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RETIREMENT SECURITY POLICY: PROPOSALS TO PRESERVE AND PROTECT SOCIAL SECURITY

HEARING

BEFORE THE

COMMITTEE ON FINANCE
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RETIREMENT SECURITY POLICY: PROPOSALS TO PRESERVE AND PROTECT SOCIAL SECURITY

WEDNESDAY, SEPTEMBER 9, 1998

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:04 a.m., in room SD–215, Dirksen Senate Office Building, Hon. William V. Roth, Jr. (chairman of the committee) presiding.

Also present: Senators Chafee, Grassley, D'Amato, Gramm, Mack, Moynihan, Rockefeller, Breaux, Conrad, Bryan, and Kerrey.

OPENING STATEMENT OF HON. WILLIAM V. ROTH, JR., A U.S. SENATOR FROM DELAWARE, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. Today the Finance Committee will hear testimony on a number of proposals to preserve and protect Social Security for the long term.

Social Security is a vitally important program for most Americans. Today, 44 million of our fellow citizens receive monthly Social Security benefits. That includes the retired and disabled workers, their families, and the families of workers who have died. Indeed, at some point in their lives, most Americans will receive a check from Social Security.

But, as is well known, Social Security has serious financial problems in the future. In about 15 years, 2013, annual Social Security revenues will no longer cover benefit payments and the program will need to call upon assets now accumulating in the trust funds.

However, because Social Security benefits are necessarily paid from current government resources, redeeming these bonds could create serious budget pressures. This morning, the committee will hear from witnesses who will address that issue, among others.

But there is also good news in these projections as well. Although timely action is needed, Social Security faces no immediate crisis. Congress can, and should, take thoughtful action. Indeed, no senior today, or anyone approaching retirement age, should be concerned about their Social Security. The task, really, is protecting Social Security for today's younger workers, their children, and grandchildren.

Today, the committee is fortunate to have a number of distinguished witnesses, including several members of this committee. In the first panel, we will hear from Senators Moynihan and Kerrey, who will describe S. 1792, the Social Security Solvency Act of 1998.

We will then hear from Senators Judd Gregg and John Breaux on their proposal, S. 2313, the 21st Century Retirement Act of 1998.

Finally, in the first panel, we will hear from Senators Phil Gramm and Pete Domenici on their proposals for reform.

Senator Moynihan is, of course, perhaps the Senate's most knowledgeable expert about Social Security and a long-time staunch advocate and friendly critic of the program.

In 1983, he was a member of the small group who helped broker the last Social Security solvency bill at a time when the program was facing an immediate financial emergency. In 1994, as chairman of this committee, Senator Moynihan shepherded through legislation to make Social Security an independent agency.

We appreciate having the panel here. I would like to ask each pair of Senators to limit their presentation to 10 minutes so that we have some time for discussion. I had hoped that the committee might conclude the first panel by 10:45 a.m.

Senator Moynihan?

OPENING STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM NEW YORK

Senator MOYNIHAN. Thank you, Mr. Chairman. Thank you for holding this hearing and bringing together some of the great names of this extraordinary central program of American domestic policy. We are particularly honored this morning, sir, as I know you would agree, that Robert Myers is going to be testifying. It gives you a sense you can go back and touch the beginning.

Bob Myers was a graduate student at the University of Iowa when Edwin E. Witte, who was heading the staff of the Committee on Economic Security, that Frances Perkins put together, asked him to come down to help and he has been helping ever since, and he still is.

You mentioned legislation in 1994, reestablishing the independent agency that we started with. Something else, and a little bit of an example of why we needed to do that.

I put it, not entirely in jest, that in that Congress we decriminalized baby-sitting. Nobody had noticed it, but the Social Security laws required anybody who hired anyone to work, anywhere, any time, to pay Social Security payroll taxes four times a year, and file forms in triplicate pages; things like that.

One cabinet officer after another fell to the ground as it turned out they had not done this, and they did not know they were supposed to. The Social Security Administration never told them and made it easy to do. We paid too little attention to the hands-on aspects of this program and we ended up today in a situation where a majority of non-retired adults do not believe they're going to get Social Security.

When you reach a point like that, if people do not think they are going to get it, they may not miss it if it is taken away. That is what we are addressing in the proposals that Senator Kerrey and I have before you. Senators Gregg and Breaux, and Senators Gramm and Domenici are here to discuss the legislation introduced by Senator Kerrey and me and by Senators Gregg and Breaux have some common features. I will just go right through them, and you will have heard from me.

First, we think we can have a payroll tax cut for all working Americans. The present payroll tax brings in more revenues than are needed for benefits and the revenues are used for other things.

We would create an opportunity for all workers to invest in personal savings accounts of the sort that Federal employees have.

We would have a progressive benefit formula, which we do have today. Keep that. We would—and this is central—provide for accurate cost-of-living adjustments—COLAs. In 1961 I came to this city as a member of the Kennedy Administration at the Labor Department. I had a nominal responsibility for the Bureau of Labor Statistics. Waiting for us was a report from a group called the National Bureau of Economic Research, headed by George Steigler, later to be a Nobel laureate—Senator Gramm would know him—on the price indexes of the Federal Government.

It said the consumer price index overstates the cost of living. It is just structural aspects which make that something you cannot avoid. We have had a generation of this information. It is time we attended to it, or so we feel.

The CHAIRMAN. I share that feeling.

Senator MOYNIHAN. I know you do, sir.

I think, in time, we will want to increase the retirement age to keep the balance between the amount of years working, the amount of years in retirement—gradually over a long period of time. I mean, 50–75 years hence.

We should have income tax provisions that provide equitable treatment of workers and retirees. We should repeal the earnings test so that beneficiaries are free to work while collecting benefits. The earnings test involves too much detail and fuss and it is not understood and it is not needed.

Finally, we would provide permanent solvency for the Social Security program with a reduction in the Federal Government's unfunded liabilities.

I would conclude, Mr. Chairman, by saying, Social Security is not complicated. It is simply difficult. I would put it against Medicare, which is a hugely complex matter because you are dealing with medicine. Here, you are just dealing with numbers and actuarial benefits. It can be done if we summon the kind of energy and conviction you so frequently show in these matters.

Thank you, sir.

[The prepared statement of Senator Moynihan appears in the appendix.]

The CHAIRMAN. Thank you, Senator Moynihan.

I will now call on Senator Gregg.

STATEMENT OF HON. JUDD GREGG, A U.S. SENATOR FROM NEW HAMPSHIRE

Senator GREGG. Thank you, Mr. Chairman. It is certainly a pleasure to participate in this panel with Senator Moynihan, Senator Gramm, Senator Domenici, and I know Senator Breaux and Senator Kerrey are coming, and yourself as chairing the committee, who obviously have been on the point of addressing this issue which is so critical to every American.

I do think the problem needs to be put in context, if for no other reason than the record. We all understand at this table, and certainly the chairman does, but the fact is, we are facing a predictable event, one which I compare to a predictable major hurricane, flood, or natural disaster.

If we knew the date that California, for example, was going to have a major earthquake, we would do something about it. If we knew the date that the Midwest was going to have a major flood, we would do something about it. If we knew the date that a hurricane was going to come ashore and wipe out large sections of some part of the East Coast, we would do something about it.

Well, we know the date when we are going to face a fiscal meltdown of the Social Security system because the people are already born and living who are going to go on the system and create that problem. It is a demographic event which cannot be denied and which is going to occur.

As responsible stewards of our government, we have an obligation—an obligation—as a government to step forward to try to address the issue.

And, like that oil filter ad, "You can pay me now or pay me later," we can take action now, which can be constructive, effective, and very positive for Americans, or we can wait and face a precipitous event. So my representation is, let us go now, as is everybody else's representation on this panel.

I think there is a lot of common ground between this panel, and that, I think, reflects the fact that the solution to the Social Security problem is resolvable. It is doable. It may be difficult, which is absolutely right, as Senator Moynihan says, but it is certainly within the bounds of any good legislative body to be able to push it forward.

The commonality of approaches is significant. Senator Moynihan has outlined a number of them between our plan and his plan. Let me outline a little it more.

Our plan was reached as a result of a group of folks sitting down for 15 months. They were people who had a tremendous amount of expertise in the area of Social Security and it was a bipartisan organization chaired by myself and Senator Breaux on the Senate side, and Congress Stenholm and Congressman Colbey on the House side.

We put together a report, which was unanimously approved, and the report was scored by the Social Security Administration as putting the system into solvency for the next 100 years.

The whole concept, beyond the common points which have been discussed here, is that in order to address this issue we must begin to prefund the liability of the Social Security trust fund. The fact is, it is now a huge contingent liability which we face as a country.

So how do we begin to prefund the liability? How do we put in place assets which will be available for the baby boom generation when it retires?

Well, the best way to do this, in our opinion, is to do it through personal accounts, where we basically say to people, we will let you save some percentage of your Social Security taxes which you are now paying and allow you to control those taxes which you are now paying and have no control over and allow those taxes to be invested for you in vehicles which will generate a better return than the present Social Security trust fund generates to an individual.

The practical effect of personal accounts is that we do two things. We give ownership over some of your benefits which you do not have now. Today, you pay Social Security taxes. You pay a lot of Social Security taxes.

In fact, if you are in your 20's, you are paying taxes at a rate which will probably exceed the benefit which you get back from Social Security when you retire. Most people are getting a bad deal out of the Social Security who are younger because the rate of return is so low.

And you do not have any ownership over those taxes that you pay. In fact, if you die before you are 62, you get essentially nothing. If you happened to be survived by a spouse or children you get a small stipend, but essentially you lose all your assets that you have been saving all these years.

Well, one way to correct that is to allow savings accounts, and that is what we stress in our proposal, is to give people savings accounts which they can then actually have physical ownership over, and then allow them to control, to some degree, the investment of how those savings accounts are invested.

Our plan tracks what is presently the Federal Thrift Savings Plan. We essentially will have the Social Security Administration set up 4, 5, 6, hopefully over time as many as 7, 8, or 10 different, what amount to mutual funds and they will vary in their investment schemes, depending on what the person who is paying the taxes wishes to invest in. They can invest very conservatively, they can invest moderately, or they can invest reasonably aggressively.

It has worked very well for Federal employees under the Federal Thrift Savings Plan; we think it will work very well for all Americans under the Social Security plan.

So we give them ownership and we give them an asset which builds up faster than the manner in which the present Social Security trust fund builds up. That is very important.

Under our plan, the vast majority of people in America will receive more in the way of benefits under our plan than they will receive under the present Social Security plan, assuming you could even make the present Social Security plan solvent through some sort of tax increase or some other activity.

That is an important point. Because of the growth that will occur in these personal accounts through savings, we are going to give people a much better deal than they presently have.

But you must also acknowledge that, in order to correct the Social Security system's present problems, there is going to have to be some tough choices made on the benefit side of the ledger.

Senator Moynihan has outlined a few of the ones which we have reached consensus on between our plans. But there is no free lunch. You do not get something for nothing in this country. There are going to have to be benefit issues addressed. Why is that? Because the generation that is retiring is so huge.

If we do not reflect the fact that that generation is far exceeding any generation in history and, thus, has reduced the number of people working to the number of people who are retired and benefitting from the system, we can simply not afford the system in any structure that is put forward. So, there has to be an acknowledgement of these difficult decisions, and our plan does that also.

I think my final comments would be these. I believe right now in the Senate, as a result of the leadership of this committee, the people at this table, and others who have worked hard on this issue, that there is a developing consensus for Social Security reform which will allow us to have a strong and vibrant system for the next 100 years without any question, and it is a very doable event. It is not a difficult legislative event to undertake because it has bipartisan participation and it is a confined event, as was defined by Senator Moynihan.

The only real issue we have right now, is how do we politically get there. The ground has been harrowed, the seeds have been planted, and crops have been grown on the basis of developing a plan that will work, a variety of plans that would work, in order to make the system solvent. The only thing that is lacking is the political resolve to move forward and take the action.

So, I greatly admire you, Mr. Chairman, for having these hearings, and your committee for stepping out on this issue. But we well need White House participation. You cannot address an issue like this that has such a massive effect on the American people without having strong participation by the executive branch.

I admire and appreciate the fact that the White House been, and the President has been, holding forums around the country. But the forum period is pretty much over. We need to move to actual substantive action. That has to occur in a fairly prompt time frame, in my opinion.

In fact, I believe we must be acting legislatively early in the next year, because if we fail to act early next year, we all know that the political calendar works against us.

If we do not have in place a solution which is a consensus solution which is bipartisanly agreed to by the middle of next year, then we are going to have a difficult time doing it in the middle of an election cycle that involves the campaign for the presidency.

So I do hope we will get specific proposals from the White House in the near future from which we can develop and evolve the consensus which is already developing around this table.

Thank you, Mr. Chairman.

[The prepared statement of Senator Gregg appears in the appendix.]

The CHAIRMAN. Thank you, Senator Gregg.

We will now hear from Senator Gramm and Senator Domenici.

OPENING STATEMENT OF HON. PHIL GRAMM, A U.S. SENATOR FROM TEXAS

Senator GRAMM. Thank you very much, Mr. Chairman. Let me, first, say that I agree with everything that has been said. I would like to just try to make several simple points.

Number one, the Social Security crisis is not just about numbers. We hear people talk about a $10 trillion unfunded liability. Nobody can really fathom that kind of number.

The Social Security crisis is about real, honest-to-God people and about the fact that, soon, we as a society are going to be forced to choose between payroll taxes that will diminish the economic future of our children and benefit cuts that will threaten the security and dignity of our parents.

If we do not change the current system, in about a decade, and virtually for every year thereafter, we are going to have to make that kind of excruciatingly painful decision.

I do not know of any human emotions that are more powerful than the emotions to try to see your children have a brighter future and the emotions to try to protect your parents. I think that is a debate that we do not want to get into.

I have concluded, and I think everybody that has looked at this problem has basically reached a conclusion, that we cannot solve this problem just by raising the payroll tax, that the kind of payroll taxes we are talking about, doubling the payroll tax over the next 25 years to pay for Social Security and Medicare, those kinds of payroll tax increases will have a dramatic and negative economic effect on the country, the economy, and our competitive position on the world market.

I think most people have also concluded that cutting benefits of the magnitude that would be required under the current system to keep the system solvent without a payroll tax increase would wear away, and perhaps destroy, the social fabric of the country.

So the point is, if you cannot raise taxes and deal with a problem because the tax increases are too big, if you cannot cut benefits and deal with the problem because you would fray the social fabric of society, what are the alternatives?

Well, we each have an alternative. I think the longer we all work on them, the more similar they become, which is encouraging to me.

But there are three pieces of very encouraging news. Number one. Three percent of payroll by a 22-year-old, invested in a broad-based portfolio of stocks and bonds over that 22-year-old's working life would yield him an asset that is valuable enough that, if converted into an annuity, would roughly equal their Social Security benefit.

Number two. The projected surplus is more than adequate to pay for the transition cost for at least 10, and probably 15, years, the transition cost to this investment-based system.

The third point is, it has already been done. It is not as if we are theorizing here. Australia did it under a labor government. Britain did it partially in its upper tier program under Margaret Thatcher. Chile has done it in a developing country.

In each and every case, benefits are more secure and benefits are more generous. We have a choice between staying in a system based on based on debt, where we have to raise payroll taxes and cut benefits continuously, or transitioning to a system based on wealth. That is basically what we are all recommending.

Two final points. Some people have taken the decline in the stock market in the last four or 5 months as being an indication that this investment in the market of retirement funds is inordinately risky.

The market would have to decline by 2,500 points for the rate of return over the last 5 years on equities to be insufficient to make the numbers that all three of these programs are talking about work.

Quite frankly, I think the flutter in the stock market has been a reminder that we are talking about making sound long-term investments. We should not get carried away with the idea that, based on the last four or 5 years, that we are going to make every worker an instant millionaire. So I think this can be turned into a positive in this debate and not a negative.

Finally, we believe that you need to structure the system where the benefits of investment, at least initially, largely go to paying off benefits to people in the current system. If we are going to sell people on an investment-based system, we are going to have a very hard time doing that in the context where most of the debate is about cutting benefits.

The CHAIRMAN. Senator Domenici?

STATEMENT OF HON. PETE DOMENICI, A U.S. SENATOR FROM NEW MEXICO

Senator DOMENICI. Thank you, Mr. Chairman and members of the committee.

Obviously, I think that when you look at what has happened over the last 6 or 8 months, there is a growing tendency to look at one very important fact with reference to Social Security in the future, and that is the power of compound interest. There seems to be an obvious understanding that we do not now harness the power of compound interest to any significant extent in the system we have got.

I might say, by way of background, the last forum was held in my home city in New Mexico. I might say to the committee, I was very pleased to note that one rather renowned economist who used to be against investing any of the Social Security money in bonds or the market, Henry Aaron, or Hank Aaron, has come full circle in that he now believes that we ought to harness the power of compound interest and invest part of it.

The only difference between his approach and the approach of everyone at this table, is that he would like the U.S. Government to establish a group that would do the investing for the people. In other words, let the government, through an entity, control the investment of all this money.

There is a lot of rationale for that reasoning, which you will hear as your proceedings go on and as you work into next year. I believe the arguments are not very positive and very significant as to why the government ought to invest the money versus personalized or privatization accounts.

My second point, is I agree wholeheartedly with Senator Gramm that, if we can, we ought not change the benefit system in order to have a better system, and a solvent system.

I think, when we are finished with our proposal, which can be melded with others—I do not claim that it is the absolute best—I think we will be able to prove, Mr. Chairman and fellow members, that you do not have to dramatically, or even significantly, change the current system of benefits, investing times, and the like if you have a proper investment of the 3 percent.

My last observation is this. What we do with our proposal that is significantly different, and I think everybody should know, is we reinvest part of the privatized account—in fact, a significant portion—in the trust fund so that you are making the trust fund solvent, more solvent, as this plan works. As Phil Gramm puts it, you are investing about 80 percent of the gain into the current beneficiaries who are a part of the system.

I believe, in the end, this issue is going to be the decisive issue: do you want the accounts to be totally owned and totally controlled and used by the beneficiaries, or do you want part of it to go to make the system solvent, thus using compounding of interest, so that you do not have to cut benefits significantly in incorporating a total new plan.

I would also comment that the President, at the meetings in Albuquerque, New Mexico, actually had some very interesting debates with those who would like the government to invest the money.

Now, he obviously left room to come down either way, but he actually did, in his typical excellent manner of debating an issue, concluded that the public would be very, very reluctant to see the U.S. Government establish the investing institution for all of this money, that it would far better be handled by individuals through properly certified companies.

Thank you very much, and thanks for letting us testify.

The CHAIRMAN. Thank you, Senator Domenici.

Now, time is going by rapidly because we started late. But I do want to give an opportunity, both to Senator Kerrey and Senator Breaux, to make any brief comments they may care to make.

Senator Kerrey?

OPENING STATEMENT OF HON. J. ROBERT KERREY, A U.S. SENATOR FROM NEBRASKA

Senator KERREY. Thank you, Mr. Chairman.

First of all, let me say that I think the most important thing is, you look at the Social Security program as to get your arms around what it is and what it is not. It is one of the most misunderstood programs that is on the books today.

Social Security is not a defined contribution program. In other words, it is not a paid pension. Lots of people believe that it is. It is not a rate of return program, it is a moral commitment. It is based upon our saying, this is the way we want our country to be.

So we have written a program that says, if you satisfy a test of age, test of disability, or a test of survivor, we are going to make a progressive payment to you and the source of that revenue will be a tax on people who are in the workforce. That is what it is. It is a strong intergenerational commitment.

It has broad support, but it is not a program that ever promised any rate of return. It is a program whose promise is connected to a moral commitment in our desire to have our country the way it is, which is you face retirement with a lot more dignity than you otherwise would have.

Second, I think it is very important to define the problem. There are two aspects of the problem, Mr. Chairman. The first, is that, according to the trustees, the current level of taxes will enable us to pay somewhere between two-thirds and 75 percent of the benefits in 2029.

That means if you are under the age of 45, expecting to live to be 75, or under the age of 35, that means that when you go to retire, your benefits cannot be paid by the current level of taxes. That is problem number one, so we have a promise on the table that we know we cannot keep.

The second problem, Mr. Chairman, is that Social Security does not dovetail to a general movement that is going on in the country of individuals who are managing their own plans for retirement.

I think it is very important to expand our view of Social Security to include personal savings and personal retirement, because most people consider both of those two things when they are considering their retirement options.

What is going on in the country is quite remarkable. We now have 25 million Americans in the workforce with 401(k) accounts. In 1980, Mr. Chairman, 6 percent of Americans were in mutual funds, and it is almost 40 percent of Americans today. So, there is a movement that is going on.

One of the arguments that critics of this proposal will make, is that Wall Street is driving this deal. Wall Street is now. Wall Street is in town trying to get financial services deregulation. They are not down here talking about Social Security changes.

What is driving this thing, are individuals in the country who are increasingly going to 401(k)s, going to mutual funds. They have the sophistication, they understand what is at stake, and you see it in almost every walk of life, Mr. Chairman.

That is what is producing this movement, the citizens themselves saying that we understand that when we hear politicians talk about the rich getting richer and the poor getting poorer, that there is a solution to this problem. One of the most frustrating groups of people that I deal with are so-called liberals who say they do not want to change the law to give people an opportunity to acquire wealth.

Well, I say, you either talk about the rich getting richer and the poor getting poorer and want to do something about it, or just keep talking. All of these proposals are united, not by a desire to create savings, but by a desire to help the average American who works very hard acquire wealth. That is the goal here. The goal is the acquisition of wealth, the security that comes with that wealth, and all other sorts of values that come with that wealth as well.

My poster child in the entire effort is a woman by the name of Osceola McCarty from Hattisburg, Mississippi, who worked for 70-some years. When she finally quit working as a washerwoman, she left Southern Mississippi University close to $200,000 cash.

When they asked her where she got all that wealth, she said, it is simple: it is the magic of compounding interest rates. On that basis, she could be chairman of the Federal Reserve because she understands more than most people do about simple economics.

What was extraordinary about this, is she then acquires the capacity for inspirational generosity, to help other people acquire things that she wants them to be able to acquire, establishing a scholarship program for young people.

So there are values that come with the acquisition of wealth, Mr. Chairman, that I think needs to be considered. Our proposal, as does Senator Gregg's and Senator Breaux's, keeps the defined benefit program in place for old age, survivor, and disability and adds a wealth component. So, Social Security would become WOASDI. That is essentially what we describe.

As Senator Moynihan and Senator Gregg already described, we do fully pay for ours. Ours has been fully funded and analyzed by the actuaries at the Social Security Administration and is a fully paid for program.

As both Senators Domenici and Gramm have said, there is, I think, a very good possibility that we could bring all of these together. I am very much encouraged that you are holding these hearings, and very much encouraged that there are an increasing number of members in the Senate who are looking at this.

But what encouraged me most, Mr. Chairman, as I said earlier, is the increasing number of Americans who have already got it, who already understand this, who are already managing their own retirements by acquiring wealth through 401(k)s and mutual funds.

[The prepared statement of Senator Kerrey appears in the appendix.]

The CHAIRMAN. Thank you, Senator Kerrey.

Senator Breaux?

OPENING STATEMENT OF HON. JOHN BREAUX, A U.S. SENATOR FROM LOUISIANA

Senator BREAUX. Thank you very much, Mr. Chairman. I am, indeed, honored to be part of this panel to present some ideas.

I think there is obviously a great deal of talent in this room, from an elected standpoint, that should be able to come up, I think, with the answers to this national problem.

The good thing that we have here today, is that this is not a group of Democrats or only a group of Republicans talking about this. We have a bipartisan group who have come together with some principles about addressing this problem.

For years, we have all sat on that side of the table and listened to witness after witness that has come up before various committees in Congress and said, Congressman or Senator, fix Social Security but do not increase my premiums. Fix Social Security, but do not cut my benefits. Fix Social Security, but do not means test it. Fix Social Security, but do not increase the eligibility age. But, Senator, fix it.

So what people have done, is to take most of the options off of the table. We have politicized the process so much that, up until this point, we have never been able to come together and come up with common ideas about how to solve this problem.

I think what you see here today is some common ideas that are coming from both parties. I think we have shown that there is in the Congress in this cycle the political courage to be able to argue, talk about, and debate these various options. I think we have a great deal in common with what we are suggesting.

So let me just outline. And I will not take a lot of time because I think my colleague, Judd Gregg, he and I, as he said, served as co-chairs, along with Congressman Colbey and Congressman Stenholm in the House, of a measure that took 15 months to come up with, with a great deal of talent. Not us, but a great deal of economic talent was involved in this process and we have a bill that has been introduced as S. 2313 in the Senate. It has also been introduced in the House.

The principles are quite simple. We refund two percentage points of the 12.4 percent payroll tax to allow people to create their own private investment account, much like Federal employees have.

We will establish a risk account, an investment account, that they have, a thrift savings plan, if you will, a high-risk plan, a medium-risk plan, and a low-risk plan.

While Social Security has been returning 2.7 percent on their investments, the Federal plan, under the high risk, last year returned 41 percent. The average for the high, low, and medium accounts have been about 15 percent over the last 10 years.

So what we are saying, is that everyone should have the same opportunity as Federal employees have, to be able to control, to own, to direct where their money is going to be invested. Not the whole amount, not to totally privatize it, but to take a very small part, to give people a sense that this belongs to them and that they have an interest in it.

There is no wonder why young people think that it is never going to work because they do not really have any ties to it directly. This would go a long way towards giving them direct control over their investments. It would create a non-forfeitable ownership plan for them to be able to inherit. Our plan has been scored as being actuarily solvent, which is obviously one of the big tests.

We would gradually increase the retirement age to 70. If you go to many of the senior groups, and we talk about it, and when I tell them it affects none of them, they say, oh, really? It does not. It affects people younger than me. No one, really, 55 or over would be affected by our recommendation. But it would affect younger people. We would gradually increase the retirement age 2 months a year for the next 30 years. Two months a year, merely reflecting that people live longer and can have active lives for a much longer period of time.

We would create a new minimum benefit provision that ensures that no one who works within the system for 40 years would ever have a benefit package that still allows them to be in poverty, to make sure that no one would live in poverty if they participate in this plan.

So I think we all have a great deal in common. I think we are all moving in the same general direction. These people here have spent a long time on it and they know the history of these programs. But I think, when we come back in the next session, it really is time for us to move. I think we can do it collectively and in a bipartisan fashion.

Thank you.

The CHAIRMAN. Thank you, Senator Breaux.

I am going to ask each of the Senators to limit their questions to 5 minutes, because we do have a very important second panel.

I have two questions I would like to ask. A number of you have discussed about the importance of a bipartisan consensus. Now, we have a number of different proposals. You have three listed by the panel before us; the second panel will have a number of other recommendations.

My question is, if we are going to expedite action, how do we reach a bipartisan consensus? What recommendations do you have that this committee do to achieve that goal? Senator Moynihan?

Senator MOYNIHAN. Mr. Chairman, if I could just point out that Senator Domenici, I believe, said we are getting closer, Senator Gramm said the same thing. Senators Gregg and Breaux put together their bill. Ours was the first bill in this sequence. But we now have a set of common provisions which make up most of the legislation. We find it can be done. We are doing it.

The CHAIRMAN. Thank you.

Senator KERREY. Mr. Chairman, I would recommend that you pick a bill and mark it up. [Laughter.]

The CHAIRMAN. I thank you for that recommendation. [Laughter.]

Senator BREAUX. I do not know, Mr. Chairman. If you and the Ranking Member, Senator Moynihan, could kind of take the best of the ideas that have been presented and come up with a package, I think it would be an excellent place to start.

The CHAIRMAN. All right. Senator Gregg?

Senator GREGG. Well, I think we have to face reality, which is that Social Security has, unfortunately, been used as a political club over the years. You cannot reach a consensus on this issue unless you do do it in a bipartisan way, and you are going to have to have White House participation.

So I believe we need to create a forum where the leadership of this committee, those in the Congress who are playing an active role, and the White House can reach cloture on what type of language can be agreed on. I believe all the language is on the table.

There is a tremendous menu on the table. It is easy enough, quite honestly, to pull it together into a meal. But to do that, you have got to get everybody around the table. Somehow you have got to structure an event which gets everybody around the table.

I know the President has talked about some sort of meeting in December, but I am not sure its purposes are to get finality on language. But I would like to see such a meeting for the purposes of getting to some sort of working document around which this committee could mark up.

The CHAIRMAN. Senator Gramm.

Senator GRAMM. Well, Mr. Chairman, I think we are already beginning to see the plans merge. I think when you start out studying this problem, it looks like there are many different avenues of approach. But I guess being in the second year of focusing in on it, I think the more you understand it, the more you tend to have your thoughts channel in certain directions.

So I think this thing can be worked out and I think what we have got to do is to get together, sit down around the same table, look at all of the ideas that have been proposed, and basically go through and try to ferret out, given the task we face in changing the most popular program in American history, and the most loved program in American history, what can we do that will solve the problem and what can we come behind.

I think, again, I see more and more commonality among these proposals as we get into it, and I think that a consensus can be worked out.

The CHAIRMAN. Finally, Senator Domenici.

Senator DOMENICI. Well, Mr. Chairman, I thought 6 months ago, a year ago, that it was not going to be possible to have a broad consensus that is bipartisan, but I am currently of the opposite persuasion. I believe it is possible if we do not let the well get poisoned, if we keep our powder dry, and the committee keep its options open and really begin to look at the proposals and start ferreting out, what are the similarities, where are the areas that are different, and then have some really bona fide discussions about that.

I am not a strong advocate of ad hoc committees; I have been on enough in my life. But I kind of look at your committee, Mr. Chairman, and think you are a pretty good cross-section of this institution and I think you ought to keep it within this committee, but be very open to input.

The CHAIRMAN. Thank you, Senator Domenici.

Let me ask one final, quick question. All of you have proposed some form of an investment option. Now, there have been a lot of market gyrations the last few days. Has that changed any of your views with respect to your recommendation?

Senator BREAUX. Mr. Chairman, I think that is a good point because people have said, well, would you have wanted to have this in the market last Monday, whenever it dropped 500 points or so. You have to look at it in the long term. If you look at the facts, and we debated this a lot in the commission hearings that we had. From 1926 to 1996, there was no 20-year period in the stock market with a negative return.

If you are looking at these investments in the long term for investments, you are not talking about investing for 1 year, 1 month, or 1 day. You are looking at someone putting these into these types of investments over the lifetime that they are employed.

There has been no 20-year period in the market's history where there has been a negative return. I would daresay that, over those periods, it has been much greater than what we are getting in the current 2.7 percent return in government bonds.

Senator GRAMM. Mr. Chairman?

The CHAIRMAN. Senator Gramm.

Senator GRAMM. Let me just say that everybody is basically working off the same data period. We are looking at the past to try to see the future. When you go back to 1926, which most of the good data does, you have got the Great Depression, you have got four major recessions, you have got a world war. Except for a civil war, you have got every event in American history.

Second, even with the decline in the market in the last five or 6 months, the last 5 years as a whole is still a remarkable period which far outpaces the historic norm and, in fact, in our data we have thrown out the last 5 years because the numbers are simply so big that we think it is better to cut off the thing at 1992 and 1993.

But people look at the experience of the last 6 months and forget that the market would have to decline another 2,500 points for the rate of return to slip below double digits in the last 5 years. So, if you invested in the last 5 years, you have made tremendous amounts of money.

I think, again, as I said, I see a positive in this. I think there are some people who tend to look at these big returns of the recent past and say, we can make everybody a millionaire. That is not what we are talking about. We are talking about a sound, solid investment where there is wealth and where it grows rather than where there is debt and there is no real growth at all.

Senator GREGG. I think the important thing to remember is that if you are 20 years old today entering the workforce, your rate of return on the taxes you pay in Social Security will probably be a negative number. In other words, you will pay more in taxes than you will get back out of the Social Security system.

If you go this route we propose, these personal accounts, your rate of return is going to be 40 years, compounded interest, on 2 percent, 3 percent, or whatever the investment is that you are allowed, and you know it is going to be huge, it is going to be significant, and it is going to be a lot better than a negative return.

Senator KERREY. Mr. Chairman, I would recommend, to get a good answer for that question, to invite some employees of the Federal Government who are in the Thrift Savings program up and ask them, how do they feel about it; do they want to abolish the program because the market went down? I think what you will get are some real interesting responses.

First of all, they are going to say, no, and here is how we are managing it. I think it would be very useful for the American people to see that there are an awful lot of people out there who are managing their own accounts and creating wealth for themselves as a result.

If the answer to the question is, yes, you want Social Security to become a source of wealth, I think in addition to the question that you are raising, Mr. Chairman, I think there are also some questions about, do you want to get the accounts opened early. We have a companion piece of legislation that opens a $1,000 account and contributes $500 for the first 5 years.

Do you want to address the differential that will exist as a result of a fixed percentage, giving more to people with higher incomes than it does for people with lower incomes by making the contribution more progressive?

I mean, there are other elements that can be addressed in addition to the one you are asking about, the rate of return, and there is also a question about management and keeping the program simple enough so that the administrative costs are low.

But the threshold question is, do you want people to have an opportunity, through this program, to acquire wealth?

Senator DOMENICI. Mr. Chairman?

The CHAIRMAN. Senator Domenici. My time is up, so please be brief.

Senator DOMENICI. I think your question is a most important question right now because I believe the atmosphere is getting poisoned already. I already have some local political people in my State, who have changed their mind publicly and are no longer for personalized accounts, who are running for office. They were four months ago, and they say the stock market drop changed our minds. Now, obviously, they did not understand the program to begin with and what we were doing. But I think it is important.

My suggestion is that your committee, and anyone else that can, begin to do the best explanation on this issue as we can. We take this issue for granted. I think it has to be explained and we have to have some simple ways of letting people understand the long-term investment is not going to be determined by the last two or three gyrations, or even the gyrations of the past 50 years. We have got to make the case better than we are, because I think we will start losing support, in my opinion.

Senator MOYNIHAN. Yes.

The CHAIRMAN. I think your point is well taken.

Senator Bryan?

Senator BRYAN. Thank you very much, Mr. Chairman, for convening these hearings. I think we owe a special debt of gratitude to our colleagues for their thoughtful presentations this morning.

Like many of you, I have just returned from a month in my State, 3,000 miles, traveling to dozens of small communities. It my sense that the American people are beginning to understand that the Social Security system in the future is going to have to change. I think we have kind of crossed the rubicon on that.

Their concern is, how does the transition occur; at what point does the new system, whatever it is, plug in; who is going to be part of the new, who is going to be part of the old?

Those who are a bit more sophisticated ask, how do we pay for this transitional period of time? With the life expectancy in America growing, there are going to be people that, for decades yet to come, are going to be part of our old system, even at the time that we plug in the new system. So, let me ask each of you contemplate that transition would occur.

Senator MOYNIHAN. Mr. Chairman, if I could speak as someone who was on the 1983 Greenspan Commission with Senator Dole. It is a matter that is not fully understood and not always easy to understand, but we put in place at that time a partially funded system such that the actual payments of Social Security have been considerably lower than the revenue that comes in from the payroll tax. Although, theoretically, this money goes into government bonds, in fact, it is spent for ongoing government activities that have nothing to do with Social Security.

What we are in a position to do now, since we have basically balanced our budget, the income/outcome is in basic balance, finally, once again, is we can cut payroll taxes by 2 percentage points and give the worker the option of keeping—you can take it down 2 percent, two full percentage points.

The workers would then be given two options: either the 2 percentage points goes into a thrift savings plan or the worker keeps 1 percentage point. Economists will tell you that eventually wages will go up if the employer does not have to put another percent into the payroll tax. The transition is easy: it is a tax cut.

Senator BRYAN. Senator Breaux? Senator Gregg?

Senator GREGG. Well, the transition is a tax cut in ours, also. That is how it is paid for. But your question of how it is phased in is a good one, and that really is up to this committee. There are all sorts of different ways you can do it.

