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HOUSE OF REPRESENTATIVES
COMMITTEE ON THE BUDGET

R E P O R T

OF THE

TASK FORCE ON SOCIAL SECURITY

TO THE

COMMITTEE ON THE BUDGET

(Together with Additional and Minority Views)

JANUARY 2000

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LETTER OF TRANSMITTAL

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
Washington, DC, January 20, 2000.

Hon. JOHN R. KASICH,
Chairman, Committee on the Budget, House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: By the direction of the Task Force on Social Security, I submit herewith the Task Force's report to the Committee on the Budget. The report is based on hearings and briefings held by the Task Force during the first session of the 106th Congress.

Sincerely,

NICK SMITH, *Chairman.*

106TH CONGRESS
1st Session

HOUSE OF REPRESENTATIVES

COMMITTEE
PRINT NO. 2

SOCIAL SECURITY FINDINGS

JULY 15, 1999.—Submitted to the Committee on the Budget and ordered to be printed

Mr. SMITH, from the Task Force on Social Security of the Committee on the Budget, submitted the following

R E P O R T

together with

ADDITIONAL AND MINORITY VIEWS

[TO ACCOMPANY FINDINGS OF THE TASK FORCE ON SOCIAL SECURITY]

The Task Force on Social Security of the Committee on the Budget, which was authorized pursuant to a unanimous consent request by the Committee on the Budget, having considered findings regarding Social Security, do report the following findings:

1. Social Security is a universal program that has provided a safety net for Americans.
2. Time is the enemy of Social Security reform and we should move without delay.
3. Change should be gradual to allow workers to adjust their retirement plans and any change for current or near-term retirees should be minimal.
4. Social Security under the current structure is projected to become insolvent during the next 75 year period.
5. The Social Security Trust Fund is a secure, legal entity comprised of U.S. Treasury Bonds backed by the full faith and credit of the U.S. Government. While the United States has never defaulted on any of its obligations, these represent a legal claim on future Federal revenue. Such securities will have to be redeemed from funds outside the Trust Fund itself.
6. Solvency and reform are not necessarily tied together.

7. The current demographic projections may very well underestimate future life expectancy.

8. Any reform must consider the effects on all generations, genders, and those currently receiving Social Security benefits.

9. No payroll tax increase.

10. Social Security surpluses should only be spent for Social Security.

11. Social Security reform should encourage savings and overall economic growth.

12. We can learn from the experiences of other countries to more effectively develop Social Security reforms.

13. Investment in the capital markets presents an opportunity to restore Social Security's solvency.

14. Any investments in the capital markets should be limited for retirement years.

15. Private or other capital investments can be managed to minimize administrative costs to avoid substantial reductions in rates of return on investment.

16. Guaranteed return securities and annuities can be used with personal accounts as part of an investment safety net.

17. A universal Social Security survivor and disability benefit program needs to be maintained.

18. Congress should consider paying for a portion of disability benefits for workers who have been in the system a short time, using moneys from the general fund.

LETTER FROM CHAIRMAN OF THE TASK FORCE ON SOCIAL SECURITY TO THE COMMITTEE ON THE BUDGET ON THE TASK FORCE'S RECOMMENDATIONS

U.S. CONGRESS,
HOUSE OF REPRESENTATIVES,
October, 5, 1999.

TO MY COLLEAGUES ON THE BUDGET COMMITTEE: Public opinion polls are consistent. Social Security is one of America's most popular Federal programs. Born in the Depression, Social Security was originally designed to bring peace of mind to Americans who lived longer than 65 years—an age that most failed to reach. The public view of its 65-year old citizens was akin to the way we view those who reach 80 today. Frail bodies and minds could not be expected to sustain themselves in the rigors of the workplace. To guarantee that the elderly would live with some security, Congress approved a modest payroll tax on a limited amount of wages, earmarking the funds for seniors over 65.

Over time, Americans of all ages have grown healthier. We all enjoy a high probability of living past 65. For the first time, we can view our elderly years as a period of retirement activities. Today, workers who retire at 65 can look forward to an average of 17 years of retirement. They will have time to enjoy the company of family members and friends, participate in charitable activities, and take up long-neglected hobbies. This is one of the great health and social achievements of the 20th century. Social Security must keep pace with these advances. It takes much larger resources to spread a safety net across 39 million retirees than it did to insure one-tenth that number just 40 years ago. With the certain prospect that this number will double in the next 30 years, it is time to review the adequacy of our resources to the task at hand and to evaluate options to assure its continuance.

To assist the Congress in this objective, House Budget Committee Chairman John Kasich requested in May 1998 that I chair a bipartisan task force on Social Security. Budget Committee Ranking Member John Spratt asked Representative Rivers to serve as ranking member of the task force. Working in a collegial atmosphere, the House Budget Committee Social Security Task Force has taken statements from 29 individuals. Its members have explored numerous issues that we believe are essential to a comprehensive understanding of this vital program.

We began our work by reviewing the insolvency problem. We heard first from Social Security's top actuaries, then we held closed sessions with Alan Greenspan and now Treasury Secretary Larry Summers. Our scope then broadened into inquiries about the possibility that life expectancy may reach 100, or even 120 years of age. We then explored the mechanics of creating personal retirement savings accounts, trying to determine the advantages and disadvantages of such a system—how much workers might benefit from their creation even if they are unwilling to expose themselves to equity market risk, and answering questions about administrative costs and feasibility. We moved on to a discussion of how other nations are handling their demographic challenge as the ratio of workers to retirees plunges throughout Europe, Japan, and else-

where—just as it is here. As is appropriate for a Budget Committee task force, we explored how operation of the Social Security Trust Funds will interact with other elements of the Federal budget, how Social Security affects taxpayers of all generations, and how to quantify transition costs that must be covered as part of Social Security reform.

We learned from congressional Members who made personal appearances to outline their reform plans, including: Representatives John Kasich, Bill Archer, Clay Shaw, Jim Kolbe, Charlie Stenholm, Roscoe Bartlett, and Peter DeFazio; Senators Judd Gregg, John Breaux, and Charles Grassley.

As we come to the end of our 4-month fact finding mission, we can proudly say that Republicans and Democrats found many points of agreement. The fact that the Task Force members reached consensus on 18 findings gives us hope that a bipartisan reform solution can be reached within the next 2 years. I believe the attached compendium answers many questions about Social Security reform, and we are pleased to distribute it to our colleagues as a useful guide in their own deliberations.

I would like to take this opportunity to express appreciation to the many individuals who helped make this experience rewarding and personally enjoyable. The Task Force benefited from the active participation and thoughtful contributions of its members: Wally Herger, Mac Collins, Paul Ryan, Pat Toomey, Ken Bentsen, Eva Clayton, and Rush Holt. In addition, I want to thank the Budget Committee for providing valuable support. Finally, special appreciation goes to my own staff—Kurt Schmautz and Susan Sweet—for the hundreds of hours spent in research and for their work in guiding the Task Force through a most intensive inquiry of the current problems and possible solutions for Social Security.

Sincerely,

NICK SMITH,
Chairman, House Budget Committee
Bipartisan Task Force on Social Security.

TASK FORCE ACTION

By unanimous consent on January 20, 1999, the Budget Committee authorized the Task Force on Social Security for a period of 6 months. The Task Force was authorized to hold hearings and issue a report on the budgetary implications of the proposed reforms of the Social Security reform.

The Task Force held hearings and briefings from March 2, 1999 to July 13, 1999.

On July 15, 1999, by voice vote, the Task Force agreed on 18 findings and reported their recommendations.

LIST OF BRIEFINGS AND HEARINGS

Date	Topic	Witnesses
March 2	The state of Social Security (briefing)	Steve Goss, Chief Deputy Actuary, Social Security Administration; Representative Nick Smith, Chairman, Task Force on Social Security
March 16	Effect of investing Social Security moneys in the capital markets (briefing)	Lawrence Summers, Deputy Treasury Secretary
March 23	The need for comprehensive structural reform to Social Security (briefing)	Alan Greenspan, Chairman, Federal Reserve
April 13	How will advances in health sciences and increased life-expectancy affect Social Security (briefing)	Dr. William Haseltine, Human Genome Sciences; Dr. Kenneth Manton, Duke University Center for Demographic Studies; Felicity Bell and Steve Goss, Social Security Administration
April 27	Administrative costs of privatization (briefing)	William Shipman, Principal, State Street Global Advisors; Dallas Salisbury, President, Employee Benefits Research Institute
May 4	How uniformity treats diversity (hearing)	Larry Kotlikoff, Professor of Economics, Boston University; Darcy Olsen, Entitlements Analyst, Cato Institute; Kilolo Kijakazi, Center on Budget & Policy Priorities
May 11	Using long-term market strategies for Social Security (hearing)	Dr. Roger Ibbotson, Professor of Finance, Yale University; Dr. Gary Burtless, Senior Fellow, Brookings Institute
May 18	Establishing a framework for evaluating Social Security reform (hearing)	Dr. Robert Reischauer, Brookings Institute; Stephen Entin, Institute for Research on the Economics of Taxation
May 25	National retirement reforms in other countries (hearing)	Dan Crippen, Director, Congressional Budget Office; David Harris, Watson Wyatt Worldwide; Lawrence Thompson, Senior Fellow, Urban Institute, President-elect of the Board of Directors, National Academy of Social Insurance
June 8	The Social Security Trust Fund (hearing)	Ken Holt, AARP; David Koitz, Congressional Research Service
June 15	Guaranteed Investments and Life Annuities (hearing)	James Glassman, Resident Scholar, American Enterprise Institute; Steven Bodurtha, Merrill Lynch; Mark Warshawshy, TIAA–CREF
June 22	The Social Security Disability Program (hearing)	Jane Ross and Mark Nadel, Social Security Administration; Marty Ford, Consortium for Citizens With Disabilities

LIST OF BRIEFINGS AND HEARINGS—Continued

Date	Topic	Witnesses
June 29	Review of Current Proposals (hearing)	Senators Breaux, Grassley, Gregg; Representatives Archer, Bartlett, DeFazio, Kasich, Kolbe, Shaw, Smith, Stenholm
July 13	Social Security Transition Costs (hearing)	Dr. Rudolph Penner, the Urban Institute; David John and William Beach, the Heritage Foundation

SUMMARY OF BRIEFINGS AND HEARINGS

APRIL 13 BRIEFING: HOW ADVANCES IN HEALTH SCIENCE AFFECT SSA'S LONG-RANGE PROJECTIONS

Statements provided by: Steven Goss, Deputy Chief Actuary, Social Security Administration; Felicity Bell, Actuary, Social Security Administration; Dr. Kenneth Manton, Director, Duke University Center for Demographic Studies; Dr. William Haseltine, President, Human Genome Sciences.

When Alan Greenspan gave a closed briefing to the Task Force on March 23, he advised the members that we faced many uncertainties in developing a plan for Social Security reform; however, a falling dependency ratio could be considered a certainty, and must be planned for. Under the pay-as-you-go structure of Social Security, the retirement benefits paid are financed by taxes deducted from the wages earned by current workers. As the baby boom generation retires, the income of a growing number of Social Security beneficiaries will depend on the payroll taxes of a dwindling number of workers. When Social Security was enacted, tax revenue from 36 workers supported each retiree. Today, that ratio of workers to retiree stands at 3 to 1, and will fall to 2 to 1 by 2030.

Social Security actuaries are charged with the important responsibility of estimating events for many years into the future so that policy makers can make the correct decisions in the present. Retirement programs will affect government cash flows for many years to come. On April 6, 1999, the Washington Post reported that The Veterans Administration is still paying retirement benefits promised to Civil War veterans over 130 years ago, and the Civil Service Retirement System, which stopped accepting new employees in 1983, will pay benefits until 2070.

Life expectancy projections are a key factor that affects both sides of the worker/retiree dependency ratio. Social Security currently estimates that women and men who retire at age 65 today will collect Social Security benefits for 19 years and 16 years, respectively. Some baby boomers will live a third of their life in retirement—an unprecedented high that results in fewer workers and more retirees.

Medical advances during the twentieth century—vaccines, antibiotics, more widely available health care—have dramatically reduced child mortality and increased life expectancy. In 1900, male newborns had an average life expectancy of 46 years, 3 years less than female life expectancy of 49 years. In the following 80 years, both life expectancy and the male/female longevity gap rose materi-

ally. A male baby born in 1980 was expected to live 70 years, compared to 78 years for females. More children have grown into adult workers. In addition, the mortality rate for working adults dropped significantly from 1900 to 1960. Even these improvements have not kept the worker/dependency ratio from falling.

Medical advances on the horizon in the 21st century promise marginal improvements in child and middle age mortality, but significant increases in life expectancy and quality of life for the aged. Scientists expect many of these improvements to become cost-effective anti-aging tools that become widely available. Lifestyle changes in exercise and diet can add up to 10 years of life. New drugs control afflictions that disable the elderly, such as high cholesterol and osteoporosis. Computer controlled mechanical devices, such as hearing aids, are further lowering disability rates among the elderly. Improved cancer surveillance is reducing cancer death rates.

Dr. William Haseltine provided his vision of what the future holds for tomorrow's elderly. As President of a firm that participates in the human genome research project, he knows of the medical benefits we can expect from the culmination of years of gene mapping research. He expects this research to produce more transplant technology and a new generation of drugs that will slow the aging process. In addition, Dr. Haseltine is a pioneer in regenerative medicine, which uses gene mapping technology to develop medicines that can repair physical damage and slow the signs of aging—extending baby boom life expectancy to 120 years for Generation X. One goal of regenerative medicine will be to first halt the process of aging, then reverse it. Human Genome Sciences has started clinical trials on three potential drugs: one helps protect bone marrow cells from the effects of chemotherapy; another speeds recovery from burns, wounds, or chemotherapy; and a third helps regenerate blood vessels. Dr. Haseltine is aware of research that will lead to joint regeneration, reversing the effects of arthritis and rheumatism.

Such ground breaking research causes Dr. Manton to believe that the medical community is entering a turning point that will make it impossible to use past trends to accurately project future improvements in life expectancy, as Social Security now does. He sees reductions in the risk of stroke and cardiovascular disease mortality. He expects improvements in elderly health stemming from the long-term effects of reduced incidence of smoking, improved nutrition, revolutionary drugs, and greater public understanding of the benefits of a healthy lifestyle. Dr. Manton expects many of the baby boomer's children to reach their 100th birthday. Therefore, Social Security's projections overstate the future dependency ratio and understate the system's unfunded liability.

Manton's demographic trends indicate that a defined benefit Social Security system will continue to provide the greatest benefits to members of the Asian/Pacific Island ethnic group. Current Census Bureau estimates place male and female life expectancy at 80 and 86 years. White women will continue to receive a higher than average of both retirement and disability benefits. African American life expectancy will continue to fall short of the average, giving this group less from Social Security. However, African Americans

have a higher prevalence of chronic disability, which Manton expects to continue, and are more dependent on disability benefits. Hispanics will experience the greatest gains in life expectancy, and they will be receiving a greater share of Social Security benefits.

Both Dr. Manton and Dr. Haseltine are nationally recognized experts in aging and the elderly. Since they anticipate unprecedented increases in life expectancy, they both emphasized the importance of developing policies that encourage the elderly to remain in the workforce.

Manton and Haseltine acknowledge the important role that such policies will play in restoring long-term solvency to Social Security. However, they consider a greater reason to be the need to integrate the growing ranks of the elderly into productive society and expand human capital. They view this as essential to maintaining a healthy, active lifestyle long past our current retirement age. As we move to a more information-based economy, with more jobs requiring less physical exertion, the job opportunities for elderly workers will grow.

APRIL 27 BRIEFING: THE ADMINISTRATIVE COSTS OF REFORM

Statements provided by: Dallas Salisbury, President, Employee Benefit Retirement Institute (EBRI); William Shipman, Principal, State Street Global Advisors; James Phelan, Associate, State Street Global Advisors.

Various reform plans introduced in Congress include personal retirement savings accounts. In his briefing, Mr. Greenspan called the administrative costs of personal accounts a mechanical problem that could be solved.

EBRI published a November 1998 analysis that identified the following issues as obstacles to reform using personal retirement savings accounts:

- No existing system has the capacity to administer an undertaking as large as universal personal accounts for 140 million workers.
- Social Security reform cannot be compared to employment-based retirement savings plans.
- Pay-as-you-go is less difficult to administer than a personal account system.
- Some proposed reform plans would significantly increase employer burdens.
- Accounting for personal accounts of married couples as joint property may pose significant administrative challenges.
- Many reform proposals only vaguely address the structure of personal accounts.
- Administrative costs significantly influence the anticipated rate of return from personal retirement savings accounts.

In his statement, Mr. Salisbury added that administrative cost models do not provide for educational programs to introduce the new accounts to workers, and that the cost of annuitization of accounts at retirement may further increase the administrative costs of personal accounts. Although he was a member of the CSIS panel that recommended 2 percent personal accounts, Mr. Salisbury stated that he does not personally support individual accounts. If re-

form is enacted with personal accounts, he advised that provisions should be made for low-income workers that have small balances so that fixed administrative costs assessed on a per-account basis do not consume a majority of account earnings.

Mr. Shipman of State Street Corporation presented a study of administrative costs that based its conclusions on State Street's actual cost experience as a major pension fund manager. The State Street study, published in March 1999, designs a plan that creates personal accounts owned by each worker that give them the opportunity to invest in the capital markets. It advocates personal choice and offers inexperienced investors a variety of professionally managed index funds. Administrative costs are shared by a large pool of accounts, ensuring reasonable costs for all participants, regardless of income. Technology and automated services already in use by private financial firms will minimize costs, as well.

State Street recommends a three-level plan that will minimize employer costs. It expects each account to cost between $3.38 and $6.58 per account annually, depending on the level. In Level One, account contributions are deducted from payroll and invested in a collective money market fund. The funds stay in this privately managed collective account until contributions are reconciled with individual W-2 forms. Within six to eighteen months, the Social Security Administration will have the information needed to transfer an appropriate amount of funds and accrued interest into personal accounts. Then, a worker's savings are treated as Level Two assets and invested in index funds. A worker can choose from one of four index funds—three balanced funds and a money market account. The funds would be managed by professional firms chosen through open competitive bidding.

After approximately 3 years, the average account balance will grow to an amount that can be efficiently managed by a financial services company meeting reasonable and specified standards. Each worker will have the option to transfer account balances to a Level Three manager. Administrative costs will rise for individuals who choose Level Three, as they will be paying for more active management of their account. The administrative costs for Levels One and Two are only a few basis points. Costs rise in Level Three as individuals choose actively managed accounts; however, individuals have the option of moving funds back to the lower-cost Level Two.

The dilemma of managing the cost of smaller accounts is a major reason that the President's plan exempts low income workers from USA accounts. Both Mr. Salisbury and Mr. Shipman advocate universal availability, if reform incorporating personal accounts is enacted. Mr. Shipman advised members to establish accounts with percentage contributions that are large enough to achieve administrative efficiencies. This is one reason Mr. Shipman supports comprehensive reform and opposes piecemeal changes to the system that will be expensive to implement.

Mr. Salisbury commended the State Street study for focusing on detail and questions of feasibility. As Chairman of the Task Force, Mr. Smith requested that the Government Accounting Office study the methods and conclusion of the State Street study to determine its accuracy. In a report made public on July 19, the GAO states

that the State Street study provides the most detailed analysis of costs per administrative function based on known costs.

MAY 4 HEARING: HOW UNIFORMITY TREATS DIVERSITY: DOES ONE SIZE FIT ALL?

Witnesses: Dr. Laurence Kotlikoff, Professor of Economics, Boston University; Darcy Olsen, Entitlements Policy Analyst, Cato Institute; Dr. Kilolo Kijakazi, Senior Policy Analyst, Center on Budget and Policy Priorities.

Under the current Social Security system, all workers pay the same payroll tax and all retirees receive a benefit based on the same payroll calculation. However, Social Security treats people differently. For example, although women pay 38 percent of all Social Security payroll taxes, they receive 53 percent of the Social Security benefits. Some critics of the current Social Security system note that African Americans start working at a younger age and pay FICA taxes for a longer period of time, yet they have a lower life expectancy, so they receive retirement benefits for a shorter period of time.

Since Social Security is a pay-as-you-go system, the taxes of working generations are being used to pay benefits to current retirees. However, under current law formulas, benefit payments exceed tax receipts every year after 2014, and the Social Security Trust Fund is depleted in 2034. Over time, either workers' taxes will increase or retirees' benefits will be cut. These reforms will treat people differently, too. Some young workers worry that they may be on the losing end of Social Security if benefits are cut for future retirees. They are asking Congress to make reforms that increase the rate of return earned on the tax payments they make to support Social Security.

Dr. Kotlikoff presented testimony that described the theory of intergenerational accounting which strives to measure how various age groups receive different treatment from Social Security. Generational accounts compare the present value of taxes paid to benefits received by age group. If benefits exceed taxes for a particular age group, the residual represents an obligation left for future generations. For countries expecting to have a slowly growing working population and a faster growing senior population, as in the United States during the next decades, a stable system must keep a balance between taxes and benefits.

Using numbers provided by the Social Security Administration, Dr. Kotlikoff's research team has completed a microsimulation of Social Security, including survivor, mother, father, and children benefits, earnings testing, and early retirement. This quantitative research, included with his written testimony, shows that women fare much better than men in terms of internal rate of return, but even women are earning less than a risk-free rate of return provided by long-term Treasury bonds protected against inflation. People of color have a slightly worse rate of return than men do. The noncollege educated do not do as well as the college educated. No group enjoys a rate of return from the current Social Security program that is higher than 4 percent.

Dr. Kotlikoff advocates radical reform that creates a private Social Security retirement system for all new workers, depositing 8 percent of taxable wages into personal retirement accounts. Transition cost financing is accomplished through an 8 percent consumption tax that will decline over time. His plan keeps a 4.4 percent FICA tax in place to pay for disability and survivors insurance.

In conclusion, Dr. Kotlikoff said, Social Security does not represent a very good deal for postwar Americans. On average, they are losing 5 cents out of every dollar they earn to the OASI program. * * * The problem is that Social Security's generally bad actuarial deal is likely to get lots worse because this is a system which is not going to be able to pay for itself through time. He cited a 1998 study by the Congressional Budget Office and the Federal Reserve, which found that an immediate and permanent income tax increase of 24 percent would be needed to eliminate the unfunded liability and assure that future generations pay the same FICA tax rates that workers pay today. He added: The only way we are really going to help our kids in the long run—and that means with the poor male kids, poor nonwhite kids, and poor female kids as well in the future—is to limit their fiscal burden.

Ms. Olsen agreed that the current Social Security system gives every worker, regardless of income, ancestry, or gender, a meager return on a lifetime of payroll tax contributions. This poor rate of return leaves women with an average retirement benefit of about $600 per month, three-quarters of the average monthly retirement benefit for a male worker. As a result, poverty rates among women are twice as high as among men. In addition, 25 percent of working women pay into the system for years, but receive no higher benefit than they would if they had never worked.

Cato's research shows that all women are better off under a privatized system that increases the rate of return that all workers can earn on their FICA taxes. Ms. Olsen advocated transition to a fully private Social Security system. She argues that a fully private plan will give married, divorced and widowed women at least $200,000 more in retirement benefits than does Social Security or the partly private system proposed by various reform plans.

