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PERSONAL RETIREMENT ACCOUNTS

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BEFORE THE

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PERSONAL RETIREMENT ACCOUNTS

TUESDAY, MARCH 16, 1999

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 Grassley, Gramm, Moynihan, Baucus, Rockefeller, Conrad, Graham, Bryan, and Robb.

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

The CHAIRMAN. The committee will please be in order.

Today the committee will hear testimony on personal retirement accounts from the General Accounting Office and a distinguished panel of pension, budget, and social policy experts.

Personal Retirement Accounts are a new, and I think very exciting, element in the debate over Social Security reform. In recent years, members of Congress of both parties, as well as outside groups, have offered proposals. The President has endorsed personal accounts. The committee is awaiting the specifics of his program.

While these programs differ widely in design and detail, all plans envision that each working American would have an account he or she owns invested in stocks and bonds and that would be available upon retirement.

As with any important national issue, there are arguments on both sides. Proponents believe the accounts will protect the benefits of future retirees, provide Americans with personal wealth, and increase savings and promote economic growth.

Others are not so sure and raise concerns about investment risks and the cost and complexity of any accounts program. Certainly, there are important, practical issues in financing and in designing a workable personal account program. For example, about 149 million Americans reported some earnings last year and might be eligible for accounts.

Yet, I think we can be encouraged by a small piece of history. Pat is the expert, but I will seize the opportunity. In the beginning of Social Security in 1936, at a time before computers or the Internet, the Social Security Administration signed up 26 million Americans in just 4 months, and shortly thereafter employers were re-

porting quarterly earnings of their workers. As if often the case, where there is a will there is a way.

Let me also note that this hearing is about the future of Social Security. No senior, or anyone approaching retirement age, should be concerned about their Social Security. The task, really, is protecting Social Security for today's younger workers and for their children and grandchildren.

Today, the committee will look forward to information and suggestion from our witnesses on the design and implementation of personal accounts.*

With that, I would call upon my good friend, Senator Moynihan.

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

Senator MOYNIHAN. Just a comment, Mr. Chairman. There is a grand sequence which we can see in the subject we will discuss today, as the society has organized itself in sequence, to deal with the wholly new experience of industrialism and the modern economy.

First, we developed, in Britain, unemployment insurance to deal with that inexplicable event when you are out of work. You are never out of work on a farm. You may be starving, but you are not out of work.

Then we move toward retirement benefits. Then we move towards health care. Now we are on the verge, surely, of the idea that workers should be able to leave an estate.

Our friend, Senator Kerrey, who is not here—he is being honored on the floor at 10:30 today; it is the thirtieth anniversary of his wounding in Vietnam—is such a fierce advocate of that, as are many of our witnesses. It is a wonderful idea. It gives you a sense of progress that has not been much in evidence lately, and I thoroughly appreciate the opportunity to join with you in this hearing.

The CHAIRMAN. Well, thank you, Senator Moynihan.

We would ask any other panelists to limit their opening remarks to, hopefully, one minute. Who is next? Senator Grassley, I am told.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA

Senator GRASSLEY. Well, first of all, thank you, Mr. Chairman, because this is a very important subject. In its current form, Social Security has accomplished a great deal, as we all know, bringing down poverty among the elderly and providing a universal type of insurance for families when the breadwinner becomes disabled.

To the best of my knowledge, none of the prominent reform proposals undermine these basic underpinnings of Social Security. Proposals may modify those guarantees, but the foundation is still there.

This is done for a very good reason, because Social Security has a dim financial outlook in the years ahead, losing public support from people who are just now entering the workforce. It is their

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*For more information on this subject *see also* Joint Committee on Taxation staff report "Analysis of Issues Relating to Social Security Individual Private Accounts, March 15, 1999 (JCX-14-99).

support that is needed most if we really want Social Security to protect the elderly from poverty-ridden old age in the next century.

Creating a personal account as a component of Social Security could help save this program by giving these young workers a stake in its future. With an individual account, they will know that Social Security is a retirement program, not just another Federal program that confiscates a large amount of their income each year.

Under the President's plan, it will not be just a payroll tax that this generation pays, but more in income taxes and less in government services to help buy a house, get child care, and to send the child to college.

We have some questions and I think these hearings will help answer these questions. But the most important thing, you are setting the stage, Mr. Chairman, for having younger workers feel an ownership of the Social Security program, and that is very important for its long-lasting survival. Thank you.

The CHAIRMAN. Thank you, Senator Grassley.

Now, Senator Baucus, please.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA

Senator BAUCUS. Thank you, Mr. Chairman. I will be within a minute very easily.

I am just intrigued and would be very interested in the witnesses' views on how we can, in fact, increase savings. In 1944, Americans saved 25 percent of their income. Today, it is zero. The stock market passed 10,000 a short while ago.

People are not saving, in part because they are putting money in the stock market, mutual funds, et cetera, or spending because they have recent capital gains. I would just like to know how we can encourage Americans to save. We know that 10,000 is going to fall sometime.

