserves have been invested exclusively in nonnegotiable provincial government securities, earning the federal long-term bond rate of interest. The CPP presently has reserves equal to approximately two years' worth of benefits, or nearly \$40 billion, as mandated. A 1993 actuarial report projected the depletion of the fund by 2015, assuming the established schedule of contribution rates was followed.

## CANADA PENSION PLAN INVESTMENT BOARD ACT

In December 1997, following two years of extensive nationwide public "consultations," the Canadian Parliament passed the Canada Pension Plan Investment Board Act. The legislation, effective April 1, 1998, established the Canada Pension Plan Investment Board, an independent panel to oversee the investment of pension funds in the stock and bond markets. The Board will invest the reserve fund in a diversified portfolio of securities beginning in February 1999. The new investment policy requires the Board to secure the "maximum rate of return without undue risk of loss."

The Investment Board will be subject to investment rules similar to those governing other Canadian pension funds. The Board is permitted to invest as much as 20 percent of its assets in foreign securities, although some policy makers want to relax this regulation so as to allow the Board to better fulfill its mandate to maximize returns. Eventually, the share of CPP funds invested in provincial securities will be limited to the proportion held by private and provincial pension funds in Canada. As a transitional measure, provinces will be given the option of rolling over existing CPP bonds, upon maturity, for a 20-year term at the same rate of interest they pay on their market borrowings. For the first three years, provinces will also have access to half of the new CPP funds the Board invests in bonds. The Board is required to act as a "passive" investor for at least the first three years, investing its stock holdings in broad market indexes, so as to help smooth the transition.

The Investment Board, which is accountable to the public and the government, will provide Canadians with quarterly financial statements and annual reports. The Board will also hold public meetings in participating provinces at least every two years.

## APPOINTMENT OF THE BOARD OF DIRECTORS

On October 29, 1998, the Canadian Minister of Finance, in consultation with participating provincial finance ministers, named the 12 directors who will serve on the CPP Investment Board. The directors will serve staggered three-year terms. Prominent businesswoman Gail Cook-Bennett was selected as the chair. Ms. Cook-Bennett holds a Ph.D. in economics from the University of Michigan. She is a director of several major Canadian companies and served on the Ontario Teachers' Pension Plan Board—now one of Canada's largest institutional investors—when it was first permitted to invest in equities in 1990.

## CONCERNS ABOUT THE INVESTMENT FUND

Concerns that the fund will use its market power to pressure corporations, or that the fund might succumb to pressures to invest in politically favored ventures, led the government to postpone the effective date for the CPP Investment Board Act from January 1 to April 1, 1998. This delay allowed Canada's Senate Banking Committee to hold hearings on the development of regulations relating to the board's operation.

Another concern is that the Canadian stock market is not broad enough or large enough to deal with all of the new pension money that will be generated by sched-

<sup>3</sup>The pensions of Canadians who continue paying into the CPP until age 70 are raised by six percent for each year worked after age 65. After age 70 Canadians are no longer required to contribute to the CPP.

uled increases in contributions. Although only a small trickle of pension funds will be available for investment in 1999, the stock fund will grow by about \$10 billion a year thereafter, according to government projections. Canadian stock indexes lack the breadth of U.S. indexes, making it difficult for investors to track the market accurately. Moreover, many of Canada's largest companies are subsidiaries of foreign concerns, the shares of which are not traded on the Canadian exchanges.

#### OTHER CHANGES TO THE CPP

The Canada Pension Plan Investment Board Act is part of a broad overhaul of the CPP designed to keep the program solvent in the wake of baby-boom retirement. Today, there are about 3.7 million Canadian seniors; by 2030, there will be 8.8 million. According to Prime Minister Jean Chretien, "this major overhaul makes us the first industrialized country to ensure the sustainability of its public pension system" well into the 21st century. The other major changes to the CPP are outlined below.

##### *Changes in the Benefit Structure*

An estimated 75 percent of the changes to the CPP will fall on the financing side, and 25 percent on the benefit side. The administration and calculation of some benefits will be tightened so as to slow the growth of costs. The formula for converting previous earnings to current dollars will be changed to reduce average pensionable earnings slightly. This change will be phased in over two years.

The administration of disability and death benefits has been altered in several ways. Eligibility for disability benefits is now contingent on CPP contributions in four of the last six years, whereas previously it was contingent on contributions in five of the last 10 years or two of the last three years. Rather than being based on maximum pensionable earnings at age 65, disability benefits are to be based on maximum pensionable earnings at the time the disability occurs and then price-indexed until age 65. The one-time death benefit still equals six times the monthly retirement benefit of the deceased worker, but the maximum has been lowered from \$3,580 to \$2,500, where it will be frozen (this change was favored over the option of eliminating the death benefit entirely). Changes have been implemented to limit the extent to which new beneficiaries may combine survivor's benefits with either retirement or disability benefits.

##### *Changes in Contribution Rates*

Over the next six years, the contribution rate will increase from the current 5.85 percent rate to a "steady-state rate" of 9.9 percent of contributory earnings. This rate is shared equally by workers and their employers. By contrast, a 1995 actuarial report projected that, without any changes to the pension plan, the contribution rate would have to rise to 14.2 percent by 2030. The Basic Exemption, below which no contributions are paid, is to be frozen at the current year's level of \$3,500; this measure will widen the earnings base, since the upper limit (currently \$35,800, approximately corresponding to the average wage) will continue to rise according to the established formula. All contributors are to receive regular statements about their CPP contributions.

The Ministers of Finance have the authority to alter contribution rates, in connection with a triennial review, through regulation. If stocks perform poorly, contributions will be increased to offset losses. If the market does well, the profits will help obviate future rises in contributions, and may even lead to a reduction.

##### *Unchanged Aspects of the CPP*

The future benefits of persons age 65 or older on December 31, 1997 are unaffected by these changes, as are those paid to persons under age 65 who received benefits before January 1, 1998. The early, normal, and late retirement ages remain unchanged. All benefits except the lump-sum death benefit remain indexed to inflation.

#### INVESTMENT FUND PROJECTIONS

The government has projected, based on "prudent assumptions," that the new fund will generate an average long-run return of 3.8 percent above inflation. Within a few years, the investment board is expected to become the country's largest stock-market investor. The total CPP account is projected to grow from \$37 billion at the end of 1997 to about \$90 billion at the end of 2007; of that amount, \$60 billion to \$80 billion would be available for management by the board. By 2017, the investment fund is expected to have amassed a reserve of roughly five years' payout, compared to the current two years' worth of benefits, moving the CPP from a pay-as-you-go system to a more fully-funded one.

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Chairman SHAW. Thank you, Dr. Reischauer.  
Dr. Weaver.

**STATEMENT OF CAROLYN L. WEAVER, PH.D., DIRECTOR,  
SOCIAL SECURITY AND PENSION STUDIES, AMERICAN  
ENTERPRISE INSTITUTE; AND FORMER MEMBER, 1994-1996  
ADVISORY COUNCIL ON SOCIAL SECURITY**

Ms. WEAVER. Thank you, Mr. Chairman.

In current discussions of investing Social Security in the stock market, the choice between centralized investment and personal accounts is sometimes portrayed as a choice between two different investment policies, two ways of skinning the same cat and improving investment returns for workers.

When viewed in this way, the debate quickly turns to administrative structures and costs. And then it seems logical to some to go with centralized investment because it would appear easier and quicker and cheaper than turning the problem over to 100 million or more people.

While administrative structures and costs are worthy of careful attention, in my view, they distract attention from the more fundamental issue, which is whether centralized investment, even if cheaper and perfectly managed—and I used quotation marks on the word cheaper—can deliver the range of economic benefits offered by a system of personal accounts? Economic, social, and political benefits, I should say.

I believe the answer is no. In my written testimony, I identify some of the key differences between centralized investment and personal accounts and highlight the benefits of personal accounts that I believe cannot be achieved through centralized investment. I will briefly summarize those now.

First, personal accounts offer the prospect of higher rates of return and more secure retirement incomes for younger workers and future generations. Centralized investment offers the prospect of more revenue for the trust funds, with no assurance that enhanced revenues will flow back to benefit any particular worker or cohort of workers.

Second, personal accounts are built on private ownership. Workers would own their contributions and investment earnings. Centralized investment would not change the statutory basis of workers' claims to future benefits in any way.

Third, personal accounts would allow low-wage workers to accumulate financial wealth through Social Security and share in the benefits of capital ownership. With centralized investment, Social Security would continue to offer all workers long-term benefit promises.

Fourth, personal accounts would reduce workers' reliance on government benefit promises and the political risk to which their retirement incomes are now exposed. With centralized investment, workers' entire income from Social Security would continue to be politically determined.

In fact, with centralized investments, you would have new margins for political influence, those surrounding investment decisions

on the one hand and, if trust fund reserves are swelled through an investment strategy involving centralized investment, there would be new pressures to increase benefit obligations, the type of pressure that could not come to bear on a system of personal accounts funded with workers' contributions.

Fifth, with personal accounts, it is clear who bears the risks and reaps the rewards of stock market investment. Workers do. These risks would be mitigated by the government safety net that buttresses all proposals for personal accounts. With centralized investments, it continues to be unstated and thus entirely unclear who bears the risks or reaps the reward. Financial risks are present under both systems. Spreading or sharing them through centralized investment cannot reduce or eliminate financial market risk.

Sixth, personal accounts would allow workers to tailor the risk of their investment funds or portfolios to meet their personal needs and circumstances, depending on their age, other private savings, and the like. With centralized investment, the government would impose on workers a level of risk they may be ill equipped to bear. This would be most disadvantageous to low-wage workers.

Seventh, personal accounts would create a system that is fully funded at all times and immune to the vagaries of uncertain demographic trends. Centralized investment leaves our quasi pay-you-go system in place and thus leaves Social Security exposed to all of the financial dangers to which it presently is exposed.

Eighth, personal accounts would enhance public understanding about Social Security and facilitate retirement-income planning. Workers would have something they could understand and build upon. Centralized investment leaves Social Security opaque and would have no effect on workers' ability to plan for retirement.

Finally, even as a means of investing in private markets, a system of personal accounts offers clear benefits. It offers an inherently decentralized and highly competitive mechanism for channeling investment funds into capital markets. Centralized investment would require the development of new and untested structures that could withstand political pressures to use the government's control over large amounts of capital investment to affect the distribution of wealth and income in society. This is a tall order and one that I believe cannot be filled.

Before closing, I would like to reiterate and stress a point that Michael Tanner made. There has been a lot of talk about how the Thrift Savings Plan provides a good model for centralized investment and how it is structured to minimize political influence. It is critical to note, however, that the central defining characteristic of the Thrift Savings Plan, which you all well know, is individual accounts that are privately owned. It is a voluntary 401(k)-type plan for Federal workers.

The congressional conferees who crafted that original legislation made clear that it was "the inherent nature of the thrift plan that precluded political manipulation and the private ownership of those accounts," not any particular structure of investment managers and financial safeguards.

Thank you.

[The prepared statement follows:]

**Statement of Carolyn L. Weaver, Ph.D., Director, Social Security and Pension Studies, American Enterprise Institute; and Former Member, 1994–1996 Advisory Council on Social Security**

In current discussions of investing social security in the stock market, the choice between centralized investment and personal retirement accounts is sometimes portrayed as the choice between two investment strategies—two ways of improving investment returns for workers—in effect, two ways of skinning the same cat. When viewed in this way, the debate quickly turns to administrative structures and costs. It then seems quite natural, to some at least, to conclude that a government-controlled investment strategy makes sense since it would seem to be easier, quicker, and cheaper than turning the problem over to 100 million or more people.

While administrative structures and costs are worthy of careful attention, these issues distract attention from the more fundamental issue: In particular, can centralized investment, even if “cheaper” and perfectly managed, deliver the range of economic benefits offered by a system of personal accounts? I believe the answer is no.

In the testimony that follows, I identify the key differences between personal accounts and centralized investment, highlighting the benefits of the former approach that can not be achieved with the latter. To avoid confusion, I use the term “personal accounts” to mean a system of personal retirement accounts that are owned by workers, fully funded with a share of their payroll taxes, and invested in private stocks and bonds. By “centralized investment,” I mean a government-run program of investing a share of trust fund reserves directly in stocks, where the government, or its appointed board, decides how much of the reserves to invest in stocks, which investment classes or funds to invest these monies in, which financial institution(s) to rely on to manage how much of the social security portfolio, and how proxies are voted, among other important matters.

The key differences between personal accounts and centralized investment are these:

- Personal accounts offer the prospect of higher rates of return and more secure retirement incomes for younger workers and future generations. Centralized investment offers the prospect of more revenues for the trust funds.

- Personal accounts are built on private ownership: workers would own their contributions and investment earnings, and typically could pass any balances along to heirs. Centralized investment would not change in any way the nature of workers’ claims to future benefits, which is statutory at base, not contractual.

- Personal accounts would allow low-income workers to accumulate financial wealth and to share in the benefits of capital ownership. With centralized investment, social security would continue to offer workers, high- and low-income alike, long-term promises by government.

- Personal account would reduce workers’ reliance on long-term benefit promises and the political risks to which their retirement incomes are now exposed, risks that currently-scheduled benefits will not be met in full when they come due. With centralized investment, workers’ retirement incomes from social security would continue to be politically determined.

- With personal accounts, it is clear who bears the risks (and reaps the rewards) of stock market investment—individual workers do. These risks would be mitigated by the design of the government safety-net that buttresses all proposals for personal accounts. With centralized investment, it is unstated and thus entirely unclear who bears these risk (or reaps the rewards). Financial risks are present under both systems. “Spreading” or “sharing” risks through centralized investment can not reduce or eliminate them.

- Personal accounts would allow workers to tailor the riskiness of their investment funds to their personal needs and circumstances—their willingness and ability to take risk, given their age, their work prospects, their private pensions and other savings, and other important factors. With centralized investment, the government would decide how much risk workers must bear through social security. This would be most disadvantageous to low-wage Americans.

- Personal accounts would create a system that is fully funded at all times and immune to the vagaries of uncertain demographic trends. Centralized investment leaves our quasi pay-as-you-go system in place, and thus leaves social security exposed to all of the financial dangers (and thus political uncertainty) to which it presently is exposed.

- Personal accounts would depoliticize social security to a considerable extent. Centralized investment would have no effect on the political nature of social security’s benefit and tax structure and yet would create many new margins for political

influence—those surrounding investment decisions—and, by swelling trust fund reserves, would create new pressures to increase benefit obligations.

- Personal accounts would be consistent with significant pre-funding of social security and with a substantial increase in saving and capital investment. Centralized investment, and the structures necessary to sustain/regulate it, place sharp limits on the extent to which social security can be pre-funded and contribute to national saving.

- Personal accounts would enhance public understanding about social security and facilitate retirement income planning—they would give workers something they could understand and build upon. Centralized investment would leave social security opaque and have no effect on workers' ability to plan for retirement.

- Personal accounts can be structured to respond to the changing needs and circumstances of American women. Centralized investment would have no impact on social security's current (outdated) benefit structure.

This list, which is not exhaustive, is suggestive of the significant benefits that can be expected to flow from a system of personal accounts independent of the benefits of such a system as a pure "investment strategy."

As a means of investing in private markets, personal accounts also offer clear benefits. A system of personal accounts would provide an inherently decentralized, competitive mechanism for funneling investment funds into financial markets, which would allow these funds to flow toward their highest valued uses while spurring the development of new investment products and services for small savers. Centralized investment would require the development of new and untested structures that could withstand political pressures to use the government's control over investment capital to affect the distribution of wealth and income and society. To prevent political influence on investments and on matters of corporate governance, which would undermine the efficiency of capital investment and possibly rates of return on trust fund investments, these structures would have to be capable of withstanding such pressures on a sustained, long-term basis. This is a tall order and one that I do not believe can be filled.

Here it is worth noting that the Thrift Saving Plan for federal employees does not provide a model for how centralized investment could be organized to minimize the risk of political interference, as often suggested by proponents of centralized investment. The Thrift Saving Plan is a voluntary pension plan for federal employees, whose central defining characteristic is that which proponents of centralized investment seek to preclude in social security—individual accounts that are owned by workers. The TSP is the public-sector counterpart to the wildly popular 401(k) plan. Workers decide whether to participate, how much to contribute (up to stated limits), and how to invest their funds among three investment options. (As an aside, the plan has assets that are a small fraction of what social security would need to invest.)

The Congressional conferees who crafted the original legislation made clear that it was "the inherent nature of a thrift plan" that precluded the possibility of "political manipulation." In their words, "...the employees own the money. The money, in essence, is held in trust for the employee and managed and invested in the employee's behalf.... This arrangement confers upon the employee property and other legal rights to the contributions and their earnings."

This is precisely the kind of plan proponents of personal social security accounts would like to see offered to the rest of American workers, one based squarely on private ownership and real capital investment. Whether the government should administer the accounts or narrow the investment options so sharply (the typical participant in a 401(k) plan has six or more options) are matters worthy of debate, but they are of secondary importance to establishing a plan that gives working men and women the opportunity to accumulate real financial wealth through social security—an opportunity that would be denied with centralized investment.

Ultimately, the debate about whether the government should invest in private equity or individual workers should be allowed to do so boils down to the question of whether workers will be allowed to build financial wealth through social security and to capture the benefits of stock market participation. With centralized investment, it doesn't matter how many "fire walls" you build, how "independent" the investment board is, or whether the government subcontracts with one or ten firms to manage one or ten funds, at the end of the day, workers would still accumulate benefit promises to be made good by future taxpayers, rather than investment funds of their own. While proponents of stock market investment—both those endorsing personal accounts and those endorsing centralized investment—agree on the higher expected returns to stocks and on the associated risks, we part company on the question of whether these risks should be made explicit, whether workers or the government should decide how much risk to take, and whether workers or an ac-

count in the federal treasury should capture the higher expected returns to risk taking.

CONCLUSION

Changes in the economic and demographic landscape since the 1930s create the need—and the development of modern financial markets creates the opportunity—to transform social security into a vital program that is of economic value to the workers it covers and to the nation as a whole. U.S. financial markets, which channel literally trillions of dollars each year into productive investments, have developed a wide range of investment products and services attractive to ordinary working men and women. Allowing workers to invest a portion of their social security taxes in private capital markets and to draw on these products and services to build retirement protection holds the potential for not only enhancing retirement income security but also generating a stronger national economy in the twenty-first century. The time is right to move away from our low-yielding system of income transfers toward a system of true retirement pensions—personal retirement accounts fully funded with a share of workers' payroll taxes.

Chairman SHAW. Thank you, Dr. Weaver.

Mr. Goldberg, if you would correct my pronunciation of your law firm, I would appreciate it.

**STATEMENT OF HON. FRED T. GOLDBERG, JR., SKADDEN, ARPS, SLATE, MEAGHER & FLOM, LLP; FORMER COMMISSIONER, INTERNAL REVENUE SERVICE; AND FORMER ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY**

Mr. GOLDBERG. Skadden, Arps is fine, Mr. Shaw. Thank you very much.

Chairman SHAW. Thank you.

Mr. GOLDBERG. I believe there are three keys to Social Security reform. First, and most important, is keeping faith with current retirees and those about to retire. Second, is maintaining the basic defined benefit structure and enhancing the Social Security safety net. And third, is providing for a universal system of private retirement accounts.

You and your colleagues who endorse PRAs, private retirement accounts, as part of an effort to preserve and protect Social Security are right on the mark. PRAs should plan an important role in shoring up Social Security but they are so much more. They will be of most benefit to low-income workers, blue collar union members, single parents, working mothers, and minorities. And they will create the universal infrastructure for future policies to create wealth and opportunity for all Americans.

Now, I agree with those if you direct government investment in the markets is a bad idea. Since Dr. Reischauer already has been ganged up on, I will forgo the opportunity to beat on what I hope is a very dead horse.

The question that I would like to talk about is that private accounts may be a terrific idea, a terrific policy, maybe good politics, but at the end of the day the question is whether it's possible to institute a workable system. Since testifying before this Subcommittee last year, I have had the pleasure of working with Professor Michael Graetz of Yale Law School on a paper that addresses in detail the design of a workable system of private accounts. A copy of that paper, which is prepared under the auspices of NBER,

National Bureau of Economic Research, Inc., accompanies my testimony.

By building on an existing system, universal private accounts can be implemented in a way that minimizes costs, distributes those costs fairly, imposes no additional burden on employers, meets the expectations of participants for simplicity, security and control, and is flexible enough to accommodate a wide range of policy choices, and can accommodate changes in those policy choices over time.

Due to time constraints, I won't begin to try to describe the system we have laid out in the paper. I would be happy to answer questions. I would also be happy to work with you and your staff on implementation issues. My testimony addresses three particular comments and suggestions we have received dealing with flexibility and the like in the light of the hearing this morning, I would like to mention two topics briefly not covered in my written testimony.

The first has to do with Secretary Summer's comments about the alleged cost of private accounts. He indicated that those accounts could cost as much as "20 percent." While I'm not sure of the analysis that he has gone through, I believe what he is doing is taking all of the costs to administer a given year's contribution over a 40-year period and summing those costs back to the present without discounting. Now, the math may be correct, but that in my judgment is a misleading statement.

If you work through his numbers and if you work through the numbers of those who have looked at the cost of administering private accounts, including those who question the wisdom of that policy on the merits, I believe the universal view is that a simple system of private accounts that provides workers with some reasonable modicum of choice, safety, and security, and ease of understanding can be implemented for a cost of under 50 basis points a year spread across all accounts. It can be done in a price-effective way.

Second, unfortunately, Mr. Matsui has left, but I would like to comment very briefly on the study he referenced about how private accounts will benefit no one. It is a terrific study. It demonstrates that with the right assumptions, you can prove the world is flat. They assume complete privatization, they assume all of the burdens of transaction costs are imposed on low- and middle-income workers, and, gee, there's a problem, right. Well, the Earth is 6 inches by 6 inches and 1 inch deep across. It is a flat square. And the reason I mention that is that in this discussion it's important to look at assumptions. It is very easy for any of us at this table to take any proposal, make up the assumptions, and conclude there is no way it's working.

We assume the government's going to pick and choose individual stocks. That's a terrible idea. You have, I think, honestly tried to come up with safeguards. And if this is going to work, I think it's important to get beyond the kind of outlier, assume ridiculous assumptions that prove it won't work and get back to the center, where the program can be discussed reasonably.

I am absolutely convinced that thanks to public- and private-sector systems and information technology, it is now possible to implement a system of private—a universal system of private ac-

counts that minimizes costs, distributes those costs fairly, imposes no additional burden on employers, and meets the expectations of everyday Americans and can accommodate whatever policy choices you collectively make with respect to funding, with respect to voluntary add-ons, with respect to tax-incentive-based add-ons, with respect to guaranteed minimum benefits. The technology is there to make private accounts work.

This wasn't true 20 years ago, and it certainly was not true in 1935. When we talk about the difficulty of private accounts, it's important to put those questions in perspective. In 1935, there were no Social Security numbers, there were no payroll taxes, there was no computer-based financial infrastructure, all records were entered and maintained by hand. And yet they made Social Security work. By comparison, private accounts are easy.

If you go back, and you read the debates in the thirties, those who opposed private accounts are using exactly the same kind of arguments used by those who opposed Social Security in 1935.

Thanks to your leadership, thanks to the leadership of the administration in coming out with a specific set of proposals, many of which I disagree with. But they had the courage to come out with something. It is now possible to craft a bipartisan package that maintains defined benefits, protects current retirees, and has a universal system of private accounts.

The question should be debated on the merits. Those who oppose private accounts should not hide behind the excuse of administrative costs.

Thank you very much.

[The prepared statement follows. The "NBER Working Paper Series" is being retained in the Committee files.]

**Statement of Hon. Fred T. Goldberg, Jr., Skadden, Arps, Slate, Meagher & Flom, LLP; Former Commissioner, Internal Revenue Service; and Former Assistant Secretary for Tax Policy, U.S. Department of the Treasury**

Mr. Chairman and Members of the Committee, it is a pleasure to appear today on the subject of investing Social Security funds in the private capital markets. I have three observations:

#### PRIVATE ACCOUNTS

There are three keys to Social Security reform: (i) keeping faith with current retirees and those about to retire; (ii) maintaining the basic defined benefit structure and enhancing the safety net; and (iii) private retirement accounts (PRAs). You and your colleagues—Republicans and Democrats, Representatives and Senators—who endorse PRAs as part of an effort to preserve and protect Social Security are right on the mark. You deserve public respect and support for your wisdom and courage in embracing a concept that was political heresy only several years ago. While PRAs figure prominently in the debate over Social Security, they are much more. PRAs will be of most benefit to low income workers, blue collar union members, single parents and working mothers, women and minorities; they will also provide the infrastructure for policies to create wealth and opportunity for all Americans.

#### DIRECT GOVERNMENT INVESTMENT

Second, I agree with those who view direct government investment in the markets as a bad idea. All human experience teaches us that government is certain to misuse its ownership of private capital. Maybe not today, maybe not tomorrow, but someday for sure. Those who cite experience with the Thrift Savings Plan as proof that the government can make direct investments without political interference should know better. Their failure to cite contrary state experience is, at best, misleading. It's also downright silly to suggest that what has been true (perhaps), must always be true. Most importantly, they fail to acknowledge the obvious—individual

workers own their Thrift Savings Plan accounts. It's theirs. The funds don't belong to the government. This is a primary reason why, at least to date, the Thrift Savings Plan has been able to resist pressures for politically correct investment policies. The Plan is not investing the government's money; it's investing the workers' money.

#### A WORKABLE SYSTEM

Third, PRAs may be great policy, but the question is whether it's possible to implement a workable system. Since testifying before this Committee on the subject of private accounts last June, I have had the privilege of working with Professor Michael Graetz of the Yale Law School on a paper addressing in detail the design of a workable system of private accounts. That paper is being published in a forthcoming volume of papers presented at a conference sponsored by NBER. A working draft of our paper accompanies my testimony.

By building on existing systems, universal PRA's can be implemented in a way that: (a) minimizes costs, and distributes those costs fairly; (b) imposes no additional burden on employers; (c) meets the expectations of participants for simplicity, security and control; and (d) is flexible enough to accommodate a wide range of policy choices, and changes in those choices over time.

Due to your time constraints, I won't describe the system we have proposed, but would be happy to answer any questions you have. We would also be happy work with you and your staff on implementation issues. In light of recent events and comments we have received, however, I would like to mention three matters: (i) the need for flexibility, (ii) the role of the IRS, and (iii) workers' investment options.

#### THE NEED FOR FLEXIBILITY

The wide range of policy recommendations that have surfaced during the past year demonstrate that flexibility should be the hallmark of any system for implementing private accounts. With this in mind, the approach described in our paper would accommodate any of the policy choices listed below (reflecting a wide range of proponents), and would also accommodate changes in those policies over time:

- funding through a carve-out of payroll taxes
- funding from general revenues
- integrating Social Security's traditional defined benefits and the returns generated by private accounts (with or without guarantees)
- using general revenues to fund universal private accounts outside the four corners of Social Security
- any type of funding formula (for example, a fixed or progressive percent of covered wages; a fixed or phased-out flat dollar amount)
- integrating private accounts with existing retirement plans or accounts
- voluntary additional contributions
- tax incentives to encourage additional contributions
- spousal rights (at the time accounts are funded, on divorce, or at distribution)
- a wide range of investment options and payout alternatives.

While each of us has his or her own views on these policy questions, the key is that the implementation of private accounts should accommodate any of these choices—and, *equally important, should accommodate changes in these choices over time*. The system described in our paper meets these objectives.

#### ROLE OF THE IRS

The IRS receives substantially all of the information necessary to set up and fund private accounts, and we have recommended that workers select their investment options on forms filed along with their tax returns. We believe this approach minimizes the burden on workers, places no burden on employers, minimizes delays in funding, minimizes costs to the Federal government, and maximizes flexibility (*e.g.*, progressive funding and tax incentives for voluntary contributions).

It is important to make clear, however, that under the system we describe, participants would not deal directly with the IRS on any matters relating to their PRAs. Likewise, the IRS would not be involved in any way in the ongoing administration of accounts or providing information to participants.

We do not share the concern that some have expressed over "perception" problems if workers make investment elections on their tax returns. These concerns, however, should not be a barrier to the implementation of PRAs. While the IRS already collects most of the information necessary for setting up and funding PRAs, the idea of having the IRS share that information with another Federal agency (such as So-

cial Security) with responsibility for setting up and funding private accounts may be worth exploring.

#### WORKER INVESTMENT OPTIONS

Most commentators have recommended one of two approaches to providing for investment options. Some have suggested using a Thrift Savings Plan model, where workers would be offered a limited number of investment alternatives that is easy to understand, limits risk, and won't cost much. Others have rejected this approach and have suggested instead that workers invest in qualified funds sponsored by the private sector. For the reasons summarized in our paper, we have rejected this "either-or" approach, and have concluded that a two-tier system is preferable. Workers should be permitted to invest in a limited number of low cost options sponsored by the Federal government and administered by the private sector—workers should also be permitted to invest in qualified funds directly sponsored and managed by the private sector, subject to appropriate regulation.

#### CONCLUSION

Thanks to private and public sector systems and information technology, it is now possible to implement a system of universal private accounts that minimizes costs and distributes those costs fairly; imposes no additional burden on employers; meets the expectations of everyday Americans for simplicity, security and control; and can accommodate a wide range of policy choices. This was not true twenty years ago—and surely was not true in 1935 when Social Security was first enacted. Which brings me to my final observation.

As noted in our NBER paper, it is important to put the administrative challenge of private accounts in perspective. Recall what the world was like when Social Security was enacted. There were no Social Security numbers. There was no payroll tax withholding. Many Americans didn't have a telephone. There were no computers—information was entered by hand, records were maintained on paper, correspondence was delivered by mail. There was no computer-based financial infrastructure. Implementing Social Security under those conditions was hard; by comparison, implementing universal private accounts would be easy. Those who oppose private accounts today sound much like those who opposed Social Security in 1935.

Thanks to your leadership—and thanks to the Administration's leadership in coming forward with its proposals—bi-partisan action can lead to a universal infrastructure for the creation of private wealth that will benefit all Americans, especially those who've been left behind and those who are struggling to make ends meet. Some may oppose that policy, but they should do so on the merits, not hide behind the excuse of administrative costs.

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Chairman SHAW. Well, thank you, Mr. Goldberg, and thank this entire panel. We will recess. Those of you on the panel that can remain with us, we would appreciate it so that our Members can ask questions that might be on their mind or make traditional speeches, as we very often do.

As to the final panel, if for some reason you cannot remain with us, your full testimony would be made a part of the record. But we are hopeful that you will be able to stay and deliver it to us in person.

We will now recess for 1 hour. We will reconvene at 1 o'clock in this room.

[Whereupon, at 12 noon, the Subcommittee recessed, to reconvene at 1 p.m. the same day.]

Chairman SHAW. I apologize. The delay was outside of my control. I apologize to you, Mr. Matsui, and to the witnesses. Would you care to inquire?

Mr. MATSUI. Thank you, Mr. Chairman. That was quick.

Let me ask—Mr. Goldberg, I'm sorry I wasn't here for your testimony. I had to go out, but you were somewhat critical and con-

cerned with the National Committee To Preserve Social Security's testimony or at least their study. Could you just very quickly reiterate, if you had reiterated, or restate your concerns. And, again, I apologize. I wasn't here.

Mr. GOLDBERG. Mr. Matsui, my ill-mannered comment was—

Mr. MATSUI. You are never ill-mannered, but just go ahead.

Mr. GOLDBERG. They basically—it demonstrates that if you make the correct assumptions, you can prove the world is flat. And essentially, if you look the modeling that they did, in terms of the underlying assumptions, for example, immediate and complete privatization, imposing all transition costs on low-income workers, eliminating survivability of the assets in event of early death, they have managed to design a system that screws just about everybody. But that is not the point of the exercise. The point of the exercise is to look for systems that meet the needs of low-income workers and middle-income workers and families where the income earner dies at a relatively early age. And I think that it reflects a problem in the discussion generally, that if the object is to prove, design a system that doesn't work, all of us can do that very well.

Mr. MATSUI. Don't get me wrong. I want you to have as much time as you want. My time is somewhat limited, although there's only two of us here. So maybe not. [Laughter.]

Let me ask you, though, now I haven't reviewed your plan, but just taking the basic assumptions that are made in the National Committee's study, one is that there is a unfunded liability.

Mr. GOLDBERG. That's correct.

Mr. MATSUI. And that unfunded liability, from what I understand from Mr. Reischauer—no, I guess it was either Mr. Aaron or Mr. Reischauer who said it could be anywhere from \$3.5 trillion to \$8 trillion. And I know that Secretary Rubin has said it is \$8.5 trillion, and he didn't give a range, he just said \$8.5 trillion.