In our bill, we phase in eligibility requirements over 30 years. We also say to people who are over 55, you will absolutely not be affected at all. Your present system is what you are going to get. You have the option of going to personal savings accounts if you want, but we do not ask you to do it, we do not tell you you have to do it. So, anybody over 55 is protected.

Basically, our system is targeted on making sure that people who are under the age of 40 are phased into a system effectively where they can anticipate where they will have, literally, 20, 30, 40 years to anticipate what their benefit structure is going to look like and to be saving, and to have savings creating wealth for them.

So it is a very doable event, it is simply a question of working numbers and having the desire, setting out the parameters of what you want to do and then getting to them.

Senator GRAMM. Well, our basic approach is, if we are going to sell this thing, we are going to have to give people a choice. We are going to have to say to anybody who holds a Social Security card on January 1, 2000, you can either go into the new system or you can stay in the old system.

What we are going to have to do over the ensuing years, if people opt to stay in the old system, we are going to have to have resources to pay their benefits. How, basically, our system works is for the people who go into the new system, 3 percentage points of their wages go into real investments and we make up that loss to the Social Security by taking the current surplus, or at least a portion of it, and having that make up the difference.

Second, when people retire with a joint retirement, because under our system, for the people who opt into the new system, unless they are in the system for an extended period of time, they are going to end up getting benefits from both the old system and the new system.

But all of the savings that occur to the old system as these levels of investment build up and displace current payroll funding, all of those, or 80 percent of those savings under our system, go to the old system to pay off these benefits.

We have concluded, and it is a political decision but we think it is an important one, and obviously this is a thing that we have to prove and that we have to work out as we come to a consensus, that we have got to be in a position, to the maximum extent possible, to hold people harmless who do not want to participate in the new program. What that means, is that most of the benefits of the transition will go to people in the old system.

The benefits to my two sons will not be dramatically higher returns. The benefits to my 22- and 24-year-old sons will be: (A) their payroll tax will not go up, and (B) we are not going to cut their grandmother's and their pop's Social Security benefits. That is how we approach it. But we need a substantial part, if not the entire surplus, to make ours work.

Senator BRYAN. Thank you very much, gentlemen. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Graham?

Senator GRAHAM. Thank you, and thank the panelists for an extremely interesting presentation. I would like to ask, first, a question of Senator Moynihan, who mentioned that he had served on the 1983 Commission on Social Security Reform.

Could you tell us, what has happened in the intervening 15 years that was unexpected by your commission? We are back at this issue again, 15 years later. So, assumedly, there were some alterations in the demographic, economic, or cultural landscape that caused the decisions made in 1983 not to have had the intended long-term effect.

Senator MOYNIHAN. Yes, sir. Senator, I can say that, and with some confidence. In 1983, we had a crisis. Mr. Myers is here, and he can so assert or tell me if I am wrong. We knew we had a crisis because he said we had a crisis. [Laughter.] After all, it was his legislation from 1935.

In the late 1970's, in that period of great inflation, for the first time in our history, wages increases fell behind price increases, is that not right, Bob?

Mr. MYERS. Yes.

Senator MOYNIHAN. That had never happened before. So, suddenly, since we had indexed the outgoing benefits in 1972 to the consumer price index, which is over-indexed, the payroll contributions coming in were falling behind the outlay.

We were getting down, down, down to a very difficult point where, in fact, there could come a time very shortly at hand when we would be a day late. Now, we were not going to go bankrupt, but Mr. Stockman did say in 1 year's time we would see the world's largest bankruptcy. We might be a day late or 2 days late, but the Social Security system was not in bankruptcy.

Now, this is the point I would make to the committee and to my colleagues. That has all resolved itself. We are in a stable moment. What we are looking at now, what Senator Gramm will insist, is we are looking at a demographic tsunami waiting to hit us and we had better be prepared for it. Now is the time to do it because we are not in a crisis. That is a hard, hard argument to make, I know, but I think we agree.

Did I satisfy you?

Senator GRAHAM. I would look forward to an opportunity to continue to pursue that inquiry to better understand what were the goals of 1983, and what were the intervening factors that caused those objectives to fall short, what can we learn from that experience as we approach this problem again.

Senator MOYNIHAN. Yes.

Senator GRAHAM. Let me ask a second question of any member of the panel who would like to comment on it. I think I look at the issue of Social Security reform as a subset of a larger issue. That larger issue is retirement security reform.

The average American gets about 40 percent of his or her retirement income from Social Security, the other 60 percent comes from employer-based pensions, return on personal savings, or earnings through employment while they are in retirement.

My question is, as you look at this subset issue, Social Security reform, in that larger context, are there any changes that your reforms in Social Security would indicate would be appropriate for public policy in the non-Social Security components of retirement security?

That is, is there anything we should do in things like public policy on employer-based pensions, or on earning levels for people in retirement as a consequence of what you are suggesting be done to the Social Security system?

Senator KERREY. Well, I would answer, emphatically, yes, Senator. In fact, you have got a piece of legislation dealing with the reforming of pensions, making it easier for businesses to establish pensions. I think you do have to step back and look at the overall picture that individuals themselves are facing.

I think it is also very important to define the goal. That is why I keep saying it. My objective is to try to change the laws so, through individual savings, through private pensions, and through Social Security an individual, over the course of their working life, can accumulate wealth. That is the goal.

I think when you do that, it leads to an examination of whether or not there needs to be some kind of a progressive contribution or something that would more progressively benefit that lower wage worker that is extremely important in our economy, but may not benefit if all you do is use a flat percentage.

So I think you are exactly right, to do Social Security outside the context of private pension and savings would be a mistake.

Senator GRAHAM. Do you think the issue of risk should be thought of as a commodity to be equally distributed among those sources of retirement income, or should one component of that mix of retirement income be more or less risk averse, and if so, what component?

Senator KERREY. Well, my answer is, yes, I think there should be a piece of it that is less risk averse and that is why, in our proposal, we maintain a defined benefit for all three, old age, survivor, and disability.

Senator GRAMM. Well, anything you do to make it easier for people to save is going to be beneficial in terms of building up cf private retirement, no question about that.

Senator GREGG. We also, as part of our proposal, has a complex and fairly extensive package on the private benefits, so we did address both because we felt they were dovetailed.

On the risk issue, our package says we have a minimum benefit which exceeds the present Social Security minimum benefit. Our proposal was more progressive to the present Social Security structure. So, yes, we do feel that nobody should fall below the minimum benefit and that that should be risk averse.

Senator GRAHAM. Thank you.

The CHAIRMAN. Senator Mack?

Senator MACK. Thank you, Mr. Chairman.

I, too, appreciate the work that you all have done. I think that you have clearly helped to begin the discussion in the country as a result of your work, so I congratulate you for that.

I must say, though, that I am a little bit puzzled, and I think most of my colleagues know that I have been somewhat of a champion for reducing taxes. But, as you laid out kind of the present situation, I do remember someone saying something to the effect that the unfunded liability is somewhere in the neighborhood of $10 trillion, and most of us cannot really comprehend what that really is.

A question was asked about the transition, how do you handle the transition. The response was, we cut taxes. At least, that is what I thought I heard.

Senator MOYNIHAN. I said it.

Senator MACK. All right. How is the average person going to understand that, that we have got a $10 trillion unfunded liability, and the way we are going to handle it is to cut taxes?

Senator GREGG. Well, there are two ways it is handled. Number one, you do use the surplus to reduce taxes, invest it in private accounts, and, because you are getting a much better rate of return on your private accounts than you are on the Social Security Administration, you are generating a bigger pool of money that is available for retirement and, therefore, you benefit people.

Senator MACK. Senator Moynihan, do you agree with that?

Senator MOYNIHAN. I do. And if you will just make that correction in the cost-of-living adjustment you reduce liabilities.

Senator KERREY. But I also think it is very important to understand that, to get a final answer to your question, every proposal needs to be sent to the Social Security Administration actuaries.

Senator MACK. Say that again. I am sorry.

Senator KERREY. Every proposal that is examined by this committee, I believe, should also have been examined by the actuaries at the Social Security Administration.

Senator MOYNIHAN. Which we have done on ours.

Senator KERREY. What you do have to do, Senator, is to reduce future liabilities. You do have to do both simultaneously. One of the most important things that I believe that is a common element in all of ours is that we all go back to a pay-as-you-go system. We are currently paying into our system $88 billion—I think that is the number—annually, more than what is needed to pay the bills.

We started doing that in 1983 because the idea was we were going to prefund the baby boom generation. Well, obviously we did not. Congress does not have the discipline to set that money aside, so we go back to a pay-as-you-go system, reduce future liabilities.

But, most importantly, when a citizen in Nebraska asks me that question after I have gone through all of the programmatic changes that I make, is do not trust me, you have got to send the thing to the Social Security Administration and ask them the question: do the changes that are in the piece of legislation reduce the future liability enough that the problem itself is solved, and the problem being that all beneficiaries are going to get the promise that we have on the table.

Senator MACK. Let me try this, and then I will let Phil respond. I think what you are saying, and I am just trying to find a way that the average person is going to understand how this is going to work, that paying benefits in the future, that pool of funds necessary to do that can come basically from two sources. It can come from the taxes collected from individuals or it will come as a result of earnings of investments that have been made.

What we are talking about here, is what combination is the right combination to provide the best benefit level to retirees. Is that a fair statement?

Senator GRAMM. Let me respond in the following way. You can view letting the worker invest a percentage of their wage as a tax cut. Certainly, from the point of view of a young worker that does not expect anything from the current Social Security system, the fact that three percent of their wages are going into investments that they own represents to them a change in their wealth position.

But where the benefits come in paying off the unfunded liability, is that as those investments build up and pay benefits to that individual worker, not based on payroll taxes collected at the time but based on the value of the wealth they have accumulated, that money that would have gone to pay them under the existing system can go to pay off part of the liabilities of the existing system.

So, for example, under our program, in 14 years, someone who has been in the program for 14 years, if they retire, their annuity already covers 10 percent of their benefit. That is 10 percent that nobody in the future ever has to pay a payroll tax to pay. That is a permanent solution, to that percentage of the problem for that retiree. Someone mentioned the baby boom generation.

If we start the program in the year 2000, the first baby boomers will have investments that will fund about 10 percent of their retirement, and the last baby boomers will have investments that will fund about half of their retirement. That is the solution.

Senator MACK. Yes.

Senator GREGG. A last point, Senator Mack. I think that is true of their plan. Our plans are a little different. We use the adjustments in the benefit structure to also assist in the funding transition, which is the point Senator Moynihan was making.

Senator MACK. Yes. My last point, Mr. Chairman, and I would ask Senator Moynihan.

The CHAIRMAN. Yes.

Senator MACK. Is your proposal actually a net reduction in ~~taxes~~? Do you not increase the wage base?

Senator MOYNIHAN. We do somewhat, getting it closer to the traditional ratio of taxing about 90 percent of covered wages. In our bill we tax 87 percent; under current law 84 percent is taxed. So there is this increase.

Senator BREAUX. Ours does not.

Senator MACK. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Rockefeller?

Senator ROCKEFELLER. Mr. Chairman, thank you. One-half of the panel is on the Medicare Commission. Since we have spent most of the last 24 hours together anyway, I thought I might just ask my friend, Bob Kerrey, a question.

Senator KERREY. We have become friends again. [Laughter.]

Senator ROCKEFELLER This is practical and parochial and has nothing to do with defining the problem. The State that I represent, West Virginia, has now passed Florida as the oldest population State in the country, 36.4 years.

The average senior, as you have heard me say not only in this forum but in the other forum a number of times, makes about $10,600 a year from all sources of income, and then about $2,600 of that goes to medical expenses, leaving about $8,000 to spend on everything.

Now, my understanding is, in the plan that you and Senator Moynihan have presented, there has been a little bit more freedom of the individual, or responsibility of the individual, to make investment decisions.

In the Medicare Commission, one of the things that we have decided is that people really do not understand Medicare very well. They understand a fee-for-service system to the extent that they are confronted with it, Medicare choices, all of those things are very complicated. Investing is an entirely different world, a world which these folks have never entered before.

How does that senior in West Virginia make a decision about investing which is likely to inure more to his or her benefit than that which is done more institutionally, suggested by some of the other plans? I need guidance on this issue.

Senator KERREY. I am here to help you, Senator, to guide you through this one. Back to my answer earlier to the Chairman's question. I think it would be very useful for our committee to bring in some individuals who are both current beneficiaries, as well as some people who can explain the current benefit formula.

It is very much like Medicare. Medicare is viewed by many people to be a very generous program. You and I know, when you are out there paying the bills, it does not look very generous. Social Security is the same way. There is a growing percentage of people out there who are looking to Social Security as their only source of income, and it is a relatively small benefit. It is a relatively small monthly payment, $700 a month, in Nebraska. We have got almost two-thirds of our people that have 90 percent of their income or more as Social Security. So, it does not put an individual in the lap of luxury.

I think if we can get, in a calm way, Senator, a look at the lives of individuals who are turning increasingly to Social Security as their only source of income, I think a number of things will happen.

One, I think we will examine the possibility in a context, as Senator Gramm has said, of all retirement programs, personal savings, individual retirement programs in the workplace, you have got to see it all together.

I do, as well, think that it leads you to the conclusion that, somehow, whether you eliminate the risk altogether and require that it all go into Treasury bonds for that individual, or a savings account. I mean, Osceola McCarty put it in CDs and accumulated wealth that way.

Whatever way you do it, I think what it will cause you to see is that to promise somebody only Social Security and encourage them to think that all they ought to fight for is to maintain the Social Security program, I think, is a cruel promise because it is inadequate. All by itself, it is inadequate.

Senator ROCKEFELLER. Senator, I am not disputing that.

Senator KERREY. I did not clarify?

Senator ROCKEFELLER. I think that the possibility that, as Senator Gramm has suggested has possibility to it. But, in the meantime, we are not likely to link up all of these income security programs and we are dealing on a fairly urgent basis with the question of, how do we do Social Security.

I come back, therefore, to the question of the individual West Virginian, unaccustomed to making investment decisions, entirely unaware of market conditions, isolated in many rural hollows.

Senator MOYNIHAN. Could I make a suggestion?

Senator ROCKEFELLER. Please, sir.

Senator MOYNIHAN. I believe, and perhaps I am mistaken, but I understand that there are a considerable number of Federal employees in West Virginia, and that this has been a matter of some special concern to the West Virginia senatorial delegation. But why do we not ask some of those Federal employees how they pick their thrift savings plan?

Senator ROCKEFELLER. But, Senator Moynihan, that does not really answer my question, sir, because there are some and they are located mostly in the eastern part of the State. But they are not typical. They are not representative.

Senator KERREY. Senator, the threshold question that you are really getting to is an educational issue, it is a risk issue. All those can be addressed, they really can. I do not underestimate the difficulty of it. I think there is an educational component that has to be a part of this.

I do think that we have got to keep the administrative costs low. We have got to keep it relatively simple, not only from the standpoint of the issue you are raising of risk, but just from the standpoint of confusion.

But the threshold that I think is important to cross is not one that says, gee, there is an urgent crisis with Social Security, because there is not. I mean, 2029 is a long ways away. Social Security, as Senator Moynihan said, even then it is not going to be bankrupt, we are just not going to be able to pay the full benefits.

If you answer the question, yes, I would like to help low- and moderate-income people who are in the workforce acquire wealth, there is an urgency attached to getting the program started as soon as possible, because if you can design it simply and do the education component as you are suggesting, the sooner those accounts get open, the more likely it is that those individuals have a chance to take advantage of compounding interest rates.

The CHAIRMAN. The gentleman's time is up. I would call on Senator Chafee.

Senator CHAFEE. Thank you very much, Mr. Chairman. One of the questioned posed was, do you think this can come about, these changes. I believe they can come about. Obviously, we all know there is going to be some demagoguery on this, but I have confidence that, with the distinguished group that is before us, plus the efforts of this committee, that we can put across something like this. Now, I am not speaking for the House; I do not know enough about that. But for the Senate, I think you can.

Many here remember, Senator Breaux certainly does, when we brought forth provisions that had some tough measures in them involving changes in the CPI. We got 46 votes, just out of the blue, and nobody ever suffered from that, that I am aware of, as a result of those votes.

So I would like to just take a quick poll here, if I could. How many of your plans involve a new look at the CPI? Yours does, does it not?

Senator MOYNIHAN. Yes.

Senator KERREY. Yes.

Senator CHAFEE. How many involve an increase in the retirement age? Now the retirement age goes to 67 by the year 2000.

Senator KERREY. Senator, if I could just interrupt and change your question, if you would not mind. Over 50 percent now of people who are retiring with Social Security are using the early eligibility moment of 62. They are retiring at 62. So 65 is actually an eligibility age, it is not a retirement age.

Senator CHAFEE. All right.

Senator MOYNIHAN. Sir, our increase to age 70 is for the year 2073.

Senator CHAFEE. Wow. I can hardly envision. [Laughter.] I do not think I will be here to cross examine you on whether we have met the date or not. In any event, I personally believe those have to take place.

Let me ask you another question. This I would ask each of you to briefly answer, if you could. If we are going to have this privatization, if you would, or individual accounts, is there such a thing as over-investment in the stock market? In other words, too many dollars chasing too few opportunities? We are talking such massive sums here, beyond anything that the Federal Employees Thrift Plan has. Is that a possibility, or the more money the merrier, the better off we all are? I will just ask each of you quickly. Do not make the answers too long.

Senator Breaux?

Senator BREAUX. Well, I think 2 percent is not going to create a problem. That is why we decided, arguing about total privatization, we selectively said only 2 percent of the 12.4 percent.

I think that Jay Rockefeller's question was really good. Jay, the point of that retired person in West Virginia making the investment, really, he or she is not going to be making the investment, it will be the young working person who will be making that decision. We have given them three choices: a high-risk, a low-risk, and a medium-risk account.

Senator CHAFEE. Sort of like the Federal Employees Thrift Plan.

Senator BREAUX. Patterned right after that.

Senator CHAFEE. All right.

Senator Gramm, is there such a thing as too many dollars going into the market?

Senator GRAMM. Well, we have looked at this very closely because our plan is a change in the system, not filling up the gap with taxes or spending cuts so that, in working with the actuaries, I think we have pretty good agreement at this point that, for 35 years, the build-up of capital relative to the market itself is small enough that you would not have to make any assumptions about a change in the marginal rate of return.

I think the general feeling is, beyond that period, that you could expect some downward pressure on the marginal rate of return on capital, which is a positive thing. It means there is more capital. It means it is cheaper to build homes, new farms, new factories. As Judd said, but not into the microphone, you cannot have too much capital.

The second thing is that we, in trying to do our estimates, we have to do an estimate about how much of these investments are going to spill abroad, for example. At the end of 35 years, these numbers are going to start to adjust, but nothing that would threaten the viability of the system. There are problems with a massive growth in capital, but they are small relative to no growth in capital.

Senator CHAFEE. All right. Now, you all know that Social Security is more than the retirement plan, it is also a disability plan. Have you taken that into consideration? Just yes or no. I assume the answer is yes.

Senator MOYNIHAN. Yes.

Senator BREAUX. Our plan creates a commission that maintains the present, but asks for an expedited commission to make recommendations on how to revise and improve the disability program.

Senator DOMENICI. We kept it in.

Senator CHAFEE. Now, all of the plans, quickly, have an outside advisor in the investment portion of it, I presume, sort of like the Federal Employees Thrift Plan. You do not have the individual making those decisions, him or her, themselves; is that correct?

Senator MOYNIHAN. The Social Security Administration will have a panel to do it.

Senator CHAFEE. I see.

Senator GRAMM. We have a Social Security investment board that will do that.

Senator CHAFEE. All right. Fine. Thank you very much.

The CHAIRMAN. Senator Conrad?

Senator CONRAD. Thank you, Mr. Chairman. Thank you for holding this hearing, and thank all the members of this panel for the special efforts that you have made, especially Senator Moynihan, for special efforts over a very long period to strengthen the Social Security system.

I think all of us understand there is a clear need for reform that we face, the demographic time bomb of the baby boom generation, and that there is a clear need for reform. I have been sympathetic to the notion of exploring private accounts to get a better rate of return. It seems to me to make some very great sense.

But I heard some things this morning that I must say troubled me. When the question was raised, I think by Senator Bryan, about how you pay for this, because there is a transition.

Obviously, we already have a hole to fill here and that is one reason we are looking at reform, because we have got a shortfall in meeting future obligations. When the question is asked, how do you pay for the shortfall, I think Senator Mack pursued this.

The answer that several gave was, we are going to pay for it with a tax cut. I will tell you, honestly, I find that jarring because I do not believe it. I just do not believe that we are going to pay for what is already a shortfall and we are going to provide a new avenue. We are going to set aside money so people can put it in private accounts, which actually digs the hole deeper, and that we are paying for it with a tax cut. I mean, is that really the language we want to use here?

Senator KERREY. Senator, if I could take a shot at it.

Senator CONRAD. Yes.

Senator KERREY. First of all, we are all a little bit confined in what we can say because of the brief remarks that we can give in answer to your questions. But, second, the overall transaction in, I think, all three of the proposals that are here, is that a younger person says, I will take a changed program in exchange for an opportunity to accumulate wealth.

So if you are over the age of 65 in all of these proposals, you are not impacted. It does not have an impact. In Senator Gregg and Senator Breaux's, it is 55. There is no impact at all. But for the younger person, we reduce the liability by reducing their future benefits.

But, in exchange for that, they have the opportunity to acquire wealth. And they can measure it. Just look at the numbers. Even in a safe account. Even if you were to deal with Senator Chafee's concern by saying, just change the law and say it has got to go into a CD.

In other words, that is the first transaction. I do accept, if I am under the age of 35, a lower benefit. And, by the way, the Social Security Administration right now is saying I am going to get a 30 percent cut anyway out there in the future, which critics very often do not evaluate.

The next thing I would say, Senator, is that the two percent tax cut is really the money that is available for the savings, so instead of going into the program, it goes into an individual account and those individual accounts are then owned by that individual.

Senator CONRAD. Let me just say, I find that a more credible description of what we are doing.

Senator GREGG. I think that all of these plans approach it differently, and the Gramm-Domenici plan approaches it significantly differently than our plan does.

But, essentially, you have got to remember, for each point that we reduced the tax burden under Social Security, that is about $27 billion. So you get can, with a surplus in the system, about $60 billion. You can get two points without any great problem, and you are taking that and investing it. As you move into the out years, you have to do a benefit structure change.

Senator CONRAD. But it is not important to say to people honestly that you would have to take that two percent, and the money is coming from somewhere. We have got to accurately describe to people, it seems to me, where the money is coming from.

Senator GREGG. It is coming from the surplus for the period of the next 10 years. After that point, and as you lead into that point in our plan, at least, a fair amount of transition costs is also borne by the adjustments in benefit structure, the assumption that the CPI will be accurately accounted for. We do not legislate it, we just assume it will be accurately accounted for.

We make a bends point change, which is more progressivity, and we also address the aging up issue. So those two combined, using the surplus to fund the personal accounts and benefit structure adjustments, allow you to transition this and it has been scored by the actuaries.

Senator GRAMM. Senator Conrad, let me just respond, very briefly, on this point. Under our plan, it costs more over the next 32 years in the current system, and then it costs substantially less.

The major point being, if you look at the next 75 years, the good news is, it is far cheaper to get into an investment-based system than it is to stay in the current system that we are in. I think that is a major point to understand, is basically we are making an investment in 32 years to restructure the system under ours, if permanently fixed.

Senator DOMENICI. Senator, could I just comment briefly?

The CHAIRMAN. Yes.

Senator DOMENICI. Senator, I think you asked a question that deserves an answer this way: it depends upon what you are trying to buy. In our case, we buy the existing system, in its entirety, and we do not change anything.

So we have to make up for some of that by saying some of the earnings on the privatized accounts go back into the Social Security system so that they are not individual retirement accounts in that you could really say, I own X amount and it is all of it.

When it comes to retirement time, we have calculated where it is sufficient for you to get at least what you are getting now, and probably 20 percent more at a point in time. But we are replenishing the system. Since we are doing that, we do not have to cut any benefits. Or we are replenishing it because we do not cut any benefits, either way you look at it.

The CHAIRMAN. Gentlemen, I thank you very much for being here today. I think this has been an exceedingly worthwhile discussion.

Senator MOYNIHAN. Thank you, Mr. Chairman.

The CHAIRMAN. It is a dialogue that we want to continue.

At this time it is my pleasure to call forth our second panel, a group of very, very distinguished experts on Social Security. We have Dr. Edward Gramlich, Dr. Alicia Munnell, Mr. Robert Myers, Dr. Andrew Samwick, and Dr. Carolyn Weaver.

Again, let me express my appreciation to each and every one of you for being here today. We look forward to your testimony and answers to our questions.

So we will start, if we may, with Dr. Gramlich.

STATEMENT OF HON. EDWARD M. GRAMLICH, Ph.D., GOVERNOR, FEDERAL RESERVE SYSTEM; AND CHAIR, 1994–1996 ADVISORY COUNCIL ON SOCIAL SECURITY, WASHINGTON, DC

Dr. GRAMLICH. Thank you, Mr. Chairman. I am pleased to appear before the committee to testify on Social Security reform. At the outset, let me say that I am speaking as a member of the Advisory Council, 1994–1996—actually the chair of that council—and not as a member of the Federal Reserve Board.

In trying to reform Social Security, I have stressed the importance of two goals. The first, is to make affordable the important social protections of this program that have greatly reduced aged poverty and the human cost of work disabilities.

The second, is to add new national saving for retirement, both to help individuals maintain their own standard of living in retirement and to build up the Nation's capital stock in advance of the baby boom crunch.

My compromise plan, called the Individual Accounts Plan, achieves both goals. It preserves the important social protections of Social Security and still achieves long-term financial balance in the system by what might be called kind and gentle benefit cuts. This is how I deal with the unfunded liability issue. Most of the cuts would be felt by high-wage workers, with disabled and low-wage workers being largely protected from cuts.

The plan includes some technical changes, such as including all State and local new hires in Social Security and applying consistent income tax treatment to Social Security benefits. These changes go some way to eliminating the unfunded liability problem.

Beginning in the 21st century, two other measures would take effect. There would be a slight increase in the normal retirement age for all workers in line with the expected growth of overall life expectancy. This was also proposed in the earlier panel.

There would also be a slight change in the benefit formula to reduce the growth of Social Security benefits for the high-wage workers. This was proposed by the National Commission on Retirement Policy plan that you heard about a minute ago.

Both of these changes would be phased in very gradually to avoid benefit cuts for present retirees and notches in the benefit schedule. The result of all of these changes would be a modest reduction in the overall real growth of Social Security benefits over time.

When combined with a rising number of retirees, the share of the Nation's output devoted to Social Security spending would be approximately the same as at present, limiting this part of the impending explosion in future entitlement spending.

These benefit cuts alone would mean that high-wage workers would not experience rising real benefits as their real wages grow, so I would supplement these changes with another measure to raise overall retirement and national saving. Workers would be required to contribute an added 1.6 percent of their pay to individual accounts.

Like the accounts you heard about a minute ago, these would be owned by workers but centrally managed. Workers would be able to allocate their funds among 5 to 10 broad mutual or indexed funds covering stocks and bonds.

Central management of the funds would cut down the risk that the funds would be invested unwisely, would cut administrative costs, and would mean that it would not be a Wall Street bonanza.

The funds would be converted to real annuities on retirement to protect against inflation in the chance that retirees would overspend in their early retirement years.

Some have objected to these add-on individual accounts because they seem like a new tax. First off, I should point out that, since the accounts will be returned to the individual in the future with investment earnings, they are very different from a tax.

Indeed, if people who already have significant pension savings beyond Social Security want to reduce their private contributions and preserve their disposable income, there is nothing to stop them.

Finally, as a further sweetener—this was not part of my plan, but it is something that I think might be considered—it may be possible to let those who can certify the existence of their own private pensions opt out of these add-on individual accounts and, thus, save Social Security some administrative costs.

Whatever is done, the basic idea is to raise national saving for the people who do not have much pension savings beyond Social Security, and this scheme accomplishes that.

The Social Security and pension changes that I have recommended would mean that approximately the presently scheduled level of benefits would be paid to all wage classes of workers of all ages. The difference between this outcome and present law is that, under this plan, these benefits would be financed, which they are not under present law.

The changes would eliminate Social Security's long-run financial deficit while still holding together the important retirement safety net provided by Social Security. They would reduce the growth of entitlement spending. They would significantly raise the rate of return on invested contributions for younger workers.

The changes would move beyond the present pay-as-you-go financing scheme by providing new savings to build up the Nation's capital stock in advance of the retirement crunch.

So, Mr. Chairman, as the Congress debates Social Security reform, I hope you will keep these goals in mind and consider these types of changes in this very important program.

Thank you very much.

[The prepared statement of Dr. Gramlich appears in the appendix.]

The CHAIRMAN. Thank you, Dr. Gramlich.

Dr. Munnell?

STATEMENT OF HON. ALICIA H. MUNNELL, Ph.D., PETER F. DRUCKER CHAIR IN MANAGEMENT SCIENCES, BOSTON COLLEGE (FORMER ASSISTANT SECRETARY FOR ECONOMIC POLICY, U.S. TREASURY; FORMER MEMBER, COUNCIL OF ECONOMIC ADVISERS) CHESTNUT, MA

Dr. MUNNELL. Mr. Chairman and members of the committee, I am delighted to have the opportunity today to appear before you to discuss proposals to preserve and protect Social Security. Everyone here today wants to restore balance to the program and confidence in the program as soon as possible, but we differ very significantly on the ways that we would like to see the changes made.

Despite the views of the august panel that you had just before us, my view is that the best way to assure Americans and adequate basic retirement income is to maintain the current defined benefit plan and not to move towards individual accounts.

The plans discussed in the earlier panel cut back on current promised defined benefits and replaced them with individual accounts, to some extent. I do not think that is a good idea. Let me briefly explain why.

First, Social Security's financing situation does not require major structural change in the program. I do not think that language like "fiscal meltdown" or "demographic time bomb" applies to Social Security. What the actuaries' reports show, is that the cost of the program is going to increase by 2 percent of GDP by the year 2030, and the costs are going to stay at that level thereafter.

We have seen changes in the budget of 2 percent of GDP before. They are not enormous, they are not unprecedented. Defense spending went up by 5 percent of GDP at the start of the Cold War, and has declined by two percent of GDP in the last 7 years.

My second point, is that the desire to increase national saving and the desire to broaden investment options for workers, goals that have been used to justify the creation of individual accounts, can be achieved more effectively within the structure of the current program.

I think the present is different than the past. I think it is now reasonable to think about the Federal Government actually accumulating reserves. The non-Social Security portion of the budget is going to be in balance by the year 2002, according to the CBO.

We can keep it there and build up reserves in the Social Security trust funds. It will provide a benchmark that will show the government is actually saving. The States do it for their pension funds, the Federal Government should be able to do it for its major retirement system.

In addition, broadening Social Security's investment options to include stocks is feasible. We know how to do that. We know how to prevent interference in private sector activity. The TSP, Thrift Savings Plan, has shown us the way. You set up an independent investment board, you invest in a broad-based index, and you delegate the voting rights to the individual pension fund managers.

In short, if we want to increase national savings and if we want to increase returns on Social Security contributions, we can do it through the trust funds. We do not need to introduce individual accounts.

This leads me to my third point. The economics are very clear. Social Security's defined benefit plan is better than individual accounts for providing Americans with their basic retirement pension.

Let me quickly tick off the reasons. Because Social Security is a defined benefit plan, it can spread risk across the population and over generations. This means that individual retirees would not have to absorb the kinds of losses that the stock market has suffered in the last few weeks.

The risks do not disappear, but the gains and losses can be averaged across individuals and they can be averaged across time.

Second, pooling investments in the Social Security trust funds also keeps transaction costs low, ensuring higher net returns than individual accounts. Administrative costs for individual accounts an equal up to a 20 percent cut in benefits. Annuitizing accumulations can cut benefits an additional 10 percent.

The third point, is that Social Security avoids the pressure for individuals to gain early access to their accounts, which would leave retirees with inadequate retirement income. We have seen this in the case of IRAs, we have seen this in the case of 401(k)s. Such pressure would inevitably emerge with individual accounts under Social Security.

Fourth, Social Security assures that accumulated funds are transformed into inflation-indexed annuities so that retirees do not outlive their retirement resources.

Fifth, Social Security provides full benefits for disabled workers who would not have time to build up adequate reserves under a system that includes individual accounts.

Finally, Social Security protects dependent spouses, both before and after the worker dies. Individual accounts, as currently structured, do not have these provisions.

In short, the current defined benefit arrangement is the best way to provide basic retirement income. There is no reason to move towards a defined contribution system. Much of the projected shortfall in the current system can be eliminated with good policy changes.

For example, extending coverage to new State and local workers, slightly increasing the maximum taxable earnings space, reflecting BLS corrections in the CPI for the COLA, are all consistent with the goals of the program.

Broadening the investment options within the trust fund will also increase the return on trust fund assets and improve the program's financing.

Social Security has served us well for nearly 60 years. Let us modernize its financing, but let us keep its defined benefit structure.

Thank you very much.

[The prepared statement of Dr. Munnell appears in the appendix.]

The CHAIRMAN. Thank you.

It is now a pleasure to call on Mr. Myers.

STATEMENT OF ROBERT MYERS, LL.D., (FORMER CHIEF ACTUARY AND FORMER DEPUTY COMMISSIONER, SOCIAL SECURITY ADMINISTRATION; AND FORMER EXECUTIVE DIRECTOR, NATIONAL COMMISSION ON SOCIAL SECURITY REFORM), SILVER SPRING, MD

Mr. MYERS. Thank you, Mr. Chairman.

I shall discuss only two important points that I bring out in my prepared testimony. First, privatization of the Social Security program, and pay-as-you-go financing of the Social Security program.

There are different definitions of privatization. As I see it, privatization means a significant reduction in the Social Security benefit level on a gradual basis, and transfer of part of the Social Security taxes to individual savings accounts administered and invested in the private sector.

I do not consider as privatization investing the trust funds in the stock market, or establishing individual accounts administered by the government. Both of these procedures are undesirable, I believe, no matter what controls are introduced, such as indexing, because of the possibility of eventually the government having too much control over private industry.

Nor do I think that a supplementary system of individual accounts, built on top of a reformed Social Security program, should be considered as privatization.

I believe that privatization is undesirable, and possibly unworkable administratively. First of all, there is the difficulty of a reasonable coordination of the disability and young survivor benefits.

Second, there is the question of market fluctuations. Not that over time investments in equities will not have a good rate of return, but it is the fluctuations that hurt. So, even on an average it may turn out well, people who retire when the market is down will have, for the rest of their lifetime, benefits that are inordinately low.

Then there is the problem of annuitization. If you do not annuitize, people will outlive their accounts. If you do annuitize, then women will be treated unfairly because of their longer life expectancy. They will get lower benefits per hour of accumulation.

Another point that is very rarely mentioned is the great difficulty administratively, the great complexity that will arise, for the millions and millions of small accounts. The cost of individual savings accounts is a constant amount regardless of how much goes into it each year, maybe $30 or $40 per year, per account.

There are many millions of people who earn only $1,000 or $2,000 a year. The contribution to the individual account on that basis would be eaten up very largely, or even entirely, by the administrative expenses.

I think there is a desirability of a mandatory system of supplementary individual accounts built on top of a reformed Social Security system. However, there should be excluded people who are low income persons, largely low income because they only work part-time, because of the administrative inefficiency of it.

I would certainly start off with a very high level and say that people only earning, say, $4,000 or more per quarter would be required to contribute. Those below, it just is not administratively feasible.

Now, as to pay-as-you-go financing, this means that the tax rates are scheduled over the future year to match the benefit outgo and, at the same time, have a fund balance that is not less than, say, half a year's outgo, nor more than a year's outgo.

It should be responsible pay-as-you-go financing, which means you should take a very long-range look at it and have a schedule that, according to best estimates available, is supporting. Also, the plan should be a reasonable one so that the tax rates will not reach too high a level in the very long run.