Senator GRASSLEY. It did this morning.

Senator BAUCUS. Well, it could fall greatly. It could be very significant. A lot of people who put money in the stock market, individual investors, for example, mutual funds, might find that life is not as rosy as they thought it might be. Certainly, if their income was in these savings accounts, some of that would be cushioned.

So, I think it is very interesting to pursue the question of personal savings accounts, and also whether it is within Social Security's system, whether it is a supplement to Social Security.

There are a myriad of ways of doing this. I want to be sure we do not transfer one form of savings to another. But, basically, the main goal is, I think, to increase savings, personal savings. I would be very interested in what the witnesses might say about that, given the deplorable condition of personal savings at this point.

The CHAIRMAN. Thank you, Senator Baucus.

Now, Senator Conrad.

OPENING STATEMENT OF HON. KENT CONRAD, A U.S. SENATOR FROM NORTH DAKOTA

Senator CONRAD. Thank you, Mr. Chairman. Thank you for holding this hearing. I, too, look forward to the witnesses that we have scheduled today.

Obviously, we are on a course here that cannot be sustained because we have the demographic time bomb of the baby boom generation. When those of us who are baby boomers start to retire, we are going to put enormous stresses and strains not only on the Social Security system, but the Medicare system. So, we must find solutions.

There are really only three ways to go. One, is to raise taxes, which I oppose and I think a majority of members opposed. The second, is to cut benefits, which I also oppose and I think a majority of members strongly oppose.

Third, is to find a way to increase the rate of return on the invested assets. I think that is where we need to spend our time and our energy, focusing on a way to increase the rate of return.

I thank the Chairman.

The CHAIRMAN. Thank you, Senator Conrad.

It is now our pleasure to welcome David Walker, our very distinguished head of General Accounting, who will discuss with us the critical issues in setting up a workable and equitable personal account program.

Welcome, Mr. Walker. Please proceed.

STATEMENT OF HON. DAVID M. WALKER, COMPTROLLER GENERAL OF THE UNITED STATES, WASHINGTON, DC

Mr. WALKER. Thank you, Mr. Chairman. I must say at the outset, and say it for the record, congratulations to Senator Moynihan on his birthday today.

The CHAIRMAN. Twenty-one.

Senator BAUCUS. Oh. Happy birthday.

Mr. WALKER. Twenty-nine again, I think, is what the story is. I look forward to returning on Thursday on another important topic, Medicare.

It is a pleasure, Mr. Chairman and Senators, to be back before you. As you know, I testified in February before this committee regarding the nature, extent, and timing of the fiscal challenges facing the Social Security program, including the impending demographic tidal wave that we face.

Given the projected temporary budget surpluses, the Congress and the President have an opportunity to make decisions today that will enhance our future economic capacity and flexibility.

At the same time, the Congress and the President have an obligation to engage in meaningful and comprehensive Social Security reform to assure the solvency and sustainability of this important national program for current and future generations of Americans.

A number of organizations and members have proposed individual accounts as a possible element of comprehensive Social Security reform. In evaluating individual account proposals, it is important to understand three basic factors.

First, the role of Social Security in ensuring income security for the Nation's seniors. Second, the nature, extent, and timing of Social Security's financing challenge. Third, the differences between the current program and one that might include individual accounts as an element for the future.

Mr. Chairman, I would request now that my entire statement be included in the record. I am going to summarize it for the benefit of the Senators.

The CHAIRMAN. Without objection.

Mr. WALKER. Thank you, Mr. Chairman.

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

Mr. WALKER. Social Security forms the foundation of this Nation's retirement income system. In doing so, it provides critical benefits to millions of Americans. Social Security has helped to significantly reduce the poverty level among the Nation's elderly population.

However, all too many Americans rely on Social Security as their primary or sole source of retirement income. These seniors rely on the certainty and security of Social Security in order to maintain a decent standard of living in retirement.

However, Social Security faces a significant financing challenge caused in great degree by known demographic trends. These demographic trends will result in the Social Security program experiencing a negative cash flow beginning in 2013, and leading to trust fund exhaustion by 2032, absent program reforms or other changes.

The related projected financial imbalance serves to put Social Security benefits for future beneficiaries at risk. As you pointed out, Mr. Chairman, it is really not current beneficiaries or near-term retirees that are really at risk, it is really baby boomers and Generation X'rs, if you will.

Individual accounts would provide a means for greater individual choice and achieving increased rates of returns on Social Security payroll tax revenues. Individual accounts would not, however, by themselves solve Social Security's financing challenges.

In fact, individual accounts could have an adverse effect on solvency and sustainability unless they are accompanied by benefit offsets to the existing program obligations, or sharing of the incremental returns to support existing defined benefit promises.

Additional program reforms will be necessary to assure the solvency and sustainability of the Social Security program. Individual accounts might, however, play a role in the context of comprehensive Social Security reform.