Dr. Kijakazi's testimony emphasized the importance of Social Security to elderly people of color. Since its inception, Social Security benefits have reduced the elderly poverty rate from about 50 percent to 12 percent. She argued that women and minorities have received the greatest antipoverty relief because they are less likely to have other sources of retirement income, such as a pension. Social Security makes up 43 percent of the income of elderly African Americans and 41 percent of the income of elderly Hispanic Americans, compared to 36 percent of income for white senior citizens. She believes that the benefits that African Americans receive from the disability and survivors programs balance their lower retirement benefits due to shorter life expectancy.

Social Security's design benefits women in several ways. Since women earn lower wages than men, women benefit from Social Security's progressive benefit formula. Women live longer, so they are paid more in benefits for the same earnings history than men are, and these benefits are adjusted for inflation which protects the purchasing power of the elderly. The spousal benefit grants monthly

income to women who do not have the personal earnings history to support their own benefit. Women are more likely to receive survivors benefits.

Dr. Kijakazi recognized that reform is needed to assure that Social Security can continue to pay 100 percent of current benefits once the trust fund is depleted in 2034. She called reform of the disability program a high priority issue, since the disability trust fund is depleted in 2022. She questioned the viability of personal accounts reform plans, arguing that they may not provide sufficient rates of return after accounting for administrative costs and annuitization expense. She criticized the Archer-Shaw Social Security proposal for diverting Federal funding from discretionary programs to finance its personal retirement accounts. She praised the Clinton proposal for using the budget surplus to pay down debt, thereby reducing future interest payments, and for establishing USA accounts which would be targeted to low-wage and moderate-wage workers. She supported having the government invest a portion of the trust fund in equities, as the Clinton proposal does.

MAY 11 HEARING: USING LONG-TERM MARKET STRATEGIES FOR SOCIAL SECURITY

Witnesses: Dr. Gary Burtless, Senior Fellow, Brookings Institution; Dr. Roger Ibbotson, Professor of Finance, Yale University.

Today's Social Security system almost included a personal investment option. During floor debate on Social Security in 1935, various Senators argued vigorously to support choice in the Federal retirement program, and the Senate bill included this option. This was eliminated in conference. Instead, Congress opted for pay-as-you-go financing that matched current tax receipts to benefits. Long-term investment strategies were not relevant to a pay-as-you-go structure, but are now being considered as the Social Security surpluses become larger and the unfunded liability grows.

Social Security's $9 trillion funding gap can be closed in only three ways: Cut benefits; raise taxes; or increase the rate of return earned on workers contributions. The current Social Security programs give the average worker a 1.8 percent investment return on their payroll taxes. In contrast, corporate stocks have given investors average annual rates of return of 8.1 percent, measured from 1926 to 1998. Stock prices fluctuate, but over time the upswings outweigh the downturns, and investors have learned that they can count on higher returns for funds that can be invested for the long run. Since many workers pay Social Security taxes for forty years or more, they can use long-term investment strategies with confidence.

Dr. Roger Ibbotson has been recognized as a leading expert in measuring rates of return for the last 20 years. In 1974, during one of the worst bear markets in U.S. history, Dr. Ibbotson predicted that the Dow would reach 10,000 by 2000, actually underestimating this landmark by a year. He is now expecting to see the Dow reach 100,000 by the year 2025. Dr. Ibbotson serves as Chairman of Ibbotson Associates, which publishes an annual yearbook of rates for stocks, bonds, treasury bills, and inflation. This yearbook is used broadly within the financial industry, and is considered the

definitive source by investment experts. Ibbotson has made the following long-term forecasts for the period between 1999 and 2025:

IBBOTSON'S LONG-TERM INVESTMENT FORECASTS

Total Return on Stocks	11.6 percent
Total Return, Long-Term Government Bonds	5.4 percent
Total Return, Treasury Bills	4.5 percent
Forecasted Inflation Rate	3.1 percent
Dow Jones Industrial Average, 12/25	120,368

Dr. Burtless deferred to Dr. Ibbotson's opinions concerning financial history, and directed his testimony toward how investment return can be used to provide greater social insurance protection. Using fifteen-year investment horizons, Dr. Burtless has modeled the earnings that a 40-year old worker can expect if 2 percent of his taxable payroll is invested in stocks and converted to a life annuity at retirement. He found a high variability in the retirement income a worker would enjoy, depending on market conditions in these fifteen-year horizons and at the time that the investment account was annuitized. Income from annuitized personal accounts could be up to six times higher for some workers who made the same contributions as others and retired at a time when stock market values were high. In addition, he warned that simple annuities did not protect against inflation, so retirees would find their living standards falling as they grew older.

Dr. Burtless supports using stock investments to increase Social Security's rate of return. However, he opposes personal retirement accounts. He believes that government investment on a collective basis is more consistent with the spirit of social insurance that provides crucial protections to the elderly. However, he recognizes that public opinion does not support collective government investment in individual securities. To refute these arguments, he pointed to the Federal Reserve Board's retirement plan and the Thrift Savings Plan as examples of how such a system could work. If individual accounts are incorporated in reform, he does not believe that the government should offer a minimum return guarantee. Such a guarantee would only encourage individuals to take more risk, since they have loss protection, and increase the government's contingent liability. Most current reform proposals convert only a portion of Social Security taxes to personal investment accounts. If individuals make higher-risk decisions that result in losses, they will still have a smaller Social Security benefit for their retirement.

Dr. Ibbotson pointed out that Social Security's pay-as-you-go structure operates as a wealth-transfer system, taking funds from current workers to pay benefits to current retirees. No investment fund has been accumulated to support future benefits. Any plan that utilizes equity investment, either by individuals or by the government, will need prefunding. He emphasized that long investment horizons are needed to measure the true benefit of higher compounded rates of return. A dollar invested in stocks earning 11.2 percent, the historic rate including inflation over the past 73 years, grew to $2,351; a dollar invested in treasury bonds, earning a modest 5.3 percent return, grew to $44. While stocks represent higher risk, the odds are high that long-term investment strategies including stocks will yield a higher rate of return.

Dr. Ibbotson recommended that individual account reform proposals restrict choices to a limited number of accounts that emphasize diversification. If government is allowed to invest funds collectively, it should be limited to index funds to minimize political intervention in investment choices. Government investment in individual company's securities should not be allowed. To minimize the risk that savings converted to annuities in a down market would give workers lower retirement income, he recommended that a series of annuities be purchased starting several years before retirement.

MAY 18 HEARING: CUTTING THROUGH THE CLUTTER—WHAT'S IMPORTANT FOR SOCIAL SECURITY REFORM?

Witnesses: Stephen Entin, Executive Director, Institute for Research on the Economics of Taxation; Dr. Robert Reischauer, Senior Fellow, Brookings Institution.

During the past 50 years, Congress has enacted reforms that both expanded and contracted the Social Security program. In 1972, Congress increased benefits by 20 percent. The following year, as the House of Representatives voted for an additional 11 percent increase—raising benefits by more than 30 percent in just 2 years—Representative Barber Conable stated: Nobody is worrying about where we are headed with Social Security. We better not put off a careful review much longer if we are to face the next generation with as much sympathy as we are here showing to the last generation.

In less than 5 years, the system faced financial crisis. Congress passed legislation in 1977 that included tax increases and benefit cuts to fix Social Security's problems.

By the early eighties, Social Security again faced insolvency. Representative Conable was among the experts who served on the Greenspan Commission, which recommended reforms that were to assure Social Security's long-term health. Many of the recommendations of the Greenspan Commission were enacted by Congress in 1983. Despite these reforms, Social Security today has a $9 trillion unfunded liability, and is facing a cash deficit as early as 2013.

History shows the difficulty of enacting reforms that will end the cycles of insolvency that Social Security has experienced in the last 20 years. Developing a framework for evaluating reform proposals is an important part of this process. Such guidelines will point us to the key issues that must be addressed in any comprehensive reform plan.

Mr. Entin encouraged the Task Force to consider wholesale reform that makes higher output and productivity a priority, and not to settle for piecemeal changes, as Congress did in 1977 and 1983. Effective reform will make workers more willing to work by letting them direct a portion of their payroll tax to personal accounts. Mr. Entin opposes an add-on approach to finance personal accounts, which would decrease the incentive to work. Higher output requires more saving and investment. Mr. Entin supports investment incentives, such as faster depreciation and extension of IRA-type tax treatment to other forms of saving.

Mr. Entin made six additional recommendations concerning design:

1. Do not keep younger people in the system.
2. Maintain an independent safety net that is not mixed into the retirement plan.
3. Do not allow the government to own or vote stock in U.S. businesses.
4. Do not cut COLAs.
5. Do not change benefits significantly for people who are 55 or older.
6. Do not force annuitization of personal retirement accounts.

Mr. Entin pointed out that the Social Security trust fund does not provide a source of assets to continue to pay benefits. The Treasury securities in the trust fund represent the authority to request funds from the Treasury without a specific authorization and appropriation. The Secretary of the Treasury will have to come up with funds by issuing public debt, or Congress will provide funds by raising taxes or cutting spending. Ultimately, Congress will be forced to trim benefits or cut other government spending to preserve overall economic growth.

Mr. Entin's quantitative analyses treated all government revenues, whether taxes or new debt, as revenues, and all government outlays, whether appropriated spending or redemption of debt, as outlays. To finance the transition to a prefunded system of personal accounts, Mr. Entin presented estimates of how spending reductions, debt financing and tax increases affect GDP and GNP. Government spending reductions brought up to 8 percent increases in GDP, depending upon the amount of debt financing that is needed. In order to reduce the debt burden, Mr. Entin recommended the sale of Federal assets that are not in use. The data presented measured a strong saving response, which assumed that the additional saving in personal accounts does not substitute for other saving while it lowers the cost of capital and stimulates investment. A weak saving response assumed that the additional saving in personal accounts displaces other saving in the absence of tax relief, and that it neither lowers the cost of capital nor spurs investment without changes in the tax treatment of investment. With the right incentives for saving and investment and proper rewards to labor, reform could boost real after-tax wages by 6 percent to 10 percent, and create an additional 4 to 7 million jobs.

In closing, Mr. Entin advised that time is not on our side, but no reform is better than piecemeal solutions. Comprehensive growth-focused reform will give people higher incomes in their working years and during their retirement. The public is ahead of the Congress. Once they understand the benefits to them, they will urge Congress to proceed.

Dr. Reischauer opened his testimony by reflecting on why Social Security was established, explaining: The reason was the belief that, left to their own devices, many workers would not save sufficient amounts to support themselves and their dependents when they could no longer work. People tend to be myopic. They focus on immediate needs and those crowd out their long run needs. In addition, there are those whose earnings are so low or so unstable that even if they did salt away what any reasonable person might

think was a pretty hefty proportion of their incomes each year for retirement, the amount that they would have accumulated by the time they turned 65 would not be sufficient to purchase an annuity of an adequate size. He presented six criteria to evaluate reform proposals:

1. Benefit adequacy with protection against inflation; Stability/Predictability, avoiding unexpected fluctuations in incomes; and Equity, including protection for widows/widowers, divorcees and others
2. Equitable distribution of risk between taxpayers and beneficiaries, and sharing of adverse events
3. Fair return on contributions
4. Administrative efficiency, simplicity, and ease of compliance for government, employers, and participants
5. Political sustainability; the current system has become too rigid, and should be changed to reflect the social, economic and demographic changes since 1935, but these changes should be adequately funded and should not put Social Security in constant flux.
6. Macroeconomic consequences on national saving and labor supply, assuring that reform adds to national saving and economic growth and does not discourage labor participation

Dr. Reischauer supports a reform plan that cuts benefits, raises tax revenue, and increases the rate of return by allowing the government to invest a portion of the Social Security trust fund in the capital markets. He does not favor COLA reductions. He strongly favors paying down debt. He believes it will strengthen the economy, reduce interest payments, and prepare us for the second decade of the next century, as the baby boomers begin to retire. A former Congressional Budget Office Director, Dr. Reischauer agreed that the Social Security trust fund is an accounting device. However, he also sees it as a political device that sends a signal about the need where the adjustments will be made, saying: It strikes me it would be inconceivable to say to beneficiaries we are going to reduce your benefits or even to payroll taxpayers, workers, that we are going to raise the payroll tax to make the necessary adjustment. The adjustment would take place in the balance of our budget. It might take the form of increased borrowing or increased income taxes or reduced spending on discretionary items or Medicare cuts or something like that.

In closing, Dr. Reischauer commented that reform would not move forward without strong and consistent presidential leadership that involved significant political risk. He did not see that happening right now.

MAY 25 HEARING: INTERNATIONAL SOCIAL SECURITY REFORM

Witnesses: Dan Crippen, Director, Congressional Budget Office; Estelle James, Lead Economist/Policy Research, World Bank; Lawrence Thompson, Senior Fellow, the Urban Institute; David Harris, Research Associate, Watson Wyatt Worldwide.

The United States was the last of the developed countries to adopt a compulsory social insurance program that was aimed at eliminating poverty among the elderly. When Congress passed the

Social Security Act in 1935, it looked to the examples provided by other countries to design the U.S. system.

The demographic changes behind the unfunded liability of pay-as-you-go systems are a global phenomenon. Most European countries face even more alarming dependency ratios than in the United States, and already have higher payroll tax rates. In Eastern Europe, the average payroll tax rate exceeds 40 percent. In Western Europe, the average payroll tax rate is above 20 percent.

International reform initiatives undertaken over the last 20 years give us the opportunity to learn from experiences abroad—taking the best ideas and learning from others' mistakes. Once we have learned from these examples, we can design a reform plan that will become a model for more than 135 countries that have yet to implement reforms that bring stability to their Social Security systems for the next century.

Dr. Crippen offered testimony concerning CBO's January 1999 report, Social Security Privatization: Experiences Abroad. The report studied reform initiatives undertaken by Chile, the United Kingdom, Australia, Mexico, and Argentina. All of these countries started out with an old-age income support system that relied on pay-as-you-go financing. They have converted to a system with personal retirement accounts that prefund at least a portion of retirement income by requiring people to accumulate savings during their working years. Moving from pay-as-you-go to a prefunded private system imposes a financial burden on transitional generations who must support retirees under the old system while saving for their own retirement. However, such prefunding can have benefits for the economy by increasing private savings. As long as government savings do not decline by an amount equal to or greater than the increase in private savings, the economy experiences an increase in capital stock and productive capacity.

All of the countries in the CBO study have aging populations due to increases in life expectancy and a steep drop in birth rates. However, there are many differences between these five countries and the United States. There are great differences in wealth as measured by GDP per capita. Their annual GDP growth rates range from 2.4 percent in the United States and the U.K. to 7.2 percent in Chile, and annual inflation varies widely.

The existing reform plans could not be adopted as is, but they provide examples of what can work. In addition, they identify problems that every country had to solve. The report found four relevant issues that all countries had to address in designing their reforms:

- Who will pay for the transition between the pay-as-you-go system and a prefunded system? This issue is not unique to plans that advocate privatization, and must be faced as part of any reform that moves toward a prefunded system.
- Will the new system be voluntary or mandatory? Allowing choice can mean that the pay-as-you-go system lingers on, resulting in an additional administrative burden.
- Should there be a minimum benefit guarantee? If so, how much; should it be means tested; should it be paid from the retirement program or from general revenues? Without guarantees some

retirees may not have adequate income. Such guarantees, however, impose a new contingent liability on future generations.

• How much regulation is needed for investment managers, and what rules should be imposed on the use of retirement funds? Rules and regulations that control fraud and imprudence also restrict an individual's choice about investment and retirement.

CBO found that the major reform plans it studied had three structures. Chile, Mexico, and Argentina used a model in which workers establish private retirement accounts. The United Kingdom allowed its workers to choose between the old pension system and the new. Australia requires employers to contribute to retirement accounts for workers. The CBO report noted that the countries it studied were not successful in designing a government-run savings program, and ultimately chose to fund at least a portion of benefits from private retirement accounts. It concluded that Social Security privatization in these countries probably increased national savings and economic growth. Finally, it found that administrative cost concerns can be overcome with appropriate attention to detail.

The experience of these countries suggests that privatization can help meet our obligations to future retirees. However, any plan must address two critical questions: Can the reform help economic growth, and can it reasonably be expected to work? Dr. Crippen emphasized the primacy of economic growth, asking: Does whatever we are trying to do, reform of any kind, increase net national savings either by the government or individuals and, in so doing, boost economic growth and give us a larger economy? This is the first and foremost question.

Ms. James agreed that economic growth is a crucial element of successful reform. The preliminary evidence from Chile, which was the first country to enact reform, indicates that private accounts have a positive impact on savings, financial markets, and growth. Here testimony focused on the experiences of Australia, Chile, and the United Kingdom.

Ms. James' international studies have found two approaches to transition costs and administrative costs. The Latin American model uses a carve-out that diverts funds from the old system to the prefunded accounts in the new program, and requires moneys to pay benefits during the transition. The OECD model achieves prefunding through add-on contributions. Countries adopting carve-outs have covered transition costs through four methods:

• Gradually downsizing the old system in a way that does not affect current pensioners;

• Using hybrid structures that still rely on pay-as-you-go;

• Employing other resources, such as a budget surplus or privatization assets; and

• Borrowing money during the early years of transition, spreading the burden over many generations.

Research done by Ms. James indicates that administrative costs for personal accounts will average out to between 70 and 100 basis points over a worker's lifetime. Preliminary estimates of 15 to 20 percent in the Latin American model are too high. They assume that start-up costs and early expenses will continue as the system matures. However, the data shows that countries using retail mar-

keting of retirement investment accounts are experiencing higher expense rates. Other countries are attempting to control administrative costs through competitive bidding and fee ceilings.

Ms. James has seen growing consensus in the Social Security reform debate since 1994. She finds general agreement that some degree of prefunding is needed to restore system insolvency as well as strengthen the economy of the whole. She believes that prefunding should be done in personal accounts to insulate these moneys from political manipulation, but these accounts should be designed carefully to keep administrative costs low.

Unlike Ms. James, Mr. Thompson does not consider any international reform plan implemented to date to be an acceptable model for the United States. There are two key differences that particularly influence reforms with personal accounts: U.S. policymakers seem unwilling to increase the employer reporting burden, as other countries have done; and the 2 percent contribution rate used in most plans is lower than what other countries have, which increases administrative cost pressure.

Mr. Thompson provided a summary of major international reform models:

MAJOR INTERNATIONAL REFORM MODELS

	Chile	Switzerland	Australia	UK	Sweden
Mandatory Participation?	Yes	Yes	Yes	No	Yes
Contribution Rate	13 percent	7–18 percent	9 percent	4.5–5.8 percent	2.5 percent
Budget General Funds Financing?	Transition	No	No	Partial	No
Who Collects Taxes/Contributions?	Pension Fund	Pension Fund	Pension Fund	Tax Authority	Tax Authority
Who Sends In Taxes/Contributions?	Employer	Employer	Employer	Employer	Employer
Who Maintains Records?	Pension Fund	Pension Fund	Pension Fund	Investment Manager	Government
Employer Reporting Frequency	Monthly	Monthly	Monthly	Annual	Annual
Who Selects Investment Manager?	Worker	Social Partners	Employer	Worker	Worker
Who Selects Investment Strategies?	Investment Manager	Investment Manager	Investment Manager	Worker	Worker
How Many Investment Options do Individuals Have?	None/Investmt Mgr chooses	None/Investmt Mgr chooses	0–5	Unlimited	Unlimited
Time Lag for Investment Changes	Days	Days	Days	18–24 mos.	18–24 mos.
Lump Sum Withdrawal Allowed?	No	Up to 50 percent	Yes	Up to 25 percent	No
Annuities Mandatory?	No	Yes	No	Yes	Yes
Price Indexing Required?	Yes	No	No	To 3 percent	Not decided

MAJOR INTERNATIONAL REFORM MODELS—Continued

	Chile	Switzerland	Australia	UK	Sweden
Who Picks Annuity Provider?	Worker	Pension Fund	Worker	Worker	Government
Guaranteed Absolute Rate of Return?	No	Yes	No	No	No
Guaranteed Relative Rate of Return?	Yes	No	No	No	No
Guaranteed Minimum Benefit?	Yes	No	No	No	No

According to Mr. Thompson, the devil is in the details. To address these details, Social Security reform plans with personal retirement accounts should be judged by the following objectives:

• Provide a reasonable rate of return, after adjusting for expected administrative costs and annuitization fees. The goal of minimizing administrative costs must be balanced against the desire to provide individual choice, which increases costs. Mr. Thompson observed that systems providing more guarantees limit individual investment choice and management options.

• Establish proper regulation for contribution reporting and to ensure prudent investment choices.

• Give workers a reasonable degree of choice about how their money will be invested.

• Avoid an increase in the employer's reporting burden.

• Insulate the economy from inappropriate political interference.

Proposals that create huge government guarantees need careful examination. Mr. Thompson believes that these plans mortgage the future by betting that the stock market will continue to rise. He supports a forthright approach that deals with the fact that if people live longer, they are either going to have to work longer or else save more each year they work. He believes that we can learn about what works and what doesn't work from these international examples and apply these lessons to our own reform program.

Mr. Harris agreed that no one particular international model can be used as a template for Social Security reform in the United States. However, he believes we can take many lessons from Australia's reforms, which were implemented by a liberal government with the support of a broad coalition of trade unions, businesses, and consumer groups. He explained: What is striking about the Australian system is that political pressures are the reverse of those in the United States. It was a Federal labor government, a largely liberal-leaning administration, who established and extended individual retirement accounts in 1987 and again in 1992. This policy was not only supported by organized labor but also was actively encouraged by the leadership of the Australian Council of Trade Unions (ACTU). Businesses and consumer groups also backed the changes. He attributes this consensus to overall fiscal concerns about the impact of an aging population on the economy.

As a first step, the government introduced a superannuation program in 1986 that required contributions equal to 6 percent of payroll—a 3 percent payroll tax paid by the employer, and a 3 percent contribution made into individual retirement accounts. The 3 percent payroll tax acts as a source of revenue for the government to

pay a means tested, pay-as-you-go Old Age Pension benefit equal to 25 percent of inflation-adjusted average weekly earnings. In 1992, the second pillar of superannuation was established. Each worker's individual account received 7 percent of an employee's salary over $450 Australian per month; the contribution rate increased to 9 percent over time. The government also established a third pillar, which consists of additional voluntary contributions that receive favorable tax treatment. Workers are making voluntary contributions of 4 percent above the 7 percent compulsory contribution.

The Australia model depends on private competition to control administrative fees. These fees have fallen as managers have gained more experience. In 1997, the administrative costs averaged between 69 to 83 basis points as a percentage of assets, or about 66 cents U.S. per week.

Mr. Harris urged members to learn lessons from Australia, Chile, and the United Kingdom, where individual account reforms have been put in place. However, he did not highlight increased rate of return as the greatest benefit of reform. Instead, he identified reduced political risk, citizen involvement in their own retirement planning, and reduced long-term liabilities related to the retiring baby boomer generation as key reasons to move ahead. The demographic shifts that drive Social Security's unfunded liability in the United States are happening around the world. Countries that address these fiscal imbalances will gain a competitive edge in the world markets during the 21st century.