The present law, despite what many people say, is not financed on a pay-as-you-go basis. It is nearer to pay-as-you-go than it is to full funding, but it is sort of temporary partial funding. At present, the fund balance is over 2 years' benefit payments, which, in my opinion, is really excessive.

Now, I believe that Social Security has not been, and should not be, an investment program based on the magic of compound interest. I believe that people should have investment programs available, possibly on a mandatory basis, but it should be kept separate from Social Security.

Rather, Social Security is based on a program of income maintenance under social insurances based on the magic of insurance. Under insurance, like fire insurance or automobile insurance, the rate of return on the assets of the insurer are irrelevant, so pay-as-you-go financing is appropriate for this intergenerational pooling of risk, and it avoids the problem of how to invest funds because the investment income is really negligible.

If the present Social Security were pay as you go, the employer-employee rate could be reduced by 1.3 percent for the next 10 years, but then it would have to rise to a level of almost 19 percent in 75 years. This is too much as an increase. It is caused primarily by the estimated increase in longevity over the long-run future.

So the solution is to raise the retirement age steadily and significantly. The result, I think, would be something like having a retirement age of 75 in the year 2073. At the moment, if you think statically, this seems outrageous. But, if you think dynamically, it is reasonable. Just think. If 150 years ago you set up a Social Security system, you would have had a retirement age of 50 or 55. That would have been untenable to have kept.

So I think, if you have this increase in the retirement age as the major change, the system would be put on a sound basis and ultimate pay-as-you-go tax rate would be little more than the present 12.4 percent.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Myers appears in the appendix.]

The CHAIRMAN. Thank you, Mr. Myers.

Dr. Samwick?

STATEMENT OF ANDREW SAMWICK, Ph.D., ASSISTANT PROFESSOR, DARTMOUTH COLLEGE, AND NBER FACULTY RESEARCH FELLOW, HANOVER, NH

Dr. SAMWICK. Thank you, Mr. Chairman and distinguished members of the committee. It is an honor to be able to discuss the results of my ongoing research about privatization of Social Security with you.

Over the next few years, I do not think there is a more important decision that we all have to make than how we are going to restore solvency to our Social Security programs.

We are fortunate that the projected cash flows into the system will sustain it for at least the next 30 years. This was our window of opportunity that Senator Moynihan spoke about earlier.

The longer we wait to act, the more severe will be the policy changes that are required to restore solvency. The most recent trustees report shows that, at the end of the 75-year forecasting period, the cost rate on the OASDI program will rise to over 19 percent, under intermediate assumptions.

This cost increase would necessitate a pay-as-you-go tax increase of over 6 percentage points from the current level if benefits are to be maintained. Alternatively, actuarial projections show that, over that 75-year period, approximately 2 percentage points of covered payroll per year must be raised in order to cover the shortfall. These two numbers, two to stabilize, and six if we procrastinate, are the most succinct means of describing our current situation.

My remarks today are based on the results of my ongoing research with Professor Martin Feldstein of Harvard University, and the submitted version of my comments has references to all the work that I will describe.

What we have done, is to design a straightforward simulation model of the OASDI system that allows for prefunding and, hence, privatization of the program's future liabilities. All of our demographic and economic assumptions match the intermediate assumptions in the 1998 trustees' report.

Under our proposal, workers and their employers make mandatory contributions to personal retirement accounts, or PRAs. The balances in the PRAs are invested in broadly diversified portfolios of stocks and bonds.

As workers reach retirement, PRAs are converted into annuities. These annuities replace a portion of their promised OASDI benefits. Over time, more workers will retire with PRA balances that reflect an entire working career of contributions.

As more benefits are replaced, outflows from the trust fund are reduced. With sufficiently large PRA contributions, we can avoid the forecasted increases in the payroll tax rate and potentially increase retirement income levels will provide further payroll tax relief.

What makes this system feasible is that PRA balances are assumed to earn the historical average rate of return on the corporate sector. This return, after inflation, has been approximately 5.5 percent in the post-war period. This figure is net of corporate tax payments, but prior to individual tax payments. It is substantially above the implied rate of return on a pay-as-you-go system.

Under our baseline scenarios, a system of 2 percent PRA contributions generates sufficient balances to stabilize the pay-as-you-go tax rate at 12.4 percent, while permitting some increase in the generosity of the program.

The key to achieving these results is the accumulation of new capital to prefund the liabilities. This was the source of Senator Mack's question in the earlier panel, also echoed by Senator Conrad, and it was also the source of Senator Gramm's eloquent response to it. If you do not get new capital into the system, then you have not done anything to privatize.

What happens in this reform, is we have to figure out where the new capital is to come from. Note that this is a different issue from the more widely discussed proposals to invest the existing Social Security trust fund in corporate stocks and bonds.

Our primary objective in designing the PRA system was to make only those changes that are necessary to allow for the prefunding of future liabilities. Other topics that have come up today, such as indexing the normal retirement age on Social Security, possibly adjusting the CPI to reflect more accurately the cost of living, may be good ideas to do to reform the system in terms of its overall generosity, but it is not directly related to the issue of whether you want to prefund future liabilities or retain the pay-as-you-go system.

It should be inferred from our remarks that what I am advocating is that additional step of prefunding benefits, whatever the representatives of the people decide that generosity of those benefits should be.

To describe, again, the new capital required to establish and fund the PRAs, either personal or public consumption needs to fall. Because covered payroll is approximately 40 percent of GDP, the 2 percent PRA contributions represent 0.8 percentage points of GDP.

As many policy makers have noted, the budget surpluses that are forecast for the next 10 to 15 years can exceed this number.

There has been some confusion today as to where that money came from.

Now, what I remember earlier this year was that, in March, there was a CBO forecast, and then in May there was some new revenue in the CBO forecast. If you proceed from the assumption that that found money had not already been allocated, then that generates new capital. It is very similar to if you had just paid down existing obligations to the Treasury.

The PRA system that I am proposing should be seen as a very convenient way of taking new capital of that sort and using it to reduce future obligations.

I will reserve the balance of remarks to answer questions that you might have later. Thank you.

[The prepared statement of Dr. Samwick appears in the appendix.]

The CHAIRMAN. Thank you.

Dr. Weaver?

STATEMENT OF CAROLYN WEAVER, Ph.D., DIRECTOR OF SOCIAL SECURITY AND PENSION STUDIES, AMERICAN ENTERPRISE INSTITUTE, WASHINGTON, DC

Dr. WEAVER. Thank you, Mr. Chairman. I appreciate the opportunity to appear here today at what I trust will be just months before Congress and the administration set about the task of developing a comprehensive reform bill.

With the retirement of the baby boom arriving so quickly, within 10 years, I, too, would like to underscore the importance of prompt action to shore up the financing of the system, to restore public confidence in the viability of the system, as well as to take the steps necessary to create a system of real value to younger workers.

As I explain in my written testimony, I share the views expressed by Senator Gregg and others this morning, that the best way to secure Social Security is to transform it from a low yielding system of income transfers into a system of true pensions: personal retirement accounts that are owned by workers, fully funded with a share of their payroll taxes, and invested in real capital, and buttressed by a government safety net.

In my statement, I discuss the problems arising from continuing our pay-as-you-go system and the economic benefits likely to flow from a saving- and investment-based system.

I also discuss the proposal I helped develop on the Social Security Advisory Council, which garnered 5 of 13 votes, the proposal for personal security accounts, which would create relatively large, privately managed accounts funded with 5 percent of workers' earnings.

Under this plan, Social Security would gradually be transformed to a two-tiered system, where the first tier effectively provides a floor benefit for all full-career workers that is designed to supplement or underlie the personal security account accumulations to ensure that full career workers retire with an income at least as high as the poverty level.

The PSA proposal can be seen as a hybrid between the kinds of proposals you were hearing about this morning and the system now in place in the United Kingdom. It differs from the proposal offered by the chairman, Ed Gramlich, in that personal accounts would replace a portion of Social Security rather than be an add-on, and workers would have significantly more investment discretion and discretion at the time of withdrawal.

I would simply note in passing that the Social Security projection showed that workers would generally fare better under this plan than under the other two plans, or under a shored up pay-as-you-go system. The reason, is the relatively large personal accounts that bring forth larger long-run economic and financial gains.

I would also note for the record that I do not think there is one right way to move towards personal accounts or to incorporate them into Social Security, and I do not think there is one right way to fashion that government safety net that underpins personal accounts.

The range of options is revealed by the reforms that are now in place in countries including the U.K., Canada, and Chile, and as well a wide range of proposals that have been offered by scholars and by members of Congress.

In the limited time I have, I would like to touch briefly on two issues that are pertinent to any proposal to move toward personal accounts, the issue of transition costs, which keeps coming up, and investor savvy, and the question raised about perhaps workers in West Virginia who might not know how to invest.

On the issue of transition costs, I would like to stress the point that there is a cost of sustaining the status quo, or attempting to sustain the status quo, and there is a cost of moving to a system of personal accounts.

In the first case, the cost is permanent and brings forth no additional benefits or economic value. In the latter case, the cost is transitional and makes possible the attainment of larger and more secure retirement incomes, as well as a stronger national economy. In present value terms, the long-term gains to society would substantially outweigh the costs.

The important point there, is that there is a price to be paid up front in the way of increasing saving and capital investment, which then allows us to generate these higher retirement incomes, higher real wages, and higher standard of living in the future.

I would like to stress that privatizing a portion of Social Security does not create transition costs. Privatization creates retirement accounts that are owned by workers and funded with their taxes. Because of the higher return to private capital investment, the tax rate used to support these accounts can actually be lower than that which would be required to sustain benefits under a pay-as-you-go system.

In addition to the mandatory saving rate, though, there is the cost of meeting outstanding benefit obligations. This cost could be met in any number of ways and spread over time through the issuance of some new formal debt. Although that is not popular, that is something contained in the personal security account proposal.

Briefly, then the transition cost of the PSA plan was estimated to be 1.5 percent, roughly, of taxable payroll. We proposed a transitional payroll tax increase of 1.5 percent, supplemented by new Federal borrowing.

I will quickly note that that 1.5 percent payroll tax supplement, unlike the supplement in the case of the Chairman's plan, would then allow you to transform over time into some fully funded accounts of 5 percent. It is a transition tax that gets you there. The amount of new debt issued pales in comparison to the debt that will continue to accumulate under our pay-as-you-go system without reform.

If I could just make one final comment on investor savvy. I would like to echo Senator Kerrey's remarks that American workers have never been bettered positioned to make sound investment decisions. An estimated 43 percent of Americans own stock, roughly 40 percent own mutual funds, 25 million have 401(k) plans.

It was my view, and the view of the others on the Advisory Council, that when workers are unsophisticated about investment strategies, it tends to be because they have nothing to invest. Personal accounts would change all that.

We were presented with no evidence that, with education or experience, workers at all income levels could not basically invest prudently, meaning investing for the long run in broadly diversified portfolios.

Thank you, Mr. Chairman.

[The prepared statement of Dr. Weaver appears in the appendix.]

The CHAIRMAN. Thank you, Dr. Weaver.

I would like to repeat my first question to the first panel for all of you. I believe all of you support some form of stock market investment. As has been pointed out, the stock market has been very volatile recently.

I have two questions. First, have the market gyrations changed your views in any way? Second, most personal retirement account proposals either require or encourage people to cash in their accounts to purchase an annuity at retirement.

Yet, as one of you pointed out, over a short period of time market volatility can dramatically affect how much an individual has in an account to buy an annuity. Is this likely to be a problem, and if so, how should a personal retirement account avoid this problem? Dr. Gramlich?

Dr. GRAMLICH. Well, I think, first off, that your earlier panel gave very good answers to the first part of your question. That is, the stock market has gone down in the last short time. I do not know if it is down or up today, but it does that.

But the point of these plans that have stock market-supporting retirement benefits is it is much more a long-term consideration. So, there are wiggles, but in the long run it is probably a good idea to have some retirement saving invested into equities, however that is done. There are different ways to do it, as you have heard.

On the second part of your question on the annuities, I think that is a good point. You are raising a good point. On the plans where you have individual accounts and compulsory annuitization, which is true in my plan, because that is one place where short-term volatility in the stock market can hurt you.

So, therefore, I think it would be only fair, and I do not know what the horizon is, but to give people some horizon, that they can start converting to annuities maybe within 5 years of the time they retire, or something like that.

You would have to think about this, and I do not have the details on it. But I think you would have to give some kind of flexible window so that there could be some smoothing of the short-term gyrations in the stock market on the annuity problem alone.

The CHAIRMAN. Dr. Munnell?

Dr. MUNNELL. The recent fluctuations in the stock market made me more convinced than ever that if you are going to introduce equity financing into Social Security, into this basic retirement pension, you want to do it in one big pile so you can spread the risk so that individuals do not have to take the hit.

People talk as if you are talking about a 20-year-old who has lots of time and can take a long-run view. I think my own advancing age has made me think that not everyone has 40 or 50 years to wait until retirement. So, for people approaching retirement, these gyrations become more important.

People who, like myself, are opposed to people taking on additional risk are only concerned about that for this basic pension because Social Security benefits are so modest. For the low-income individuals, they are sort of $5,400. For a person with a history of average earnings, they are $8,900 a year. That is the place that I do not think it is appropriate for people to take more of a risk.

Similarly, for that level of income, I think you want to have automatic annuitization, and that is much more cheaply and effectively done within the Social Security program itself.

The CHAIRMAN. Thank you.

Mr. Myers?

Mr. MYERS. The recent volatility of the stock market has only reinforced my view that, for the basic floor of protection, the Social Security program should be just the defined benefit concept and should not be based on individual accounts that can fluctuate greatly and can hurt a person if they retire when the market is low as compared to when it is high.

So, for any supplementary plan built on top of a sound, vigorous floor of protection, these fluctuations people can bear, but not for the basic floor.

Thank you, Mr. Chairman.

The CHAIRMAN. Dr. Samwick?

Dr. SAMWICK. Thank you. This is what happens in markets. Some things are useful to note about keeping your money in equities, is that in the plan we have proposed, it is 60 percent equity, 40 percent debt, just like the corporate sector looks. So already it is not as if we are describing a plan in which everybody is 100 percent in the market.

Another aspect of this to keep in mind, is that too much can be made of this cashing out on one particular day. Like, what if I had to cash out last Monday? That would be terrible. There already exist vehicles in financial markets that alleviate this burden to some extent.

One, is a variable annuity. I should be punished for saying this phrase in front of this committee, but I would presume that financial institutions that are competing to try to manage people's money would think about single premium deferred annuities with all the contributions as they come in. That would be one margin along which firms might be able to offer more security. So, I think too much can be made of that issue.

The CHAIRMAN. Dr. Weaver?

Dr. WEAVER. Well, the market gyrations have reinforced my view that investing for retirement is a long-term proposition. Patience and diversification are the key to generating sound and secure retirement incomes. Being a daily watcher of the ups and downs of the stock market is not the best way to generate a sound and secure income at any age.

Having said that, on the issue of annuitization, I would bring to your attention the fact that the PSA plan actually is one of the few plans that does not require workers to annuitize their accounts. We felt quite strongly that, given the minimum benefit that was retained, the floor benefit that basically provided a poverty level income, it was not clear what the government's interest was in forcing you to withdraw all your funds in the form of an annuity.

It raises all the problems you have raised, as well as limits the flexibility of people to continue building wealth in retirement through a variety of investment vehicles and passing along estates to heirs, which we think is an important trade of personal accounts.

The CHAIRMAN. Dr. Munnell, if I might just ask you one question. You proposed investing the trust funds in private securities. Does that not run the risk that political considerations will control investment decisions?

We have had some examples of that recently. The Texas Board of Education sold off a $46 million stake in the Walt Disney Company because of social policies. The State of Minnesota divested tobacco stock from its State Employee Pension Plan. Then there is the other side of the coin, pressure to use the trust funds for economically targeted investments and social investing.

In light of these examples, is it possible to build an impenetrable barrier between Social Security investments and political decision-making?

Dr. MUNNELL. Senator Roth, I could not be more sympathetic with your concerns. If I thought those things were really going to happen, then I do not think I would want to go that route at all.

My sense is that TSP gives you a model of how you could set up an investment structure that would really minimize interference with the private sector. You set up an independent investment board. You could limit fiduciary duties. You invest in a very, very broad index so that no one is going in and picking stocks.

The other issue is voting rights. And you do not get the board involved in voting rights, you delegate that down to the individual fund managers.

I am very familiar with the issues at the State and local level. I looked at it in the early 1980's in the case of within State housing mortgages and I was concerned that States were going to give up a lot in the way of rate of return to do this kind of social investing.

I have gone back to look recently and the examples you cite exist, but they really are the rare occurrence, that the States have moved away from the things that I was most concerned that they were going to do.

In terms of this economically targeted investment, there was a 1993 study done for Goldman Sachs where people used a very comprehensive definition of economically targeted investments and they could only sort of conjure up 2 percent of total State and local investments in that area.

Just one thing, and then I will conclude. That is, I think that that type of activity is more easily achieved at the State and local level, which is sort of subject to less scrutiny than would be given to the type of investments that would be undertaken by the Social Security trust funds.

So I think it is a valid concern. I think you would want to set it up very carefully to avoid those kinds of problems, but I think it can be done.

The CHAIRMAN. Thank you. My time is up.

Senator Mack?

Senator MACK. I have a question related to, there are a number of different ways to refer to investing on an individual basis, the different names. I gather that four out of the five of you feel that there is some role for investing in equities. My only question would be to Dr. Munnell.

Dr. MUNNELL. I am for doing this in the pile.

Senator MACK. All right.

Dr. MUNNELL. I am not for doing it for the basic retirement benefit individually.

Senator MACK. So, Mr. Myers, would it be fair to say that you are the only one who feels that there should not be a role for investment in equities in the Social Security system?

Mr. MYERS. That is correct, within the Social Security system. Although I would support a supplementary mandatory individual account system built on top of a reformed Social Security system, and applicable only to middle and higher income workers because lower income people just do not contribute enough to offset the administrative expenses per account.

Senator MACK. Let us make an assumption here that there would be a way to offset those costs, as you referred to. Would you deny lower income in participating in some program of equity investment?

Mr. MYERS. No, I would not oppose it if there could be some way that the administrative expenses would not eat up most, or all, of their contribution to the individual account.

Senator MACK. And I think in your opening comments you made reference to, if we went back to a straight pay-as-you-go system it would be a reduction in payroll taxes in the short-term of about, what 1.6 percent, did you say?

Mr. MYERS. Yes. I think if certain other changes were made that I think are desirable, like coverage of new State and local hires, it could be a reduction of two percent, as in Senator Moynihan's bill.

Senator MACK. Right. Again, do you have an objection to that 2 percent, again, being invested in equities?

Mr. MYERS. No.

Senator MACK. I think at some point, when it is appropriate, there is some data and some charts that I have that I received from Jeremy Seigal from Wharton that has done some studies on the return on stocks and bonds and so forth, which I think really makes the case that, again, if we would think of this thing in the long term, we really do have an opportunity for many people in the country who have been denied the opportunity to, in fact, accumulate wealth.

I cannot say that I fully understand the concerns that have been raised this morning as to why people are not supportive of equity investments, but I am trying to listen to your concerns and see if we cannot accommodate that as we move forward.

My reaction to the fluctuation in the market is, I mean, which fluctuation are people concerned about; is it the fluctuation over the last 5 years that drove up the market, or is it the fluctuations that took place in the last few days? I think, and I am not positive about this, we can check it, but I think the market today is still up compared to where it ended last year.

But, again, we ought to think about this in the long term. I am confident that the folks who make a living in investments, in equities, and in bonds can come up with a way that can allow us to eliminate almost all the risk out of making a decision about when to withdraw those funds for retirement. I am just confident that that can be done.

Several suggestions have been made this morning, but I am sure that there are ways that you can address this issue of what happens when a fluctuation takes place during the year in which you are going to retire. Whether you can preplan it for 5 years, 4 years, 3 years, I do not know, but it can be done.

I thank you, Mr. Chairman, for holding this hearing.

The CHAIRMAN. Thank you, Senator Mack.

Senator D'Amato?

OPENING STATEMENT OF HON. ALFONSE M. D'AMATO, A U.S. SENATOR FROM NEW YORK

Senator D'AMATO. Well, Mr. Chairman, I am going to ask that my full statement be placed in the record as if read in its entirety.

I would commend you and Senator Moynihan for these hearings. This is a most important issue. It is one that I fear can be easily politicized. That is not good when we have scare tactics advanced by some, when we have nothing but political propaganda put forth by others. It will only be the thoughtful consideration in a truly bipartisan manner.

I know that you, in your efforts to achieve or begin to build a consensus, have the support and the admiration of this committee, both Democrats and Republicans, and that your work will be the cornerstone if we are going to make any progress in dealing with the opportunities, as well as the problems that are in the present system. I believe there may be opportunities.

I share with you, I heard your question as it relates to, how do we keep the political—and I strongly support political action. It is the basis of democracy. But how do we keep it from improperly finding its way into the dollars that may be placed for investment opportunities?

That is something that I think we all would say absolutely cannot be tolerated. What methodology? How do we arrive at a system whereby we can gain the great benefits of a free market capital system, where we have the kinds of laws that this country has?

Unfortunately, capitalism would be declared, in some areas, not to be a great system.

I am thinking of the Soviet Union, or Russia, and other areas, because they do not have the kinds of laws that we have, the transparency, the seeing to it that the marketplace is not stacked, contractual rights which are respected. We have that here.

So to think that capitalism is going to work throughout the world when you do not have the basis by which it has to operate, which is these fundamental principles that we take for granted is absurd.

That is why we have seen this calamity in areas where we have said, oh, capitalism should be working. Well, how can it work when somebody does not guarantee the sanctity of a contract and can break it, or where they are cooking the books and there is no transparency? That is why you have had this collapse in Indonesia, in Russia, and in other markets where these are not guaranteed.

But here, I believe we have that framework where we can minimize the kind of political intrusion that would not be welcome in a system that we seek to strengthen and to use the capital markets as one of the ways to advance it.

So, I am very pleased, Mr. Chairman, that you and Senator Moynihan are heading these efforts and hopefully we can move in the direction and build a sense of confidence with all of the various groups. I do not think it is going to be an easy thing to do going in with 50 some-odd days—not that I count them—to election time. [Laughter.]

But, certainly, this is so important, this should be an ongoing effort that goes well beyond any one election and one that has the totality of commitment from all of our colleagues here to do the best that we possibly can, recognizing that there are some very real, legitimate differences that may exist.

I cannot help but think, given the great aptitude that so many of my colleagues have, that we cannot make some substantial improvements, and using the great academic minds that we have, the experts in the capital market system collectively.

So I commend you for these hearings, for your undertaking, you and Senator Moynihan, of this most important area of responsibility. Social Security has worked. It has lifted so many senior citizens out of that era of impoverishment or total dependency upon their families and/or government. It has been a great, great program of great success, and how can we strengthen it and continue it? It is in that attitude that I think we have to move forward.

Again, I commend the Chairman and my distinguished senior Senator, Senator Moynihan, for their efforts in this area and I look forward to learning more about this and working with you collaboratively.

[The prepared statement of Senator D'Amato appears in the appendix.]

The CHAIRMAN. Thank you, Senator D'Amato. I cannot stress too much how important it is that we develop a bipartisan consensus. I think that this is one step in that direction.

Senator Moynihan?

Senator MOYNIHAN. Sir, forgive me. I was called out. I got a telephone call from Secretary Rubin. I would not presume to ask or interrogate this panel at all.

I would like to record that the Guiness Book of Records establishes that Robert J. Myers of Maryland, United States of America, has testified before Congress 175 times, from 1947 to 1970, and from 1981 to 1982.

The CHAIRMAN. You have our deepest sympathy. [Laughter.]

Mr. MYERS. Thank you, Mr. Chairman.

Senator MOYNIHAN. I would like to make one comment, and then one statement. I thank Dr. Samwick for the notion that we are fortunate that the projected cash flows in the system will sustain it for at least the next 30 years. This then is our window of opportunity. We have time to think, now.

Dr. Gramlich and Dr. Weaver I know you were on the Social Security Advisory Council.

It was interesting that, while you could not find a majority, you were all talking about moving some portion of this system into equities.

From our point of view—I am thinking particularly of Senator Kerrey—we are not actually thinking of annuities which transpire at the end of life, but of the creation of wealth. Senator Kerrey would like people to have an estate that they can pass on.

You can see a certain coherence in the movement from a 19th century notion that, with people living in cities and increasingly isolated from families, there ought to be some measure of subsistence living after you stop working, and then add health care to that later on.

In the 21st century it is entirely appropriate in the 21st century to think of acquiring some wealth over your lifetime. I mean, one of the great first insurance systems, I think, in Great Britain in the early industrial revolution was burial insurance. People paid a penny a week so that they did not end up in a pauper's grave. It was not much, but you were going to have a decent funeral.

Senator Kerrey, in particular, but Senator Breaux, Senator Gregg, and I think this is an excellent idea. It is a sequence which is appropriate and doable. I have to say to you, and do not ever let Senator Gramm hear this, but if we do succeed in these various programs everybody is going to be a Republican by the year 2000. [Laughter.] And I do not know about that. But there will be different kinds of Republicans. They will find something to argue about. [Laughter.]

Senator GRAMM. I figured that out a long time ago. [Laughter.]

Senator MOYNIHAN. But we have got some wonderful testimony to be read very carefully. Thank you very much.

The CHAIRMAN. Thank you, Senator Moynihan.

Senator Gramm?

Senator GRAMM. Well, Mr. Chairman, let me apologize to our panel. When I went out to grab a cup of coffee after Pat and I testified, and I saw Senator Byrd speaking on the floor about impeachment. When he speaks, I listen, so I figured I had better get over there and hear what he had to say.

I want to pose a question, but in order to pose it I need to explain the logic of it. I am sure there will be differences of opinion on the panel, but I want to pose it to get everybody's thinking.

One of the things that I think is important in this debate about investment-based Social Security, which I like to call it because I am not talking about privatizing Social Security, I am talking about maintaining every benefit of the current system and taking the strengths of the current system and the strength of private investment, which is the power of compound interest, and combining the two.

But one of the things I think it is important to get people to understand, that at least by my definitions, we do not have a trust fund for Social Security today. We talk about trust fund.

You read in the newspaper. Every article that is written about this talks about the trust fund, talks about the rate of return on the trust fund. But, yet, the way I define a trust fund is, can you spend beyond your income with its use without changing, fundamentally, your behavior. I mean, it is the sort of question, do you have money in the bank or do you not?

I liken it to, let us say you have got a young man and he is a paper boy, and he gives his mother money to put aside for him to go to college. His mother builds the money into the family budget. He gets ready to go to college. Does she have the money or does she not? Well, the test is, can she give him the money to go to college without changing the financing of the family?

Now, as I look at our so-called trust fund, it is not counted as the outstanding debt of the government. When we have a notional interest payment, it is not counted as an outlay of the Treasury. Since we started building up the surplus with the 1983 reforms, what it has allowed us to do is tax less, spend more, and borrow less.

When we talk about, Social Security is good until 2032, we are really talking about requiring the government to pay back huge amounts of money, every penny of which would require raising taxes, cutting spending, or borrowing from the public. So, really, our crisis is in 12 or 13 years, not in 30, because we would have to come up with $2.5 trillion by that point, or $3 trillion to pay that money back.

Now, I wanted to get everybody's take, and let me just start with Carolyn on the far end. In any real sense, would you say that we do or do not have a Social Security trust fund today?

Let me tell you, and I will stop, why this is important. People get the idea we are talking about investing government bonds versus investing in stock. I see it as the difference between investing and not investing. I just wanted to try to get everybody's take on it.

Dr. WEAVER. I think I share your view. The way I would put it, is that there are no physical assets backing up those securities in the trust funds, that when it comes time to redeem them you have to raise taxes or cut spending.

That is precisely what you would have to do if you did not have those bonds at all. To that I would simply add, that does mean that the financing problem begins the minute the cash flow goes negative and you have to start redeeming those bonds.

Beyond that, I think any mention of rate of return on trust fund assets is really a red herring. It has got nothing to do with what individuals earn on their taxes, which is determined by the benefits in effect at the time you retire relative to the taxes you pay. As you say, we do not have an investment-based system, we have got a debt-based system.

Dr. SAMWICK. Not much to add. Your story makes sense because the paper boy actually had less candy and mom did not spend the money or work less, so the family has more resources available.

Presumably, the analog to our story is that we would have more debt if we had not run up what is called this notional trust fund, and we would be in worse shape when the cash flows turned from positive to negative than we are now.

So I would not go out of my way to dismiss the idea of what that trust fund has represented under the assumption that we did not spend all the money along the way. That is the missing element of it.

Mr. MYERS. I very much regret that I have to take the opposite view of the distinguished Senator, but I think that the Social Security trust funds are valid. I think they are real.

My point is, if the Social Security trust funds had not had the money to lend to the government to spend however it might, the government would have had to borrow that money from somebody else, so the total national debt is exactly the same.

These bonds are not marketable, it is true, but they are redeemable at par. There is no question that they are going to be redeemed, because each month about $30 billion of government securities in the trust funds are redeemed to pay benefit and the interest on them is at a reasonable rate.

The interest is also used to pay benefits. Every month, part of the benefits, a small part, comes from the accrued interest on the bonds that are redeemed. The rest of the interest goes into the trust fund and it is invested in these government securities.

You cannot tell just ones they are, but, in my opinion, it is a completely valid investment. Just like any other IOU, the government spends the money, just like General Motors when it issues bonds and spends the money. That does not mean that they are not valid bonds.

Dr. MUNNELL. Senator Gramm, I think your question goes to the heart of the issue of, can we accumulate reserves at the Federal level, really, can the government save? I think that the past is sort of murky because we have had a unified budget, we have had large deficits, and it is very hard empirically to sort out exactly what has happened.

I think, going forward, the story is different. If the CBO estimates are correct and we are really going to balance the non-Social Security part of the budget in the year 2002, I think it is plausible to think about really accumulating reserves at the Federal level.

You have to change the way CBO reports the budget, you have to change the way OMB reports the budget, but you can have a balance in the non-Social Security part of the budget. Keep that balance there, and you could really accumulate reserves in the Social Security system and have government saving in a way that we have not had government saving before.

So I think your description of the past raises valid questions. I think we can think somewhat differently about the future.

Dr. GRAMLICH. I am actually fairly close to Alicia on this one, and also to Bob Myers. The one other thing I would say, is that the Social Security system has in the past operated according to actuarial rules. That is, there is long-run planning and they have not spent beyond the interest credited, and so forth.

Having said that, I, too, would like to see the OASDI split out of the Federal budget in the interest of better government accounting. The OASDI would operate according to its own long-run budget constraint and the rest of the government would be laid bare, and the rest of the government is running a deficit even now. That would be made more visible.

I would also personally like to see this done largely in individual accounts, but you could also justify having, somehow or other, retirement benefits prefunded. So I would like to build up the capital stock in that way.

So it is a little bit hard to describe what it is, I agree. But I think, in many important respects, it has operated like a trust fund and I think a lot of us would like to make changes to make it operate even more like a trust fund.

Senator GRAMM. Thank you, Mr. Chairman.

Senator MOYNIHAN. Mr. Chairman, could I just ask one question?

The CHAIRMAN. Please.

Senator MOYNIHAN. I would have thought it difficult for government to save. Perhaps a surplus could be used to buy back debt—pay off the debt. But to actually have a positive net worth so to speak, that would not seem likely at the Federal level.

Dr. GRAMLICH. Well, Senator, State and local governments actually, I think, have a better budgetary answer to this than the Federal Government does, because they do split the pension fund from the operating budget. They have constitutional——

Senator MOYNIHAN. And the pension fund is invested in equities.

Dr. GRAMLICH. It is. It is. But it is also out of the budget, and they have constitutional restrictions on what their operating budget can be, their budget deficits. They basically are in balance in their operating budgets. Then they do accumulate reserves for their own employees through their pension fund.

A comparable thing at the Federal level would be just to split OASDI out of the budget and have it work out in its own account what its long-run benefit and taxes should be, and then you would be balancing the rest of the budget. I think a lot of us here on the panel would favor that.

Senator MOYNIHAN. Thank you very much.

Thank you, Mr. Chairman.

Senator GRAMM. Mr. Chairman, could I make one more point, if we have time.

The CHAIRMAN. Yes.

Senator GRAMM. You see, here is a concern that I have. The debate is really following the same pattern it has followed in about 15 countries that have had this debate. It is amazing; there is nothing new under the sun.

At first, the opponents of an investment-based system say there is no problem. Then they say, well, there is a problem and we need investment, but we will have government make the investment. Then, finally, they will say, look, let us not have investment based for the whole system, let us just have it for part of the system. Let us break it up; we will have an upper tier and a lower tier.

But here is the problem. We are creating the impression, by creating the impression that there is a trust fund, that without any other economic effects, let us say that we had $1 trillion in the trust fund. This is this notional trust fund, as I would call it, that Social Security has now.

The idea would be, these people say, look—in fact, there is a person in the House who has written a bill that says, just take the trust fund and take it out of government bonds and invest it in the stock market. That is this guy from North Dakota or somewhere.

This is the response commissioned by the House Democratic leadership. Basically, it creates the impression that you could go and take that $1 billion out of the Treasury today and invest it in common stock. The point is, the only way you could get it out is for the government to do all the things it would have to do if it did not exist.

They would have to raise taxes by $1 trillion, they would have to cut spending by $1 trillion, none of which, of course, they could do, or they would have to go out and borrow $1 trillion with government bonds, but in doing so, they preempt $1 trillion worth of private investment so there is no net new wealth created and there are no resources to pay benefits, even though it appears that you now own stock instead of bonds. That is why I think it is so detrimental to the debate for people to think we have got this free resource sitting there.

The truth is, that when we talk about using it as part of our Social Security fixes, the only way we can use it is to raise taxes, cut spending, borrow more money, and in the end, it is of no value to us that it is there, given that we want to fix the system, I would say.

Dr. GRAMLICH. Yes, that is right, Senator. You are right on point there. I think every one of us here says that we all believe that wealth accumulation is important, and we all believe that we have to do it through new saving. But whether that be higher taxes, lower benefits, or add-on individual accounts, or what, there are different ways to do it.

But if we want to create new wealth, and I think we all think we should, we have to have new saving. There is where the idea of this notional trust fund really does confuse people, I think. So I actually totally agree with your point.

The CHAIRMAN. Well, ladies and gentlemen, let me thank you again for the excellence of your presentation. We look forward to continue working with you.

The committee is in recess.

[Whereupon, at 12:44 p.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted for the Record

Prepared Statement of Hon. Alfonse M. D'Amato

Mr. Chairman, I commend your leadership in holding early hearings on Social Security reform legislation. I welcome my distinguished colleagues who will testify today and look forward to learning more about their proposals on preserving the Social Security system.

Although the system is not fundamentally broken, it's obvious that this is a critical time for the future of Social Security. The program is projected to be in deficit in the near future, so it is imperative that we act soon to avert a possible crisis down the road.

Social Security is one of this Nation's most vital programs with 116 million workers supporting Social Security and 34 million beneficiaries relying on it. Three million of those beneficiaries live in the State of New York.

As you know, Mr. Chairman, in their 1998 report, the Social Security Trustees projected that without changes, Social Security will begin to incur financial problems in 2013, and by 2032 there will not be sufficient income to cover expenditures. At that time it is expected that Social Security will be able to cover only 75 percent of benefit payments. My constituents surely don't like the sound of that. However, I assure them that Congress will not allow Social Security to go bankrupt anymore than it will let Medicare slide into oblivion.

I am pleased that there are a number of bipartisan reform proposals that have been introduced by my colleagues. Although they go about reform in different ways, the bottom line is that each piece of legislation has the same goal in mind: to protect current and future retirees by looking at the problems facing Social Security in the most constructive and bipartisan way possible. Doing so will dispel the widespread thinking—especially by those in the "baby boom" generation—that Social Security will not be around for them.

As we consider proposals to preserve and protect Social Security, our goal must be to restore confidence in the system, ensure its long-term solvency, and to guarantee the financial security of current and future retirees.