A number of reform proposals include individual accounts as an element as part of a broader package. As I said, they would give individuals more control over their payroll tax investments and would provide hard assets for them to invest in order to achieve a higher long-term rate of return than under current Social Security financing methodologies. These higher rates of return could then be used to enhance total retirement income and/or reduce the financing gap in the current defined benefit program.

Some see individual accounts as an all-or-nothing proposition. For example, in Chile. They changed their system from defined benefit to defined contribution. We recently issued a report on three counties in Texas that opted out of the Social Security system and created a defined contribution structure with individual accounts, providing for disability benefits, survivor benefits, and retirement income on an all-or-nothing scenario. However, most individuals see individual accounts as a piece of a possible Social Security reform option rather than an end in and of themselves.

For example, some are talking about a two-tiered program in which there would be a base defined benefit amount and a supplemental individual account. Alternatively, an individual account could be integrated into the Social Security defined benefit formula via a benefit offset or a return sharing approach.

Someone offer a guaranteed minimum benefit relating to the individual account. This would enhance the certainty and security of retirement income for American retirees, but it would also create a contingent liability for the program and future taxpayers that would have to be considered.

Some see individual accounts as being mandatory, and some would have them on a voluntary basis. Some would finance individual accounts from existing payroll tax revenues via a carve-out approach, and some would dedicate new revenues or increased payroll taxes.

The implications of individual accounts on the solvency and sustainability of the Social Security program will vary greatly based upon the size of the individual account, the population affected, and the timing, nature, and financing sources for the accounts.

Creating individual accounts under the current payroll tax structure would create significant transition costs that would need to be addressed through either additional program reforms or additional revenue sources.

While individual accounts are feasible from an administrative point of view, they would involve a significant number of challenges and costs that would need to be addressed. The nature and extent of these challenges and costs would vary greatly based on the program's design and the implementation time frame.

The administrative challenges involve a number of issues, such as what population would be served by these individual accounts. For example, many proposals talked about offering individual accounts for individuals under 55, or under 50.

Second, would the individual accounts be voluntary or mandatory? Would there be an offset to existing defined benefit promises or sharing of the investment returns? How would the cash flows be handled? Who will maintain the individual account records for the tens of millions of Americans that would be involved?

How many investment options will be offered, and how frequently would individuals be able to change their investment options? What, if any, access to the account through loans or other withdrawals would be provided prior to retirement? What forms of distribution would be available at retirement? How will account holders be educated with regard to investment and other related matters?

The actual administrative cost, complexity, and feasibility of individual accounts will vary based upon the programs designed. In general, the simpler and more standardized the design is, the lower the cost and the quicker the implementation can occur.

One potential result of creating a system of individual accounts would be the development of an infrastructure that would allow workers to build up savings to meet future retirement income and health needs. This could help Americans, help themselves plan, save, and invest for a secure retirement.

The administrative challenges of individual accounts are significant, but solvable, if the Congress decides to adopt individual accounts. However, the implementation of individual accounts would take time and involve significant start-up costs.

Social Security is one of this Nation's most important and visible programs. We cannot afford to have major expectation gaps or administrative problems. This would be even more important if individual accounts were adopted because they would be more visible and would represent the personal accounts of millions of Americans. Again, they are feasible, they can be done, but with a cost and it would take time.

In closing, Mr. Chairman and Senators, the temporary surpluses that we face provide the Congress with an historic opportunity to prepare us for a better future. Congress also has an obligation to put the Social Security system on a solvent and sustainable path.

We at GAO stand ready to assist this committee and the Congress address the issue of Social Security reform in a manner that, quite frankly, Mr. Chairman, I think can exceed the expectations of all generations of Americans.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Walker. I appreciate that note of optimism. I share that view.

Let me ask you this. Could the budget surplus be used to finance the costs of the transition to a system that included personal retirement accounts? If so, would additional funding be necessary? It is, I think, extremely important—I know we all do—that we keep our commitments to today's Social Security retirees. How can we meet these commitments, fund a personal retirement account program, including the transition period?

Mr. WALKER. It would be possible to use all or a portion of the budget surpluses to finance individual accounts, but by doing so, obviously, those funds would not be available to pay down debt held by the public. You could only use it once.

Second, there would need to be additional program reforms in order to assure the long-term solvency and sustainability of the Social Security program. But, yes, it is feasible to do that if the Congress so chose.

The CHAIRMAN. Let me ask you this question. How might Social Security benefit under a system with personal retirement accounts compare with current law?

Mr. WALKER. Mr. Chairman, it would depend to a great extent on the design of the program.

The CHAIRMAN. Sure.

Mr. WALKER. For example, what percentage of payroll tax would be allocated to an individual account. Would it be a carve-out, would it be an add-on? Would there be an offset to existing benefits under the program or not?