These numbers are so large it's hard to even amortize, but the individual who came from the American Enterprise Institute, Ms. Weaver, I believe it was, she tries to amortize this unfunded liability, although she doesn't state what the amount is. And she comes to the conclusion that over 75 years you have to increase payroll taxes by 1.52 percent. How do you propose doing it with your private accounts?

Mr. GOLDBERG. Mr. Matsui, in terms of the testimony today, what I was talking about was a much more pedestrian set of questions about could you do private accounts at all. I think that is an important question.

Mr. MATSUI. So OK—

Mr. GOLDBERG. But now once you get to the funding issues you are raising, the way I see things unfolding at this point is that the administration and, on a bipartisan basis, majority of the Congress have concluded that somewhere around 60 percent of projected surpluses over the next number of years should be used to help bolster or shore up Social Security.

And I think we get into all sorts of arcana about accounting and double accounting. I think that is too confusing for people. The way I understand what is being said, is we are going to take general revenues over the next number of years and use those general revenues one way or another to try to shore up the Social Security

Program by investing in the market or by transferring Treasury IOUs or setting up private accounts. I believe that that 60 percent of the projected surplus would go a long way to solving the actuarial problem.

Beyond that, it is my judgment that at the end of the day, other choices are going to have to be made on the revenue side or on the benefits side. But I'm not sure the political process can get there yet. But the 60 percent gets you a long way down the road.

I would get there by using them to fund a private accounts system for all the reasons I have said. I think the benefits of private ownership, the ability to craft policies to help low- and middle-income workers—the benefits there are so overwhelming, that is the direction I would go in using the surplus. At the end of the day, I think we are all going to have to make some choices.

Mr. MATSUI. Let me say this, Fred. One of my problems, and I again don't know if you have a complete plan in that pamphlet you showed. You do or don't?

Mr. GOLDBERG. It is just the plumbing. Just how to make them work.

Mr. MATSUI. I will tell you what my problem is. And it's great. I understand what you are saying now, and I apologize for not having been in the room when you testified.

My real problem is, if you are saying that private accounts are good versus the current system, I suppose if you were setting the system up from scratch and you didn't have the unfunded liability and a few other things, maybe you can even make that case, but that's in a vacuum. Right now you have such little things as survivors benefits, you obviously have disability benefits. Obviously, we are not addressing in your pamphlet those issues, and no one is expecting you to, but talking about private accounts, individual accounts, in a vacuum is like taking the President's program and saying because it has deficit reduction it's a great plan. But you have got to look at the overall plan.

See, that's where part of my frustration is. Not at you, but just generally in discussing private accounts. My time is running out but I want to ask Representative Baronian this question: I know that in Connecticut when Colt Manufacturers did get a rather sizable investment from the pension program, there was a significant amount of interference mainly because of the way the pension system was set up. I don't know if it currently still is, but the Governor and the Treasurer, who are elected officials, had a significant role. And they, in other words, had almost the legal ability to interfere. In the PERS, California Public Employee Retirement System, back in the seventies there was a problem when Treasurer Unruh was the State Treasurer, but they really straightened that out through legislation.

And you will find that the PERS system in California is pretty free of political interference. Now maybe you haven't done that yet in Connecticut. Maybe you have cleaned it, maybe you have made the changes after the Colt issue?

Ms. BARONIAN. Well, I have to say I think that they did do some, but as far as I know—for instance, they have another investment, \$100 million investment in a piece of real estate in downtown Hartford that still hasn't produced any returns at all. But what I'm say-

ing is, is that I don't think there's been too much done. They had a Connecticut programs fund, and that's where this money came out of within the treasury.

I do believe that they still could interfere with—

Mr. MATSUI. Let me just say this. I believe somebody said this at one of the hearings we were at—that I suppose you could even interfere with the Federal Reserve Board if we had the political will and wanted to make a scene about it. So, if you are saying that anything can happen, I agree with you, anything can happen. But what Mr. Reischauer and Dr. Aaron and a number of others are working on is a way to come up with a structure for government investment in the equity markets, a fail-safe system that will result in political repercussions if, in fact, you violate it.

And that is why we don't mess around with the Chairman of the Federal Reserve Board. There have been attempts over the last decade to influence him, but we get criticized for that, so we back down. What you want to do is set up a system where the political process will insulate the fund managers and the investment bankers from that process.

Now maybe in Connecticut you don't have that. I believe we do in California.

Ms. BARONIAN. Well, California has a highly sophisticated method. I don't believe that the Federal Government would—I would like to think that they could—but I doubt it.

Mr. MATSUI. Anybody could make that kind of a statement: I wish it would happen but it doesn't happen.

Ms. BARONIAN. I don't think you can insulate a board that is going to be appointed by politicians. And the Federal Reserve has enjoyed hands off with the exception of, probably, Richard Nixon, who wanted to do something in 1972.

But it could happen. And things change. Unless it's in the Constitution, legislation can be retracted, corrected, and so forth.

Mr. MATSUI. I don't want to belabor this because we are going to get circular in our discussion, but even the Constitution could be violated. I mean, I can probably cite instances. So anything can happen as long as human beings are the ones that are conducting life. But the reality is that we are trying to insulate the process, and maybe Connecticut doesn't work, but in other cases we have seen it work.

I just want to thank all of you. I know my time is expired.

Thank you, Mr. Chairman.

Chairman SHAW. Mr. Doggett.

Mr. DOGGETT. Thank you very much. Mr. Tanner, is it your view that ideally we should replace the Social Security system with a system that relies exclusively on individual accounts?

Mr. TANNER. Yes it is, as the primary system. And then I believe that any safety-net system should be funded out of general revenues.

Mr. DOGGETT. Basically, a welfare system for meeting kind of the basic needs of the poorest people in the society?

Mr. TANNER. That's right. We should insist that no senior should ever fall below a minimally acceptable level of retirement. But I believe that the best way to finance such a system is taxing across

all classes of income and all classes of assets, not to focus on a regressive payroll tax as the primary way to do that.

Mr. DOGGETT. Thank you. Mr. Goldberg, do you share that view?

Mr. GOLDBERG. No, sir, I do not.

Mr. DOGGETT. What is your view about the appropriate mix of government involvement and individual decisionmaking?

Mr. GOLDBERG. I think that the defined benefit structure, a progressive defined benefit structure of the current Social Security system is where we have been and where we should stay forever. I think it says something about how we deal with each other and I think it's terrific. I think over and above that, a system of private—a universal system of private accounts that puts in place structure for building private wealth for all Americans is so important. And I think, with all due respect to Congressman Matsui, I think maybe we are being too honest now about all of the numbers, and we are not paying enough attention to the barriers to wealth creation for workers. So I would do both. I would keep your basic program in place—

Mr. DOGGETT. Are your comments to be viewed then as an endorsement of the President's USA account approach?

Mr. GOLDBERG. I think that it is—none of us know what the approach is. I think that in the current environment, I think that the better place to begin is to try to integrate private retirement accounts, a universal system of private retirement accounts, as part of Social Security. I think that is going to be easier to do. I think it is going to put in place a system that is going to be better able to address lots of retirement issues that we run into down the road.

And so I would prefer to link it to retirement.

Mr. DOGGETT. You would take it out of the 12.4 percent? Part of that you would allocate to individual accounts?

Mr. GOLDBERG. I think there are a couple of ways to do it. One is to carve out a proportion 12.4 percent. The other way to do it is to fund them through general revenues. A third way to do them at the end of the day is some combination. And I think that the numbers work better than we are giving them credit for. I personally think that some adjustments in the benefits may ultimately and/or method of revenues need to be addressed. That is heresy at this point, but I think at the end of the day that's going to be part of the truth.

But I think the numbers with the surplus let's you keep a very strong defined benefit program that enhances the safety net at the bottom, let's you fund meaningful private accounts, let's you fund those private accounts on a progressive basis, such as what Senator Santorum's bill—I think you can do it, I think it would be very close.

Mr. DOGGETT. You would have to reduce the defined benefits under the defined benefit program?

Mr. GOLDBERG. I think you may. I think collectively the judgment may be that is a good decision. I don't think you have to do it. If you don't do it, I don't think you are going to get all the way to the end solution. But I think you can get a long way toward the end solution without "cutting benefits" at all. I think you may, as you look at this, you may make the judgment at the end of the day that if the private account piece is a effective enough, you can

make some modest adjustments in terms of accelerating the age change to 67, adjusting the cap—I know these are terrible things to talk about now, and you don't have to do any of them. The point is, you can do none of those, you can use the surplus to create private accounts to give you an infrastructure to deal with issues affecting low- and middle-income workers, and to say we have done terrific work. We are not finished, but we have done terrific work.

Mr. DOGGETT. Let me ask Dr. Reischauer if he agrees with that?

Mr. REISCHAUER. Basically, no. I think that the foundation for retirement income in this country should be a defined benefit program. I would agree with Fred, if we had a defined benefit program now which I thought was overly generous, but the defined benefit program that we do have pays the average new retiree something between \$9,000 and \$10,000 a year, which isn't a tremendous amount of money by anyone's standard. This is given in the form of an annuity, an inflation-protected annuity.

When we move over to private accounts, there is no guarantee that the balances would be annuitized or that there would be inflation adjustment associated with them. And, barring the possibility that we funded them out of new revenues, we would have to cut back on that basic foundation to finance them, that is if we carved them out. Now Fred might be in favor of increasing contributions, as we call them, euphemistically, rather than taxes, to fund his private accounts. That would be a different wrinkle on things. Maybe he and I could reach some agreement over this. But I think what we have now is a very modest and a very essential program that provides society with a lot of benefits as well as individuals with security that couldn't be found through private accounts.

Mr. DOGGETT. Thank you. Thank you, Mr. Chairman.

Chairman SHAW. Mr. Doggett. You don't have to rush there. There's nothing that says that the legislation could not have some safety nets in it itself. I think that the legislation could be drawn in such a way that it would fulfill the three problems that Dr. Summers referred to in his testimony and that you are referring to in yours. These safety nets can be designed by the Social Security system. So clearly, we could answer your objections in those areas.

Mr. REISCHAUER. You could, but a lot of the proposals that are out there don't. And you have to ask some more questions about the pensions that would be provided through private accounts. One of those questions is, how much variability do you want to have in your foundation retirement income program across cohorts and across individuals within any single cohort? In a private account, how much you get out the other end depends critically on what your investment choices have been. We know that some people are risk averse and some are real risk takers. You will find in a private account system that two individuals earning exactly the same amount of money, contributing the same amount to the system but investing in different types of assets, end up with hugely different pensions at the end of their working lives.

Similarly, because of fluctuations in asset values over time, you can find that a cohort that retires a few years after another cohort, could end up with 40 or 50 percent larger or smaller benefits. There is a role for such retirement saving in our society, and I am

not opposed to it. But we do have alternative vehicles. We have private pension plans, we have IRAs, we have individual savings, which, if you want to play that game, we can encourage.

Chairman SHAW. Well, in addition to the investment philosophy of the individual worker, it also would depend on the time picked for retirement. Obviously, in a downturn of the market, there would be some problems. But those we certainly have to address. We don't want to tell a worker who works with his hands that at age 65, 67 or whatever it is, that work a few more years and let the stock market go back up. Obviously, we have got to address those problems and try to anticipate that.

And in that regard, Dr. Reischauer, I would appreciate if you would make a list of all the objections that you would have to the individual accounts so that we might try to address that in any legislation that comes out that uses individual accounts. The more we can learn about the problems, the more warts we can find on our own theories, the more we can anticipate and try to correct them in advance. And the more you can do that, the more you can bring people along in order to try to get a system that answers everybody's problem. I think that would be very helpful.

Mr. Goldberg, we start out by using the surplus. Do you see a day, and if so when would this be, that the FICA tax would be sufficient so that the surplus would no longer be needed to fund the individual retirement accounts?

Mr. GOLDBERG. I don't think you get there, Mr. Shaw. I think that with the demographics, unless you are talking about raising the FICA tax, which I think would be a bad mistake.

Chairman SHAW. No. We are not.

Mr. GOLDBERG. But at the current 12-plus percent, I think they—you are going to end up using, if you don't want to change revenues and you don't want to change benefits, then, as Dr. Reischauer says, you are going to be using general revenues, I believe, for the foreseeable future to cover Social Security, regardless of how you decide private accounts or govern investment.

I don't think you can get there.

Chairman SHAW. Mr. Tanner, do you agree with that statement?

Mr. TANNER. Yes, I think that you end up in a situation in which you have demographics down the road that an unfunded liability that Alan Greenspan estimates at \$9.5 trillion. So everybody's got a different number. But you have a sufficient unfunded liability that the surpluses you have projected until 2013 will not be enough to deal with that.

Chairman SHAW. Let me see if I have asked the right question. And that question is, that obviously the FICA tax is going to be necessary to continue to fund Social Security system for those that are already in it, who don't have time to build up any individual retirement account. There will come a time when the individual retirement accounts would become the larger supporter of the retirees. Do you see a situation down the line where the FICA tax, having paid over the period of a working career, would be sufficient to invest in these equities so that the surplus would be freed up? That's the question.

Mr. REISCHAUER. We seem to have a little bit of role reversal going on here. I think your question is, If somehow we could ab-

solve ourselves of the unfunded liability—pay for it through income taxes or something else—and say to every 20-year-old entering the system, we will guarantee you a disability insurance policy and you will contribute into a private retirement account, would you need a payroll tax as high as 12.4 percent to achieve expected benefit levels 40 years from now? You would need one much lower tax rate.

Chairman SHAW. You what?

Mr. GOLDBERG. You would need a lower—you wouldn't have to have 12.4 percent. It could be a much lower number.

Chairman SHAW. You can see that the FICA tax actually could be lowered after a number of years if we create individual retirement accounts.

Mr. GOLDBERG. But I assume that the \$9 trillion of unfunded liability was lifted off the system's back somehow. And that is a huge assumption.

Mr. TANNER. One caveat, though, when we are talking the \$9.5 trillion unfunded liability. That is to preserve the current system. If you move to a system of individual accounts, where you stop incurring additional debt as of whatever date you set, that unfunded liability is actually less than the \$9.5 trillion.

Chairman SHAW. It would go down in time.

Mr. TANNER. You wouldn't accumulate—

Chairman SHAW. The transition period is going to be tough. There's no question about that.

Mr. TANNER. Absolutely. That's a cost that you have run up regardless. The cost of moving to the private system should not be looked at as a net new cost when you compare it to the total unfunded liabilities within the current system. It is a actually a smaller cost. In many ways you could liken it to refinancing your mortgage, where, if you pay your points up front, it is certainly painful to have to do that this year, but in the long run, you pay out a lot less because you have gotten a lower interest rate. This would be roughly the same thing. You would have to move forward in many of those expenses and pay them the next 25 or 30 years, but the total amount that you pay out will be less under any scenario.

Thank you.

Chairman SHAW. Mr. Cardin.

Mr. CARDIN. Thank you, Mr. Chairman. I appreciate all of your appearances here today. I think that last round of questions is very misleading in many respects. And that is, the unfunded liability reflects the current situation. If we were to try to set up private accounts, or private plans, or a private system, you need to deal with the current liabilities. You are not going to put away enough in reserve to deal with that, and if you then take away from the 12.4 percent that currently is paid into the Social Security trust system, you are either going to be increasing your unfunded liability or you are going to change the system for the people who are currently in the system, which means reduced benefits.

Mr. TANNER. Only in the short term. In the long term, it would be less. For example, if you allowed me out of Social Security today into a private system, you would no longer be accruing unfunded

liability to me, which go on every day that I live and pay into the Social Security system. There's an increase in unfunded liability.

Mr. CARDIN. If I am 60 years old, and you are saying, Gee, I can now go into this new system, thank you, and if I don't go into the new system, you are only going to get a 20-percent reduction in benefits or some other amount in order to make these figures right, that isn't much of a deal for me, at 60 years of age.

I understand your point, but I think we make too light of the fact of the unfunded liability. It is not as simple, say, if we just got rid of it. You can't get rid of it, number one. And number two, it affects people at different age brackets differently because there are people who are very young, yes, who could benefit if they do what you say, but most Americans aren't in their twenties and thirties today.

Most Americans are working and have already paid into the Social Security system and are expecting some benefits from what they have paid into the Social Security system. And in addition to dealing with that age group, you have to figure out how to deal with the unfunded liabilities, and if we start diverting from the concept that current workers pay primarily for people who are retired, it presents a whole set of transitional problems.

Mr. TANNER. What I'm suggesting, Congressman, is that that cost you have to bear regardless of whether you move to a privatized system or whether you try to preserve the current system. The difference is, in the long term, it will always be less to move to a privatized system.

Mr. CARDIN. But it is complicated if you take out a dime of the 12.4 percent that currently goes into the system. It just makes it that much more difficult to meet the future liabilities for every dollar you take out of that system.

Mr. REISCHAUER. Can I just put a footnote onto this without taking away from your time? [Laughter.]

I disagree with Michael that it would be less in a privatized system. There are two questions here. Are you going to increase the funding of the system be it privatized or collectivized? And second, what are you going to allow the reserves, be they held in private accounts or collectively, be invested in? If you give Social Security the same freedom to invest in a broad spectrum of assets, it is not cheaper to do this through private accounts than it is to do it collectively. In fact, just the reverse would be the case because administrative costs would be less for a collective system than for a individualized system.

Mr. CARDIN. I appreciate that.

Fred Goldberg, I first thank you for—and I have deep respect for your views, although I do take issue with your citing of the thrift-savings plans as being somewhat irrelevant to all of our discussions here today on collective investments. And I am somewhat amazed at the concern for collective investments by the trustees to get a better return for the Social Security system collectively.

Because it seems to me that is just about risk free as far as the system is concerned. Over time, they are going to do better, and everyone acknowledges that they will do better. And as far as manipulation, you sort of dismissed the thrift savings plans, which could be a vehicle for mischief, and has not been a vehicle for mischief. And you sort of dismiss the recommendations made by Treasury

that in setting up these accounts, there would be a Federal Reserve-type firewall created and that there would be private investment counselors who would make all the investments and they could only invest in indexed, generic funds.

Why are you so concerned about that?

Mr. GOLDBERG. I really do respect Dr. Reischauer and the administration's efforts to create these firewalls. And I think that you don't sort of make up arguments to blow them away. It is my judgment and observation that at the end of the day, despite all of the good faith and all of the efforts that are put into place to build the firewall, I believe someday, sometime there will be efforts to breach that firewall. I believe the efforts to breach that firewall can, in many respects, be as harmful as an actual breaching of that firewall because of the market uncertainties that they create.

Mr. CARDIN. But it would require a change in underlying law, which any Congress can always change any law at any time. It can change Social Security at any time. We always run that risk that even if we develop whatever plan we want to, the next Congress might change that plan. Nothing is ever in concrete, and I agree with you that nothing is ever in concrete.

But if we build these protections in the basic law that we create, it just seems to me there is something wrong about saying that we have trustees of the Social Security system and we don't let those trustees do what any other fiduciary would do, and that is, mindful of the purpose of the fund, mindful of safety, maximize the return to the system. And we don't let our trustees do that. That seems contrary to a fiduciary responsibility. That seems like we are manipulating.

Mr. GOLDBERG. We are going around in circles. I believe that there is a measurable risk that at some point in time the government will misuse those funds, and I believe history tells us that is actually close to a certainty. But there is a second point here that I personally feel more strongly about. This is the one chance I believe we collectively, the country, will have to make a choice about our collective retirement system. And I believe that if we make that choice to say we are going to let the government invest in the markets, and we therefore are choosing not to create——

Mr. CARDIN. Excuse me, not government, allowing the managers or trustees——

Mr. GOLDBERG [continuing]. The Dr. Reischauer system, we are going to go with that system and there is going to be no political interference, terrific. I believe that we are making a choice not to create an infrastructure that will let us build wealth for all Americans. And I think that the opportunity cost in saying we are comfortable with these safeguards and therefore we are going to rely on IRAs and Keoughs and employer plans and private savings, we will leave 20 to 30 to 40 percent of the American people behind forever. And I think this is the once chance to say, let's not leave them behind.

Mr. CARDIN. I think we are in agreement. We are in agreement. I think we have to strengthen the proposal that the President has come in with the universal savings accounts. I think we have to make that much more available to all wage earners, particularly lower wage earners, so that we do get private savings and retire-

ment from private wage earners. I think we can do a better job than the President's proposal in that regard. So I think we might be in agreement on that.

But to me that is not inconsistent with preserving the basic concept of Social Security and allowing it to be adequately financed. And to allow it to get a better return to me carries out that objective but doesn't answer your concern and my concern about strengthening income security for all Americans, particularly those at more modest wages. I don't want to lose that opportunity either.

If we just strengthen Social Security and don't deal with the other part, I agree with you.

Mr. GOLDBERG. Take Dr. Reischauer's proposal. Give all workers, in effect, defined contributions—pieces of that single investment portfolio have some kind of guarantee top-out that they don't get what they get. Yes, you are getting pretty close. But it is theirs. They own it.

Mr. CARDIN. I don't want to agree with everything you just said, but I think we are getting closer, and I think that is one of the purposes for these hearings, quite frankly. And I really do congratulate Chairman Shaw because he has been very open to listen to all points of view. And there is certainly a lot of merit to increasing more private savings and retirement for Americans. I agree with you completely on that point, and I don't want to see the debate on Social Security end without us first strengthening Social Security, but also dealing with the issue that you raise.

Mr. Chairman, thank you for your patience.

Chairman SHAW. Thank you, sir. Mr. Tanner.

Mr. TANNER of Tennessee. Thank you, Mr. Chairman. I'm glad we are talking about increasing the national savings rate in whatever form. I have just one question, and apologize for my lack of understanding. But as it relates to individual accounts, I've heard the term "clawback" feature at the end of the workers days, could any of you all explain what is meant by that and how it would operate?

Mr. Tanner.

Mr. MICHAEL TANNER. There are essentially two ways to look at it. You are targeting a certain level of benefits between the private, individual account portion and the government's defined benefit portion. That they would in some way total to a particular level of benefit. And then you can either raise or lower the government portion to reach that level, or you can tax back the private portion to bring it down so that the total level is in some way. But some way it claws back a portion of the benefit from these accounts.

I think it is a poor way to go because it deprives people of the potential higher rates of return that they could get in private investment accounts.

Mr. REISCHAUER. Let me try and add a little bit to Mr. Tanner's—

Mr. TANNER of Tennessee. Yes, I think this is an important point.

Mr. REISCHAUER. Establishing private accounts in and of themselves does nothing to reduce Social Security's expenditures or liabilities. And so some advocates of private accounts have said, well, we will let people build up the balances in their private accounts

and, depending on how big those balances are, we will reduce their Social Security benefit. And that's the clawback.

So in Marty Feldstein's plan, you would reduce Social Security's payment for an individual by \$3 for every \$4 produced by his private account. And this is the way you go about solving Social Security's problem in the long run.

Mr. GOLDBERG. Mr. Tanner, I might add, and I think Bob's description is right. This is not an uncommon mechanism. The notion of integrating defined benefit arrangements and defined contribution arrangements. The private sector does it. For example, they may integrate private-sector retirement plans and Social Security, for example. You can integrate defined contributions—

Mr. TANNER of Tennessee. Well, we have setoffs now in government programs.

Mr. GOLDBERG. You have setoffs now. I think that describing it as "clawback" has this rather harsh notion to it. I think a setoff mechanism or an integration mechanism is a little bit more benign.

Mr. REISCHAUER. Attacks. [Laughter.]

Mr. GOLDBERG. Attacks. That is even uglier in some quarters, but—

Mr. TANNER. There is a difference between two types of proposals, one of which adjusts the government-provided Social Security level of benefits in comparison to the private accounts to ensure that no one falls below an acceptable level of benefit. The other, in essence, penalizes people whose accounts perform very successfully and who get a very high rate of return and claws back a portion of that even in excess of what is necessary to do that. And they use that to fund, in the Marty Feldstein proposal, part of the transition.

Mr. TANNER of Tennessee. Yes, I would like to be around that day when you take \$3 out of every \$4 from somebody who invested wisely and listen to the proponents who say that is all right. I don't know. Thank you.

Chairman SHAW. There is one provision that I would just like to comment on briefly. That is the proprietary interest that people would have in their individual retirement accounts. If we were to go that route, if someone should die prior to receiving the benefits, they would have something that they could leave to their heirs.

Under existing law, there is no vested interest in the Social Security system. It is just faith in the political process that it is going to be there for you. And that faith has been well placed throughout the years. But if you die, you not only lose your life, you lose whatever you paid into the Social Security system with the exception of certain death benefits, which don't compensate you for the amounts that you may have invested.

This type of accumulation of wealth for the lowest income people among us is something that this Subcommittee should consider in its deliberations of reforming the Social Security system.

This has been an excellent panel. I think all of us have benefited greatly by your presence, and we thank you very much. And thank you for waiting past the recess.

The final panel today, is Martha McSteen who is the president of the National Committee To Preserve Social Security and Medicare, former Acting Commissioner of the Social Security Adminis-

tration, and John Mueller, who is a senior vice president and chief economist of Lehrman Bell Mueller Cannon, Inc., in Arlington, Virginia.

We welcome both of you, and thank you for staying with us as long as you have. As with previous panels, we have your full testimony, which will become a part of the record. And you might proceed in the way you see fit.

Ms. McSteen.

**STATEMENT OF MARTHA A. MCSTEEN, PRESIDENT, NATIONAL COMMITTEE TO PRESERVE SOCIAL SECURITY AND MEDICARE; AND FORMER ACTING COMMISSIONER, SOCIAL SECURITY ADMINISTRATION**

Ms. MCSTEEN. Mr. Chairman, Mr. Tanner. As you know, there have been many claims and counterclaims in recent months about privatizing Social Security. For the public, and I'm sure many Member of Congress, the puzzle has been, which claims are solid and sound, and which are less so. More than 1 year ago, the National Committee concluded that the most valuable service we could provide the country and the Congress regarding Social Security was to commission the most rigorous, objective, professional, and exhaustive analysis possible of how privatization would impact this and future generations.

The report we released yesterday, "The Winners and Losers of Privatizing Social Security," uses the most sophisticated computer model in existence, the EBRI/SSASIM model, developed by the Employee Benefit Research Institute and the Policy Simulation Group. I am pleased the author of our report, economist John Mueller, is here to answer your questions about its conclusions because they provide a clear and critical warning about the Social Security reforms you may consider. Some of them, like privatized accounts, sound attractive but the numbers we know now simply don't add up.

Every demographic group alive today would face retirement with fewer benefits under a system of privatized accounts in large part because of the heavy and inescapable costs of financing the transition from Social Security to a privatized system. Women, no matter what age, marital status, employment history, or income level, comprise the largest group of losers from privatization. For African-Americans living today, the average household would lose about half of its retirement benefits under any plan to privatize Social Security.

These are burdens and risks that today's and tomorrow's retirees should not have to bear, Mr. Chairman.

[The prepared statement follows:]

**Statement of Martha A. McSteen, President, National Committee To Preserve Social Security and Medicare; and Former Acting Commissioner, Social Security Administration**

Mister Chairman, Congressman Matsui, members of the Committee, good morning. As you know, there have been many claims and counter-claims in recent months about privatizing the Social Security.

For the public, and I'm sure many members of Congress, the puzzle has been which claims are solid and sound and which claims are less so.

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rigorous, objective, professional and exhaustive analysis possible of how privatization would impact this and future generations.

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I'm pleased the author of our report, Economist John Mueller, is here to answer your questions about its conclusions, because they provide a clear and critical warning about the Social Security reforms you may consider.

Some of them, like privatized accounts, sound attractive, but the numbers—we know now—simply don't add up. Every demographic group alive today would face retirement with fewer benefits under a system of privatized accounts, in large part because of the heavy and inescapable costs for financing the transition from Social Security to a privatized system.

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These are burdens and risks that today's and tomorrow's retirees should not have to bear, Mister Chairman. Thank you very much and I would now like to introduce John Mueller, the study's author, to address the specifics of the report.

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Ms. McSTEEN. I would like now to introduce John Mueller, the study's author, to address the specifics of the report.

John.

**STATEMENT OF JOHN MUELLER, SENIOR VICE PRESIDENT  
AND CHIEF ECONOMIST, LEHRMAN BELL MUELLER  
CANNON, INC., ARLINGTON, VIRGINIA**

Mr. MUELLER. Thank you. Mr. Chairman, Members of the Subcommittee. I appreciate the chance to testify on Social Security reform. I am especially grateful for your openness, Mr. Chairman, in seeking out what you called warts upon the private accounts proposal. And I'd like to tell you about a couple of them that I found.

In fact, I'd like to call the Subcommittee's attention to what I consider to be a serious problem. To anyone who has closely followed the Social Security debate over the years, it's become increasingly obvious that the quality of analysis has lagged far behind the importance of the subject. Congress is being asked to make informed judgments about proposals for sweeping changes that would affect the retirement security of American families for at least a century, yet most studies about who would win and who would lose from such proposals have been seriously flawed.

Claims that most households would fare better if pay-as-you-go Social Security were replaced by individual retirement accounts depend on three basic errors.

First, projections for returns in the financial markets are not consistent with the economic projections for Social Security. One example of that was the 1994 to 1996 Social Security Advisory Council and its report, which projected, as the Social Security Administration does, that future economic growth will be about 1.4 percent, down by almost two-thirds from the past, but that stock market returns would continue at nearly 7 percent on top of inflation.

The model that we used shows that this implies that the stock market would rise over the next 70 years to equal 468 years' worth of earnings. And by the time some of the people in the report re-

tired, it would be selling for 1,063 years' worth of earnings, simply because of the inconsistency between those two sets of forecasts. It is inadmissible to speak of Social Security in the future tense while speaking of the stock market in the past tense.

The second problem, which is also universal, is that examples for winners and losers are typically based on what is called the "unisex flat earnings assumption," which assumes that all workers at every age, men and women, earn the same amount of money, and that this is equal to something called the average wage index. According to Census data, this assumption overstates the average earnings of American women by nearly 100 percent because that simply does not comport with the facts.

The third problem with most studies is that the transition tax inherent in any move away from pay-as-you-go Social Security is understated or even ignored by assuming that funding retirement benefits through general revenues is somehow less costly than funding it through the payroll tax.

To correct these errors, I used an advanced Social Security policy simulation model called SSASIM. This model was developed by Policy Simulation Group, initially under contract with the Social Security Administration, and has been intensively developed through the efforts and in partnership with the Employee Benefit Research Institute. SSASIM is now used by several Federal agencies, including SSA, OMB, Treasury, and GAO, though not, as far as I know, here on Capitol Hill.

The study compares the impact of Social Security reform on those born in four different years: 1955, which is the middle of the baby boom; 1975, the smallest birth year in Generation X; 1990, which is the largest birth year in the so-called echo of the baby boom; and finally, 2025, to show the longer term effect of Social Security reform. I constructed a sample population of 128 individuals based on census data, varying by sex, marital status, earnings, race, and mortality.

I compared benefits and rates of return under three different plans: one plan for complete privatization phased in over one lifetime, and two traditional methods of balancing pay-as-you-go Social Security. Comparing the experience of the four generations under the three different plans illustrates the whole range of policy choices facing the Congress today: everything from balancing the current pay-as-you-go system to various degrees of partial privatization to complete privatization.

I tested four different sets of assumptions, from the most extreme to the most realistic, and conducted 1,000 case random simulations for each household. As for the results, SSASIM shows, as I mentioned, that the low expected returns for Social Security are not due to its pay-as-you-go funding but rather to the assumption of slow future economic growth, which would equally reduce stock market returns. The model shows that future average real returns would have to be about 4.7 percent instead of 6.7 percent. And there is a similar problem with the assumptions for interest rates.

The study also shows, however, that for everyone now alive, your financial market assumptions don't make much difference. Because of the transition tax, every group now alive faces substantial losses from partial or full privatization. Those born in 2025 could gain

only under the most extreme assumptions, that is stock market price earnings ratios surpassing 1,000. All four birth years would be substantially better off with even a scaled back version of the OASI Program than with full or partial privatization.

The largest group of losers is women, including every birth year, income class, and marital status. The only groups avoiding losses under realistic assumptions would be unmarried men and a few high-income, two-earner couples as long as they are born far enough in the future to avoid the transition tax. These groups would break even.

Substantial losers include unmarried women, married couples, especially one-earner couples, and African-American households, among which the largest losses would be for single mothers.

Thank you, Mr. Chairman, I know I have gone over my time slightly. I apologize. I would be happy to answer any of your questions.

[The prepared statement follows:]

**Statement of John Mueller, Senior Vice President and Chief Economist,  
Lehrman Bell Mueller Cannon, Inc., Arlington, Virginia**

Thank you, Mr. Chairman. I'd like to describe for you a new study on "Winners and Losers from 'Privatizing' Social Security" I've just completed. The report is sponsored by the National Committee to Preserve Social Security and Medicare. This is my fourth paper on Social Security reform sponsored by the National Committee.