PROJECTED FUTURE STATE SPENDING ON PENSIONS AS A PERCENTAGE OF GDP

[Countries noted in **bold** have implemented comprehensive retirement system reform]

	1995	2000	2010	2020	2030	2040	2050
Australia	2.6	2.3	2.3	2.9	3.8	4.3	4.5
Canada	5.2	5.0	5.3	6.9	9.0	9.1	8.7
France	10.6	9.8	9.7	11.6	13.5	14.3	14.4
Germany	11.1	11.5	11.8	12.3	16.5	18.4	17.5
Italy	13.3	12.6	13.2	15.3	20.3	21.4	20.3
Japan	6.6	7.5	9.6	12.4	13.4	14.9	16.5
Netherlands	6.0	5.7	6.1	8.4	11.2	12.1	11.4
New Zealand	5.9	4.8	5.2	6.7	8.3	9.4	9.8
United Kingdom	4.5	4.5	5.2	5.1	5.5	4.0	4.1
United States	4.1	4.2	4.5	5.2	6.6	7.1	7.0

Mr. Harris explained: Developed countries that delay necessary reforms will be spending two to four times more of their Gross Domestic Product (GDP) on public pensions by 2010 than countries that have implemented comprehensive reform.

ADDITIONAL TESTIMONY

Dr. Crippen provided further written testimony in response to an analysis of the CBO study that criticized its methodology. The critics claimed that the CBO analysis chose countries that have little relevance to the U.S and predetermined the conclusion that privatization could help restore solvency to Social Security without exploring the possibility of prefunding Social Security investment on a collective basis through the Federal Government. In addition, the

critics faulted the CBO for not evaluating the impact of the Social Security trust fund and surpluses on solvency.

Dr. Crippen wrote: My testimony, which focused on experiences abroad, included a simple observation drawn from CBO's January 1999 analysis—none of the five countries CBO studies successfully maintained permanent prefunding of their government-run defined benefit pension systems, although four of them expressly intended to do so. He noted that the Social Security system was originally set up as a collectively funded system in 1935, but the goal of building large reserves was shortly abandoned, and the pay-as-you-go structure was adopted.

In response to comments concerning the Social Security trust fund, Dr. Crippen said: Despite projections that current-law Social Security revenues will exceed benefits until 2014, some observers believe that pressures will inexorably mount to use the resulting Social Security surpluses for either tax cuts or additional spending. That view has some currency at many points along the political spectrum. * * * A review of recent fiscal history suggests that the surpluses that accumulated in the Social Security trust funds were spent on other items in the budget. Indeed, after adjusting for the effects of the business cycle, the unified deficit in the next 12 years remained higher than it was in 1983. * * * Yet as the Social Security surpluses grew, even without adjustment the unified deficit fluctuated with no apparent relation to the trust funds. Since 1983, the Social Security surpluses have been spent on other programs, and the government accumulated debt, not assets. And at least through the last fiscal year, at the same time that the Federal Government has been collecting historically high revenues, an on-budget deficit remains—because we are still using some of the Social Security surplus to finance the rest of the budget.

Dr. Crippen concluded: Although alternative explanations are possible, the coincidence of U.S. history and that of other countries raises legitimate concerns about the potential difficulties of prefunding Social Security.

JUNE 8 HEARING: THE SOCIAL SECURITY TRUST FUND—MYTH AND REALITY

Witnesses: Ken Huff, AARP; David Koitz, Congressional Research Service.

The Social Security trust fund has existed as only an accounting entity since 1937, when Congress transformed the system to pay-as-you-go. It was created to keep track of all the funds that the government collected for Social Security. When Social Security taxes received exceed Social Security benefits paid, the Treasury entered a credit in the trust fund.

Until the 1983 reforms, the trust fund balances did not grow to a significant amount. After 1983, this changed. Congress passed the recommendations of the Greenspan Commission, which included a payroll tax increase, the taxation of some benefits, and an increase in the retirement age. The higher payroll tax brought money rushing into the Social Security trust funds, which now holds more than $740 billion for the Old Age Survivors programs and $90 billion more for Disability. Current Social Security projec-

tions show that cash uses exceed cash sources in 2014. After that, the actuaries anticipate redeeming Old Age Survivors trust fund assets to make up the difference between inflow and outgo until 2034. In 2035, program receipts will fund more than 70 percent of the benefits now paid under current-law formulas.

Although the trust funds hold Treasury securities, these have a different meaning than they would for private citizens. It means one part of the government has an obligation to pay another part of the government. When these funds are needed in 2015 and later, the government can only obtain the cash by borrowing, reducing other expenditures, or taxing citizens. Few people expect the government to default on its obligation to repay the trust funds. However, meeting the cash needs of Social Security by redeeming Treasury securities will affect the ability of the government to fund other government programs in the future.

Ken Huff, AARP Vice President for Finance, outlined the organization's position on Social Security. It supports prompt action on reform to allow time to adopt more incremental solutions and gradually phase in changes. However, it does not consider Social Security to be in crisis. The system produces surpluses until 2013, and these funds will build up the trust fund. Since the Federal Government has never reneged on its debts, AARP expects that trust fund assets will be available to pay benefits until 2034, and disputes the argument that trust fund assets are worthless IOUs. The trust funds currently hold about 14 percent of the national debt. Mr. Huff contested a July 1998 Harris/Teeter finding that 79 percent of the American people agreed that the Federal Government had used the Social Security trust funds for other purposes. He asserted: There has been no raid or misappropriation of the Social Security trust funds.

The AARP is encouraging discussion of bipartisan comprehensive reform, not just debate of whether 2014 or 2034 is the year that Social Security first faces financial difficulty. It believes that reform solutions should maintain the program's guiding principles of old age income security, ensure benefit adequacy, and achieve solvency in a fair and timely manner.

Mr. Koitz's testimony addressed five questions: Where do surplus Social Security taxes go; Does this mean that the government borrows surplus Social Security taxes; Are the Federal securities issued to the trust funds the same sort of financial assets that individuals and other entities buy; What is the purpose of the trust funds; How much of the system's future benefits would be payable if the system relied exclusively on its tax receipts?

Like all taxes paid to the U.S. Treasury, Social Security funds flow into government accounts each day. Excess funds do not sit idle. These funds become part of the government's cash accounts used to pay all Federal expenses, including Social Security benefits. The Treasury issues bonds to the Social Security trust funds to keep track of Social Security moneys it has taken into its operating accounts. The trust funds do not pay benefits; the Treasury does. As the Treasury issues checks to beneficiaries, it reduces the trust fund security holdings by an equal amount.

The balances of the Social Security trust fund represent what the government has borrowed from Social Security, plus interest. Trust

fund securities are not marketable, but their interest rates are set to reflect the market. They have specified maturity dates. They are legal obligations of the U.S. Government. However, they are not backed by assets that can be used to repay the debt when it comes due. When Social Security needs these funds in the future, the Treasury must find a source of funds to repay the trust fund debt.

The Federal securities have a political reality. They represent permission to spend. As long as a trust fund holds securities, the Treasury Department has legal authority to keep issuing checks for the program. Even though the government has not set aside assets to pay future benefits, it still has the responsibility to honor the securities when they are presented for payment. If the Treasury does not hold the cash on hand, it must borrow the funds, or Congress must enact legislation that immediately raises revenue or cuts spending.

Starting in 2014, incoming Social Security receipts will cover only a portion of projected benefits, based on the trustees 1999 intermediate or best estimate. The average annual shortfall over this 20-year period amounts to approximately $85 billion, in 1999 dollars:

Year	Percentage of benefits covered by current year receipts
2014	99 percent
2020	85 percent
2034	71 percent
Average, 2014–2034	78 percent

This table shows that Social Security cash needs will affect the Federal budget long before 2034.

Mr. Koitz submitted a recent CRS memorandum for the record, written by Thomas Nicola, Legislative Attorney, American Law Division. The memo expressed the opinion that, if Social Security revenue is insufficient to cover benefit payments, then-current beneficiaries would have a legal claim to promised benefits. However, until the system received funding to pay these benefits, the beneficiaries would just get a judgement against the United States for the amounts due.

JUNE 15 HEARING: SECURE INVESTMENT STRATEGIES FOR PRIVATE INVESTMENT ACCOUNTS AND ANNUITIES

Witnesses: James Glassman, DeWitt Wallace-Reader's Digest Fellow, American Enterprise Institute; Stephen Bodurtha, Senior Director & First Vice President, Merrill Lynch & Co.; Dr. Mark Warshawsky, Director of Research, TIAA–CREF.

Submitted to the Record: "The Costs of Annuitizing Retirement Payouts from Individual Accounts," James Poterba, Mark Warshawsky.

Many young people today are concerned about the rate of return that their Social Security tax payments will earn. Retirees and others nearing retirement age worry that they will be left unprotected if future Social Security deficits force unexpected benefit cuts. A better return on investments can restore confidence in Social Security. As Dr. Roger Ibbotson has testified, equity investments held

over 20 years or more have always historically given investors a high positive return.

Mr. Glassman supports Social Security reform with personal retirement accounts in a system that gives individuals a broad choice of investments. He believes that the increased returns individuals can earn through continual investments in a diversified portfolio of stocks over a long period of time justify the risks of equity investments. He noted that no investment is entirely risk-free, not even Treasury bonds, which may lose value in periods of inflation. Social Security payments have been protected from market risk by the government's power to tax.

According to Mr. Glassman, personal retirement account investments should be concentrated in equities, and the best vehicles for stock investing are broadly diversified mutual funds—either index funds that track the S&P 500 index or the Wilshire 5000 index. Individuals who are concerned about losing money in the stock market, despite its historical performance, can protect themselves by purchasing alternative equity investments that provide guarantees against loss but gives the investor the gain. The most popular product available today, Market Index Target-Term Securities (MITTS), has been developed by Merrill Lynch. Paine Webber, Salomon Smith Barney, Lehman Brothers, and other investment firms offer similar vehicles. Insurance companies, including Nationwide and American Skandia, offer annuities with similar loss protection. Merrill Lynch offers MITTS linked to a technology index, a health care index, a European index, the Consumer Price Index, and more.

A MITTS security trades like an individual stock, but it is tied to a particular index, such as the S&P 500. The first MITTS was sold to the public in January 1992 at $10 a share with a guarantee that, in August 1997, investors would be repaid the original $10, plus any gain equal to 15 percent above the percentage increase in the S&P 500 from 1992 to 1997. Investors who bought $10 shares in 1992 were paid $24 in 1997. They gave up some of their potential gains to be insured against losses that have less than a 10 percent likelihood of occurring, based on past market performance.

Mr. Glassman recommends MITTS as a natural investment for risk-averse investors to purchase for personal retirement accounts. There are many benefits, but investors should be aware of the differences between private guaranteed securities and public debt:

- The security's guarantee is backed by a private entity. Some of the products have been combined with bank deposits so that deposit insurance protects against losses up to $100,000 in the event the issuer cannot repay the investment.
- Such products do not distribute periodic earnings (interest or dividends).
- Currently, MITTS have negative tax consequences if they are held in taxable accounts. Reform proposals will need to assure that taxes on gains are deferred until funds are drawn during retirement.

Mr. Glassman concluded: Complete insulation from risk is impossible but the kind of risk reduction that prospective retirees want and should have is not only possible but it is here today.

Mr. Bodurtha was one of the specialists who designed Merrill Lynch Protected Growth Investing, which incorporates the MITTS product. Growth-oriented investments, such as stocks, historically have provided the best opportunity to increase wealth over the long run. However, potential downside risk keeps many people from investing in stocks, even when long-term growth is the objective. Mr. Bodurtha said: When aversion to risk stands in the way of investing for long-term growth, people may fail to achieve important financial goals.

Merrill Lynch advises Protected Growth Investing to allow investors to:

- Build wealth but protect against downside risk.
- Maintain and add to equity exposure, even if they are concerned that the market is near a peak or may be entering a period of volatility.
- Diversify a portfolio that is heavily weighted in bonds, yet minimize risk.
- Enter into new markets and hedge against losses while they learn how these markets work.

Addressing his comments toward Social Security reform that includes personal accounts, Dr. Warshawsky testified in favor of converting investment accounts into life annuities at retirement, which would guarantee monthly income to a retiree. In its most basic form, an annuity, whether issued by a life insurance company, an employer pension plan, or a government program, pools the mortality risks of people together. He advocated mandatory annuitization of personal retirement accounts for the following reasons:

- *Moral Hazard.* If individuals accumulate a large sum of money at retirement to enable them to support themselves comfortably in old age, some will spend or lose their retirement assets quickly and be forced to rely on public assistance. Alternatively, individuals will underestimate their life expectancies, avoid the purchase of individual annuities, and spend down their assets before they die.
- *Adverse Selection.* Individuals with higher than average mortality risk may conclude that annuities are too expensive for them, and not buy them. If this avoidance is widespread, it will be impossible for insurance companies to sell low-priced annuities based on a large pool of participants.
- *Marketing Costs.* Annuitization through the Social Security Administration or a trustee of personal accounts will minimize costs through scale economies and competitive bidding.

While at TIAA–CREF, Dr. Warshawsky has seen many benefits from a life annuity. He believes that a annuity will pay a higher flow of income—as much as 30 percent—to each participant. TIAA–CREF recently introduced an inflation index bond account that can be used for variable life annuity payments, giving retirees COLA-like benefit increases.

Dr. Warshawsky submitted a comparative analysis of annuitization costs for retail annuities sold to individuals to private annuity contracts negotiated by the Thrift Savings Plan and TIAA–CREF. His research indicates that higher annuity payouts can be negotiated through competitive bidding contracts that offer a high volume of investment funds. Annuitization through a fund man-

ager may lower the administrative costs to individual retirees, thereby increasing their retirement income.

In the design of a system to invest in the markets, Dr. Warshawsky advised the Task Force to keep in mind the inevitable trade-offs between cost and choice of who invests, and in what to invest, saying: There definitely is a trade-off, and it is a very difficult trade-off between the political issues that are involved in centralized investments versus the costs, the inevitable administrative costs which are involved in decentralized individual investments. He also emphasized the importance of educating workers if a personal account system is adopted.

During questions to witnesses, various opinions about the safety net and a government guarantee surfaced. The need for a guarantee is a political issue. However, the more generous the guarantee becomes, the greater the moral hazard for the government. Mr. Glassman commented: Risk is an important discipline. It makes people invest wisely. If you take that away, people are going to do things which, down the road, will end up costing the Federal Government a lot more money.

With regard to indexed annuities, Dr. Warshawsky sees new products coming that will expand choices for retirees. Although these annuities are new to the U.S. market, companies in the United Kingdom have much more experience. Annuities could be priced on a unisex basis, comparable to current Social Security benefit calculations.

JUNE 22 HEARING: THE SOCIAL SECURITY DISABILITY PROGRAM

Witnesses: Jane Ross, Deputy Commissioner for Policy, Social Security Administration; Mark Nadel, Associate Commissioner for Disability and Income Assistance, Social Security Administration; Marty Ford, Consortium for Citizens with Disabilities.

In 1965, 1 million workers were collecting disability benefits. In 1998, 6 million workers and family members received $49 billion in Social Security disability benefits. Reforms that restore solvency to Social Security are especially important for the disability programs, because we have less time before the disability trust fund reaches insolvency. By 2010, program outflow will exceed receipts. By 2020, when Social Security projects that 11 million people will be receiving disability benefits, the Disability trust fund will be depleted.

In his briefing to the Task Force, Federal Reserve Chairman Alan Greenspan told us that one key reason the 1983 reforms have not ensured Social Security's solvency for the 75 year period projected at the time was an unanticipated explosion in disability beneficiaries and, ultimately, disability insurance costs.

Approximately 6.2 million of current Social Security beneficiaries are disabled workers and their children, and 200,000 are the surviving family members of deceased disabled workers. Ms. Ross equates Social Security's disability coverage to a $233,000 insurance policy for a young, married average worker with two children. Benefits are funded through a 1.7 percent payroll tax on covered earnings, paid by employees/employers and the self-employed.

Qualification for disability enables these Social Security beneficiaries to participate in the Medicare program. Eligibility for health insurance is a very important benefit, because disabled workers do not usually have employer health plans and do not meet underwriting qualifications for private insurance. Medicare paid over $24 billion in benefits.

Ms. Ross explained that qualification for Social Security disability benefits depends on a determination that a worker suffers from a medical condition that lasts at least 12 months which leaves the worker unable to perform any substantial work in the national economy. Applicants must have worked 20 quarters during the 40 quarter period ending with the quarter in which disability began, and they must complete a 5-month waiting period after the onset of the disability. Social Security undertakes substantial administrative review of disability cases, which increases the program's administrative costs to 3.3 percent of benefits.

The GAO considers Social Security DI to be a high-risk program, which means it has greater vulnerability to waste, fraud, abuse, and mismanagement. Ms. Ross described the fraud prevention programs that Social Security employs. She did not view fraud enforcement as a likely means of reducing benefit growth.

The latest GAO Performance and Accountability Series found that only 1 in 500 disability beneficiaries return to work after receiving benefits. Ms. Ross provided details about the vocational rehabilitation programs that Social Security is initiating to improve these statistics. Ms. Ford pointed out that rehabilitated beneficiaries who lose their disability status also lose their Medicare coverage. This is a strong disincentive to rehabilitation, and she encouraged Congress to pass legislation that allowed them to stay on Medicare.

Social Security disability benefits are integrated with most state workers compensation programs so that the combined Social Security/workers compensation amounts are limited to 80 percent of pre-disability earnings. Similarly, most employer-sponsored long-term disability plans are integrated with Social Security disability and workers compensation. Individuals can purchase private disability insurance that will provide benefits in addition to the integrated Social Security/workers compensation/employer disability payments. However, few workers buy such coverage. High-risk applicants who might want the additional coverage often cannot meet the private insurers underwriting requirements.

Ms. Ross concluded: Only Social Security provides coverage to all workers and dependents—coverage that is provided at lower cost and greater value than now available on the private market.

Ms. Ford emphasized the insurance characteristics of Social Security are extremely important to the disability program. She cited Social Security Administration statistics that say a 20-year-old today has a 1-in-6 chance of dying before reaching retirement age and a 3-in-10 chance of becoming disabled. Noting that the poverty rate for working age adults with disabilities is 30 percent, she said: The capacity of beneficiaries with disabilities to work and to save for the future and the reality of their higher rates of poverty must be taken into consideration in any efforts to change the Title II programs.

Ms. Ford believes that privatized reform plans with personal retirement accounts that shift risk from the government to the individual are not in the best interest of the disabled. Reform programs that establish personal retirement accounts offer less benefit to disability recipients. They typically have shorter work histories with long periods of unemployment, so they are not earning wages or making ongoing contributions to personal accounts.

The Consortium of Citizens with Disabilities believes that Congress should only consider legislation that maintains the basic structure of the current system and preserves the social insurance disability, survivors, and retirement programs. It supports strengthening the trust funds to meet the needs of current and future beneficiaries and implementing program changes that do not undermine or dismantle the basic structure of Social Security. Social Security reform proposals have targeted their design changes toward the retirement program. However, disabled beneficiaries are indirectly affected by various provisions:

• *Changes to the Benefit Formula.* Modifications to the Primary Insurance Amount (PIA) decrease both retirement and disability benefits. Current proposals reduce disability by as little as 8 percent or as much as 45 percent. Reductions to the lowest bend point without any minimum benefit provisions will force more of the disabled into poverty.

• *Access to Retirement Accounts.* The personal accounts established by many reform plans cannot be accessed until a worker reaches age 62. The disabled do not have access to income from these funds to supplement reduced Social Security payments. In addition, adult disabled children and workers who are disabled early in their work years will have no personal account to access.

• *Adequacy of Accounts.* Social Security currently pays benefits to spouses, children, adult disabled children, surviving spouses, and former spouses. The assets of personal accounts could not provide equivalent benefits to this many beneficiaries. In plans that require life annuitization of personal accounts, there will be no account left to provide for dependents and adult disabled children.

• *Computation of Years of Work.* Plans that increase computation years disproportionately reduce the benefits of workers with more low or no earnings years.

• *Raising the Normal Retirement Age (NRA).* Increasing the retirement age will increase disability applications in two ways. First, if the NRA rises, the early retirement benefit available at age 62 will fall. Unless disability benefits give a similar reduction, workers will apply for disability instead of opting for early retirement. Second, manual laborers who cannot work the additional years will seek to stop working at an earlier age by applying for disability.

• *Capacity to Manage Accounts.* Disabled beneficiaries who suffer from mental retardation, mental illness or other cognitive impairments may not have the ability to make wise and profitable investment decisions. Privatization places these individuals at substantial personal risk.

In concluding, Ms. Ford recommended that reform proposal evaluations include a beneficiary impact statement from the Social Security Administration.

JUNE 29 HEARING: REVIEW OF CURRENT SOCIAL SECURITY PROPOSALS

Witnesses: Senators Breaux, Grassley, and Gregg presenting the Bipartisan Plan as a panel; Representatives Archer and Shaw presenting the Archer/Shaw plan as a panel; Representatives Kolbe and Stenholm presenting the 21st Century Retirement Security Act as a panel; Representative Kasich presenting the Kasich Social Security plan; Representative Smith presenting the Social Security Solvency Act; Representative DeFazio presenting the DeFazio Social Security reform plan; Representative Bartlett presenting H.R. 990 as a panel.

Statements from: Senators Gramm and Moynihan, Representatives Markey and Nadler.

OVERVIEW OF REFORM PROPOSALS PRESENTED TO THE SOCIAL SECURITY TASK FORCE

All proposals except H.R. 990 restore long-range solvency, depend on general revenue transfers; all proposals except H.R. 990 and the DeFazio plan modify or eliminate the earnings test.

SOCIAL SECURITY SOLVENCY ACT/REPRESENTATIVE NICK SMITH

- Diverts a growing percentage of OASDI tax rate to voluntary Personal Retirement Savings Accounts (PRSAs), which are used to finance future OASI benefits and give workers the opportunity to increase their retirement income.
- Accelerates the scheduled increase in full retirement age.
- Increases benefits for aged surviving spouses.
- Future benefit calculations reflect changes in life expectancy.

21ST CENTURY RETIREMENT SECURITY ACT/REPRESENTATIVES KOLBE AND STENHOLM

- Diverts 2 percent of OASDI tax rate to mandatory Individual Security Accounts (ISAs) which offset future OASDI benefits; allows additional voluntary contributions.
- Provides government match on voluntary contributions made by low wage earners (funded from general revenues).
- Reduces COLAs.
- Accelerates the scheduled increase in full retirement age.
- Increases the early eligibility age for retirement.
- Lengthens benefit computation period from 35 to 40 years, but lower wage earner in a two-earner couple keeps 35 year period.
- Future benefit calculations reflect changes in life expectancy.
- Redirects income from taxation of Social Security benefits to OASDI.
- Establishes a guaranteed minimum benefit.

SOCIAL SECURITY GUARANTEE PLAN/REPRESENTATIVES ARCHER AND SHAW

- Establishes mandatory Social Security Guarantee Accounts (SSGAs) funded by an annual tax credit equal to 2 percent of OASDI taxes.
- Guarantees a benefit at least equal to current law benefit.

• Reduces OASDI tax rate by 2.5 percent in 2050 and an additional 1 percent in 2060.