We have recently issued a report on those three Texas counties which, unfortunately, is sort of a polar opposite comparison. It shows the Texas counties with a total defined contribution, advance funded, hard-dollar asset approach versus Social Security, which is total defined benefit, primarily pay-as-you-go, non-hard-dollar asset funding mechanism, and compares some of the rates of return and some of the replacement benefits, if you will. The bottom line is,

it would be impossible to answer that question until we know what the design of the program would be.

The CHAIRMAN. Would you be able to give any range, or do you think there is a chance of really future beneficiaries enjoying significantly greater benefits?

Mr. WALKER. That possibility does exist. There are reform proposals that are out there today from various organizations or individuals that have run numbers to show that it is possible to construct a reform proposal that has individual accounts that would ensure the solvency and sustainability of the Social Security program and enhance rates of return and savings over the long term without raising payroll taxes.

At the same time, most of those proposals talk about making structural reforms to the basic defined benefit program in order to finance those individual accounts and to close the existing gap that exists in the basic defined benefit program right now. But, yes, it is possible to do that.

The CHAIRMAN. Let me ask you this. GAO has reported that women and minorities tend to be conservative investors. That would hamper the performance of their accounts. I might point out also that women tend to live significantly longer than men.

Could this situation be improved by some kind of educational program, or perhaps by building into a system of personal accounts balanced portfolio accounts?

Mr. WALKER. Yes, they could, Mr. Chairman. I think that if individual accounts were adopted as an element of comprehensive Social Security reform, one of the issues that we would have to focus on is the need for education, to educate individuals with regard to investment matters, with regard to distribution matters, with regard to other critical issues relating to these sums of money. So, education would be important.

In addition to that, it would be possible to construct investment options such that there might be certain balanced portfolio options available to individuals that they might choose based upon their age, or based upon other circumstances to make it easier for them to be able to make these choices.

I think the other thing that we would have to consider is, what would the default options be? What would happen in the event that an individual failed to make a choice? Would it be appropriate to have the most conservative investment or would it be more appropriate to have a balanced portfolio based upon their age and expected investment horizon?

One of the other key things here, Mr. Chairman, that I would point out is the issue of preservation. Right now, by definition, all the retirement income portion of Social Security's benefits is preserved for retirement.

That would be a very important issue, I think, to consider if individual accounts are created. Would those sums be preserved for retirement? If they would be, that would give one a very long-term investment horizon that would be relevant in considering and determining how to invest that account.

The CHAIRMAN. Mr. Walker, you have suggested that Social Security reform should permanently balance Social Security's books rather than for 75 years. Now, others have argued that we might

be better off trying to take a shorter term, 30 to 50 years. Is there any merit to that?

Mr. WALKER. Mr. Chairman, we believe that it is important to engage in comprehensive reform that will ensure the solvency and sustainability of the program. I would hate for the Congress to have to come back and revisit this every 15 to 20 years. It is difficult enough to do it once, much less to program in that you are going to have to do it numerous times.

Second, the other reason we believe that is because, candidly, Social Security reform, while being challenging, is easy lifting compared to Medicare reform. The nature and extent of the challenges we face in Medicare are much more acute, much, much larger, and much nearer to us.

As a result, we believe it makes sense to engage in comprehensive Social Security reform that will make it solvent and sustainable, because there is a lot of tough work that has to be done on Medicare and other programs that probably will require a more installment-based approach, which is what you are touching on.

The CHAIRMAN. Senator Moynihan?

Senator MOYNIHAN. Yes, sir. Just to continue, if I may. Let me see. It would be just February 9, sir, that you came before us on Social Security, what the President's proposal does and does not do. You said you could not be more explicit. It does not represent a Social Security reform plan.

I assume you stand by that position. You said this morning that the individual accounts offer potential for increased investment returns, but they cannot, by themselves, restore Social Security's solvency without additional changes in the current system.

Senator Kerrey and I much agree. There are some changes which are just so elemental. I do not know about those three counties in Texas, but one quarter of State and local employees do not pay Social Security taxes. This is a residuum of the 1930s, when it was not thought that the Federal Government tax another government, and that sort of thing went on.

These individuals get Social Security by working on the side, but they do not contribute anything. These are government employees. They are not particularly needful folk. Not to do that because there are some interests in not doing it, it is to say you do not want to change anything that needs changing.

But the issue that has caused us the most difficulty with the administration has been the Consumer Price Index. As you may have reason to know, several years ago the then-Chairman, Senator Packwood, and I appointed a commission headed by Boskin, who had been chairman of the Council of Economic Advisors.

People like Zieg Millich, who go back on this subject, to studies by Steigler in 1960, and Robert Gordon in Northwestern, and Jorgenson of Harvard, a colleague of one of our distinguished witnesses later on this morning. They came up with a proposal saying what people have known for the years, and working hard at it, that the present CPI overstates price increases by 1.1 percent.

The BLS, in a distinctly unhelpful way, as if it were a department of disinformation instead of a once-fine institution of fine civil servants, keeps telling the White House that the routine, every 10-year changes they make in adjusting the market basket are the

changes that the Boskin Commission proposed. They are not. They have made some formula changes of an enduring quality.