For the past decade I've been a principal of a financial-markets forecasting firm. I first became involved in the issue of Social Security reform in the 1980s, when I served as Economic Counsel to the House Republican Caucus under Jack Kemp. Like many Reagan Republican conservatives, I began with the conviction that pay-as-you-go Social Security ought to be "privatized." But analyzing the facts and sifting the arguments turned me around. I was surprised to discover that Social Security is one of those cases, like national defense, in which the government is necessary to perform a role that the private markets alone cannot—in this case, providing the "foundation layer" of retirement security. Social Security was never intended to grow so large as to "crowd out" investment in the private capital markets, or the even more important investment in raising and educating future citizens. But the current study clearly illustrates why moving in the opposite direction—"privatizing" Social Security—would be a big mistake.

The current project was undertaken in co-operation with the Employee Benefit Research Institute (EBRI) and Policy Simulation Group. Under Dallas Salisbury, EBRI has performed a valuable service to the nation's debate over Social Security. As part of its Social Security Project, EBRI has helped to develop a Social Security policy simulation model called "SSASIM." SSASIM has been developed by Martin Holmer of Policy Simulation Group, at first under contract with the Social Security Administration, then most intensively in partnership with EBRI. The National Committee recently joined EBRI in its effort to develop SSASIM, by funding two important features that had not yet been incorporated: the model's ability to calculate stock-market returns consistent with long-term economic projections, and to include Social Security benefits for spouses and survivors of covered workers. SSASIM is now arguably the most advanced Social Security policy simulation model in existence. Martha McSteen of the National Committee asked me to use the model to undertake the current study of winners and losers under "privatization."

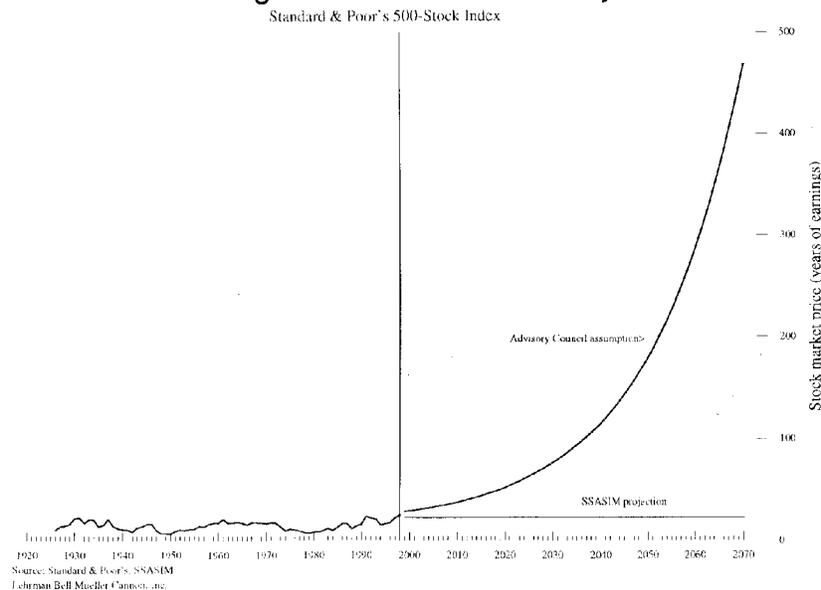
To anyone who has closely followed the debate over Social Security, it has become increasingly obvious that the quality of analysis has lagged far behind the importance of the subject. Congress is being asked to make informed judgments about proposals for sweeping changes that would affect the retirement security of American families for at least a century. Yet most studies about who would win and who would lose from "privatizing" Social Security have been flawed by at least three serious errors.

The first error is that projections for returns on stocks and bonds are inconsistent with projections for Social Security. Projections for Social Security are typically based on the "intermediate" assumptions of the Social Security Actuaries, which envision a sharp slowing of economic growth over the next 75 years—partly on the as-

sumption that the United States will reach “zero population growth.” However, projections for the stock and bond markets are usually based on the past performance of those markets, during a period when the economy and the population were growing almost three times as fast. Putting the two together leads to absurd results. Right now Wall Street is wondering how long the stock market can maintain its record level of about 30 times annual earnings. Under the projections adopted by the 1994–96 Social Security Advisory Council, the Standard and Poor’s 500-stock Index would surpass 500 years worth of earnings in the next 75 years. By the time some of the people in this study retire, each share of common stock would be assumed to be selling for over 1,000 years’ worth of earnings. (See Graph 1.) SSASIM calculates that to be consistent with the Actuaries’ intermediate economic projections, rates of return on common stocks would have to be about 2 percentage points lower than the Advisory Council projected: 4.7% a year instead of 6.7% a year above inflation. In the study I point out a similar inconsistency in the projections for bond yields.

Graph 1

### Price/Earnings Ratio: Actual and Projected

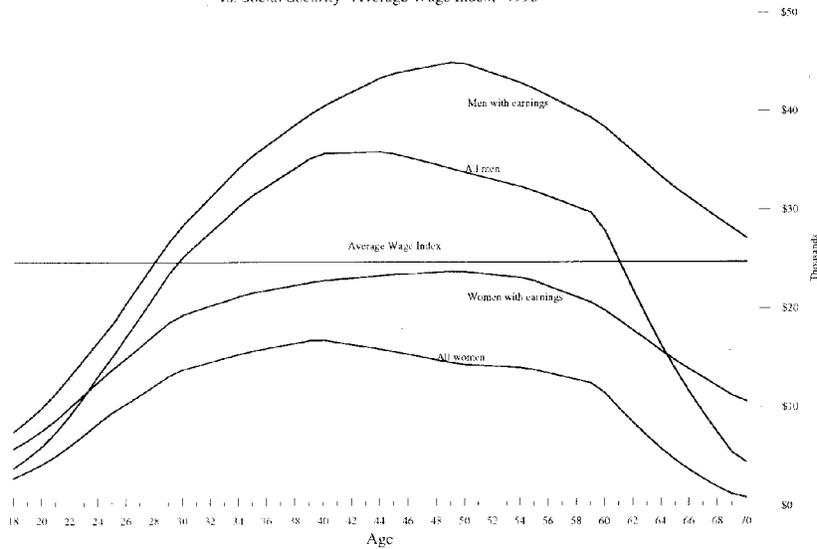


The second kind of error concerns the earnings of American households. Nearly all examples used in the debate over Social Security assume that the average worker—man or woman—has earnings at every age equal to something called the “Average Wage Index.” But Census data show that this is not the case. Earnings vary widely by age, sex, marital status, and education. Moreover, the average man can expect about 1 in 5 zero-earnings years, and the average woman about 1 in 3—time spent outside the labor market due to unemployment, illness, or family responsibilities. Taking these factors into account, we find that the average man does have lifetime average earnings slightly more than the Average Wage Index—but the average woman has lifetime earnings equal to about 53% of the Average Wage Index (Graph 2). This means that most studies have overstated average annual earnings of women by almost 100%. This makes a huge difference in calculating benefits under Social Security and individual accounts. Yet this erroneous method has been widely used even by the Social Security Administration.

Graph 2

## Average Annual Earnings by Sex and Age

vs. Social Security "Average Wage Index," 1995



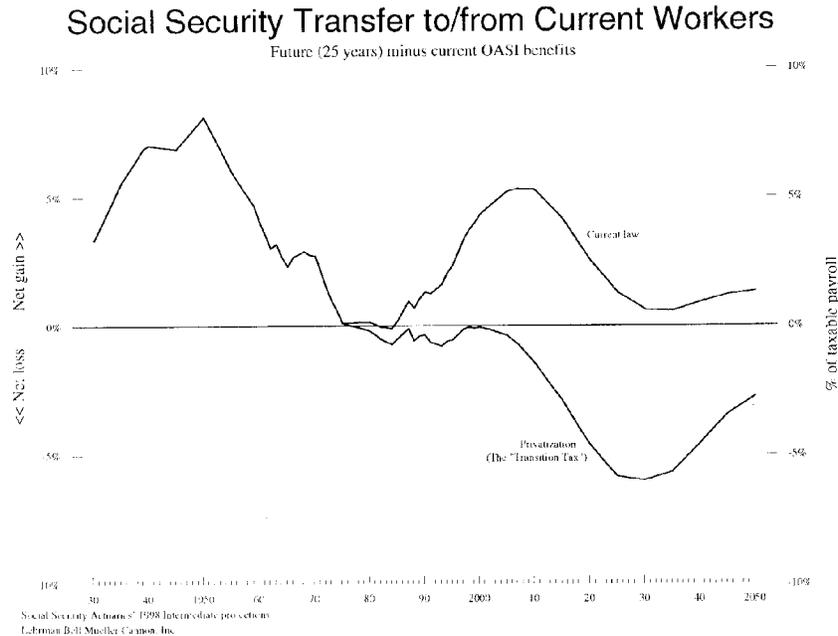
Source: Current Population Survey (Smoothed)  
Lehman-Bell Mueller Cannon, Inc.

The third kind of error concerns treatment of the "transition tax" involved in any move away from pay-as-you-go Social Security. "Pay-as-you-go" means that each generation of workers pays for the benefits of its parents. That's why the first generations covered by Social Security received rates of return far above the long-term average. It also means that if pay-as-you-go Social Security were ended, the last couple of generations would have to pay twice: they would keep paying for their parents' Social Security benefits, while receiving drastically reduced benefits, or no benefits, themselves; at the same time, they would have to save for their own retirement through individual accounts (Graph 3). If pay-as-you-go Social Security were phased out over one lifetime, this "transition tax" would fall partly on the Baby Boom, but especially on "Generation X" and the children of the Baby Boom.

This "transition tax" far exceeds any changes in payroll taxes and/or Social Security benefits that would be necessary to balance the existing pay-as-you-go system. The reason is simple: paying once for retirement is always cheaper than paying twice. Those who favor ending pay-as-you-go Social Security have resorted to various tricks of creative accounting to try to disguise the "transition tax." These techniques generally involve income tax credits, or borrowing against general revenues, or some combination. But creative accounting can only try to disguise the cost of retirement benefits; it cannot change that cost by a single penny. Likewise, income-tax credits only shuffle the cost around without changing it.

SSASIM is especially suited to a study of this kind, because it permits us to sidestep the errors I've just described. First, the model makes it possible to project financial market returns that are consistent with projections for the economy. The model can also realistically account for transaction costs involved in investing in stocks and bonds, and in purchasing the private annuities that would have to replace Social Security. Second, SSASIM also makes it possible to simulate the impact of Social Security reform on American households with a high degree of realism, surpassing the "flat unisex earnings" assumptions of the Social Security Administration. Finally, SSASIM has the great virtue of requiring you to say exactly how the cost of benefits will be paid: no creative accounting tricks are possible. I think you'll find that the results of a rigorous analysis of Social Security reforms are eye-opening.

Graph 3



The study is divided into two parts (along with appendixes examining some of the important issues raised). The first part illustrates the basic choices for Social Security reform in their effect upon the average benefits and rates of return for couples representing four different birth-years (1955, 1975, 1990 and 2025). Those born in 1955 are the middle of the Baby Boom; those born in 1975 are the smallest cohort in "Generation X"; those born in 1990 are the largest cohort in the "Echo of the Baby Boom"; and those born in 2025 represent the longer-term effects of various kinds of Social Security reform. The second part of the study looks at winners and losers among households within each of those birth-years or "cohorts"—unmarried or married; two-earner or one-earner couples; those with average, above-average or below-average earnings; and also selected African-American households.

There are essentially two possible approaches to Social Security reform: either balance the current pay-as-you-go retirement program, or else replace it with a system of individual retirement accounts. Every reform plan does one or the other, or else some combination. The current study examines the whole range of options, by comparing results under three different plans to reform the current OASI (Old Age and Survivors Insurance) program.

The first plan would completely "privatize" Social Security, by replacing it over the course of one lifetime with a system of individual accounts. Initial benefits for new retirees would be phased out evenly over 45 years, which means that the payroll tax would disappear after about 80 years. At first, the total contribution rate would be increased by 2 percentage points, though it would later fall back to equal the current payroll tax rate.

The couple born in 1955, whom I call John and Debra, would therefore live under a partially privatized system—putting about 3 percentage points into individual accounts and about 9 percentage points into Social Security. Their Social Security retirement benefits would be just under two-thirds of current law. This approximates the various plans to "carve" out part of workers' contributions for individual accounts to supplement reduced Social Security benefits.

The couple born in 1975, Carl and Amy, would live under a mostly privatized retirement system. By the time they retired, the payroll tax would have fallen, and account contributions risen, by about 3 percentage points. Social Security retirement benefits would be reduced by about four-fifths. Plans like the Personal Security Ac-

counts (PSAs) favored by some of the Social Security Advisory Council members, or the more recent Feldstein plan (which would combine investment in individual retirement accounts with Social Security benefits reduced from current law by 75 percent), would fall somewhere between the experience of John and Debra and the one for Carl and Amy.

The couples born in 1990 (Patrick and Hilary) and 2025 (Abraham and Dorothy) would receive benefits that depended entirely on their individual accounts—similar to plans favored by the Cato Institute. The main difference is that the Patrick and Hilary, born in 1990, would still have paid substantial payroll taxes to fund benefits to earlier retirees, but payroll tax rates would almost have disappeared by the time the Abraham and Dorothy retired nine decades from now.

The other two plans are “traditional” reforms to balance the current pay-as-you-go Social Security system. One “traditional” plan would raise the Normal Retirement Age faster and higher than under current law: this was recommended by a majority of the 1994–96 Social Security Advisory Council. The OASI payroll tax would be maintained at the current rate of 10.6% until the trust fund fell to one year’s reserve; then the payroll tax would be adjusted as necessary to keep the system in balance.

The other “traditional” plan has two features. First, the system would be restored to a pure pay-as-you-go basis by cutting the payroll tax rate 20% (just over 2 percentage points) immediately; at the same time, benefit formulas for new retirees would be scaled back over 45 years until they reached 80% of current law. Inflation-adjusted Social Security retirement benefits would therefore rise, but not as fast as under current law. If the trust fund reserve ever fell to the minimum one-year reserve, payroll tax rates would be adjusted to keep income and outgo in balance.

Of course, any actual reform plan would be more complicated; these were chosen to illustrate the major issues.

The study examines four different sets of assumptions, from the most extreme to the most realistic. The most important conclusion from the first part of the study is this: for everyone now alive, it doesn’t greatly matter what assumptions you use about the stock and bond markets. (See Graph 4.) For the Baby Boom, Generation X and the children of the Baby Boom, not even unrealistically high stock and bond market returns can offset the “transition tax.” For everyone now alive, both average benefits and rates of return are much higher under even a scaled-back Social Security system than could be had from a partly or fully privatized retirement system.

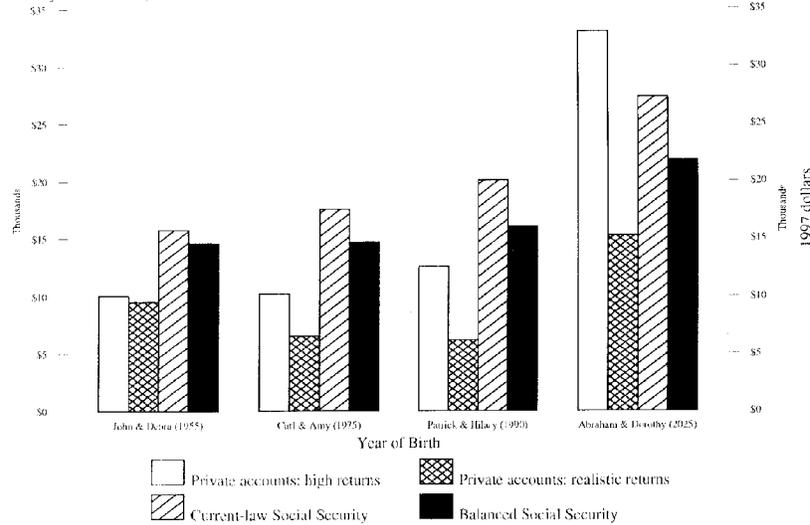
The assumptions do make a difference for people who are not born yet. The couple born in 2025 would come out ahead under a “privatized” retirement system, if you assumed that the stock market’s price/earnings ratio will in fact surpass 1,000 years worth of earnings. But with reasonable financial asset returns, the average couple born in 2025 would be better off with even a scaled-back pay-as-you-go Social Security system than with a system of individual retirement accounts.

The second part of the study goes into much deeper detail about the impact of the various plans upon a wide variety of American households. A sample population of 32 individuals was created for each of the four birth-years, using Census data about earnings and employment by age, sex, marital status, and education level. The individuals are chosen to reflect differences in marital status (unmarried individuals or married couples); labor market behavior (two-earner couples with wives working full-time or part-time, as well as one-earner couples), and education levels (average education [some college], high-school graduates and college graduates). Individuals with below-average education and earnings are assumed to have higher-than-average mortality (that is, they don’t live as long), and vice versa.

Graph 4

### Average Retirement Benefits for Representative Couples

For everyone now alive, not even unrealistic financial returns could offset the "transition tax" from privatizing Social Security.



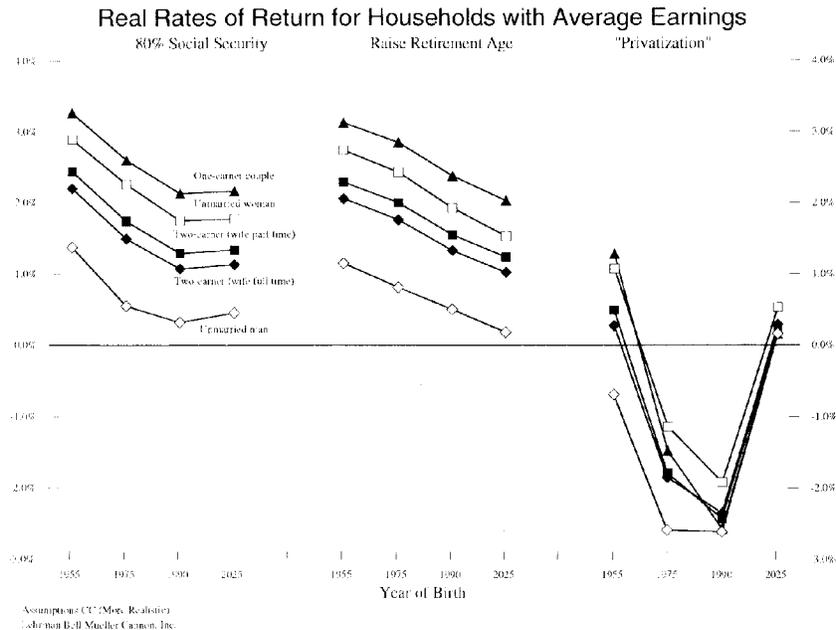
Assumptions: AA (high market returns) and BB (realistic market returns)  
 Johnson & B. J. Mallick, Cannon, Inc.

Three of the 16 pairs of men and women in each birth-year are intended to represent selected African-American households which may differ from the general population: one unmarried man and woman each, and a two-earner married couple (all with average education and earnings for African-American men and women); as well as a couple intended to represent the most economically and socially disadvantaged African-Americans: a single mother with children and her separated partner, both of whom are high-school dropouts. All the African-American individuals are assumed to have significantly higher mortality (shorter lives) than the general population with the same education and earnings. There are no separate examples for college-educated African-Americans, on the assumption that such households have socioeconomic characteristics very similar to those for other college graduates.

The results of the second part of the study are richly detailed, and bear examining in some detail. However, in summarizing the results, I will concentrate on a few overriding themes, and focus on the most realistic set of assumptions. (See Graph 5.)

The first important finding is that the largest group of losers from "privatizing" Social Security would be women. This is true for women in all birth-years, all kinds of marital status, all kinds of labor-market behavior, and all income levels. The main reason is that Social Security was specifically designed to protect women in three ways, all of which would be eliminated by "privatization." First, Social Security benefits are progressive, and at all education levels, women have lower average earnings than men. Second, Social Security provides the same annual benefits to men and women with equal earnings, but women live longer and so collect more benefits. Third, Social Security provides benefits for spouses of retired workers, as well as survivors benefits, which are far more advantageous to women than the private market can provide. The study shows that even unmarried women with high earnings, and women with high incomes in two-earner families, lose from privatization. However, the losses are even greater for women who work part-time, intermit-

Graph 5



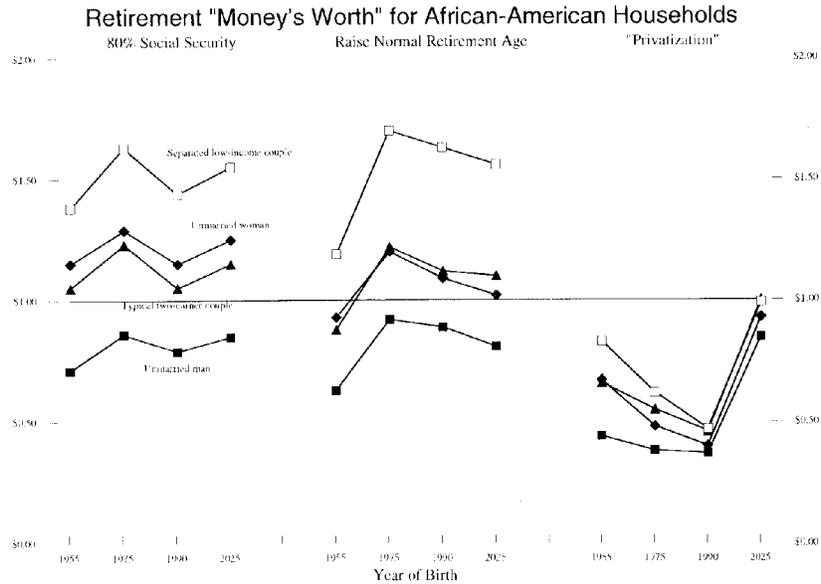
The second important finding is that, to the degree Social Security is "privatized," the current progressivity of benefits would be eliminated. The actual progressivity of Social Security is rather mild: this is because the progressivity of combined taxes and benefits is partly offset by the fact that individuals with less education and lower earnings tend to have shorter lifespans, so they collect benefits for fewer years. Individuals with more education and higher earnings tend to live longer and so collect benefits for more years. However, Social Security is still progressive, and this feature would be eliminated by "privatization." The study finds that individuals with lower education and earnings will tend to lose more, and individuals with higher education and earnings will tend to lose less, from privatization.

The third important finding is related to the first and second; it concerns the relative treatment of unmarried individuals and married couples. (Of course, we need to bear in mind that fewer than 5% of those who reach retirement age have never been married, and perhaps 10% have never had children.) "Privatizers" have claimed that Social Security is biased against unmarried individuals. But the study shows that this claim is the result of the faulty "unisex wage" assumption. The facts are more complicated, and much more interesting. Unmarried women actually receive a higher rate of return from Social Security than most married couples. Unmarried men receive a significantly lower rate of return than unmarried women, because the men have higher average earnings and don't live as long. If we considered husbands and wives separately, we would find that married men receive a lower rate of return than unmarried men, because unmarried men spend less time in the labor market, and so have lower average earnings and benefit more from Social Security's progressivity. Viewed as individuals, the highest rates of return are received by married women—the lower the earnings, the higher the rate of return.

The final important finding concerns how African-American families would fare if Social Security were "privatized." A recent study sponsored by the Heritage Foundation gained notoriety by claiming, against earlier research, that African-Americans are big losers under Social Security and would gain tremendously if Social Security were replaced by individual retirement accounts. However, the Heritage Study contained all the errors of method outlined earlier—inconsistent projections, unrealistic earnings, entirely ignoring the "transition tax," and a few more besides. The current study squarely contradicts the Heritage findings. Of African-Americans now alive, the average household would lose about half the value of its

retirement savings if Social Security were "privatized." (See Graph 6.) For African-Americans who are not born yet, the pattern is like that for the general population. The only African-Americans born in 2025 who would not lose under "privatization" would be unmarried men without children: they would receive approximately the same rate of return from Social Security or a private retirement account. However, under realistic assumptions all other future African-American households studied would lose from "privatization"—including typical two-earner married couples, unmarried women, and those with substantially below-average education and earnings.

Graph 6



Assumptions: 3D (Most Realistic), "Money's worth" is a comparison against cost-free investment in Treasury bonds. Courtesy: Bill Mueller, Canyon, Inc.

**What does the study imply for the future of Social Security reform?**

In the first place, the study is a wake-up call to policy analysts. Policymakers and the public require much better information than they are now getting—about the financial markets, about earnings of American households, and about the funding of Social Security reform. That information is available—but so far, it has not been used.

Second, the study strongly indicates that policymakers should be focusing on fixing the Social Security system, instead of getting rid of it. The "transition tax" under privatization dwarfs any possible cost of balancing Social Security. The low future returns predicted for Social Security are not due to its pay-as-you-go nature, but simply to the projections about the future economy. If the United States is in fact about to enter an Economic Ice Age, then the rates of return on everything—Social Security, stocks and bonds alike—are going to be substantially lower than in the past. It must be said that in the past few years the economy has not been behaving that way. So far, inflation, unemployment and interest rates have all been significantly lower than the intermediate projections. The economy has so far most closely resembled the Social Security Actuaries' "Low-Cost" economic assumptions. It would not be surprising if, in the next annual report, the Actuaries' intermediate assumptions were modified. However, the projections in the current study are based on the 1998 intermediate projections.

But this raises an important issue for policymakers. How is it possible to set retirement policy when the future is so uncertain? As we have seen, even in the long run, the case for "privatizing" Social Security depends entirely on being right about a long string of highly specific—and in part, highly unlikely—forecasts.

Most "traditional" reform plans have the great advantage of not depending on a particular forecast. Unlike "privatization," they are reversible. If the economy per-



I came, regretfully, to the conclusion that the case for privatization had not been well founded, that it is a mixture of one part ignorance of the financial markets, one part ignorance of the labor markets, and one part wishful thinking. And I don't mean that metaphorically. I mean that literally in the three areas that I have pointed out today: first, the economic and financial-market assumptions that are not consistent; second, labor-market assumptions that do not conform to reality; and third, the attempts to ignore the transition tax.

So, you are correct. I began making precisely the same arguments you have heard from the earlier panel today. I would hope, a little bit better, perhaps. But I just had to conclude that I was wrong. And my particular conversion doesn't mean anything, but I'd like it to point to the facts involved here.

Mr. MATSUI. If I may, and I know the graph over there is a little far, and I wouldn't want you to go over there, but the blue part of the graph is the current—

Mr. MUELLER. That is, the blue part—perhaps I should set up, what all the parts mean.

Mr. MATSUI. Maybe you can explain it briefly.

Mr. MUELLER. That is a bar graph, which shows average annual retirement benefits for four couples, each representing the average couple born in each of four different years. The first group of bars on the left represent John and Deborah, who are born in 1955. They are 44 years old this year. The second group of bars is for Carl and Amy. They were born in 1975. They are 24 years old this year and not married yet. The third group of bars is for Patrick and Hillary. They were born in 1990 and are all of 9 years old now, and thinking about Social Security is probably not on their agenda. The fourth group of bars is for Abraham and Dorothy. They will be born in 2025 and will be eligible for retirement at the earliest in the year 2087.

Now, what the four colors represent are four different possibilities for Social Security reform. The first two sets of bars, those are the blue and the red, represent what the different experience would be for each one of those four couples under two sets of assumptions, if Social Security were privatized within one lifetime, and by that I mean, the initial retirement benefit would be phased out evenly over 45 years, permitting the payroll tax to disappear after 80 or 90 years. John and Deborah, who are 17 years away from retirement, would still live under a partially privatized system. They would be putting in about 3 percentage points of taxable earnings into an individual account. The remaining 9 percentage points would be paying the Social Security benefits to existing retirees. Their own Social Security benefits would be reduced by 38 percent from current law.

Carl and Amy would live under a substantially privatized system, receiving Social Security benefits which had been reduced, instead of by a little over one-third, by about 80 percent. So they would be much more reliant on private retirement accounts.

Patrick and Hillary would have to rely entirely on their individual accounts, but still would be paying substantial payroll taxes. Abraham and Dorothy have pretty much passed the transition tax.

Now the first two bars show what happens under two different sets of assumptions for the privatized system. The blue bar is what you would get under the most optimistic projections for the financial markets. Those include the thousand-years'-worth-of-earnings scenario for the stock market. The red bar is what you could get under what I found to be realistic assumptions. The green bar is what you could get under currently promised Social Security benefits. And the yellow bar is what would happen under a scaled back Social Security system, which was balanced by adopting some of the proposals which were mentioned earlier today.

What the chart shows is that for the first three cohorts or birth years, that is, those who are now alive, it doesn't matter what you assume for the stock market. The cost of giving up Social Security benefits is too great to be made up by any stock market assumptions. So everyone now alive would lose. It's only a question for the people born in 2025.

If you assume that in fact the stock market will be worth 1,063 years' worth of earnings in the year 2087, they come out ahead. If you assume that P/E, price-earning, ratios are roughly flat between now and then, they would receive lower benefits than you would receive from even a pared back Social Security system.

Mr. MATSUI. My time has run out. If I may just ask one further question, and then I will yield back, with the Chairman's permission.

In terms of the concept of the transition cost, you basically have three provisions, the transition cost, the modeling of that average person or average family, and then the third is the disparity between investment patterns of the Social Security system. In other words, investing in the bond market, and second investing in the equity markets, and how one is, as you suggested, backward and the other one is forward in terms of its thinking.

Those are the three areas, is that correct?

Mr. MUELLER. That's right.

Mr. MATSUI. What is the most significant aspect of all this? Is it the transition cost, or is it the latter, disparity between bond market and equity market and the assumptions behind it?

Mr. MUELLER. For everyone now alive, it is the transition cost, which is the problem that the earlier panel was wrestling with. I'm grateful that Mr. Goldberg pointed to the importance of the assumptions because that is, in fact, the whole point of the study, that the assumptions are important. And I think the squawks of outrage are due to the fact that the gimmick in this study is that there are no gimmicks. What I have done is make explicit for each individual what the cost of that transition would be. And the cost of ending Social Security is just—the cost would be much greater than any possible cost of balancing the system.

Mr. MATSUI. I wanted to ask this one last question. In terms of the yellow bar, which is using assumptions that are a scaledback Social Security plan, which I suppose if you cut benefits you would have. Did you figure it to be 80 percent of current benefit level?

Mr. MUELLER. Yes. It ultimately reached 80 percent. For the baby boomers it would be 92 percent. It would be 84 percent for Carl and Amy, and for the last two couples, it would level off to 80 percent of currently promised benefits.

Mr. MATSUI. OK. Now compare that with what the privatized system. That is what bar? That's the—

Mr. MUELLER. The privatized system under realistic assumptions is the red bar.

Mr. MATSUI. Right.

Mr. MUELLER. And you are comparing that with the pared back Social Security system is the yellow bar.

As you can see, the biggest burden of the transition cost actually falls on those born in 1975 and 1990, not on the baby boom or those born in the future. And for those two cohorts, the possible benefits from a partly or completely privatized system are less than half of what you would receive from a pared back, pay-as-you-go system. It would be a little bit higher than that if you adopted the more optimistic financial market assumptions, but still substantially lower than the pared back, pay-as-you-go plan.

Mr. MATSUI. Thank you very much. Thank you, sir.

Mr. MUELLER. Thank you.

Chairman SHAW. Mr. Mueller, a couple of questions.

What has been the performance of the equity markets, the stock markets, over the last 20 years in terms of real dollars?

Mr. MUELLER. The last 20 years, it's about 12 percent.

Chairman SHAW. And, what is your assumption for the next 20 years?

Mr. MUELLER. For the next 20 years? It's going to be quite low. According to SSASIM, the average real equity return in the future will be 4.7 percent, but historically, after a period of 20 years in which you outperform the average by nearly 100 percent, you have periods where you underperform by an equal amount.

From 1901 to 1921, from 1929 to 1949, and from 1962 to 1982, in all those 20-year periods, the real return on equities in this country, before taxes, was approximately zero.

Chairman SHAW. So, your assumption is that in the next 20 years the growth is only going to be a little over one-fourth of what it has been in the last 20 years?

Mr. MUELLER. Perhaps one-third.

Chairman SHAW. Yes. One-third. OK. In the benefits. What benefits do you cut?

Mr. MUELLER. I modeled two different possibilities because they have been discussed. One was raising the normal retirement age according to what is known as the Gramlich Plan, which would index the retirement age in the future to rises in longevity. The other is—

Chairman SHAW. How high would you raise it?

Mr. MUELLER. It ultimately goes to age 70. And this is not my plan. I modeled it merely for the—

Chairman SHAW. That's your assumption?

Mr. MUELLER. Right.