BIPARTISAN SOCIAL SECURITY REFORM PLAN/SENATORS BREAUX, GRASSLEY, AND GREGG

• Diverts 2 percent of OASDI tax rate to mandatory Individual Security Accounts (ISAs), which offset future OASDI benefits; allows additional voluntary contributions.
• Provides government match on voluntary contributions made by low wage earners and establishes KidSave accounts (funded from general revenues).
• Reduces COLAs.
• Raises taxable earnings base.
• Accelerates the scheduled increase in full retirement age.
• Lengthens benefit computation period from 35 to 40 years, but lower wage earner in a two-earner couple keeps 35 year period.
• Future benefit calculations reflect changes in life expectancy.
• Redirects income from taxation of Social Security benefits to OASDI.
• Phases in benefit to surviving spouses equal to 75 percent of combined benefit.

KASICH SOCIAL SECURITY PLAN/REPRESENTATIVE KASICH

• Diverts a percentage of OASDI tax rate to voluntary Personal Retirement Savings Accounts (PRSAs), which are used to finance future OASI benefits.
• Reduces the growth rate for future benefits.

DEFAZIO SOCIAL SECURITY REFORM PLAN/REPRESENTATIVE DEFAZIO

• Taxes all wages, but exempts the first $4,000 from payroll tax.
• Allows the government to invest 40 percent of the Social Security surplus in the stock market.
• Increases benefits 5 percent at age 85 and allows up to five drop-out years in benefit computation.

H.R. 990/REPRESENTATIVE BARTLETT

• Invests a portion of the Social Security trust fund in the stock market to extend solvency of Social Security.

JULY 13 HEARING: THE COST OF TRANSITIONING TO SOLVENCY

Witnesses: Dr. Rudolph Penner, American Enterprise Institute; David John, Heritage Foundation; William Beach, Heritage Foundation.

Submitted to the Record: "Would a Privatized Social Security System Really Pay a Higher Rate of Return?" John Geankoplos, Olivia Mitchell and Stephen Zeldes.

The topic of transition costs is an essential element of the Task Force's mission to review the long-term budget ramifications of the various Social Security reform proposals. There are only three ways to eliminate Social Security's $9 trillion unfunded liability and return the system to solvency: raise taxes, cut benefits, or increase the rate of return earned on the taxes workers pay. This transition

to solvency will change the system we have today. By initiating comprehensive reform as soon as possible, we can phase in changes slowly—minimizing the Federal budget impact and giving workers time to plan for the changes.

In its early years, Social Security's pay-as-you-go system paid retirees much more than they had contributed in taxes. Rate of return calculations comparing the present value of taxes paid to benefits received estimate that early retirees received a high return on their taxes, but that the rate of return has been dropping steadily as the system matured. Current money's worth calculations show that workers can expect less than a 2 percent real rate of return on their taxes. When this is compared to the 8.5 percent return that Dr. Ibbotson is expecting from equities over the next 25 years, the question naturally arises: How can we give the American worker a better deal? Although the method of investment varies, most reform plans use equity returns to enhance the yield on taxes paid.

However, higher equity yields will only be achieved by prefunding a portion of Social Security—putting cash aside to be invested in the markets. This changes Social Security from pay-as-you-go to a hybrid system. Such a conversion imposes transition costs by diverting pay-as-you-go funds from current consumption to future benefits. During periods of surplus, prefunding imposes no cost on current retirees. However, this flexibility is lost once Social Security enters into a projected period of never-ending deficits. Then, the transition to prefunding reduces cash available to pay benefits to retirees.

Dr. Summers addressed transition costs in his closed briefing for the Task Force. He called current surpluses an opportunity to partially cover transition costs and provide fiscal space by paying down debt and investing a portion of the Social Security trust fund in the stock market to enhance returns. He argued that using funds to pay down debt will reduce future interest costs and will give us fiscal space in the future as Social Security and Medicare spending rises. Dr. Summers supported government investment in the stock market to spread the market risk across a large pool of beneficiaries, to minimize administrative costs, and to maintain Social Security's progressive nature by assuring that low-income workers were given a higher benefit as a percentage of wages.

Dr. Penner urged members not to confuse these two types of transition costs, saying: In current policy discussions, the problems of fixing the current system are often merged and muddled with the problems involved in moving toward funding. The two problems are distinct and should be separated conceptually. But it is desirable to solve both simultaneously, and it is necessary to consider this twofold burden when analyzing reforms. Dr. Penner supports a hybrid system that uses income from personal retirement accounts to offset traditional fixed benefit reductions. Although he advocated gradual changes to the current Social Security benefit, he acknowledged that a go-slow approach means that the ultimate reduction in benefits will be greater. Future generations pay a higher cost for delays in reform now.

In theory, there should be no difference in rate of return and economic benefit between government investment and personal retirement accounts. However, Dr. Penner doubts that the government

could resist dipping into the reserves of a public account to fund deficits in other government accounts. In addition, he worries that the government would use its investment policy to achieve political ends instead of maximizing long-run portfolio returns.

Transition costs cannot be avoided, Mr. John asserted, saying: High transition costs will be a fact of life for Social Security regardless of whether the program is radically reformed or just left as it is. While some consider transition costs to apply only to proposals that would reform Social Security, this is not the case. Since the existing program will begin to run cash flow deficits in 2014, the transition costs of various reform proposals should be measured against the costs associated with doing nothing at all. He presented a Heritage Foundation analysis which evaluated current reform plans, using a definition of transition costs as the total amount of money that must come from sources other than Social Security payroll taxes at the current level and the small portion of the income tax on benefits paid to certain higher income retirees. In 2030, the transition cost in 1999 dollars for current-law Social Security OASI is $252 billion, compared to $133 billion for the Kolbe-Stenholm plan, $130 billion for the Senate Bipartisan plan, $187 billion for the Kasich plan, $95 billion for the Smith plan, and $255 billion for the Archer-Shaw plan. Current-law OASI annual solvency-only transition costs reach $516 billion in 2070.

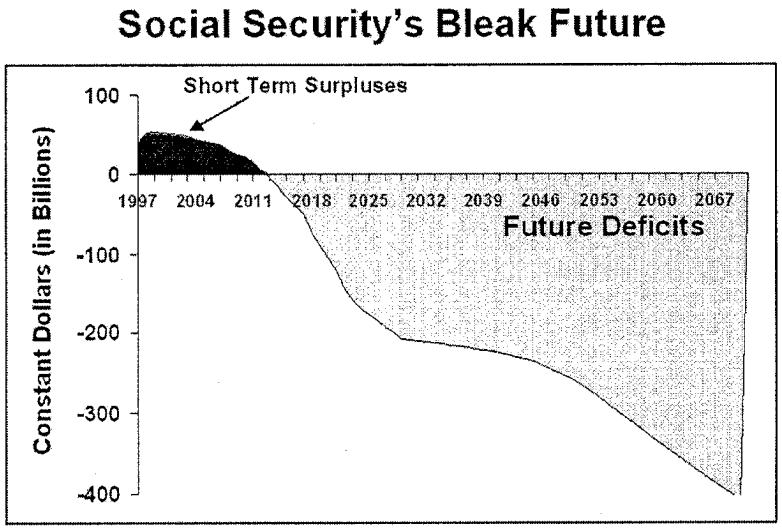
Where will the money come from to fund these transition costs? Future Congresses will be forced to weigh the economic effect of large tax increases against massive spending reductions for discretionary budget categories such as education, highways, or defense. Deficit spending and mounting Federal debt will again be in vogue.

Like Dr. Penner, Mr. John saw Social Security reform in intergenerational terms, concluding, "[t]he real question is how responsible this Congress and the one following wants to be to future generations. It can do nothing and place a significant burden on our children and grandchildren, or it can act responsibly and reduce that burden."

The paper submitted by Geanakoplos/Mitchell/Zeldes warns against depending on a higher rate of return to avoid structural reform that cures Social Security's unfunded liability, which they estimate to be $10 trillion. The paper suggests that unless investment accounts—either individual or government-owned—are prefunded and actually invested in the equities market, there is no potential for enhanced returns in the future. Furthermore, gradual reform that phases in prefunding will benefit future generations, but the go-slow prefunding approach does not cure the projected deficits for the baby boom generation. In addition, administrative costs and transition costs for both solvency and prefunding will lower the rate of return for near-term retirees. The authors believe there is no free lunch, and Social Security reform must balance the sacrifices needed to achieve solvency across generations. Finally, the authors argue that other factors—economic impact, savings incentives, minimization of political risk, and anti-poverty goals—should influence the design of reform.

ADDITIONAL VIEWS

IT'S TIME FOR REFORM, AGAIN



Facts are stubborn things. As the official projections by the actuaries of the Social Security Administration make clear, America's most popular program is headed for financial collapse.

The Social Security program, which is vital to the well being of millions of Americans, must be reformed so that it can continue to provide workers the retirement and disability protection they deserve. Although the financing crisis may seem distant now, as we enjoy record surpluses, in just 15 years, surpluses will be a thing of the past. By 2014, Social Security's expenditures will begin to exceed its tax revenue by ever increasing amounts.

Federal Reserve Board Chairman Alan Greenspan, who presided over the 1982–83 Social Security Commission, told the Task Force that the program's unfunded liability equals $9 trillion. This is a staggering sum. Put another way, a private pension fund would require the legal right to collect 12.4 percent of the nation's payroll in perpetuity, plus an up front payment of $9 trillion, in order to cover the Social Security system's financial obligations.

During the past two decades, the program has experienced two serious crises, one in 1977 and another in 1983. By waiting until the last moment, previous Social Security reformers had to cut benefits with almost no warning, generating claims of unfairness. In 1977, for example, reform legislation created "Notch Babies" who receive lower benefits than those granted to friends who were born just 1 year earlier. Again, in 1983, when Congress passed legislation that raised the normal retirement age to 67, it also, for the first time, taxed up to half of a beneficiary's Social Security income. This new tax, coupled with a 6-month delay in cost of living adjustments, cut net benefits to some retirees by 27 percent. Further-

more, when the 1993 Budget Act passed, some seniors suffered net reductions of 14 percent when the Clinton Administration and Congress decreed that up to 85 percent of Social Security benefits were taxable. The millions who were affected by such changes were given at most a few months to prepare. This is not how a great nation should treat its citizens.

Another crisis is approaching. Indeed, Social Security's long-term shortfall is larger today than it was before the 1983 amendments were enacted. This time, we must not wait until the last minute to take action. Learning from the mistakes of the past, we recommend that Congress and the Clinton Administration adopt necessary changes now and implement them gradually. This will provide ample notice to workers so that they know well in advance what to expect when they reach retirement age. The longer we delay the more difficult it will be to eliminate the unprecedented deficits that loom over the horizon. Delay risks hitting future workers and retirees with unexpected and unnecessary tax increases and benefit cuts. Social Security must be put on sound financial footing for the long-term. There are no responsible excuses for delay.

The majority of this Task Force believes Social Security must be transformed into a system that includes personal savings accounts funded out of the current payroll tax, giving workers direct personal ownership of their retirement accounts. Such a transformation cannot be achieved overnight, and it must take place while the government continues to honor its current promises and maintain the income safety net provided by Social Security. Current retirees who count on their monthly benefits must be confident that the Federal Government will faithfully keep the promises it has made. Older workers who have paid Social Security taxes for decades must be assured that Social Security will have the funds to pay benefits when they retire. Restoring solvency to Social Security and modernizing it are not easy tasks. However, successful reform will come from forward-looking leadership that weighs the value of change against the cost of delay. We must take action to give our children a robust, solvent system that will stand up to the uncertainties that we cannot predict today. The longer we wait, the more difficult our task becomes.

SOCIAL SECURITY REFORM IS ONLY A FIRST STEP

The troubled Social Security system is part of an even larger challenge. Other essential entitlement programs are unsoundly financed, too. In 1995, the Bipartisan Commission on Entitlements and Tax Reform published its findings that in the years ahead total entitlement spending would rise from 11 percent of Gross Domestic Product to 20 percent by 2030. The Commission's calculations showed that if taxes were raised to accommodate increased spending, the Federal receipts and outlays would be balanced with taxation reaching 30 percent of GDP, an historic high. If future spending is financed through new debt, with additional interest costs, the Commission calculated that Federal spending would hit 37 percent of GDP in 2030. Senator Kerrey and Senator Danforth, the Commission's cochairmen, warned that unless Congress enacted changes that limited nondiscretionary spending, the Federal Gov-

ernment would no longer exercise real control over the Federal budget. In the words of Senator Kerrey, it would "act as an oversized ATM machine whose only function is to collect money and hand it back out." The bipartisan Balanced Budget Act of 1997 represented an important first step toward reclaiming control over our fiscal future. The Budget Resolution for FY 2000 made further progress toward this goal. However, much more will be needed, and on a bipartisan basis, if we are to avoid mortgaging our children's future. As a first essential step, we must move a portion of Social Security from a fixed benefit to a fixed contribution.

ACTUARIAL PROJECTIONS MAY BE UNDERSTATING THE SOCIAL SECURITY PROBLEM

The actuaries at the Social Security Administration (SSA) have the official responsibility for preparing the 75-year solvency projections needed by policy makers to make appropriate long-term decisions. For some time now, their annual reports have confirmed the adage that "demographics are destiny." In 1945, 41.9 workers contributed FICA taxes to pay the benefits of each retiree—a "dependency ratio" of 41.9-to-1. Today, that ratio is 3.4-to-1. According to the actuaries, declining birth rates and rising life expectancies will result in a dependency ratio of 2.1-to-1 by 2030.

Since Social Security is funded on a pay-as-you-go basis, the ratio of workers to beneficiaries determines how much the system will cost. Today, the average benefit is about 36 percent of the average wage, and there are 3.4 workers per beneficiary. Therefore, the cost of the program is about 11 percent of wages (i.e., 36 percent / 3.4). By 2030, there will only be 2.1 workers per beneficiary, therefore, the cost of the program will be approximately 18 percent of wages. By 2075, the ratio is expected to decline to 1.8-to-1. The cost of the program to each worker will rise substantially, to nearly 20 percent of wages.

Unfortunately, estimates of long-term life expectancy projected by SSA actuaries may be understated. Medical advances already on the horizon promise significant increases in life expectancy and quality of life for the aged in the 21st Century. Many scientists expect these cost effective anti-aging tools will be widely available within 20 years. Yet, the SSA projections anticipate only a 3-to-4 year increase in life expectancy over the next 75 years for individuals reaching 65 years of age.

Dr. Kenneth Manton, recognized widely as one of the world's leading experts on aging, told the Task Force that medical science is entering a "turning point" that will make it impossible to use past trends to accurately project future improvements in life expectancy, as SSA now does. For example, he forecasts substantial reductions in stroke and cardiovascular disease mortality. These two diseases, along with cancer, are currently the leading causes of death for seniors. He also expects improvements in elderly health stemming from the long-term effects of reduced smoking, improved nutrition, and revolutionary drugs. Dr. Manton expects many of the baby boomer's children to reach their 100th birthday.

Dr. William Haseltine, perhaps the nation's foremost pioneer in human genome research and regenerative biology, advised the Task Force to expect even better results from science than Dr.

Manton suggested. As President of a firm in the forefront of the Human Genome research project, he is in a unique position to judge the likely impact of years of future gene mapping research. He expects this research to produce a new generation of drugs that will sharply slow the aging process, extending life expectancy to 120 years for Generation Xers.

This is amazing and wonderful news, but it calls into question how centenarians and those even older can have the resources necessary to make their long lives rewarding. Government promises about future benefits will mean little if the future worker/beneficiary ratio collapses toward 1-to-1—creating not only a tax burden on future workers but a deterrent on economic expansion. The possibility these predictions will occur creates even more urgency for action now. Social Security is not the only problem we face. We must address the long term needs of Medicare and Medicaid, as well.

REDEEMING TRUST FUND ASSETS WILL NOT BE EASY

It is important to draw the correct conclusions about the meaning of the Treasury securities held by the Old Age Survivors and Disability Insurance trust funds. Although these trust funds are expected to hold $887 billion in Treasury securities by the end of this year, that does not mean the government will have the money it needs to redeem these securities and pay benefits in the future. As the President's Office of Management and Budget (OMB) has observed:

> "These [trust fund] balances are available to finance future benefit payments and other trust fund expenditures—but only in a bookkeeping sense. * * * They do not consist of real economic assets that can be drawn down in the future to fund benefits. Instead, they are claims on the Treasury that, when redeemed, will have to be financed by raising taxes, borrowing from the public, or reducing benefits or other expenditures. The existence of large trust fund balances, therefore, does not, by itself, have any impact on the Government ability to pay benefits." *Budget of the United States Government FY 2000, Analytical Perspectives,* Washington DC, Government Printing Office, 1999, page 337.

In short, these securities simply mean one part of the government has an obligation to pay another part of the government. While most people believe the government will honor its obligations, meeting the rapidly escalating cash requirements of Social Security to pay promised benefits will seriously compromise the government's ability to fund other worthwhile programs in the future.

In his appearance before the Task Force, David Koitz, a Specialist in Social Legislation with the Congressional Research Service, explained the nature of the relationship of the Trust Funds to the rest of the budget. By answering five questions, he explained how Social Security's future imbalance between spending and revenue will pressure other program as early as 2014:

Where Do Surplus Social Security Taxes Go? Along with all other government receipts, Social Security funds flow each day into and out of thousands of depository accounts maintained by the government and become part of the government's operating cash pool. Once these taxes are received, they become indistinguishable from other moneys the government takes in. They are accounted for through the issuance of Federal securities, but the trust funds themselves do not receive or hold money.

Does This Mean That the Government Borrows Surplus Social Security Taxes? Excess funds do not sit idle. They are used to finance other operations of the government. The balances of the Social Security trust fund represent what the government has borrowed from Social Security, plus interest.

Are the Federal Securities Issued to the Trust Funds the Same Sort of Financial Assets That Individuals and Other Entities Buy? They are not marketable, but they do earn interest at market rates, have specific maturity dates, and by law represent obligations of the U.S. Government. However, they are not assets for the government. These claims are not resources that the government has at its disposal to pay future Social Security benefits.

What is the Purpose of the Trust Funds? The Federal securities issued to any Federal trust fund represent "permission to spend." As long as a trust fund holds securities, the Treasury Department has legal authority to keep issuing checks for the program. Money has not been set aside for Social Security purposes, but this does not dismiss the government's responsibility to honor the securities when they are redeemed. If the Treasury does not have the cash on hand to meet these claims, it must borrow the funds—or, alternatively, Congress would have to enact legislation to raise revenue or cut spending.

How Much of the System's Future Benefits Would Be Payable If the System Relied Exclusively on Its Tax Receipts? Starting in 2014, incoming Social Security receipts will cover only a portion of projected benefits, based on the trustees' 1999 base projections. The average annual shortfall over this 20-year period amounts to approximately $85 billion.

Year	Percentage of benefits covered by current year receipts
2014	99 percent
2020	85 percent
2034	71 percent
Average, 2014–2034	78 percent

Reform Will Bring Economic Growth, Financial Stability, and Federal Budget Flexibility

During his presentation before the Task Force, Federal Reserve Board Chairman Alan Greenspan urged Congress to adopt reforms that will increase long-term savings and investment to generate the largest possible future resource base. He pointed out that it is easier to be generous with Social Security beneficiaries when resources are plentiful because of years of sustained economic growth. Enhanced savings and investment, he told us, will produce the larger resource base. On a related question, Chairman Green-

span stated that reducing Social Security's unfunded liability will cause the capital markets to respond favorably, lowering interest rates. Lower interest rates also will lead to expanded investment and a larger future resource pool. Thus, tax reform and Social Security reform compliment each other in our efforts to provide for future retirees and to carry out other vital missions of the Federal Government. He cautioned against depending on revenues outside of the Social Security system to support benefit payments that cannot be funded through the FICA tax. In the short run, the income tax base offers a new source of revenue; however, this "solution" does not take entitlement spending off its unsustainable growth track.

REFORM MUST BE COMPREHENSIVE, NOT PIECEMEAL

Stephen Entin, Executive Director of the Institute for Research on the Economics of Taxation and a former Deputy Assistant Secretary of the Treasury, warned the Task Force not to do another "patch job." Less than 5 years after the 1977 amendments, the Social Security trust fund was again on the brink of insolvency. Despite the reforms enacted in 1983, he pointed out that only 16 years later the system faces insolvency early in the next century. Reforms that just make adjustments to the existing system do not provide a long-term solution. To safeguard the system for the future, more fundamental change is needed. As a policy prescription, he encouraged the Task Force to make higher private savings a priority, saying, "This is one of those reforms where more is better than less. The more people can put their own saving to work in a real funded system, the better the retirement income picture is going to be." A well-crafted proposal must address four key elements:

- *Labor supply.* Reform can increase the rate of return workers get from FICA contributions by diverting a portion of their taxes to personal accounts that can be invested in the capital markets. For the same work effort, they will receive more retirement income—in effect, raising their overall compensation. As compensation rises, labor force participation and hours worked will follow suit.
- *Personal saving.* The savings deposited into personal accounts must represent additional savings, not just a replacement of one account with another. More favorable tax treatment of personal savings will assure that the overall savings rate increases once personal retirement accounts are established.
- *National saving.* Additional Federal borrowing should be avoided. As entitlement spending grows, this means that government spending must be restrained.
- *Capital formation.* Additional savings will mean that more capital will be available for businesses to invest and expand. Favorable domestic tax treatment of investment capital and depreciation will keep these funds in the United States, so American workers benefit through higher productivity and greater employment opportunities.

As explained by Mr. Entin, letting workers direct a portion of their payroll tax to personal accounts will make them more willing to work. He opposes an "add on" approach to finance personal accounts. Proposals that increase the tax burden for current workers,

either through mandated "add on" contributions above the current FICA tax or through other direct tax increases, will decrease their incentive to work. Mr. Entin also supports increased savings investment incentives, including faster depreciation schedules for business investment and expanded IRA-type tax treatment for other forms of saving.

Mr. Entin presented estimates of how spending reductions, debt financing and tax increases to finance the transition to a system of personal retirement accounts would affect GDP. According to Mr. Entin, with the right incentives for saving and investment and proper rewards to labor, Social Security reform could boost real after-tax wages by 6 percent to 10 percent, and create an additional 4 to 7 million jobs.

Time is not on our side, warned Mr. Entin, as he said, "Very soon you are going to have no choice but to solve the funding problem. You have got a deadline. If you just solve the funding problem, there will be a great tendency on the part of Congress to say, "We have done the job, let us not do any more." In that case, it will have passed up the opportunity to give people much higher incomes while they are working and much higher incomes while they are retired.

AN ESSENTIAL ELEMENT OF REFORM: MARKET RATES OF RETURN

Expert recommendations differ on the details of reform; however, numerous reform proposals rely on higher rates of return to reduce the gap between future payroll taxes and promised benefits. The current Social Security programs give the average worker a 1.8 percent investment return on his payroll taxes. In contrast, corporate stocks have given investors average real annual rates of return of 8.1 percent, measured from 1926 to 1998. Stock prices fluctuate, but over time the upswings outweigh the downturns, and investors have learned they can count on higher returns on funds that are invested for the long run. Since most workers pay Social Security taxes for 40 years or more, they should use long-term investment strategies with confidence.