Just now, I have from Janet Yellen, who is chairman of the council, a letter saying that, indeed, there are about 2.29 percent of corrections that have been made that were not anticipated by the Boskin Commission, so that their adjustment ought probably now to be about 0.8 percent. That makes for incredible changes in the viability of the system, you would agree, would you not?

Mr. WALKER. Absolutely. The power of compounding over the years. Just a 30-basis point change would have huge implications on a compounding basis.

Senator MOYNIHAN. And 0.8.

Mr. WALKER. And 0.8 would have obviously much greater.

Senator MOYNIHAN. Yes. Do you think you could help us on this? Somebody has to persuade the administration that the BLS is being, well, protective and may think it is doing what the administration wants it to do, but it is not what it ought to do.

Would the GAO like to get involved in this? [Laughter.] You have a 15-year term. Nothing to worry about. [Laughter.] And you have a pension system, sir, of which I believe there are only five members.

Mr. WALKER. And I cannot lose too much more hair here. [Laughter.] Senator, obviously we are a client service organization. The Congress is our client. I can take a look and find out what work we have done in this area before. I would be happy to make you aware of that and discuss what, if anything else, might be appropriate.

Senator MOYNIHAN. Can we do that, sir?

Mr. WALKER. Yes, sir.

Senator MOYNIHAN. Either you get by issues like this or the discussion of real reform never proceeds. As you have said, what we have from the administration right now is no reform, you do recall.

Mr. WALKER. We have financing reform. We do not have program reform.

Senator MOYNIHAN. That is right.

Mr. WALKER. We need both.

Senator MOYNIHAN. I very much agree. I thank you, sir. We will be in touch.

Mr. WALKER. Thank you.

Senator MOYNIHAN. Senator Kerrey, I am sure, would join me in this regard.

The CHAIRMAN. Next, we call on Senator Grassley.

Senator GRASSLEY. Thank you, Mr. Walker, for your testimony. I would like to have GAO's perspective on proposals that have both a defined contribution and defined benefit component.

How important is it to coordinate the benefits of the defined benefit portion with the defined contribution portion? Some proposals, like maybe you know about Senator Breaux's plan, consider the benefits a worker will get from the defined benefit portion when structuring the individual account component.

Mr. WALKER. Senator, it is very important to look at this in an integrated fashion. You need to look at what the individual account is, how much it is, how much it is expected to generate, and how

that relates to the defined benefit portion in coming up with total retirement income.

In addition, you need to consider how you are going to finance the individual account portion. Unless you come up with new revenues, whether it be from the surplus or elsewhere, then obviously in order to finance that individual account you are going to end up having to make some benefit changes in order to, (a) finance the individual account, and (b) deal with the structural imbalance that already exists in the Social Security program based on current promises.

So you have to consider both. You could have a two-tiered structure, which is what Senator Breaux talks about. Basically what he proposes is to carve out two percent of the payroll tax and to reform the basic defined benefit program that would provide a certain and secure form of benefit through a progressive formula, including a minimum benefit based upon the poverty rate.

But he makes more dramatic reforms, such as changes in retirement age, in replacement rates, et cetera, in order to finance this 2 percent individual account, because one of the objectives is to make sure the program is solvent and sustainable over the 75-year period and beyond.

But that proposal, it is my understanding, would increase rates of return for individuals over time and it would only create individual accounts for individuals below age 55, or 50, or so. So you do have to consider both, Senator. It is very important to look at both.

Senator GRASSLEY. On another matter, the President's USA account proposal is kind of short on detail. It is not on paper yet, at least not up here. I would like to have you respond, in a very general way, from the perspective of good government, if that were to be put into place. But, more specifically, is it wise to establish another Federal retirement program that is separate and apart from Social Security benefits?

Mr. WALKER. Well, the President, as you say, has proposed a concept. We do not have the details yet, so, therefore, it is very difficult to respond with any degree of specificity without the details.

Intellectually, he is talking about creating individual accounts, which is a major change. He is not talking about doing it within the context of the Social Security system. He is talking about using part of the budget surplus to fund these individual accounts. He is talking about targeting these individual accounts to lower and lower-middle income individuals.

But, as I recall, I believe it is not mandatory. It is something that would be an incentive-based system and you would not have to do it. Therefore, the question would be whether or not lower and lower-middle income individuals would take advantage of these incentives to actually save or not. As you know, individuals who are making less money tend to have less resources to save, less propensity to save, and that would have to be considered.

I think we also have to be concerned with, how many different structures are we going to maintain, and who is going to administer these accounts? Are they going to be administered by the Federal Government, or are they going to be administered by the pri-

vate sector? There are just a lot of questions, I think, that we really cannot answer until we get more details.

Senator GRASSLEY. All right. I want to ask you a question about something that there is little consensus on, is what is supposed to happen to a divorced spouse? Obviously, in the case of Social Security, if you have been married 10 years, you can attach to your divorced spouse's benefit; if you remarry, you do not have that opportunity.