Chairman SHAW. That's what the yellow line tells us?

Mr. MUELLER. I'm sorry?

Chairman SHAW. That's what the yellow line tells us?

Mr. MUELLER. No. The yellow line is what is called an across-the-board plan. That would leave current benefits essentially as they are today, except all would be scaled back to 80 percent of currently promised benefits over 45 years.

Chairman SHAW. Well, you are raising—is that the green line? Or is that even on there?

Mr. MUELLER. The yellow line.

Chairman SHAW. Oh, it is yellow. OK. And what other benefits would you cut?

Mr. MUELLER. None. It is across-the-board reform.

Chairman SHAW. OK. You raised the age to 70?

Mr. MUELLER. No. That is a separate reform. Currently, under the current system, the normal retirement age is scheduled to rise from 65 to 67 in steps. That would remain the same, and the only other benefit changes would be across-the-board benefit changes.

Chairman SHAW. And what would they be?

Mr. MUELLER. They would be a scaling back over 45 years of initial retirement benefits in even percentage amounts until initial benefits beginning in the 45th year would be 80 percent of what is currently promised under Social Security.

Chairman SHAW. I think the politics of that are dismal.

Mr. MUELLER. If so, then the politics of the individual accounts would be even worse because that promises less than half the benefits—

Chairman SHAW. It's your assumption that the stock market is only going to perform at one-third of the level that it has for the last 20 years at historical levels, then obviously that—

Mr. MUELLER. Well, sir. It is not my assumption. It is the assumption of SSASIM. That is one thing that I did not make up.

Chairman SHAW. Well, somebody did because it hasn't happened yet. So someone had to come up with these figures and these theories. Obviously.

Mr. MUELLER. The underlying research comes from an economic textbook by John Campbell, Andrew Lo, and Craig MacKinlay called "The Econometrics of Financial Markets," Princeton University Press, 1997. That is the underlying basis for the forecast in SSASIM.

Chairman SHAW. I see. And I would assume that you have read forecasts that would be far rosier than that?

Mr. MUELLER. Yes. I have read many rosier forecasts, but they are inconsistent forecasts.

Chairman SHAW. Inconsistent with yours?

Mr. MUELLER. No. Inconsistent with the Social Security Administration's intermediate economic assumptions.

Chairman SHAW. Oh. Then let me ask you another question then. If this is the assumption of the Social Security Administration, what would be your thoughts with regard to the President's plan and investment of the surplus, or portion of the surplus, into equities? Have you assessed that plan?

Mr. MUELLER. Not in this paper. If you ask for my opinion, I don't think it would make a great deal of difference one way or the other. We heard Mr. Summers say this morning that it would affect only 4 percent of benefits in the middle of the next century. I did think it was interesting though how much time was spent, especially in your colloquy with Mr. Summers, about the question of the accuracy of the figures.

I think the difficulty raised by this study for privatizers is that I am merely demanding the same sort of fiscal responsibility and

accounting that you, in my view, are correctly asking of President Clinton.

The common assumption of everyone who was at this table before us was that in some form or another, we will be funding Social Security through general revenues and that somehow this would not show up in the cost of investment for the people who were covered by Social Security.

Now, in my view, all that President Clinton has done is to say to the privatizers, "You say you can fund privatized accounts out of general revenues; why can't we fund Social Security out of general revenues? If there's no cost, what's the problem?" I think they are both equally off base, but of the two, I would say President Clinton is at least less wrong.

Chairman SHAW. I'm sure he will appreciate that. [Laughter.]

Even with your gloomy predictions of the future as far as the stock market is concerned, do you know what the present level of return on Treasury Bills to the Social Security Administration is in terms of real dollars?

Mr. MUELLER. Are you asking me what his rate-of-return assumption is?

Chairman SHAW. Yes. Do you know what it is?

Mr. MUELLER. I believe it is 2-point-something. That is what Mr. Summers said.

Chairman SHAW. Yes. Well 4 percent is better than 2 points. Maybe the President is more right or more wrong.

Mr. MUELLER. Well, it would be except even the 2.8 percent would be inconsistent with real growth of the economy equal to 1.4 percent. The reason is that it is generally agreed by macroeconomic theorists that a situation in which the rate of interest remains permanently above the rate of economic growth is inherently unstable because under those conditions, the total burden of debt, both public and private, would mushroom indefinitely. And I don't believe that the interest-rate assumptions——

Chairman SHAW. Let me ask you one other question. I think it is sort of interesting here.

I guess that your prediction that the stock market is only going to rise at the level of approximately a third of where it has risen for the past 20 years would assume that there is going to be some dips in the market. That it is not going to be a constant upward spiral. Is that correct?

Mr. MUELLER. I would assume so.

Chairman SHAW. Are you making any predictions as to the performance of the market over the next 2 years?

Mr. MUELLER. I do as a professional forecaster. In fact, I predicted the 20-percent decline of the market last summer.

Chairman SHAW. And it didn't last very long, however.

Mr. MUELLER. No, it didn't. But I also predicted the recovery. [Laughter.]

Chairman SHAW. When did you predict the recovery?

Mr. MUELLER. I'm sorry?

Chairman SHAW. When did you predict the recovery?

Mr. MUELLER. When the market was at its bottom. I am willing to supply the report, sir. This will be wonderful advertising for Lehrman Bell Mueller Cannon, Inc. [Laughter.]

Chairman SHAW. Could I ask you what is your prediction for the next year?

Mr. MUELLER. I think we are going to have another correction in the market, and then it will recover again.

Chairman SHAW. After it hits the bottom, it will go back up again?

Mr. MUELLER. Yes.

Chairman SHAW. OK. Mr. Doggett.

Mr. DOGGETT. Thank you very much. I think that your study is very important. I appreciate the work that you have done on it. I think you were in the room when Mr. Goldberg, as I understood it, suggested you might be a member of the Flat Earth Society on these transition and administrative costs.

I guess the first specific I would want to turn to, as I understood his criticism, he said you assumed total privatization. That is in error, is it not? You considered two options.

Mr. MUELLER. Well, I considered actually all degrees of privatization. You could see, again from the earlier panel, what my difficulty was. If I took a single plan which was only a partially privatized plan, Michael Tanner would say, Oh, but our plan at Cato is complete privatization.

Mr. DOGGETT. Right.

Mr. MUELLER. If you model complete privatization, then Mr. Goldberg says oh, but you didn't model partial privatization. So what I did was to take a plan that privatized the Social Security Program over one lifetime, and looked at what the experience of people born in different years was, because at any moment, you could stop the system and say this is our partially privatized system.

If you stopped where the 1955 couple is, you would have roughly a one-third privatized system. If you stopped where the couple born in 1975 is, you would have roughly a three-quarters privatized system. For the other two, it is completely privatized, only with two different degrees of paying the transition tax.

So I try to cover all the bases by using three plans, experienced by four different generations, with four different sets of assumptions.

Mr. DOGGETT. There was also the suggestion that over time, all these administrative costs will work themselves out. Does the experience in other countries suggest that we will ever see administrative costs of a fully privatized or partially privatized system down at levels that are anywhere near the current administrative costs of the Social Security system?

Mr. MUELLER. No. The current annual administrative costs for Social Security are equivalent to four basis points or four one-hundredths of a percentage point. Mr. Goldberg, in his defense, said that he thought we could get costs down to 50 basis points with private accounts. The difference between his assumption and the assumptions in this study is only 50 basis points. Right now, the average equity fund costs the average shareholder 1½ percentage points per year. I rather charitably assumed that over time, there would be in fact efficiency gains and that the annual cost would fall to 100 basis points. I doubt it would ever go much below that.

Mr. DOGGETT. I understand basically the bottom line of your analysis is that if you use realistic assumptions, that there is no one in this room today or alive on this planet today that will come out better under the partial or complete privatization plan under either one, than they would under Social Security?

Mr. MUELLER. It is certainly true for everyone in this room today. I think the planet may go a little far since much of it is not covered by the Social Security system.

Mr. DOGGETT. Well, we have got people on Social Security I guess scattered around the world, literally in this system.

Mr. MUELLER. That's true. But I did find no group now alive that would benefit from privatization. In fact, no group that could avoid substantial losses from either partial or full privatization.

Mr. DOGGETT. And it will be those people born, is it after 2025 or beginning in 2025, a small portion as I understand your study, of those that are at the very top of the pyramid of the economic scale who are Anglo males who might have some benefit if the system were fully or partially privatized after the year 2025?

Mr. MUELLER. That is correct, if you add the qualifier "with the realistic assumptions." As the last set of bars shows, under the unrealistic assumptions the average person born in 2025 could come out ahead. But by those unrealistic assumptions, I mean the stock market selling for more than one millennium worth of earnings.

Mr. DOGGETT. Well, I just hope that the research that you have done, and Ms. McSteen, I am really appreciative of the role the National Committee has played in getting this research to us, that it will form the basis of what should be a truly bipartisan effort, but it has to be a bipartisan effort that accepts certain principles, one of which, it seems to me, has to be that the system which we have had has been one of the best the world has ever known. Before we junk it and experiment on the American people, we ought to take into consideration this simulation, recognize its value, and try to strengthen and preserve the system rather than to weaken and destroy it. Thank you.

Mr. MUELLER. Thank you.

Mr. MATSUI. The Chair was gracious to give me another question. Mr. Mueller, I just wanted clarification or perhaps you can even expand on this. For the economic assumptions you are using for both the current system minus 20-percent or an 80-percent benefit level and a privatized system, you are using the same inflation rate, the same economic growth rate, the same projections. What you are doing is using a different assumption in terms of what the economic benefits to the stock market would be based upon projections over the long period of time that you have done your study, right? Am I understanding that correctly?

Mr. MUELLER. That is correct. I was going to say to Mr. Shaw in response to his last question that in fact, I do not agree with those assumptions, but they happen to be the ground rules for the debate. The intermediate economic assumptions of the Social Security Administration amount to saying that we are about to enter an economic ice age, one key feature of which is that we are going to reach zero population growth because the birth rate will fall below the replacement rate. That will be roughly made up by immigration. But there will be no growth in the population beyond mid-

century. The only growth in the economy would come from a 1-percent annual increase in labor productivity.

You asked me for my opinion. I think that is probably too pessimistic. In fact, so far the economy has been behaving more like the low cost assumptions. I wouldn't be surprised in the least if the actuaries raised their intermediate assumptions in the next annual report. All I was insisting on is that if you are going to adopt the economic ice age forecast, you can not at the same time assume that the stock market is going to be flourishing like a hothouse plant.

Mr. MATSUI. What you are saying is that assuming even a higher growth rate, the numbers in your graph would be similar in terms of who benefits and who doesn't benefit?

Mr. MUELLER. The shape would be the same. What would happen is that for each percentage point of higher economic growth, you would get a 1 percentage point higher return both in the stock market and from Social Security.

Mr. MATSUI. Right. I would just conclude by saying that I think you have responded consistently with your testimony, that you are using the same basic economic assumptions for the equity market, and also the bond market in terms of Social Security, and other components Social Security is involved in. In other words, you are not saying one has a different growth rate than the other.

Mr. MUELLER. That is correct. Right.

Mr. MATSUI. Thank you.

Chairman SHAW. Just one more question, if you could clear up a confusion I have got in my head. You are projecting the growth in the stock market of 4 percent, real dollars. We have a system now that is making 2.5 percent in real dollars. How can you say that 4 percent is not as good as 2.5 percent?

Mr. MUELLER. It is because you don't get the 4 percent. If you take the 4 percent, you have to subtract first the transaction costs, which are a little over 100 basis points a year. In addition, you have to subtract the cost of the lost benefits. If you are going to give up all the Social Security benefits over a period of 45 years, you have to subtract another 2.2 percent from your rate of return. That puts you in the hole compared with Social Security.

Chairman SHAW. How do you figure that?

Mr. MUELLER. It is because if you are giving up Social Security benefits—this is the “clawback” that the earlier panel was talking about—that comes out of your rate of return. That is a negative. I mean you are starting in the hole. It is so large because in each case we are talking about a benefit loss of about 38 percent for the first couple, 82 percent for the second couple, and 100 percent for the other two couples.

Chairman SHAW. Do these examples take into effect that both the President's plan and some on the Senate side, as far as Republicans are concerned, assume up to an infusion of 62 percent of the surplus going into the retirement accounts or into the Social Security system?

Mr. MUELLER. No, sir. It assumes what the Social Security Administration assumes, which is essentially current law. My point about the transition tax is that—

Chairman SHAW. I think all of the witnesses, and I think anybody who has studied this at all knows that if we do get into some type of personal accounts, that there is going to be a transition cost. That transition cost is going to require some of the surplus. I think that is a given. We can't go from one system to another system without having some type of cost to bridge the transition.

If we do nothing, the system is going to take a huge infusion of cash. Once you get into two or three generations from now, if you do nothing, our grandchildren will suffer greatly.

Mr. MUELLER. I am certainly not proposing to do nothing. The whole reason I modeled two different plans for balancing pay-as-you-go Social Security was to show that even a pared back, balanced Social Security system would give you a higher rate of return than you could get from a partially or fully privatized system.

Chairman SHAW. OK. But now your system assumes a greater working population and it assumes a smaller than historical stock market escalation. Is that not correct?

Mr. MUELLER. It assumes that economic growth will be slower and that equity returns will become lower commensurate with that lower growth, yes.

Chairman SHAW. What is your forecast on corporate bonds?

Mr. MUELLER. Corporate bond yields are assumed to equal the growth rate of the economy. The Social Security Administration assumes that long-term growth of the economy would settle down at 4.7 percent. So that is the corporate bond rate assumption.

Chairman SHAW. So it is about the same as the stock market, in your opinion?

Mr. MUELLER. No. I'm sorry, 4.7 percent would be in nominal terms. After inflation, it would be 1-point something, less than 2 percent.

Chairman SHAW. Oh. Corporate bond return is going to be lower than the Treasury bills?

Mr. MUELLER. No.

Chairman SHAW. Treasury bills are at 2.5 percent in terms of real dollars.

Mr. MUELLER. Well, they are if you have an inconsistent forecast for the bond market as well as for the stock market. You can not have the burden of debt, public or private, compounding at a rate, a real rate of 2.7 percent, while the economy is only growing at 1.4 percent. You run into the same sort of problem that you do with the price/earnings ratio; in this case, the burden of all debt, public and private, would mushroom. Under those assumptions, you would have nonfinancial corporate debt, which is now at a record 210 percent of GDP, going to 16 times GDP. You would have all of the economy being eaten up by interest costs, with nothing left over for anything else.

This is precisely the point I am making. These projections are not consistent.

Chairman SHAW. I think if we have proved anything by this segment of the hearing, it is why CPAs do not understand economists. [Laughter.]

In any event, we thank you for your input. We do have your study and we are analyzing it at this time. I wish we had had an opportunity to fully digest it before this hearing.

[A response from Mr. Mueller to Mr. Matsui follows. The attachment is being retained in the Committee files.]

LEHRMAN BELL MUELLER CANNON, INC.  
ARLINGTON, VA 22201  
11 March 1999

Honorable Clay Shaw  
Chairman, Social Security Subcommittee  
House Ways and Means Committee  
*Rayburn HOB*  
*Washington, D.C. 20515*

Dear Congressman Shaw,

At the March 3rd Social Security Subcommittee hearing, Congressman Matsui asked me to submit a written response to Fred T. Goldberg's remarks about my study, "Winners and Losers from 'Privatizing' Social Security." I request that this response be made part of the published written record of the hearing.

Mr. Goldberg's opening comments on geography were somewhat enigmatic, but I took him to mean that anyone who disagrees with Mr. Goldberg must believe that the earth is flat. As it happens, my casual observations of the horizon from commercial aircraft, combined with some basic knowledge of geometry, incline me to endorse Mr. Goldberg's general views about the shape of our planet. However, regarding the subject of the hearing, Social Security reform, I can agree with Mr. Goldberg about only one thing: the critical importance of assumptions. The main point of my testimony was that "privatizers" necessarily require erroneous assumptions to support their case. Mr. Goldberg proved me correct on all three points I raised:

1. a fundamental inconsistency between the "privatizer" projected returns for Social Security and those for financial assets;
2. unrealistic assumptions by the "privatizers" about earnings of American households; and
3. "privatizers" attempts to ignore or conceal the "transition tax" inherent in any move away from pay-as-you-go Social Security toward a partly or fully privatized system.

1. (IN)CONSISTENCY OF FINANCIAL-MARKET AND ECONOMIC ASSUMPTIONS.

a. Mr. Goldberg generally objected to my new study's projections, including those concerning equity returns, but under questioning from the chairman he could not offer any projections of his own. If Mr. Goldberg would be kind enough to supply the committee with specific 75-year projections for average real equity returns and real GDP growth, it should be possible to calculate the implied price/earnings ratio, as I did for the projections of the 1994-96 Social Security Advisory Council. As I showed, those projections implied price/earnings ratios surpassing 500 or even 1000 years by the time some of the people in the study retired.

In response to a question from Chairman Shaw, I cited the source for these calculations and for the stock market projections used in my study. The equity projections are those calculated by the SSASIM model to be consistent with the 1998 Intermediate economic assumptions of the Social Security Trustees (which project 1.4% average real GDP growth over the next 75 years), upon which projections of returns on Social Security are based. As I noted, the SSASIM model is not my own creation. SSASIM was developed by Policy Simulation Group, initially under contract with the Social Security Administration, and most intensively in partnership with the Employee Benefit Research Institute (EBRI). SSASIM is being used by several Federal agencies (SSA, OMB, Treasury and GAO) to analyze Social Security reform. SSASIM calculates that, given the SSA projections for economic (and thus long-term corporate earnings) growth, the real rate of return on equities would have to fall from about 7% in the past 75 years to about 4.7% in the next 75 years. I also cited the survey of stock market research on which this feature of the model is based.<sup>1</sup> In short, there is a glaring contrast between the "privatizers" projections for the equity market and for the economy, the result of a fundamental and indefensible logical inconsistency.

b. Mr. Goldberg argued that the average transactions costs for investments in private accounts would be lower than my study assumed. At the hearing, Mr. Goldberg

<sup>1</sup> Holmer, Martin, "New SSASIM Equity Return Stochastic Process," September 28, 1998, Policy Simulation Group, Washington, D.C. Holmer cites John Y. Campbell, Andrew W. Lo and A. Craig MacKinlay, *The Econometrics of Financial Markets*, Princeton University Press, 1997.

cited a figure of 50 basis points a year for management fees, and his submission suggested a range of 30–50 basis points; the assumption for annual management fees I used was 100 basis points. (The comparable figure for Social Security is about 4 basis points.) Now, the average total shareholder cost ratio for equity funds in 1997 was 149 basis points, according to the Investment Company Institute.<sup>2</sup> Therefore, my estimate already assumes a further one-third reduction in the average expense ratio. A recent study of administrative expenses by the Employee Benefit Research Institute (EBRI) cited evidence “401(k) plan fees varied by as much as 300% and can comprise of up to 3–5 percent of 401(k) balances per year.”<sup>3</sup>

My study also assumed a 5% “load” on the purchase of private annuities, which is far below the going rate. But to this Mr. Goldberg does not appear to object. In his own submission, he writes: “Because the administrative costs of individual annuities may be as much as 5 to 10 percent of the purchase price (even without premiums for adverse selection), we believe that it is appropriate for retirees who choose to purchase such annuities to bear these costs themselves.”<sup>4</sup> Thus he thinks my estimate may be right, or may be understated by as much as 50%.

These are the only transactions costs assumed in the study. I suggest that it is Mr. Goldberg’s estimate that is unreasonable. And if “privatization” really stands or falls on a 50 basis-point difference over management fees, I think it reinforces my point: the “privatizers” case depends upon a highly specific (and in large part highly unlikely) set of assumptions.

## 2. UNREALISTIC LABOR MARKET ASSUMPTIONS.

Mr. Goldberg touched on this point only indirectly, when he claimed that those who would be helped most by “privatizing” Social Security would be low-income households, blue-collar workers and African-Americans. However, he did not cite any source for this claim. My study showed that a recent Heritage Foundation study making an assertion similar to Mr. Goldberg’s was based entirely on several errors, including the three discussed here (Appendix K, “A Syllabus of Errors: The Recent Heritage Foundation Study”). Whatever the source, Mr. Goldberg’s assertion necessarily implies unrealistic earnings assumptions on his part. My study found that households with lower earnings would be hurt more than those with higher earnings, in part because (for example) high-school dropouts are not employed enough of the time to generate the savings claimed by using the faulty “unisex flat earnings” assumption. But of course, Mr. Goldberg’s claim may also partly have to do with unrealistic assumptions for returns on financial assets, already discussed.

## 3. IGNORING THE “TRANSITION TAX.”

a. This is the most important practical question in the debate about Social Security reform, because the “transition tax” dwarfs any possible cost of balancing pay-as-you-go Social Security. In general, I believe Mr. Goldberg is confused about the transition tax, but he is not alone.

Every penny of current benefits is paid out of someone’s current income. This means that for a whole generation, what matters is the total amount of retirement benefits, not how they are financed. The net “transition tax” on a generation may be defined as the difference between the Social Security benefits it pays to earlier retirees while in the labor force, and the (smaller) Social Security benefits it receives during its own retirement. This is the point of Graph 3 in my testimony, which shows the difference between current OASI benefits and benefits received 25 years later (both measured as a share of taxable payroll). The graph shows that under “privatization in one lifetime,” the “transition tax” rises to at least 7% of taxable payroll each year by the year 2030, before beginning to decline. The chart stops at 2050 because SSA projections only go as far as 2075, but this tax would continue for at least 75 years. For an individual or household, the calculation is the same, except for secondary differences due to any unequal distribution of the burden among workers within the generation. (The whole burden is paid by workers: see below.)

<sup>2</sup>John D. Rea and Brian K. Reid, “Trends in the Ownership Cost of Equity Mutual Funds,” *Investment Company Institute Perspective* Vol. 4 No. 3, November 1998, page 2.

<sup>3</sup>Kelly A. Olsen and Dallas L. Salisbury, “Individual Social Security Accounts: Issues in Assessing Administrative Feasibility and Costs,” EBRI Special Report and Issue Brief #203, November 1988, 32.

<sup>4</sup>Fred T. Goldberg Jr. and Michael J. Graetz, “Reforming Social Security: A Practical and Workable System of Personal Retirement Accounts,” *NBER Working Paper 6970*, February 1999, 27.

Mr. Goldberg asserted that my study arbitrarily assumes that the transition cost would fall entirely on lower-income households. This is simply incorrect. The burden falls on whomsoever loses the Social Security benefits without any compensation (or pays extra contributions without extra benefits). A relatively larger burden is indeed imposed on lower-income families. This is not due to any assumptions on my part, but simply to the fact that full or partial "privatization" aims precisely to strip out those components of Social Security which favor lower-income families most (progressivity of benefits, spousal and survivors benefits).

Mr. Goldberg strongly implied that the burden of the transition cost might be significantly different if it were funded out of general revenues. This objection is presumably based on the argument that the burden of the payroll tax differs from the burden of the income tax. However, the argument contains several fatal flaws.

First, neither Mr. Goldberg nor any other "privatizer" has produced any figures to support his contention. Rather, all "privatizers" have made the ridiculous assumption that the income tax—or borrowing against the income tax—has zero cost to anyone. All rates of return calculations in studies advocating privatization of Social Security use this absurd convention. This is precisely the "creative accounting" against which I warned, which enjoys no support from any theory or evidence. Based on the "privatizers" preposterous logic—which ignores any cost but the payroll tax in calculating rates of return—funding Social Security completely through general revenues would provide everyone an infinite rate of return.

Social Security is now financed (in fact, overfinanced) through payroll taxes; but using some other means (such as current income taxes or current borrowing against future income taxes) would not significantly affect the calculation. If benefits were instead funded, say, partly through payroll taxes and partly through income taxes, then for each individual we must subtract part of the payroll tax and add back that individual's share of the income tax levy that replaces it. In any case, before measuring rates of return for individual workers or households, the first requirement is that the whole cost must be attributed to someone. This the "privatizers" fail to do.

Second, if Mr. Goldberg troubled to do the calculations, he would learn that his objection is not merely of secondary, but of tertiary significance. Most of the transition "tax" under partial or full privatization consists of the loss of Social Security retirement benefits without a corresponding reduction in payroll contributions. (In some proposals, the loss of benefits is coupled with an increase in mandatory contributions.) It is primarily this loss of benefits—not any explicit increase in either payroll or income tax rates—which turns part or all of the existing payroll contribution into a pure tax. Mr. Goldberg himself argued that such changes must be part of any Social Security reform package. An explicit increase in tax rates would only come into play when the "privatizers" seek to make those workers whole again out of general revenues. Yet they do not attribute any of that cost to anyone, thereby invalidating their calculations. This flaw is contained in every single study on privatization of which I am aware, for example, from the Cato Institute or the Heritage Foundation.

The third problem with Mr. Goldberg's argument is that the whole burden of retirement benefits must be financed out of labor compensation—no matter how it is formally financed. In the jargon of economists, the "incidence" of a tax differs from its "burden." For example, half the payroll tax is paid by employers: its "incidence" is on businesses; yet economists generally agree that the "burden" of the payroll tax actually falls on labor compensation, not on corporate profits: it is paid out of income that would otherwise go to workers.

Let us suppose that the payroll tax were completely replaced by income tax funding of retirement benefits. By Mr. Goldberg's argument at least part of the cost of Social Security benefits would be paid out of property compensation (interest, dividends, etc.) rather than labor compensation, because the income tax falls on labor and property compensation, while the payroll tax falls only on labor compensation. However, this is not in fact possible. The theory of the distribution of income suggests that any shifting of the payroll tax burden to owners of property would be offset by an approximately equal loss of pretax income by workers. And the evidence supports this. I have done extensive analysis of the distribution of U.S. national income—both labor compensation and property compensation, before and after all Federal, state and local taxes and transfer payments—going back to 1929, and can show that the theory of income distribution is supported by the evidence.

Mr. Goldberg's real objection, I contend, was to the fact that my study allocated the transition cost at all—not to the way in which that cost was accounted for. This is exactly the sort of "creative accounting" by privatizers against which I warned in my testimony. It also reveals the great virtue of using SSASIM as I did: the user must allocate the transition cost to someone. I invite Mr. Goldberg to allocate the transition tax in any way he chooses—as long as he allocates the whole cost to

somebody. He will find that doing so would not affect the qualitative results of the study in the least. The "transition tax" is simply too large to be affected by any estimates about its distribution.

b. Mr. Goldberg objected that my study only modeled a bill for complete privatization of Social Security, whereas he, personally, was against going beyond partial privatization. Yet there was a great deal of disagreement on this point among the members of the first panel, ranging from those who are against or skeptical of private accounts (Mr. Summers and Mr. Reischauer), to those favoring various degrees of partial privatization (Ms. Weaver and Mr. Goldberg) to those favoring complete privatization (Mr. Tanner).

Precisely because there is no agreement among "privatizers," my study was constructed to survey the whole range of possible options, from balancing the pay-as-you-go system without private accounts, to various degrees of partial privatization, to full privatization. I did this by comparing a plan to privatize Social Security over one lifetime (roughly 80 to 90 years) with two plans to balance the pay-as-you-go system. As I pointed out in my testimony, and in response to one of Congressman Matsui's questions, the experience of those born in 1955 involves partial privatization; of those born in 1975 substantial privatization; and of those born in 1990 and 2025 complete privatization (the 1990 cohort facing the heaviest burden and the 2025 cohort the lightest). Thus no one can complain that his or her favorite approach was neglected in my study.

I believe the foregoing thoroughly refutes Mr. Goldberg's objections. But before closing I would like to remark on another important issue raised by the morning panel March 3rd. In his testimony, Professor Lawrence J. White outlined what he aptly named the "canned goods" theory of investment, his lucid metaphor for the "neoclassical" economic theory devised in the late 19th century. I urge members of the committee to compare this explanation with a newer and better grounded opposing view, summarized in a paper which I am enclosing ("The Economics of Pay-as-you-go Social Security and the Economic Cost of Ending It"). Despite their disagreements on several points, all members of the morning panel were partisans of the "canned goods" theory, which argues that the only investment that matters to the economy is investment in things—so-called "nonhuman capital." All the panelists agreed that the funding of Social Security depends on the growth of labor compensation—and yet all ignored the past 40 years of research showing that labor compensation is the return on investment in so-called "human capital" the size and earning ability of the labor force. A large body of research shows that investment in "human capital" is between two and three times as important to economic growth as investment in "nonhuman capital." The "transition tax" is levied precisely on the return on such investment, and must tend to discourage it. None of the "privatizers" take this negative impact into account.

I am grateful to the subcommittee for the opportunity to testify on this important question.

Sincerely yours,

JOHN MUELLER

Chairman SHAW. I thank you both for being with us. The hearing is now adjourned.

[Whereupon, at 2:50 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

**Statement of Emma Y. Zink, Chairperson, Teachers' Retirement Board,  
California State Teachers' Retirement System, Sacramento, California**

CALSTRS AND OTHER STATE AND LOCAL GOVERNMENT RETIREMENT SYSTEMS HAVE MET THEIR FIDUCIARY RESPONSIBILITIES TO PROVIDE PRE-FUNDED RETIREMENT BENEFITS FOR MILLIONS OF STATE AND LOCAL GOVERNMENT EMPLOYEES

In the course of the recent debate over the President's proposal for direct investment of a portion of the Social Security trust fund in equities, there has been the suggestion that public pension plans, including State and local retirement systems, have underperformed in their investments because of political interference. While we do not intend to inject ourselves into the debate over Social Security privatization, as one of the largest State retirement systems in the country we feel compelled to respond to the suggestion that State and local plans and their governing bodies have failed to fulfill their fiduciary responsibilities.

In testimony before the Senate Budget Committee on January 28, 1999, Federal Reserve Board Chairman Alan Greenspan, in discussing the President's proposal for direct investment of Social Security trust fund assets in equities, asserted: "Even with Herculean efforts, I doubt if it would be feasible to insulate, over the long run, the trust funds from political pressures—direct and indirect—to allocate capital to less than its most productive use. The experience of public pension funds seems to bear this out." Chairman Greenspan argued that the returns on State and local pension funds are lower than private sector counterparts, while conceding that much of this disparity would be eliminated were these returns adjusted for risk in light of the fact that State and local pension funds often are invested more conservatively than private plans. The remainder of the disparity, Chairman Greenspan suggested, may be ascribed to political interference in the management of the State or local pension fund.

The California State Teachers' Retirement System (CalSTRS) covers more than 600,000 active and retired elementary, secondary, and community college teachers in California. Established in 1913, CalSTRS has successfully provided benefits to generations of retired teachers in California. The CalSTRS retirement system has assets with a total market value of \$93.456 billion as of December 31, 1998. Last year, as of June 30, 1998, CalSTRS collected \$1.005 billion in contributions from the State, and its investments returned \$12.949 billion in earnings and asset growth. CalSTRS is essentially fully funded (to meet its actuarial accrued liability). Last year, CalSTRS paid, on a pre-funded basis, over \$3 billion in benefits to 150,000 retirees and families.

A twelve-member Teachers' Retirement Board governs CalSTRS. The Governor appoints eight members representing active and retired teachers, business people from the insurance field and commerce banking, or savings and loan field, and a public representative to serve four-year terms. Four Board members serve in an ex-officio capacity and actively participate in Board matters; the State Superintendent of Public Instruction, the State Controller, the State Treasurer, and the State Director of Finance.

The Teachers' Retirement Board vigorously discharges its fiduciary obligations in the management of the retirement plan for the exclusive benefit of its active and retired members. Providing retirement security is the driving force of the investment policy. To meet this goal of retirement security, CalSTRS is dedicated to obtaining the highest possible return on its investments of the mandatory employer and employee contributions and other fund income, given an acceptable level of risk. The CalSTRS Investment Management Plan incorporates strategies that implement the Board's investment direction. The Board has established safety, diversification, liquidity, and structure as the appropriate standards for a complete and profitable investment portfolio. Reducing the System's funding costs within prudent levels of risk, diversification, and reduction of costs associated with managing the System assets are measures that have contributed to a solid investment portfolio. The Board establishes and regularly reviews the asset allocation policy that is designed to meet the investment objectives with an acceptable minimum risk.

We do not wish to become involved in the debate over the President's proposal for direct investment of Social Security trust fund assets in the stock market. However, we cannot let rest any implication from Chairman Greenspan's testimony or elsewhere that the Teachers' Retirement Board of the State of California or the governing bodies of other State and local government retirement systems are failing to live up to their fiduciary responsibilities. The members of the California State Teachers' Retirement Board take our fiduciary responsibilities very seriously, vigorously exercise those responsibilities and have fully discharged them.