Mr. Chairman, I look forward to an informed discussion from today's panelists.

Prepared Statement of Edward M. Gramlich

I am pleased to appear before the Committee to testify on Social Security reform. I speak for myself, as past chair of the 1994–96 Quadrennial Advisory Council on Social Security, and not in my current status as a member of the Federal Reserve Board.

Let me first engage in some retrospection. At the time our Advisory Council released its report in early 1997, there was much publicity about the fact that we couldn't agree on a single plan, but had three separate approaches. Since that time it strikes me that there has been a coalescence around the middle-ground approach I advocated. After our report, both the Committee for Economic Development (CED) and Senator Moynihan came out with plans which were similar to my plan and adopted some of its features. Earlier this year the National Commission on Retirement Policy (NCRP) came out with a similar plan, again adopting some features of my plan. In political terms the center seems to be holding—since our report there has been increased interest in sensible middle-ground approaches, and I would encourage this Committee to work in that direction.

In trying to reform Social Security, I have stressed the importance of two goals. The first is to make affordable the important social protections of this program that have greatly reduced aged poverty and the human costs of work disabilities. The second is to add new national saving for retirement—both to help individuals maintain their own standard of living in retirement and to build up the nation's capital stock in advance of the baby boom retirement crunch.

THE INDIVIDUAL ACCOUNTS PLAN

My compromise plan, called the Individual Accounts (IA) Plan, achieves both goals. It preserves the important social protections of Social Security and still achieves long term financial balance in the system by what might be called kind and gentle benefit cuts. Most of the cuts would be felt by high wage workers, with disabled and low wage workers being largely protected from cuts. Unlike the other two plans proposed in the Advisory Council report, there would be no reliance at all on the stock market to finance Social Security benefits, and no worsening of the finances of the Health Insurance Trust Fund.

The IA plan includes some technical changes such as including all state and local new hires in Social Security and applying consistent income tax treatment to Social Security benefits. These changes go some way to eliminating Social Security's actuarial deficit.

Then, beginning in the 21st century, two other measures would take effect. There would be a slight increase in the normal retirement age for all workers, in line with the expected growth in overall life expectancy (also proposed by the CED, Senator Moynihan, and the NCRP). There would also be a slight change in the benefit formula to reduce the growth of Social Security benefits for high wage workers (also proposed by the CED and NCRP). Both of these changes would be phased in very gradually to avoid actual benefit cuts for present retirees and "notches" in the benefit schedule (instances when younger workers with the same earnings records get lower real benefits than older workers). The result of all these changes would be a modest reduction in the overall real growth of Social Security benefits over time. When combined with the rising number of retirees, the share of the nation's output devoted to Social Security spending would be approximately the same as at present, limiting this part of the impending explosion in future entitlement spending.

These benefit cuts alone would mean that high wage workers would not experience rising real benefits as their real wages grow, so I would supplement these changes with another measure to raise overall retirement (and national) saving. Workers would be required to contribute an extra 1.6 percent of their pay to newly-created individual accounts. These accounts would be owned by workers but centrally managed. Workers would be able to allocate their funds among five to ten broad mutual or index funds covering stocks and bonds. Central management of the funds would cut down the risk that funds would be invested unwisely, would cut administrative costs, and would mean that Wall Street firms would not find these individual accounts a financial bonanza. The funds would be converted to real annuities on retirement, to protect against inflation and the chance that retirees would overspend in their early retirement years.

Some have objected to these add-on individual accounts because they seem like a new tax. First off, I should point out that since the accounts will be returned to the individual in the future (with investment earnings), they are very different from a tax. Indeed, if people who already have significant pension saving beyond Social Security want to reduce their private contributions and preserve their disposable income, there is nothing to stop them. Finally, as a further sweetener it may be possible to let those who can certify the existence of their own private pensions opt out of these add-on accounts, and thus save Social Security the administrative costs. Whatever is done, the basic idea is to raise national saving for the people who do not have much pension saving beyond Social Security, and this scheme seems well-suited for that.

FEDERAL BUDGET SURPLUSES

A welcome new development since our Council issued its report is the arrival of surpluses in the overall federal budget. Some observers have suggested using these surpluses in some way to build up the individual accounts. One example is your own bill, Mr. Chairman.

While the advent of these overall surpluses lessens future interest payments and the overall growth of entitlement spending, I see some problems with "using" the surpluses for Social Security. A first problem from a budget standpoint is that the surpluses already are being used in that way. The overall surplus is more than accounted for by the OASDI surplus, which is already used to finance future Social

Security benefits, so there is double-counting in using these federal surpluses again for retirement programs, whether to finance individual accounts or to finance future Social Security spending. The second problem is that use of the surplus in such a way does not generate new national saving, and I continue to think that that should be an important part of Social Security reform. Hence I would not favor taking any additional steps to use the surpluses to raise future retirement benefits.

CONCLUSION

The Social Security and pension changes that I have recommended would mean that approximately the presently scheduled level of benefits would be paid to all wage classes of workers, of all ages. The difference between the outcome and present law is that under this plan these benefits would be financed, as they are not under present law. The changes would eliminate Social Security's long run financial deficit while still holding together the important retirement safety net provided by Social Security. They would reduce the growth of entitlement spending. They would significantly raise the return on invested contributions for younger workers. And, the changes would move beyond the present pay-as-you-go financing scheme, by providing new saving to build up the nation's capital stock in advance of the baby boom retirement crunch.

As the Congress debates Social Security reform, I hope it will keep these goals in mind and consider these types of changes in this very important program. Thank you very much.

PREPARED STATEMENT OF HON. CHARLES E. GRASSLEY

Thank you Senator Roth. I want to first commend our Chairman for convening today's hearing to discuss Social Security. This program has been fundamental to improving the lives of our country's elderly, workers, and their children. The need to ensure income security for people who have worked and paid taxes their entire lives is of utmost importance. I think that convening this hearing will help ensure that reform of this program remains high on the list of priorities.

There are events occurring nationally and internationally that are eclipsing the national discussion that we have been engaged in during 1998. Of course, we must address the many issues that call out for attention, but we must not let other events delay the timetable that the President set back in early 1998. 1 have tried to build a substantive record on various reform issues—such as stock market investing and the impact of raising the retirement age through hearings in the Senate Aging Committee.

I have also worked on helping my constituents learn as much as they can about the problems this program will face in the next century by convening town hall meetings back in Iowa. I know that this hearing will help move the discussion forward even further. I am confident that we will see some positive action on the Social Security front in the very near future. The public need only look at the list of the Members assembled today who will discuss their reform proposals to know that the Congress is committed to making Social Security work in a fair way for everyone.

I look forward to today's discussion from both panels since these witnesses have led the way by shaping reform proposals that deserve serious consideration. Thank you.

PREPARED STATEMENT OF HON. JUDD GREGG

Chairman Roth, and ranking member Senator Moynihan, I thank you for the opportunity to testify before the Senate Finance Committee concerning the Social Security reform legislation that I have introduced with my colleague, Senator John Breaux of Louisiana. I want to congratulate you, Mr. Chairman, for your leadership on this issue, and to thank you for the open communication that your staff has maintained with my own. This is truly a critical time for the future of Social Security, and you are to be commended for your attention to this vital policy concern.

Time constraints forbid me to review every aspect of the reform legislation that we developed with the National Commission on Retirement Policy, sponsored by the Center for Strategic and International Studies. Let me, then, simply highlight certain important aspects of it.

First of all, it is a truly bipartisan effort. Our legislation currently has six co-sponsors from both sides of the aisle (Senators Gregg, Breaux, Thompson, Robb, Thomas, and Coats.) For six Senators to sign on to a plan that is this specific, this forthright, and that deals with a problem this vast, has to be a modern record of some sort.

Our Commission included members of every political persuasion; and they put aside their differences and voted 24–0 for our package. It represents the preferences of no single member of the Commission. But it does demonstrate what is possible when a bipartisan group decides to work together in a spirit of good faith and compromise.

I need not tell you, Mr. Chairman, that bipartisan cooperation is essential to the cause of strengthening Social Security. You have in the past shown that you are able to work with other Finance Committee members in a truly bipartisan way to take on the toughest of policy issues, including Medicare. Clearly, a similar effort will be required here.

I would add that our bipartisan efforts have not stopped with developing and introducing bipartisan legislation. We are working with Senators Moynihan and Kerrey as well to develop a list of bipartisan principles that our two reform plans have in common. I believe it is important to demonstrate that, while we may individually favor differing elements from our own plans, we should not let the specifics of different proposals prevent us from recognizing the goals that our plans have in common. Focusing on where there is already widespread bipartisan agreement will help us ultimately develop a bipartisan solution.

Second, our proposal works. It has been scored as actuarially sound using the conservative assumptions of the Social Security actuaries. There are no funny numbers here, no attempts to "estimate" the problem away. If the stock market goes up, the proposal works. If the stock market goes down, the proposal works—something not true of every plan. It will keep Social Security solvent through the next century. At the end of the Trustees' 75-year valuation period, the trust fund ratio under our plan would be rising comfortably, strengthening the health of the Social Security system.

Media attention often focuses on the personal account element of our plan and of similar plans. So I would like to say a word about why we chose such a feature.

First, is that we have to recognize what is happening under current Social Security law. Currently, we collect more in payroll taxes than is needed to pay current benefits. What happens to that surplus? It is used to buy treasury bills, which in turn finance government consumption. The government promises to pay that money back in the future. It will be explicitly on the hook to do so, by current estimates, to the tune of $3.78 trillion by the year 2020.

Mr. Chairman, this financing system simply cannot work. It is untenable, and it is, in a way, dishonest. Social Security cannot be considered to be truly sound, even if officially "actuarially sound," as long as the whole system depends on the taxpayers coughing up an additional $4 trillion, or $5 trillion—beyond payroll taxes!—or whatever amount is needed under a "traditional fix" of the system that builds up a "trust fund" in this way. If surplus Social Security taxes are truly to finance current benefits, we cannot continue forking them over to the government to be repaid later by the trillions.

What we would do is to take 2% of the payroll tax base and refund it directly to the individual contributor, in a personal account. This is money that the beneficiary would own. That portion of their benefit would not depend on a government promise in the future to raise taxes by $4 trillion. That money starts building in their own name immediately.

As an aside, I would like to take a moment to mention a regrettable tactic that is sometimes employed by opponents of personal accounts. When we take that money, those surplus taxes, and turn it from an unfunded, contingent, untenable promise, into a real, personally-owned benefit, some will call that a "benefit cut." I am still trying to figure that one out. But basically the thesis is that it's not a real "benefit" if the beneficiary owns the money, in the form of a personal account, but it's a real "benefit" if it is simply a government promise. This is economic nonsense, but we have heard this type of description from opponents of structural reform. Personal accounts are not "benefit cuts." They are a different kind of benefit, and one that is personally owned, controlled, and protected from the whims of government.

Our proposal has often been referred to as a "2% account" plan because that is the amount of the payroll tax refund that we would place in personal accounts. But that is the mandatory portion only. Individuals could make voluntary additional contributions each year of up to $2,000. This distinction is sometimes lost in press accounts, especially when comparing to other voluntary plans. We have a voluntary account contribution, too, that should be counted when comparing the size of our accounts to other voluntary plans.

We use the Thrift Savings Plan model to set up our personal accounts. We did this because it is a tried and true means of limiting administrative costs, something that is especially important for low-income wage-earners. It is also a known commodity, something familiar, and something that works to the benefit of federal employees throughout this city. Americans would not be cut loose to "gamble" or to "play the market"—they would simply be given the type of investment opportunities that federal employees currently enjoy.

Because this is the Committee of jurisdiction over Social Security, I would like to articulate some standards, some criteria for success, that our plan attains, and which I believe are very important for your Committee to bear in mind while considering Social Security reform.

First, I would appeal to you to look beyond actuarial solvency. You can have a system that is actuarially sound on paper, and yet be a disaster. This will be true of any plan that builds up a "Trust Fund" into the trillions, and relies for solvency on the federal government's buying such a fund down during the baby boom years. In reality, such a plan solves no problems at all. It simply displaces problems onto the backs of future workers.

Let me give you an example from current law. In the year 2030, Social Security is still solvent, in theory. But in that year, the cost of the program approaches 18% of the national payroll tax base. The gap between Social Security revenues and outlays is slated to be $684 Billion. If the federal government must then raise taxes by $684 billion in that year alone just to fund benefits, we cannot say that we have solved any problems today. Remember, this is a date on which the program is considered still to be solvent. By contrast, a credible Social Security plan must show a sustainable balance between annual revenues and outlays, a principle that Senator Moynihan has joined with me in espousing.

I would also stress the importance of using the advance funding in personal accounts to replace, not to add to, the liabilities of the current system. Under current law, taxpayers are on the hook for a bill that they cannot possibly pay and yet still achieve the American dream. But we can spare them from this, by moving a part of that funding burden off of the backs of future taxpayers, and to use today's surpluses to create funded retirement accounts. We can phase down the liabilities that taxpayers are faced with tomorrow, gradually replacing unfunded benefits with funded ones. We can't try to have it both ways, to leave all of tomorrow's taxpayer-funded guarantees fully in place, and eliminate unfunded liabilities at the same time. Only by gradually transferring a well-chosen portion of tomorrow's benefits into funded accounts can we reduce the burden that taxpayers face tomorrow.

I would like to say a word about the benefit structure of the traditional Social Security system and how it can be made to work better for tomorrow's seniors. We do not currently have a system that adequately rewards work. The plan that I and Senator Breaux have co-authored will greatly improve the work incentives in the system. Much press attention has been focused on the changes we would make in the normal retirement age—although too little attention has been given to the fact that our personal retirement accounts would allow individuals to set their own retirement age, that our eligibility age changes are phased in gradually over decades, and that individuals will still have the option of early retirement. But I would like to make especial mention of some of the other ways that we believe that the system needs to better reward work.

We would repeal the earnings limit, a principle that Senators Moynihan and Kerrey have also endorsed. But we also make a number of other reforms. First, we would change the earnings formula so that it is no longer simply an average of an individual's top earnings years. We would reward every year of earnings, no matter how small, with an ultimate increase in benefits. This will provide a helpful incentive to seniors who continue to work part-time into their later years. This provision of our plan is too little understood. But under our plan, an additional low-earnings year wouldn't bring down the measure of average earnings, it would continue to add to the earnings credited to one's eventual benefits, whether it is in the individual's top earnings years or not.

Our plan would also reward work by correcting the actuarial adjustments for early and delayed retirement. Under current law, individuals have little incentive to keep working, because the extra benefits they will receive don't offset the actuarial value of the payroll taxes they would pay in the meantime. Our plan would correct this; this means actually increasing the delayed retirement credit from its current level.

I will not review every feature of our plan, but I would like to raise the issue of progressivity. As members of this Committee know, the current Social Security system serves a dual function. On the one hand, it is considered social insurance against poverty. On the other, political support for the program hinges on individual's receiving a reasonable return on his contributions.

It is almost impossible to achieve the second goal without personal accounts. Traditional fixes to the system that simply cut benefits or raise taxes will destroy an already deteriorating rate of return for young workers. But care must be taken, when implementing personal accounts, to recognize that personal accounts do not have a progressive or redistributive character. Accordingly, it was our judgment that the progressivity of the underlying traditional system must be increased, in order to maintain the system's overall progressivity once the personal accounts have grown to large levels, as they will even if they achieve only modest rates of return.

Calculations by the Social Security actuaries show that our plan will provide a better deal for most individuals than if the program is simply balanced with tax increases or benefit cuts. While this is true for most workers across the board—and is true for low-income individuals in all birth cohorts—it is most obviously true in the case of the youngest workers, those retiring after the year 2030. It is for the sake of these people that personal accounts must be established. Otherwise, they will get a truly wretched deal from Social Security.

I would caution the committee to be wary of solutions that are allegedly painless solutions, and to be wary of attempts to demagogue this issue. There are no free lunches here. We cannot solve this problem simply by shuffling investment around. To take a specific example—we cannot solve this problem by leaving the current unfunded guarantees in place, and then simply investing the trust fund in a different way. All that would do is to change the form of the tax burden that we would be levying on future generations to fund those benefit guarantees. A higher rate of return on Social Security would come at the cost of lessening individuals' income from private saving—never mind the inevitability of political interference. Changing the investment practices of Social Security can help only if it is combined with the other measures needed to bring the system into balance—it is not a means of ducking those choices. Otherwise we are simply shifting costs and solving nothing.

Moreover, be wary of the various arguments that are designed to lull us into denying the problem, and to attack those who offer solutions. There are a lot of supposed "solutions" that would simply swell the size of short-term Trust Fund surpluses to improve measures of solvency, and yet make the annual out-year balances even worse than they currently stand to be. Such "solutions" include lifting the cap on taxable wages, raising taxes, or simply hoping for higher economic growth. When you hear proposals like this, ask the actuaries for an estimate of how the cash flow looks under a year such as 2020, 2025, or 2030. Ask what the net tax burden is in those years, and how much the federal government would have to pay back to the Trust Fund in order to make such a plan work. Ask whether those plans assume that the government will have to sell stock by the hundreds of billions to meet benefit payments, and what happens if the hoped-for appreciation doesn't come in. Ultimately, such plans leave all of the liabilities of current law on the doorstep of the taxpayer.

I have every confidence, Mr. Chairman, that the members of this Committee are committed to looking at these problems in the most constructive and bipartisan way. I will make myself and my staff available to review the implications of our proposed changes to Social Security law, as we have learned them from the Social Security actuaries and the experts on the National Commission on Retirement Policy. We have a splendid opportunity here, Mr. Chairman, to leave posterity in a greatly improved position relative to current law, and I hope that this is an opportunity that Congress will seize. With your help, and with the help of ranking member Senator Moynihan, I know that it can be done. I thank you again.

Prepared Statement of Hon. J. Robert Kerrey

Thank you, Mr. Chairman, for the opportunity to testify, even though I feel a bit disadvantaged by the speaking order. Following Senator Moynihan for testimony on Social Security is a little like following Mark McGwire for a lecture on how to hit a home run. I will simply tell you that I wholeheartedly endorse the principles he outlined, and that it has been a high personal honor to work with him on our bill. And I very much appreciate the proposal that Senators Breaux and Gregg have put forward. It closely resembles our own and I am confident the four of us will wind up sitting together on a final product just as we are on this panel. I am also encouraged by the words of President Clinton at a recent Social Security Town Hall meeting in Albuquerque and am hopeful that we can and will pass landmark Social Security reform legislation in 1999.

I. There is a movement going on in this country

You're going to hear a lot today from my colleagues and the other panelists about demographic and financial problems facing our Social Security program. Today I want to talk to you about what I see happening wherever I go in this country. That is a movement towards working Americans managing their own retirements; Over 25 million workers are now participating in 401(k) plans; 37.4% of American Households are participating in mutual funds—up from 5.7% in 1980. You see the change in people's eyes when they own something. It changes their view about the future; 53% of working Americans are now retiring at age 62—and only one-sixth of men aged 65 or older are choosing to stay in the work force—because they can afford to retire with a combination of pension and Social Security benefits.

II. I also hear a lot of people out there complaining about the growing wealth gap between the rich and poor.

Ownership of assets is what truly enables everyone to participate in the rewards of the American economy. Income gets us by, while wealth gets us ahead; The least wealthy 90% of American households earn 60% of all household income, but own just 28% of all net worth and just 16% of financial assets; By contrast, the wealthiest one percent of households earn just 16% of household income but own 39% of all net worth and 48% of all financial assets.

III. Why can't working and middle class families save and invest? The payroll tax is too high.

CBO estimates that 80% of American families pay more in payroll tax than federal income tax; In 1996, the median household income was $35,492. A family with this income, taking the standard deductions and exemptions, paid $2,719 in federal income taxes, but lost $5,430 in income to the payroll tax; The tax is higher than needed to fulfill the purpose for which it is levied. Commissioner Apfel testified before this committee in July that the Social Security Administration brought in $88.6 billion more in revenue last year than it needed to pay benefits; Families are shouldering a disproportionate share of deficit reduction.

IV. The solution is keeping the defined benefit plan and adding a defined contribution component.

It's time to say if you think wealth inequality is the problem, what's the right solution? Senator Moynihan and I, and my colleagues at this table, are bound together with the common belief that the answer is preserving the basic defined benefit floor of the PAYGO system and adding a new individual account component to the Social Security program; Individual accounts allow workers to accept personal responsibility for their futures and to accumulate wealth; Our plan, like others, minimizes risk by modelling savings accounts after the Federal Employees' Thrift Savings Plan, offering broad-based investment funds, including a government bond fund option, and forbidding investors to pick individual stocks; This is not an effort driven by Wall Street—it's an effort driven by people like Al Rowell, who works in the service department in the Senate and participates in his Federal Employee Thrift Savings Plan. He never paid attention to the stock market or savings before—but he sure does now.

V. Other provisions of the bill.

- Reducing the payroll tax rate by 2% and returning the payroll tax rate to the level necessary to meet the obligations of that year's beneficiaries;
- Increasing the normal eligibility age to 68 by 2017 and 70 by 2060;
- Expanding mandatory coverage to all newly-hired state and local employees;
- Reducing COLAs to more accurately reflect the inflation rate;
- Increasing the taxable wage base to $96,600 by 2003 and indexed to the average wage growth thereafter;
- Change the computation years from 35 to 38 when figuring benefits levels;
- Taxation of benefits;
- BUT, elimination of the earnings test;
- Introducing the companion KidSave bill (S. 2184). This bill will use the surplus generated by the Moynihan-Kerrey bill to provide each child a $1000 account at birth and $500 for each of the first five years of life. The idea is to help kids save early for their retirement.

VII. Conclusion

I emphasize, Mr. Chairman, that none of these provisions are as important as our answer to the simple question: Do you want to make Americans wealthy?

Once we answer that question, Mr. Chairman, we have an opportunity not just to complete the important task you outlined in naming this hearing: protecting and preserving Social Security, but also to finish an equally important job: solving the problem of the rich getting richer and the poor getting poorer.

PREPARED STATEMENT OF HON. DANIEL PATRICK MOYNIHAN

Mr. Chairman, we commend and thank you for holding today's hearing on "Proposals to Preserve and Protect Social Security." The two panels you have assembled will present the full spectrum of proposals this Committee will be called upon to consider as we address the future of this singularly important Federal program.

In March of this year, Senator Kerrey and I introduced S. 1792, The Social Security Solvency Act of 1998. In July, Senators Gregg and Breaux introduced S. 2313, The 21st Century Retirement Security Plan. (Congressmen Koble and Stenholm have introduced identical legislation in the House.) Both bills attempt to steer a course between those who seek *to maintain* the current system (albeit with some traditional modifications of payroll tax rates and benefits) and those who seek *to replace* Social Security with private accounts. The Moynihan/Kerrey and Gregg/Breaux bills are quite similar. Indeed, recent discussions among the four of us lead us to conclude that in order to preserve a Social Security program that truly guarantees income security for retirees, for the disabled and for survivors, any Social Security reform plan must provide the following:

- A payroll tax cut for all working Americans;
- An opportunity for all workers to invest in personal savings accounts;
- Payroll tax rates set so that annual revenues closely match annual outlays throughout the actuarial valuation period;
- A progressive benefit formula;
- Accurate cost-of-living adjustments;
- An increase in the retirement age for future generations that reflects increases in life expectancy, and provides an affordable balance between years in the work-force and years in retirement;
- Income tax provisions that provide equitable treatment of young and old;
- Repeal of the earnings test so that beneficiaries are free to work while collecting benefits; and
- Permanent solvency for the Social Security program with a reduction in the Federal Government's unfunded liabilities.

For those who care—as we do—about preserving this vital program, I would simply suggest that without these changes, Social Security as we know it will not survive. For some 20 years now, opinion polls have shown that a majority of non-retired adults do not believe they will get their Social Security when they retire. Ask anyone on the street; ask anyone in their thirties or forties. They are convinced that Social Security will not be there for them. In one sense, they have good reason to think so: the Social Security Trustees so state in their annual report released earlier this year, which pointedly notes that:

> . . . in 2034, tax income of OASI (Social Security) is estimated to be sufficient to pay about 3/4 of program costs; that ratio is projected to decline to about 2/3 by the end of the projection period.

Lack of confidence is partially the result of neglect by a Social Security Administration that has made little effort to stay in touch with Americans before retirement. But there is also a more powerful influence at work: a serious ideological movement opposed to government social insurance as a threat to individual initiative and, indeed, liberty. There is now abroad a powerful set of distinguished political leaders and academics (including some who will be testifying today) who would turn the 60-year-old system of Social Security retirement, disability, and survivors benefits over to a system that depends solely on personal savings invested in the market.

This is a legitimate idea, with respectable intellectual support. (One thinks of the energetic work of Martin Feldstein, who 20 years ago argued that "Social Security significantly depresses private wealth accumulation.") It is an idea that has gained world-wide recognition. Since 1988, workers in the United Kingdom have been permitted to opt out of a part of the Social Security system, if they sign up for some personal retirement savings plans similar to our IRAs or 401(k) arrangements. In Sweden, the model welfare state, the Social Democrats and their coalition members recently passed a pension reform plan that includes a mandatory private pension component equal to 2.5 percent of earnings.

As the 1990s arrived, and the long stock market boom, the call for privatization of Social Security has all but drowned out the more traditional views. For the first time, something akin to abolishing Social Security became a possibility.

Don't think it couldn't happen. In 1996, we enacted legislation which abolished Title IV-A of the Social Security Act, Aid to Families with Dependent Children. The mothers' pension of the progressive era, incorporated in the 1935 legislation, vanished with scarcely a word of protest.

Will the Old Age pensions and survivors benefits disappear as well? What might once have seemed inconceivable is now somewhere between possible and probable. I, for one, hope that this will not happen. A minimum retirement guarantee, along with survivors benefits, is surely something we ought to keep, even as we augment the basic guarantee—as both the U.K. and Sweden have done—with some form of private accounts.

Here is what Senator Bob Kerrey and I proposed, in legislation introduced in March.

Our bill makes changes that will preserve Social Security and make it solvent indefinitely. Under our plan, private accounts would complement Social Security, not replace it. Markets go up, but they also, as has been made painfully clear these last two months, frequently go down.

We believe that the best approach to retirement savings in the 21st century is a three-tier system founded on the basic Social Security annuity. To which is added one's private pension—which about half of Americans now enjoy—and one's private savings.

Our plan would return Social Security to a pay-as-you-go system. This makes possible an immediate payroll tax cut of approximately $800 billion over the next 10 years, as payroll tax rates would be cut from 12.4 to 10.4 percent.

The bill would permit voluntary personal savings accounts, which workers could finance with the proceeds of the two percentage point cut in the payroll tax. Under this provision in our legislation—together with a total of $3,500 deposited in an individual's account at birth and between ages 1–5 under Senator Kerrey's Kidsave bill, of which I am a cosponsor—all workers will be able to accumulate an estate which they can pass on to their children and grandchildren.

Our plan also includes a one percentage point correction in cost of living adjustments for all indexed programs except Supplemental Security Income, and an increase in the retirement age to 68 by 2023 and 70 by 2073, which is a form of indexation because it is related to increases in life expectancy.

We propose to eliminate the so-called earnings test, which reduces Social Security benefits for retirees who have wages significantly above $10,000 per year, and is a burden and annoyance to persons who wish to work after age 62.

Finally, Social Security benefits would be taxed to the same extent private pensions are taxed. And Social Security coverage would be extended to newly hired employees in currently excluded State and local positions.

This package of changes ensures the long-run solvency of Social Security while reducing payroll taxes by almost $800 billion over the next decade, and adding to the Federal budget surplus. Beginning in the year 2030, payroll tax rates would increase gradually to cover growing outlays, and would rise only slightly above the current level in the year 2035.

Can this be done? From an actuarial perspective, it's easy. We know—or at least the actuaries can tell us—within a couple of million persons how many workers will be supporting how many retirees in 2050. Contrast this with Medicare, where you do not know where gene therapy will lead in three years, let alone 30 years. Four members of the Finance Committee serve on the National Bipartisan Commission on the Future of Medicare—Senator Breaux as Chair, along with Senators Gramm, Kerrey, and Rockefeller and I am sure they can attest to the analytic complexity of the issues they are discussing as part of that important Commission's work.

Politically, however, it won't be easy to fix Social Security. In a manner that the late economist Mancur Olson would recognize, over time Social Security has acquired a goodly number of veto groups which prevent changes, howsoever necessary. In so doing they also undermine confidence in Social Security by supporting a promised level of benefits which the Trustees, as noted above, readily admit cannot be delivered.

The veto groups assert that the Moynihan-Kerrey bill will reduce benefits by 30 percent. Not true when compared to what actually can be delivered. With pay-as-you-go, and adjustments in benefits related to an accurate cost of living index and the increase in life expectancy, the Moynihan-Kerrey bill delivers higher benefits than the current system can afford to provide. For example, in 2040 the Social Security actuaries estimate that the current program can only deliver 73 percent of promised benefits. We do slightly better than that. Add in the annuity—financed with voluntary contributions of 2 percent of earnings—and benefits are 20 percent or more higher than the current program can deliver—even assuming real rates of interest no higher than a modest 3 percent. For 2070, the actuaries estimate that current financing will only support benefits equal to 68 percent of what is promised—a reduction of more than 30 percent. Again we do slightly better even without the private accounts—and more than 25 percent better with the private accounts.

As I say, this won't be easy. Which is why this is a time for courage as well as policy analysis. Social Security, one of the great achievements of our government in this century, is ours to maintain. Our bill does just that.

PREPARED STATEMENT OF ALICIA H. MUNNELL

Mr. Chairman and Members of the Committee, I am delighted to have the opportunity to appear before you today to discuss proposals to preserve and protect Social Security. All the participants in this hearing are united in their desire to restore financial balance to the program and thereby re-establish public confidence in Social Security. We differ significantly, however, on the type of changes that should be made. My view is that the best way to assure all Americans an adequate basic retirement income is to maintain the current defined benefit structure and not to move toward a system of individual accounts. Let me provide a brief summary of the reasoning behind that conclusion.

I. Social Security is not facing a crisis. The projected increase in Social Security spending due to the aging of the population is neither enormous nor unprecedented. The cost of the program is projected to rise by 2 percent of GDP. Budget changes equal to 2 percent of GDP are not uncommon; defense spending increased by 5 percent of GDP at the start of the cold war and declined by 2 percent between 1991 and 1998. The financing situation does not require radical change.

II. The desire to increase national saving and broaden investment options for workers—changes that have been used to justify individual accounts—can be achieved more effectively within the structure of the current program.

- The federal government can accumulate reserves. The non-Social-Security portion of the budget is headed for balance in 2002. We can keep it there and build up reserves in the Social Security trust funds. The states do it for their pension funds; the federal government should be able to do it for its major retirement system.
- Broadening Social Security's investment options to include stocks is feasible. We know how to prevent interference in private sector activity: set up an independent investment board, invest in a broad index, and delegate voting rights to fund managers.

III. The economics are clear: Social Security's defined benefit plan is better than individual accounts for providing Americans with their basic retirement pension.

- Because Social Security is a defined benefit plan, it can spread risks across the population and over generations. This means that individual retirees would not have to absorb the kind of losses that the stock market has suffered in the last few weeks. The risks would not disappear, but gains and losses could be averaged over time.
- Pooling investments in the Social Security trust funds also keeps transaction costs low, ensuring higher net returns than individual accounts. Administrative costs for individual accounts are equivalent to a 20-percent cut in benefits. Annuitizing individual accumulations reduces benefits by another 10 percent.
- Social Security also avoids the pressure for individuals to gain early access to their accounts, leaving retirees with inadequate retirement income.
- Social Security assures that accumulated funds are transformed into inflation-indexed annuities so that retirees do not outlive their retirement resources.
- Social Security provides full benefits for disabled workers who would not have time to build up adequate reserves under a system of individual accounts.
- Finally, Social Security protects dependent spouses after the worker dies.

IV. In short, the current defined benefit arrangement is the best way to provide basic retirement income; there is no reason to move towards a defined contribution system.

- Much of the projected shortfall can be eliminated with good policy changes. For example, extending coverage to new state and local workers, slightly increasing the maximum taxable earnings base, and reflecting BLS corrections to the CPI in the COLA are all consistent with the goals of the program.
- Broadening the investment options will increase the return on fund reserves and also improve the program's finances.

- Social Security has served us well for nearly sixty years; let's modernize its financing but keep its defined benefit structure in place.

I. Social Security is Not Facing a Financing Crisis

Social Security is not facing a financial crisis. It is true that current projections show the trust fund being exhausted in 2032, but that does not mean the program ends in that year and nothing is left. Even if no tax or benefit changes were made, current payroll tax rates and benefit taxation would provide enough money to cover roughly 75 percent of benefits thereafter.

Social Security is not about to disappear, but it does have a projected long-run financing problem unless remedial action is taken, as it almost certainly will be. According to the Trustees' 1998 Report (intermediate assumptions), between now and 2013 the Social Security system will bring in more tax revenues than it pays out. From 2013 to 2021, adding interest on trust fund assets to tax receipts produces enough revenues to cover benefit payments. After 2021, annual income will fall short of annual benefit payments, but the government can meet the benefit commitments by drawing down trust fund assets until the funds are exhausted in 2032. Over the next 75 years, Social Security's long-run deficit is projected to equal 2.19 percent of total payroll earnings. Since the system currently faces permanent deficits beyond the 75-year horizon, forecasting beyond then produces a higher average deficit.

It is also useful to look at the program as a percent of GDP. The cost of the program is projected to rise from 4.6 percent of GDP today to 6.8 percent of GDP in 2030, where it is projected to remain. This increase is due entirely to the aging of the population. A 2-percent-of-GDP increase in Social Security costs is significant, but hardly qualifies as a "demographic time bomb." (The reason that costs as a percent of taxable payrolls keep rising while costs as a percent of GDP stabilize is that taxable payrolls decline as percent of total compensation.)

Although Social Security's financing problems are manageable and do not require radical changes in the system, the situation is different than it was in 1983 when Congress last passed major financing legislation. First, as noted above the system is not facing a short-term financing crisis. The emergence of a long-term deficit in the absence of a short-term crisis gives policymakers time to consider comprehensive reform as well as incremental fixes to the system. Second, in considering both incremental and comprehensive reform, two relatively new considerations are playing an important role. One is the maturation of the Social Security program. Unlike earlier generations who received large benefits relative to the taxes they paid, today's workers face a sharp decline in returns that they can expect to receive on their payroll tax contributions (the so-called money's worth issue). Since raising taxes or reducing benefits will only worsen returns, almost all reform plans involve equity investment in one form or another to provide additional revenue. The second factor influencing the Social Security reform debate is concern about our low levels of national saving. This concern along with the desire to avoid high pay-as-you-go tax rates in the future has led to considerable interest in some prefunding.

Almost all proposals to restore financial balance to Social Security respond to concerns about rate of return and national saving. Both proposals to maintain Social Security's existing defined benefit plan and proposals to institute individual accounts involve a substantial accumulation of assets. Similarly, most proposals provide that those covered by Social Security should have access to the higher risks and higher returns associated with equity investment either through investments in individual accounts or through broadening the investment options of the trust funds. Because it is possible to have equivalent amounts of funding in the Social Security program and in a system of individual accounts and because equity investment is possible in either scenario, the question comes down to whether defined benefit or defined contribution arrangements are better for people's basic retirement income.

II. More Funding and a Broader Portfolio within the Current Program

Accumulating reserves in the Social Security trust funds and investing part of those reserves in equities offers many of the advantages of individual accounts without the risks and costs. It has the potential to increase national saving and offers participants the higher returns associated with equity investment. But, unlike individual accounts, a partially funded Social Security program with equity investments ensures predictable retirement incomes by maintaining a defined benefit structure that enables the system to spread risks across the population and over generations.

Accumulating Reserves

Would it really be possible for the federal government to accumulate reserves? To date, increasing saving through accumulations in the Social Security trust funds has produced ambiguous results. Critics contend that the existence of Social Security surpluses encourages either taxes to be lower or non-Social-Security spending to be higher than it would have been otherwise. Although little evidence exists to support this contention, a unified budget and large deficits have blurred the picture to date. But the fiscal outlook is changing; the unified budget is in surplus and the Congressional Budget Office projects that the non-Social-Security portion of the budget will be balanced by 2002.