I think that this is an area where we can improve on what Social Security does for divorced women. Are there private sector practices that helped divorced women that could be adapted for Social Security?

Mr. WALKER. There are, Senator. I mean, clearly, there are a number of individuals who believe that more attention has to be focused on spousal benefits and survivor benefits. Frankly, not just in Social Security, but also in the private sector as well.

There are concepts in the private sector that could be looked at, such things as spousal consent with regard to forms of distribution prior to retirement, automatic joint and survivor annuities in certain circumstances. There are administrative complexities associated with it, but there are things that we could look at that the Congress could consider in this regard.

Senator GRASSLEY. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Grassley.

Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman.

Mr. Walker, just a couple of questions. One, your opinion on what the benefit structure should be of any individual account. As I understand it, the Texas plan tilts more toward higher income workers compared with Social Security. I do not know whether that is good or not good, depending on what the exact results are.

But do you think that any individual account benefits, or plans, should be structured in a way so that lower or middle income people receive about the same benefits as Social Security pays, or should it be different?

Mr. WALKER. Well, obviously, the difference in the case of the Texas plan was that it was a defined contribution system. And because it was a total defined contribution system, in large part, you get some of those distributional effects.

Most of the reform proposals that we have seen at GAO with regard to individual accounts would only have individual accounts represent a piece of a broader Social Security reform program, and that there would be a base defined benefit that would provide a certain and secure form of benefit that would have a progressive benefit structure, therefore, and provide higher replacement rates for lower and lower-middle income individuals.

In many cases, these proposals also talk about providing an additional guaranteed minimum benefit above and beyond what is there at the present point in time, but then to use individual accounts to either provide additional income or as an offset to what otherwise would be paid under the defined benefit program.

I think we have to keep in mind, Senator, that Social Security is the foundation of retirement security. We need to make sure that, in the aggregate, it provides higher replacement rates for

lower and lower-middle income individuals, certainty and security, but hopefully, also, a better rate of return for younger generations of Americans whose rates of return have been declining dramatically, and will decline in the future.

Senator BAUCUS. I wonder if you could talk a little bit about rates of return. A CRS study found that, assuming a 10 percent annual rate of return, which apparently is what the S&P 500 has been on average from 1926 through 1996, that the baby boomers, with a 3 percent set-aside at the beginning of the year 2000, retiring at age 65 in 2010, with 10 years, would have an investment equal to 7 percent of the Social Security benefits. Retiring after 20 years' participation would have an account with 19 percent of Social Security benefits. After 30 years, it would build up, I think, 40 some percent. Does that sound about right? I am just curious what the actual rate of return would be. We make a lot of assumptions around here, fairly loose assumptions.

We all marvel at the phenomenon of compounding, et cetera, and how much a little bit grows so much after a period of time. But just how great would, say, a set- aside grow? We are talking, say, about 3 percent. You have to include administrative costs.

Mr. WALKER. Right.

Senator BAUCUS. Because it is my understanding that, in some countries, administrative costs have gone up quite a bit as private investment firms compete for business. They have large marketing costs, advertising costs, et cetera. This assumption I gave you assumes a one percent administrative cost. So I am just curious. If you add that all together, do you get some feel, some sense of what the rate of the return would be?

Mr. WALKER. I am not familiar with the CRS study. I will take a look at it. I will give you a few general comments. Number one, what is really important, I think, is the real rate of return. What is the incremental rate of return above inflation?

In general, over long periods of time you will find that the historical real rate of return for equities has been about seven percent, whereas the historical real rate of return on Treasury securities, which is what the trust funds are currently invested in, is close to three percent. So that is one thing to be considered.

Second, compounding. Those small differences—and they are not so small, quite frankly—on real rates of return can make huge differences when compounded over time. As a result, to the extent that individual accounts are focused on younger workers, which most of the proposals would do under the concept that you really want to leave current retirees and near-term retirees largely unaffected. They do not have time to adjust. They do not have much time to build up much of an account. They do not get much compounding. But, for younger workers, that could build up considerable sums over time.

I would be happy to provide you with some numbers for the record, if you would like. But the power of compounding is considerable for younger workers.

Senator BAUCUS. All right. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Baucus.

Next, is Senator Conrad.

Senator CONRAD. Thank you, Mr. Chairman. Thank you, Mr. Walker, for participating today. It is good to see you again.

Just in the interest of full disclosure, you participated in the Center for Strategic and International Studies' review of Social Security, did you not?

Mr. WALKER. I did, Senator.

Senator CONRAD. And you endorsed the recommendation that they made?

Mr. WALKER. Well, let me clarify what I did and I did not do. I voted for the package. There are some things in that package I do not like, there are some things in the package I do. There are some things that I wish were in the package.