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### **Statement of Century Foundation, New York, New York**

#### SOCIAL SECURITY REFORM PROPOSALS: HOW THEY STACK UP AGAINST PRINCIPLES FOR PRUDENT CHANGE

Members of Congress, private organizations, academics, and others have put forward widely differing plans for reforming Social Security. Many of the details of those proposals are complicated and the extent to which they address the primary problem confronting the program—a projected shortfall beginning in the year 2032—vary considerably.

To help those who care about the future of Social Security understand the most prominent proposals under consideration, the Century Foundation is publishing a series of *Social Security Reform Checklists*. Each summarizes the main provisions

of a particular plan and then assesses whether it adheres to seven principles for prudent reform that were developed by a panel of leading Social Security experts.

#### THE SEVEN SOCIAL SECURITY REFORM PRINCIPLES

1. *Social Security should continue to provide a guaranteed lifetime benefit that is related to past earnings and kept up-to-date as the general standard of living increases.*

2. *American workers who have the same earnings history and marital status, and who retire at the same time, should receive the same retirement benefit from Social Security.*

3. *Social Security benefits should continue to be fully protected against inflation, and beneficiaries should continue to rest assured that they will not outlive their monthly Social Security checks.*

4. *Retirees who earned higher wages during their careers should continue to receive a larger check from Social Security than those with lower incomes; but the system should also continue to replace a larger share of the past earnings of low-income workers.*

5. *Social Security's insurance protections for American families, including disability insurance, should be fully sustained.*

6. *Social Security's long-term financing problem should not be aggravated by diverting the program's revenues to private accounts and benefits should not be reduced to make room for private accounts; any such accounts should be supplementary to Social Security, entirely as an add-on.*

7. *In addition to securing Social Security as the foundation of income support for retirees, their dependents, the disabled, and survivors, more needs to be done to encourage private savings and pensions.*

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### Social Security Reform Check List #1

#### The Robert M. Ball Plan

##### OVERVIEW

Robert M. Ball, a former commissioner of Social Security, advocates a plan that retains Social Security's current structure while making a series of adjustments to assure the system's long-term financial integrity and giving wage earners a way to save additional money for retirement. His plan is similar to a proposal endorsed in January 1997 by six out of thirteen members of the 1994–96 Advisory Council on Social Security. The Ball plan requires only limited benefit cuts and tax increases. It would invest a portion of the Social Security trust funds, now exclusively comprising U.S. Treasury securities, in private equities. All disability and life insurance benefits would be maintained at present levels. Benefits to retirees would continue to be guaranteed for life and indexed for inflation. Those who paid more in payroll taxes would continue to receive larger benefit checks, while the program would also continue to replace a greater portion of wages for low earners than for higher earners. In addition, beginning in 2000, wage earners would have the option of contributing up to 2 percent of their wages to voluntary private savings accounts.

##### SUMMARY OF KEY FEATURES

*Benefit Changes.* The Ball plan would avoid major benefit cuts. Like most other reform proposals, however, it does include minor changes in the cost-of-living adjustments to reflect corrections to the consumer price index recommended by the Bureau of Labor Statistics. Those changes, most of which are already scheduled to take effect, should reduce annual cost-of-living adjustments by about 0.25 percentage points a year. The Ball plan would also increase the number of working years counted to determine benefit levels from today's 35 to 38. Adding more years would reduce average benefits by about 3 percent because the average past salaries that benefits are based on would include more years when workers were young and earning less—or nothing at all. Those with long absences from the workforce—women more commonly than men—would end up with the largest reductions.

*Tax Changes.* The plan does not include major tax changes; but it would raise the ceiling on earnings subject to Social Security taxes (currently \$68,400 per worker) at a rate faster than current law allows. The plan would seek to raise the portion of taxable wages from 85 percent of the national payroll to 90 percent—the traditional level of the program.

*Structural Changes.* The Ball plan would invest part of the Social Security trust funds, which now hold exclusively U.S. government securities, in stocks beginning in 2000. By 2015, 50 percent of the trust funds' assets would be invested in a broad index of equities. A Federal Reserve-type board would oversee these investments.

The plan would also move toward making Social Security universal by including all newly hired state and local government employees, some of whom are now covered under separate retirement systems. (Federal employees hired since 1974 are already covered under Social Security.) In addition, the Ball plan would allow workers to invest up to an additional 2 percent of their pay in voluntary supplementary retirement accounts administered through Social Security.

#### EVALUATING THE PLAN

To assess the impact of various proposals to change Social Security, The Century Foundation organized a group of experts to develop principles for prudent reform. Here's how Robert Ball's plan stacks up against those principles:

*Principle 1. Social Security should continue to provide a guaranteed lifetime benefit that is related to past earnings and kept up to date as the general standard of living increases.*

*Analysis:* The Ball plan leaves intact nearly all basic features of the current system, including lifetime benefits based on past earnings (with adjustment to account for past changes in the cost-of-living).

*Principle 2. American workers who have the same earnings history and marital status, and who retire at the same time, should receive the same retirement benefit from Social Security.*

*Analysis:* None of Ball's changes would alter this basic feature of the current system. However, workers who chose to make use of voluntary supplementary retirement accounts usually could expect to receive higher overall benefits than those who did not.

*Principle 3. Social Security benefits should continue to be fully protected against inflation, and beneficiaries should continue to rest assured that they will not outlive their monthly Social Security checks.*

*Analysis:* By endorsing modifications to the cost-of-living adjustment recommended by the Bureau of Labor Statistics to correct for current overstatements of inflation, the Ball plan would slightly reduce the amount by which Social Security checks are increased each year. Still, this proposal would retain the current system's protections against inflation.

*Principle 4. Retirees who earned higher wages during their careers should continue to receive a larger check from Social Security than those with lower incomes; but the system should also continue to replace a larger share of the past earnings of low-income workers.*

*Analysis:* Again, the Ball plan maintains the current benefit structure of Social Security. Higher earners would continue to receive larger benefit checks than lower earners, but low-income retirees would receive checks that replaced a larger share of their average earnings.

*Principle 5. Social Security's insurance protections for American families, including disability insurance, should be fully sustained.*

*Analysis:* The Ball plan maintains all of Social Security's insurance protections and current benefit levels for the disabled and for family members of workers who die.

*Principle 6. Social Security's long-term financing problem should not be aggravated by diverting the program's revenues to private accounts and benefits should not be reduced to make room for private accounts; any such accounts should be supplementary to Social Security, entirely as an add-on.*

*Analysis:* The Ball plan would not divert any of Social Security's payroll tax revenue into private accounts. However, it does feature voluntary add-on accounts that would be administered by Social Security and that workers could use to build greater retirement savings. The Ball plan would also invest a portion of the Social Security trust funds in private equities, which historically have increased in value more rapidly than the Treasury securities the system now holds. This change would potentially help alleviate the long-term financing challenge facing the system. But be-

cause stocks can lose value during particular periods of time, the assets in the trust funds might decline during a bear market.

*Principle 7. In addition to securing Social Security as the foundation of income support for retirees, their dependents, the disabled, and survivors, more needs to be done to encourage private savings and pensions.*

*Analysis:* By creating add-on accounts supplementary to Social Security, the Ball plan would institute a new mechanism for workers to accumulate savings for retirement. This provision would be especially beneficial to Americans who have no private pensions or other retirement savings options. On the other hand, a variety of tax incentives currently in place to promote savings, such as tax breaks for individual retirement accounts and 401(k) plans, have not been sufficient to induce low- and moderate-income households to increase their anemic savings rates. It is unclear whether a voluntary program like Ball's would create significant new savings.

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## Social Security Reform Check List #2

### Two Percent Personal Retirement Accounts

#### OVERVIEW

Harvard economist Martin Feldstein, a former chairman of the Council of Economic Advisors, has proposed reforming Social Security by creating "two percent personal retirement accounts." Feldstein's proposal, unlike most other plans, seems painless. It imposes no reductions in Social Security benefits or increases in taxes. In fact, its most distinctive feature is the creation of a new benefit: a fully refundable income tax credit, equal to 2 percent of each worker's earnings subject to the Social Security payroll tax that would finance new personal retirement accounts. (This tax credit is fully refundable because workers with no income tax liability and those who owe less than 2 percent of their earnings would still receive the full 2 percent contribution to their account.)

Under the plan, workers would have flexibility to choose from a group of regulated stock and bond mutual funds that would be administered by private managers. After retirement, however, every dollar a retiree withdraws from his or her personal account would reduce that retiree's guaranteed Social Security benefit by 75 cents. In cases where workers invested so badly or the market performed so poorly that little money was left in the accounts, they would continue to receive the benefits promised under today's system. Social Security's projected shortfall in the year 2032 would be deferred because the system would presumably owe less money to beneficiaries thanks to the accumulations in the investment accounts.

#### THE PRICE-TAG

According to the Congressional Budget Office, which recently released a critique of the Feldstein plan, the proposed tax credits would cost the government about \$800 billion over the next ten years. Rather than raise taxes or reduce government spending over that period, Feldstein proposes allocating anticipated federal budget surpluses to pay for the tax credit. Whenever federal surpluses become insufficient, then Congress would determine how to raise the money. But for the near future, Feldstein argues, his proposal could be implemented without imposing either benefit reductions or revenue increases that other plans for strengthening Social Security include.

Since Social Security faces a projected shortfall in 2032, can the system really be strengthened painlessly? The Feldstein plan appears to do so by financing the new accounts with the surplus in general revenues, as opposed to the payroll tax that is dedicated to Social Security benefits, thereby tapping a new well of resources for mandatory retirement savings. But because current federal budget surpluses reduce the debt, creating a new tax credit and diverting the surpluses to private accounts would increase the government's long-term obligations and interest costs. Therefore, as the report stated, "The policy would implicitly increase the tax burden on future workers if no further adjustments were made on the spending side of the budget."

#### EVALUATING THE PLAN

To assess the impact of various proposals to change Social Security, The Century Foundation organized a group of experts to develop principles for prudent reform.

Here's how the Feldstein proposal for 2 percent personal retirement accounts stacks up against those principles:

*Principle 1. Social Security should continue to provide a guaranteed lifetime benefit that is related to past earnings and kept up-to-date as the general standard of living increases.*

*Analysis:* Under the Feldstein plan, guaranteed Social Security benefits under the current formula, which is based on past earnings and takes into account cost-of-living changes, would become the minimum that workers receive. The actual payments that workers would collect, however, would depend to a significant extent on how the investments in their personal retirement accounts fared. Because the personal retirement accounts would be financed through a flat-rate income tax credit of 2 percent, the dollar amount of the contributions to the accounts would be higher for workers with larger incomes and would rise over time as a worker's earnings grew. Therefore, a retiree's total benefits would continue to be related to past earnings, although less so than under current law because of variations in the investment performance of his or her account.

*Principle 2. American workers who have the same earnings history and marital status, and who retire at the same time, should receive the same retirement benefit from Social Security.*

*Analysis:* The Feldstein 2 percent plan would produce new disparities in benefits earned by retirees with the same earnings history and marital status because some workers could be expected to make better investments than others. Variations in investment performance would be somewhat limited, however, because every extra dollar that workers accumulate in their personal retirement accounts would increase the benefits they receive by just 25 cents under the plan's formula. Distributions would be further reduced by the cost of administering the accounts, paying investment management fees, and integrating them with the rest of the Social Security system. Economist Peter Diamond has shown that the administrative costs in countries that have set up individual accounts (Britain, Chile, Argentina, Mexico) reduce benefits by 20 to 30 percent compared to what the U.S. Social Security system would pay given the same resources.

*Principle 3. Social Security benefits should continue to be fully protected against inflation, and beneficiaries should continue to rest assured that they will not outlive their monthly Social Security checks.*

*Analysis:* Because the baseline benefit would remain intact, beneficiaries would continue to receive some lifetime benefit. To date, however, the Feldstein 2 percent personal account plan does not specify whether and how the amounts accumulated in personal accounts would be converted into monthly payouts. Even if beneficiaries were required to annuitize their accounts (that is, convert the lump sums into smaller periodic payments based on life expectancy levels), the value of those payments would be eroded by inflation unless they were indexed to increases in the cost of living, as are today's Social Security benefits. The Feldstein plan does not indicate that the payments would be adjusted for inflation, however. If retirees were allowed to withdraw the money in a lump sum, as they can with individual retirement accounts, for example, they might spend all that money before they die.

*Principle 4. Retirees who earned higher wages during their careers should continue to receive a larger check from Social Security than those with lower incomes; but the system should also continue to replace a larger share of the past earnings of low-income workers.*

*Analysis:* When the payouts from personal retirement accounts are included, the overall effect of the plan would be that higher earners would receive disproportionately greater increases in their total benefit package than lower earners. Brookings Institution economists Henry J. Aaron and Robert D. Reischauer show that a worker with a high income would see their combined Social Security and private account payment increase by more than twice that of a low-income worker.<sup>1</sup> That would happen mainly because 1) contributions to the accounts would be made at the same 2 percent rate regardless of income, but 2) guaranteed benefits, which would be reduced at the same rate for all retirees, replace a larger share of the past earnings of low-income workers. These calculations don't factor in the probability that high

<sup>1</sup> In the table below, Social Security benefits correspond approximately to the average replacement rates of low and maximum earners—56 percent and 25 percent, respectively. Each worker contributed proportionately to earnings. When Social Security benefits are reduced by three-quarters of the pension based on the individual account, the low earner's pension goes up 12 percent, and the high earner's by 21 percent.

income workers would invest more aggressively and successfully. The bottom line is that lower-income workers would benefit less from the proposed formula than upper-income workers. (Feldstein has said that this problem could be addressed by imposing a modest redistributive tax on the investments of higher earners).

Average Earnings	Social Security	Individual Account	Total Pension	Change in Pension
Low earner—1,000 .....	560	240	620	+11%
High earner—5,600 .....	1,375	1,340	1,720	+25%

*Principle 5. Social Security's insurance protections for American families, including disability insurance, should be fully sustained.*

*Analysis:* The Feldstein 2 percent account plan is not explicit about what changes, if any, would be made to the survivor's and disability features of Social Security. By skirting this issue, the plan leaves important questions unanswered. For example, if a worker died prematurely and left dependents, what formula would be used for paying out the proceeds of his or her personal retirement account and integrating these funds with Social Security survivor's benefits? If workers became disabled, would they be entitled to gain access to the investments accrued in their accounts?

*Principle 6. Social Security's long-term financing problem should not be aggravated by diverting the program's revenues to private accounts, and benefits should not be reduced to make room for private accounts; any such accounts should be supplementary to Social Security, entirely as an add-on.*

*Analysis:* By creating a new refundable income tax credit to finance personal accounts, the Feldstein plan avoids, for now, diverting payroll tax revenues earmarked for current benefits and the Social Security trust funds. But because the tax credit would create a new long-term government obligation, future Congresses would need to find a way to pay for the personal accounts when and if surpluses run out. One inviting target at that point would be the Social Security trust funds themselves, which are projected to have accumulated over \$2 trillion by early in the next century to finance guaranteed payments to the baby boomers. Any shifting of assets from the trust funds to private accounts would reduce the money available to pay for guaranteed benefits in the future. Another "fix" would be for Congress to allow the national debt to grow to keep the program whole.

*Principle 7. In addition to securing Social Security as the foundation of income support for retirees, their dependents, the disabled, and survivors, more needs to be done to encourage private savings and pensions.*

*Analysis:* Initially, the Feldstein plan would neither increase nor decrease America's low levels of national savings, which many economists believe should be raised to promote investment and long-term economic growth. Every federal surplus dollar shifted to investment in a personal account would remain a dollar saved. To gauge the effect of the plan on national savings when and if surpluses run out, one would need to predict what actions Congress would take in the absence of the plan—which obviously are unknown. Professor Feldstein assumes that, without his plan, Congress would spend any anticipated surpluses. Under that assumption, his plan would increase savings and, consequently, economic growth. But the Congressional Budget Office argues, at least as plausibly, that the new accounts would lead to higher government budget deficits and lower national savings because they constitute a new, costly, and unlimited commitment of federal resources.

Moreover, if the government guarantees prevailing Social Security benefits as a baseline regardless of how well each worker's personal account performs, it risks encouraging workers to take greater, perhaps imprudent risks with their investments than they otherwise might. Under that scenario, akin to the savings and loan debacle of the 1980s, the government's future obligations would be even greater.

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### Social Security Reform Check List #3

#### The National Commission on Retirement Policy Plan

##### OVERVIEW

The National Commission on Retirement Policy (NCRP), a bipartisan group convened by the Center for Strategic and International Studies, has endorsed a proposal that would fundamentally restructure Social Security. The plan channels two percentage points of the current payroll tax (12.4 percent of wages, divided equally between workers and their employers, with a cap at \$68,400 in yearly income) into mandatory individual savings accounts. To compensate for the reduction in tax revenue and eliminate the projected shortfall in Social Security beginning in the year 2032, the NCRP plan cuts benefits substantially—in part by increasing the retirement age to seventy.

##### SUMMARY OF KEY FEATURES

*Benefit Changes.* According to the Congressional Research Service, the NCRP plan would reduce guaranteed benefit levels set under current law by 33 percent for an average-wage-earning worker retiring at the age of sixty-five in the year 2025. By 2070, after the plan is fully phased in, benefits for the average worker (who retires at sixty-seven) would be 48 percent lower than under present law. The specific changes leading to those reductions include:

Raising the normal retirement age from sixty-seven in 2029 (an increase that is already scheduled to be phased in under current law) to seventy. The plan would also increase the age of eligibility for reduced benefits from sixty-two to sixty-five by 2017. Raising the retirement age amounts to cutting benefits, since workers will receive lower lifetime benefits.

Reducing benefits for middle-income and high-income retirees. The portion of pre-retirement earnings that Social Security pays middle-income beneficiaries would decrease from 32 percent to 21.36 percent by 2020. For higher-income beneficiaries, the reduction would be from 15 percent to 10.01 percent by 2020.

Increasing the number of working years counted to determine benefit levels from today's thirty-five to forty by 2010. Adding more years would reduce benefit levels because the average past salaries that benefits would be based on would include more years when workers were young and earning less—or nothing at all. Those with long absences from the workforce—women more commonly than men—would end up with the largest reductions.

Reducing benefits to dependent spouses from 50 percent of their spouses' benefits to 33 percent.

*Tax Changes.* The plan would not increase payroll taxes, raise the cap on taxable earnings, or increase the taxation of benefits to help close the existing financing gap. But it would divert two percentage points of the current payroll tax into individual savings accounts.

*Structural Changes.* The NCRP proposal's structural changes to the Social Security program include:

Introducing individual savings accounts modeled on the Federal Thrift Savings Plan, which allows workers to invest in several broad-based funds. At retirement, workers would be required to annuitize the majority of funds in their accounts—that is, convert them from lump sums into monthly payments that are made for the duration of their lives.

Expanding Social Security coverage to include all newly hired state and local government employees.

Creating a new minimum benefit equal to 100 percent of the poverty line for those who have spent forty years or more working and 60 percent of the poverty line for those with twenty to thirty-nine years in the workforce.

##### EVALUATING THE PLAN

To assess the impact of various proposals to change Social Security, The Century Foundation organized a group of experts to develop principles for prudent reform. Here's how the National Commission on Retirement Policy plan stacks up against those principles:

*Principle 1. Social Security should continue to provide a guaranteed lifetime benefit that is related to past earnings and kept up to date as the general standard of living increases.*

*Analysis:* Although the plan retains a guaranteed benefit based on a worker's past earnings, the size of that benefit would be cut by 33 percent for the average worker retiring at 65 in 2025. Those reductions would be offset somewhat by provisions for new individual savings accounts and minimum benefits of 100 percent of the poverty line for those who spent forty years or more working and 60 percent of the poverty line for those with twenty to thirty-nine years in the workforce. But, in the process, benefit levels would become less closely tied to past earnings and more dependent on the performance of the investments in each worker's individual savings account.

*Principle 2. American workers who have the same earnings history and marital status, and who retire at the same time, should receive the same retirement benefit from Social Security.*

*Analysis:* While workers with similar earnings histories and marital status would receive the same, reduced baseline benefit from Social Security, the introduction of individual savings accounts would produce significant variations in overall benefits. Those who enjoyed better luck with their individual accounts, who invested more aggressively, and retired when their investments were at a peak would receive higher payments than workers who invested less wisely, opted for more conservative investments, or retired when their investments were down.

*Principle 3. Social Security benefits should continue to be fully protected against inflation, and beneficiaries should continue to rest assured that they will not outlive their monthly Social Security checks.*

*Analysis:* Although guaranteed benefits are cut substantially under the NCRP plan, they would still be indexed for inflation and continue until death. However, payments from individual accounts would not be protected against inflation. The NCRP plan would require retirees to convert most of their individual savings accounts investments into annuities upon retirement, but it does not mandate that these annuities make payments that are indexed for inflation. Unless workers chose to convert the accumulations in their accounts into annuities that are indexed for inflation, the value of each payment would decline over time as inflation reduced the value of the dollar. Today, inflation-adjusted annuities are very expensive and not widely available in the private market.

*Principle 4. Retirees who earned higher wages during their careers should continue to receive a larger check from Social Security than those with lower incomes; but the system should also continue to replace a larger share of the past earnings of low-income workers.*

*Analysis:* The NCRP changes in the benefit formula would result in middle-income and higher-income retirees receiving a lower percentage of their past earnings than is currently the case. This would represent a substantial cut in their benefits. Still, workers who earned more would continue to receive somewhat higher benefits than individuals who had lower incomes. And the new guarantee of benefits equal to 100 percent of the poverty level for workers who spent at least forty years in the workforce and 60 percent for those who worked twenty to thirty-nine years would offer protection for some low-income retirees—though less than the current system does in most cases.

*Principle 5. Social Security's insurance protections for American families, including disability insurance, should be fully sustained.*

*Analysis:* Although the NCRP plan would retain insurance coverage for the disabled and for surviving spouses, the reductions in guaranteed retirement benefits would dramatically reduce protections for workers whose earned income plummets for an extended period because of disability. The combination of delaying the retirement age, extending the number of working years counted in determining baseline benefits, and changing the formula for calculating those benefits would especially imperil those, like the disabled, who leave the workforce for years at a time.

*Principle 6. Social Security's long-term financing problem should not be aggravated by diverting the program's revenues to private accounts and benefits should not be reduced to make room for private accounts; any such accounts should be supplementary to Social Security, entirely as an add-on.*

*Analysis:* The NCRP plan imposes significant benefit cuts to allow two percentage points of payroll tax revenue to be diverted to individual savings accounts. The reduction in guaranteed benefits is far greater than the cuts that would be needed to assure that the system will be adequately financed throughout the next century.

*Principle 7. In addition to securing Social Security as the foundation of income support for retirees, their dependents, the disabled, and survivors, more needs to be done to encourage private savings and pensions.*

*Analysis:* The NCRP plan shifts assets accumulating in the Social Security trust funds to individual savings accounts, a process that would neither increase nor decrease national savings (the combined savings of the government, companies, and households), or personal savings levels. Many economists argue that increasing the nation's low savings level would help to promote long-term economic growth by supplying more capital for long-term investment.

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### **Social Security Reform Check List #4** **The Moynihan-Kerrey Plan**

#### OVERVIEW

Senators Daniel Patrick Moynihan (D–N.Y.) and Robert Kerrey (D–Neb.) have introduced legislation that would make significant changes in Social Security. Their plan would establish voluntary private retirement accounts while instituting major reductions in guaranteed benefits, a large, temporary payroll tax cut, and some tax increases. Most notably, the plan would reduce the payroll tax that finances Social Security from 12.4 percent (divided equally between workers and their employers) to 10.4 percent, giving individuals the option of either contributing the two point difference to a savings account or keeping one percentage point to use as they see fit.

The guaranteed benefits received by today's retirees, currently adjusted for inflation as the consumer price index rises, would increase at a slower rate because in calculating benefits a percentage point would be subtracted from the rate of increase in the Consumer Price Index each year. By the end of the average retirement period of twenty years, that change alone would leave beneficiaries with monthly checks about 25 percent below what they would be under current law. Economist Alicia H. Munnell of Boston College calculates that by the year 2070, when all the plan's changes would be fully phased in, the cut in guaranteed benefits for a worker with an average earnings history who retires at age sixty-five would amount to 31 percent. That's substantially more than the 25 percent across-the-board cut in guaranteed benefits that the government estimates will be required in the year 2032 if no changes whatsoever are made to Social Security in the interim.

#### SUMMARY OF KEY FEATURES

*Benefit Changes.* In addition to subtracting a full percentage point from the rate of increase in the consumer price index each year when adjusting retirement benefits for inflation, the Moynihan-Kerrey plan reduces benefits in the following ways.

It would increase the age at which full retirement benefits could be collected by two months per year from 2000 to 2017, and by one month for every two years between 2018 and 2065. This means that workers who reach sixty-two in 2017 will not be eligible for full retirement benefits until age sixty-eight and workers reaching sixty-two in 2065 will only become eligible at seventy. Under current law, workers reaching sixty-two in 2022 will be eligible for full retirement benefits at age sixty-seven.

Benefit levels would be based on how much a worker earned over the course of thirty-eight years rather than over thirty-five years, which is the period currently used. On average, the change would reduce a worker's retirement benefits by about 3 percent because it includes in the average the earlier years in workers' careers when they likely earned less—or nothing at all. Because women are more likely than men to withdraw from the workforce for years at a time to raise children, this change would affect them disproportionately.

*Tax Changes.* The Moynihan-Kerrey plan's payroll tax cut would begin in 1999 and last through 2024. After that, the payroll tax would increase according to the following schedule:

from 2025 to 2029, it would rise from 10.4 percent to 11.4 percent;

from 2030 to 2044, it would return to the current level of 12.4 percent;  
 from 2045 to 2054, it would be 12.7 percent;  
 from 2055 to 2059, it would rise to 13.0 percent,  
 in 2060 and thereafter, it would be 13.4 percent.

Other tax increases would be imposed sooner, however:

The cap on yearly earnings subject to the Social Security payroll tax would increase from \$68,400 in 1998 to \$97,500 in 2003, and thereafter would be indexed to wage inflation.

Social Security benefits would become taxable to the extent that a retiree's benefits exceed his or her tax contributions to the system. This change would result in more extensive taxation of benefits than under current law, which taxes only half of benefits received by retirees with total yearly incomes in excess of \$25,000 (\$32,000 for married couples).

*Structural Changes.* The largest structural change is the incorporation of voluntary private retirement accounts. This new component of Social Security would give an individual earning \$30,000 a year—who now pays \$1,860 in Social Security payroll taxes—the option of investing \$600 in a savings account or keeping an extra \$300 in take-home pay. The individual could put the \$600 either in investment funds that the government now offers to federal employees or in privately run accounts. Other structural changes include:

Newly hired state and local government workers would be required to participate in Social Security. They are the last group of workers now excluded from Social Security.

The earnings test, which may reduce current benefits for individuals who continue to work after electing to receive their Social Security benefits, would be eliminated beginning in the year 2003 for all beneficiaries aged sixty-two and over.

#### EVALUATING THE PLAN

To assess the impact of various proposals to change Social Security, The Century Foundation organized a group of experts to develop principles for prudent reform. Here's how the Moynihan-Kerrey plan stacks up against those principles:

*Principle 1. Social Security should continue to provide a guaranteed lifetime benefit that is related to past earnings and kept up to date as the general standard of living increases.*

*Analysis:* Under the Moynihan-Kerrey plan, guaranteed retirement benefits would continue to be based on past earnings, adjusted for changes in the cost of living. But those benefits would be significantly lower than under reform proposals such as those put forward by former Social Security commissioner Robert M. Ball or Brookings Institution economists Henry J. Aaron and Robert D. Reischauer. That's mainly because of the annual one-percentage-point reduction in the cost-of-living adjustment and the increase in the retirement age.

*Principle 2. American workers who have the same earnings history and marital status, and who retire at the same time, should receive the same retirement benefit from Social Security.*

*Analysis:* While workers with the same earnings history and marital status would receive the same *guaranteed* benefits from Social Security, the introduction of personal retirement accounts would produce significant variations in overall benefits among workers with the same earnings history. Because these accounts are voluntary, some workers would choose not to participate. (Only 3 percent of Americans earning \$30,000 or less, for example, have elected to open Individual Retirement Accounts despite considerable tax advantages in doing so). Moreover, investment returns on the accounts are certain to vary widely. Investors with greater financial acumen and better luck, and those who retire when investment markets are strong, would receive higher payments than workers who invested less skillfully or retired during a bear market. As a result, under the Moynihan-Kerrey plan, Social Security would more closely resemble an investment program than retirement insurance.

*Principle 3. Social Security benefits should continue to be fully protected against inflation, and beneficiaries should continue to rest assured that they will not outlive their monthly Social Security checks.*

*Analysis:* Under the Moynihan-Kerrey plan, Social Security would continue to pay guaranteed lifetime benefits indexed for inflation. However, by reducing the benefit adjustment tied to the consumer price index by one percentage point each year, the plan would hurt many low-income elderly who are already struggling with rising medical costs (which rise more rapidly than the consumer price index). These costs

have come to consume an ever-growing share of elderly Americans' personal expenses—20 percent of such expenses on average and an even higher share for poor seniors. Over the past fifteen years, adjustments in Social Security benefits have failed to take account of this rising burden. As for the assets accumulated in private retirement accounts, their value could be significantly reduced by a period of high inflation.

*Principle 4. Retirees who earned higher wages during their careers should continue to receive a larger check from Social Security than those with lower incomes; but the system should also continue to replace a larger share of the past earnings of low-income workers.*

*Analysis:* The Moynihan-Kerrey plan would retain this feature of the current program for determining guaranteed benefits.

*Principle 5. Social Security's insurance protections for American families, including disability insurance, should be fully sustained.*

*Analysis:* The Moynihan-Kerrey plan retains all of the disability and survivor's insurance features of the current Social Security program.

*Principle 6. Social Security's long-term financing problem should not be aggravated by diverting the program's revenues to private accounts and benefits should not be reduced to make room for private accounts; any such accounts should be supplementary to Social Security, entirely as an add-on.*

*Analysis:* By reducing the payroll tax in order to introduce personal retirement accounts, the Moynihan-Kerrey plan would deplete the asset buildup in the Social Security trust funds. This would shift a much greater share of the burden of financing Social Security to future workers after the retirement of the baby boomers. The benefit cuts will reduce those obligations to some extent but cutting revenues to the system now will add to, rather than lessen, the challenge of keeping Social Security sound in the next century.

*Principle 7. In addition to securing Social Security as the foundation of income support for retirees, their dependents, the disabled, and survivors, more needs to be done to encourage private savings and pensions.*

*Analysis:* The Moynihan-Kerrey plan includes no measures that would encourage private savings and pensions. Indeed, reducing payroll taxes (which by definition reduces the federal surplus or increases the deficit) without requiring households to save the money threatens to reduce further the nation's already low level of national savings.

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## Social Security Reform Check List #5

### The Gramm Plan

#### OVERVIEW

Senator Phil Gramm (R-Tex) is sponsoring a plan to transform Social Security by diverting nearly one-fourth of the payroll taxes that finance today's retirement insurance system into individual investment accounts. Under his proposal, workers would have the option of either retaining their current Social Security coverage and benefits or electing to shift three percentage points of their 12.4 percent Social Security payroll tax (split equally between workers and their employers) into their own investment account. Workers would not be allowed to opt out of the system altogether or transfer a different share of their payroll tax into the accounts. Those who opted for the investment accounts would be allowed to invest that money in a selection of privately managed mutual funds that would be certified and regulated by a new government oversight board. Initially, the accounts would be restricted so that no more than 60 percent of an investment portfolio could be in stocks, which can decline precipitously in value.

Upon retirement, workers with investment accounts would be required to convert the accumulated assets into an annuity that, like today's Social Security, would provide a lifetime monthly payment that increases as inflation rises. After the system was fully phased in, retirees who opted for the personal accounts would be guaranteed a total monthly benefit equal to the guaranteed payment promised under today's system, plus 20 percent. If the assets accumulated in a retiree's personal account proved to be insufficient to pay the full 20 percent bonus, the government

would make up the difference. Retirees who invested more successfully would be entitled to cash out any accumulations in excess of the 20 percent bonus as a lump sum if they wanted to.

Senator Gramm claims that his plan would end prospects that Social Security will face a shortfall in the year 2032, when payroll taxes combined with system's trust fund assets are expected to become insufficient to pay guaranteed benefits in full. The main reason is that the assets accumulated in the private accounts would significantly reduce the benefits that the system would have to pay out from the remaining 9.4 percent payroll tax and the assets in the Social Security trust funds.

#### THE PRICE-TAG

Diverting three percentage points of the Social Security payroll tax into private accounts for every worker who makes that choice would significantly reduce the anticipated growth in the Social Security trust funds, which currently are expected to tide the system over from 2013 to 2032—a period when promised benefits are expected to exceed payroll tax revenues. Because current retirees will have no private accounts to draw on and older workers will have little time to accumulate much in their private accounts, maintaining today's guaranteed benefits for them while payroll tax revenues decline by up to 24 percent (depending on how many workers opt for the new system) poses an expensive transition challenge.