Professor Roger Ibbotson of Yale University, the leading expert in measuring historical rates of return on numerous assets, described to the Task Force how higher rates of return materially increase retirement income. A dollar invested in stocks 73 years ago would have earned a nominal annual yield of 11.2 percent, growing to $2,351 today; a dollar invested in treasury bonds, earning a modest 5.3 percent return, grew to just $44 over the same 73 years. While stocks may represent higher risk in the short-term, the odds are very high that, over time, investors will come out far ahead in the stock market.

The Majority found Dr. Ibbotson's presentation especially thought provoking. In 1974, during one of the worst bear markets in U.S. history, Dr. Ibbotson predicted that the Dow would increase to 10,000 by the year 2000, actually underestimating this landmark by a year. He now expects the Dow to reach 100,000 by early 2024. Dr. Ibbotson has made the following forecasts for the period between 1999 and 2025:

IBBOTSON'S LONG-TERM NOMINAL RATE OF RETURN/INVESTMENT FORECASTS

Total Return on Stocks	11.6 percent
Total Return, Long-Term Government Bonds	5.4 percent
Total Return, Treasury Bills	4.5 percent
Forecasted Inflation Rate	3.1 percent
Dow Jones Industrial Average, 12/25	120,368

If retirement savings are invested in securities that give a higher rate of return, workers of all ages will benefit. They will have more retirement income in the future:

COMPOUND INTEREST'S POWER: COMPARATIVE RATES OF RETURN IN TODAY'S DOLLARS FOR $100 INVESTED NOW PLUS $10 WEEK

	Treasury bills	Current law Social Security	Long-term Government bonds	Stocks
For 20 years	$12,122	$12,640	$13,326	$26,736
For 30 years	$19,509	$20,802	$22,568	$68,493
For 40 years	$27,998	$30,557	$34,169	$162,903
For 50 years	$37,753	$42,218	$48,732	$376,363
For 60 years	$48,963	$56,156	$67,014	$858,992
For 70 years	$61,845	$72,817	$89,963	$1,950,208

Source for Social Security's projected annual real rate of return of 1.8 percent is the Urban Institute; all other annual real rates of return provided by Ibbotson Associates (T-bills, 1.4 percent; Government bonds, 2.3 percent; stocks, 8.5 percent).

During his briefing before the Task Force, then Deputy Treasury Secretary Lawrence Summers called current surpluses an opportunity to provide fiscal space by paying down debt and investing a portion of the Social Security trust fund in the stock market to enhance returns. The question of investing Social Security funds in the capital markets is not if; it is when and how.

INDIVIDUALLY OWNED ACCOUNTS, NOT GOVERNMENT INVESTING, IS THE BEST APPROACH

There are several compelling reasons why the majority feels that it would be inadvisable for the Federal Government to control investing the Social Security surpluses rather than individual workers. First, the "government-as-shareholder" approach brings with it unavoidable conflicts of interest. Experience with some state pension funds suggests that short-term political interests often take precedence over the long-term interest of retirees. Hard working Americans should not have to worry about government officials trying to decide which duty comes first, producing the largest returns for retirees, or promoting the partisan objectives of the party in power.

Second, Federal investment opens up unnecessary avenues for government corruption. Imagine the potential for abuse when a few government officials meet in secret to buy or sell billions of publicly traded securities. Consider the consequences if these officials have the ability, through large discretionary stock purchases, to pressure CEOs, who receive large stock options as incentive pay, to make campaign contributions.

Third, government investment will not give workers the retirement security they deserve. Under government entitlement programs, there is no legally binding relationship between the amount that a worker contributes to Social Security and the benefits a

worker receives. This is not subject to debate. The Supreme Court has confirmed this fact in two important cases, *Flemming v. Nestor* (1960), and *Richardson v. Belcher* (1971):

• It is apparent that the noncontractual interests of an employee covered by the Act cannot be soundly analogized to that of the holder of an annuity. * * * To engraft upon the Social Security system a concept of 'accrued property rights' would deprive it of the flexibility and boldness in adjustment to ever-changing conditions which it demands.

• "The fact that Social Security benefits are financed in part by taxes on an employee's wages does not in itself limit the power of Congress to fix the levels of benefits under the Act or the conditions upon which they may be paid. Nor does an expectation interest in public benefits confer a contractual right to receive the expected amounts."

With no legal connection between tax payments and retirement benefits, there is no guarantee that future retirees would receive any of the gains earned through government investment. The gains could be used for some entirely different purpose. Workers would have no enforceable right to these gains, their retirement income would remain at risk.

In the 1930's, the architects of Social Security, President Roosevelt and a Democrat-controlled Congress, rejected the idea of allowing the Federal Government to invest Social Security surpluses outside of the government because of these very dangers. Those who support such investment today must explain why the architects were wrong.

SOCIAL SECURITY'S INTERGENERATIONAL IMPACT

Since Social Security is a pay-as-you-go system, each generation of workers pays taxes to support the retirement of current retirees. However, as future benefit payments exceed tax receipts, either taxes will have to increase or benefits will have to be cut. Generational accounting systems, such as the one developed by Professor Laurence Kotlikoff of Boston University, provide a useful way of evaluating the current system. Generational accounts compare the present value of taxes paid to benefits received by age group. If benefits exceed taxes for a particular generation, the residual represents an obligation left for future generations.

Using numbers provided by the Social Security Administration, Prof. Kotllikoff's research team completed a microsimulation of Social Security, including survivor, mother, father, and children's benefits, earnings testing, and early retirement. This quantitative research shows that no group enjoys a rate of return from the current Social Security program that is higher than 4 percent. Dr. Kotlikoff concluded, "Social Security does not represent a very good deal for postwar Americans. On average, they are losing 5 cents out of every dollar they [contribute] to the OASI program. * * * The problem is that Social Security's generally bad actuarial deal is likely to get lots worse because this is a system which is not going to be able to pay for itself through time."

Gradual implementation of personal savings accounts will help balance the intergenerational impact of reform. Younger workers with long-term horizons can invest in equities and reap the long-

term gain. Older workers who have more immediate retirement needs can invest appropriately for a shorter time frame. When each worker retires in the future, Social Security payroll taxes will give the system the resources to augment personal accounts so that Social Security continues to play an important role in combating poverty and providing retirement security by maintaining an income safety net. Gradually, the higher yield from personal accounts will reduce the Social Security system's dependence on taxes collected from current workers. The "dependency ratio" will no longer control the future of Social Security.

ADMINISTRATIVE COSTS AND FEES CAN BE KEPT LOW TO GIVE WORKERS HIGH RETURNS

Testimony before the Task Force refuted one objection frequently cited as a major reason why individual accounts should not be created—that administrative costs would consume much of the higher investment returns intended for workers. This objection has always puzzled reformers who are aware that the Federal Thrift Savings Plan, which offers personal accounts to Federal workers, operates with an annual expense ratio of 0.08 percent of assets.

As further evidence, William Shipman, from State Street Global Advisors, presented the Task Force with a program for administering a universal private account system that costs only pennies a day per person. Subsequent to Shipman's testimony, the General Accounting Office (GAO) released its own analysis of administrative costs and found that the annual cost for administering individual accounts invested in index funds would be as low as 0.1 percent of assets. The GAO analysis reviewed the State Street study presented to the Task Force. GAO concluded that the study "provides the most detailed analysis of costs per administrative function based on known costs." Dallas Salisbury, President of the Employee Benefit Research Institute (EBRI), a pension expert called by the Minority, commended the State Street study for its detailed focus on questions of feasibility.

The State Street study, published in March 1999, outlined the following goals:

- Create individual accounts with assets owned by the account holder.
- Ensure reasonable costs for all participants, low- as well as high-income workers.
- Minimize employers' administrative burden.
- Provide the opportunity for workers of all incomes to invest in capital markets.
- Ensure that inexperienced investors will not suffer poor returns relative to experienced investors.
- Provide investment choice.
- Offer a solution for workers who make no investment choice.
- Automatically adapt to changing technology and services offered by the financial services industry.

State Street advocates a three-level approach:

- *Level one:* Collective Account Accumulation. Workers' savings are deducted from payroll and invested in a collective money market fund, where the funds are held until contributions are rec-

onciled with individual W–2 forms. Upon reconciliation, the funds and accrued interest are transferred to each worker's account.

• *Level two:* Personal Accounts Invested in Index Funds. For the first 3 years the funds are held in a worker's personal account, they are invested in one of four index funds—three balanced funds and a money market account—selected by the worker. The funds would be managed by professional firms chosen through open competitive bidding.

• *Level three:* Individual Chooses to Transfer Moneys From Index Funds to Actively Managed Retirement Accounts. After building up account balances for approximately 3 years, the individual has the choice, but not the obligation, to transfer their assets to a qualified account with a financial services company meeting reasonable and specified standards.

The administrative costs for Levels One and Two estimated to range between $3.38 and $6.58 per account annually, equally only 1 or 2 cents a day. Costs rise in Level Three as individuals choose actively managed accounts; however, individuals always have the option to move funds back to the lower-cost Level Two.

Accounts with small balances present the largest administrative cost challenge. Cost concerns are a major reasons that the President's plan exempts low income workers from USA accounts. Provisions should be made for low-income workers that have small balances so that fixed administrative costs assessed on a per-account basis do not consume a disproportionate share of account earnings.

ANNUITIZATION PROVIDES OPPORTUNITIES FOR RETIREMENT SECURITY

We believe that personal accounts are well suited to annuitization at retirement. This is important since many personal account proposals either recommend or require annuitization of some or all of a worker's account balances to guarantee stable monthly income throughout retirement. Workers should be offered cost-effective annuities that give them the opportunity to set up a stable monthly retirement benefit. As needed, future Social Security taxes can be used to augment annuity income, keeping the program's anti-poverty safety net in place. Studies show that centralized managers can negotiate annuitization structures that will minimize the cost of annuities. Dr. Mark Warshawsky, Director of Research, TIAA–CREF, testified in favor of converting investment accounts into life annuities at retirement, which would guarantee monthly income to a retiree. In its most basic form, an annuity, whether issued by a life insurance company, an employer pension plan, or a government program, pools the mortality risks of individuals.

Dr. Warshawsky believes there are many benefits from a life annuity. He asserted, "It pays out a higher flow of income—about 30 percent—to each participant for his or her entire lifetime than if each individual were left to his or her own devices." Dr. Warshawsky has completed a comparative analysis of annuitization costs for retail annuities sold to individuals to private annuity contracts negotiated by the Thrift Savings Plan and TIAA–CREF. His research indicates that higher annuity payouts can be negotiated through competitive bidding contracts that offer a high volume of investment funds. Annuitization through a fund manager may

lower the administrative costs to individual retirees, thereby increasing their retirement income.

MARKET INVESTMENT CAN OFFER WORKERS HIGHER RETURNS WITH LOSS PROTECTION

The Task Force also learned that cautious workers who would shun equity investments despite higher long-term returns do not need to "settle" for low-yielding Treasury bond investments. Their concerns can be addressed through expansion of private investment products that already exist. Individuals who are concerned about losing money in the stock market, despite its historical performance, can protect themselves by purchasing investment products that provide guarantees against loss while giving investors the right to reap most gains. One product available today, Market Index Target-Term Securities (MITTS), has been developed by Merrill Lynch. Merrill Lynch offers MITTS linked to a technology index, a health care index, a European index, the Consumer Price Index, and more. Paine Webber, Salomon Smith Barney, Lehman Brothers, and other investment firms offer similar vehicles. Insurance companies, including Nationwide and American Skandia, offer annuities with similar loss protection.

A MITTS security trades like an individual stock, but it is tied to a particular index. Merrill Lynch's first MITTS was tied to the S&P 500. It was sold to the public in January 1992 at $10 a share with a guarantee that, in August 1997, investors would have the right to be repaid their original $10.

James Glassman of the American Enterprise Institute told the Task Force that investment products like MITTS are "natural" investments for risk-averse investors to purchase for personal retirement accounts. Stephen Bodurtha, one of the specialists who designed Merrill Lynch Protected Growth Investing, encourages investing in stocks for the best opportunity to increase wealth over the long run. However, potential downside risk keeps many people from investing in stocks, even when long-term growth is the objective. Mr. Bodurtha said, "When aversion to risk stands in the way of investing for long-term growth, people may fail to achieve important financial goals."

OTHER COUNTRIES FACE SIMILAR DEMOGRAPHIC SHIFTS

One finding that gave the Task Force little solace is the fact that we are not alone.

PROJECTED FUTURE STATE SPENDING ON PENSIONS AS A PERCENTAGE OF GDP

[Countries noted in **bold** have implemented comprehensive retirement system reform]

	1995	2000	2010	2020
Australia	2.6	2.3	2.3	2.9
France	10.6	9.8	9.7	11.6
Germany	11.1	11.5	11.8	12.3
Italy	13.3	12.6	13.2	15.3
Japan	6.6	7.5	9.6	12.4
United Kingdom	4.5	4.5	5.2	5.1
United States	4.1	4.2	4.5	5.2

Source: Watson Wyatt Worldwide.

The demographic changes behind the unfunded liability of pay-as-you-go retirement systems are a global phenomenon. European countries face even more alarming future worker/beneficiary ratios than the United States does. Many countries already have higher payroll tax rates. In Eastern Europe, the average payroll tax rate exceeds 40 percent. In Western Europe, the average payroll tax rate is above 20 percent. Countries that address these demographic imbalances now will gain a competitive edge in the world markets during the 21st Century. Developed countries that delay necessary reforms will spend two to four times more of their GDP on public pensions by 2010 than countries that have implemented comprehensive reform.

Countries that are delaying reform are already suffering economic consequences. A September 28 article in the Washington Post, "In Europe's Economic Boom, Finding Work Is a Bust," tells the stories of young workers in Europe who cannot find permanent employment. Sixteen million people in the European Union (EU) are looking for work while employers in their countries are outsourcing work elsewhere to avoid high payroll taxes and mandated benefits for permanent workers. In Germany, payroll taxes and fringe benefits add 70 percent to the average textile worker's salary. One-third of young Italians are jobless. Only one EU country is successfully fighting unemployment—and that is the country that has reformed its Social Security program. Great Britain is experiencing the lowest unemployment rate since 1980.

International reform initiatives undertaken over the last 20 years give us the opportunity to learn from experiences abroad by taking their best ideas and learning from their mistakes. In January 1999, the Congressional Budget Office (CBO) published "Social Security Privatization: Experiences Abroad." CBO Director Dan Crippen summarized the results of this report in testimony to the Task Force on May 25, 1999. The report analyzed reform initiatives undertaken by Chile, the United Kingdom, Australia, Mexico, and Argentina. All of these countries started out with an old-age income support system that relied on "pay-as-you-go" financing. They have converted to systems with personal retirement accounts that pre-fund at least a portion of retirement income by requiring people to accumulate savings during their working years.

The CBO report found four relevant issues that other countries addressed in designing their reforms:

- Who will pay for the transition between the pay-as-you-go system and a prefunded system?
- Will the new system be voluntary or mandatory?
- Should there be a minimum benefit guarantee?
- How much regulation is needed for investment managers, and what rules should be imposed on the use of retirement funds?

CBO drew the following conclusions:

- None of the countries successfully maintained permanent funding of their government-run defined benefit system and are now deriving at least a portion of benefits from a defined contribution private account plan.
- Social security privatization in these countries has probably increased national savings and economic growth.

• Administrative concerns, including the costs of administration, do not appear insurmountable, but the details are important.

Economists who have studied international reform efforts presented testimony to the Task Force reviewing their concepts on what constitutes successful reform. Their findings can guide other reformers through the task at hand.

Estelle James, an analyst with the World Bank, told the Task Force that the pace of economic growth after reform is an important measuring rod of success. The evidence from Chile, which was the first country to enact comprehensive reform, supports the view that private retirement accounts have a positive impact on savings, financial markets, and economic growth.

Lawrence Thompson, an analyst with the Urban Institute, recommends Congress use the following objectives to "rate" reforms:

• Provide a reasonable rate of return, after adjusting for expected administrative costs and annuitization fees.

• Establish proper regulation for contribution reporting and to ensure prudent investment choices.

• Give workers a reasonable degree of choice about how their money will be invested.

• Avoid an increase in the employer's reporting burden.

• Insulate the economy from inappropriate political interference.

He concluded, "What we can learn from experience abroad is what not to do. We don't want the employer burdens that are associated with the Australian, Swiss and Latin American systems. We don't want the administrative costs associated with the U.K. and Latin systems. Instead, we want choice, we want security, and we want the politicians to keep their hands off of the funds."

David Harris believes we can take many lessons from Australia's reforms, which were implemented by a liberal government with the support of a broad coalition of trade unions, businesses, and consumer groups. He explained, "What is striking about the Australian system is that political pressures are the reverse of those in the United States. It was a Federal labor government, a largely liberal leaning administration, who established and extended individual retirement accounts in 1987 and again in 1992. This policy was not only supported by organized labor but also was actively encouraged by the leadership of the Australian Council of Trade Unions (ACTU). Businesses and consumer groups also backed the changes."

The consensus reform created a retirement system with three distinct pillars. The first pillar is a means tested, pay-as-you-go Old Age Pension which provides benefits equal to 25 percent of inflation-adjusted average weekly earnings. Benefits are paid from general revenue funding. The second pillar is a mandated individual account which receives 7 percent of an employee's salary over $450 Australian per month; the contribution rate will increase to 9 percent over time. The third pillar consists of additional voluntary contributions, encouraged through savings rebates and tax credits. Workers are making voluntary contributions of 4 percent above the 7 percent compulsory contribution.

Australia has used competition to drive down administrative fees. In 1997, the administrative costs averaged between 0.69 to

0.83 percent of assets, or about 66 cents U.S. per week. Administrative costs are continuing to decline as the system matures.

Mr. Harris does not highlight increased rate of return as the greatest benefit of reform to Australia. Instead, he identified reduced political risk, citizen involvement in their own retirement planning, and reduced long-term liabilities related to the retiring baby boomer generation as key reasons to move ahead.

COMPREHENSIVE REFORM MUST RETAIN SAFETY NET FOR DISABLED WORKERS

In his briefing to the Task Force, Federal Reserve Chairman Alan Greenspan told us that one key reason the 1983 reforms did not ensure Social Security's solvency for the 75 year period projected at that time was an unanticipated explosion in disability insurance. In 1965, one million workers were collecting disability benefits at a cost of $1.6 billion. In 1998, six million workers and family members received $49 billion in Social Security disability benefits.

Most Social Security reform proposals generally focus on the retirement and survivor programs. However, comprehensive reform cannot ignore the interests of the most vulnerable in our society. Approximately 6.2 million current Social Security beneficiaries are disabled workers and their families and 200,000 are the surviving family members of deceased disabled workers. The separate benefits are currently funded by 1.7 percent of the total 12.4 percent payroll tax.

We have even less time to enact changes that bring the disability program into balance. By 2010, program outflow will exceed receipts. By 2020, Social Security projects that 11 million people will be receiving disability benefits, and the Disability Insurance trust fund will be depleted. Long-term solutions may involve shifting a portion of program funding from the payroll tax to general revenues, as Congress did for Medicare in 1997 in the Balanced Budget Amendment. In addition, we should encourage the Social Security Administration to expand its efforts to provide training that returns disabled workers to the workforce. The latest GAO "Performance and Accountability Series" found that only 1 in 500 disability beneficiaries return to work after receiving benefits.

Congress should consider changes to Medicare that will encourage SSA's rehabilitation efforts. Qualification for disability enables beneficiaries to participate in the Medicare program. This health insurance is very important to disability recipients, who often are not covered by employer health plans and cannot find private insurance because of their medical condition. Beneficiaries who lose their disability status also lose their Medicare coverage. This is a strong disincentive to rehabilitation that must be addressed.

We must reinforce the government safety net for the disabled. However, ignoring the pending financial problems of retirement portion of Social Security will not help us achieve this goal.

THE CHALLENGE OF TRANSITIONING TO LONG-TERM SOLVENCY

If we were designing a retirement system today from a clean slate, we could choose from a menu of attractive options. But, we

have not been given a clean slate. We have been given a Social Security program with an unfunded liability of $9 trillion. This funding gap can be closed in only three ways—cut benefits; raise taxes; or increase the rate of return earned on workers' contributions.

Because Social Security funds invested in personal accounts will no longer be available to pay for current benefits, critics contend that prefunding benefits will impose additional "transition costs." However, in testimony to the Task Force, Dr. Rudolph Penner, a Senior Fellow at the Urban Institute and former Director of the Congressional Budget Office, urged members not to confuse the cost of paying for the current system with the cost of setting up personal accounts. "In current policy discussions, the problems of fixing the current system are often merged and muddled with the problems involved in moving toward prefunding. The two problems are distinct and should be separated conceptually. But it is desirable to solve both simultaneously, and it is necessary to consider this twofold burden when analyzing reforms."

As David John of the Heritage Foundation explained, "High transition costs will be a fact of life for Social Security regardless of whether the program is radically reformed or just left as it is. While some consider transition costs to apply only to proposals that would reform Social Security, this is not the case. Since the existing program will begin to run cash flow deficits in 2014, the transition costs of various reform proposals should be measured against the costs associated with doing nothing at all."

Since the cost of Social Security will rise from less than 11 percent of wages today to nearly 20 percent of wages by 2075, "doing nothing" means promised benefits must be reduced by 33 percent, or payroll taxes must be increased by 50 percent. Thus, when considering the alternatives the proper question to ask is how do they compare to the cost of maintaining the current system?

How the Alternatives Compare to the Current System

The Task Force heard from a number of Members who outlined their proposals for reforming Social Security. While the details vary, each of these plans rely on some combination of benefit cuts, tax increases, stock market investment, and general revenue transfers. While the transfers from general revenue would be funded out of the projected budget surpluses, it seems unlikely these surpluses will be large enough or last long enough to cover all of the proposed transfers. Any remaining shortfall would have to be offset by raising taxes, reducing spending or borrowing from the public, just like under current law.

The proposals that provide promised benefits without raising taxes must by definition rely on general revenue. If these transfers are invested in the capital markets, we will reduce our future liability as these funds earn a higher rate of return than the government bond rate used to calculate the current $9 trillion unfunded liability. While higher rates of return are virtually guaranteed over the long-run, annual fluctuations in the stock market might create temporary shortfalls. During any period in which market returns are less than the historical average, general revenues transfers would be required to cover the shortfall.

The proposals that combine stock market investment with tax and benefit adjustments recognize the fact that the market will not always earn the historical average. Rather than depending on future taxpayers to make up any unanticipated shortfall, they balance the Social Security system on a pay-as-you-go basis first, and only then do they provide the opportunity for individuals to earn additional retirement income by investing in the stock market. They view fixing Social Security and helping workers save for retirement as distinct, yet complementary goals.