But in the end what we did, as a commission, on a 24 to nothing basis, is we came up with some reform elements and objectives. We came up with a package that we believe met those objectives, and we believe represented improvement over current law. So, I did vote for it, but I also have a statement in the final report that clarifies my views.

Senator CONRAD. And that plan included individual accounts, did it not?

Mr. WALKER. That is correct, Senator. It did.

Senator CONRAD. And that plan also included extending the retirement age to 70 by 2029.

Mr. WALKER. That is correct. It did, Senator.

Senator CONRAD. The nature of those individual accounts, were those mandatory? Was it required that people participate in those accounts?

Mr. WALKER. They were mandatory.

Senator CONRAD. And did that plan include benefit cuts?

Mr. WALKER. It included making changes in the benefit formulas that would affect largely baby boomers and Generation X'ers, but they would also be the ones that would be getting the individual accounts.

Senator CONRAD. But were benefit cuts a part of the package?

Mr. WALKER. There were reductions to promised benefits targeted to baby boomers and Generation X'ers, who, again, Senator, would get the individual accounts. When you run the numbers on that particular proposal—and I do not, in my current position, endorse any proposal, much less that proposal—you will find that rates of return are improved.

Senator CONRAD. One of the changes proposed, as I understand it, was to reduce what would go to a retired, married spouse, that she would get a cut. Currently, they could get 50 percent of what the husband gets, and that would be cut to 33 percent. Was that part of the plan?

Mr. WALKER. There was an increase in one type of survivor benefit and a decrease in another. So it increased in one situation and it decreased in another, based upon comments that we had gotten.

Senator CONRAD. Let me just say that I personally think that this exercise was a contribution. There are parts of it that trouble me, and parts of it I do not think would ever sell with the American people. But I think it was valuable to have a group go through the exercise and lay down a proposal.

I must say that I am also interested in personal accounts. But I think we have go to talk about this, debate it, and discuss it because the implications are significant. One of the biggest implications is a question of risk, who bears the risk. If there are increased rate of return possibilities, obviously there are also increased possibilities of risk.

In your own judgment, when you were part of that exercise, how did you deal with that question, the question of the possibility of higher rates of return, but also the possibility of increased risk?

I mean, we all know people, unfortunately, who would probably make very bad investment decisions. What happens if people make bad investment decisions in what, as you have described for many, as their sole retirement income?

What happens if people make very bad investment decisions, when they get to retirement age and are in even worse situation than they would be if they had just had normal Social Security retirement because, unfortunately, they made bad decisions?

Mr. WALKER. Well, it varies with the proposal. In the case of the particular proposal that you referred to, Senator, that proposal represented a two-tiered structure: a base defined benefit program that everybody would get with certain and secure benefits where the risk is borne by the trust fund and future taxpayers, but which is financed to be solvent and sustainable, and which provides a proposed minimum level of benefit equal to the poverty level as an absolute minimum. So there was a floor benefit that was guaranteed. The individual account was a supplement to that.

Under the particular proposal that you referred to, the individual bore the risk, but at the same point in time had this floor guaranteed benefit that they would always get no matter what happened. They could get incremental returns from that individual account.

There are some alternative proposals, however, Senator, where people talk about guaranteeing a total benefit and using the individual account as an offset to that total benefit.

If you do that, you do, however, create a contingent liability. That contingent liability for the risk then would be shifted from the individual to the trust funds and to future taxpayers. So, in the case of the one you are talking about, the risk was on the individual, subject to a floor. It could be changed, depending upon how you structure the proposal.

Senator CONRAD. In that final circumstance, those situations that you have described, they have what they call a claw-back proposal, where the gains you experience in your personal account are shared with the Social Security trust fund. In other words, the gains that you experience in the account, you only keep a part of them, is that correct?

Mr. WALKER. One of the proposals that I am aware of, there would be a so-called claw back, which helps to finance the defined benefit portion of the program. I think one would have to be concerned with potential expectation gaps associated with that claw back in an individual account environment, because if you have an individual account with your name on it and it is building up money over a number of years, and at the end all of a sudden the government is going to take 75 percent of it back, that might raise

some questions, even though you are getting a better deal than otherwise you might get.

So, I think there are some expectation gap issues that would have to be looked at. There are different ways to deal with that. Rather than an offset you could share investment returns, but there are communication challenges here that would have to be addressed.

Senator CONRAD. Thank you.

The CHAIRMAN. Thank you, Senator Conrad.

For purposes of the record, I would like to reemphasize that Mr. Walker's participation in the CSIS study was when he was in the private sector and not since he became part of GAO.

With that, I would like to call on Senator Bryan.

Senator BRYAN. Thank you very much, Mr. Chairman. Good morning, Mr. Walker. Thank you for joining us.

We are engaged in this discussion this morning because we have a long-term solvency problem, 2032. It is frequently said—misstated, in my judgment—that in 2032, if we do nothing, that the whole system becomes bankrupt.

More accurately, would it not be fair to say that if we do nothing—parenthetically, I think that would be irresponsible—we would have to reduce the benefit structure by about 25 percent. Is that not what we are really talking about?