Revising the presentation of government accounts to separate Social Security completely from the rest of the budget also would clarify the extent to which the system is adding to national capital accumulation. Technically, the Social Security Amendments of 1983 already have placed the Social Security trust funds "off-budget." This legislation reversed the reliance on the concept of the unified budget first used by Lyndon Johnson in FY1969. The difficulty is that, while Social Security is exempt from most enforcement procedures, budget targets are always stated in terms of the unified budget and the budget numbers reported by the Administration, Congress, and the press always include the balances in the trust funds. Thus, separating Social Security from the rest of the budget requires changing culture more than changing legal requirements.

Is it realistic to evaluate the budget without Social Security? Comparisons of the federal government with the states are always tricky, but states have been successful in this endeavor. They accumulate reserves to fund their pension obligations but generally present their budgets excluding the retirement systems. Their non-retirement budget balance has remained positive, while annual surpluses in their retirement funds have been hovering recently around 1 percent of GDP. Thus, states are clearly adding to national saving through the accumulation of pension reserves. With a commitment to balance the non-Social-Security portion of the budget, the same should be achievable at the federal level.

Investing in Equities

Equity investment for Social Security is also a feasible option, and a partially funded Social Security program with a broad portfolio is the realistic alternative to individual accounts. Everyone involved in the debate recognizes that having the federal government in the business of picking winners and losers and voting on corporate proposals is undesirable. Thus, it is essential to establish mechanisms to ensure that the government does not interfere in private sector decisions, and we know how to do that. For example, trust fund equity investments would be indexed to a broad market average, and the goal of investment neutrality be established in law. An expert investment board, similar to the Federal Retirement Thrift Investment Board that administers the Thrift Savings Plan for federal employees, would be responsible for selecting a broad market index, such as the Russell 3000 or the Wilshire 5000, for trust fund investments. This board would also be responsible for choosing, through competitive bidding, several portfolio managers to manage the accounts, and for monitoring the performance of these managers. To ensure that government ownership does not disrupt corporate governance, the investment board would be required to delegate voting on proxy issues to the individual portfolio managers. Caps on the holdings in any individual company can be introduced to ensure that Social Security does not disrupt financial markets.

Even though equity investment by Social Security would not disrupt the markets, some critics still worry that it could have a substantial effect on relative rates of return, perhaps driving up government borrowing costs. The portfolio restructuring would be expected to have some effect on relative returns. The equity premium would decline to reflect the increased efficiency of risk bearing in the economy. Some movement would also be expected in interest rates. The one study that has estimated the effect on relative returns concluded that the shift to equities in the trust funds would lower the equity premium by 10 basis points and raise the interest on Treasury securities by roughly the same amount (Bohn 1998). With current levels of federal debt, this increase in Treasury rates should have a relatively small effect on the unified budget. As the economy grows and the debt declines, the effect should be negligible.

While Social Security investment in equities is unlikely to disrupt financial markets or cause major shifts in rates of return, many people are concerned that Social Security investment in equities could lead to government interference with the allocation of capital in the economy and with corporate activity.

In the Social Security debate, both supporters and opponents of trust fund investment in equities point to the performance of public pension funds to argue their case. Supporters cite the success of federal plans, particularly the federal Thrift Savings Plan (TSP). The TSP has established a highly efficient stock index fund and has steered clear of any issues of social investing. TSP designers insulated investment decisions by setting up an independent investment board, narrowing investment choices, and requiring strict fiduciary duties. The TSP also operates in a political culture of noninterference. Its creators made clear from the beginning that economic, not social or political, goals were to be the sole purpose of the investment board. The TSP has perpetuated this norm by refusing to yield to early pressure to invest in "economically targeted investments" or to avoid companies doing business in South Africa or Northern Ireland. It has avoided government interference with private corporations by pushing proxy decisions down to individual portfolio managers.

Opponents of trust fund investment in equities point to state and local pension funds. They contend that state and local pensions often undertake investments that achieve political or social goals, divest stocks to demonstrate that they do not support some perceived immoral or unethical behavior, and interfere with corporate activity by voting proxies and other activities. Opponents charge that if the investment options are broadened at the federal level, Congress will use the trust fund money for similar unproductive activities.

My view is that the social investing activity of state and local pension plans has been grossly exaggerated, and that any such activity would be even less likely to occur at the federal level. For example, using a very comprehensive definition, a 1993 study for Goldman Sachs reported that economically targeted investments totaled less than 2 percent of total state and local pension fund holdings. Similarly, most of the divestiture activity, which centered on firms doing business in South Africa, ended in 1994, although the issue has arisen again somewhat with respect to tobacco stocks. Proxy voting activities, which may or may not be desirable, is limited to a few large pension funds, most notably the California Public Employees Retirement System (CalPERS). This would not occur at all in the case of Social Security, since all advocates support the notion of delegating voting to the pension fund managers. Moreover, pressures for economically targeted investment would be much less likely under the public scrutiny associated with federal government activity than in the relative secrecy of state-local pension plan management.

In short, a partially funded defined benefit plan with equity investment is feasible and can do everything that privatized accounts can do but at lower costs, thus yielding higher net returns. A recent GAO report did not identify any insurmountable hurdles with direct trust fund investment in equities. Canada should provide some confirmation about the feasibility of equity investment since is in the process of setting up a board that will oversee the investment of its Social Security trust funds in equities.

III. Social Security's Defined Benefit Plan Is Better than Individual Accounts for Basic Retirement Benefits

Accumulating reserves in the Social Security trust funds and investing part of those reserves in equities offers many of the advantages of individual accounts without the risks and costs. A partially funded Social Security program with equity investments ensures predictable retirement incomes by maintaining a defined benefit structure that enables the system to spread risks across the population and over generations. In addition, pooling investments keeps transaction and reporting costs to a minimum, producing higher net returns on equity investments than individual accounts.

While Social Security's defined benefit provisions provide a predictable basic retirement benefit, moving toward individual accounts, such as the IRA-type proposals, puts much of people's retirement income at risk. Individuals' basic benefits would depend on their investment decisions. What stocks did they buy? When did they buy them? When did they sell? Uncertain outcomes may be perfectly appropriate for supplementary retirement benefits, but not for the basic guarantee. Herb Stein, Chairman of the Council of Economic Advisers under President Nixon, summarized the argument best:

> "If there is no social interest in the income people have at retirement, there is no justification for the Social Security tax. If there is such an interest, there is a need for policies that will assure that the intended amount of income is always forthcoming. It is not sufficient to say that some people who are very smart or very lucky in the management of their funds will have high incomes and those who are not will have low incomes and that everything averages out."

Retirement income that depends on one's skills and luck as an investor is not consistent with the goals of a mandatory Social Security program. Social Security is the major source of income for two-thirds of the 65-and-over population and virtually the only source for the poorest 30 percent. The dollar amounts are not very large: the benefit for a low-wage worker who retired at age 62 in 1997 was only $450 per month or $5400 per year and for a worker with a history of average wages was $742 per month or $8904 per year. Does it really make sense to put these minimum dollar amounts at risk?

In addition to spreading risks, Social Security's pooled investments keep costs low. In contrast, the 1994–96 Social Security Advisory Council estimates that the administrative costs for an IRA-type individual account would amount to 100 basis points per year. A 100-basis point annual charge sounds benign, but estimates by Peter Diamond of MIT show that it would reduce total accumulations by roughly 20 percent over a 40-year work life. That means benefits would be 20 percent lower than they would have been in the absence of the transaction costs. Moreover, while the 100-basis-point estimate includes the cost of marketing, tracking, and maintaining the account, it does not include brokerage fees. If the individual does not select an index fund, then transaction costs may be twice as high. Indeed, costs actually experienced in the United Kingdom, which has a system of individual accounts, have been considerably higher than the Advisory Council estimate. Finally, because these transaction costs involve a large flat charge per account, they will be considerably more burdensome for low-income participants than for those with higher incomes.

In addition to keeping costs low during the accumulation phase, Social Security provides inflation-adjusted benefits at retirement. Without such a transformation, individuals stand a good chance of outliving their savings. But the costs of setting up an annuity in the private sector are high and few people purchase private annuities. As a result, workers could face another 20 percent charge when they reach retirement age (Mitchell, Poterba, and Warshawky 1997). Roughly half of this charge covers administrative costs—selling expenses, clerical salaries, investment expenses, and profits—and is inescapable. The other half reflects the price of adverse selection—that is, people with longer life expectancies tend to purchase annuities. This half would disappear if annuities were mandatory, but not if they remained voluntary. Not only is the private provision of annuities expensive, but the products currently available in the private market do not offer inflation protection.

In addition to less risk and lower costs, Social Security ensures that individuals receive their full benefit at retirement. In contrast, individual accounts create a very real political risk that account holders would pressure Congress for access to these accounts, albeit for worthy purposes such as medical expenses, education, or home purchase. Although most Social Security reform plans prohibit such withdrawals, our experience with existing IRAs and 401(k)s suggests that holding the line might be quite difficult. To the extent that Congress acquiesces and allows early access, retirees will end up with inadequate retirement income.

Finally, when evaluating a shift from Social Security's defined benefit system to individual accounts, it is important to consider not only the effect on the worker, but also on the worker's family. A defined benefit system with auxiliary benefits is very different from a defined contribution system where the annuity protection for the family is paid for by the worker and may involve choice. The evidence suggests that left on their own, workers do not always make very good choices for themselves, much less for their dependents. The small size of the current U.S. annuity market indicates that retirees do not choose to annuitize their accumulations. Evidence from the U.K. suggests that people do not purchase inflation protection even when they have the opportunity. Finally, pre-ERISA data indicate that many workers select single-life annuities with no protection for surviving spouses. Thus, without explicit provisions to protect dependent spouses, elderly widows, who already suffer very high rates of poverty, could be made worse off under a system of individual accounts.

Because the IRA-type approach is so risky and costly for the basic retirement benefit, some suggest the 401(k) or federal Thrift Savings Plan (TSP) approach. Instead of individuals holding their funds and investing them in anything they like, the government would hold the money and designate a series of investment options. In my view, this approach—when it comes at the expense of existing Social Security benefits—has little to recommend it and undermines protections in the current program. First, the TSP approach introduces much of the same unpredictability into retirement income as the IRA-type alternative. Second, while its costs would be lower, it would still double the costs of the current Social Security program. Finally, for those concerned about government involvement, this approach has the government picking the appropriate equity funds and retaining control of the money. This is not a particular problem in my view, but the TSP approach does raise all the same corporate governance issues as investment by the central trust funds.

IV. There Is No Reason to Substitute Individual Accounts for Social Security's Defined Benefit Plan

The financing requirements of the Social Security system do not require any radical change in the benefit structure. Prefunding Social Security and investing in equities not only improves the distribution of risk in the economy, it also reduces the size of the financing gap within the Social Security program. In addition, most observers agree on some further steps that are both inherently fair and would further cut the long-run deficit. These include: extending coverage to new full-time state and local government employees (about 3.7 million workers) not now covered by Social Security, making Social Security benefits taxable to the extent they exceed worker contributions (comparable to other contributory defined benefit plans), lengthening the averaging period for the Social Security benefit calculation, and improving the accuracy of the Cost-of-Living Adjustments as the BLS refines the Consumer Price Index. Many would also argue for a slight increase in the Social Security maximum earnings base to bring the proportion of earnings subject to tax more in line with the 90 percent figure established in 1983. In short, it is not difficult to close the 75-year financing gap in the Social Security program; this can be done with only a modest impact on benefits.

Once balance is restored to the existing program, it is possible to consider changes that would improve the likelihood that future retirees will have adequate incomes. One option is to introduce voluntary supplemental individual accounts within Social Security for those who would like to set aside more money. Thus, the debate is not about whether individual accounts are good or bad in general. Once people are assured basic retirement protection, individual accounts may be a perfectly reasonable addition. What opponents of individual accounts object to in the context of Social Security reform is cutting back on existing Social Security benefits and replacing those benefits with a risky and costly alternative. Introducing individual accounts as an add-on to Social Security is a good idea; substituting individual accounts for existing Social Security benefits needlessly undermines protection for retirees, the disabled, and their dependents.

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STATEMENT BY ROBERT J. MYERS PRESENTED TO THE SENATE COMMITTEE ON FINANCE, SEPTEMBER 9, 1998, WITH REGARD TO PROPOSALS TO PRESERVE AND PROTECT SOCIAL SECURITY

Mr. Chairman and Members of the Committee: My name is Robert J. Myers. I served ~~in~~ various actuarial capacities with the Social Security Administration and its predecessor agencies during 1934-70, being Chief Actuary for the last 23 years. In 1981-82, I was Deputy Commissioner of Social Security, and in 1982-83, I was Executive Director of the National Commission on Social Security Reform. In 1994, I was a member of the Commission on the Social Security "Notch" Issue, being an appointee of the Senate.

Meaning of Privatization of the Social Security Program

In recent years, many proposals have been made for the purpose of privatizing the Social Security program, in whole or in part. Terms have different meanings for different people, but I believe that the proper definition of this concept is the replacement of part or even all of Social Security retirement-benefit protection by individual savings accounts administered in the private sector.

Thus, not included in "privatization" are proposals which involve individual accounts administered and invested entirely or partly in the private sector by the federal government. This approach does not seem to be politically or economically acceptable for plans covering large numbers of private-sector employees (especially, all of them), because of the possible concentration of economic powers in the hands of the government. This is so regardless of any automatic safeguards, such as investing only on an indexed basis and not attempting to control corporations' activities by proxy voting or otherwise that may be established initially, but may be weakened over time.

For the same reasons, "privatization" should not be used to connote the changing of the investment procedure for the Social Security trust funds such that some of their assets would be invested in the stock market.

Nor included as "privatization" should be proposals for mandatory or optional supplementary individual accounts established on top of a reformed Social Security program with benefit amounts maintained at about the current level, with such accounts administered in the private sector -- to be discussed later.

Privatization of the Social Security program is undesirable for several reasons, which I will later briefly discuss. The Achille's heel of privatization proposals which have been made to date is that they are not administratively feasible, which fact has rarely been pointed out in public discussions.

Nature of the Social Security Program

From the inception of the Social Security program in 1935, it has has always been a social insurance system designed as an income-maintenance plan in the event that certain risks occur -- currently, age or disability retirement and death of the worker (either before or after retirement). Conversely, it was not intended to be an investment plan, under which every participant is supposed to receive the same investment rate of return

Rather, the Social Security program is a mixture of individual equity and social adequacy, with emphasis on the latter. For example, larger benefits relative to contributions are paid in some cases than in others -- (1) workers near retirement age at the start of the program, (2) low-earnings workers, and (3) workers with dependents.

Public education is based on social adequacy principles, rather than individual equity ones -- even more so than is the Social Security program. Thus, two families with the same number and ages of children receive the same education benefits, and yet the family with a mansion pays much more real estate school taxes (i.e., a lower rate of return) than does the one with a modest home. Similarly, a family which never has children receives a very poor "rate of return" on its school taxes (unless one takes a broader view as to what is good for the nation).

Current Financial Status of Social Security Program

From a short-range cash-flow standpoint, the Social Security program is in excellent condition. At the beginning of 1998, the trust-fund balance was $656 billion, an increase in the past 12 months of $89 billion. It is likely that, in the next decade, the annual excesses of income over outgo will increase to a level of about $150 billion. Thereafter, however, according to the intermediate estimate in the 1998 Trustees Report, such excesses will become smaller, and after a decade will cease to exist (and, in fact, will turn negative). As a result, the trust-fund balance will decrease and will become exhausted in 2032.

A good measure of the long-run financial status of the Social Security program is the long-range actuarial balance. This element, expressed as a percentage of taxable payroll, if negative, indicates the increase in the combined employer-employee tax rate which would be needed immediately if the program is to be fully financed over the 75-year valuation period. According to the intermediate estimate, the long-range actuarial balance is -2.2% of taxable payroll. On the other hand, the low-cost estimate shows a small positive balance, while the high-cost estimate shows a much larger negative balance.

The conclusion to be drawn is that a significant, but not overwhelming, long-run financing problem very likely exists. This can be solved in numerous ways within the existing structure of the proram. However, it should be realized that solving the problem by the simple, not too painful, method of increasing the combined employer-employee tax rate by 2.2% is not a complete solution, because insufficient financing would be present after the end of the 75-year valuation period.

What would happen if the assumptions of the intermediate estimate were exactly fulfilled, and the combined employer-employee tax rate were increased by 2.2%, is that huge fund balances would be built up in the next few decades and then thereafter drawn down. So, at the end of the 75-year valuation period, the fund balance would be only one year's outgo, and a higher tax rate (by about 4%) would be needed thereafter. This would hardly be a reasonable way to solve the problem.

Why Pay-As-You-Go Financing Is Most Desirable

I believe that pay-as-you-go financing is, by far, the most desirable way to finance a national pension system like the Social Security program. By pay-as-you-go financing is meant that, each year, payroll tax income is kept closely in balance with outgo, and a fund balance of at least 50%, but not more than 100%, of annual outgo is maintained. At the end of 1998, such fund ratio will be about 190%, while in subsequent years for the next decade it will rise even higher. Then, under the intermediate estimate, it will decrease -- until reaching zero in 2032. Thus, it is clear that the Social Security program is now not being financed on a pay-as-you-go basis.

The key to success for pay-as-you-go financing is that it must be responsibly done. Not only must adequate contribution rates be provided over all future years according to the best actuarial estimates available, but also the benefit structure must not be such that the contribution rates will rise to too high a level ultimately.

Under present law, according to the intermediate estimate, the combined employer-employee tax rate for the next decade would, under pay-as-you-go financing, be 11.1% (as compared with the actual scheduled rate of 12.4%). It would the have to rise slowly, reaching 12.4% in about 15 years, and then continue to increase, reaching 18.7% at the end of the 75-year valuation period. Even after that the rate would continue to rise. This would hardly be a responsible or desirable situation because the level of the ultimate tax rates is so high as compared with the current rate in present law, and moreover it does stabilize for decades.

The reason for this unsatisfactory situation is primarily due to the ever-increasing retirement-life expectancy assumed in the cost estimates. On the one hand, it could be argued that it is inappropriate to assume perpetually increasing life expectancies for only small, fixed increases in the full-benefits retirement age. This argument is similar to what was assumed with regard to economic factors (wage and price trends) before 1972, when the program structure was based on static, current-day economic assumptions (instead of containing indexing provisions, as is the case now). Then, constant future economic conditions were assumed -- even though it seemed certain that rising prices and wages would, over time, occur. To do otherwise and assume dynamic economic conditions would have significantly understated the cost of the program and would have led to undue optimism about its financial condition.

On the other hand, if "realistic" longevity assumptions are to be used, it is essential that, in order to have responsible financing, the program should be modified to have somewhat parallel increases in the full-benefits retirement age. This can be done by providing for prescribed future increases (as is done, to some extent in present law) in all future years or providing for indexing of the retirement age, or by a combination of the two procedures.

I fully realize that such a proposal is not liked by many people. I believe that this is because they have a static view of the situation and only consider what such an age of 70 (or higher) is in today's setting. They should realize that, if we had developed the Social Security program 150 years ago, we would have chosen a retirement age of 50 or 55. Certainly, it would not have been tenable to have kept such a low age up to the present time. In the same way, the present age of 65, going up to 67 in about 30 years, is not really tenable or responsible.

How Should Social Security's Financing Problems Be Solved?

Long-range financing problems of the Social Security program can be solved in many different ways. Some alone can be the entire solution, while others can do part, and a "package" of them will be needed. Some changes can be described as "structural" (involving significant alteration of the program's basic principles), while others can be described as "traditional" (only modifying the benefit and/or financing provisions).

The most widely discussed structural change is privatization. This procedure would be undesirable for several reasons. Covered individuals would bear the risks of (1) market fluctuations, depending upon choice of investment vehicles (2) the time when they retire as it relates to the level of the stock market, and (3) how long they live in retirement. Huge costs, paid from general revenues, would occur for paying the benefits of those now retired or near retirement and for minimum-pension guarantees; such costs could be met only through the undesirable action of higher taxes, budget deficits, and/or increases in the National Debt. Suitable disability and young-survivor benefit protection would be very difficult to provide in a simple, consistent manner. Women would be disadvantaged because of greater longevity and lower labor-market participation. Perhaps insoluble administrative problems would arise with respect to the millions of part-time, generally low-paid, workers, for whom the contributions to the individual accounts would be very small. As a result, the administrative expenses to operate such accounts would sharply reduce the allocated contributions. Employers would be faced with overwhelming administrative work if each worker had complete freedom of choice as to which investment company that he or she wanted.

Another structural change would be to means test the benefits completely. This is now partially done by the weighted benefit formula and the income taxation of benefits. Such procedure would deny benefits to high-income persons, other than a return of their contributions, with a gradual phasing in for lower-income persons. This procedure is undesirable because popular support for the program would be destroyed, and eventually it would become a welfare program, which would be difficult to finance and administer, as well as resulting in much fraud and abuse.

Another structural change would be to invest a sizable portion of the trust-fund assets in the stock market, so as to produce more investment income. As discussed earlier, this procedure would be undesirable. Further, if pay-as-you-go financing is followed, the amount available for investment in this manner would be small, so that additional investment income would be negligible.

In the area of traditional changes, three relatively non-controversial proposals have been made. First, all newly-hired state and local government employees would be compulsorily covered. Second, benefits would be subject to income tax in the same way as are private pensions, and the proceeds given to the trust funds (present law does this to a considerable extent, but not completely). Third, the Consumer Price Index would be technically corrected, so that cost-of-living adjustments would be made. These changes would reduce the long-range deficit under the intermediate estimate by about one-third.

Many other traditional changes are possible. First and most important, the full-benefits retirement age could be increased more than scheduled under present law, by prescribed increases and/or by indexing to retirement-life expectancy. Second, general benefit levels could be gradually reduced, either at all earnings levels or only for the highest earners. Third, the COLAs could be the increase in the CPI (after being technically corrected), minus an arbitrary amount. Fourth, the computation period for retirement benefits could be lengthened from the present 35 years, affecting women the most adversely, because of their time of the labor force while homemakers. Fifth, contribution rates could be increased, either at once or deferred for some years, and then possibly in small steps. Sixth, the maximum taxable earnings base could be increased somewhat more than would occur under present law by the wage indexing provision.

I believe that the best solution would be a package that first includes the three "noncontroversial" changes. Further, the maximum taxable earnings base would be increased gradually so that it would cover 90% of the total payroll in covered employment. The remainder of the long-range actuarial deficit, according to the intermediate estimate, would likely be met by increasing the full-benefits retirement age, beginning for those reaching age 62 in 2000, by 2 months for each year-of-birth cohort until it reaches age 70 for those reaching age 62 in 2029, and indexing such retirement age thereafter according to changes in relative retirement-life expectancy. This change reflects the "logic" that, if people live longer (as is so significantly assumed in the cost estimates), they can and should work longer.

Specifically, the indexing of the retirement age would be done as follows. For each year-of-birth cohort reaching age 62 after 2029, the retirement age would be increased by 2 months, subject to the condition that, for a particular year, it would not exceed the oldest age, expressed in 2-month intervals, at which the life expectancy according to the U.S. Life Tables for the fifth year preceding such year exceeds 12.80 (the life expectancy at age 65 in the U.S. Life Tables for 1939-41).

Also, I propose reducing the employer and employee contribution rates for the next 10 years by 1% each. This would return the financing of the program to a pay-as-you-go basis and thus avoid the dangers inherent in a large build-up of the fund balance.

Any long-range deficit remaining after these changes would be met by small increases in the employer and employee contribution rates (e.g., 0.3% each) in 2015 and, if necessary, at future 5-year intervals. Such increases would not be overly burdensome, because they would be well less than the likely increases in real wages.

Finally, I propose the establishment of a mandatory supplementary individual-account system administered by the private sector, with a 2% combined employer-employee contribution rate. Excluded, however, would be workers with low earnings (e.g., less than $4,000 in a quarter), because their participation would not be cost effective; such persons are well protected by Social Security alone, due to the weighted benefit formula. I would not favor such a supplementary system being administered by the government, for the same reasons as not favoring investment of the trust-fund assets in the stock market by the government. However, I am not at all certain that my proposal, despite its elimination of non-cost-effective very small individual accounts, is administratively feasible. I would urge that, before any proposal for mandatory or voluntary individual accounts is seriously considered for legislative enactment, it should be extensively studied by experts in this field so as to be certain that it is both administratively feasible and equitable.

"Retirement Issues II:
Proposals to Protect and Preserve Social Security"

Testimony to the Senate Finance Committee

Andrew A. Samwick
Dartmouth College and NBER
September 9, 1998

Honorable members of the committee and distinguished guests, it is both an honor and a privilege to be asked to discuss my research on the potential privatization of the Social Security program with you this morning. Over the next few years, we as a nation will find ourselves confronted by many decisions that are critical to the economic security of the generations that follow us. None of these decisions are more important than the way we choose to restore solvency to our current Old Age, Survivors, and Disability Insurance (OASDI) programs.

We are fortunate that the projected cash flows in the system will sustain it for at least the next 30 years. This is our window of opportunity. At the end of that period, every member of the Baby Boom generation will have reached the current normal retirement age. It is important to note at the outset that the long-term financial condition of OASDI is the result of trends toward lower mortality rates and lower fertility rates. The presence of the Baby Boom generation accelerates, but does not directly cause, these trends.

The longer we wait to act, the more severe will be the policy changes that are required to restore solvency to the system. The most recent Trustees' Report shows that at the end of its 75 year forecasting period, the cost rate on the OASDI program will rise to over 19 percent under the intermediate assumptions. This cost increase necessitates a pay-as-you-go tax increase of over 6 percentage points from the current level of 12.40 percent if benefit levels are to be maintained. Alternatively, actuarial projections show that over that 75-year period, approximately 2 percentage points of covered payroll per year must be raised in order to cover the shortfall. These two numbers, 2 to stabilize and 6 if we procrastinate, are the most succinct means of describing our current situation.

My remarks today are based on the results of my ongoing research with Professor Martin Feldstein of Harvard University (cited in the references section below). We have designed a straightforward simulation model of the OASDI system that allows for prefunding and hence privatization of the program's future liabilities. All of our demographic and economic assumptions match the intermediate assumptions in the 1998 Trustees Report.

Under our proposal, workers and their employers make mandatory contributions to Personal Retirement Accounts, or PRAs. The balances in PRAs are invested in broadly diversified portfolios of corporate sector liabilities (stocks and bonds). As workers reach retirement, PRAs are converted into annuities that replace a portion of their promised OASDI benefits. Over time, more workers will retire with PRA balances that reflect an entire working career of contributions. As more OASDI benefits are replaced, outflows from the Trust Fund are reduced. With sufficiently large PRA contributions, we can avoid the forecasted increases in the payroll tax rate and potentially increase retirement income levels or provide further payroll tax relief.

What makes this system feasible is that PRA balances are assumed to earn the historical average rate of return on the corporate sector. This return, after inflation, has been approximately 5.5 percent in the postwar period. This figure is net of corporate tax payments but prior to individual tax payments, analogous to the income tax treatment currently enjoyed by IRAs and 401(k) plans. It is substantially above the implied rate of return on a pay-as-you go system, which is equal to the growth rate of the covered wage base or approximately one percent under the current intermediate assumptions.

Under our baseline scenarios, a system of 2 percent PRA contributions generates sufficient balances to stabilize the pay-go tax rate at 12.40 percent while permitting up to a 25 percent increase in future benefits. With a system of 6 percent PRA contributions, the entire pay-as-you-go system could be phased out, generating a substantial reduction in future payroll tax rates.

The key to achieving these results is the accumulation of new capital to prefund future liabilities. Note that this is a different issue from the more widely discussed proposals to invest the existing Social Security trust fund in corporate stocks and bonds. Exchanging the government securities that are currently in the Trust Fund for higher return, higher risk assets will decrease the expected future payroll tax increases. But the Trust Fund balances are not so large that this measure by itself will restore solvency to the system.

Our primary objective in designing the PRA system was to make only the changes that are necessary to allow for the prefunding of future OASDI liabilities. The most important consequence of this approach is that all benefits that have been accrued under the current system will be paid out of the current system. This includes benefits to current retirees as well as those to current workers based on their earnings to date.

We also maintain the legislated ages of normal retirement and average income replacement rates. While academic arguments can be made for indexing the normal retirement age to expected longevity or changing the inflation adjustment of benefits, the public seems to be comfortable with the existing benefit formula. It should also be noted that any additional policy, such as the benefit cut implied by raising the normal retirement age, reduces the necessary additional funding for PRAs. Finally, in implementing the transition, the existing Trust Funds earn the currently forecasted rates and are not consumed any faster than is stipulated under the intermediate assumptions in the Trustees Report.

Overall, our plan works as follows. Starting in the year 2000, contributions are made on behalf of every worker who is covered by Social Security. As shown in Table 1, this starts out at $70 billion in constant 1998 dollars and grows to over $150 billion by 2070. As noted above, PRAs are invested in broadly diversified portfolios of stocks and bonds. Beginning the following year, workers who retire do so with both entitlements under OASDI and PRA balances. The PRA balance is annuitized, and 75 percent of it is allocated to the OASDI Trust Fund. The retiree keeps the remaining 25 percent. Over time, withdrawals from PRAs grow from about $5 billion in 2010 to nearly $700 billion in 2070. This latter figure represents 8.89 percent of covered payroll. Three-fourths of this amount, or 6.67 percent of covered payroll, is enough to cover the forecasted difference between the 12.40 payroll tax rate and the cost rate in that year. The last column of Table 1 shows that the Trust Fund never goes bankrupt under this scenario.

The new capital required to establish and fund the PRAs must necessarily come from reduced consumption, either personal or public. Because covered payroll is approximately 40 percent of GDP, the 2 percent PRA contributions represent 0.8 percentage points of GDP. As many policy makers have noted, the budget surpluses that are forecast for the next fifteen years exceed this number. Under the assumption that these revenues would have been spent on consumption goods or tax relief that would have been disproportionately consumed rather than saved, then PRA contributions funded out of the surpluses will represent additions to the capital stock. Logistically, workers and employers would make the contributions and receive a rebatable, dollar-for-dollar tax credit on their income taxes.

Table 2 shows that after 30 years, PRA assets will be about 36 percent of GDP. Using the historical rate of return on the corporate sector (including corporate tax payments) of 8.5 percent, returns to this capital will generate an additional 3.1 percent of GDP. Assuming that the federal government will be able to tax 25 percent of these additional corporate profits, the corporate income tax receipts will be approximately 0.8 percent of GDP higher than in the absence of the PRAs. The PRA system becomes self-financing after 2030, around the time when the OASDI system would enter bankruptcy if no reforms were undertaken. On average, the system of PRAs would require additional and as yet unspecified sources of financing only from the end of the current budget surpluses through the year 2030.

Much of the early criticism of proposals to privatize Social Security focuses on the administration and management of the individual accounts. I do not agree that these two issues present insurmountable problems. First, administrative costs will not be prohibitive. Mutual funds and other investment companies routinely keep administrative costs on passively managed accounts well below 50 basis points. Fixed fees on retirement accounts like IRAs are generally waived. And perhaps most importantly, investment companies clearly recognize that successful management of PRAs is the best advertising they could do to attract more of the investors' saving outside of PRAs.

Second, it is easy to overstate the possible catastrophes that could arise if workers and retirees play a more active role in managing their retirement accounts. As a necessary precaution, investment choices will be regulated with straightforward restrictions on permissible investments. To make choices easier, a default plan similar to the Federal Employees Thrift Savings plan can be established for those who do not want to play a major role in choosing their investments.

The most important issues regarding a system of PRAs pertain to income redistribution and portfolio risk. The current OASDI system is progressive in that it transfers resources from members of a cohort with high average earnings to those with low average earnings. Furthermore, there is no other federal program that bases redistribution on a more comprehensive measure of earnings. There is no reason to construe a privatized system as necessarily eliminating this type of redistribution. A convenient method of implementing it would be to place a small redistributive tax on PRA balances at retirement. The PRA balance is the counterpart to the average indexed monthly earnings under the existing program. Alternatively, the incremental corporate tax revenue that is used to finance the PRA contributions in the later years of the program could be allocated to individual accounts in a progressive manner.

A more pressing concern is the issue of portfolio risk. The higher return on the corporate sector than less risky government securities comes at the cost of more variable returns. In our ongoing research, we consider how to effectively eliminate this risk through higher PRA contributions. The idea is to overfund the accounts on average so that there is a cushion in scenarios in which the asset markets underperform. It is also possible for the government to provide a guarantee that total benefits do not fall below the specified OASDI levels. The incremental corporate tax revenue is typically sufficient to provide this guarantee even when the amount of "oversaving" is only about a percentage point or two. I would like to stress, however, that results on the risk consequences of PRAs are at this stage quite preliminary.

I would like to conclude my remarks by stating that the main contribution of our research on PRAs is not to identify "2 percent" as some sort of magic number. It is clear that policy makers may place different emphasis than we have on issues such as the riskiness of returns, income redistribution, administrative costs, and general equilibrium effects of the PRA system. All of these factors may ultimately change the 2 percent contribution to some other number. Instead, what our research adds to the discussion is to show that by prefunding future liabilities in the private capital market, retirement opportunities can be expanded using the roughly the same contributions that would merely stabilize the current system in the absence of substantive reform. We must seize our 30-year window of opportunity to re-establish retirement income security for the generations of workers, including my own, who at the moment seem to believe that it is lost.

Thank you.

Table 1
Effects of PRA Deposits and Annuities on Social Security Outlays

Year	PRA Deposits (1)	PRA Annuities (2)	PRA Annuities (3)	SS Outlay Reductions (4)	SS Trust Fund (5)
2000	70.56	0.00	0.00	0.00	26.41
2010	81.92	5.83	0.14	0.11	43.26
2020	92.22	38.26	0.83	0.62	44.33
2030	101.55	119.46	2.35	1.76	26.52
2040	113.62	236.96	4.17	3.13	8.60
2050	125.75	406.77	6.47	4.85	6.10
2060	138.46	570.80	8.24	6.18	10.02
2070	152.70	678.98	8.89	6.67	10.53

Notes:
1) These figures correspond to Feldstein and Samwick (1998a), Table 1, updated to the 1998 Trustees' Report.

2) Columns (1) and (2) are reported in billions of dollars at the 1998 price level.

3) Columns (3), (4), and (5) are reported as a percentage of Social Security covered earnings.

Table 2
PRA Assets, Increases in GDP, and Corporate Tax Revenue

Year	PRA Assets		GDP Increase		Corporate Tax Increase	
	(1)	(2)	(3)	(4)	(5)	(6)
2010	1073.81	10.38	91.27	0.88	22.82	0.22
2020	2703.29	22.85	229.78	1.94	57.44	0.49
2030	4840.57	36.45	411.45	3.10	102.86	0.77
2040	7251.74	47.87	616.40	4.07	154.10	1.02
2050	9541.93	55.83	811.06	4.75	202.77	1.19
2060	11306.58	58.94	961.06	5.01	240.26	1.25
2070	12586.04	58.36	1069.81	4.96	267.45	1.24

Notes:

1) These figures correspond to Feldstein and Samwick (1998a), Table 2, updated to the 1998 Trustees' Report.

2) Columns (1), (3) and (5) are reported in billions of dollars at the 1998 price level.

3) Columns (2), (4), and (6) are reported as a percentage of Gross Domestic Product.

4) GDP Increases are equal to 8.5 percent of the PRA assets.

5) Corporate Tax Increases are equal to 25 percent of the GDP increases.

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PREPARED STATEMENT OF CAROLYN L. WEAVER, PH.D.