Stephen C. Goss, deputy chief actuary of the Social Security Administration, calculates that if all workers opted for the private accounts, the cost to the federal budget and the Social Security trust funds would be an average of \$140 billion a year from 2000 to 2009. Senator Gramm has said that those transition costs could be paid out of projected federal budget surpluses. Drawing on surpluses poses problems, however. First, surpluses are projected to be adequate to pay for only \$81 billion of the \$140 billion that would be needed. Second, if the projected surpluses were to be used to finance the transition to the new retirement system, actual surpluses would be substantially lower each successive year because the surplus from the previous year would not have been used to reduce the federal debt and thereby reduce interest obligations. Third, the projected federal budget surpluses through 2007 are almost entirely attributable to the surpluses in the Social Security trust funds. So paying for the transition with budget surpluses essentially means depleting 72 percent of the Social Security trust funds, which would raise the level of government debt.

Senator Gramm projects that it would take 32 years before his plan would become financially self-sustaining and 50 years before the assets accumulated in individual investment accounts would be sufficient to generate a benefit equal to 20 percent above the level promised by the existing system. If the investments in the private accounts don't increase in value as rapidly as Senator Gramm predicts—5.5 percent annually over and above the inflation rate—the system's long-term financial burdens could increase rather than decrease. Senator Gramm also claims that the government would gain additional revenues from higher corporate tax collections attributable to increased corporate profits that would arise from more money flowing into capital markets through the private accounts. There is little historical evidence, however, that higher levels of market capitalization generate increased corporate profits.

#### EVALUATING THE PLAN

To assess the impact of various proposals to change Social Security, the Century Foundation organized a group of experts to develop principles for prudent reform. Here's how Senator Gramm's proposal stacks up against those principles:

*Principle 1. Social Security should continue to provide a guaranteed lifetime benefit that is related to past earnings and kept up-to-date as the general standard of living increases.*

*Analysis:* Guaranteed Social Security benefits under the current formula, which are based on past earnings after taking into account cost-of-living changes, would remain the minimum that workers would receive if they decided against opening their own accounts. If they opted for the accounts, they would be guaranteed a 20 percent bonus on top of a benefit that would still be based on past earnings. And because the personal retirement accounts would be financed through a 3 percent flat-rate contribution, the dollar amounts flowing into the accounts would be higher for workers with larger incomes and would rise over time as a worker's earnings grew. Workers who invested so successfully that they could collect even more than the 20 percent bonus would receive benefits less proportionate to past earnings, however.

*Principle 2. American workers who have the same earnings history and marital status, and who retire at the same time, should receive the same retirement benefit from Social Security.*

*Analysis:* Workers who elect to open private accounts gain a guaranteed 20 percent benefit bonus above the amount that those who declined the option would receive. So the same past earnings history and marital status would not lead to identical benefits for workers who 1) made different decisions about whether to open an account and 2) had different degrees of investment success. Those who earned more than the 20 percent bonus in their accounts would be able to collect the difference as a lump sum.

*Principle 3. Social Security benefits should continue to be fully protected against inflation, and beneficiaries should continue to rest assured that they will not outlive their monthly Social Security checks.*

*Analysis:* The Gramm plan stipulates that the accumulations in the personal investment accounts would be required to be converted to lifetime, inflation-adjusted annuities akin to current benefits, and that those payments would be a minimum of 20 percent higher than the benefits currently promised. Although many questions could be raised about whether the plan adequately accounts for the cost of financing those benefits, the proposal adheres to this particular principle. An important ambiguity about the plan remains, however: it is unclear what benefits surviving spouses would receive. Under current law, survivors receive 100 percent of the benefit that their late spouse collected (presuming that benefit was higher than the payment the survivor was previously entitled to). The Gramm plan, as summarized to date, does not specify what happens upon the death of a beneficiary.

*Principle 4. Retirees who earned higher wages during their careers should continue to receive a larger check from Social Security than those with lower incomes; but the system should also continue to replace a larger share of the past earnings of low-income workers.*

*Analysis:* Workers whose private accounts grow enough to provide more than the 20 percent guaranteed bonus would receive larger payments relative to their past earnings than those who invested less successfully. In all probability, the most prosperous investors will be clustered at high income levels because 1) they have much greater experience and familiarity with investing, 2) they would have more money in their accounts to build on (since the contributions are a flat 3 percent rate), and 3) low-income workers with no investment experience may be more reluctant to open accounts in the first place.

*Principle 5. Social Security's insurance protections for American families, including disability insurance, should be fully sustained.*

*Analysis:* The Gramm plan stipulates that the survivor's and disability insurance features of the current system would be preserved in full. But Social Security actuary Stephen Goss points out that the proposal allocates only 1.5 percentage points of the 12.4 payroll tax toward maintaining those protections, even though that insurance now costs the system about twice as much—3 percentage points. Because the plan does not provide an explanation of how current disability and survivor's insurance could be maintained on half the funding it now receives, that aspect of the proposal deserves further scrutiny.

*Principle 6. Social Security's long-term financing problem should not be aggravated by diverting the program's revenues to private accounts and benefits should not be reduced to make room for private accounts; any such accounts should be supplementary to Social Security, entirely as an add-on.*

*Analysis:* By diverting 3 percentage points of the payroll tax financing the current system into private accounts, for those who choose them, the Gramm plan compounds the challenge of alleviating the long-term financial pressures on Social Security. Because current retirees and those now near retirement age must continue to receive promised benefits from payroll taxes in the years ahead, the cost of creating the new accounts will, in essence, deplete the Social Security trust funds and the federal budget surplus while increasing the national debt and government interest costs. Although the accumulations in the investment accounts after several decades might indeed be sufficient to finance the more generous benefits proposed, that eventuality depends on a variety of uncertainties about the number of workers who opt for the accounts, the performance of the economy, and investment growth. In any case, no one disputes that the cost of making a transition to Senator Gramm's system would add to federal budgetary pressures.

*Principle 7. In addition to securing Social Security as the foundation of income support for retirees, their dependents, the disabled, and survivors, more needs to be done to encourage private savings and pensions.*

*Analysis:* At first blush, the Gramm plan would seem to neither increase nor decrease national savings because payroll taxes would be moved from one category of savings—the Social Security trust funds—to private savings in the form of the personal accounts. But because of the need to finance the transition to the new system, the government will either have to borrow more, reduce promised Social Security benefits, or increase taxes. Increased federal borrowing by definition is the same as reduced government savings. And either reducing Social Security benefits or increasing taxes would cut the amount of money available to households to save.

The government guarantee of a 20 percent bonus above today's benefits for those with investment accounts—even those that perform poorly—risks encouraging workers to take greater, perhaps imprudent risks with their investments than they otherwise might. Under that scenario, akin to the savings and loan debacle of the 1980s, the government's future obligations could skyrocket since the bonus would be guaranteed whether the money was there or not.

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### Issue Brief #8

#### Investing the Social Security Trust Funds in Stocks

The Social Security program is running surpluses that, by law, must be invested exclusively in U.S. Treasury securities. The assets accumulating in the system's trust funds, currently in excess of \$900 billion and projected to peak at around \$3.8 trillion in the year 2020, are intended to enable Social Security to continue paying full benefits well after payroll tax receipts are no longer sufficient to pay benefits to retirees. One reason why those receipts are expected to fall below the system's obligations is the impending retirement of the baby boom generation—the enormous cohort of citizens born between 1946 and 1964. By 2031, the ratio of Social Security beneficiaries to workers is expected to increase from today's 30 per 100 workers to 50 per 100 workers. In addition, longer lifespans largely attributable to improvements in health care will increase the financial pressures on the system.

One proposal for easing those pressures is to diversify the holdings in the trust funds from safe but low-yielding Treasury securities into stocks, which historically have generated much higher investment returns. Indeed, trust fund diversification is an important element of President Clinton's Social Security reform plan. The rationale is that the change would enable the trust funds to grow more rapidly and pay out benefits further into the future. (Under current projections, the trust funds will be depleted in the year 2032. Thereafter, revenues would be sufficient to pay 75 percent of promised benefits). Depending on assumptions about the rate of growth in the stock market, the overall size of the trust funds, and the portion of them that would be invested in stocks, diversification could add anywhere from two to 20 years to the lifespan of the trust funds.

It should be noted that neither President Clinton's proposal nor anyone else's relies exclusively on trust fund diversification to strengthen the finances of Social Security. The centerpiece of the President's plan is an infusion of \$2.8 trillion over the next 15 years—or about 62 percent of the projected federal budget surplus over that period—into the trust funds from the general fund of the Treasury. About \$600 billion of this amount would be invested in stocks, while the remainder would be used to retire publicly held debt. The administration estimates that shifting additional money to the trust funds would delay the date when they would become depleted from 2032 to 2049. The investment in the stock market, which under the president's plan would increase incrementally and would never exceed 15 percent of the value of the trust funds, would add five more years.

Allowing the Social Security trust funds to invest in equities has significant consequences for the U.S. economy, the federal budget, and the Social Security system.

#### HOW MUCH WOULD DIVERSIFICATION STRENGTHEN SOCIAL SECURITY?

The projected annual rate of return on U.S. Treasury securities held in the Social Security trust funds is 2.7 percent, after inflation. In contrast, stocks generated an annual return of about 7 percent above the inflation rate from 1900 to 1995. If past serves as prologue and stocks continue to significantly outperform Treasuries in the future, diversification would bolster the trust funds.

Several variables will affect the extent to which diversification ultimately strengthens Social Security:

**Actual rates of return.** Century Foundation Research Fellow Dean Baker, in a paper titled "Saving Social Security with Stocks," points out that stocks may not grow as rapidly in the future as they have in the past if consensus forecasts for slower future economic growth turn out to be accurate. Social Security's trustees project that the U.S. economy will expand at an annual rate of less than 1.5 percent a year over the next 75 years, far below historical levels. The main reason for this decline is that the workforce is expected to grow much less rapidly than in the past. Since slower economic growth implies that corporate profits will increase more slowly, stocks may not be able to maintain 7 percent real returns in the future.

**The share of the trust funds to be invested in stocks.** The Clinton administration has proposed limiting the portion of the Social Security portfolio that could be invested in stocks to 15 percent. Many state and local pension funds, in contrast, allocate as much as half their assets to stocks. More extensive investment in stocks would create the possibility of higher returns for the portfolio as a whole, but it would also expose the trust funds to greater risk. During a bear market, a portfolio half-invested in stocks would be more likely to decline in value than one with only 10 percent in equities.

**Time frames.** During particular periods when stocks perform poorly, diversification may leave the Social Security trust funds with less than they would have if they had remained fully invested in Treasury securities. From 1968 to 1978, for example, the market fell 44.9 percent in real terms. During the twentieth century, average stock prices have failed to appreciate over three different 20-year stretches. But over longer time frames, stocks have consistently outperformed other investments. Because current projections indicate that the trust funds will not face a shortfall until 2032, market ups and downs over such a lengthy period would be more likely to leave a diversified trust fund with more reserves than one solely invested in Treasuries.

#### WOULD GOVERNMENT OWNERSHIP OF STOCKS LEAD TO UNWELCOME POLITICAL INTERFERENCE IN THE INVESTMENT MARKETS?

Federal Reserve Board Chairman Alan Greenspan and others object to diversifying the Social Security trust funds because they believe politics will inevitably intrude on decisions about how the money is invested. Greenspan argues that instead of seeking the highest returns, the managers of the funds will be constrained from investing in companies that arouse political controversy—say, tobacco companies or firms accused of discrimination or union busting. Because the trust funds have the potential to become the largest single shareholder in the entire stock market, the ultimate fear is that the government could significantly affect whether shares of different companies rise or fall—undermining the idea of freely operating markets.

Treasury Secretary Robert Rubin and others respond that the scenario Greenspan fears can be avoided by erecting barriers between Congress and the management of the trust funds. Those barriers would include creating an independent board, much like the Federal Reserve itself, to oversee the trust funds. Its members would be appointed by the president and confirmed by the Senate, serving staggered 14-year terms and shielded from dismissal from office for political reasons. In addition, the power of the board could be limited to selecting fund managers who would be required to make only passive investments in securities that represent broad market averages—so-called "index mutual funds." Moreover, Congress could require the board to waive its voting rights on shares in the trust funds' portfolio to prevent any efforts to influence the management of any company. Perhaps the strongest evidence that Social Security could keep politics out of the process of investing in stocks is the experience of the Federal Thrift Savings plan of the Federal Employees Retirement System, which covers 2.3 million government workers. Since 1984, the plan has invested in three different index funds, including a stock fund, without taking any action that has reflected a political consideration. Francis Cavanaugh, who was executive director of the agency responsible for administering the Federal Thrift Savings plan from 1986 to 1994, has said that though many individuals and groups have attempted to influence the investment decisions of the fund, the barriers against such forces have proven sufficient. Of course, Social Security's assets are many times larger than the \$66 billion in the Federal Thrift Savings plan, making it a far more conspicuous target for political activists.

Some state and local government retirement funds, most notably CALPers in California, play active roles in corporate governance. But many other government pension plans are required to behave as completely passive investors. And even CALPers's energy is usually focused on maximizing shareholder value rather than

imposing political-based demands on companies. If Congress decides that the Social Security trust funds should be diversified, examples like the Federal Thrift Savings plan and other passive government retirement plans would be the most suitable models.

WOULD THE TRUST FUNDS' PURCHASE OF STOCKS CAUSE THE MARKET TO BECOME OVERVALUED, RUNNING THE RISK OF A DISASTROUS CRASH IN THE NEXT CENTURY AS THE ASSETS ARE LIQUIDATED?

As large as the Social Security trust funds are expected to become, they would still be a relatively small fraction of the value of the entire stock market. Based on the assumptions of the 1997 report of the Advisory Council on Social Security, gradually investing up to 40 percent of the Social Security trust funds would produce a stock portfolio of an estimated \$1 trillion (in 1996 dollars) in 2020. Today the capitalization of the U.S. stock market is about \$12 trillion, and it will grow to something like \$40 trillion by 2014 according to the advisory council forecasts. Under President Clinton's plan, which would limit the trust funds' stock holdings to 15 percent of assets, Social Security's share of the market would be between 3 percent and 4 percent, according to actuary Stephen C. Goss of the Social Security Administration. In contrast, state and local pension funds held about 9.5 percent of corporate equities in 1996. Keep in mind, as well, that Social Security's investment in the stock market would occur gradually—no more than 0.3 percent of overall stock market capitalization in any year. Social Security would not suddenly come to Wall Street with a trillion dollar stake to place on the table. Similarly, the liquidation of shares in the next century to pay benefits to retired baby boomers would be gradual.

WOULD TRANSACTION AND ADMINISTRATIVE COSTS REDUCE THE BENEFITS OF DIVERSIFICATION?

The administrative and transaction costs of individual investment accounts like 401(k)s, IRAs, and other plans where each investor has a specified amount of money invested in his or her name can add up to about 20 percent. Tracking the value of each account, switching funds from investment to investment upon request, sending updates to investors, and so forth is expensive. In contrast, a large pension fund serving many members who are not directly in control of a specified amount incurs negligible costs. In the case of the Federal Thrift Savings plan—the best existing equivalent of a diversified Social Security trust fund—administrative costs amount to a scant 1/10th of 1 percent of assets.

WHAT WOULD BE THE IMPACT ON THE FEDERAL BUDGET OF DIVERSIFYING THE TRUST FUNDS INTO STOCKS?

Investing trust fund assets in equities would have the immediate effect of decreasing the federal budget surplus (or increasing a deficit if there is one in that year). That's because current accounting rules consider stock purchases to be a federal outlay, just like spending on roads or tanks. In contrast, the current practice of investing excess payroll taxes in Treasury securities adds to the federal surplus (or reduces deficits). Under President Clinton's plan, the contributions to the Social Security trust funds from general revenues would be counted as government expenditures even when they were not used to buy stocks. The rationale for this rule is that those contributions would be earmarked to retire publicly held federal debt, substituting government-owned debt held by the trust funds in its place.

The administration claims that its plan would reduce the share of publicly owned government debt from about 45 percent of the economy to just 7 percent by 2014—a level last reached in 1917. Reducing the government's debt to the public, the administration and many economists argue, would promote investment and economic growth by 1) injecting capital into the economy through the purchase of government securities and 2) reducing competition that private bond-issuers face in raising funds, lowering their borrowing costs and interest rates generally. The additional Treasury securities in the trust funds would insure that, in the future, the government would have to meet its obligations to Social Security before appropriations were made to other priorities. These changes, in combination with others that Clinton has proposed, would soak up the entire projected surplus.

WHAT WOULD BE THE IMPACT ON THE ECONOMY OF DIVERSIFYING THE TRUST FUNDS  
INTO STOCKS?

There is no reason why shifting a share of the trust fund reserves from Treasury securities into stocks would either increase or decrease economic growth. The change would not directly affect national saving, investment, capital stock, or production. It is possible that government borrowing rates might have to rise slightly to induce private investors to buy the securities that the trust funds would be eschewing for stocks. And private savers might earn slightly lower returns because their portfolios would contain fewer common stocks and more government bonds—those that the trust funds no longer purchased. Still, most analysts believe that these effects would be almost undetectable.

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**Statement of Credit Union National Association**

The Credit Union National Association (CUNA) is pleased to submit a statement on the topic of investing Social Security in the private market for the Committee's March 3, 1999 hearing.

CUNA applauds the Committee for tackling the difficult issue of the investment of Social Security's trust funds. One of the options under consideration is to allow individuals to invest a portion of their Social Security funds in "private retirement accounts" or PRAs. Another option would be for the Social Security Administration to invest directly in equity markets. CUNA does not have a position on the second of these options, but would like to point out that the two options need not be mutually exclusive. A Social Security reform package could include both some investment by the Social Security Administration in equities, and the introduction of private retirement accounts.

If PRAs are a feature of final Social Security reform, and CUNA believes the idea has considerable merit, CUNA strongly recommends that account holders be offered a wide range of investment options, including investments in depository institutions, such as credit unions. Investors should not be restricted only to financial securities, such as stocks, bonds and mutual funds. Many households are comfortable and familiar with investments in certificates of deposit in credit unions and other depositories. They are completely safe if held under \$100,000, and offer a variety of return options, many of which are fixed and known. We believe this would be good public policy for a number of reasons.

First, different households have very different levels of risk tolerance. Not all households will want to be fully invested in direct securities all the time. In fact, for some households, the lack of a safe harbor among investment options would be extremely troubling. More generally, the opportunity to structure a diversified portfolio of stocks, bonds and certificates of deposit in depository institutions would provide the correct level of choice where it properly belongs, with the individual investor.

Second, some concern has been raised about the ability of individual investors to manage the risks inherent in investments in the stock market. Offering households a safe-haven option such as shares and deposits in credit unions reduces the risk of poor management.

Third, investors' needs change over their life cycles. We certainly do not believe that someone saving for retirement should hold all assets all the time in lower-risk, lower-yielding investments, such as those available from depository institutions. However, the closer one gets to retirement, the more a portfolio should be weighted to more liquid, safer investments. Allowing investment in depository institutions would ensure such investments were available to PRA holders.

Finally, peace of mind is important to investors. This is particularly true as one approaches retirement and accumulated balances grow relatively large. Consumers trust credit unions. Credit union members are as likely to believe that credit unions have skilled professional management as banks, and they are much more likely (by 54 percent to 31 percent) to believe that credit unions provide reliable money-management information than banks. (*Credit Union Magazine's* "1998 National Member Survey," page 20.)

Instituting PRAs would make individual investors out of many people who had never previously faced the daunting task of directing their own investment portfolios. Offering such households access to institutions they trust, such as a credit union, will make the transition that much smoother.

**Statement of Richard Freeman and Marianna Wertz, Executive Intelligence  
Review News Service**

The debate that is taking place here today, and around the nation this year, on the pros and cons of government- or individually-directed Social Security fund flows into the stock market, is itself completely wrong in its assumptions, as well as its recommendations.

Firstly, the stock market is, in effect, a bubble of wildly inflated values and expectations, and like other bubbles of the worldwide speculative financial system of recent years which have popped (Russian GKO's, Brazilian debts, Asian "emerging" markets, etc.), it too cannot last. Proposing or condoning throwing more money into the frenzy of stock speculation, is the last thing that lawmakers should be doing.

The most intense argumentation for Social Security flows into the stock market comes from Merrill Lynch, State Street Bank of Boston, the Cato Institute, and other advocates of keeping the bubble going at all costs.

The real issue before us in 1999, as more of the worldwide "casino economy" blows out, is: how do we intervene to protect and restore the functioning of national economies serving the public interests, and end the parasitical effects of global speculation? In response to this strategic crisis, since fall, 1998, over 150,000 people internationally, have signed a petition-appeal to President Clinton, to take the step of appointing economist Lyndon LaRouche, *EIR's* founder and contributing editor, as economic adviser to the Administration.

*EIR News Service*, since its founding over 25 years ago, has documented in detail, the growing disparity between the increase in money flows into speculative activity, and the decline in productive investment flows into infrastructure, agriculture, industry, etc., to the point where today, we are seeing worldwide financial disintegration, and physical-economic breakdown. We will gladly make this documentation available.

For the purposes of the specific hearing topic today, however, we here provide the following references for the Committee, that bear on the point that channeling Social Security money into the stock market should NOT be done:

1. The idea that there is a federal budget surplus is a hoax.
2. The idea that Social Security is not "solvent" is a hoax.

Debating the pros and cons of how to put Social Security money into the stock market, only serves as an opening for extremist privatization schemes, subversive to the national interest. On Jan. 19, National Economic Council director Gene Sperling demurred that, under the Administration's new, limited proposal, the Social Security Trust fund would never have more than 15% of its assets in the stock market. [In fact, were \$600 billion to go into the markets over a 15-year period—the State of the Union address plan—that would represent one-fifth of what the projected asset level of the Social Security trust fund is projected to be in fiscal year 2014.] The very next day, Rep. Mark Sanford (R-S.C.), the proponent of one of the most radical Mont Pelerinite Social Security privatization plans, said that the presentation of the Administration plan helps clear the way for others in Congress, like himself, to now bring forward their plans of how to invest Social Security funds into the stock market. The following facts and figures show how insane would be this course of action.

Currently, the Federal budget of the United States has a deficit of more than \$100 billion, and it will continue to be significantly in deficit for the next several years. But, it is widely proclaimed in the press and on Capitol Hill that the fiscal year 1999 Federal budget (which runs from Oct. 1, 1998 through Sept. 30, 1999) will run a surplus of \$60–70 billion! What this refers to, however, is not the actual budget of the United States, but a phony construct called the "unified budget." This concoction was developed about 15 years ago to hide the actual size of the deficits that the U.S. budget is running. It figures prominently in the hoax that the United States will have a \$4.2 trillion budget surplus current over the next 15 years.

Let us first determine what the actual U.S. budget deficit is, and then see how the "unified budget" has been used to distort it. There are two ways to determine the actual budget deficit.

The actual Federal revenue budget of the United States is the "general revenue budget," sometimes called the "on-budget budget." It provides for most of the functions of government: education, building infrastructure and public works, running the various departments of the Executive branch, the military, and so on. Its revenues come from a variety of sources: primarily, personal, corporate, excise, and estate taxes.

The Office of Management and Budget (OMB), which reports the official budget expenditures, revenues, and deficit, and makes future projections, reported its projections of future deficits of the "on-budget budget" in the official *Budget of the United States Government, Fiscal Year 1999*. This was reported in the "Historical Tables" appendix to the budget, on page 20. The data are presented in *Table 1*. The OMB projected that the "on-budget" U.S. budget deficit would be \$94.7 billion in FY1999, and that the United States would still have a deficit of \$62.7 billion in FY2003. It does not project beyond the year 2003. The size of the deficit may be revised downward, after correcting for increased tax revenues, but according to the government's own official figures, there is no surplus.

Table 1.—Projected budget deficit of "on-budget" U.S. budget  
(billions \$)

1999 .....	\$95.7
2000 .....	104.9
2001 .....	94.1
2002 .....	44.6
2003 .....	62.8

AAAAA (Source: OMB)

However, the official "on-budget budget" incorporates some accounting tricks whose effect are to still understate the actual deficit. To correct that, a budget expert at the Congressional Budget Office (CBO) stated that the real budget deficit can be derived best by measuring the yearly increase in the "Federal debt outstanding." This is the cumulative outstanding debt of the United States. It is only increased each year for one purpose: because the U.S. Treasury has floated new debt obligations to cover that year's budget deficit. That is, when expenditures exceed revenues, that results in a budget deficit, and the manner by which the government covers the gap is by issuing new Treasury debt. That increases the Federal debt outstanding for the year. *Table 2* shows the result of using this more accurate method. (In this case, the data for this table are taken from the CBO estimate of the Federal debt outstanding, because it is more up-to-date than the OMB's data.) One can see that the actual U.S. general revenue budget deficit for FY1999 will be \$119 billion. Though this figure may be revised a little downward if tax revenues increase, it will exceed \$100 billion.

Table 2.—Projected budget deficit of actual U.S. budget  
(billions \$)

1999 .....	\$119
2000 .....	127
2001 .....	124
2002 .....	82
2003 .....	94
2004 .....	81
2005 .....	72
2006 .....	31
2007 .....	18

AAAAA (Source: CBO, FY 1999  
Mid-Session Review)

How, then, can one transmute an actual U.S. budget deficit of \$119 billion for FY1999, into a surplus of \$60–70 billion, as the media, the Congress, and the White House allege? This is done by the legerdemain of the "unified budget," whose function is to mask the actual budget deficit. What the unified budget does is to find various funds that are in surplus, and mix them in, quite improperly and illegally, with the actual budget deficit, to produce an apparent surplus. This practice was started in a major way during the Reagan administration, because the administration was wracking up large actual deficits.

The favorite target to mix in with the actual budget deficit is the OASDI trust fund, because, since the Social Security reforms of the 1980s, this fund has been

running growing annual surpluses (see below). (OASDI refers to the formal name for the Social Security trust fund, which is the Federal Old Age and Survivors and Disability Insurance Trust Fund, or OASDI.)

But this is quite illegal. The Social Security trust fund has its own dedicated tax, which produces a revenue stream earmarked only for the Social Security trust fund's purpose. *This special tax, by law, cannot be used to fund or to be mixed into the revenue stream of the general revenue or "on-budget budget."* Therefore, the ruse of the "unified" budget, which says that the actual budget is not in deficit, because we have now mixed in the surplus of the OASDI trust fund, is a complete fraud. Everyone who works on the budget knows that.

Let us show how this fraud works in FY1999. As stated above (Table 2), the FY1999 actual budget will have a deficit of \$119 billion. Let us assume that tax revenues are higher than originally projected, so the deficit is only \$100 billion. Now, in the current fiscal year, the OASDI trust fund will have a surplus of \$81 billion. Mixing the two together, one has reduced the deficit to only \$19 billion. The government also adds in, quite illegally, surpluses from other trust funds (such as the Highway Trust Fund), and employs other gimmicks. *Voila!* It produces a surplus of \$60–70 billion.

But there is an additional key element in the government's work to produce an alleged \$4.2 trillion budget surplus over the next 15 years: The OMB has incorporated into its budget calculations, that U.S. tax revenues will continue to grow at an accelerating rate, because of the impact of the U.S. stock market bubble in swelling capital gains and other tax revenue. Thus, the OMB and all other agencies are counting on the continuance of the stock market bubble for revenues, a stinging commentary on the state of affairs of the U.S. economy.

The OMB does not take account of the deepening worldwide financial and economic disintegration, which will blow out tax revenues, whether generated from the stock market or the real economy, and send the budget deficit through the ceiling.

Thus, the government's estimate of a \$4.2 trillion surplus is based on fraud combined with fantasy.

MYTH THAT SOCIAL SECURITY IS INSOLVENT

The rationale for diverting Social Security funds to the stock market, is that it would generate a higher yield on investment, which is alleged to be critical to add some years of solvency to the Social Security trust fund (which is formally known as the Federal Old Age and Survivors and Disability Insurance Trust Fund, or OASDI). However, the OASDI trust fund is not in any imminent danger, and investing a portion of it in the stock market is not a way to make it sound.

Table 3 shows the CBO's projected Social Security annual surpluses. By fiscal year 2008, it is estimated at \$186 billion. During fiscal years 1999 to 2008, the OASDI trust fund is expected to build up a cumulative surplus of \$1.516 trillion. The CBO and OMB have not yet publicly released figures of what they project the Social Security surplus will be for the five fiscal years 2009 through 2013, but were the rate of growth assumed for 1999–2008 to continue, the sum for those five years would be approximately \$1 trillion. Hence, for 1999–2013, the OASDI projected surplus is \$2.516 trillion, or three-fifths of the total \$4.2 trillion "budget surplus" that the government is projecting for next 15 years.

Table 3.—Projected Social Security annual surplus  
[billions \$]

1999 .....	\$117
2000 .....	125
2001 .....	130
2002 .....	142
2003 .....	146
2004 .....	155
2005 .....	165
2006 .....	173
2007 .....	181
2008 .....	186

Cumulative total, 1999–2008: \$1.516 trillion  
(Source: CBO, FY 1999 Mid-Session Review)

Therefore, when the government says that it will distribute, out of its imaginary \$4.2 trillion surplus, \$2.7 trillion to the Social Security fund over the next 15 years, all that it is doing is giving back to the Social Security trust fund money that already belongs to the Social Security trust fund, i.e., the \$2.516 trillion surplus that the Social Security trust fund would be building over the next 15 years. This act consists of finding the OASDI's surplus, taking it, and then giving it back. This is an elaborate ruse, but if the government did not use it, it could not so easily pretend that it had a \$4.2 trillion budget surplus.

#### WHAT SOCIAL SECURITY NEEDS

The main rationale given for investing a portion of the Social Security trust fund into the stock market is that this will make the Social Security fund "solvent." Otherwise, it is claimed, the trust fund would go broke. This story is not true, on several levels.

First, as a result of reforms of the Social Security System in the 1980s, the OASDI trust fund was mandated to build up a surplus over succeeding years to plan for contingencies. According to the mandate, the OASDI trust fund will go through three phases. First, by the year 2012, the revenue that the fund gets from a special dedicated Social Security payroll tax, will not be enough to cover payouts to retirees. At that point, the trust fund will also have to rely on the interest income it earns from the Treasury bonds it holds. In the second phase, by the year 2019, the combined tax income and interest income will not be enough to meet payouts to retirees, and the trust fund will then have to start drawing down the surplus it has built up. In the third phase, by the year 2032, all the trust fund surplus will be gone, and the rate of payout to retirees will exceed the income from the social security tax and interest. At that point, according to the story, the OASDI trust fund is broke.

Keep in mind that this last phase will not be reached until one-third of a century from now. The story that the collapse of the trust fund is imminent, is hokum. That is a lot of time to do something to reverse post-industrial society policies.

Second, the trust fund, by law (unless it is changed), is required to invest all of its money in U.S. Treasury securities. They are far sounder than stocks.

Third, the real issue is economic policymaking. The assumption that the OASDI trust fund will go broke by the year 2032 is premised on the assumption that U.S. GDP will grow by a real rate of about 1.9% per year between now and 2032. Were real transformation of the physical economy to occur—i.e., especially if President Clinton were to appoint Lyndon LaRouche as an economic adviser—the growth of the economy would take off like a shot.

The other problem is that there are fewer younger workers, as a percentage of the total population, entering the workforce. It is the tax contributions of the younger workers which helps provide the money needed for retired workers. The demographic collapse is simply a part of the economic collapse. Were economic growth and optimism to return to the United States, families would have more children—not as a result of being told to, but as a result of the enjoyment and confidence in the future that an advancing economy instills in a family.

Fourth, despite the official claim, that the purpose of putting the money into the stock market is to "make solvent" the Social Security system, in reality, it would bail out the stock market bubble. The Wall Street financier sharks want to have that new money in the stock market to prevent the its decline and to churn the market higher. They have been pushing for the trust fund's money to go into the stock market for years. The speculative U.S. stock market bubble is wildly out of control. It will pop, and will lose perhaps 50 to 75% of its value. The OASDI trust fund is now invested in Treasury securities, which, following upon the proper changes in broader economic policymaking, are a reliable investment.

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#### **Statement of David Oliveri, MFS Investment Management, Boston, Massachusetts**

##### THE FUTURE OF RETIREMENT: BEYOND SOCIAL SECURITY

Social Security has long been described as the "third rail" of American politics: Touch it and you're dead. Today, however, doing nothing has far more dangerous consequences. When the first wave of baby boomers begins retiring in the next 15 years, the world's largest governmental program will approach bankruptcy, according to the Social Security Administration. To restore the public's trust in the federal

government—and ensure the economic viability of its citizens—politicians are being forced to toss out conventional political wisdom and find a solution.