While opponents of personal accounts focus on the uncertainties of investing in the stock market, there is one thing that is absolutely certain, the cost of "doing nothing" will be much higher than any of the alternatives. In his testimony before the Task Force, Senator Gregg clearly articulated the terms of the current debate: "What we have to do is begin to advance fund the current system, and that means taking some of that surplus Social Security money today out of the Federal coffers and into a place where it can be saved, invested—owned by individual beneficiaries. That money would belong to them immediately, even though they could not withdraw it before retirement. But it would be a real asset in their name. By doing this, we can reduce the amount of the benefit that needs to be funded in the future by raising taxes on future generations. This is the critical objective, but it allows for flippant political attacks. If you give someone a part of their benefit today, in their personal account, and less of it later on, some will say that it is a "cut" in benefits. It is no such thing. Only in Washington can giving people ownership rights and real funding for a portion of their benefits, and increasing their total real value, be construed as a cut. Accepting such terminology can only lead to one conclusion—that we can't advance fund, because we simply have to be sure that every penny of future benefits comes from taxing future workers. So we need to get out of that rhetorical trap."

SUMMARY OF SOCIAL SECURITY PROPOSALS PRESENTED TO THE TASK FORCE

Every proposal but Bartlett/Markey has been scored by the Social Security Administration. This scoring is predicated on two challenging assumptions: First, debt to the Trust Fund will be repaid, and second, 75-year solvency is achieved.

SUMMARY OF SOCIAL SECURITY PROPOSALS

Sponsor(s)	Revenue change	Benefit change
Archer/Shaw	All workers would receive a refundable income tax credit equal to 2 percent of taxable wages to fund personal accounts. The payroll tax rate would be reduce by 2.5 percent in 2050 and 1.0 percent in 2060.	The Social Security earnings test would be eliminated. Personal accounts would be used by the government to fund the Social Security benefits promised under current law.
Bartlett/Markey	The government would invest $1.2 trillion of general revenue in the stock market between 2001 and 2015.	The stock market investments would be used to help fund the Social Security benefits promised under current law.

SUMMARY OF SOCIAL SECURITY PROPOSALS—Continued

Sponsor(s)	Revenue change	Benefit change
Gramm	All workers would be allowed to invest 3 percent (rising to 8 percent) of their taxable wages in a personal account. Workers age 35–55 in 2000 could invest 5 percent, rather than 3 percent.	Workers with a personal account would be guaranteed an amount equal to 120 percent of the Social Security benefits promised under current law.
Gregg/Breaux/Grassley	All workers would be required to invest 2 percent of their taxable wages in a personal account. The annual CPI indexing of the income tax brackets, personal exemption, and standard deduction would be reduced by 0.5 percent. The amount of wages subject to the payroll tax would be increased.	The Social Security earnings test would be eliminated. A new Kid-Save account ($1,000 at birth, $500 from age 1 to age 5) would be created. Annual COLAs would be reduced by 0.5 percent. The scheduled increase in the normal retirement age would be accelerated, and then indexed to life expectancy. Social Security benefits would be reduced by a portion of a worker's personal account balance.
Kasich	Workers under age 55 would be allowed to invest from 1.0 percent to 3.5 percent of their taxable wages in a personal account. Wage from $0 to $72,599: 3.5 percent. Wage $72,600 up: 1.0 percent.	Initial Social Security benefits for workers under age 55 would be increased by the CPI rather than by average wages. Social Security benefits would be reduced 0.33 percent for each year a worker contributes to a personal account, up to maximum of 15 percent.
Kolbe/Stenholm	All workers would be required to contribute 2 percent of taxable wages to a personal account. The annual CPI indexing of the income tax brackets, personal exemption, and standard deduction would be reduced by 0.3 percent.	The Social Security earnings test would be repealed. A new poverty level minimum benefit would be created. Annual COLAs would be reduced by 0.5 percent. The scheduled increase in the normal retirement age would be accelerated, and then indexed to life expectancy.
Nadler	The amount of wages subject to the payroll tax would be increased. 62 percent of annual unified budget surpluses over the next 15 years would invested in the stock market.	The additional payroll taxes and the stock market investment would be used to help pay for the Social Security benefits promised under current law.
Moynihan/Kerrey	The payroll tax would be reduced by 2 percent, and workers would be allowed to contribute that amount to a personal account. The amount of wages subject to the payroll tax would be increased. The payroll tax rate would be increased to 12.4 percent in 2030, rising to 13.7 percent by 2060. The amount of Social Security benefits subject to the income tax would be increased. The annual CPI indexing of the income tax brackets, personal exemption, and standard deduction would be reduced by 0.5 percent. All newly hired State and Local workers would be covered under Social Security.	The Social Security earnings test would be eliminated. A new Kid-Save account ($3,500 at birth) would be created. Annual COLAs would be reduced by 1.0 percent. The scheduled increase in the normal retirement age would be replaced with a life expectancy index.

SUMMARY OF SOCIAL SECURITY PROPOSALS—Continued

Sponsor(s)	Revenue change	Benefit change
Smith	Workers under age 65 would be allowed to invest 2.6 percent (rising to 9 percent) of their taxable wages in a personal account. Spousal accounts are held jointly in equal amounts. All newly hired State and Local workers would be covered under Social Security. Disability beneficiaries returning to work would be eligible for Medicare or equivalent coverage. Earnings test is eliminated.	Increase Social Security benefits by 10 percent surviving spouses. The scheduled increase in normal retirement age would be accelerated, and then indexed to life expectancy. A portion of the Social Security benefit formula would be indexed to the CPI rather than to average wages. Social Security benefits would be reduced by a portion of a worker's personal account balance.

MOVING FORWARD REQUIRES PRESIDENTIAL LEADERSHIP

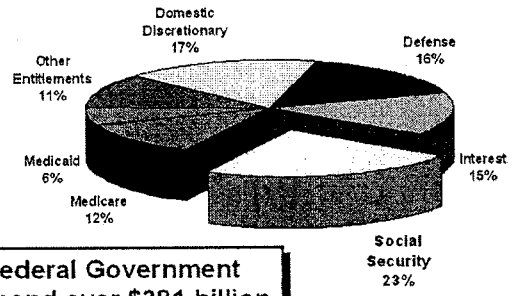
Time is running out. Energized by the unanimous bipartisan finding of the Task Force that time is of the essence, we should begin the process of reform now. Unfortunately, the proposals released thus far by the Administration are a step backward in the search for real reform because they falsely suggest that there is a "painless" way to achieve a "partial" solution. A "partial" solution is just a band-aid, not a cure. Simply putting more government securities in the Social Security trust fund as the President suggests does not reduce the burden on future taxpayers of redeeming these securities. By exercising fiscal discipline and not spending the current Social Security surplus on other government programs, we are making a good start. However, this action alone will not solve Social Security's long-term problems.

We must not be satisfied with "partial" solutions which are only placebos that lull some people into thinking that something significant has been accomplished. Extending the life of the trust fund for few years will only reinforce the belief among younger workers that Social Security won't be there for them. A "partial" solution, which will only require additional solutions later, will prevent workers from reliably planning for their retirement years. As long as the future of Social Security remains in doubt, public cynicism and uncertainty will continue to grow.

Congress and the administration must provide the vision that moves the cause of comprehensive reform forward. We urge the President to put forward a credible plan to close the $9 trillion funding gap and stop playing politics with our nation's retirement future. Only by outlining his own proposal to solve the long-term problem can this debate be fairly joined. We encourage the Republican and Democratic leadership in the House and Senate to work together on consensus solutions. The scope of the problem demands leadership committed to bipartisan agreement, not demagoguery, and is the stuff from which legacies are made.

Social Security Is the Largest Budget Expenditure

1998 Budget

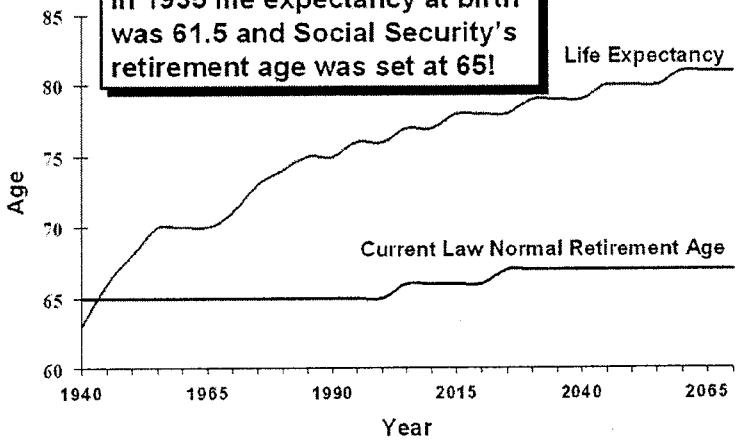


The Federal Government will spend over $381 billion on Social Security in 1998!

Prepared by Congressman Nick Smith

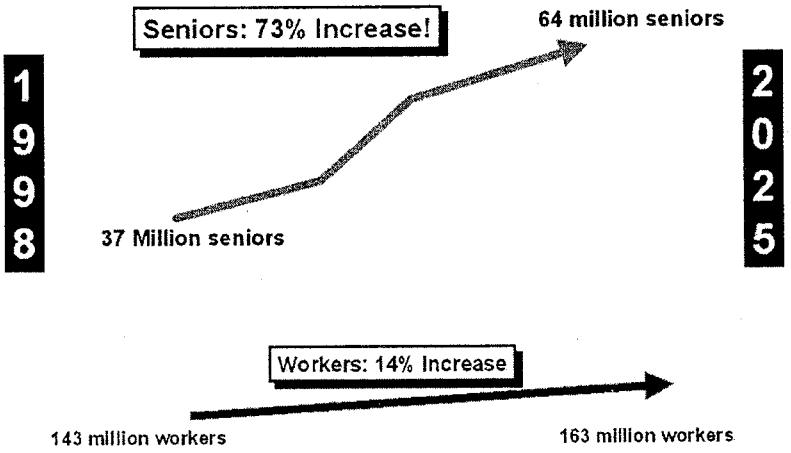
Americans Are Living Longer

In 1935 life expectancy at birth was 61.5 and Social Security's retirement age was set at 65!



Prepared by Congressman Nick Smith

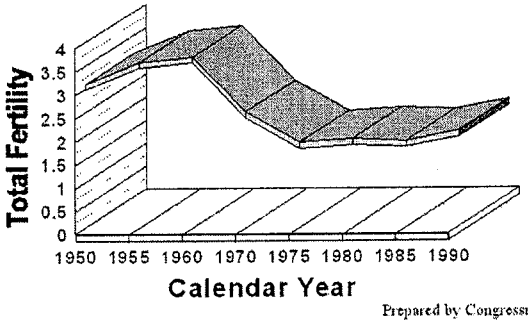
Projected Population Growth - Seniors vs. Workers



Prepared by Congressman Nick Smith

We are Having Fewer Children

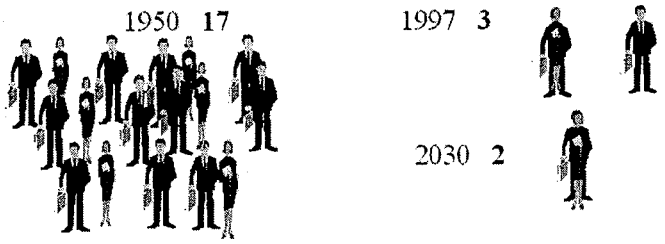
Birth Rate Is Declining...



Prepared by Congressman Nick Smith

Workers to Recipients Ratio is Declining

- In 1950, there were 17 workers for every beneficiary. Today, there are 3.4 workers per beneficiary, and by 2030 there will only be 2.
  (National Commission on Retirement Policy)



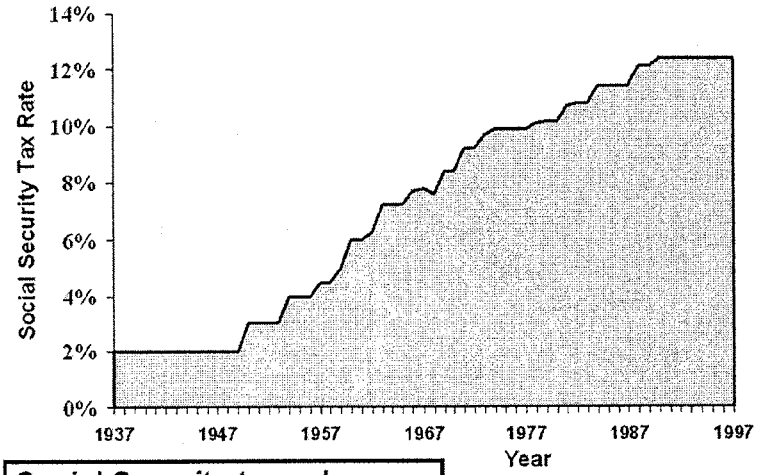
Prepared by Congressman Nick Smith

So, what long term options are there?

- Raise Taxes -- Again.
- Cut Benefits.
- Take advantage of higher investment returns afforded by the capital markets.

Prepared by Congressman Nick Smith

Social Security Has Relied on Tax Increases



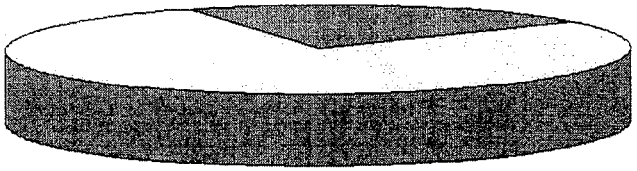
Social Security taxes have Gone up 36 times since 1971!

Prepared by Congressman Nick Smith

78 Percent of Families Pay More in Payroll Taxes Than Income Taxes

Percentage of families that pay less in payroll taxes than income taxes

22%

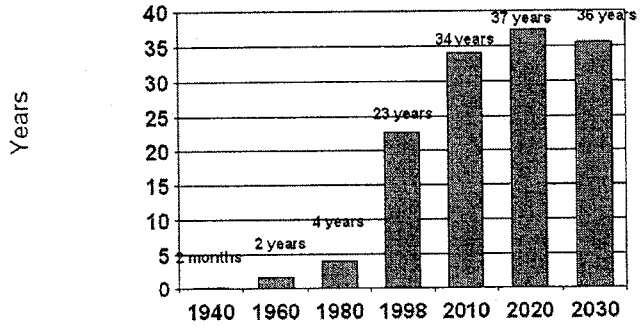


78%

Percentage of families that pay more in payroll taxes than income taxes

Prepared by Congressman Nick Smith

Getting Back Your Social Security Tax



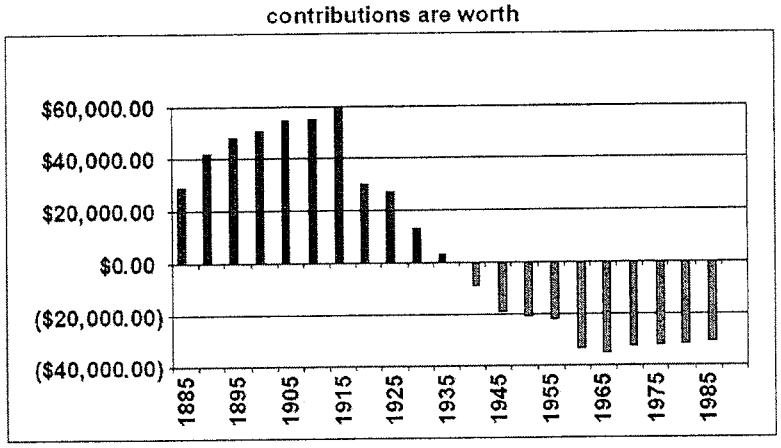
By 2020, you will have to live to 101 to get back what you paid into Social Security

Year of Retirement

Prepared by Congressman Nick Smith

SOCIAL SECURITY'S BAD DEAL

Under the pay-as-you-go system , Social Security participants born after 1940 will receive less in lifetime benefits than their contributions are worth

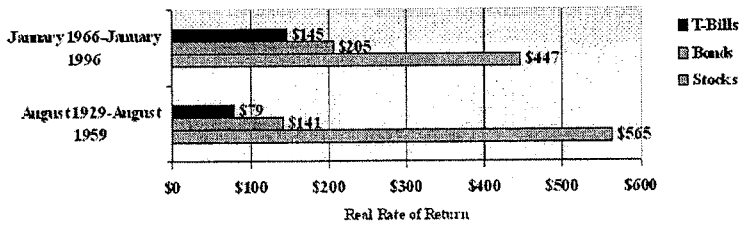


Prepared by Congressman Nick Smith

Personal accounts promise a better retirement future for Americans

By allowing individuals to take advantage of safe, diversified investment opportunities, we can dramatically improve the living standards of future retirees

If I Invest $100, What's It Worth After 30 Years?



Source: Stocks for the Long Run, Dr. J. Siegel

Prepared by Congressman Nick Smith

NICK SMITH.
WALLY HERGER.
MAC COLLINS.
PAUL RYAN.
PAT TOOMEY.

ADDITIONAL VIEWS OF CONGRESSMAN NICK SMITH

Congress and the administration must provide the leadership that moves the cause of comprehensive reform forward. I urge everyone to put aside demagoguery so we may work together to reach bipartisan consensus. We must not be satisfied with partial solutions which are only placebos that lull some people into thinking that something significant has been accomplished.

In his closed briefing to the Task Force, Chairman Greenspan advised us to start by addressing three questions:

1. *Do we use general revenue?* Members of the 1983 reform commission considered using general revenues to achieve solvency, but ultimately decided against it. They decided that a dependence on general revenues would make the program less like social insurance and more like welfare.

2. *Do we make changes to taxes and benefits?* The 1983 reforms achieved solvency by tax increases, such as income taxes imposed on higher income retirees, and benefit reductions, such as an increased retirement age.

3. *What data do we use?*

I recommend the Social Security Task Force Statement of Findings serve as the foundation for bipartisan reform. These findings were developed from the testimony the Task Force heard during 4 months of fact finding hearings, that are summarized in this additional comment.

CHAIRMAN SMITH'S COMMENTS ON THE 18 FINDINGS OF THE BIPARTISAN TASK FORCE

Social Security is a universal program that has provided a safety net for Americans. The Task Force heard the opinions of experts who may disagree on many details of reform, but agree that Social Security has combated poverty among the elderly and disabled and should not be jeopardized by demographic changes.

Time is the enemy of Social Security reform and we should move without delay. Current surpluses give us the opportunity to use funds so that changes to the system will be less severe and can meet the benefits of current future retirees. Social Security taxes are estimated to exceed benefits until 2014. Every year of delay increases the challenge of meeting these obligations.

Change should be gradual to allow workers to adjust their retirement plans and any change for current or near-term retirees should be minimal. There are transition costs related to restoring solvency to Social Security and more transition costs related to prefunding our future obligations. These changes should be made over time so that several generations can shoulder the burden and so that those with less time to make adjustments have greater assurance that promised benefits will continue.

Social Security under the current structure is projected to become insolvent during the next 75 year period. In 1983, Social Security's unfunded liability equaled 1.8 percent of payroll, and the actuaries judged it to be insolvent, as measured over its 75-year horizon. An immediate payroll tax increase of 1.8 percent would have been needed to restore solvency for the 75 year period. The data provided by the Social Security trustees in its 75 year projections done

this year show that cash outflow exceeds receipts in 2014 and that the Social Security Trust Fund is depleted in 2034. Expressed in terms of taxable payroll, the unfunded liability today equals 2.1 percent of payroll.

The Social Security Trust Fund is a secure, legal entity comprised of U.S. Treasury Bonds backed by the full faith and credit of the U.S. Government. While the United States has never defaulted on any of its obligations, these represent a legal claim on future Federal revenue. Such securities will have to be redeemed from funds outside the Trust Fund itself. Under its pay-as-you-go structure, Social Security did not historically maintain large balances in its trust fund. The moneys that were put into the trust fund account were invested in special Treasury bonds. After the 1983 reforms mandated higher taxes, the trust funds balances began to grow, and the amount of special Treasury bonds held by Social Security now equals over 2 years worth of estimated benefits. As Social Security needs these funds to pay benefits after 2014, it will present the bonds for redemption. The Treasury will increase public borrowing to repay its indebtedness—or, as has happened in the past, Social Security taxes will be increased so that depletion of the Trust Fund is put off. Paying back the Trust Fund out of the General Fund may reduce the amount of Federal moneys available to pay for other government programs in the future.

Solvency and reform are not necessarily tied together. Solvency can be achieved by enacting changes to the system that eliminate the 2.1 percent of payroll funding shortfall. Many reform plans recommend altering the current pay-as-you-go structure and providing for prefunding that presents the opportunity of increasing the projected rate of return for future Social Security benefits. This prefunding requires additional financing above the 2.1 percent of payroll, and new sources for these funds must be identified.

The current demographic projections may very well underestimate future life expectancy. Public health education, lifestyle changes, and medical advances are increasing the probability that more Americans will enjoy long, productive retirement years. Fewer workers per retiree than now projected will result in more deficit for Social Security.

Any reform must consider the effects on all generations, genders, and those currently receiving Social Security benefits. The tradeoffs involved in various solvency and reform proposals should be evaluated by using a beneficiary impact statement from the Social Security Administration and intergenerational accounting measures being developed by the Congressional Budget Office.

No payroll tax increase. The current Social Security OASDI tax rate of 12.4 percent already inhibits the ability of many working Americans to save. For 72 percent of American workers, this is a higher tax burden than their personal income tax liability.

Social Security surpluses should only be spent for Social Security. Considering Social Security projected cash deficits, its funds should not be diverted to other uses that makes paying future benefits more difficult and reduces the possible return on investment.

Social Security reform should encourage savings and overall economic growth. Another way to improve Social Security's financial condition is to increase economic output. This will lead to higher

employment and more taxable income. Social Security benefits cannot accommodate the needs of retirees and more individual personal saving will be needed to finance a reasonable retirement income.

We can learn from the experiences of other countries to more effectively develop Social Security reforms. The demographic trends that are driving the need for reform in the United States are occurring all over the world. The successes achieved by other countries, as well as their mistakes, can help us design our own model.

Investment in the capital markets presents an opportunity to restore Social Security's solvency. Rate of return measures show that future Social Security retirees will earn less than a 2 percent investment yield on the taxes they are paying today. Over the next 25 years, the most respected experts in the United States are predicting that the stock market will average over 8 percent. Investing a portion of Social Security taxes in the stock market will reduce our reliance on taxes to pay future benefits.

Any investments in the capital markets should be limited for retirement years. Successful stock investment strategies depend on long-term horizons. If reform includes personal retirement accounts enacted, withdrawals should not be allowed for any reason other than retirement.

Private or other capital investments can be managed to minimize administrative costs and avoid substantial reductions in rates of return on investment. Careful design of trustee accounts that builds on existing systems in the Treasury Department and the Social Security Administration can use economies of scale to assure cost efficiencies, driving administrative costs to as low as .08 percent of assets.

Guaranteed return securities and annuities can be used with personal accounts as part of an investment safety net. If reform that includes personal retirement accounts is enacted, individuals should be allowed to invest in securities that guarantee against principal losses and in annuities that will assure them income through their retirement. These investments are sold in the private market today and will offer risk-averse investors a higher-yield alternative to Treasury securities.

A universal Social Security survivor and disability benefit program needs to be maintained. Proposed Social Security reform plans have focused their attention on reforms to the retirement program that reflect demographic shifts in the population. There should be no unintended impact on the disability and survivor insurance programs, which are now funded by 1.7 percent of taxable payroll. However, the disability program (DI) is in greater financial peril than OASI, and separate reforms should be considered to make sure this safety net remains intact.