Thank you, Mr. Chairman. I appreciate the opportunity to appear today, just months (I trust) before Congress and the Administration will set about the task of developing comprehensive social security reform legislation. With the retirement of the baby-boom generation beginning in just 10 years, policy makers need to move quickly to shore up the financing of social security, restore public confidence in the long-term viability of the system, and, at the same time, take the steps necessary to create a system of real value for younger people. Traditional "fixes"—reductions in future benefits and increases in the payroll tax designed to restore actuarial balance—are not up to the challenge. They have not offered lasting solutions to the financing problems of the past and will only exacerbate the unfavorable treatment of younger workers and future generations.

In my view, the best way to secure social security in the decades ahead lies in transforming it from a low-yielding system of income transfers into a system of true pensions—personal retirement accounts fully funded with workers' contributions and invested in real capital—buttressed by a government safety net.

Over the past 6-1/2 decades, social security has lifted tens of millions of older Americans out of poverty and made large wealth transfers to many more. It has been able to do so not because of any inherent superiority over other types of retirement programs, but because of its pay-as-you-go method of finance during a finite and now passing time. When social security was relatively young and economic and demographic trends still favorable, pay-as-you-go financing allowed social security to transfer enormous amounts of wealth from younger to older generations at a relatively low tax cost.

As the 1990s come to a close, social security is a mature pay-as-you-go system confronting unfavorable long-term demographic and economic trends. Wealth transfers are fast disappearing and wealth losses are now in the offing for many middle-aged and younger workers. Attempting to sustain the status quo through tax increases or benefit reductions would consign younger workers to lower retirement incomes than are attainable and leave the national economy in a weaker position. Periodic funding crises would become the norm. This fate can be avoided by taking steps now to move toward a savings-based system of personal retirement accounts.

In the testimony that follows, I discuss the general merits of replacing a portion of social security with personal retirement accounts and then present the proposal for Personal Security Accounts (which I helped develop) contained in the final report of the Social Security Advisory Council as an example of how this might be accomplished. I then turn to two issues that must be confronted with any proposal to move toward personal accounts—transition costs and "investor savvy." In particular, how do we meet outstanding benefit obligations to current retirees and older workers and also begin saving for our own retirement? And can American workers really make their own investment decisions? The latter question is particularly salient now, with the stock market experiencing considerable day-to-day volatility.

SOCIAL SECURITY FACES MORE THAN A FINANCING PROBLEM

To some people, the long-range deficit is the problem confronting social security. If this were the case, policy makers could just turn to a catalog of spending and revenue options to see which set of policies added up to the right number to close the deficit. Perhaps to be fair, a compromise would be reached in which taxes were raised to meet part of the financing gap and future benefits were scaled back to meet the balance of the gap. This was the approach taken in 1983.

But financing is decidedly not all that ails social security. This is revealed in many ways, including the declining level of public confidence in the future of social security and growing concerns about the value of the system to younger workers; the growing interest in private alternatives to social security, including the reforms undertaken in Chile over a decade ago; and growing concerns about the impact of social security and other entitlement programs on the federal budget, national saving, and economic growth. Social security's financing problem is a manifestation of other, more deep-seated problems that render the same old prescriptions less and less palatable.

For example, under our current social security system, which is financed basically on a pay-as-you-go basis, workers amass claims to future benefits with no real capital backing up these claims. This results in a huge unfunded liability (benefit promises far in excess of assets on hand), estimated by the Social Security Administration actuaries to be on the order of $9 trillion in present value terms.[1] This is debt, pure and simple, although it is not included in official federal budget accounts.

By retaining the pay-as-you-go structure, which amounts to an income transfer mechanism from workers to retirees rather than a retirement saving mechanism for workers, workers—and society more generally—forgo the opportunity to invest in real private capital and to earn the higher rate of return it would afford. Under current projections, the best our pay-as-you-go system can offer younger workers, in terms of return on taxes, is determined by the rate of growth of taxable earnings, in the economy—projected to be only 1-1/2 percent net of inflation. By contrast, the contribution of a savings-based system to the economic well-being of the nation would be determined by the real pre-tax return to private capital investment, estimated to be on the order of 8 percent to 9 percent net of inflation. The lost income stemming from the opportunity foregone, that of moving toward a fully funded pension system built on real saving and capital investment, is a very real economic cost of perpetuating the status quo.

If not reversed somehow, the loss of potential wealth, particularly among younger workers, will certainly weaken political support for social security. Averaging over the period since 1926, the annual return on equities has averaged about 7 percent, net of inflation, and the average annual return on a mixed portfolio of stocks and bonds has been about 5-6 percent, net of inflation—substantially above what social security can offer. Increasingly, young people ask "Why can't we put our taxes into higher yielding investments?" "Why can't we have retirement savings accounts like IRAs or 401(k) plans?"

Also, social security is running temporary surpluses invested entirely in U.S. government bonds. Only with Congress operating subject to strict budget discipline could this be said to constitute saving that would lighten the burden of future benefits. Social security is thus amassing claims to hundreds of billions of dollars of general revenues yet to be collected, which may well be distorting fiscal decision making and adding to—rather than ameliorating—economic and fiscal woes in future decades. Over the past decade, Senator Moynihan has helped highlight the importance of this problem.

Finally, there have long been concerns about the tenuous link between the taxes an individual pays, at the margin, and the benefits he or she can expect to receive. What is the relationship between benefits and hours worked (or taxes paid)? Does extra work increase future benefits? How knowledgeable are people about this relationship, given the extreme complexity of social security? More recently, concern has been expressed about the effects of the unfavorable relationship between taxes paid and benefits received for middle-aged and younger workers. A weak or non-existent tax-benefit link—or a strong link with a poor return on taxes—distorts the labor supply decisions of workers and the form in which they receive their compensation, resulting in another potentially large source of foregone income and wealth.

Evidently, quite apart from the costs that arise from failing to close trust fund deficits in a timely way, there are real costs to society from failing to reform social security—the costs that arise from the nation's opportunities foregone. Scholarly research by economists Martin Feldstein, Andrew Samwick, and Laurence Kotlikoff, among others, suggests that moving toward a system of personal retirement accounts that are owned by workers and fully funded with a portion of their payroll taxes would result in very large gains in economic well-being. Reforms that deal only with the imbalance of numbers—such as the reforms adopted in 1977 and 1983—would fail to tackle the most important problems confronting social security today and, in so doing, most surely would exacerbate them.

GENERAL SUPPORT FOR ADVANCE FUNDING AND EQUITY INVESTMENT

While not all of the members of the Advisory Council shared my concern with the economic consequences of our pay-as-you-go system, we were in general agreement that raising taxes or cutting benefits to restore long-range balance would weaken rather than secure the economic and political foundation of the system in the years ahead. Improving the value of social security to younger workers and future generations was a high priority, and private capital investment was seen to be the key. Beyond this, a majority of members (7 of 13) agreed on: (1) the desirability of moving toward a fully funded component of social security; (2) the hazards of centralizing and politicizing investment decisions; and (3) the powerful effects that private ownership could have in building confidence about the future of social security. In the end, a majority of Council members supported fully-funded personal savings accounts as a key component of long-range reform.

[1] Data for October 1996, supplied by SSA's Office of the Actuary.

There are many ways that personal accounts might be incorporated into social security—on a limited basis, as in legislation offered by several members of the Senate (including Senators Kerrey, Robb, Moynihan, Breaux, Gregg and others), or on a broad-scale basis, as in Chile and elsewhere in South America. Contributions to personal accounts can be mandatory or voluntary. Workers' investment options and their withdrawal options at retirement can be limited or quite broad. The government safety-net can take many forms, ranging from a scaled back pay-as-you-go system to a system of well-targeted subsidies for low-wage workers or workers with low account balances. And the cost of ongoing benefit liabilities during the transition to the new system can be met in any number of ways.

The range of options for introducing personal accounts into social security is revealed in part by the reforms already adopted in countries such as Chile, the United Kingdom, and Australia, and in part by the range of legislative proposals and other proposals now in the public domain. The proposal for Personal Security Accounts is something of a hybrid. It incorporates fairly large mandatory individual accounts which substitute for a portion of social security. It gives workers relatively wide discretion in their investment and withdrawal decisions. And it retains a floor benefit for all workers. The transition would be financed by a combination of new (explicit) federal borrowing and a payroll-tax supplement.

WHY PERSONAL ACCOUNTS MAKE SENSE

Before looking at the PSA plan, it is worth noting, at least in general terms, why moving toward a system of fully-funded personal retirement accounts makes sense. From a purely economic perspective, there is a large body of research that suggests that moving toward a system in which workers save and invest for their retirement would result in substantial improvements in economic well-being. Increased saving and investment would boost labor productivity, resulting in higher wages for American workers and ultimately higher living standards. In addition, due to the much higher rate of return available in private capital markets, workers could expect to accumulate much larger retirement incomes through a savings- and investment-based system than through our wage-based tax-and-transfer system.

A system of personal retirement accounts—privately managed, owned by workers, and fully funded with a portion of their payroll taxes—would have other benefits as well. For example, such a system would create a direct link between the taxes workers pay and the benefits they can expect to receive, that link being the market rate of interest. As with an IRA or 401(k) plan, workers would make regular contributions to their accounts and would have a claim to their contributions and any investment earnings that is secured by the force of law. The linking of taxes and benefits, backed up by private ownership, is the source of three additional economic benefits:

First, payroll taxes would become true contributions, like deferred compensation in the private sector, and would no longer distort the choices workers make about when and how much to work, when to retire, and the form in which they receive their compensation. Workers would gain retirement protection from the first dollar earned. Retirement would become a much more flexible concept, at least in so far as government policy is concerned.

Second, workers would have the peace of mind of knowing that the money they put away for retirement was theirs, period, shielded from political manipulation. This would greatly facilitate long-term financial planning. Presently, workers and their families have little way of gaging what social security will offer decades in the future and thus how much and what kinds of additional financial protection they require. While workers would take on investment risks, risks that would need to be managed effectively, they would shed considerable political uncertainty about the size and cost of future benefits—risks that individuals are powerless to hedge against.

As Nobel Laureate Paul Samuelson once observed, in comparing public pension systems that are pay-as-you-go financed and fully funded, "In an epoch when most social compacts are not worth the paper they are written on, full funding has the virtue that reneging on promises is least likely to be politically feasible."[2] With full funding backed up by the force of law, a system of personal accounts would have the virtue that reneging on promises would simply be illegal.

Third, every worker, rich and poor alike, would have the opportunity to accumulate real wealth and to build estates with which to better their own lives and the lives of their children and grandchildren. (Unless prohibited by law, families could

[2] Paul A. Samuelson, "Comment," in *Financial Aspects of the United States Pension System*, Zvi Bodie and John Shoven, eds. (Chicago: University of Chicago Press, 1983), p. 277.

inherent any balances remaining in a worker's account at death.) Every worker would be involved directly in the decisions that so vitally influence their future well-being. Opportunities to build and to hold wealth that now exist mainly for higher income Americans would become available to all Americans.

In this latter regard, personal retirement accounts would have important indirect effects on the economy. By transforming social security into a vehicle of wealth creation, personal accounts would give ordinary working men and women a highly visible stake in the U.S. economy. Broader-based support for pro-growth tax and regulatory policies would likely result. At the same time, funds accumulated in personal accounts would reduce the dependence of American workers on federal transfer payments, ultimately relieving pressures on the federal budget and leaving society more flexibility with which to meet future pressing objectives (including national security objectives). With pay-as-you-go financing in place, there always is the temptation—no matter how ill-advised—to increase benefits and shift costs to future generations. Overpromising is far less likely in a system based on saving and capital investment.

In addition, allowing workers to choose how—or with whom—to invest their retirement savings would expand opportunities and spur the development of new products and services. Mutual funds, securities firms, banks and other financial institutions would compete for the right to invest workers' taxes, and, unless prohibited by the government, they would offer a range of investments and investment services from which to choose. Workers would be able to seek out those products and services that best met their needs. Through a highly decentralized system of personal accounts, the funds available for capital investment would flow toward their highest-valued uses, without political interference or manipulation.

Finally, from the narrower perspective of social security financing, a system of personal accounts would fundamentally transform the financing base of at least a portion of social security, eliminating the funding crises that have become the norm. Since personal accounts would be fully funded at all times, they would basically run on automatic pilot. The system's fortunes would no longer be tied inextricably to uncertain demographics and to uncertain political actions and reactions.

Moving toward a system of personal retirement accounts would not get us around the problem of having to dig out from under the debt accumulated under the current system. Meeting ongoing liabilities for older workers and retirees is a given. But personal accounts would create a "light at the end of the tunnel" that does not presently exist—the prospect that social security can provide something of real value to younger workers in the future as it has in the past.

With this as background, the PSA plan provides a concrete example of how personal retirement accounts can be incorporated into social security on a relatively large-scale basis.

THE PSA PLAN

Under the Personal Security Account (PSA) plan, which was supported by 5 out of 13 Council members, social security would gradually be transformed into a two-tiered system in which roughly half of the retirement program is fully funded through a system of privately-managed, individually-owned retirement accounts. The first tier of the new system would provide a flat retirement benefit for full-career workers which is scaled to years of work and financed on a pay-as-you-go basis. This benefit would be financed (together with disability and survivor benefits) by 7.4 percent of the current 12.4 percent social security payroll tax.[3] The second tier would amount to a system of mandatory personal retirement accounts funded with the remaining 5 percent of the payroll tax. These accounts would be managed by private financial institutions.

All workers under 55 would have personal accounts and they would be free to invest them in a wide range of investments and institutions. Workers could begin making tax-free withdrawals at 62—regardless of their income or work status—and would be free to purchase annuities if they wished, but would not be compelled to do so. Any balances remaining at death could be bequeathed to heirs.

Other aspects of the two-tiered system would take several decades to be phased in and would be fully effective only for workers under 25. Retirees and older workers would not be affected by the new two-tiered system.

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[3] The PSA proposal retains the spouse benefit. Unless a woman earned a higher benefit on her own work record, she would be eligible for one-half of her husband's benefit (which ultimately would be one-half of the flat benefit). Widow's and widower's benefits would continue as well, only at a higher percentage amount. Benefits for young survivors would be calculated as under present law. Disability benefits also would be calculated as under present law except that they would be capped so as not to exceed that payable to an age-65 retiree.

The PSA plan would turn the vast majority of social security's 130 million taxpayers into investors and, in the next decade alone, release literally hundreds of billions of dollars of payroll taxes for investment in the private sector. As an indication of the magnitudes involved, taxable payroll in the U.S. is now about $3 trillion, 5% of which is $150 billion annually, with the amount of additional money available for investment each year growing at the rate of growth of total wages in the economy. With workers assumed to allocate roughly half of their contributions to equities and half to U.S. government securities, with an average real yield on their PSAs of 3.5%-4.0% (net of administrative expenses), the SSA actuaries projected that, in constant 1995 dollars, the aggregate balance in personal accounts would be close to $6 trillion in 2020 and $10 trillion in 2030.

When fully phased in, workers' personal accounts would be backed up by the first tier benefit, which would ensure all full career workers—high- and low-wage alike—a level of retirement income at or above the poverty level.[4] As under present law, this benefit would be cost-of-living adjusted and payable as a monthly annuity until death. The flat benefit is explicitly redistributive toward low-wage workers, intended to ensure that, together with second tier accumulations, all full-career workers, regardless of income level, can expect to receive a minimally adequate retirement income from social security. By minimally adequate we mean enough so that even low-wage workers—and even workers who invest in relatively low-yielding assets—should not have to resort to means-tested poverty assistance. Our expectation is that workers will do considerably better than this.

According to the SSA actuaries, under reasonable assumptions, single workers and two-earner couples would fare better under this plan than they would under either of the other plans offered by the Advisory Council (the "Maintenance of Benefits" plan, endorsed by former Social Security Commissioner Robert Ball and five other members, and the "Individual Accounts" plan, endorsed by the Council Chair, Ned Gramlich, and one other member) or under a shored up pay-as-you-go system. The relatively large personal accounts would fully fund a significant share of social security, bringing forth larger, long-run financial and economic gains. It would do so, moreover, without running the risks of centralizing and thus politicizing investment decisions. Younger workers stand to gain the most, both in terms of expected benefits and increases in national wealth.

TRANSITION COSTS

One issue that raises concerns about any proposal for personal accounts is the issue of transition costs. Opponents of personal accounts say that in order to make the transition to the new system, workers would have to pay "twice"—once for their own retirement and once for their elders'. The implication is that the social security tax would have to be doubled or at least increased very substantially, making workers much worse off. This argument is deeply flawed.

In reality, there is a cost to sustaining (or attempting to sustain) the status quo and there is a cost to moving to a system of personal accounts. In the first case, the cost is permanent and brings forth no additional benefits or economic value. In the latter case, the cost is transitional and makes possible the attainment of larger and more secure retirement incomes as well as a stronger national economy. In present value terms, the long-term gains to society would substantially outweigh the transitional costs.

As noted earlier, social security has extended trillions of dollars of benefit promises to current retirees and older workers as well as to younger workers who have already paid into the system. The official government estimate puts the figure at about $9 trillion. These benefit promises are almost entirely unfunded. Short of abrogating on these benefit promises, they must be met—and this is true whether or not social security is privatized or replaced by a system of personal accounts.

There are basically two ways these costs can be met. First, we can do as proponents of the status quo would have us do—keep the social security debt implicit

[4] There has been much confusion about the level of the flat benefit. For computation purposes, the flat benefit would initially be $410/mo. for an individual in 1996 ($615 for a worker and non-working spouse), which is presently only about two-thirds of the poverty level. No one would actually receive this amount, however. During the phase-in of the two-tiered system, workers would receive a benefit that combines the benefit they have accrued under the present system, wage indexed until retirement, plus a share of the flat benefit based on the number of years covered by the new system, also wage indexed until retirement. In 2041, the first year workers could retire at the normal retirement age receiving only the flat benefit (and their PSA accumulations), the benefit is projected to be $664/mo. in 1996 dollars, 62% higher than today in real terms, and higher than the projected poverty level at that time. The real growth of the flat benefit stems from the wage indexing prior to the date of eligibility for benefits. Once on the rolls, benefits would be cost-of-living adjusted.

and then do our best to try to prop up the system by raising taxes, cutting benefits, and continuing to shift costs to younger workers and future generations, who already are expected to earn sub-market returns on their taxes. In the face of declining worker-to-beneficiary ratios and slow earnings growth, this is not the most secure basis on which to build a "social compact" or to pin one's hope for retirement income security.

In aggregate dollar terms, the cost of perpetuating the status quo under current official projections is about $3.1 trillion in present value terms. (That is in addition to the roughly $10 trillion we already expect to collect from today's children and future generations to pay benefits for the current adult population.)[5] Under a revised estimate, which takes into account the system's deteriorating financing picture beyond the actuaries' 75-year projection period, the deficit would be closer to $4-$5 trillion. This can be thought of as the "transition cost" of sustaining the status quo. Any effort to substantially improve the funding base of social security would increase this cost.

Alternatively, we can take steps now to recognize and begin paying down the implicit debt that will otherwise saddle future generations and start saving for our own retirements. How much of this debt must be recognized depends on how large the personal accounts are (or how much of the system becomes fully funded) and how quickly the accounts are phased in. How quickly the debt is repaid depends on how ongoing benefit liabilities are financed during the transition—either through general spending reductions, the use of federal budget surpluses, the sale of federal assets, some additional borrowing, or, if necessary, increases in federal taxes. Presumably it would be repaid through a combination of these measures. (Nations that have transformed their social security systems to include personal retirement accounts generally have scaled back benefits under the ongoing system as well.) The savings-induced increase in national income that would result from reducing the government's overall indebtedness (including explicit and implicit debt) would provide another source of financing.

Importantly, "privatizing" a portion of social security does not create transition costs. Privatization creates retirement accounts that are owned by workers, fully funded with a portion of their taxes, and invested in private capital. Because of the higher return to private capital investment, the tax rate (actually the contribution rate, since workers would own the proceeds of their accounts) required to replicate benefits under our current system would be lower than the rate required to meet benefits on a pay-as-you-go basis. Precisely how much lower would depend on expected investment returns, the target level of retirement income, and the certainty with which one wished to achieve that target. In addition to the mandatory saving rate, there would be the cost of meeting outstanding benefits under the current system.

Stated another way, there are no "free lunches." Moving to a savings-based system requires an increase in saving (or a decrease in consumption) by current generations, which generates the larger capital stock necessary to sustain higher expected retirement incomes as well as higher future living standards. This increase in saving is brought about by a combination of paying off (and possibly reducing the size of) the accrued liability and capping the growth of future unfunded liabilities.

In a very real sense, the "transition cost" is an investment in the future, one that can be expected to pay off handsomely. It is the price that must be paid to move to a system that offers much brighter opportunities for workers and for future generations.

Evidently, the argument that workers would have to pay "twice" suggests erroneously that workers would have to pay double the amount they currently do, when in fact, they would pay less for their retirement pensions than they presently do and would bear only a portion of the transition liability. It suggests erroneously that there are no "transition costs" associated with sustaining the status quo, when in fact there are and they are substantial. And it ignores the fact that the costs associated with the transition to a system of personal accounts are just that—transitional—and that they would bring forth substantial economic benefits.

The workers-pay-twice argument also obscures the fact that the risks of additional tax increases (or benefit reductions) down the road are far greater with a shored up pay-as-you-go system than with a system of personal accounts. The reason is the dependence of our current system on uncertain demographic and economic developments. With a system of personal accounts, the contribution rate would be set in

[5] This is the difference between the tax income (plus the starting reserve fund) projected for the open group and for the closed (aged 15 and older) group. Data for 1996 supplied by SSA's Office of the Actuary.

the law and known in advance. The transition liability, moreover, would be capped (in present value terms) as of the time of the reform.

With this as background, the transition cost of the PSA proposal, which is spread over 70 years, was estimated by the SSA actuaries to be about 1.5 percent of taxable payroll on an average annual basis. This would be met by a 1.5 percent payroll tax supplement which, because of the relatively heavy benefit costs in the next few decades, would be supplemented by new federal borrowing. Under SSA's projections, this borrowing would equal 1.23 percent of GDP in 1999 and rise to a peak of 1.93 percent of GDP in 2007, then fall gradually to 1% of GDP in 2020 and to zero by 2030. Beyond 2030, social security would improve the overall federal budget relative to present law. In cumulative terms, total borrowing would peak at $2.3 trillion (in constant 1995 dollars) around 2020-2025. This debt would be repaid (with the proceeds of the payroll tax supplement) during the latter part of the 70-year transition period, at the end of which the tax supplement would be repealed.

While much has been said about these transition costs, several points should be noted. First, none of the proponents of the PSA plan supported a payroll tax increase to help finance the continuation of the current structure of benefits or to fund a personal accounts add-on to social security. We supported this tax only as a means of transitioning to a new system, one-half of which would be fully funded through personal accounts.

Here it is worth noting that the 1.5 percent payroll tax supplement bears no relation to the 1.6 percent payroll tax increase contained in the Chairman's proposal, despite the similarity of their magnitudes. Under the PSA proposal, the payroll tax supplement (with bond financing) is a means to pay off accrued liabilities and to make possible the transition to fully-funded accounts that ultimately comprise half the retirement program. When the transition is passed, there would be no continuing tax liability and personal accounts would be fully funded with 5 percent of earnings. In addition, the 1.5 percent tax supplement is an estimate of the cost of transition based on projections that do not take into account any savings-induced increase in the capital stock or per capita income. If, as we expect, the reforms are beneficial to the economy, the transition tax would be lower. In the case of the Council chairman's proposal, on the other hand, 1.6 percent would be established in the law as the increase in the payroll tax used to fund the individual accounts. These accounts (and the tax) are permanent add-ons to the current retirement program, in contrast to our plan in which the accounts are a substitute for a portion of the program.

In addition, among taxes, we would have preferred a broad-based consumption tax, which would be paid by a broader segment of the population, create fewer labor market distortions, and be consistent with our more general goal of boosting saving. However, since the U.S. does not presently have such a tax, we concluded that the costs of setting up the administrative apparatus and layering this tax on top of the existing income tax structure would surely outweigh the gains. Should the U.S. tax system move in the direction of a consumption base, we would regard this as a highly preferable means of meeting part of the cost of transition.

We also would have preferred to couple general spending reductions with any tax increase. Without having the time, the resources, or the mandate to identify specific spending reduction measures, however, the consensus was that an explicit tax was required to deal forthrightly with the issue of transition costs.

We did believe that debt-financing part of the transition was desirable. This helps spread the burden to future generations, who stand to gain the most from these reforms, rather than concentrating it on today's workers. Also, as discussed further below, this borrowing basically amounts to making explicit a portion of a debt that already exists—in the form of outstanding, unfunded benefit promises—but is not officially recognized in federal budget accounts.

PUTTING THE BORROWING INTO PERSPECTIVE

In the current budget climate, it is not surprising that concern has been expressed about a reform plan that involves significant amounts of federal borrowing. It is essential to bear in mind, however, that social security already has amassed a huge debt—on the order of $9-$11 trillion—and annual changes in this debt are ignored in the nation's cash-flow budget. Increasing the funding base of social security involves making explicit a portion of this implicit debt.

To provide some perspective on the amount of borrowing under the PSA plan, Table 1 shows a measure of social security's unfunded liability. Referred to as the system's "closed-group" unfunded liability, it shows benefits projected to be paid to current workers and retirees over the next 75 years in excess of the taxes they are projected to pay (plus the current reserve fund), expressed in present value terms. According to the SSA actuaries', social security is projected to spend $18.6 trillion on benefits to current workers and retirees; this is $8.9 trillion more than the amount already held in reserves plus the taxes they are projected to pay. This implicit debt grew by $836 billion in 1996 alone—which was substantially more than the increase in formal debt issued to the public over the same period. The cumulative increase in social security's implicit debt exceeded $2 trillion in the 5- year period 1991 to 1996; over the period 1986 to 1996, the increase was $3.5 trillion.

The $2.3 trillion in explicit debt envisioned in the PSA plan, accumulated over a 20 to 30 year period, is thus not large in relation to the amount of implicit debt social security accumulates on automatic pilot over much shorter periods of time. (If expressed in present value terms, as are the data in Table 1, the new explicit debt peaks at $650 billion.)

Even in the context of conventional budgeting, the amount of new borrowing is not large by recent historical standards. The increase in debt under the PSA plan is about equal to the amount of federal debt absorbed by financial markets between FY1980 and FY1994 (which was $2.2 trillion in constant 1995 dollars), a period about one-half as long as envisioned in the PSA plan. The issuance of this debt, moreover, would be accompanied by the rapid accumulation of assets in personal accounts, with the total amount of debt always less than and ultimately dwarfed by the balances in personal accounts.

While the impact of the PSA plan on the federal budget is initially negative—and is projected to remain so until 2030—it is critical to consider broader measures to assess the long-term economic consequences of the plan. For purposes of the Advisory Council report, a simple measure of national wealth was developed, which takes into account the increase in private assets under the various plans net of any changes in federal borrowing. It is referred to as a "first order" wealth effect because it does not take into account offsetting actions that might be taken by private individuals or by the federal government.

Using this measure, the cumulative effect of the PSA plan—including the personal accounts, the transition tax and borrowing, and significant reductions in long-range benefits—on the nation's wealth is positive from the start and grows more rapidly than under either of the other two plans. In terms of increasing national saving and raising national wealth, the PSA plan ultimately outperforms the other plans by a significant margin.

In terms of reducing entitlement spending, the PSA plan outperforms the other plans by an even larger margin. For purposes of comparison, the PSA plan reduces long-range benefit costs from a projected $21.3 trillion (in present value terms) to $14.6 trillion, or by about 31.5%. (This option includes a number of changes to reduce the ongoing cost of the program, such as raising the retirement age to 67 then indexing it to longevity, in addition to creating the new tier 1 benefit.) The "Maintenance of Benefits" plan reduces long-range benefits slightly—to $21.2 trillion—and the "Individual Accounts" add-on plan reduces costs to $18.9. Surely, forward-looking financial markets would respond favorably to comprehensive reforms that promised to boost national saving and future national income.

While concerns about transition costs have led some to propose relatively small personal accounts, funded with 2 percent of earnings, smaller accounts means less additional saving and capital investment and thus smaller economic and financial benefits. In my view (and in the view of other proponents of the PSA plan), it is highly desirable to move toward larger personal accounts. Larger accounts offer workers the potential for higher benefits and a better rate of return on their social security taxes, and on net should result in significantly larger economic benefits. In addition, larger accounts would give workers keener incentives to make informed investment decisions and to monitor the performance of their investments. Larger accounts also would be relatively less costly for financial institutions to administer.

CAN WORKERS MAKE THEIR OWN INVESTMENT DECISIONS?

Another concern raised by critics of personal accounts is that many Americans are inexperienced with investing and would, if left to their own devices, make unwise decisions. The conclusion they draw is that either the government should do the investing, on a centralized basis, or the problem of asset management should be sidestepped altogether by returning to pay-as-you-go financing. Neither is an appropriate response to this ill-defined concern.

To begin, it is worth noting that American workers have never been better positioned to make sound financial decisions. With the introduction of IRAs, 401(k) plans, and other self-directed investment vehicles, workers have gained an enormous amount of experience with making investment decisions. In addition, with the explosion of mutual funds and, in particular, equity index funds, ordinary working men and women do not need to "play the market"—incurring large transactions costs and exposing themselves to excessive risk—in order to reap the benefits of stock market participation. And, no doubt owing to the tremendous competition for new customers and new funds, there is a wealth of financial information available about alternative investment strategies and institutions, and performance ratings are widely available.

While there are workers who own no stocks and who are inexperienced at investing, they represent a declining share of the population. According to a study by NASDAQ, for example, an estimated 43 percent of Americans owned stock in 1997—either directly or indirectly through their pension plans or mutual funds—up from 21 percent in 1990 and 10 percent in 1965.[6] A majority of investors were under age 50 and roughly half were not college graduates.

An estimated 40 percent of Americans own one or more mutual funds, with total mutual fund assets (in 1997) topping $4.5 trillion.[7] Mutual funds offer men and women from all walks of life a safe, low cost means of investing in broadly diversified portfolios of stocks and bonds. According to a 1996 survey by the Investment Company Institute, 40 percent of mutual fund owners had family incomes below $50,000; 42 percent were not college graduates.

As observed by Walter Updegrave, an associate editor of Money Magazine,

> "By making investing so accessible that novices with just a few hundred dollars (in some cases even less) can invest with confidence by phone or through the mail, funds have effectively democratized America's financial markets. They've given Americans of modest means the investing advantages that had once been available only to big institutions or to the wealthy—namely the ability to earn high rates of return by investing in diversified portfolios of stocks and bonds that are chosen and monitored by some of the best professional money managers in the nation."[8]

Some 35 percent of mutual fund assets come from company pension plans (mainly 401(k) plans) and IRAs—up from 17 percent in 1988 and less than 10 percent in 1983—leading Richard Ippolito to observe that "mutual funds gradually are becoming a dominant vehicle for retirement saving."[9] Commenting on the "explosive growth" of mutual funds since the mid-1980s, Peter Fortune, a Boston Federal Reserve Bank economist, attributes "much of this growth" to "the increasing convenience offered to owners of long-term assets."[10]

On the company pension front, the rapid growth of defined-contribution plans—and especially 401(k) plans—has been transforming the profile of pension coverage in America. Of the roughly 50 million workers with defined contribution plans, roughly half, or 25 million, participate in 401(k) plans—up from 7 million in the early 1980s. With 401(k) plans, workers make voluntary tax-deductible contributions (which employers may match) and decide how to invest their contributions among a set of options offered by employers.[11] Total assets of 401(k) plans were $650 billion at the beginning of 1996, projected to increase rapidly in the future.[12] According to a 1996 survey by EBRI and the Investment Company Institute, the average account balance was about $29,000. (Long-tenure workers and older workers were found to have much higher balances—exceeding $100,000 for workers with 20 to 30 years of service.)[13] Americans have another $1 trillion plus invested in IRAs.[14]

As noted by Zvi Bodie and Dwight Crane, of the Harvard Business School,

> " . . . the growth of mutual funds and self-directed retirement accounts in the past few decades has transformed the asset holdings of millions of middle-class individuals. In contrast to the period before 1960 when "investing" (as opposed

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[6] NASDAQ and James Glassman testimony of July 24, 1998.

[7] Data supplied by Investment Company Institute.

[8] Walter Updegrave, *The Right Way to Invest in Mutual Funds* (1996), p. 1.

[9] Data for 1997 and earlier years supplied by the Investment Company Institute. See also Richard A. Ippolito, "Pensions, Public Policy and the Capital Market," unpublished manuscript, Pension Benefit Guaranty Corporation (March 1998), p. 12.

[10] He too comments that "Mutual funds offer portfolio diversification and financial research unavailable to the individual investor" and do so "in an economical way." See Peter Fortune, "Mutual Funds, Part I: Reshaping the American Financial System," New England Economic Review (July/August 1997), p. 45.

[11] Since 1993, employers have been required to offer at least 3 investment options, including a broad-based equity fund, a bond fund, and a money market fund. Most participants work at firms offering six or more options. See James M. Poterba and David A. Wise, "Individual Financial Decisions in Retirement Saving Plans and the Provision of Resources for Retirement," NBER Working Paper No. 5762 (September 1996), pp. 8, 15-16.

[12] Poterba and Wise, pp. 5-6.

[13] This is because the figures exclude assets accumulated with former employers or rolled over into IRAs.

[14] Poterba and Wise, p. 6.

to putting money in savings accounts) was something only wealthy people did, today, millions of middle-income Americans hold a substantial fraction of their accumulated savings in mutual funds and are interested in how best to allocate them across asset classes."[15]

What do we know about "investor savvy?" For one thing, with a substantial amount of investing taking place through 401(k) plans and mutual funds, a great deal less "savvy" is required than when investing takes place in individual stocks. And with 401(k) plans, there is evidence that workers make reasonable investment decisions.

In a study of TIAA-CREF participants (the staff and administrators of universities, secondary schools, and other non-profit organizations), for example, Bodie and Crane found that participants followed "generally accepted investment principles," meaning, among other things, that they tended to invest more heavily in equities and longer term fixed-income securities and that they held relatively more equity as their wealth rose and relatively less equity as they approached retirement.[16] While the population under study was generally better educated and had more experience with self-directed retirement funds, the authors concluded that "given enough education, information, and experience, people will tend to manage their self-directed investment accounts in an appropriate manner."[17] Other studies of 401(k) plans also reveal clear and predictable differences in asset allocation by age and income group, with the proportion of assets held in stock funds or company stock declining markedly with age and rising markedly with income.[18]

Examining aggregate data on portfolio holdings in 1993, Richard Ippolito reports that workers allocated roughly the same share of 401(k) plan assets to equities—about 50 percent on average—as did sponsors of defined benefit plans and other defined contribution plans. He concluded that the rise of 401(k) plans "apparently does not portend dramatic change for asset allocation."[19]

As for the suggestion that women make inferior investment decisions, evidence on 401(k) plan participation and asset allocation decisions does not appear to support this claim. A study by Robert Clark, Sylvester Schieber, and others reports that women are slightly more likely than men to participate in 401(k) plans; their contribution rates generally are higher; and, when company stock is not offered (men do invest markedly more than women in company stock), women generally hold a higher proportion of their assets in equities. The researchers conclude that women do not "devote a higher percentage of their retirement savings to low-risk/low-return assets" and that "women are as effective in their use of 401(k) plans as their male counterparts."[20]

None of this is intended to suggest that workers make "optimal" investment decisions. Researchers have neither the models nor the data with which to evaluate this in a rigorous way. And none of this is intended to suggest that with personal accounts everyone will make the best financial decisions, reaping the best possible rates of return. Surely, some workers will take on too much risk; some workers will not take enough—particularly those with the least experience. But good decisions come with education and information, and with experience and learning—all of which would be gained rapidly by workers making regular contributions to personal accounts offered by competing financial institutions. Market returns on workers' accounts would provide steady information on investment performance; the relative success of competing financial institutions would provide valuable information as well.