Traditionally, Americans have accumulated retirement income through a combination of sources including government, employers, and individual savings. However, the potential insolvency of Social Security and the massive reduction in the number of defined benefit plans offered by employers have reduced the role of both sources, leaving individual investors with virtually the sole responsibility of planning for their own retirements. Americans are gearing up for the challenge ahead. Indeed, seven of 10 Americans (69%) agree that the trend toward individuals taking more responsibility for their retirements than in the past is “more of a good thing than a bad thing,” according to Roper Starch Worldwide, Inc. (Roper Starch).

Not surprisingly, opinion research revealed that retirement planning weighs heavily on the minds of most Americans. Unfortunately, however, most individuals are woefully unprepared to fulfill this obligation. The national savings rate, for example, has fallen to its lowest level since the Great Depression, according to the National Center for Policy Analysis.

To encourage personal investing, the federal government has enacted legislation providing tax incentives for those who invest for their retirements. As a result, financial services companies have pioneered a vast array of retirement products, such as 401(k) plans; Individual Retirement Accounts (IRAs), which are funded through annuities and mutual funds; and other investment products. These products were originally designed to provide investors with supplementary sources of retirement income; today, however, they have become the foundations of many Americans’ retirement portfolios.

But despite the growing popularity of these retirement vehicles, the government has an obligation to preserve the legacy of the Social Security system by providing a safety net for all Americans, particularly for lower-income citizens. With the projected date of its bankruptcy drawing near, the issue of how to fix Social Security has been taken off the back burner. To date, the debate has been shaped by two radically different philosophies. One school of thought is to maintain the current Social Security system through a mix of benefit cuts and tax increases. The second view is to entirely overhaul the system by introducing the concept of mandatory savings, which allows participants to invest, own, and manage some or all of their contributions through private investment accounts.

Proponents of the private investment account concept contend that unfunded liabilities under the current system will have a devastating impact on the American economy during the next century. Furthermore, they argue, citizens would achieve far better returns on their investments based on the historical performance of the stock market. Of course, past performance is no guarantee of future results. Opponents counter that introducing risks to Social Security could devastate benefits in the event of a stock market downturn. They also suggest that benefits under a privatized system would be unfairly skewed toward higher-income citizens.

In either scenario, there is little question that the next few years will see many hands touching the ominous “third rail” of American politics. Leadership is needed to energize Americans to plan for their retirements and enact reforms that deliver retirement security for all citizens in the 21st century.

#### THE STATE OF SOCIAL SECURITY

The U.S. Social Security system was created in 1935 under The Social Security Act to provide economic relief for retired citizens in the aftermath of the Great Depression. Two years later, the first Federal Insurance Contributions Act (FICA) taxes were collected. The program was extended in 1939 to provide survivors’ benefits to the spouses and children of workers. In 1956, it was expanded further to provide disability insurance called Old-Age and Survivors Disability Insurance (OASDI).

In the years since Social Security was enacted, the program has played an integral part in improving the lives of our nation’s senior citizens. During the early part of this century, most elderly Americans received financial support from their extended families. Those who had no families were poor. As a result of governmental assistance, the elderly poverty rate has dropped sharply. In 1959, the poverty rate was more than 35% for retirees. In 1979, it declined to 15.2%, and by 1996, the poverty rate was down to 11%, according to the Social Security Administration.

True to its goal of providing a safety net, Social Security reported that it had lifted 11.7 million elderly people out of poverty in 1996 alone. In addition, the program elevated 3.5 million nonelderly adults and 800,000 children out of poverty. The world’s largest government program, Social Security spends more than \$350 billion each year.

Unfortunately, however, too many Americans began to rely on Social Security for a level of financial support that extended beyond its original scope. Indeed, economic theorists have suggested that these entitlements are directly tied to the declining savings rate in the United States. The National Summit on Retirement Savings in 1998 reported that this benefit has become the single most important source of retirement income for 80% of senior citizens. For 18%, it is the only source of income.

The Social Security system was designed as a "pay-as-you-go" system, which means that each generation of workers makes contributions to the Social Security Administration, which in turn pays the benefits for current retirees. This system, dubbed "an intergenerational transfer of wealth," worked well in 1940 when America had 159 workers per beneficiary, but declining birth rates have caused that ratio to decline significantly. Today, there are only 3.3 workers per beneficiary, and, by 2060, it is projected that there will be 1.8 workers per beneficiary. (See Figure 1.) Thus, as most Americans have grown to depend on Social Security as a vital source of retirement income, the program is approaching bankruptcy.

The resulting fiscal imbalance is largely a function of dramatic shifts in the demographics of the American population, particularly a vast increase in birth rates between 1946 and 1964. There are currently over 44 million people who receive Social Security benefits, which accounts for approximately 12% of the population. When baby boomers begin to retire, that figure will move up to about 20%, according to the Heritage Foundation. In other words, there will be virtually double the number of retired citizens as there are today.

Furthermore, life expectancies have risen substantially since the system was established in 1935. The original retirement age for Social Security, 65, was agreed upon when life expectancy at birth was 63. Social Security was not intended to fund the lengthy retirements of American citizens but to support the elderly who lived longer than expected and could no longer work. Today, life expectancy is 76 and is projected to rise to 81 over the next 75 years. This means that Social Security will have to pay benefits to individuals for 18 more years than it had originally planned. The normal retirement age today remains 65 and is scheduled for only a slight increase, to 67, under current law.

To deal with the rising number of retirees, the government has increased FICA taxes on workers and employers 36 times since 1970. These rates have grown steadily, from 2% in 1940 to 12.4% today, with most increases being enacted in the past two decades. (See Figure 2.)

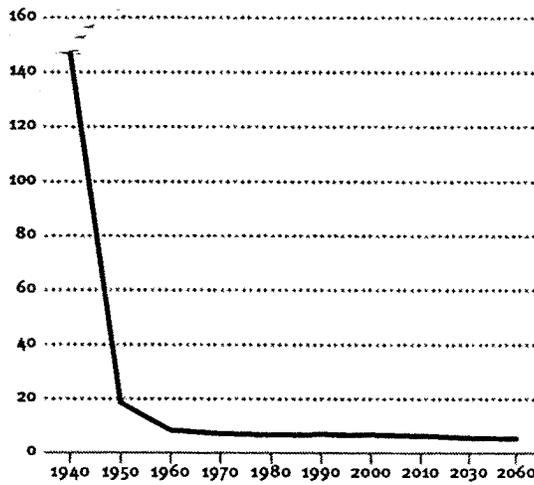
In 1983, the National Commission on Social Security Reform was created to restore Social Security to solvency. The commission called for an increase in the self-employment tax, partial taxation of benefits to upper-income employees, expansion of coverage to include federal civilian and nonprofit organization employees; and an increase in the retirement age from 65 to 67, to be enacted gradually beginning in 2000. As a result of these reforms, Social Security was declared actuarially sound.

Today, few legislators support the notion that Social Security can be saved with these types of minor changes. According to the 1998 Social Security Trustees report, the annual expenditures of the system will begin to exceed the amount of money it will collect in 2013 as the first wave of the 77 million baby boomers begins retiring. As a result, the Social Security Administration will begin to draw down the surplus it has generated since 1984, until 2032, when there will be insufficient funds to pay out benefits to citizens.

If the Social Security program is allowed to continue unfettered, it will begin to cause a considerable strain on the fiscal stability of the federal government. Pundits fear that Social Security and other entitlements will swallow up federal revenues, leaving Congress with little discretionary spending. Currently, entitlements account for 64% of spending capability. Under the Balanced Budget Act of 1995, they would rise to 72% of spending by 2002.

**Figure 1**

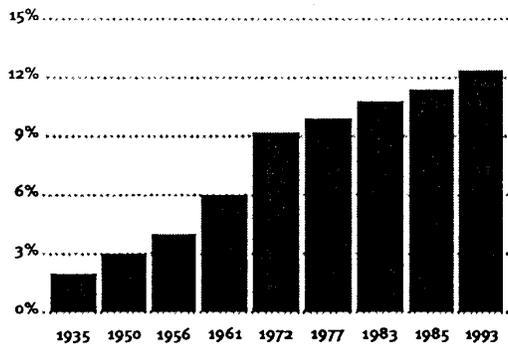
**NUMBER OF COVERED WORKERS  
PER SOCIAL SECURITY BENEFICIARY**



Source: The Social Security Administration

**Figure 2**

**PERCENTAGE OF FICA PAYROLL TAXES PAID BY  
AMERICAN WORKERS**



Source: The Social Security Administration

Social Security, alone, accounts for approximately 34% of entitlement spending. The trust fund is currently running a surplus and as a result of contributions from baby boomers will continue to do so in the near term. The annual surplus is estimated to be nearly \$100 billion by 2000, but it is dwarfed by an estimated \$3 trillion in unfunded liability over the next 75 years. Moreover, once baby boomers begin leaving the work force, the trust fund will be virtually gone by 2029, when Americans who are now between the ages of 30 and 50 expect to receive their benefits.

It is important, however, to note that this surplus should not be viewed as money that has been tucked away for future retirees. The trust is a myth; it contains no money. Instead, it consists of nonmarketable IOUs issued by the federal government to repay the fund, with interest.

Budget rules have allowed the government to invest all surplus dollars coming into the trust fund in nonmarketable special government debt. In other words, the government simply collects the trust fund's surplus revenue, replaces it with nonmarketable government debt in the same amount, and then uses the money from the surplus for other government spending. For example, in fiscal year 1997, Social Security's cash surplus of \$40 billion was used to reduce the \$62 billion deficit in the rest of the unified budget.

The projected shortfall will become reality not in the distant future, but in the next several decades. If substantial changes are not made, by the time baby boomers begin to retire revenue will not be adequate to cover costs, and the government will have to go deeper into debt, raise taxes, or reduce benefits.

In any event, future generations will be much worse off than those that have preceded them. According to Michael Tanner, director of health and welfare studies at the Cato Institute, today's retirees will generally get back all they paid into Social Security plus a modest return on their investment. But when today's young workers retire, they will receive a negative rate of return—they will get less than they paid in.

#### THE INDIVIDUAL'S INCREASED RESPONSIBILITY FOR RETIREMENT PLANNING

Traditionally, an individual's financial security in retirement has been called a "three-legged stool" of Social Security benefits, employer-provided benefits, and personal savings. However, the uncertainty surrounding Social Security has put a tremendous amount of strain on the retirement strategies of the American public.

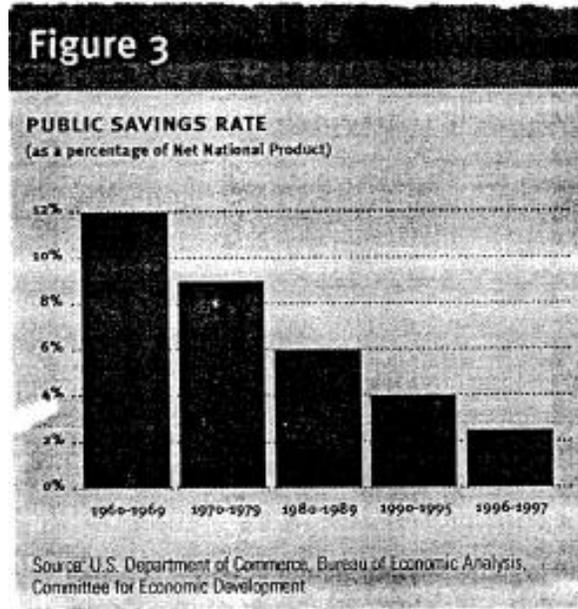
Moreover, changes in American corporations including corporate downsizing have required large companies to restrict employee benefits, mainly by replacing the traditional pension plans of employees with defined contribution plans. These plans remove a considerable financial burden from institutions, many of which are more focused on profitability than at any time in the past.

The Pension Benefit Guarantee Corporation (PBGC) estimates that the number of current workers participating in pension plans has dropped from 29 million in 1985 to fewer than 25 million in 1994. If this trend continues, PBGC projects that by the year 2005 most participants in defined benefit plans will be retired. Indeed, the number of plans insured by PBGC has decreased from 114,000 in 1985 to only 45,000 today.

The diminishing responsibility of the federal government and employers has placed the burden of retirement planning on individuals. For example, a recent survey by Roper Starch Worldwide, Inc. found that most Americans (72%) agree that "individuals themselves" are responsible for their own retirements. The survey also showed that many individuals continue to expect help from sources such as employers (53%), financial advisers (42%), the government (36%), insurance companies (33%), mutual fund companies (32%), and banks (27%).

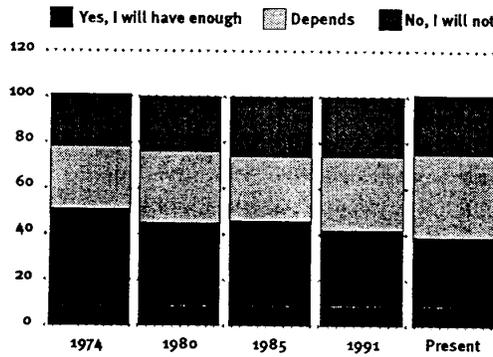
In fact, economic data suggest that individuals are not shouldering the burden to the extent necessary to provide for a comfortable retirement. For example, the national savings rate has declined dramatically in the past 15 years. So far this decade, net national saving (excluding depreciation) has averaged less than 2% of gross domestic product, down from 5% during the 1980s and from about 8% in previous decades. (See Figure 3.) Taken at face value, the figures suggest that Americans are saving less than at any time since the Great Depression.

Interestingly, most American workers are concerned about maintaining their current lifestyles after they retire. Only 39% of Americans who are not yet retired say they expect to have enough income to live comfortably during retirement, according to Roper Starch. This proportion is down from 45% in 1980 and from 51% in 1974. Meanwhile, 36% of respondents are uncertain whether they will have enough funds to retire, up from 27% in 1980. (See Figure 4.)



**Figure 4**

**WILL RETIREES HAVE ENOUGH MONEY TO LIVE COMFORTABLY IN RETIREMENT**



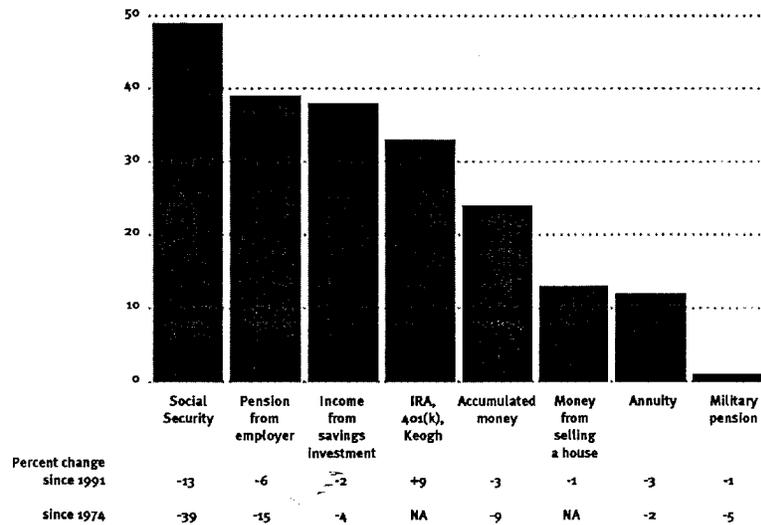
Source: Roper Starch Worldwide, Inc.

All told, the nation is becoming increasingly skeptical about the availability of funds for retirement living. Since 1974, Roper Starch has asked nonretired Americans whether they feel they can count on various sources of income in retirement. (See Figure 5.) The results reveal a significant decline in the proportion of the public saying it feels it can count on specific sources of income. The most dramatic declines have come for Social Security and pensions from employers. Today, just 49% of non-retired Americans say they can count on Social Security during retirement, according to Roper Starch. That's down by 13 points since 1991 and a staggering

39 points since 1974. It should be noted, however, that Social Security remains the source the public feels it can count on most. Just 39% think they will be able to depend on a pension plan provided by their employer, down 6 points since 1991 and down 15 points since 1974.

**Figure 5**

**PERCENT OF NON-RETIREES WHO ARE "FAIRLY SURE" THEY CAN COUNT ON VARIOUS SOURCES OF RETIREMENT INCOME**



Source: Roper Starch Worldwide, Inc.

Interestingly, while Roper Starch reported declines in confidence in sources of retirement income, the only product group to show gains were IRAs, 401(k)s, and Keogh plans, up 9 points since 1991. This finding, according to Roper Starch, reflects a much larger trend taking place among Americans: the trend of self-reliance. As Americans feel increasingly disillusioned by the elite in government and business, they increasingly feel they must depend on themselves.

**FILLING THE GAP: THE PROLIFERATION OF RETIREMENT PRODUCTS**

With the assistance of legislation designed to encourage retirement saving, the private sector has continually developed new products that enable individuals to invest in their own retirements. Originally designed as supplemental investment vehicles, defined contribution plans, IRAs and annuities have become, for many individuals, primary sources of retirement income.

*Defined contribution plans*

The federal government passed the Employee Retirement and Income Security Act (ERISA) in 1974 to empower individuals to take more responsibility for their financial well-being during their retirement—and to provide regulation to protect their assets.

401(k) plans, the most popular type of defined contribution plan, were not included in the original ERISA legislation but were added in 1981 as a variation on profit-sharing plans. It was not anticipated that these plans would play a major role in the retirement security of millions of workers.

However, the reductions in defined benefit plans since the early 1980s have elevated 401(k)s into the fastest-growing segment of pension plans. What's more, these plans allow for more flexibility than defined benefit plans because they are available to all participants, regardless of the worker's length of employment. Most employees

become eligible to join their company's 401(k) plan within six months to one year of employment.

Roper Starch reported that 52% of those surveyed agree that employers are responsible for helping individuals prepare for retirement. This, with Americans' common belief in personal responsibility, would suggest that a 401(k) or similar program is what Americans have in mind when they think of the ideal retirement plan.

These plans have quickly become the primary vehicles through which individuals contribute to their retirement nest eggs. In 1975, for example, the U.S. Department of Labor reported that there were 38 million total participants (active workers and retirees with vested benefits) in about 310,000 retirement plans. Of these, 103,000 were defined benefit plans, and 207,000 were defined contribution plans. By 1994, there were 85 million total participants in approximately 700,000 retirement plans, of which only 75,000 were defined benefit plans and 625,000 were defined contribution plans. Today, private retirement plans hold about \$3.5 trillion in assets, according to the Investment Company Institute (ICI), the mutual fund trade organization.

Mutual funds have become an increasingly popular investment vehicle for these plans, representing approximately 16% of all total retirement assets in 1997, up from only 6% in 1990, according to the ICI. Of the mutual fund industry's \$5 trillion in total assets, 35% are held in retirement accounts.

But despite the growth of 401(k) plans as a means of planning for retirement, there is much work to be done to ensure that the benefits of tax-deferred investing are available to all Americans. As opposed to defined benefit plans, these investments are not funded by an employer but primarily by the discretionary savings of participants (although many employers match contributions). This means that participation in such plans is far from universal. For example, the Employee Benefits Research Institute (EBRI) reported that approximately two-thirds of those offered plans actually participate, and that retirement benefits are frequently less generous than those offered by traditional defined benefit plans, depending on the level of employer contributions. An EBRI study reveals that the average amount of assets in 401(k) accounts is only \$29,000 and that half of all accounts have less than \$10,000. individual retirement accounts (IRAs)

#### *Individual Retirement Accounts (IRAs)*

Under the ERISA legislation of 1974, individuals were afforded the opportunity to invest up to \$2,000 on a tax-deferred basis as a supplementary vehicle for retirement planning. IRAs have been further expanded to include the Roth IRA, which instead of providing for tax-deductible contributions allows for tax-free withdrawals, and the Education IRA, which allows parents to invest for their children's college educations.

Total assets held in IRAs and Keogh plans (retirement plans for the self-employed) reached \$1.4 trillion as of year-end 1996. Between 1985 and 1996, total assets held in IRAs and Keogh plans increased 524%, according to the ICI. During 1996 alone, IRA and Keogh assets rose 15.7%, compared with a growth rate of 24.7% between 1994 and 1995, 9% between 1993 and 1994, and an average annual growth rate of 18.2% between 1985 and 1996. The ICI reported that most of the recent growth, however, was due to rollovers from qualified retirement plans, not from new contributions to the accounts.

#### *Fixed and variable annuities*

Annuities were first introduced in the late 1930s as part of Franklin D. Roosevelt's New Deal Program to encourage individuals to save for their own retirements. The first fixed annuities had guarantees of principal and set rates of return offered by the issuing insurance company. In 1952, the first variable annuity was created to provide policyholders with more control over how their money was invested. Variable annuity owners could choose what type of accounts they wanted to invest in and often received modest guarantees that their annuity value would never fall below what they originally put in the account. This guarantee, which is known as a death benefit and is not available until the death of the annuitant or the owner, depending on the contract, is backed by the claims-paying ability of the insurer.

Sales of variable annuities have exploded in the past decade from \$9.3 billion in 1987 to more than \$87 billion in 1997, according to the National Association for Variable Annuities. These products are generally geared toward a more affluent market including individuals who have already contributed the maximum amount to both their defined contribution plan and IRA.

## SOCIAL SECURITY REFORM: PROPOSED MEASURES

To date, federal government attempts to assure the future financial solvency of Social Security have relied on a combination of proposed tax increases and minimal benefits cuts. To illustrate the impact of such measures, the following is an examination of what would occur if either of these traditional options were to be adopted.

*Tax increase.* Actuarial estimates in the 1998 report of Social Security's Board of Trustees project that the program faces a \$3 trillion shortfall in funding over the 75-year estimating period. If the shortfall were to be met only by raising taxes, FICA taxes would immediately have to increase by 20%, from 12.4% to 14.6%. This tax hike could rise to more than 50% in the event that it is delayed for another decade, warned the Board of Trustees. Likewise, future additional taxes would be required to assure the program's solvency beyond the 75-year time frame.

*Benefits reduction.* If this situation were met by cutting benefits across the board, there would have to be a 28% reduction in 2032 and even larger reductions in later years (ultimately reaching 33% in 2070). These reductions would affect both those becoming entitled to Social Security benefits in 2032 and later and those already receiving benefits at that time, according to the Board of Trustees.

In either case, economists have warned about the negative effect these options would have on the domestic economy. A significant tax increase, they believe, would not only serve to slow economic growth, it would further reduce the national savings rate. They also suggest that benefit cuts could mean that, in 2032 and later years, the percentage of elderly people living in poverty would rise and that there would be greater reliance on welfare programs, diminishing the original intent of Social Security.

Furthermore, there is little support for maintaining a "business as usual" approach with regard to Social Security. According to Roper Starch, only one in four Americans would prefer to leave the system as is and simply supplement the Social Security system with additional taxes as needed.

In his January 1999 State of the Union address, President Clinton called for action to save Social Security by reserving the government's surplus until all of the necessary measures have been taken to strengthen the Social Security system for the 21st century. This surplus is projected by the Federal Budget Office to total \$679 billion over the next 11 years.

Some members of Congress have rallied behind the president's plea. Rep. Charles Rangel (D-N.Y.) has introduced legislation to create a Social Security reserve fund for any federal budget surpluses. Similarly, Sen. Ernest Hollings (D-S.C.) has called for Congress to bar any tax cuts or make any new investments with other funds until legislation is enacted to make Social Security sound.

But as the presidential election approaches and the fight for the government surplus intensifies, cutting taxes is believed to be more likely to take precedence over Social Security reform. The budget surplus notwithstanding, more than two dozen Social Security reform plans have been designed by legislators, private think tanks, and special interest groups.

Although the goal of all of these proposals is to ensure some level of income for retired persons, it is clear that individuals will be required to take on much more responsibility for their retirements than in the past. Government subsidies are being scaled back to bring Social Security more in line with its original intent of providing a safety net to citizens who have no other form of support. What follows are summaries of several key initiatives that have framed the Social Security debate as it stands today.

*Report of the 1994-1996 advisory council on social security*

In 1994, Donna Shalala, Secretary of Health and Human Services, appointed the Advisory Council on Social Security to examine ways in which Social Security could achieve financial stability over the next 75 years. The 13-member panel, however, could not agree on an approach and ultimately submitted three separate proposals to Congressional leaders.

Six of the 13 members agreed to maintain the present Social Security system, recommending a blend of cost-cutting and revenue-producing measures. Most notably, they suggested that the government itself should invest up to 40% of the surplus in the Social Security trust fund in stocks. The remaining seven members favored mandatory private savings through individual accounts, but they vehemently disagreed over whether workers should have limited or complete control over these accounts.

The following is a brief summary of the three proposals of the Advisory Council on Social Security. Although these measures were never adopted, their findings provide the basis of many of the latest proposed bills on Social Security reform.

- Option I: maintenance of benefits. This option would maintain the present Social Security system as a defined benefit plan. To ensure the system's solvency, it includes several revenue-producing measures, such as reducing benefits and/or increasing worker contributions and requiring newly hired state and local government employees to contribute to the system. The plan also favors additional taxes on Social Security benefits, among others. Furthermore, it suggested that the federal government help bring the program into balance and improve the benefits of future generations by investing a significant portion of the trust fund's assets in the equity market.

- Option II: publicly held individual accounts. The second option, endorsed by five members of the council, involves significant reductions in the growth of Social Security benefits. Specifically, it would reduce the growth of benefits to workers at all earnings levels by increasing the retirement age and by reducing benefits for middle- and high-wage workers.

In addition, this plan would introduce the use of individual accounts, or IA plans, as a means of raising overall national retirement saving. It would require all workers to contribute an additional 1.6% of their annual salaries, which would be held by the government in defined contribution individual accounts. Individuals would have limited investment choices, ranging from a portfolio consisting entirely of bond index funds to equity index funds. Upon retirement, the government would convert the money that has accumulated in a worker's individual account to a single or joint guaranteed indexed annuity, which would supplement his or her Social Security benefits.

- Option III: two-tiered system with privately-held individual accounts. The remaining council members favored reforming Social Security by making a substantial portion of the new system fully funded. Ultimately, a two-tiered system would take the place of the present Social Security system. The first tier would provide a flat retirement benefit for workers, and the second tier would provide individually owned, defined contribution retirement accounts, referred to as personal security accounts (PSAs).

In contrast to the IA plan, the funds in these accounts would not be held or managed by the federal government, the investment options would be less restricted, and workers would not be required to annuitize their accumulations at retirement. In addition, the PSAs would be funded with 5% of current FICA taxes. Survivors and disability insurance benefits would be modified but continue to be financed by the OASDI trust funds and administered through the Social Security Administration.

To bring the current system back into financial balance, provisions in the first tier would increase the retirement age and extend coverage to newly hired state and local workers. The 7.4% portion of payroll tax that was not used to fund PSAs would finance retirement benefits, spousal benefits, and survivors and disability insurance. The cost of transition to the new system would call for a 1.52% payroll tax, supplemented by added federal borrowing.

*Investment account payroll deduction plan—Sen. Daniel Moynihan (D.-N.Y.), Sen. Robert Kerrey (D.-Neb.).*

The Investment Account Payroll Deduction Plan involves a two-tier system that would allow workers to contribute 2% of their annual pay into a private account. The worker would pay 1% of the contribution, with an equal amount paid by the employer. These deposits would be placed in an IRA or sent to a newly created "Voluntary Investment Fund" to be managed like the Thrift Savings Plan available to federal government employees. Participation in the private option would be voluntary.

To restore the fiscal strength of the current Social Security system, all Social Security benefits in excess of the dollar amount of each employee's contributions would be taxable, which is similar to the tax treatment of defined benefit pension plans. Likewise, cost-of-living increases would be based on the Consumer Price Index minus 1%. The program would call for minor benefits reductions; however, the existing OASDI program would be retained in full. Other adjustments to the current Social Security system would include raising the normal retirement age to 68 by 2017, with a gradual increase thereafter until it reaches 70.

Under this plan, FICA taxes would decline to 5.2% for employees and 6.2% for employers until 2001, when the employer tax would fall to 5.2%. By 2025 to 2029, FICA taxes would rise to 5.7% for both employees and employers, with further tax increases slated for the future. The authors of this plan suggest that in 2004 all transitional costs would be recouped.

*The social security solvency act of 1997—Rep. Nick Smith (R.-Mich.)*

Similarly, the Social Security Solvency Act establishes a two-tiered system that uses the current benefit structure as a safety net. However, this plan gives workers the option to invest a substantially larger part of their 12.4% of payroll taxes.

The plan involves mandatory retirement savings with a Personal Retirement Savings Account (PRSA), through which investors can choose from a range of options. The amount of payroll contributions that can be put in a PRSA increases over time, starting at 2.5% of wages and growing to 10.2%.

Under this plan, benefits are gradually reduced for individuals making over \$50,000 who have received everything they and their employer have contributed to Social Security, plus interest. It also involves other small reductions in benefits; however, existing OASDI benefits would be retained. In addition, the normal retirement age would gradually increase to 69 between 2003 and 2018. The plan would then index the retirement age to reflect increases in life expectancy and working careers. Workers would be able to access their PRSAs at age 60.

To finance the transition, the plan would make methodological adjustments to the Consumer Price Index, fixing the index at 0.15 percentage points below assumptions in the 1997 Social Security Trustees Report.

*The individual social security retirement accounts plan—Rep. John Porter (R-Ill.)*

The Individual Social Security Retirement Accounts (ISSRA) Plan is another two-tiered system that allows workers to divert 10% of their pay to a private plan. Participation in this plan is voluntary. Social Security benefits would not change for workers who decided to remain in the current system.

For those who chose the private plan, the worker would pay 5% of the contribution and the same amount would be paid by the employer. Voluntary additional employee contributions up to 20% of taxable pay would then be permitted. Investment options would include government-approved private investment companies. Those participating in the plan would also pay 2.4% of their salaries annually (split evenly between employer and employee) during the first 10 years after election. Retirement age for full retirement benefits in either plan would ultimately increase to age 70.

For participants age 30 and older electing private savings plans, recognition bonds would be issued to ISSRAs, redeemable upon retirement for monthly benefits earned by Social Security tax payments under the current system. If, at age 62, a participant's ISSRA were not sufficient, the government would supplement it with a minimum annuity payment from the general funds of the U.S. Treasury. The ISSRA would purchase private disability and life insurance for the account holder equal to at least the same coverage under Social Security.

Transition financing would involve, among other things, \$500 billion (in 1996 dollars) of government bonds issued over the first 12 years. Unspecified reductions in other government spending of \$875 billion would be required.

*The personal retirement accounts plan—Rep. Mark Sanford (R.-S.C.)*

The Personal Retirement Accounts (PRA) Plan involves the full replacement of the current Social Security system with 8% of pay diverted to a private plan, split evenly between employers and employees. It would be mandatory for all workers entering the work force in 2000 or later. Those employed before then could decide whether to remain in the current Social Security system or participate in PRAs. For those participating in the new plan, investment options would include low- to moderate-risk index funds. The Securities and Exchange Commission (SEC), with expanded authority, would regulate these funds.

Workers would continue to pay 5.8% in FICA taxes, split evenly between employers and employees, to fund the existing OASDI system. The existing disability insurance system would be retained, however. PRA trustees would be required to provide insurance for any survivors and dependents. Retirement age would increase to age 70 by 2029.

Of note, this plan advocates the dissolution of the Social Security trust fund and would pay benefits with general revenue. Transition financing has not been determined. The plan would establish a Social Security Transition Commission to recommend spending cuts, asset sales, debt issuance, or increased revenue to fund the transition.

*The committee for economic development proposal*

This proposal would require participants to invest 3% of their pay into a mandatory private savings plan called a Personal Retirement Account (PRA), split between employer and employee. The PRA plan would offer broad-based funds managed by private companies.

The 12.4% FICA tax would continue to fund the existing Social Security system, which would offer reduced benefits. Specifically, replacement rates (the ratio of retirement benefits to the last year of earnings before retirement) would be reduced by 0.5% per year in the first 14 years and by 1.5% in the subsequent 19 years. Furthermore, 85% of all Social Security benefits would be taxable. The retirement age would also increase to 70.

Because the present Social Security system would remain intact, there would be no transitional costs.

In addition to these and other massive reform plans, there are a number of incremental reform proposals being introduced. For example, legislation introduced by Rep. Thomas E. Petri (R-Wisc.) would establish a retirement account of \$1,000 for each newborn American. The start-up funds would be derived from the sale of government assets and would be invested in the same retirement investment funds that are currently available to federal employees through the federal Thrift Savings Plan. Account holders could voluntarily add up to \$2,000 per year, tax free, to their retirement accounts.