Congress should consider paying for a portion of disability benefits for workers who have been in the system a short time, using moneys from the general fund. Currently, a person must have paid Social Security taxes for 40 quarters (10 years) to receive disability benefits. Assistance to other disabled individuals is now paid from the General Fund. If reforms that bring solvency to the DI portion require that the number of qualifying quarters must be increased, Congress should consider an increase in General Fund financing to

support the benefits of disabled beneficiaries with short work histories.

MINORITY VIEWS

INTRODUCTION

The minority agrees that Social Security faces serious challenges that require responsible action on the part of the Congress. To a great extent, demographic trends, notably the retirement of the baby boom generation and the assumption that longevity will continue to increase, largely drive the long-term projections showing that this crucial program will have insufficient resources to pay the benefits promised, given the system's current structure.

Therefore, we regret that the Social Security Task Force of the House Budget Committee largely did not concern itself with addressing these challenges facing Social Security. Instead, the Task Force focused to a great extent on promoting individual investment accounts, or privatization, as a full or partial replacement for Social Security. The possibility that the existing system might be fixed and its solvency restored was left largely unexplored.

This is unfortunate, because Social Security has important strengths that must be preserved. These strengths derive for the most part from underlying principles concerning the social insurance aspects of the system. Social Security is premised on the assumption that the risks of low lifetime earnings and premature death or disability should be shared as broadly as possible. The current system is designed to share such risks across the income distribution and across generations.

If a worker has low lifetime earnings, whether due to lack of skills, time out of the workforce for family responsibilities, or just bad luck, Social Security ensures that his or her twilight years will not be lived in destitution. If a worker suffers disability, Social Security ensures that he or she does not suffer the additional calamity of poverty. If a worker dies prematurely, the collective insurance provided by Social Security provides a basic safety net for the worker's surviving dependents.

Social Security enjoys strong support among the American people and has been a tremendous success. In 1959, the poverty rate among the elderly was over 35 percent. By 1998, the poverty rate for seniors had dropped to just over 10 percent. Without the program's benefits, more than half of the elderly would live below the official poverty line. More than three fifths of seniors receive a majority of their income from Social Security. Social Security provides the only disability coverage for three quarters of American workers. The disability and survivors' benefits of Social Security are essentially equivalent to two $300,000 insurance policies.[1]

Individual investment accounts, which have been proposed as a replacement for Social Security, are premised on a different idea. Supporters of such accounts believe that life's risks can better be addressed by allowing individuals as much latitude as possible in making their own provisions. Individual accounts are thus primarily vehicles, which enable citizens to accumulate resources to meet life's financial challenges. To a great extent, proponents of in-

[1] Social Security Administration and "Social Security: Brief Facts and Statistics" by David Koitz, Congressional Research Service Report 94–27.

dividual accounts believe that citizens should self-insure through their investments.

Because proponents of individual accounts focus on the investment aspects of Social Security rather than its insurance aspects, the core of their argument typically relies on comparisons of "rates of return." Their calculations typically show that the financial returns from Social Security compare unfavorably with the hypothetical returns from private accounts.

These comparisons of rates of return, however, are misleading. Proponents can only achieve the higher returns claimed for individual accounts by ignoring most of what Social Security's defenders consider important. Most obvious among the factors that individual account supporters ignore are the insurance protections represented by the nearly one third of Social Security payments dedicated to survivors' and disability benefits. One shouldn't expect insurance against calamity to provide a handsome financial return.[2] After all, a person wouldn't be disappointed never to receive a financial payoff from, say, fire insurance.

In addition to Social Security's survivors' and disability protections, though, the program also insures against the vicissitudes faced by workers as they prepare for retirement. The defined benefit nature of Social Security's retirement provisions shares as broadly as possible the risk of reaching old age without adequate personal resources to live out one's final years with dignity. As a result, Social Security provides retirees with income that is insulated from inflation and that lasts as long as the beneficiary lives.

Proponents of individual accounts typically try to skate past this issue of retirement security by pointing to the high average returns earned by private investments over long time spans in the past. Focusing on average returns, though, obscures the substantial and inescapable market risk that would burden a retirement system based on private accounts. In such a system, the individual would bear this market risk, eliminating much of the protection that Social Security's insurance function provides. In any fair comparison with Social Security, the average returns claimed for private accounts should be adjusted down to account for this added individual risk.

In addition to reducing returns of private investments to account for the current system's insurance protections, one must also deduct the cost of providing benefits already promised. To a great extent, the low financial returns projected for future Social Security beneficiaries result from the fact that the system is largely pay-as-you-go, with benefits promised in the past paid for with current revenues. Benefits paid to today's retirees, survivors, and the disabled consume 90 percent of the contributions paid into the system,[3] and no return can be earned on these funds. Social Security's pay-as-you-go structure results from a decision made at the system's inception to provide benefits to the generation of the Great Depression and World War II, even though its members had paid very little into the system.

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[2] 1999 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.

[3] Ibid.

The vast majority of the American workforce has earned benefits by paying into the current system, and no one is suggesting that these promises be annulled. If one were to replace Social Security with a different system, the accumulated $10 trillion in promised benefits would have to be paid. Thus, any fair comparison between Social Security's returns and those of individual accounts should deduct from the latter the $10-trillion cost of making the transition to a new system over several decades.

The presumed returns from privatization also must take account of the high administrative costs associated with individual accounts, which reduce realized returns even further. The current Social Security system has exceptionally low administrative costs, equal to less than 1 percent of yearly revenues. Any transition to a system of individual accounts would involve maintaining at least part of the existing system and adding a new administrative superstructure upon it. Responsible estimates of these additional costs are several multiples of the administrative expenses of Social Security, and they significantly reduce the returns available for retirement income.

Thus, the presumed superiority disappears once one adjusts rates of return for market risk, for the cost of providing survivors' and disability protections, for the promises already made to Social Security beneficiaries, and for administrative expenses. In order to get the higher returns claimed for private accounts, one would need to cover these costs with a massive infusion of resources from outside the system, presumably from general revenues. In fact, Federal Reserve Chairman Greenspan told the Task Force that there was no difference between a public and a private retirement system with respect to their returns, and he emphasized that privatization in and of itself doesn't do anything to address the projected insolvency.

Often, the arguments of those advocating privatization of Social Security are rhetorical. They typically talk about "allowing" citizens to invest in private securities to achieve higher returns, as if this were an expansion of the choices available. But Americans already are allowed to invest in private securities through their own saving. The government does not forbid private saving, and in fact has created a variety of tax-preferred vehicles to encourage private saving, though these tend to be used primarily by the affluent.

Social Security has always been intended to serve as only one component of retirement income, with private saving and private pensions being the others. Social Security provides a safety net, a secure but modest foundation upon which to plan one's work life and retirement. As a supplement, one can invest in private markets with the possibility of higher returns, though those returns come without many of the protections that Social Security provides. People can choose to invest in private securities despite their higher risk, in part because of the assurance that the government safety net is backstopping some of that risk.

Proponents of privatization, though, would like to transform the social insurance safety net from a defined benefit program that protects against risk to a defined contribution system. This sacrifices the mixed approach of the current system because it forces workers to accept increased risk, turning the idea of diversification on its

head. Instead of the current system, where social insurance protections can be combined with a private investment strategy, workers would be obliged to make their work life and retirement plans based solely on investments.

The current system, with Social Security providing a minimal defined benefit to which one adds returns from private savings and pensions, has served Americans well for over six decades. The minority believes that Social Security's financial challenges can and should be addressed by strengthening the existing system without eliminating the universal safety net that has been a hallmark of the program since its inception. We agree with the Task Force witnesses who emphasized that restoring solvency to Social Security and completely overhauling the system are not one and the same. Any attempt to significantly restructure Social Security either will not retain the current system's greatest strengths or will retain those strengths only by sacrificing the purported advantages of a privatized system.

THE OVERRIDING PROBLEM OF EXISTING OBLIGATIONS

The place where Social Security debates begin is the fact that the current system faces a shortfall between its long-term projections of revenues and benefits. The system faces unfunded obligations over the next 75 years that equal about $3 trillion in present-value terms.[4] This means that Social Security would be made solvent for 75 years if $3 trillion were injected into the Social Security Trust Funds.

This $3-trillion problem is the cost of keeping the existing system going. It represents a considerable challenge for those who would preserve Social Security in something like its current form. This solvency question can be addressed completely independently of "reforms" that would change the basic nature of the system. Such "reforms" may well be worth considering on their own merits, but restructuring proposals often have nothing to do with meeting the unfunded obligations that have given rise to current debates.

Unfortunately for those who advocate fully or partially replacing the existing system with individual accounts, the unfunded obligations associated with closing down Social Security, so-called "transition costs," are even larger. About 140 million American workers have paid into the Social Security system, and about 40 million Americans currently receive benefits. If, for instance, the entire payroll tax were immediately diverted into individual accounts, the government would still face obligations to pay benefits already earned by current workers and retirees worth about $10 trillion in present value terms.[5]

This $10-trillion cost would have to be born through higher taxes, benefit cuts, or increased borrowing, whether one abruptly closed down Social Security or whether the transition took place over several decades. One Task Force witness who favors private accounts, Lawrence Kotlikoff of Boston University, advocated a plan for replacing Social Security that would have paid Social Secu-

[4] Social Security Administration.

[5] "Would a Privatized Social Security System Really Pay a Higher Rate of Return?" by John Geanakoplos, Olivia S. Mitchell and Steven P. Zeldes, Working Paper No. 6713, National Bureau of Economic Research, August 1998.

rity's existing obligations by adding a new 8-percent business cash flow tax, which would decline over several decades to about 2 or 3 percent.[6]

It is important to emphasize that the cost of covering existing obligations in the transition to a new system is necessarily larger than the unfunded liability of the current system. If one fully or partially replaced Social Security with a system of individual accounts, one still would have to pay the benefits already earned under the current system but without access to at least a portion of future payroll taxes. Because some or all of the future stream of payroll taxes would be going to private accounts instead of paying Social Security benefits, the unfunded liabilities of privatization must exceed those already facing the current system.

As noted in the introduction, the cost of existing obligations would weigh heavily on the higher financial returns that privatization supporters claim derive from individual accounts. In fact, one influential paper in the economics literature states:

> "If the system were completely privatized, with no prefunding or diversification, the Social Security system would need to raise taxes and/or issue new debt in order to pay benefits already accrued. If the burden were spread evenly across all future generations via a constant proportional tax, the added taxes would completely eliminate any rate of return advantage on the individual accounts."[7]

For this reason alone, it would seem that private accounts don't measure up to the existing system since they would lack both the current protections of Social Security and also fail to achieve higher returns. This conclusion is seconded by a National Academy of Social Insurance analysis, which states:

> "[I]f the current Social Security system were to be fully replaced, it would be necessary to recognize the large unfunded obligation of Social Security. That is, some portion of current and future Social Security revenues, or some other revenue source, is needed to pay benefits to those already retired and those who will retire during any transition to a different system. This cost cannot be avoided if the expectations of retirees and those nearing retirement are to be met. Neither the unfunded obligation nor the costs of financing it go away by diverting revenue from the defined-benefit part of Social Security to individual accounts. These costs need to be paid even if a switch is made to an individual account system. If all of the cost of the unfunded obligation were allocated to individual accounts, it would completely eliminate the rate of return advantage of individual accounts."[8]

This creates a disagreeable problem for privatization advocates. It means that, however large the tax hikes or benefit cuts needed to keep the current system going, moving to a different system

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[6] Hearing of the House Budget Committee Social Security Task Force, May 4, 1999.

[7] Op. cit., Geanakoplos, Mitchell and Zeldes.

[8] "Evaluating Issus in Privatizing Social Security" National Academy of Social Insurance, December 1998 as published in the Social Security Bulletin, Vol. 62, No. 1, 1999.

would require even larger tax hikes, benefit cuts or deficit spending. After all, if the revenues currently pouring into the trust fund ultimately will be inadequate, then diverting some of those revenues into private accounts will make the trust fund even less solvent. For instance, diverting 2 percentage points of payroll taxes into private accounts, as called for in many privatization proposals, essentially doubles the size of the unfunded obligation. Therefore, these proposals double the size of the tax hikes or benefit cuts needed to restore solvency to the current system because of the added costs of transition to a new one.

USING THE NON-SOCIAL SECURITY SURPLUS

Some have suggested that benefits need not be cut nor taxes raised because the projected non-Social Security surplus could be used to finance the transition to a new retirement system over several decades. There are several problems with this. First of all, while the projected non-Social Security surplus is almost large enough to cover the unfunded obligations of the existing system, it is too small to accommodate the larger liabilities resulting from transition to a new system. Currently, OMB projects that the non-Social Security surplus over the next 15 years is just shy of the $3 trillion needed to restore solvency to the Social Security Trust Fund. As noted above, the cost of covering existing obligations in the transition to a new system is somewhere between $3 trillion and $10 trillion, depending on the extent to which the existing system is supplanted.

Even more troublesome, the Republican majority already has decided that the entire non-Social Security surplus should be used to pay for a multiyear tax cut. The Majority claims that their tax cut does not jeopardize Social Security because they have not dipped into the Social Security surplus. However, the system's $3-trillion shortfall already takes the projected near-term Social Security surplus into account, and preserving it does nothing to extend solvency.

The Task Force repeatedly heard testimony, even from advocates of privatization, that both solvency and restructuring would require resources from outside the system. Thus, devoting the entire non-Social Security surplus to the Republican tax cut means that none of these resources are available either to address the accrued obligations of the existing system or the additional cost of transition to a new system.

There is also considerable doubt about whether the projected non-Social Security surplus will materialize even without enactment of the Republican tax cut. It must be remembered that the surpluses to which we now look forward are projections, and those projections are based on assumptions that might or might not come true. As always, one might question whether the economy will perform as expected or whether unfavorable shocks might cause the projected surpluses to evaporate.

More important, though, is the precariousness of the political assumptions on which the projected surpluses are premised. The projected surpluses assume that the current and future Congresses will stay within the appropriations caps stipulated in the 1997

budget deal. This will require sharp cuts in real purchasing power for many basic government functions.

House Budget Committee Democrats (using CBO estimates) have shown that realizing the $1-trillion non-Social Security surplus projected for the next 10 years will require real purchasing power for total appropriations to be reduced 10 percent by 2009. However, if defense spending is increased as both the President and Congress have proposed and spending for highways and mass transit are increased as already called for in law, then the real purchasing power of all other appropriations in 2009 will have to be cut by 31 percent.[9]

Such cuts in appropriated spending would far exceed anything that Congress has been willing to do thus far. It would require deep cuts or even wholesale elimination of programs like NIH, the FAA, veterans' health care, Head Start, the FBI, the National Weather Service, flood control, Pell Grants, the FDA, the Coast Guard, the National Parks, DEA, and FEMA. Even now, the Republican Majority in Congress is finding that they cannot make even the modest appropriations cuts needed to stay within the FY 2000 cap. It will be even more difficult to make the far deeper cuts needed to adhere to the caps in FY 2001 and FY 2002 and then maintain that degree of austerity for a decade or more.

THE FALLACY OF THE EQUITY PREMIUM

Some advocates of private accounts acknowledge the sizeable transition costs associated with implementing a new retirement system to replace Social Security. They recognize that large transition costs might eliminate the higher rates of return earned on individual accounts during the decades of transition. However, they argue that going to a different system would be worth the trouble and expense because rates of return would be better once the transition was complete, albeit many years from now.

These advocates point to the fact that returns to private-sector investments have consistently exceeded the returns on the government bonds held by the Social Security Trust Fund, provided investments are held for long periods of time. The margin by which returns on private-sector investments have exceeded returns on government bonds over such long periods is called the "equity premium."

There is a rather wide consensus among economists, however, that returns to individual accounts might not be superior, even after the hurdle of transition costs has been overcome. These economists argue that private securities have averaged higher returns over long periods because their returns over short periods vary so much more than the returns to safe securities like Treasury bonds. Economists tend to believe that the equity premium cannot be exploited to solve fiscal problems because higher returns come with an added problem of their own, namely risk.

In order to get the higher returns that private equities offer over long periods of time, one must also deal with the problem that there will be years when returns are inadequate to serve their intended purposes. Thus, economists argue that both Treasury bonds

[9] "How Solid is the Surplus?" House Budget Committee Democratic Staff Study, July 1999.

and private securities are willingly held in portfolios and that investors do not believe that the latter are inherently superior. Rather, investors hold both types of assets because their strengths, safety on the one hand and high returns on the other, complement each other.

As a reflection of this, economists typically argue that total national saving, rather than the financial form that that saving takes, is what determines the future incomes of workers and retirees. Merely shifting money out of government bonds and into private equities without altering the total flow of new saving by governments, businesses, and individuals, does nothing to increase capital investment or economic growth. Chairman Greenspan made this argument in testimony before the Senate Budget Committee:

"As I have argued elsewhere, unless national savings is increased, shifting Social Security Trust Funds to private securities, while increasing government system income, will lower retirement incomes in the private sector to an offsetting degree. This would not be an improvement to our overall retirement system." [10]

THE MEANING OF RISK

Economists believe that financial markets rationally price returns on investments and that the equity premium reflects greater risk associated with private-sector securities. The return on government bonds, like those held by Social Security, are relatively low because they are safe. The United States has never defaulted on its obligations, a policy established at the Nation's beginning by Alexander Hamilton. The bonds held by the Social Security Trust Fund are backed by the full faith and credit of the U.S. Government, just like other U.S. Treasury securities, and defaulting on them would be unthinkable. Furthermore, inflation-adjusted returns for Treasury bonds have been much less volatile than those for private-sector stocks and bonds. This stems from the fact that Treasury bonds are backed by the Federal Government's power to tax rather than the uncertain earnings of businesses.

As noted in the introduction, advocates of privatization tend to de-emphasize the variability, or risk, of private investments. Instead, their arguments feature average rates of return for investments held a very long time. These advocates do not deny that market returns vary considerably over short periods of time. However, they claim that the ups and downs average out when private-sector securities are held for several decades, as they would be in private retirement accounts.

The claim that the short-term volatility of returns to private securities should not be a concern ignores the fact that accumulation in individual accounts would take time. Because account balances that accumulate over time are largest right before retirement, they would be subject to short-term market volatility near the end of a person's working years. After all, it is only the first installment to the account that receives the 40-year rate of return. The fact that most workers earn more later in life further magnifies the influence of short-term volatility late in the accumulation period, be-

[10] Senate Budget Committee Hearing, October 7, 1997.

cause the largest contributions to the account would be held for shortest periods.

The testimony of Task Force witness Gary Burtless of the Brookings Institution clarified this weakness of private accounts. Burtless showed that different workers with identical wage histories and identical, index-fund investment strategies could have vastly different final returns, depending on when they retired. The differences in the returns earned resulted, as argued above, from short-term market movements in the years just preceding retirement when accumulations were largest. Furthermore, the variability of outcomes is largely insensitive to attempts to diversify just before retirement because of periods like the 1970's when inflation-adjusted returns of both stocks and bonds turned negative. Burtless testified:

> "Workers fortunate enough to retire when financial markets are strong obtain big pensions; workers with the misfortune to retire when markets are weak can be left with little to retire on. The biggest pension [in Burtless' calculations] is more than five times larger than the smallest one. Even in the period since the start of the Kennedy Administration, the experiences of retiring workers would have differed widely. The biggest pension was 2.4 times the size of the smallest one." [11]

Privatization advocates frequently point out that even though the returns to individual accounts might vary, it is still unlikely that they would ever turn negative. This is a terribly low standard. A market downdraft in the years immediately preceding retirement would overthrow decades of retirement planning. In Burtless' calculations, for instance, a worker who retired in 1974 would have had a pension less than half the size of someone with an identical wage history and investment strategy who retired only 6 years earlier. One can imagine the kind of disruption in the lives of those unlucky enough to retire in such a market downdraft, watching their retirement plans evaporate in the face of falling asset prices just as their working years come to a close.

Variability of retirement outcomes resulting from economy-wide forces over which individuals have no control could easily undermine the political sustainability of a system of private accounts. Workers whom the government obliged to contribute to individual accounts, whom government prevented from accessing those accounts before retirement, and whose choice of investments was regulated by government might well insist that the government make them whole if they retired during a weak market. Such pressure could dwarf the controversy that surrounded the so-called "notch babies," who were Social Security beneficiaries whose pensions differed only slightly from those of retirees born a couple years earlier.

It is also important to emphasize that these risks would be born by the individual, even though they might result from broad-based economic forces. An individual's risk would be greater still if a system of private accounts allowed workers discretion over the types

[11] Hearing of the House Budget Committee Social Security Task Force, May 11, 1999.

of investments permitted in the accounts. Burtless' calculations are all based on the variability of broad market averages. Allowing individuals to choose their portfolios would increase the variability of retirement incomes further, as some people received above-average returns and others received below-average returns.

One must ask why such risks should be imposed on workers. As pointed out in the introduction, people already can take risks in the market with private savings to whatever degree suits them. In the current environment, the risks that savers take with their money in the market is backstopped by the predictable defined-benefit income from Social Security. Fully or partially replacing Social Security with private investment accounts would undercut this protection, which stems from the insurance principles that underlie the current system's design. As Burtless concludes:

> "Social Security provides workers with crucial protections against financial market risks. It is worth remembering that when the system was established in 1935, many industrial and trade union pension plans had collapsed as a result of the 1929 stock market crash and the Great Depression, leaving workers with no dependable source of income in old age. The private savings of many households were wiped out as well. Given these circumstances, most voters thought a public pension plan, backed by the taxing power of the Federal Government, was preferable to sole reliance on individual retirement plans." [12]

THE COST OF DUPLICATING SOCIAL SECURITY'S STRENGTHS: ADMINISTRATIVE COSTS

The costs of administering individual accounts constitute another reason that workers might never see the high returns promised by privatization's supporters. This seemingly minor consideration actually looms almost as large as the costs of meeting existing obligations or individual risk when comparing Social Security's strengths with those reputed for private accounts. Indeed, one Task Force witness, Lawrence Thompson of the Urban Institute, argued that the difficulties of keeping administrative costs low could easily reduce benefits by 50 percent from what theoretically could be achieved with private accounts.[13]

The problems of administering a universal system of individual accounts stem from the huge numbers and great diversity of workers who would participate. Currently, there are about 140 million workers paying into Social Security. Over 40 percent of these workers earn less than $15,000 per year, and most people work for relatively small employers. In our dynamic economy, many workers change jobs and locations frequently, with the result that 20 percent of workers at any point have been at their jobs a year or less.[14] Millions leave and re-enter the workforce as a result of family responsibilities. Workers come from a variety of household and family situations.

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[12] Hearing of the House Budget Committee Social Security Task Force, May 11, 1999.
[13] Hearing of the House Budget Committee Social Security Task Force, May 25, 1999.
[14] "Individual Social Security Accounts: Issues in Assessing Administrative Feasibility and Costs," Issue Brief No. 203, Employee Benefits Research Institute, November 1998.

The current Social Security system manages to keep track of our highly varied workforce at a cost of only 0.7 percent of annual contributions. The Employee Benefit Research Institute estimates that this amounts to only $10 per covered life per year. Such extraordinarily low costs result from the simplification achievable in a social insurance system, which would be unattainable with individual accounts.[15]

For instance, Social Security need only reconcile contributions with workers' earnings histories once a year. In a privatized system, posting contributions to a worker's account after such a long lag would be very costly in terms of the investment earnings that would be lost. Unfortunately, it also would be costly to have more prompt posting, given the huge number, diversity, and mobility of workers owning accounts.