With regard to allowable investments, the PSA proposal contains only one proviso: that personal accounts be invested in financial instruments widely available in financial markets. While we recognize the government's (i.e., taxpayers') interest in limiting excessive risk taking, there was no consensus about the kinds of restrictions that might be needed or be found cost-effective. (And indeed, the concern expressed most frequently, in financial news and other coverage of retirement income planning issues, is that workers do not take enough risk.) It also was unclear what benchmark one would use to determine whether workers were taking too much or

[15] Zvi Bodie and Dwight B. Crane, "Personal Investing: Advice, Theory, and Evidence from a Survey of TIAA-CREF Participants," Harvard Business School (May 1997), p. 3.

[16] Bodie and Crane, pp. 5-6.

[17] Bodie and Crane, p. 16.

[18] See Poterba and Wise, "Individual Financial Decisions," Gordon P. Goodfellow and Sylvester J. Schieber, "Investment of Assets in Self-Directed Retirement Plans," Watson Wyatt Worldwide (1996), and Robert L. Clark, Gordon P. Goodfellow, Sylvester J. Schieber, and Drew A. Warwick, "Making the Most of 401(k) Plans: Who's Choosing What and Why?" Watson Wyatt Worldwide (April 1998).

[19] Ippolito, pp. 12-13.

[20] Clark et al, "Making the Most of 401(k) Plans," pp. 22, 29-30, 34.

too little risk. Certainly, the "right" way to allocate investments depends not only on one's age and earnings but also on the size and risk-return profile of non-pension assets, among other factors. We also recognized the possibility that with some investment options offered by some institutions, administrative fees could be high in relation to investment returns.

The problem we confronted, as is so often the case with government regulation, was making sure that there was a well-defined problem worthy of federal intervention, that there was a regulatory solution well-tailored to the problem, and that the regulations were likely to result in net economic gains.

In general, we envisioned a regulatory environment consistent with a wide range of choices for workers—for example, a range of options comparable to that now available to workers through 401(k) plans—offered by a wide array of financial institutions competing for workers' business. (My own view is that it would be far preferable to delineate what is not acceptable in the way of investment options or institutions, leaving markets free to develop new ways of delivering retirement income security, than to define what is acceptable, effectively banning everything not so defined and potentially sharply curtailing innovations that could greatly improve the well-being of social security participants.) We were in general agreement that concerns about investment decisions made by unsophisticated investors could be rectified most effectively by an educational effort, not by significantly restricting investment choices or by substituting government decisions for individual decisions.

In the end, there is no getting around the fact that with a system of personal accounts, workers must bear financial risks. These risks can be managed by prudent investment practices. With these risks come the potential for higher retirement incomes. Diversification and patience are the key to long-term retirement income security, a point that the daily ups and downs in the market are, no doubt, reinforcing for experienced and inexperienced investors alike.

There also is no getting around the fact that social security is risky—with respect to benefit levels, taxes, and rates of return. These risks stem not just from uncertain economic and demographic developments but also from uncertain political reactions to them. Unlike financial risks, political risks can not be hedged. And political risks can be very large—as evidenced by the 1977 legislation (and, to a lesser degree, the 1983 legislation), which substantially reduced projected benefit "promises" for younger workers and substantially increased payroll taxes.

One of the features we found most appealing about personal accounts was that workers would own their accounts, and the retirement savings they embody, and thereby would be exposed to much less political risk than under the present system—political risks that, over the next 20, 30, or 40 years could easily dwarf the financial risks of a well-diversified portfolio.

Evidently, the financial risks inherent in an investment-based system (including the safety-net which is likely to buffer workers from poor investment returns) must be balanced against the financial and political risks inherent in our pay-as-you-go system.

CONCLUDING THOUGHTS

When Congress takes up the issue of social security reform, it will be under pressure not only to close deficits but also to shore up public confidence and restore value for younger workers. Reforms that move in the direction of creating a system of true pensions, with individually-controlled, fully funded retirement accounts, buttressed by a government safety net, hold real promise for the future. American workers would be substantially better off if they were permitted to invest a portion of their social security taxes in private stocks and bonds. The sooner Congress gets around to making this possibility a reality, the better for all concerned.

Table 1

**SOCIAL SECURITY'S MOUNTING UNFUNDED LIABILITIES:
PROJECTED BENEFITS IN EXCESS OF TAX INCOME AND CURRENT RESERVES,
IN PRESENT VALUE TERMS***
($ in billions)

	Present Value of Social Security's Long-Range Operations			
Year of Evaluation	75-Year Benefit Obligations	75-Year Tax Income	75-Year Unfunded Obligations	Annual Increase in Unfunded Obligations
1986	$11,335	$5,942	$5,394	
1987	11,795	6,215	5,580	$187
1988	12,162	6,422	5,740	160
1989	13,027	6,929	6,098	358
1990	14,943	7,824	7,119	1,021
1991	14,328	7,734	6,595	-524
1992	15,660	8,284	7,376	781
1993	16,515	8,894	7,621	245
1994	17,450	9,142	8,309	688
1995	17,026	9,005	8,020	-289
1996	18,635	9,779	8,856	836
Cumulative Increase in Unfunded Obligations, 1986-1996:				$3,462

* This is referred to as social security's "closed-group deficiency" over the next 75 years. It includes payments to and income from current workers (age 15 and older) and retirees, but not future generations of workers. Income includes current OASDI reserve funds.

Source: Office of the Actuary, Social Security Administration, 1996.

Communications

Statement of the Coalition to Preserve Retirement Security (CPRS)

[SUBMITTED BY ROBERT J. SCOTT, SECRETARY/TREASURER]

My name is Robert J. Scott. I am Secretary/Treasurer of The Coalition to Preserve Retirement Security ("CPRS"). CPRS is a Colorado Corporation formed by teachers, fire fighters, police officers, and other state and local government employees who elected not to join the Social Security system. The purpose of our organization is to assure the continued financial integrity of our members' retirement and health insurance plans by resisting efforts to mandate Social Security coverage of public employees. Our members are found in Alaska, California, Colorado, Connecticut, Illinois, Kentucky, Louisiana, Massachusetts, Minnesota, Nevada, Ohio, and Texas, and also include several national associations of public employees. With respect to mandatory Social Security coverage, the interests of CPRS are identical to those of approximately five million public employees throughout the nation who remain outside the Social Security system, as well as over one million retirees from public retirement plans outside of Social Security.

BACKGROUND

For many years after the Social Security system was created, state and local government employees were not allowed to participate in the system. Beginning in the 1950s, state and local government employers could elect to have their employees covered. Governments which elected in were also permitted to opt out again, after notification of the intent to do so, and the expiration of a two year waiting period.

This was the law for about three decades, until, in 1983, there was a major revision of the Social Security and Medicare laws, triggered primarily by a concern about the long term solvency of these two trust funds. Congress decided not to require state and local employees who were outside the system to be covered, but did end the opt out for public employees who had chosen to be covered. An "anti-windfall" rule was adopted, to ensure that public employees who also had employment that was covered by Social Security did not receive excess credit for Social Security purposes.

In 1986, as part of the Consolidated Omnibus Budget Reconciliation Act of 1985 ("COBRA"), Congress determined to require participation in the Medicare system on a "new hires" basis, but chose to leave public employee retirement plans in place, and did not change the law with respect to Social Security.

In 1990, Congress enacted a law requiring that all public employees not covered by a state or local retirement plan meeting specified standards must be covered by Social Security. That law, adopted as part of the Omnibus Budget Reconciliation Act of 1990 (the "1990 Act"), ensures that all public employees will be covered either under Social Security or under a public retirement plan which provides comparable benefits. This has proven to be an effective and workable approach. Today, about one-third of all state and local government employees, about five million people, are outside the Social Security system because they are covered by public retirement plans. Additional millions are retirees from non-Social Security public plans, who are dependent on those plans for all, or most, of their retirement income.

Over the last several years Social Security reform has been the subject of numerous bills and hearings, as well as several major study commissions.

In 1994, the Bipartisan Commission on Entitlement and Tax Reform (also known as "the Kerrey-Danforth Commission") studied the problem of projected short falls in the Social Security and Medicare Trust Funds, as well as other mid-term and long-term deficit problems. The Commission was unable to agree on a set of recommendations, but did valuable work in assessing the dimensions of the problem. In an interim report published in August, 1994, the Commission projected that with no changes in law, by 2010 entitlement spending and interest on the national debt would consume almost the entire federal revenues; by 2020, entitlement spending alone would almost equal the federal revenue stream; by 2030, there would not be enough revenue to service the federal entitlement obligations, even if no money were used for other purposes, including payment of interest on the national debt.

In 1995 and 1996, The Advisory Council on Social Security examined the mid-term and long-term solvency of Social Security and the Social Security Trust Fund The Council submitted its report in January, 1997. Once again, there was no majority on the Council for any single set of recommendations. Three different proposals were put forth by different groups of members. A majority of the Council recommended mandatory Social Security coverage of public employees, although the three labor members of the Council opposed this proposal "because of the financial burden that would be placed on workers and employers who are already contributing to other public pension systems."

In his 1998 State of the Union address, President Clinton proposed a policy of "save Social Security first," by which he meant that until such time as the President and Congress agree on a method to put Social Security on a sound footing for the foreseeable future, all federal budget surpluses must be applied to preserve the Social Security system. This proposal has enjoyed considerable support in Congress. It is not yet clear under this proposal whether surpluses are to be applied to reduce the national debt (thereby making it easier for the federal government to repay the Social Security Trust Fund when this becomes necessary) or whether the surpluses are to be invested in the stock market or else where to create a true Social Security reserve. (There are also other ideas, such as using surpluses to create individual investment accounts; beneficiaries of these accounts would give up part of their future claim on Social Security benefits.) A surplus in the Social Security Trust Fund would still be allowed to offset deficits in the rest of the federal budget.

MANDATORY SOCIAL SECURITY COVERAGE IS WRONG AND SHOULD NOT BE ADOPTED

1. Public employees are well provided for under their public plans; mandatory Social Security coverage will harm public employees as well as people who have retired from non-Social Security public plans.

Public plans do an excellent job of providing retirement security for their members. Analyses done by public plan fiduciaries indicate that public employees of almost any description (in terms of salary, length of services, etc.) are better protected under their public plan than they would be under Social Security. For example, the Public Employees' Retirement Association ("PERA") of Colorado produced a study (assuming retirement in 1998 at age 62) showing that an employee working ten years with a highest average salary of $15,000 per year, would receive a Social Security benefit equal to 20.6 percent of pay; the PERA employee would receive a benefit of 22 percent. For short term employees with higher average rates of pay, Social Security benefits are proportionately much lower. For example, a ten year employee with a highest average salary of $60,000 per year would get a benefit of 11.8 percent under Social Security; his PERA benefit would be 22 percent.

Longer term employees at all rates of pay have more secure retirements under PERA. A fifteen year employee earning a highest average salary of $15,000 would receive 28.6 percent of pay under Social Security 33 percent under PERA. A twenty year $15,000 per year employee would receive 32.4 percent of pay under Social Security fifty percent of pay under PERA. At thirty years of service, this hypothetical, relatively low pay ($15,000 per year) employee would receive 42.2 percent of pay under Social Security, but 75 percent of pay under PERA. At forty years of service, the respective numbers are 49.5 percent of pay under Social Security; 100 percent for PERA.

PERA of Colorado is a good plan, but analyses of other public plans prove that these plans also do an excellent job for their employee-members. A comprehensive study of public plans, prepared under the sponsorship of Third Millennium, entitled "Freed From FICA: How Seven States and Localities Exempt a Million Employees from Social Security and Provide Higher Pension Benefits to Retirees" (March 1997) (the "3rd Mill Report") compares the benefits provided under seven large public plans with those provided under Social Security. An employee retiring after 40 years of work at age 65 with an age 62 salary of $20,000 would receive an annual pension of $22,153 from the Public Employees' Retirement System ("PERS") of Nevada; $17,722 from the State Teachers' Retirement System ("STRS") of California; $18,609 from PERS of Ohio; $18,609 from STRS of Ohio; $20,118 from the Los Angeles City Employees' Retirement System; and $17,722 from the Maine State Retirement System. The average for the seven plans studied was $18,951. The Social Security benefit for a worker with the same background would be $8,617 for a single worker and

$12,926 for a married worker. As salary levels rise, public plans do an even better job for their workers in relation to Social Security.

Relatively low paid workers need a high return on their retirement savings in order to be able to retire with dignity. It is small consolation that the percentage return for low paid workers is relatively generous under Social Security, if the dollar benefits are low. For this reason, low paid workers are among those most adamantly opposed to trading all or a substantial part of their current retirement benefits for Social Security coverage. For example, the School Employees' Retirement System of Ohio, with average member compensation of less than $15,000 annually, has been a member of CPRS, and a strong opponent of mandatory coverage, for almost two decades.

The Social Security Advisory Council argues at pages 19–20 of its report that "over the course of a lifetime, it is impossible to tell who will and who will not need [Social Security] coverage." The Council suggests that Social Security may be superior to state or local plans because of the inflation proof aspect of Social Security, or because of the spousal benefit and other ancillary benefits, or because of Social Security's portability.

These claims are not supported by facts. It is not the case, for example, that Social Security benefits are guaranteed. At the time of the 1983 reform, Social Security benefits were reduced, most importantly, by increasing the normal retirement age for Social Security on a phased-in basis. More recently, Social Security benefits were made taxable for some recipients. Social Security's companion program, Medicare, has also been the subject of many cost control measures. Current pressures on the funding of Social Security may quite possibly result in further benefit reductions.

Social Security benefits are reduced for earnings of beneficiaries above specified levels until the beneficiaries reach age 70. Public plan benefits are generally not reduced for earnings.

All of the plans surveyed in the 3rd Mill Report provide disability benefits, as do the vast majority of public plans. The disability benefit provided by Social Security is hard to qualify for. (Generally a worker must be unable to perform any substantial gainful activity and the impairment must have lasted, or must be expected to last, for at least 12 months.) Public plans are often more generous. The average disability benefit provided by the seven surveyed plans was $10,440 annually.

All of the plans surveyed in the 3rd Mill Report provide pre-retirement survivor benefits, as do public plans generally. (Six of the seven surveyed plans also provide post-retirement survivor benefits.) For children, Social Security's survivor benefits cease when the child turns 18. Many public plans provide benefits after that age has been reached if the child is a full time student. The average survivor benefit paid by the seven surveyed plans was $6,960 annually.

Social Security provides an annual cost-of living adjustment for its beneficiaries and so do public plans. The seven surveyed plans all provided cost of living adjustments. During the period from 1988 to 1992 (when inflation was largely under control) these adjustments tended to average slightly over three percent per year. (3rd Mill Report, page 16) Public plans, in effect, also provide very high pre-retirement cost-of-living adjustments, because public plan retirement benefits are almost always based on the final or highest years of compensation (generally a three-year or five- year period is used for the benefit computations).

The greatest advantage of Social Security is supposed to be its portability. Social Security benefits are 100 percent portable after the 40 qualifying quarters have been earned. This is particularly supposed to be an advantage for people who move in and out of the work force. But Social Security benefits for people who have limited years of service may be low, even if those benefits are vested. No refunds are paid by Social Security, even to workers who have less than 40 quarters. Most public plans provide rapid vesting. All but one of the seven surveyed plans in the 3rd Mill study vest in five years, and the plan average for all seven plans was 5.71 years. Of course, public employees are always 100 percent vested in their own contributions and may roll these contributions over into an IRA if no better option is available.

Most public plans afford considerable portability, even with regard to employer contributions. Many plans allow transfer of credits within the same state. Many plans also have buy-in provisions whereby employees may purchase credit in a retirement system, often with proceeds from credits earned in another retirement system.

It is also the case that the Social Security system is not well designed to meet the needs of certain public employees, particularly fire and police. Because of the physical and emotional stress caused by their members' work, fire and police pension plans generally have generous disability benefits. Also fire fighters and police officers retire earlier than most other categories of worker, because physical conditioning is such an important part of job qualifications.

Some people make the mistake of thinking that if mandatory Social Security coverage is applied on a new hires basis, then retirees and current plan participants will not be hurt. This is not the case.

First of all, a "tiered" system of benefits is not likely to work well. Younger employees may well resent their older colleagues, resulting in serious morale problems. It is far from certain that two policemen in the same patrol car will always work together smoothly, if the newer officer is resentful of the compensation package which the older officer receives.

Public plans provide most of their benefits not from employer and employee contributions, but from investment earnings on those contributions. For example, in the Ohio STRS plan, about two-thirds of all plan benefits are paid from plan earnings. Applying Social Security taxes to new hires will reduce the capital stream upon which the earnings are based. How fast this would happen depends on factors which cannot now be determined. The most important of these factors is the definition of a "new hire." If the term is defined conservatively, employee turnover would occur at a rate of about six or seven percent per year. If the COBRA definition of a "new hire" for Medicare purposes were to be used (many people who change jobs even within the same government system are considered to be new hires), the turnover rate would be a great deal higher, at least during the initial years of the new system.

Ohio STRS has concluded that mandatory coverage of new hires would result in the loss of the medical plan which STRS now provides to members and retirees. In addition, STRS believes that it will be necessary to (1) eliminate death, disability and survivor benefits; (2) reduce cost-of-living adjustments from 3 percent annually to 1.6 percent; or (3) reduce retirement benefit accruals from 2.1 percent to 1.9 percent for current members, and from 1.47 percent to 1.32 percent for future members.

These changes are highly injurious and would fall most heavily on those already retired, who would not be in a position to easily adjust. Retirees live throughout the nation. This means that mandatory coverage, even on a new hires basis, would impact people in every state, and would create additional burdens for state and local governments throughout the nation, especially in those states which are home to large numbers of retirees.

2. Mandatory Social Security Coverage of Newly Hired Public Workers Will Not Save the Social Security System; Nor Will Mandatory Coverage Significantly Reduce the System's Problems.

The Social Security system is not in short-term trouble. Currently surpluses in the Social Security system are being used to fund operating deficits else where in the federal budget, although there is now wide spread support for stopping this practice.

The Advisory Council on Social Security expresses the actuarial deficit over the 75 year period ending in 2070 in terms of a percentage of payroll, i.e., 2.17 percent. (Advisory Council Report, p. 11) In dollars, the present value of the difference between OASDI current assets, plus OASDI tax and interest for the 75 year period, minus the present value of OASDI obligations is minus two trillion, five hundred and twelve billion. (Advisory Council Report, p.198). In cash flow terms the Advisory Council expects tax receipts to exceed outgo through 2014. Beginning in 2015, Social Security will run a small cash deficit, but growing each year, so that the short fall for the year 2030 will be $611 billion, and the cumulative short fall for the period 2015 through 2030 is estimated at $4,512,000,000,000 (about four and one half trillion dollars). (Advisory Council Report, p. 192) Estimates of the total long term shortfall are in the range of $9 trillion. (There are, of course, other unfunded federal liabilities, including Medicare and interest on the national debt, as well as other entitlements.) But the favorable economic trends which have occurred since this report was prepared have almost certainly postponed the year when cash flow problems will begin, and reduced somewhat the extent of the long term actuarial deficit.

In their April, 1998 report, the Social Security and Medicare Boards of Trustees announced that the OASDI Trust Fund would remain viable through 2032 (an improvement of three years over previous projections). Also, the Trustees now project that Social Security will continue to generate surpluses through 2013. OASI, by itself, will remain viable for several additional years. The Trustees indicated, at page seven of their report, that "key dates are 1 to 4 years later than shown in the 1997 report, due in large part to better actual and expected economic performance." In the period since publication of the Trustees' Report, the economic situation has improved still further. On May 5, 1998, the Congressional Budget Office increased its surplus projections for fiscal years 1998 and 1999 from $28 billion, to a range of between $73 and $93 billion.

The Advisory Council estimates that in terms of a percentage of payroll, mandatory coverage of new hires, beginning January 1, 1998, would save about 0.22 percent, or about ten percent of the total actuarial deficit for the period 1995 through 2070. This is largely because cash from new hire taxes would come into the system before the obligation to pay out benefits materialized. Of course, the obligation to pay out benefits with respect to contributions made before 2070 would continue long past that year.

In order to determine how to repair Social Security, it is necessary to understand what is wrong now. Although there may be many problems with Social Security, by far the most important is that the system has tried to operate on a pay-as-you-go basis. This approach worked without great strain so long as national demographics were favorable, and the pool of workers was growing much more rapidly than the pool of retirees. This was the case for many decades, but it is no longer the case.

Although there is a large Social Security Trust Fund, which will keep Social Security in actuarial balance through about 2032 (perhaps slightly longer), this trust fund consists of money which the federal government has promised to repay to itself in the future. When Social Security obligations begin to exceed tax revenues, there is no box of money that the government can go to in order to make up the short fall. The federal government can either print money, thereby fueling inflation, or repay the Social Security Trust Fund out of an operating surplus in the rest of the federal budget.

There is a third choice, which is to invest the current Trust Fund surplus in assets which may be redeemed later. For example, current surpluses could be used to pay down the national debt (thereby making it easier to create operating surpluses in the future), or to allow the federal government invest in stocks and bonds, or to allow the creation of personal savings accounts which, in the future, would reduce workers' claims on the existing Social Security system. There are problems and advantages in connection with all of these approaches. But until the federal government faces up to the fundamental difficulties of the pay-as-you-go approach, Social Security's funding problems can only be solved on a pay-as-you-go basis, which means, for years in which outgo exceeds revenues, that benefits must be cut or taxes must be increased.

Many ideas have been advanced in connection with funding Social Security. Reducing the cost-of-living adjustment ("COLA") for Social Security saves very large amounts of money. In December of 1996, The Boskin Commission reported to Congress its conclusion that the then current method of calculating the Consumer Price Index ("CPI") overstated the rate of inflation by 1.1 %. This conclusion was highly controversial, but almost everyone agreed that CPI was overstated by some factor. On April 16, 1998, The Bureau of Labor Statistics announced the last in a series of reductions to the CPI. These final changes will take effect on January 1, 1999 and, together with reductions that have already been made, will total .8 of one percent. (It is hard to determine whether the Social Security Trustees took any account of these CPI reductions in their April, 1998 Report, but it seems certain that they took no account of the more recent changes.)

Small reductions in CPI have enormous effects. The Advisory Council estimated that reducing CPI by 0.5 percent, beginning in 1998, would save 0.72 percent of payroll, or approximately a third of the entire actuarial shortfall. Even if no further changes in CPI are legislated, the long term picture is already considerably brighter than reported by the Advisory Council a year ago.

Gradually increasing the normal retirement age also results in substantial savings, even if the adjustments are relatively minor. Currently the normal retirement age is scheduled to increase very gradually beginning in the year 2000. By 2027, the normal retirement age will be 67. If the normal retirement age were to be raised by two months a year, beginning in 2000, capping at age 68 in 2017, the Advisory Council estimates that this would save 0.49 percent of payroll.

Polls show that the only Social Security reform proposal which enjoys 50 percent or more popular support is the means testing of benefits. The Concord Coalition suggested phasing out benefits for those having income over $40,000 per year, capping the reduction at 85 percent of benefits. According to the Advisory Council, this would save 1.65 percent of payroll.

Currently Social Security benefits are free of tax for most recipients. Other annuities are 100 percent taxable after the beneficiary has recovered his or her basis (after-tax contributions) in the annuity.

Eliminating the wage base cap would also raise very large amounts of money, even though relatively few people would be affected. This has already been done with respect to Medicare.

Mandatory Social Security coverage of new hires will not come close to solving Social Security's problems. Even if the Advisory Council projection of 0.22 percent of payroll is correct, it was based on the assumption that mandatory coverage would be imposed January 1, 1998. The earliest legislation is expected would be next year, and there is no way state and local governments could adjust to mandatory coverage by the year 2000, based upon legislation enacted in 1999. Many of those who have looked at the problem believe that it would take state and local governments four years to adjust to the legal, financial, and administrative problems connected with mandatory coverage. Moreover, mandatory coverage would be the subject of Tenth Amendment litigation, possibly causing more delay, and making it uncertain whether revenue from mandatory coverage would ever be realized.

In addition, there would be offsets. Some employee contributions to public pension plans are tax deductible, but all benefits are taxable (after the worker has recovered his or her basis). Employee contributions to Social Security are not tax deductible, but all benefits are tax free to most recipients. Moreover, state and local governments would have to raise taxes to pay their share of OASDI taxes (and perhaps some or all of the employees' share as well) and many of these new taxes would be deductible for federal income tax purposes.

Eventually, of course, public employees would draw out benefits on the same basis as everyone else. If mandatory coverage of new hires were to be imposed relatively soon, benefits for newly covered employees would begin to come due around 2030, exactly the time when Social Security is predicted to be in its greatest crisis, at least on an actuarial basis. The Government Accounting Office has recently estimated that on a cash flow basis, public employees would begin to draw more money out of the system in benefits than they paid in contributions by 2050. (See GAO Report HEHS 98–196, "Social Security: Implications of Extending Mandatory Coverage to State and Local Employees," p.9)

Worst of all, of course, would be for Congress to cover new hires, but fail to save the tax revenues. That policy is precisely what has created the difficulties that we face today.

On the other hand, if the government does save the surpluses in the Social Security Trust, and if the economy continues to prosper, these factors, together with reductions in the CPI which have already been announced, will make it easier to face whatever is left of the problem. It would be worth while to examine these developments before taking more radical action.

Of course, Congress may decide to modify the current structure of Social Security not merely to solve the funding problem, but to provide better retirement benefits for participants. Such action (usually described as privatization) might increase costs for Social Security participants in order to provide the increase in benefits. But there is no reason why public employees should pay these costs; they are already funding their own system.

3. Mandatory Social Security Coverage Will Harm Existing Public Plan Participants and Retirees and This Proposal Is Not Fair.

Some people argue that mandatory Social Security coverage should be imposed on grounds of fairness. The Advisory Council argues, at page 19 of its Report, "all Americans have an obligation to participate [in Social Security], since an effective Social Security program helps to reduce public costs for relief and assistance, which, in turn, means lower general taxes." Other people have an instinctive reaction that if Social Security is good enough for everyone else, why shouldn't public employees participate. It is also argued that, at least in percentage terms, Social Security confers a high benefit on very low paid workers, and that in the future most other wage earners will have to subsidize this benefit. (Until recently, almost all participants had a very positive return from Social Security in dollar terms.)

Public retirement plans also reduce public costs for relief and assistance in precisely the same way that Social Security achieves that effect. Employees covered by public plans are not candidates for welfare, SSI, or other forms of public assistance. Public plans provide higher dollar benefits in proportion to salary and years of service than does Social Security. Low income workers depending entirely on Social Security for their retirement income are virtually certain to need public assistance.

Moreover, whereas the Social Security funding problem has created substantial exposure to the federal government in terms of future needs for revenue, there is no exposure to the federal government, or to the taxpayers who support that government, in connection with public plans, because public plans are not insured by the Pension Benefit Guaranty Corporation.

It has also been argued that public employees should participate in Social Security because their parents may receive benefits. Of course, these parents also made Social Security contributions, but this argument assumes that each generation subsidizes the benefits of the preceding generation. This probably will not occur in the future. Moreover, to the extent that payment of benefits to one's elders is looked upon as a benefit to those currently making Social Security contributions, it is entirely possible that the children of public employees will contribute to Social Security, even through their parents will draw benefits only from a public plan.

There is some evidence that the Advisory Council was not that concerned with questions of fairness. In an April, 1997, speech before the National Conference of Public Employee Retirement Systems, Edith Fierst, a member of the Council, said of the mandatory coverage proposal, "We did it primarily because it would be good for Social Security, not because it would be good for the employees. Our interest was that if people came into Social Security and began to pay the Social Security tax, that helps the Social Security's trust fund, and they won't start to draw benefits based on those contributions for some years."

Public employees did not cause the current funding problems for Social Security, nor did non-covered public employees benefit during the many decades when almost every participant came out of the Social Security system a winner. Social Security surpluses have helped to disguise deficits in the general operating budget of the federal government, primarily during the last ten years, and public employees have experienced lower federal income taxes (or lower federal debt owed to third parties) on exactly the same basis as everyone else, including Social Security participants and beneficiaries, but no more so. If it is decided to repay the Social Security Trust Fund in the future out of general fund surpluses, public employees will pay their share of those surpluses through federal income taxes and other federal taxes.

Although low income employees receive high benefits in proportion to their contributions, Social Security has never been a system of income transfer from relatively rich to relatively poor, nor will it be such a system in the future. To some extent, within members of the same generation, Social Security will become a transfer system from single to married, especially single earner married.

Throughout most of its history, and even today, Social Security was an arrangement where everyone won. For example, low-wage single workers who turned 65 in 1960 paid life-time taxes of $4,000, [employer and employee] and received life-time benefits of $30,100, for a positive return of $26,100 [in 1993 constant dollars] (Steuerle and Bakija, "Retooling Social Security for the 21st Century", The Social Security Bulletin, 1997, #2, at page 47, the "Bulletin Report".) High wage earners received a more positive return measured in dollars, although low-wage workers received a better return measured as a percentage of life-time taxes to benefits. But members of every group (low, average. and high earners, male and female, single and married, one-earner and two-earner couples) that turned age 65 in 1960, on average, came out big winners. High wage single men (the least favored category) received life-time benefits equal to almost four times life-time taxes. Factors such as sex (women did better than men) and marital status (married one-earner couples received life-time benefits equal to eight- and-a-half times life-time contributions) were very important in determining how good a deal you received. Social Security was not a re-distributional system from high-earner to low-earner. Everyone won; high-earners won the most in dollars; women and married couples won the most in percentage terms. (For purposes of these calculations, high-earners are assumed to receive at least the maximum wage subject to Social Security tax ($65,400 in 1997); average-earners are assumed to receive the Social Security Administration's measure of the average national wage ($26,700 in 1997) each year from age 21 to age 65, and low-wage earners are assumed to receive 45 percent of this amount (about $12,000).)

This pattern continued for workers who reached age 65 in 1980. Positive returns for 1980 retirees were actually greater than those received by their 1960 counterparts measured in dollars; measured as a percentage of life-time contributions to life-time taxes, however, the 1960 cohort did much better. But every category of worker reaching age 65 in 1980 had a substantially positive rate of return.

For the most part, this pattern also continues for those who reached age 65 in 1995. For the first time, however, there are projected to be losers. Average-income and high-income single males who retire in 1995 will, on average, receive less in benefits than they and their employers paid in taxes. All other categories of workers, including high-earner categories, will receive positive rates of return, though not as high, measured either in dollars or percentages, as they would have received in the past.

For those reaching age 65 in 2010, most single male workers will have a negative rate of return (single male low-earners will essentially break even) and single women, other than low- wage single women, will also lose. Married couples are projected to have positive rates of return for this age category, with the exception of high-wage two-earner couples, who will experience substantial losses.

For those reaching age 65 in 2030, exactly the same categories are projected to win and lose, although losses will be greater, measured in dollars, and positive rates of return will be low for most of the categories of winners.

Nor does Social Security pay a benefit that low-wage people can live on. The average low-earner retiring at age 65 in January 1996 would receive a monthly benefit of $537. (Fast Facts and Figures about Social Security, The Social Security Administration: 1996, page 16) Any additional support that is necessary is paid out of the general fund, in the form of SSI benefits. Income taxes of public employees support the general fund on the basis as everyone else.

The average annual salary for a full time state or local government employee, nation wide, in October 1995, was $33,464. (Statistical Abstract of the United States: 1997: page 326) For all full time workers in 1995, the average annual salary was $40,367 for men, and $26,547 for women. (Statistical Abstract, page 474) (The average of these two amounts is $33,457.) Public employees are squarely in the midrange of all Americans in terms of their compensation. If public employees were to be brought within the system, there is no way that they would "subsidize" the benefits for any other group.

But it will not be possible for public plans to maintain their current benefit structure, if mandatory coverage is imposed, even for existing plan participants and existing retirees. As discussed above, page 6, Ohio STRS has estimated that mandatory coverage on a new hires basis would require the elimination of health care benefits, and would also require the reduction or elimination of cost-of-living adjustments, or normal retirement benefits, or the elimination of ancillary benefits for plan participants. (These estimates assume a relatively restrictive definition of "new hire;" If the COBRA definition were used, the situation would be much worse.) The average Ohio STRS retiree lives 25 years; three years of retirement are paid for by employee contributions; six years are paid for by employer contributions; sixteen years are paid for by earnings on investments. Other systems report similar problems.

Although most public plans are fully funded, or close to fully funded, this does not mean that current retirees and plan participants have all of their benefits paid for today. A plan is considered to be fully funded on an actuarial basis, which takes account of projected benefits, projected contributions, and projected earnings on contributions. If the stream of projected contributions dries up, most plans that are fully funded today will not be fully funded tomorrow. Moreover, these plans will reach a point where they will have to draw down plan assets to pay current benefits, making the funding situation even worse.

At page 20 of its report, the Advisory Council puts forth, as one argument for mandatory coverage, that a high proportion of state and local government workers will receive Social Security benefits because of non-government work which they perform, or through their spouses. A Council of Social Security experts should very well know, but fail to acknowledge, that state and local government workers do not receive any unfair advantage from remaining outside of the Social Security system for most, or part, of their career. In 1983, as part of the overall Social Security reforms enacted in that year, Congress adopted an anti-windfall rule, which has the general effect of reducing any Social Security benefit that the employee might otherwise be entitled to receive in accordance with a formula based on the period of time during which the employee was not covered by Social Security. This adjustment is made because Social Security is bottom weighted that is, Social Security tends to provide relatively high benefits for workers who have relatively low career average earnings. Another rule which is applicable to non-covered government workers, known as the spousal offset rule, reduces the spousal benefit which would otherwise be payable to these workers.

4. MANDATORY SOCIAL SECURITY COVERAGE HAS THE SAME ADVERSE EFFECTS AS DO UNFUNDED MANDATES.

In recent years Congress has rightly been concerned about the effects on state and local governments of imposing costly federal requirements on those governments, without providing the necessary money. The Unfunded Mandate Reform Act of 1995 passed over-whelmingly in both the House and the Senate.

The cost of mandatory coverage on a new hires basis would be over $100 million in the first year for Ohio, and almost $200 million for California. When fully phased in, California's annual cost would be over $2 billion, and states such as Texas, Colorado, Illinois, Massachusetts, and Louisiana would face annual costs in the hundreds of millions of dollars. Even states like Washington, Florida, Georgia, Connecticut, Kentucky, Michigan, and Minnesota, which are not often thought of as non-Social Security states, would face annual costs in excess of $100 million.

Organizations such as the National Conference of State Legislatures and the American Legislative Exchange Council oppose mandatory Social Security in large part because it is an unfunded mandate.

The burden caused by these extra costs would fall most heavily on those who can afford it least, such as large cities which have substantial low-income populations. In a March 15, 1998 article, The Washington Post discussed a report by the Milton S. Eisenhower Foundation. (See, "Rejuvenation of Cities: Was It Just Cosmetics?," page A3) The report concluded that "'Most adults in many inner-city neighborhoods are not working in a typical week.'" Two-third of children fail to achieve basic reading levels. Child poverty. segregation, and imprisonment have all risen.

Buzz Bissinger, author of the recent book, "A Prayer for the City," reaches similar conclusions when he discusses the energetic reform efforts of Philadelphia Mayor Ed Rendell, which he views largely as a failure. Bissinger concludes that wide-spread improvement may be possible for New York, because immigration keeps the population up, and because that city is awash in money from Wall Street. But many other cities, like Atlanta, Cleveland, Detroit, and Miami, among others, have no such advantages, and are far less likely to be able to re-define themselves in ways that benefit the poorer neighborhoods.

In a September 13, 1998, editorial. The Washington Post noted that there are over 52 million students in school this year, a number that is substantially higher than the baby boom. Although the President has called for tax credits to restore crumbling buildings, money to hire 100,000 new teachers to reduce class size, and an effort to computerize class rooms in every school, the Post argued that the real problem was "the difficulty of maintaining qualified teachers." The Post said:

"Unions as well as reformers pay lip service to the need for education programs to be more selective and for schools to hire teachers with backgrounds in the subjects they are assigned to teach. But in a situation like the present, everyone knows that these are empty words. School districts with swelling classes are forced to bring in everyone from substitutes to retirees. Scholarships that require recipients to teach for several years and for quicker certification for older teachers have been proposed. More than before, maintaining high quality will require inspiring more people to enter teaching."