#### THE CASE OF CHILE'S PENSION SAVINGS ACCOUNT

The United States is not the first or the only country to deal with a fiscal crisis in its social security program. In the late 1970s, the government-run pension plan in Chile was on the verge of bankruptcy. For reasons similar to those plaguing the U.S. Social Security system, Chile had no funded reserves, and it had already begun paying more benefits than it was collecting in revenue. As this situation worsened, higher taxes were the only solution, which stunted job creation. This led the Chilean government to scrap its social security system altogether and replace it with mandatory private savings.

Chile's Pension Savings Account (PSA) system was born on May 1, 1981. In a radical change from convention, Chile shifted the entire responsibility for funding a worker's pension from the government to the individual. Indeed, the amount of a pension was solely determined by the sum an individual worker accumulated during his or her working years. Under this system, the government required each worker automatically to put 10% of his or her wages into an individual PSA. A worker could contribute an additional 10% of his wages each month, also deductible from taxable income, as a form of voluntary savings.

This pension is available to all citizens, including those who are self-employed. It is completely portable, meaning that it is independent of the company with which a worker is employed.

These savings accounts are funded through a combination of more than 20 mutual funds of each worker's choice. These funds are managed by private companies called Administradoras de Fondos de Pensiones (AFPs). These companies can engage in no other activities and are subject to government regulation to safeguard against fraud and to guarantee a diversified and low-risk portfolio. Government regulation sets maximum percentage limits both for specific types of instruments and for the overall mix of the portfolio. Underscoring Chile's desire to remove the government from the pension business, there is no obligation to invest in government or any other type of bonds.

Workers are free to change from one AFP to another. For this reason, there is competition among the companies to provide a higher return on investment, better customer service, and a lower commission, according to Jose Pinera, Chile's former minister of labor and social security and president of the International Center for Pension Reform.

Participants are given a passbook and receive a quarterly statement. They can monitor the performance of their investments and can change the level of their contributions based on the amount of income they would like to receive and the year in which they plan to retire. Contributions are tax deductible, and the return on pension savings is tax free. Similar to the rules governing defined contribution plans and other tax-deferred investments in the United States, taxes are paid according to an individual's income tax bracket upon retirement.

The only government subsidy involves providing a minimum pension to low-paid workers. Those who have contributed for at least 20 years but whose pension funds, upon their reaching retirement age, are below the legally defined minimum will receive government-sponsored pensions from the state once their PSAs are depleted. The minimum pension for an average-wage worker is 40% of preretirement income. The PSA system also includes insurance against premature death and disability, which costs 2.9% of a worker's annual salary and is contracted from the AFP to a private insurer.

Upon retirement, there are two payout options. Under the first payout option, a retiree may use the capital in his PSA to purchase an annuity from any private life insurance company. The annuity guarantees a constant monthly income for life, indexed to inflation, plus survivorship benefits. If these payments exceed 70% of pre-retirement income, the worker is allowed to take out the excess in the form of a lump sum. The second option allows a retiree to leave his funds in the PSA and make withdrawals, subject to limits based on the life expectancy of the retiree and his dependents.

During the transition to the new PSA system, all workers were given the choice of staying in the government-sponsored program. Those who chose the new system were given a "recognition bond," which was deposited in their new pension savings accounts. These bonds were indexed and carried a 4% interest rate. Recognition bonds, which are payable when the worker reaches the legal retirement age, are also traded on the secondary markets so as to allow them to be used for early retirement. The choice of whether or not to participate in the PSA system was given only to current workers. All new entrants into the labor force were required to use the new system.

As an added incentive to participating in the system, workers' gross wages were increased to include most of their employers' contributions to the old pension system. As a result, salaries for those who moved to the new system increased by 5%. Employers continued to pay the difference in order to help finance the transition. However, that tax has since been phased out.

More than 40% of the transitional costs were financed through the issuance of government bonds at market rates of interest. These bonds were primarily purchased by the AFPs to fund their investment portfolios. The Chilean government projects that this "bridge debt" should be completely redeemed once it no longer has to fund the pensions of the participants in the old government-sponsored system.

The impact of Chile's pension savings accounts has been phenomenal. In the 14 years of its operation, benefits are already between 40% and 50% higher than under the government's plan. In 1997, PSAs have accumulated an investment fund of \$30 billion, an exceptionally large amount of money for a developing country of 14 million people and a GDP of \$70 billion.

Today, more than 93% of Chileans are in the new system. The Chilean government estimates that these workers will be able to retire with an average of 70% of pre-retirement income, more than three times the amount promised under the old system. The average rate of return on investment has been 12% per year, which was more than three times higher than the anticipated yield of 4%. (Note: This period included the longest bull market on record for equities.) Furthermore, the savings rate in Chile has increased from 10% in 1986 to 29% in 1996. All told, savings for the average Chilean is equal to four times his or her annual income, which is quadruple the average in the United States, according to Pinera.

Pension privatization, which has reduced the cost of labor, has been credited for pushing the growth rate of the economy from a historical 3% per year to 7% on average for the past 12 years. Chile ranks among the world's fastest-growing economies and has the highest credit rating of any Latin American country.

#### PRIVATIZATION: THE \$10 TRILLION DEBATE

The fundamental question in the debate over the privatization of Social Security is whether individuals would be better off directing all or a portion of their FICA taxes to private pension accounts of their own. The American public is divided on this subject. Roper Starch reported that most favor some individual control of Social Security contributions, with 60% supporting the idea that individuals be allowed to invest a portion of their Social Security contributions as they see fit. However, there is strong opposition to the government's playing the market to any degree. Only 26% support changes that would allow the government to invest a portion of Social Security in the stock market, and less than 13% support the government's investing all of Social Security in the market.

Proponents of the privatization of Social Security contend that the average individual would obtain far higher returns than he or she would under the current system. For example, a study from The Cato Institute's Project on Social Security Privatization revealed that low-income workers born in 1950 can expect to receive approximately \$631 per month from Social Security. But had those investors invested the same amount of money in a stock mutual fund, they would have earned upwards of \$2,419 per month. Moreover, individuals would own their own accounts, which would alleviate the federal government of a massive liability.

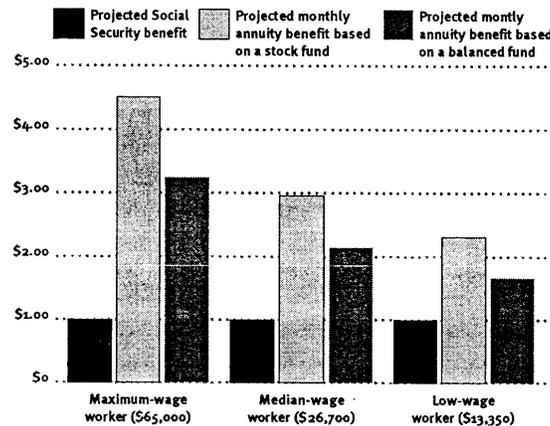
In contrast, opponents of privatization contend that Social Security is not simply an investment vehicle or a pension program—and never has been. By design, it's

a complex social program that involves massive subsidies from the next generation of retirees. Privatization would introduce a level of risk that could ultimately prove to be harmful to the investor. Furthermore, it would allow higher-income individuals to make larger contributions over their working lives, thus widening the chasm between the rich and the poor.

However, while past performance is no guarantee of future results, based on the historical returns of the stock market, returns from privately invested retirement accounts would be significantly greater for all wage earners than the benefits received from Social Security. For example, a recent article in Barron's estimated that a median-wage worker who was born in 1976 and will retire in 2043 would receive almost three times more money through a privatized plan that invested in a traditional stock fund than with Social Security based on the performance of the S&P 500 Index during that time period. (See Figure 6.) For low-income workers, the returns generated from stock funds would be 230% higher than those attained from Social Security. While there are inherent risks involved in the stock market, proponents of reform suggest that based on the historical performance of the S&P 500 Index, the higher rate of return from stocks would balance the risk of short-term fluctuations for long-term investors.

**Figure 6**

**THE DIFFERENCE BETWEEN SOCIAL SECURITY BENEFITS AND EXPECTED STOCK/BOND RETURNS**



Note: This chart illustrates the difference in monthly benefits across three different wage-levels for individuals born in 1976 who began working at age 21 and will retire in 2043.

Source: Barron's

One of the foremost proponents of privatization, Martin Feldstein, professor of economics at Harvard University and president of the National Bureau of Economic Research, estimated that Social Security privatization would raise the well-being of future generations by an amount equal to 5% of America's gross domestic product (GDP). Although the transition to a fully funded system would involve a significant investment of capital, he projected that the value of the gain would be as much as \$10 trillion to \$20 trillion.

Critics of Social Security reform have countered that Social Security benefits should not be compared with private investment vehicles because the goals are very different. For example, insurance aspects of Social Security help skew the returns downward. About one-fifth of payouts under Social Security go to wives and children of workers who are disabled or die before they have been able to contribute to the system over a full 40-year career.

Furthermore, the 68-year-old program has had the backing of the federal government and has to date fulfilled its promise to the American public. Opponents of privatization have said that the government could fix Social Security through a mix of benefit and tax reductions. What's more, there is concern that investors who retire during an extended bear market will achieve significantly less-than-average returns. For example, from 1968 to 1978, the stock market as measured by the S&P 500 Stock Index fell by 44.9% in real terms. People who retired in the late 1970s and financed retirement from stock sales had a return well below the historical market average. This scenario would have a devastating impact on the retirement income of lower earners. Opponents argued that the lower one's earnings over a lifetime, the more Social Security pensions matter to one's retirement security.

Investor education is another key determinant to the success or failure of American workers participating in a privatized system. Clearly, investors need sophisticated knowledge to invest successfully. Opponents worry that Social Security participants lack such knowledge. England's experience with social security reform offers a sobering example of the consequences of uninformed people investing money in the stock market. In 1988, the United Kingdom allowed individuals to opt out of its national public pension system and into private accounts. Sales agents often gave investors wrong and biased advice. These abusive sales practices, coupled with inadequate regulation, led to billions of dollars in losses for investors, according to SEC Chairman Arthur Levitt in a recent speech on Social Security reform at the John F. Kennedy School of Government Forum at Harvard University.

But reform proponents have said that a properly designed market-based system would build on the structures already developed for defined benefit and defined contribution plans. These plans do not require their participants to be highly sophisticated investors. For decades, workers of all income groups in defined benefit plans have entrusted their pension benefits to sophisticated investors, who, for the most part, have done very well in fulfilling their fiduciary responsibilities. In defined contribution plans where individuals have more of the investment responsibility, evidence suggests that they are more comfortable if given proper investment guidance.

Opponents have expressed concern that the transitional costs associated with privatizing Social Security could be burdensome on working Americans. For example, the National Committee to Preserve Social Security and Medicare has observed that either payroll taxes would have to be increased significantly or substantial government debt would have to be incurred. The organization estimates that a proposal to divert 5% of earnings from Social Security to private pensions would cost about \$2 trillion and require a payroll tax increase of 1.5%, combined with \$1.2 trillion in new government debt.

Reform proponents contend that the benefits of a privatized system would offset any transitional costs. According to a study by The Cato Institute, the tax revenues generated from the net increase in investment alone would be about \$150 billion in the 10th year from the start of the transition, and they would continue to grow as private investments accumulated each year. The study estimates that this effect, combined with modest spending cuts of about \$60 billion per year and modest increases in borrowing of about \$50 billion per year, would yield a positive cash flow for current retirees who depend on Social Security. There would be no further spending cuts or borrowing by the 15th year after privatization.

#### CONCLUSION

The debate over whether or not to privatize Social Security will involve considerable compromise from those on both sides of the issue. Without clear and effective leadership, the ensuing retirement crisis will have a detrimental impact on the nation's economy and the quality of the lives of its citizens. Whatever the outcome, individuals will be required to assume more responsibility for their retirements than the generations before them. To encourage saving, regulators, financial services companies, and financial advisers must not only provide more access to investment products, they must educate individuals and provide strategies to help them maintain a comfortable lifestyle in retirement. Indeed, for the sake of the nation's economy and the quality of the lives of its citizens, the debate over Social Security reform and how to encourage better retirement planning must take center stage as the 21st century approaches.

February 27, 1999

The Honorable E. Clay Shaw, Jr.  
Chairman, Subcommittee on Social Security  
House Committee on Ways and Means  
*United States House of Representatives*  
*Washington, D.C. 20515*

Dear Representative Shaw:

We understand the House Ways and Means Subcommittee on Social Security will be holding a hearing on the direct investment component of the President's Social Security reform proposal. We have also been advised that state and local government pension plans may be characterized in this hearing as allowing "political interference" in their investment decisions.

We have no position on the President's proposal. However, we strongly disagree with the current comments implying we earn a lower rate of return due to alleged politicization of investment decisions and policies that focus on social factors other than the best interests of the plan participants. We strongly believe that public pension plan assets are invested in a prudent manner that ensures that plan participants receive the benefits to which they are entitled and also in a manner that reduces the costs for taxpayer support of the plans.

Should the Subcommittee find it necessary to raise the issue of the investment performance of state and local government pension plans, we respectfully request the Subcommittee invite independent experts to testify on the rates of return obtained by public pension plans as compared to their private sector counterparts over the past several years. Such testimony will show that the rates of return achieved by public and private plans over these periods are quite similar. Furthermore, it will provide the Subcommittee with information based on current data.

Data the Ways and Means Committee has received to date, and relied upon by Federal Reserve Board Chairman Alan Greenspan, was based on information from the 1960s through the 1980s and showed the rates of return for public sector plans trailing by two to three percentage points the return rates of private sector plans. Chairman Greenspan suggested that some of the disparity might be ascribed to political interference in the management of the state or local pension plans. This is incorrect. Even the Chairman conceded that much of this disparity would be eliminated were these returns adjusted for risk in light of the fact that State and local pension funds are often invested more conservatively than private plans.

We believe virtually all of this lag is attributable to the investment restrictions imposed on public funds but not on corporate plans. As these restrictions have gradually been lifted, public funds' performances have grown to become comparable with private pension funds. *Current data shows that public retirement funds are efficiently managed financial institutions with well diversified portfolios that have achieved impressive rates of return.*

If the Subcommittee does wish to pursue the issue of state and local government pension investment practices, we would appeal for a full, fair and complete hearing record. We respectfully request that the Committee invite independent experts to testify on the rates of return obtained by public pension plans as compared to their private sector counterparts over the past several years.

We would suggest that you call Laurette Bryan and/or John Gruber, Senior Vice Presidents of State Street Bank. Their testimony will be factually rooted in the actual rates of return experienced and provided by scores of the nation's public and private pension plans to their institution as well as Chase Manhattan Bank, Citibank, Mellon Bank, Northern Trust Company, U.S. Trust, Bank of New York, NationsBank and 11 other banks. These banks support the Trust Universe Comparison Service (TUCS) which produces rates of return and other data that are used as the industry standard by which pensions measure their performance. (We have attached a summary of these independent findings for your review).

We appreciate your consideration. If you have any questions or would like additional information you may contact our legislative representatives:

GERRI MADRID/SHERI STEISEL,  
National Conference of State  
Legislators  
NEIL BOMBERG,  
National Association of Counties  
DOUG PETERSON,  
National League of Cities  
LARRY JONES,  
United States Conference of Mayors  
TOM OWENS,  
Government Finance Officers  
Association  
JEANNINE MARKOE RAYMOND,  
National Association of State  
Retirement Administrators  
CINDIE MOORE,  
National Council on Teacher  
Retirement  
ED BRAMAN,  
National Conference on Public  
Employee Retirement Systems

Attachment

[The attachment is being retained in the Committee files.]

**Statement of Peter J. Sepp, Vice President, Communications, National  
Taxpayers Union, Alexandria, Virginia**

Mr. Chairman and distinguished members of the Committee, I am grateful for the opportunity to present the views of the 300,000 members of National Taxpayers Union (NTU) as you consider proposals that would allow the federal government to direct and control the investment of Social Security funds in private financial markets. As you may know, the vast majority of NTU's members are either retirees or middle-class employees and business owners working towards retirement. Therefore, the issue before the Committee today is of great concern to them, and I commend you and your colleagues for recognizing the impact of this proposal.

INTRODUCTION

No one can deny the central role that individual investing has played in lifting the fortunes of millions of middle-class families. Nor can one deny increased public anxiety over the solvency of federal retirement programs, and the government's inability to address the problem.

These economic and political trends seem to have eluded President Clinton and many of his allies in the White House and Congress. Under the President's budget proposal, nearly 62 percent of projected budget surpluses (\$2.7 trillion over 15 years) would be funneled into the porous "Trust Fund." Of this, Clinton proposed "investing a small portion in the private sector just as any private or state government pension would do." This proposal, if enacted, would present the greatest threat to the finances of taxpayers and consumers since the Administration's attempt to nationalize 1/5 of the nation's economy under the guise of "health care reform." There is ample evidence from a range of disciplines to support this dire prediction.

AMERICAN INVESTORS ARE CONFIDENT IN THEMSELVES, BUT NOT IN THE  
GOVERNMENT

Perhaps no other economic factor is more responsible for the continued prosperity of Americans than the growth of individual investments in stock and bond markets. From 1989 to 1995, the percentage of all families having direct or indirect holdings in the stock market rose by one-third, to 40.3 percent. From 1990 to 1997, mutual fund holdings have increased an incredible 500 percent, to more than \$3 trillion. But these investments have not been fueled by short-term speculation. Indeed, most are directed towards long-term gains. Despite continued acts of Congress that have narrowed their availability and appeal, Individual Retirement Accounts contained \$1.35 trillion in 1996, double their worth just five years before.

This recent explosion in individual investment has financially empowered the middle class more than any other income level. Today, half of all families in the

\$25,000–\$50,000 bracket have holdings in the stock market. For the \$50,000–\$100,000 bracket, the level soars to more than two-thirds. It is therefore no wonder that this boom in investing has been accompanied by an explosion in financial counseling services, investment publications, and Internet sites all designed to provide consumers with the information they need to make rational choices in the stock and bond markets. Americans are unquestionably savvier about finance today than at any other period in history.

Yet, the rise in individual investor confidence has corresponded with a steady drop in taxpayer confidence in the federal government's retirement programs. As early as 1990, scientific opinion research by National Taxpayers Union Foundation revealed that less than one-fourth of workers under age 35 were confident that Social Security would pay the full level of benefits promised to them once they retired.

By 1995, significant pluralities of Americans had warmed to the idea of allowing individuals to plan more for their own retirements. A Grassroots Research Survey taken in November of that year found that 48% of Americans aged 30 to 39 would voluntarily withdraw from Social Security, even if they received nothing in return for the taxes they had already paid.

Today, public opinion not only favors individually-directed retirement investments, it also opposes government-directed schemes. A CNN/USA/Gallup poll conducted in December of last year indicated a 64%–33% approval margin for "individuals investing a portion of their savings" in the stock market as a Social Security reform option. An equally lopsided margin—65%–33%—disapproved of the "Federal Government investing a portion" of Social Security in the stock market.

#### STATE AND LOCAL INVESTMENTS HAVE A TARNISHED HISTORY

President Clinton unwittingly made the worst historical case for a federally-directed investment scheme when he referred to the experiences of state and local pension funds. The dismal political and financial track record of these funds is Exhibit Number One in the case against expansion.

- In 1990, Connecticut Treasurer Francisco Borges directed the State Pension Fund to invest \$25 million into the ailing Colt Firearms Division of Colt Industries, insisting that the money was "not a bailout, not a handout, and not a subsidy ... it is a bona fide financially prudent investment." At the time Borges didn't mention that the state brokered a deal with the company's striking union workers for a 13% pay raise and \$13 million in back wages. Borges later found himself in the curious position of supporting a ban on "assault rifles" while investing in the very company accused by gun control advocates of manufacturing the weapons. Colt later filed Chapter 11 bankruptcy.

- The Kansas Public Employee Retirement Systems (KPERs) has lost between \$138 million and \$236 million due to its Economically Targeted Investments (ETIs). Among the System's "bad picks" were a seized savings and loan once run by the head of KPERs and a now-abandoned steel plant.

- Pennsylvania school teachers and state employees have watched helplessly as \$70 million of their pension funds have been sunk into a new Volkswagen plant, an investment that has since lost half its value.

Rick Dahl, the Chief Investment Officer for Missouri's State Employee Retirement System, summed up this sad history when he observed, "Anytime you get a big chunk of money in front of politicians, you run the risk of investments made not in the best interests of the beneficiaries."

Those who consider such a statement to be too harsh should examine hard data. In 1998, John Nofsiger found that ETIs and other "socially responsible" investing practices depressed the average annual returns of public retirement funds by 1.5 percent. Ironically, former Clinton Treasury official Alicia Munnell conducted a similar study 15 years earlier that showed a 2 percent annual reduction.

#### FEDERAL FINANCIAL MANAGEMENT IS LIKEWISE TARNISHED

Beneath President Clinton's proposal is a thinly veiled contempt for the intelligence of the average American. It is based on the claim that the government, but not America's taxpayers, can invest budget surpluses wisely.

Given the plethora of policies that document the federal government's penchant for poor financial management, it is incredible that the Chief Executive would even imply such a thing. While the scope of these hearings do not permit a wholesale examination of the government's track record, the Administration's analogy forces us to remind the Committee of a few examples:

- In 1997, the average default rate on private bank loans to homebuyers was 2.8 percent. That same year, defaults on government home loans reached 8.1 percent.

- The total national debt owed by the federal government is \$5.6 Trillion. The total debt owed by consumers is \$1.235 Trillion.
  - Between 1950–97, the average annual return of money invested by citizens in the stock market has been 8.7 percent. The average annual return of the Social Security “Trust Fund” since inception has been 2 percent.
  - In 1996, nearly  $\frac{1}{3}$  of all citizens audited by the IRS were later cleared or were actually given refunds. Yet, the IRS has only cleared 1 out of 7 “audits” of its own books, as conducted by the General Accounting Office.
- Citizens are bombarded virtually every evening with newscasts exposing \$445,000 outhouses in national parks, \$1 million angora goat subsidies, and other instances of wasted tax dollars. But the facts above go beyond the sensational to the very fundamental reason why Americans do not—and will not—trust the federal government to invest wisely for the national interest.

THE BOTTOM LINE: \$350 BILLION IN LOST RETURNS AND A LESS ACCOUNTABLE  
POLITICAL SYSTEM

In order to quantify the amount at stake for future retirees if President Clinton's proposal is enacted, NTU's research staff compared the average rate of return of large company stocks over the past 70 years (as estimated by the Bank of Boston) to the average loss of return due to the political influence on retirement funds (as estimated by Nofsinger and Munnell). We then applied those rates to the estimated 15-year investment pattern of Social Security Funds provided by the White House and the Congressional Budget Office.

*NTU determined that the average loss to Americans' retirement funds under the President's plan would be \$354.53 billion over 15 years.*

However, the financial “ripple” would not end at that point. Hundreds of billions of government dollars flowing into private companies could give Washington direct control over a majority of shares in hundreds of companies. As past experience has shown, shareholders with even a 2 or 3 percent bloc of shares can significantly influence the policies of publicly traded companies. Thus, even investors who are buying shares out of their own pockets will see their influence over corporate governance diluted. In addition, the sheer volume of federal trading would affect returns on private portfolios, even those weighted to broader indices. After all, any major shareholder who pulls out of a company can depress dividends and capital gains for smaller investors.

Such linkages would likewise prevail abroad. Although the government could improve its returns by diversifying into foreign stocks and bonds, all sorts of political questions would present themselves. If Washington invests in countries whose leaders later become corrupt or violent towards U.S. military personnel, should the government sell its shares and worsen the risk of destabilizing those nations further, or should it stand pat and risk bankrolling the regimes?

Yet, perhaps the most troubling political question lies between our own shores. How would massive government investment in private companies affect the relationship between elected officials and special interests? Based on past experience, the impact would be decidedly negative. Corporate Political Action Committees could have an increased incentive to contribute to government shareholding officials, or those closest to them. For their part, federal officials would almost certainly have knowledge of impending public policy decisions that could affect the health of the companies in which the government owns shares. Those concerned with “campaign finance reform” and “insider trading” should be alarmed over President Clinton's proposal.

CONCLUSION—LET INDIVIDUALS, NOT GOVERNMENT, CONTROL THE SURPLUS

The American people were intelligent and diligent enough to produce a booming economy and a burgeoning Treasury in the first place. They are likewise intelligent and diligent enough to manage their own retirement finances.

Economic tides will always leave some individuals unprepared to retire in financial security. For this reason, many citizens support some kind of modest, targeted government program to keep the elderly out of poverty. However, Congress should not read this public mood—or knee-jerk polls that seemingly support the nebulous “Save Social Security” mantra—as an endorsement for further government meddling in the development of a sustainable middle-class retirement system. To adapt the words of entitlement expert Pete Peterson, Washington must grow up before today's workers grow old—and give hard-working Americans the credit they deserve to invest budget surpluses individually.

Once again, I thank you, Mr. Chairman, and the Committee for your thoughtful deliberation of this policy matter.

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**Statement of Chris Tobe, Plan Sponsor, Greenwich, Connecticut**

LESSONS FROM PUBLIC PENSION PLANS—PURE INDEXING IS ONLY CHOICE FOR SOCIAL SECURITY STOCK INVESTING

President Clinton outlined a proposal to invest part of the Social Security Surplus in stocks. In 1998 summer I co-wrote with Dr. Ken Miller for Kentucky Auditor Ed Hatchett a review of Kentucky's large public pension plans. As part of that review, we surveyed 41 of the largest public pension plans in the Country representing \$950 billion in assets. These multi-billion dollar plans are the closest parallels you can find to what a stock investment by Social Security would be like.

This proposal raises many issues. It is not a simple issue of privatization. However, I think it can work if we use the best examples of what our Public Pensions are doing today. They show that adding stocks to investment portfolios give us not only the historical higher returns of equities, but also more volatility and sticky governance issues that require our attention.

I am analyzing the President's plan of investing 10%–15% of Social Security assets directly in the stock market. This in my opinion is a very separate issue than the other IRA type retirement vehicles being proposed. Under this government direction scenario, you primarily need to decide who manages the stocks (private or public) and how those managers invest the proceeds.

CHOOSE INDEX FUNDS

Based on our findings in public pension plans my suggestion of how we invest Social Security proceeds is to invest in index funds. If you chose this option it matters much less who manages the money, only who can do it most efficiently. Public Pension plans have used indexing at an increasing rate because of its good performance and low cost. More importantly indexing, if strictly enforced, rids us of the sticky governance issues.

Active management leads to governance problems whether private firms or the government is managing the money. Most of us are familiar with the argument being made by political conservatives that if the government is the manager, it could have undo influence over corporations and be a step toward socialism. The conservative nightmare is that a Social Security stock selection committee will be made up of Jesse Jackson, Ralph Nader, and labor unions making demands on corporate management.

The California Public Employees Pension Plan and others have shown that they can hold at bay many of the social concerns, while maximizing returns for retirees. However, I think the resistance is much stronger for index funds than for the actively managed portfolios. We have seen this in New York and Florida, which divested Tobacco in their active portfolios while keeping them in their index funds.

Management by private firms is apt to be no better. It's susceptible to conflict of interest problems. Let us say an Investment firm has the government stock portfolio, but they also manage the pension plan of ACME auto. Do you think they would dump the stock of ACME auto, causing it to plummet and risk losing their business? In addition, the huge size of a Social Security portfolio could cause all kinds of potential for market manipulations when buying or selling stocks to benefit other portfolios or individuals. For example, the secretary overheard the portfolio manager say he was going to sell GM in the Social Security account. This information would be worth billions and is just too tempting.

An index fund, if adhered to, strictly prevents the majority of problems from government interference. It would also lower conflicts of interest if private firms were hired. Whether run by a neutral Federal Agency like the Federal Reserve, or bid out to a private vendor with oversight from a Federal Reserve type body, there would be little difference in the outcome with an index fund.

HOW TO EFFECTIVELY RUN THE INDEX

*While indexing is straightforward, it requires crucial strategic decisions*

First, you have to choose an index. With this much invested, you need to try to have as little effect on the market as possible. The index should be a market capitalization weighted index like the S&P 500 or Wilshire 5000. This means that the fund

might hold 100 times more of Microsoft than Apple because of their proportionate weight in the stock market. This would ensure that the market impact on each individual stock would be more or less spread equally across the portfolio of 500 to 5000 stocks.

I have argued that the S&P 500 is preferable because it is more widely used and is more liquid due to an active futures and options market. The Wilshire 5000 however is more indicative of the entire stock market in the United States and causes less disruption when issues are added or removed.

*Lessons From Public Plans—Low Fees*

Our public retirement review included a detailed review of the operation of a \$3 billion and \$1 billion S&P 500 index fund by two public funds, and a more general review of public pension plans nationally from our survey results of 41 large public plans.

A major finding was that index funds charged very low costs and had excellent performance for the 1, 3 and 5-year periods ending July 1997. Our reports concluded that both internal and external management of S&P 500 index funds could be very inexpensive.

Indeed, outside management fees could actually be negative for a large S&P 500 index fund, or at least cost-free. One of the reasons for this is securities lending in which the underlying stocks are loaned to other investors. While it is unclear how and if the Social Security Surplus could be subject to securities lending, it could prove very beneficial. It is conceivable that private firms would actually pay the government to have the Social Security assets and make their money off the security lending. This entire issue would need to be studied intensely to measure its market impact.

The cost advantages of indexing, however, go down if you deviate from pure indexing. A Wilshire study of the average total turnover of the AMA tobacco free indices is greater than the turnover for pure indices. This results in increased trading costs for the funds. Wilshire predicted higher trading costs of \$130,000 a year for a \$1 billion, S&P 500-index fund. The higher turnover is a result of the constant realignment of the tobacco free funds due to the over weighting of industries resulting from a zero weighting in the tobacco industry.

Public officials, therefore, need to understand the investment cost they are paying to achieve any moral gain. Investment restrictions will reduce opportunities for outperformance for active managers, increase risk for passive managers, generate one-time excess transactions costs, and cause measurement problems associated with imperfect benchmarks.

We have analyzed costs for each of these effects.

DIVESTMENT = TRACKING ERROR

Divestment of any kind causes tracking error. For our report we defined "Tracking Error" as the percentage difference in total return between an index fund and index it is designed to replicate. Our definition, based on Nobel Laureate Bill Sharpe's work, holds that even if you beat the index you still have tracking error. The objective is to exactly match the market, not to attempt to beat it. Exactly matching the index lowers the risk of underperforming your benchmark.

Public Funds have a mixed record in this regard. We found in our study of Kentucky's two plans that they deviated from a pure S&P 500 index portfolio. Kentucky Teachers and New York Teachers sold tobacco stocks in both their active and index funds. This seemed to be the exception, as New York, Florida and Minnesota public employees decided on tobacco divestiture only in their active funds, not in their index funds. Even the American Medical Association did not sell tobacco stocks from its index fund.

The Kentucky Retirement system dumped stocks in the S&P 500 that had international headquarters—like Royal Dutch and Northern Telecom—and for other reasons. Kentucky Retirement suffered significant tracking error to the index. Kentucky Teachers, however, despite the divestiture effectively minimized their tracking error through constant rebalancing, though they suffered minor error on a daily basis.

We recommend in our report that both Kentucky funds reinvest in the underweighted securities represented in the S&P 500 Index fund to reflect the correct weightings. Our reasoning was that the index fund needs to function according to its established investment policy. Our recommendation concerned the efficiency of running an S&P 500-index fund—not any social concerns. A pure index fund both reduces fees and eliminates the risk of underperforming your index.

There have been anecdotal reports of good performance by socially responsible funds. These reports depend mostly on what time period you use. Two studies show tobacco divestiture to have a negative effect on returns. One by Wilshire shows lower returns over long periods. A study from the *Journal of Investing* concludes: "The current arguments about whether to limit or prohibit pension fund investments in tobacco stocks, in contrast to earlier debates about 'sin-free' investing, focus on investment considerations rather than morality. But tobacco divestiture doesn't stand up as an investment decision. It doesn't reduce risk in the typical pension fund context, nor does it constitute a clever active strategy issued from the legislature. We should see tobacco divestiture for what it is: a moral decision."

On balance, the argument for social investing as a long term positive to performance does not seem to hold up under careful scrutiny.

#### PURE INDEXING—SOCIAL SECURITY STOCK INVESTINGS BEST CHANCE

The best example from Public Pensions is the pure index approach. For Social Security stock investing to be accepted, it needs to go into index funds with no exceptions, no matter the pressure. If states like New York and California and even the AMA resist tobacco divestiture in their index funds, so can Social Security if and only if it is in an index fund.

Our large Public plans have led the way in showing how it is possible to invest billions in stocks within a Government framework. Social Security reform should use the best of these examples when formulating how to invest in the stock market by using index funds.

Stock investing by Social Security can work with a pure index approach.

An edited version of this article will appear in the April 1999 edition of *Plan Sponsor* magazine.