Advocates of privatization sometimes extrapolate the costs associated with administering IRAs and 401Ks when assessing the likely burden of universal individual accounts. As a rule, these costs are expressed as a percent of the assets managed in an account. This tends to badly understate such costs, especially for small accounts.

If one instead looks at costs in dollar terms, as was done by Task Force witness Dallas Salisbury of the Employee Benefits Research Institute, a very different picture emerges. After all, a small account would still need to have regular statements mailed, records accurately maintained, and phone inquiries answered, irrespective of the value of the account's assets. Using plausible dollar-cost estimates of such administrative tasks, Salisbury concludes that administering a universal system of individual investment accounts would cost between five and twelve times as much as Social Security.[16]

Salisbury's estimate, however, does not take into account the considerable additional expenses associated with investor education, marketing, and annuitization. Investor education would be essential given that a majority of people do not have any financial market experience despite the recent increase in stock ownership. To the extent that workers could choose among different investments, there would be additional costs associated with firms' competition for their business.

Finally, in order to duplicate Social Security's guarantee of inflation-adjusted retirement benefits irrespective of longevity, workers would have to purchase annuities with the same protections. Salisbury's estimates don't include annuitization costs either. The cost of private-market annuities currently offered in the market reduces the size of retirement nesteggs by about 20 percent,[17] and that's without inflation protection. Annuities with inflation protection, especially for the small accounts of low-wage workers, would reduce the value of accounts even further.

Most analysts acknowledge that a tradeoff exists between having accounts that can be tailored to individual's specific needs and

[15] Briefing of the House Budget Committee Social Security Task Force, March 22, 1999.

[16] Briefing of the House Budget Committee Social Security Task Force, March 11, 1999.

[17] "New evidence on the money's worth of individual annuities," by Olivia S. Mitchell, James M. Poterba and Mark Warshawsky, National Bureau of Economic Research Working Paper No. 6002, 1997.

keeping administrative costs low. As Lawrence Thompson of the Urban Institute testified, "Choice costs money." Costs can be kept low but only if operations are centralized and individuals are offered limited investment options. This presents difficulties for privatization, one of whose benefits is supposed to be greater autonomy for individuals' decisions about retirement. Such autonomy can only be purchased at the expense of significantly lower returns. As Thompson puts it:

> "Administrative costs are the Achilles Heel of all the decentralized individual account systems currently in operation around the world. In the Latin American systems, roughly one-quarter of the money that goes into the funds is lost to administrative fees. In the U.K., administrative charges are averaging 40 percent of the system's resources. Before long, these countries will find that they are spending more than 1 percent of their GDP just to administer their pension systems. * * * No country has yet successfully implemented individual accounts in a way likely to be acceptable in the United States." [18]

Employers, particularly small employers, are concerned that a significant portion of these costs might fall on them. The current system only requires annual reporting, and the reports needn't be especially prompt. A system of private accounts would inevitably require more frequent and complex reporting by employers, raising costs to them. Not surprisingly, the Employee Benefits Research Institute found that support for individual accounts among small employers dropped dramatically when they were made aware of the likely additional costs that would fall to them.[19]

THE COST OF DUPLICATING SOCIAL SECURITY'S STRENGTHS: DISABILITY AND SURVIVORS' BENEFITS

For the most part, advocates of privatization do not address the question of disability and survivors' benefits, focusing exclusively on the retirement functions of Social Security. This is unfortunate because about one-third of all Social Security benefit payments are made to nonretirees. Disability and survivors' benefits constitute major elements of Social Security's insurance protections, and those protections are linked to the structure of the retirement program. In the words of Deputy Social Security Administrator Jane Ross:

> "Social Security pays benefits to more than 4.7 million disabled workers, nearly 1.5 million children of disabled workers, and almost 200,000 spouses of disabled workers. Because about 25 to 30 percent of today's 20-year-olds will become disabled before retirement, the protection provided by the SSDI program is extremely important." [20]

Social Security provides the only disability insurance for three quarters of U.S. workers, and it provides the only meaningful life insurance coverage for a majority of workers. In her testimony before the Task Force, Deputy Commissioner Ross stated unequivo-

[18] Hearing of the House Budget Committee Social Security Task Force, May 25, 1999.
[19] Briefing of the House Budget Committee Social Security Task Force, March 11, 1999.
[20] Hearing of the House Budget Committee Social Security Task Force, June 22, 1999.

cally that private insurers could not offer disability insurance that even approached Social Security's low cost. She noted, for instance, that private disability insurers returned only about half of their premiums as benefits, whereas Social Security remitted 97 percent of its revenues to beneficiaries.

Like the disability program, Social Security's survivors' benefits also are underwritten by the broadest possible risk pool and profit from the low costs of centralized administration. There is no evidence that the private market could offer anything like the life insurance protections of the current system, especially for low-income individuals.

It is difficult to overemphasize the importance of the web of interlocking protections provided by the entire Social Security program, not just its retirement component. The National Academy of Social Insurance has illustrated the multiple risks that the system addresses. For a hypothetical group of 100 young men first entering the workforce, only 58 can be expected to retire without prior disability. Of the rest, about 10 will die suddenly during their work lives, triggering survivors' benefits for spouses or children. Another 13 will die after becoming disabled, and Social Security in these cases would provide disability benefits during the worker's life and survivors' benefits for dependents and the spouse. Another two of these men will become disabled and recover, eventually retiring. These workers would receive disability benefits (temporarily) as well as the usual retirement and aged survivor benefits. Finally, 18 of these men could be expected to be disabled beneficiaries at retirement age.[21]

Given these strengths of the existing Social Security system, it is disappointing that many privatization plans completely avoid questions about this part of the program. Worse yet are those plans that propose changes in the basic retirement benefit that would have severe, presumably unintended, consequences for the disability and survivors' programs. Social Security has a common benefit structure that determines monthly benefit levels for retirement, survivors', and disability benefits alike. Thus, cutting back Social Security's primary benefit amount (as many privatization plans do to overcome transition costs) would cut survivors' and disability benefits as well. Task Force witness Marty Ford of the Consortium for Citizens with Disabilities testified that some privatization plans would reduce disability benefits between 8 and 45 percent.[22]

This consequence of privatizing Social Security is aggravated by the fact that disability and survivors' benefits typically go to multiple beneficiaries. Dependents of workers who become disabled or who die before retirement receive benefits, as do spouses of deceased retired workers. Because death or a disability can trigger Social Security payments to a number of individuals, it would be difficult for individual accounts to offset the reductions of traditional Social Security benefits that would likely result from privatization.

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[21] "Individual Accounts in Social Security Reform; Questions About Benefit Design," by Virginia Reno, National Academy of Social Insurance presentation to the Senate Democratic Task Force on Social Security, December 1998.

[22] Hearing of the House Budget Committee Social Security Task Force, June 22, 1999.

THE COST OF DUPLICATING SOCIAL SECURITY'S STRENGTHS: ANNUITIZATION

Social Security provides retirees income whose purchasing power is protected from inflation and which continues as long as the beneficiary lives. This is a crucial strength of the current system, since it provides workers the peace of mind that they can count on a guaranteed, if minimal, level of support after they stop working. As with so many of Social Security's strengths, advocates of privatization give short shrift to the inflation-adjusted annuity that the system provides.

If a system of individual accounts largely replaced Social Security and retirement incomes largely derived from those accounts, there would be a strong argument for mandatory annuitization of at least part of each account. Without at least some mandatory annuitization, retirees might spend down their nest eggs too quickly, gambling that a government safety net would catch them if they outlived their assets. To ensure that workers' accounts were used to provide a floor level of income in retirement, government would have to require some annuitization and also require that private accounts not be accessible prior to retirement for other purposes. Otherwise, taxpayers would bear the cost of mistakes by the imprudent and impatient.

However, mandatory annuitization creates problems of its own. As already noted, inflation-adjusted annuities would be quite expensive to provide for the entire population, significantly reducing the value of individual accounts. In addition, the fact that annuities would have to be purchased at a particular point in time makes the value of private accounts even more susceptible to short-term market fluctuations. Depending on exactly which day one chose to convert an account into an annuity, the amount of money available to fund a multiyear stream of retirement income could vary by as much as several percentage points, depending on daily market fluctuations at the time.

Furthermore, there are difficulties that stem from the very nature of annuities themselves. Annuities work by pooling longevity risks. The money saved from annuitants who die unexpectedly early is used to pay income to those who live unexpectedly long. Thus, mandatory annuitization of private accounts would tend to redistribute wealth from the poor to the rich, from blacks to whites, and from the sick to the healthy, in each case because the latter tends to live longer. Of course, the current system also redistributes money, but usually in the other direction. The benefits schedule is very progressive, so that low-income workers receive proportionately more than the affluent, and the survivors' and disability protections redistribute money in favor of those with health problems and those who die early.

The fact that annuities redistribute wealth also undercuts one of the basic tenets of privatization: that individual accounts are private property. In what sense are the accounts "property" if their owners are required to join risk pools that redistribute the accounts' wealth in fairly predictable ways? In what sense are accounts "property" if their owners can't access them prior to retirement for other worthy purposes? In what sense are the accounts

"property" if they aren't inherited by survivors after the retiree's death, but instead are used to fund someone else's retirement?

One can imagine, for instance, the sense of injustice for someone in their early sixties with an aggressive cancer or severe heart disease who was forced to annuitize. Despite the claim that the worker's account was personal property, he or she would be prevented from using the account's accumulated savings for urgent medical care both before and after retirement. If the worker's spouse decided to divorce, the spouse could claim some of the account if the divorce occurred before annuitization but not after. If the worker died, the wealth in the account might be inheritable if he or she died before retirement but not after.

THE COST OF DUPLICATING SOCIAL SECURITY'S STRENGTHS: PROTECTING WOMEN AND MINORITIES

Social Security's benefits are derived from formulas that are neutral with regard to sex and race. Nonetheless, the system's interlocking protections against life's risks are especially important to women and minorities. Social Security's progressive benefit structure, its inflation-adjusted lifetime retirement annuity, and its survivors', disability, and spousal benefits all provide support for risks that bear more heavily upon women and minorities.

Certainly, the importance of Social Security as it currently exists to women and minorities is evident from its impact on poverty among these groups. Without Social Security benefits, more than half of elderly women would have incomes below the poverty line. In fact, more than three fifths of all income received by elderly women comes from Social Security. Two thirds of elderly women rely upon Social Security for a majority of their income, and one third rely on it for at least 90 percent of their income.[23]

Similarly, for the median elderly African-American household, Social Security provides 77 percent of income, while for the median elderly Hispanic-American household the system provides 86 percent of income. In fact, 23 percent of elderly Hispanic couples and 40 percent of elderly Hispanic individuals rely exclusively on Social Security for their retirement income. Without Social Security's retirement support, most minority elderly would fall below the poverty line.[24]

However, it is not just Social Security's retirement features that provide a safety net for women and minorities. As noted above, the system's comprehensive package of protections against low lifetime earnings, inflation, unexpectedly long life, and premature death or disability of a breadwinner work together to create a web of insurance for women and minorities.

The most important strength of Social Security in this regard is the progressive nature of the system, whereby the basic benefit (from which retirement, disability, survivors', and spousal benefits are calculated) is relatively more generous for low-income workers. Of course, this benefits women who tend to have lower incomes both because they spend on average 11.5 years out of the paid labor force and because they tend to be paid less than men even

[23] Hearing of the Social Security Task Force on Social Security, May 4, 1999.
[24] Ibid.

when they work full time. It also disproportionately benefits minority workers who have lower incomes because of prejudice, weaker education and skill levels, and the lack of job opportunities.

Social Security's guarantee of an inflation-adjusted retirement benefit for as long as the recipient lives is particularly important to women and Hispanic-Americans. Because these two groups tend to have greater longevity, Social Security's life annuity with inflation protection means that women and Hispanic-Americans receive benefits that are large relative to their FICA contributions. For instance, women receive 53 percent of Social Security retirement and survivors' benefits but only pay 38 percent of payroll taxes. For the median female retiree, Social Security replaces 54 percent of lifetime earnings, compared with 41 percent for the median male. Hispanic-Americans benefit in a similar fashion from Social Security's guarantee against inflation in old age and outliving one's assets.[25]

African-Americans have relatively short life expectancies, which has led some supporters of privatization to conclude that they receive poor returns from the current system. However, these analyses ignore the fact that Social Security's survivors' benefits disproportionately favor African-Americans. Although African-American children account for 16 percent of all U.S. children, they make up 24 percent of the children receiving survivors' benefits. Furthermore, African-Americans accounted for 21 percent of the spouses with children who received survivors' benefits. Thus, when premature death takes an African-American worker, benefits to that worker's spouse and children compensate for the loss of retirement benefits that workers otherwise would have received.

Furthermore, disability benefits are extremely important to African-Americans. Although African-Americans represent only 11 percent of the workforce, they account for 18 percent of those receiving Social Security disability benefits. In addition, the children of disabled workers are eligible for benefits, and African-Americans accounted for 23 percent of children and 15 percent of spouses receiving benefits because of a breadwinner's disability.

Finally, there is a range of spousal benefits that are of particular importance to women. Social Security provides extra benefits to spouses with low lifetime earnings, even if they did not work at all outside the home. Almost three fourths of elderly widows receive benefits based on the earnings of their deceased husbands. Social Security also provides benefits to spouses of any age who care for children if a breadwinner is retired, becomes disabled, or dies. Women account for 98 percent of spouses receiving such benefits.

It is hard to imagine a system of private, individual accounts providing these kinds of protections for women and minorities. Account balances would be smallest for those with low earnings. As a consequence, retirement incomes would almost certainly be smaller for women and minorities in a privatized system. Furthermore, the disability and survivors' benefits that figure so large in the benefits that women and minorities receive from Social Secu-

[25] "Women and Retirement Security," National Economic Council, October 1998; "Social Security Reform and Hispanic Americans," Center on Budget and Policy Priorities, September 1998; "Social Security Reform, What Proposed Changes Mean for African Americans," by Cecilia Conrad and Wilhelmina Leigh, Joint Center for Political and Economic Studies.

rity would largely be absent or severely curtailed in a privatized system.

Advocates of individual accounts claim that these concerns could be taken care of through arbitrary adjustments. Such adjustments, though, would result in added regulation, complexity, and cross-subsidization in a system of private accounts. These kinds of restrictions on private accounts would tend to undermine any sense of ownership that the holders of those accounts might have.

CONCLUSION: SAVE SOCIAL SECURITY FIRST

Democrats find the Majority's headlong campaign to fully or partially replace Social Security with individual accounts to be a distraction from the task at hand. The debate about Social Security's future always begins with an acknowledgment that the current system has unfunded future obligations, but it never seems to end with proposals for the best way to solve that problem. That, at least, was the experience of the Task Force. The investigation of Social Security's impending challenges quickly became diverted into a discussion of the even greater difficulties of replacing it with a new system of private accounts.

By contrast, Democrats' position is simple: One needn't destroy Social Security in order to save it. No evidence was presented to the Task Force to indicate that creating individual accounts, in and of itself, would address existing unfunded obligations. Certainly, Democrats see great virtue in efforts to promote private wealth-building, particularly among low-income families who do little or no saving now. The President's proposals for progressively funded USA accounts that would buttress traditional Social Security benefits is one such constructive proposal. However, these efforts should not distract from the more important challenge of repairing the social insurance system that has served generations of Americans well.

The Majority's insistence that private investment accounts are the answer to the current system's troubles is highly questionable. Along with the promise of higher returns, individual accounts create manifold additional costs, complexities, and problems on top of the sufficient challenges faced by the current system that could render the promise of better returns illusory.

Huge transition costs, which necessarily exceed the existing system's unfunded liability, and burdensome administrative expenses may well overwhelm any advantage that private accounts might have with respect to rates of return. Even without transition and administrative costs, the better return claimed for private investments must reflect the greater individual risks associated with them. If the government stepped in to insure the new risks that individuals faced, the fiscal problem that private accounts were supposed to solve would again press on government finances—and those burdens might well be greater than the fiscal problems that Social Security already faces.

Attempting to duplicate the strengths of Social Security within the context of private accounts creates still greater costs, complexities, and inefficiencies. In order to preserve the existing protections for disability, for death of a breadwinner, for inflation, for outliving one's resources in retirement, for women, and for society's

most vulnerable citizens, a system of individual accounts would have to include considerable regulation. Building in these protections would presumably require extensive cross subsidies and greatly restrict individuals' control over their accounts. This would undercut the other purported advantage of privatization, namely the sense of ownership over the accounts.

This means that replacing Social Security with private accounts might not be politically sustainable over the long time spans by which one evaluates Social Security reforms. With the government obliging workers to do the saving in the first place, restricting the choice of investments in the accounts, preventing workers from having access to their money until retirement, and insisting that workers annuitize at least part of their nesteggs, the citizens might well come to the conclusion that their accounts are anything but private property.

If any aspect of such a privatized system proved unacceptable, beneficiaries might conclude that taxpayers as a whole, rather than individuals, should shoulder the responsibility. This would return us to the same fiscal dilemma faced by the current system.

For these reasons, the minority advocates that Congress first take steps to shore up the existing Social Security system before engaging in wholesale restructuring. In taking such steps, great care should be taken to preserve the system's strengths. Supplemental efforts should also be made to encourage low-income families to save more on their own. However, these efforts should not come at the expense of preserving the safety net that keeps more than half of the elderly out of poverty and insures families against the loss of a breadwinner to death or disability.

Shoring up Social Security can be accomplished in one major reform or through cautious, gradual steps. Some might question an approach that relies on incremental reform rather than dramatic steps that attempt to fix the problem once and for all. The conventional wisdom suggests that taking modest steps now can avoid the necessity for more drastic measures if we wait. The conventional wisdom, though, must be qualified by the fact that 75 years, the standard for Social Security solvency, is a very long time. Much is uncertain over time spans that long, and a compelling argument can be made for proceeding incrementally, especially if the alternative is dismantling Social Security.

After all, Social Security didn't even exist 75 years ago. In 1924, all retirement savings consisted of private, individual accounts. No one looking forward 75 years at that time could have foreseen the Great Depression, which gave rise to Social Security, nor the convulsions of World War II and its Baby Boom, the Cold War, the computer revolution, the onset of AIDS, or any number of other developments. And yet, the standard for "fixing" Social Security assumes that we can project events over such a very long period of time.

The uncertainties of making projections of 75 years are magnified by the fact that those projections are based on only about 50 years of economic data. Demographic data goes farther into the past, but comprehensive economic data gathering didn't really begin until after World War II. Even if we had 75 years of eco-

nomic data, that would still provide us only one example of how a period that long might unfold.

Even the demographic data, which extends much farther back, doesn't help much to improve the accuracy of projections. Demographers using this long-term data still failed to predict the postwar Baby Boom and also failed to foresee the equally dramatic decline in fertility that occurred in the 1970's. The actuaries' current projection assumes that birth rates will stay close to the lows of the 1970's, but that could easily reverse. Clearly, the errors in 75-year projections can be huge even with good data because the future is inherently unpredictable.

Projections over several decades necessarily are driven by the underlying assumptions because of these huge uncertainties. As a reflection of this, each year's report from the Social Security actuaries presents two alternative scenarios in addition to their intermediate estimate. The pessimistic scenario assumes that the economy barely grows for decades on end and demographic changes are unfavorable. An optimistic alternative assumes that the economy performs the way it did during the first thirty years of the postwar period and that demographics are somewhat more favorable.

In the pessimistic case, the trust fund quickly goes broke, while in the optimistic case it remains permanently solvent by a wide margin. These highly divergent possibilities stem from rather minor differences in the underlying assumptions. But that is what one should expect from 75-year projections. When dynamic systems, like Social Security, are projected far into the future, minor differences in assumptions usually result in radically different outcomes. In fact, mathematicians would argue that the conditions that give rise to stable paths over such long periods represent a "knife-edge" case.

Another possible reason to repair Social Security in steps is that we should be cautious about presuming to know what future generations will want. Future generations might find that radical steps taken today to achieve full 75-year solvency were poorly suited to future circumstances. For instance, some have suggested eliminating a substantial portion of Social Security's unfunded obligation by indexing the retirement age to longevity. However, if future generations discovered that increased longevity didn't translate into a comparable extension of work life, we would have bequeathed unexpected problems to our children. One of the benefits of a democratic form of government is that future generations are permitted to address the problems of their own time with knowledge unavailable to their predecessors.

We also should recognize that these future generations will be richer than we are. Indeed, the actuaries' assumption of growing real incomes is one factor that drives calculations of the system's unfunded obligations. They project that real GDP per capita will be 46 percent higher than today in 35 years, when Social Security is currently scheduled to run short of money. By the end of the 75-year window, real GDP per person is projected to be more than twice as high as today, despite the actuaries' projection of only 1.4 percent economic growth over the period.

This argues against being too hasty in imposing relatively large economic burdens on today's generations. Doing so could mean that

current generations sacrifice so that wealthier subsequent generations face fewer difficulties. One might argue instead that wealthier future generations should share the burdens of preserving Social Security, recognizing that their superior economic position allows them greater latitude to do so.

All of this leads Democrats to conclude that steps should be taken now to strengthen Social Security but that these measures should be thoroughly considered. Even if such steps stop short of full 75-year solvency, they must be real, rather than just band-aids and quick fixes. Reforms should leave current beneficiaries and those soon to retire unaffected.

Democrats are confident that moderate changes can be made now to the structure of Social Security that can extend solvency in ways with little immediate impact but significant long-term consequences. Policy adjustments can be phased in over many decades to address a problem projected to unfold over many decades. We can take prudent, cautious steps now, while still fully recognizing that additional steps might be needed in the future.

Addressing the unfunded obligations projected for Social Security over the next 75 years is a major challenge. However, it is no greater than challenges our society has faced many times in the past. For instance, the Social Security actuaries project that total benefits as a percent of GDP will rise by 2.2 percentage points over the next thirty years as the Baby Boom retires. This is somewhat less than the shift in national resources that occurred when the Baby Boomers were children. Between 1950 and 1975, the share of the economy devoted to public education rose by 2.8 percentage points, a larger shift over a shorter time period.[26]

During the early years of the Cold War, defense spending as a share of GDP rose 2.5 percentage points in the space of only 2 years. Between 1980 and the present, defense spending as a share of the economy first increased by 1.5 percentage points over 6 years and then declined by 2.6 percentage points over the next 10 years.[27] Also, the President's proposal to substantially pay off the public debt would reduce government's interest expense by about 2 percentage points of GDP. Clearly, the kinds of shifts in national resources contemplated for Social Security over the coming decades can be effected at least as easily as these fiscal challenges.

It is time to stop distracting ourselves from the real business at hand with untested and risky schemes. Social Security faces serious but manageable difficulties. We have an obligation to take carefully considered steps now to address those difficulties. But radical measures, taken in haste, are the wrong prescription for problems projected to unfold over several decades for the comprehensive social insurance system that continues to serve us well.

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[26] "Can We Afford Social Security When Baby Boomers Retire?" by Virginia Reno and Kathryn Olson; Social Security Issue Brief No. 4, National Academy of Social Insurance, November 1998.

[27] Ibid.

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