On September 15, 1998, Richard Riley, Secretary of Education, gave a speech before the National Press Club in which he said, "Too many school districts...are sacrificing quality for quantity in order to meet the immediate demand of putting a warm body in front of a classroom." The Post noted that Riley's remarks came at a time when "high salaries are luring away would-be teachers and an increasingly sophisticated world is raising the demands on what those who do teach must know."

It is not rational to suppose that schools which now hire teachers based on a package of salary and benefits, will be able to hire better teachers tomorrow by offering a package of the same salary and greatly reduced benefits. You get what you pay for. If government employers are unable to offer new employees the same pension plan that they offer current employees, salary and other compensation will have to go up, or the quality of recruits will go down.

On March 12, 1997, bi-partisan representatives of the National Governors' Association testified before a joint session of the House and Senate Budget Committees, urging Congress not to enact federal tax cuts which would force state or local tax hikes. Mandatory Social Security coverage would actually be worse, a federal tax hike which would force state and local tax hikes.

Statement of Nick Smith, Congressman (Michigan—7th) Chairman, House Budget Committee Task Force on Social Security

I have made Social Security reform a legislative priority since 1994, and I find it encouraging to see this issue getting the attention it deserves. Recently, I was selected to serve as the Chairman of a bipartisan Budget Committee Task Force of Social Security. Task Force members will work together to develop our best solutions to save Social Security. The only guidelines I'm suggesting is that we don't reduce benefits for current or near-term retirees, and that any solution must be fair to future generations.

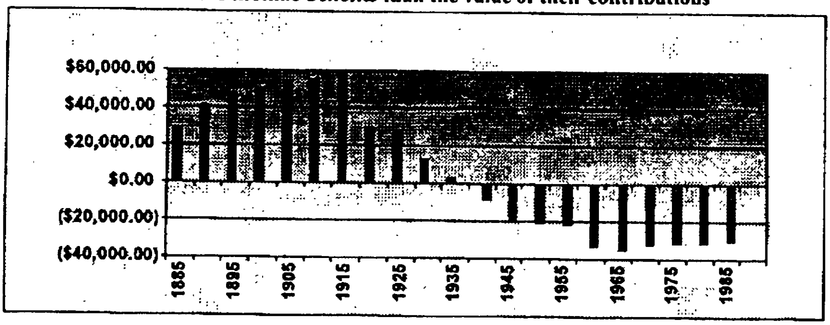
I recommend a three-way approach to Social Security reform: change the system to keep it solvent through the 21st century; require open and honest government accounting for the Social Security surplus; and test our reform proposals with a pilot program.

THE OLD SOCIAL SECURITY FRAMEWORK NO LONGER WORKS

Using 75-year projections of selected economic and demographic assumptions, Social Security's actuaries calculate the financial future of Social Security. The actuaries have determined the system has an "open" unfunded liability of $3.1 trillion. The "closed" liability is much higher, at $8.4 trillion. Under current law, Social Security benefits will exceed payroll tax revenue around 2010, and this shortfall is expected to continue indefinitely into the future—beyond the 75-year horizon used by the Social Security Administration.

Changing demographics mean that workers will pay more and more taxes to cover benefits for retirees, unless we change the system to get a better return on the taxes being paid in. Social Security has become a losing "investment" for the average worker born after 1940. The Urban Institute has compared how well the average retiree fares under Social Security by calculating the value of his payroll taxes paid during working years, including the interest these contributions should have earned, and subtracting that amount from the value of the benefits he collects over his lifetime. It found that workers who turned 65 in 1980 and retired that year are receiving benefits worth $60,000 more than what they paid in. According to Social Security economists, workers who started paying FICA taxes in 1937 and collected benefits through 1992 received an average real rate of return of 7.3%. Workers born in 1965 get the worst deal from Social Security. The Urban Institute numbers show that they will get almost $40,00 less in benefits than they contribute to the system.

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



The Social Security "fix" can only be accomplished in three ways: increase revenues by improving the rate of return on contributions; reduce benefits; or increase revenues by raising taxes. The promise of personal accounts is that they can dramatically increase returns for workers, thereby improving the living standards of future retirees. If workers are allowed to put even a portion of their Social Security contributions into investment accounts, the long-run return that these accounts should earn will keep the monthly retirement benefit in the range of what current recipients get while maintaining Social Security's solvency.

My proposal, The Social Security Solvency Act of 1997, brings the system into balance without tax increases. If we raise taxes, we are increasing the largest tax most American families pay, and we make Social Security's return on investment even a bigger negative number. Almost 80% of families pay more in Social Security taxes than they pay in income taxes. My bill:

- Keeps Social Security as a government program
- Continues the disability insurance portion of Social Security
- Slowly reforms the current system so that Social Security will have sufficient funds to honor its retirement benefit commitments as it transitions from pay-as-you-go to using a portion of FICA for personal savings accounts
- Establishes optional Personal Retirement Savings Accounts. Individual savings accounts will accumulate considerable sums resulting in higher retirement benefits. The surpluses coming into the trust fund allow private investments to start at 2.5% of payroll and increase to 10.2% percent of payroll in the year 2070.
- Gradually reduces the increase in benefits for high income retirees
- Allows private investment account withdrawals for retirement at age 59–1/2
- Provides a safety net so no American retires in poverty
- Balances the Social Security System for the next 75 years

Social Security actuaries have "scored" the Social Security Solvency Act of 1997, and they have determined that it will keep the program in balance for the next 75 years. My plan has received letters of support from Alan Greenspan, Jack Kemp, the Junior Chamber of Commerce, and various seniors organizations.

By making gradual reforms, we have an opportunity to maintain or improve benefit levels while restoring the program's long-term solvency. It's an opportunity we must not waste. Recent events remind us that the stock market goes up and down. Although some people have focused on the uncertainty associated with investing private securities, we must remember that Social Security has undergone its own share of ups and downs. Social Security's own analysis of the program's "rate of return" shows that this return has dropped steadily, from its high of 36.5% for workers retiring in 1941. Indeed, demographic, economic and political forces will continue to force change and create uncertainty about the system's future.

Prudent stock investments will yield the highest return for future retirees. According to Dr. Jeremy Siegel, a Wharton professor and author of "Stocks in the Long Run," investors who follow a "buy and hold" stock strategy are better off over time. As we have seen lately, stock market values can change overnight. This has happened in the past, and Dr. Siegel has tracked investment returns through market peaks and valleys to reach his conclusions. He discovered that an investor who put $100 in the stock market in August 1929, just before the stock market crashed, and left it there would have found that his investment had grown to $565 by August 1959, before inflation. A similar $100 put into bonds and T-bills would have been worth $141 and $79, respectively.

PROTECTING THE SOCIAL SECURITY SURPLUS

Many people believe that their FICA tax payments have been invested into a Social Security trust fund, with the money put aside to pay their benefits when they retire. This is not the way Social Security works. Instead, nearly all of a workers' Social Security taxes go to fund current retirees' benefits. Only leftover funds, a small percentage of the total, go to the trust fund. The government has kept a "trust fund" equal to about one-and-a-half years worth of benefit payments, to make sure that current benefit obligations can be met. At the end of 1997, the Social Security trust fund had a balance of $650 billion—enough to cover just twenty months of benefit payments.

For the next ten to fifteen years, Social Security is expected to take in more taxes than it will pay out in benefits. This "surplus" cash flow should be protected to help us meet the benefit commitments we are making to current workers. I have introduced H.R. 4033 to ensure open and honest discussion about how the government is using the Social Security Trust Fund. The bill directs the Office of Management and Budget and the Congressional Budget Office to exclude Social Security surpluses from official budget surplus/deficit projections, and requires the government to issue marketable bonds when it borrows Social Security's surplus.

PUTTING OUR KNOWLEDGE, EXPERIENCE AND IDEAS TO WORK

I believe we should start putting reform ideas to the test right away. I have introduced H.R. 3560, legislation that would provide for a pilot program for private accounts. Through the pilot, we can see the concept of private accounts in action, and use real-world experience to design a Social Security system for the 21st century.

THE SOCIAL SECURITY SOLVENCY ACT OF 1997/H.R. 3082

- No Tax Increase
- Establishes Personal Retirement Savings Accounts. Individual savings accounts (PRSAs) will accumulate considerable sums resulting in higher retirement benefits. The surpluses coming into the trust fund allow private investments (PRSAs) to start at 2.5% of payroll and increase to 10.2% percent of payroll in the year 2070.
- Social Security will have sufficient funds to honor all retirement benefit commitments as it transitions from pay-as-you-go to private savings accounts
- Gradually reduces the increase in benefits for high income retirees
- Allows private investment account withdrawals for retirement at age 59–1/2
- Increases retirement age two additional years over fifteen years, then indexes the retirement age to life expectancy
- Balances the Social Security System for the next 75 years
- Newly hired State and local government employees join Social Security
- Couples receive a minimum of 133% of higher benefit, and widows/widowers receive minimum 110% of married benefit payment

H.R. 4033

- Requires the government to issue marketable bonds when it borrows from the Social Security trust fund
- Requires CBO and OMB to exclude Social Security surpluses from official budget projections

SOCIAL SECURITY SOLVENCY PILOT PROGRAM ACT OF 1998/H.R. 3560

Pilot demonstrations will
- provide testing of the feasibility and popularity of worker-owned accounts
- reduce accrued liabilities of the Social Security trust fund
- be implemented with no reduction in payroll tax receipts by Social Security Administration
- require no new compliance measures for employers.

Attachments.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

October 7, 1997

The Honorable Nick Smith
House of Representatives
Washington, D.C. 20515-2207

Nick

Dear Congressman:

Thank you for your recent letter requesting my views and comments on the proposed Social Security Solvency Act. As you know, I have spoken frequently, in congressional testimony and other forums, about the significant reforms that are required to ensure the long-run viability of the social security system and to provide adequate resources for the benefits that have been promised to future retirees.

We have two basic options for providing the pension benefits that have been promised to the baby boom generation. One is to do nothing now and to provide for future retirees' consumption through large tax increases on future workers. The second is to provide more future resources by immediately taking steps to increase national saving. I much prefer the second option, both because of the economic disincentives that tax increases create and because of the greater intergenerational equity implicit in the saving option. Social security reforms that cut benefits or increase current payroll taxes would reduce the federal deficit and, of course, add to national saving. But, I also would emphasize that there are other ways of increasing national saving, such as reductions in the other parts of the federal budget or intensified efforts to encourage private household and business saving.

The Social Security Solvency Act addresses the need for adjustments to the social security system. Indeed, it features some of the approaches that I have long advocated: most notably, the gradual adjustment of the social security retirement age to reflect increasing longevity and the general concentration of the needed adjustments on the benefits side of the social security program. I trust that your proposal and others will be given careful consideration soon by the Congress, giving us the best chance for finding a timely solution to the pension security problem of our aging population that is both politically and economically viable.

Thank you for giving me this opportunity to provide some input to your social security reform efforts.

Sincerely,

Alan

Table 3. Estimated Long-Range OASDI Financial Effect of Proposal of Representative Nick Smith

Provision	Estimated Change in Long-Range OASDI Actuarial Balance 1/ (percent of payroll)
1. Reduce benefits beginning in 1998 for high-income beneficiaries who have recovered employee and employer payroll taxes plus interest.	0.03
2. Raise the NRA by 3 months per year reaching 69 for those age 62 in 2015, then index. Raise the EEA and increase the benefit computation period.	1.56
3. Reduce the benefit for aged spouses from 50 to 33 percent of the worker's PIA.	0.17
4. Cover under OASDI all State and local government employees hired after 1997.	0.23
5. Provide a third PIA bend point in 1999 with a 5 percent factor; index the second and third bend points by the CPI and gradually phase down the 32, 15 and 5 percent factors after 1998.	3.09
6. Annual statements for workers and beneficiaries.	2/
7. Assume 0.15 percent lower measured CPI growth.	0.22

Subtotal for provisions 1 through 7	4.69
8. Beginning 1999, distribute any OASDI income in excess of the amount needed to cover annual program costs and maintain a minimal contingency reserve trust fund to current workers as contributions to retirement savings accounts. Reduce subsequent benefit levels by the amount of lifetime PRSA contributions, with modified interest.	-2.44

Total for provisions 1 through 8	2.25

1/ Estimates for individual provisions exclude interaction.
2/ Negligible, i.e., less than 0.005 percent of payroll.

Based on the intermediate alternative II assumptions of the 1997 Annual Trustees Report.

Office of the Chief Actuary
Social Security Administration
October 20, 1997

Table 1C OASDI Effect of Rep. Nick Smith Proposal-2.8% PRSA to 2016*
With Ult Real Int Rate of 2.7

Year	Cost Rate	Income Rate	Annual Balance	TFR 1-1-yr	Change in Total Contrib Rate	OASDI Contrib Rate	PRSA Contrib Rate
1997	11.49	12.63	1.14	153		12.40	--
1998	11.53	12.63	1.10	167		12.40	--
1999	11.57	9.83	-1.73	179		9.60*	~~2.80~~ 2.5
2000	11.56	9.83	-1.72	168		9.60	~~2.80~~ 2.5
2001	11.53	9.84	-1.69	156		9.60	~~2.80~~ 2.5
2002	11.48	9.85	-1.64	144		9.60	~~2.80~~ 2.5
2003	11.41	9.85	-1.56	133		9.60	2.80
2004	11.31	9.85	-1.45	122		9.60	2.80
2005	11.19	9.86	-1.33	112		9.60	2.80
2006	11.03	9.86	-1.17	102		9.60	2.80
2007	10.87	9.86	-1.01	94		9.60	2.80
2008	10.71	9.87	-0.84	87		9.60	2.80
2009	10.58	9.87	-0.71	80		9.60	2.80
2010	10.44	9.87	-0.56	74		9.60	2.80
2011	10.34	9.88	-0.46	70		9.60	2.80
2012	10.26	9.88	-0.37	66		9.60	2.80
2013	10.20	9.89	-0.31	63		9.60	2.80
2014	10.13	9.89	-0.24	60		9.60	2.80
2015	10.08	9.90	-0.18	58		9.60	2.80
2016	9.99	9.90	-0.08	56		9.60	2.80
2017	9.92	9.89	-0.03	56		9.60	2.80
2018	9.85	9.83	-0.02	56		9.58	2.82
2019	9.80	9.78	-0.02	56		9.52	2.88
2020	9.75	9.74	-0.01	56		9.47	2.93
2021	9.76	9.74	-0.02	56		9.42	2.98
2022	9.74	9.75	0.01	55		9.42	2.98
2023	9.75	9.74	-0.01	55		9.42	2.98
2024	9.77	9.77	0.00	55		9.41	2.99
2025	9.78	9.78	0.01	55		9.43	2.97
2026	9.75	9.76	0.01	55		9.44	2.96
2027	9.72	9.71	-0.01	55		9.41	2.99
2028	9.65	9.64	-0.01	55		9.36	3.04
2029	9.56	9.54	-0.02	56		9.29	3.11
2030	9.45	9.42	-0.03	56		9.19	3.2[illegible]
2031	9.34	9.29	-0.04	56		9.07	3.33
2032	9.20	9.16	-0.04	56		8.95	3.45
2033	9.05	9.00	-0.05	57		8.81	3.59
2034	8.87	8.81	-0.06	57		8.66	3.74
2035	8.68	8.60	-0.07	57		8.47	3.93
2036	8.45	8.38	-0.08	58		8.27	4.13
2037	8.22	8.13	-0.09	58		8.05	4.35
2038	7.97	7.88	-0.09	59		7.82	4.58
2039	7.71	7.61	-0.10	59		7.57	4.83
2040	7.44	7.34	-0.10	60		7.32	5.08
2041	7.18	7.07	-0.11	60		7.06	5.34
2042	6.91	6.80	-0.11	61		6.80	5.60
2043	6.64	6.53	-0.11	62		6.53	5.87
2044	6.37	6.26	-0.11	62		6.28	6.12
2045	6.10	5.99	-0.12	63		6.02	6.38
2046	5.83	5.71	-0.11	63		5.76	6.64
2047	5.57	5.45	-0.12	64		5.50	6.90
2048	5.31	5.20	-0.11	64		5.25	7.15
2049	5.07	4.96	-0.11	65		5.01	7.39
2050	4.84	4.73	-0.10	65		4.78	7.62
2051	4.62	4.52	-0.10	65		4.56	7.84
2052	4.41	4.31	-0.09	66		4.36	8.04
2053	4.21	4.12	-0.09	66		4.16	8.24
2054	4.02	3.93	-0.08	66		3.98	8.42
2055	3.84	3.76	-0.08	66		3.80	8.60
2056	3.67	3.60	-0.07	66		3.63	8.77
2057	3.52	3.45	-0.07	66		3.48	8.92
2058	3.36	3.30	-0.06	66		3.34	9.06
2059	3.22	3.16	-0.06	66		3.20	9.20
2060	3.08	3.03	-0.05	66		3.06	9.34
2061	2.96	2.91	-0.05	65		2.94	9.46
2062	2.84	2.79	-0.05	65		2.82	9.58
2063	2.74	2.69	-0.04	64		2.71	9.69
2064	2.64	2.61	-0.03	63		2.62	9.78
2065	2.57	2.54	-0.03	62		2.54	9.86
2066	2.50	2.48	-0.02	61		2.47	9.93
2067	2.44	2.42	-0.02	60		2.41	9.99
2068	2.37	2.36	-0.01	59		2.36	10.04
2069	2.32	2.31	-0.01	58		2.30	10.10
2070	2.28	2.27	-0.01	57		2.25	10.15
2071	2.25	2.25	-0.00	55		2.22	10.18
2072	2.27	2.27	0.00	53		2.20	10.20
						2.22	10.18

	Summarized CostRt OASDI	IncRt OASDI	ActBal OASDI
1997 -2071	8.57	8.59	0.02

* PRSA contributions accumulated by TF Int + 1%, for benefit offset.
Based on Intermediate Assumptions of the 1997 Trustees Report
With Ult Real Int Rate of 2.70

Office of the Actuary
Social Security Administration
October 20, 1997

The Detroit News

35¢

Bravo to Nick Smith

Thanks in part to U.S. Rep. Nick Smith, the Adrian Republican, this could be a more significant budget year in Washington than expected. For some time now, Mr. Smith has been plugging a plan that would allow individuals to sock away up to 2.5 percentage points of their Social Security tax in a private retirement fund. Now he appears to be getting support from a significant source — New York Democratic Sen. Patrick Moynihan, who this week broke ranks with his party to suggest a 2 percent set-aside.

As most Americans know, the current Social Security system provides an exceptionally poor return on "investment." That's because the money is not really invested. It is simply skimmed off to pay for current benefits as well as general operations of government. The Social Security "surplus" consists of nothing more than IOUs from the U.S. Treasury. In the next century, due to a rise in the number of retirees relative to workers, the system is expected to nosedive into the red.

If individuals were allowed to set aside even a small portion of their Social Security taxes in a private investment fund, the miracle of compounding would provide far higher returns. Rep. Smith would use the budget "surplus" to fund a transition to such a system.

If individuals were allowed to set aside even a small portion of their Social Security taxes in a private investment fund, the miracle of compounding would provide far higher returns. The average return in the U.S. stock market, for example, has been 10 percent a year during the past half century. And as more and more Americans personally invest in stocks, either directly or through pension funds, they are becoming increasingly comfortable with the idea of directing their own investments.

Fiscal hawks worry that converting some of the Social Security tax to private investment funds might create a shortfall in payments to current retirees. Sen. Moynihan proposes to cover that by raising the base on which Social Security taxes are levied to $97,500 from $68,400.

Rep. Nick Smith

Rep. Smith, who chairs a House task force on the subject, has a better idea: Use the budget "surplus" to fund the transition. The Republican-controlled Senate Budget Committee this week signaled agreement by refusing to approve President Bill Clinton's new spending plans. Any surplus, it suggested, should be used — as President Clinton himself claims to want — to improve Social Security.

Bravo to Sen. Moynihan for nudging his Democratic colleagues in a more constructive direction. And bravo to Nick Smith for having the courage to touch the so-called third rail of American politics when many Republicans were running for cover. No doubt the left will issue its usual claims that folks like Sen. Moynihan and Rep. Smith are trying to destroy Social Security. In fact, they are trying to save it.

STATEMENT OF THE SOCIETY FOR HUMAN RESOURCE MANAGEMENT

Chairman Roth and Members of the Senate Finance Committee:

Thank you for holding a hearing on retirement security and for the opportunity to express the views of the Society for Human Resource Management. The Society for Human Resource Management (SHRM) is the leading voice of the human resource profession. SHRM, which celebrates its 50th anniversary in 1998, provides education and information services, conferences and seminars, government and media representation, online services and publications to more than 100,000 professional and student members through out the world. The Society, the world's largest human resource management association, is a founding member of the North American Human Resource Management Association and a founding member and Secretariat of the World Federation of Personnel Management Associations (WFPMA).

The ability of current and future retirees in the United States to financially sustain themselves can either be facilitated or eroded by legislative initiatives, influenced by the short and long-term need for tax revenue. Individuals rely on three main sources to finance their retirement: (1) Income from private sources (e.g. employer-sponsored retirement and health care plans); (2) Their own personal savings; and (3) Social Security and Medicare. A critical foundation of retirement is the affordability and access to adequate health care. Economic, demographic, social, accounting and regulatory trends, as well as the demand for current income indicate that in the long-term an increasingly large proportion of retirees may not have sufficient income and medical coverage from each of the three sources when they retire.

To provide a sound foundation for retirement planning, and minimize the number of retirees on welfare, a national retirement policy is essential to guide the various governmental entities, businesses and individuals in their fiscal and health care planning.

Such a policy should recognize significant trends and enable policy makers to institute and/or revise income, taxation and retiree health care funding systems to effectively meet longer-term challenges.

BACKGROUND:

Today most individuals are able to retire comfortably. From 1971 to 1991, the elderly poverty rate fell from 22 percent to 12 percent. On average, workers retire earlier and live longer than in the past. However, a number of trends in the economy and workplace suggest that it may be more difficult for American workers to retire with a reasonable standard of living in the future. These trends are highlighted below.

Aging Population Increases the Need for Adequate Retirement Income and Health Care Coverage:

As the U.S. population ages rapidly and the elderly live longer, an increasing proportion of the population will depend on retirement income and retiree health care. Without re-enforcing the traditional retirement support systems, the declining ratio of workers to retirees will place a huge burden on Social Security, Medicare and Medicaid. In 1990, 13% of the population was aged 65 or older, compared to 10% in 1970. The Department of Labor projects that by 2050, 22% of the population will be aged 65 or older.

Mobility Causes Inadequate Retirement Income:

Employees are likely to change jobs several times over their careers. Those frequently changing jobs, not always voluntarily, may be less likely to have adequate retirement income and employer sponsored retiree health care upon retiring since many traditional retirement programs (income and health care) provide benefits based on length of service, and vested benefits for shorter service terminations are frequently paid out in cash and not saved for retirement.

Firms Without Retirement Income and Retiree Health Care Plans:

The self-employed and employees of small firms, which create most new jobs, are less likely to have employer-provided retirement programs than employees in larger firms. According to the Employee Benefit Research Institute, in 1991, 19% of workers in firms with fewer than 25 workers were covered by an employer-sponsored retirement plan, compared to 78% of employees in companies with 1,000 or more employees. Similarly, 18% of smaller employers provide employer sponsored retiree medical coverage, while 44% of large employers provide medical coverage to retirees.

Conservative Defined Contribution Plan Investments Reduce Retirement Income:

According to the Pension and Welfare Benefits Administration (DOL), from 1975 to 1990 most of the growth in employer-sponsored plans can be attributed to an increase in the number of defined contribution plans from 207,700 to 599,200. The shift to defined contribution plans may affect retirement savings as a result of participant's conservative investment choices, which may lead to lower than expected retirement standards of living. Several studies have found that participants in defined contribution plans, which generally allow participants more discretion in investment allocation, often choose low-risk, low-return investments.

Erosion of Pre-Retirement Fund Distributions:

Based on Employee Benefit Research Institute (EBRI) data, most employees choose not to roll over their lump sum distributions, particularly small distributions, into another retirement account when they leave a job. According to EBRI's study, only 22% of lump sum distributions are rolled-over into other qualified plans, while most are used to fund current consumption or ~~other~~ expenses. Withholding regulations implemented in 1993 may be reducing this practice somewhat, leading to more funds being rolled-over into other qualified plans.

Complex Regulations Deter Employer-Sponsored Plans

The complexity of existing retirement plan regulations and the substantial administrative cost of complying with them discourage employers from establishing and maintaining retirement plans. A 1991 survey conducted by the American Academy of Actuaries found that among those actuaries whose had been involved in a plan termination in the previous year, the largest single reason (30%) cited was government regulations (including complex rules, the increasing cost of compliance, and frequent changes in the retirement plan law) as the key reason employers terminate their defined benefit retirement plans.

Accounting Standards Changes and Medical Inflation Deter Employer Sponsored Retiree Health Care:

The advent of requiring corporations to establish financial statement liabilities for retiree medical programs caused businesses to focus on this major expense. As a result, many businesses have reduced or eliminated their post-retirement medical coverage. At the end of 1994, according to a recent EBRI study, fewer than 34% of retired employees are covered by employer sponsored medical plans.

Retirement Plans Are Not Significantly Under-Funded:

According to a recent report by the Pension Benefit Guaranty Corporation (PBGC), which insures most private sector defined-benefit plans, pension underfunding fell to $31 billion in 1994 from $71 billion in 1993, and most pension plans today are adequately funded. This represents only 1% of the $3.2 trillion held in trust to pay current and future benefits, and in spite of cutbacks in the limits on contributions that were repeatedly enacted since 1982. Much of the under-funding may partly be due to the highly conservative assumptions used by the PBGC. Further, the Retirement Protection Act, which Congress passed in 1993, may help prevent future pension plan failures by increasing the incentives for funding underfunded plans.

Social Security and Medicare Are Not Sufficiently Funded:

The Social Security and Medicare trust funds have been viewed as sources of government program funding, causing them to be unreliable sources of retirement support. Since the Social Security system is currently generating more revenue than it pays in benefits, the government borrows the surplus revenue to fund other government programs. On the other hand, Medicare benefits already exceed the taxation revenue, causing the trust to decrease each year. However, as the population continues to age, more workers will rely on Social Security and Medicare benefits and proportionately fewer workers will be funding the benefit. The Board of Trustees for the Social Security Trust Fund advised in their 1995 Report that the Federal Old Age and Survivors Insurance (OASDI) Trust Fund will be able to pay benefits for about 36 years. Of more urgency is the funding of the Medicare Trust, which its trustees report will be depleted within 7 years.

A Source of Government Revenue:

Policy makers look to retirement funds for potential revenue, to reduce the national deficit. The Treasury Department estimated the government would have gained $64.9 billion in FY 1995 revenue if employers (including federal, state, local and private) were taxed on the value of contributions to retirement plan funds. According to EBRI, this tax revenue loss is overstated. More than half of this is attributable to public sector retirement plans. In addition, tax expenditure discussions focus on current revenue impact rather than the future value of taxes when retirement income would be paid out in future years.

Lower Income Individuals Depend Heavily on Social Security and Employer-Sponsored Plans:

Fifty one percent of all persons employed by private businesses with pension plans earned less than $25,000 and 89% earned less than $50,000. According to EBRI, because most workers earn under $50,000, retirement programs primarily benefit workers with income below this level. Individuals with fewer than 50,000 will depend most heavily in their retirement years on Social Security qualified retirement plans and Medicare, as they are least likely to have personal savings or private medical insurance.

Impact of the Growth in the Service Sector and the Contingent Workforce:

Traditionally, employer-sponsored retirement income and retiree medical plans have been more prevalent in the manufacturing than the service sector, where the proportion of employment has continued to increase. Economic and demographic shifts have also contributed to a rise in the number of seasonal, part-time, and contingent workers. These individuals may comprise as much as one-third of the workforce and are less likely to participate in employer-sponsored retirement income and retiree medical plans. The above trends and current regulatory burdens have created the need to reexamine the employer, individual and federally funded retirement systems and implement a uniform and consistent national retirement policy. Below is a framework of principles and specific recommendations to guide the formulation of such a national policy.

GENERAL PRINCIPLES

SHRM believes that government shares responsibility with American workers to achieve adequate retirement income and have access to adequate medical care. Moreover, to enable employers to help support retired employees; public policy should encourage the voluntary establishment of retirement programs. To facilitate sound retirement planning, we have established the following three fundamental principles:

1. **Primary Individual Responsibility for Retirement Financing:** Individuals should have primary responsibility to provide for their own adequate retirement income and health maintenance funding. Individuals should be responsible for planning and building their own retirement resources, including anticipating their retirement expenses and the sources of funding to meet their needs. To this end, the government should encourage or otherwise facilitate retirement (financial) needs planning of the American worker and families, including voluntary employer education programs. Importantly, the government should encourage individuals to provide for their own retirement income and health maintenance, by making available tax-favored savings vehicles.

2. **Government Responsibility for Retirement Income and Medical Coverage:** Through its mandated Social Security and Medicare programs, as public policy the government shares with the American worker the responsibility for providing some reliable basic retirement income and health care for all individuals. Through taxation of, and an implied promise to, all American workers, these programs have become fundamental components of our country's retirement system. The government should also facilitate the continuation and growth of employer sponsored programs and provides consistent tax incentives and simplified regulations to encourage employers to provide retirement benefits that otherwise would be sought from the government at greater cost to society. In addition, to enable American workers to have an adequate and secure retirement, it is incumbent on the government to maintain a fiscal policy that ensures low inflation over the long term.

3. **Employer's Role in Providing Retirement Benefits:** Employers may find themselves voluntarily able to help workers achieve adequate retirement incomes and maintain their health during retirement, reducing pressure on government funding for retirees. Employers play key roles in providing retirement income and medical coverage through payments into the Social Security and Medicare systems and voluntarily to employer sponsored retirement income and medical plans.

Upon these principles, we propose the following framework for a national retirement policy:

Specific Framework Recommendations:

Individual Responsibility for Retirement Financing

1. Regulation by Individual: To avoid retirement income inequities caused by multiple retirement plans, variability in generosity or finances of employers, dual family incomes, and complex retirement plan regulations, contributions set aside for retirement income and retiree health care should be regulated, if at all, only on an individual basis in aggregate rather than on an employer, family or retirement plan basis. Any necessary regulations should be understandable to the general public, and consistent with the long-term objective of individual financial stability.

2. Limitation on Retirement Plan Contributions: To obviate the need for non-qualified retirement plans, overly complex regulations, and excessive plan administration costs, all arbitrarily established limits on the dollar amounts which may be deferred for retirement income should be eliminated. If there are concerns that a few senior employees would inordinately benefit from tax qualified plans; limits should only be applied to a tightly defined group of policy making executives. In that all distributions would be taxed when received, this change would not affect the amount of taxes paid, but only the timing of tax revenues.

3. Regulations and Access to Retirement Plan Funds: The same regulations on administration and investment of, and restrictions on access to, funds set aside for retirement should apply equally to individual retirement plans and employer sponsored plans. Access to any plan funds for retirement income or medical expenses prior to retirement should be limited to significant life events, including purchase of a primary residence, funding of the taxpayer's higher education, demonstrable severe hardship, and other similar reasons acceptable to the plans administrators. All funds distributed prior to retirement should require a scheduled payback into the retirement plans within a reasonable time frame.

4. Facilitating Retiree Mobility: Recent federal legislation was enacted which prevents states from taxing retirement benefits based on the location earned rather than where received. To perpetuate this legislation ERISA pre-emption also should be applied to state tax laws to base taxation of retirement income on receipt rather than where income liability was incurred. This will more fairly align state tax revenues with the services required by retirees, will be more equitable between states, and will reduce the administrative cost of retirement plans.

5. Qualified Individual Retirement Plans: Due to increased employee mobility, the number of employees working for multiple employers and/or working for employers which don't sponsor retirement plans, and the need to facilitate employee retirement savings for years when an employee will not earn a vested retirement benefit, regulations and tax laws should be revised to:

a. Streamline the establishment of individual savings accounts for both retirement income and medical expenses during retirement.

b. Encourage self-employed individuals and small to medium size employers to provide retirement income savings and retiree medical plans,

c. Encourage personal saving for retirement, and

d. Permit retroactive contributions to individual retirement plans to make-up contributions subsequently permitted by regulatory change or plan operation (e.g. loss of vesting).

SHRM Board Approved Position, March 1991: SHRM supports efforts to permit retroactive contributions to IRA's for years for which a participant loses retirement plan vesting (e.g., short-term employment). To provide equity with married employees, who each earn retirement benefits from separate employers, IRA contribution eligibility should not be precluded by a spouse's qualified retirement plan coverage.

FEDERAL GOVERNMENT PROVIDED BASIC RETIREMENT INCOME AND MEDICAL CARE

1. Mandatory Coverage. Coverage for every employee in a federal government retirement program (such as the current Social Security and Medicare programs) should be mandatory. Current parallel plans (e.g. Federal & State Government, & Railroad Retirement and religious body plans) should be consolidated with Social Security into one successor program to produce a single consistent approach toward a floor of retirement income.

2. Maintenance of Benefit Levels: It is important to avoid further erosion of currently accrued (hence earned) Social Security and Medicare benefits. This is essential to ensure workers at every level receive the total retirement income and medical protection on which they have based their financial planning, believing Social Security and Medicare benefits were promised by the government throughout their careers. Maintaining these benefits will also facilitate the affordability of employer-sponsored retirement plans, many of which assume retirees also receive federally sponsored retirement income benefits.

3. Funding. In order that current workers and work force entrants will be assured of some minimal retirement income and retiree health care, the Social Security and Medicare trust funds, and/or their successors, must be maintained on a financially sound basis, in line with the funding required of individual and employer sponsored plans. However, this should be 10 accomplished without shifting the funding burden substantially to employers through increased taxes.

EMPLOYER-SPONSORED RETIREMENT PROGRAMS

1. Individual Retirement Savings Accounts: To encourage small employers to provide retirement programs, and to facilitate transfers of retirement funds between employers of all sizes when employees change employers, regulations should be simplified to permit and/or facilitate employers to place current retirement income and retiree health care contributions into an employees qualified individual retirement plan (savings) rather than necessarily establishing separate participant accounts within those employers plans, regardless of employer size.

2. Funding Restrictions: Reform of accounting rules (i.e. FASB) and retirement plan insurance (i.e. PBGC) should encourage faster funding of unfunded obligations and under-funded plans for retirement income and retiree health protection. For example, increasing maximum annual contributions, and using realistic or actual interest and pay assumptions would expedite funding. Public and nonprofit organizations should have identical access to plan alternatives and be subject to the same regulations as other employers. Government policy and regulations affecting retirement plans should be consistent and hence coordinated throughout all government agencies.

3. Investment Education: For retirement plans in which the employee bears the risk of investment return, employers should provide employees cost-effective diversified alternatives to direct the investment of those funds. In such plans, employers and plan administrators should be protected from unnecessary fiduciary liability to facilitate educating employees on the financial impact the investment choices they make could have on their retirement income.

Either voluntarily or involuntarily, employers should be permitted to transfer (to other qualified plans or accounts) vested benefits following termination of employment. Similarly, employers should be permitted to distribute (to other qualified plans or accounts) all vested proceeds for any pre-retirement termination, regardless of the amount involved. Receiving plans should be indemnified against any disqualified funds so received. Regulations should continue to permit service based vesting schedules, permitting employers to optimize contributions for the benefit of employees who remain employed for more than a few years.

SHRM Board Approved Position, March 1991: SHRM recognizes that the lack of a comprehensive retirement plan portability policy could adversely affect the future retirement security of this nations workers and therefore supports efforts aimed at enabling participants to easily transfer funds between pension plans and retirement vehicles such as IRAs. However, portability and preservation solutions should not interfere with the voluntary nature of the current retirement plan benefit system by imposing burdensome and unnecessary obligations upon plan sponsors.

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