Mr. WALKER. Correct, Senator. You either have to reduce the benefit structure by 25 percent, increase payroll taxes by 33 percent, or a combination thereof.

Senator BRYAN. And I believe in your report that you shared with us today that you indicate that, to restore solvency, we would have to increase program revenues by 16 percent or reduce benefits by 14 percent.

Mr. WALKER. That is if we did it today, and that is for the next 75 years. But we would still have to deal with this sustainability issue, the cliff effect that I referred to.

Senator BRYAN. There are a number of options that are being discussed in terms of this individual account concept, one of which is a carve-out proposal.

Now, as I understand the carve-out proposal, we would retain the 12.4 percent contribution but carve a portion of that out and put it into an individual retirement account concept. Am I correct on that?

Mr. WALKER. That is correct, Senator.

Senator BRYAN. Now, that would do nothing to enhance solvency. In fact, that would further erode solvency, would it not?

Mr. WALKER. Without additional revenue sources or other program cuts, yes, it would.

Senator BRYAN. Now, let us talk about the options that would be available. Within this individual retirement account concept, could you just generically describe the options that are before us?

Mr. WALKER. Well, there are many different options, Senator: First, do you have individual accounts or not? Second, how big should they be?

Senator BRYAN. I am talking about not so much how big it is, but structure. I mean, one structure is an employer type of a 401(k), another is a government management, another is strictly to let peo-

ple invest. I think that was basically the line of questioning that Senator Conrad was pursuing.

Mr. WALKER. Right. Well, you have to decide whether it is voluntary or mandatory, whether it is government-run or run by the private sector, whether or not it is going to be a single program or are you going to allow individuals to go through their IRAs, or go through their 401(k) plans. You have got to decide, depending on the answer to those questions, who is going to administer it.

You have got to decide how it is going to be integrated into the defined benefit formula, or, if there is going to be a sharing of investment returns, how you are going to handle that, who is going to maintain the individual account records, who is going to handle any pre-retirement access—if there is any—distribution options. Importantly, you have to do what you touched on: how are you going to pay for it?

Senator BRYAN. Right. I want to return to that. If you have a carve-out provision, you have still got the problem in terms of Social Security solvency. Do not most of the carve-out proposals, in effect, contemplate that the defined benefit portion of Social Security would be reduced to some extent?

Mr. WALKER. That is correct, they do contemplate that.

Senator BRYAN. So the guaranteed benefit that Americans currently understand would not be there, and that would be substituted instead for a combination of a defined benefit and the potential yield that might occur as a result of a defined contribution plan into the market in whichever variation that would take, a 401(k), or an individual, or, as Senator Conrad has pointed out, you could put the entire yield and spread that out across the system.

But, at least in terms of the personal individual situation, it would involve a reduction in his defined benefit with some hope that the defined contribution might increase the benefit because of the historical equity rate of return versus the bond market.

Mr. WALKER. Well, Senator, let me touch on a couple of things here, because it is important.

Senator BRYAN. Yes.

Mr. WALKER. One, there is a difference between the promised benefit and the funded benefit. Right now, we have certain promised benefits under Social Security.

Senator BRYAN. Yes.

Mr. WALKER. They are not, however, funded. Therefore, I think one has to look at any ratio analysis you are doing on what is the change not just for the promised benefit, but, more importantly, the funded benefit because we have got unfunded promises.

Second, how individuals would be affected would vary largely based upon the design of the program. There are some proposals out there that would actually increase the guaranteed minimum benefit under the defined benefit portion.

Most every proposal that I have seen would leave current seniors and near-term retirees largely or totally unaffected, such that these program reforms would be focused on boomers and X'ers. The reason is because the seniors do not have time to adjust. They have got expectations they are going to get a certain deal, and many believe people ought to deliver on that.

On the other hand, X'ers and boomers do not think they are going to get much from Social Security and, therefore, we have a lot more flexibility as to what can be done to assure program sustainability, solvency, increased rates of return, and yet exceed the expectations of those generations. So it really depends, Senator, on how you structure it.

Senator BRYAN. My last question. Would it not be possible for an individual who had the same income earnings history and who was part of the identical defined contribution plan, would it not be possible on some of these proposals that, depending upon the year in which the individual retired and depending upon the market condition, that individual would receive a different benefit than the individual who retired the year before, assuming in my hypothetical market conditions were more favorable, or who retired the year after under a circumstance in which the market conditions were more favorable.

Mr. WALKER. That is true. It is also one of the reasons why the Congress might want to consider maintaining a strongly based defined benefit that is certain, secure, adequately funded, and, to the extent if the Congress considers individual accounts, they may want that to be just a piece. Also, to make sure that investment options are there and investment education is there to minimize that problem.

Senator BRYAN. Some of us have heard of the notch baby. It seems to me we might have the potential for many different notches in that proposal.

I thank you, Mr. Walker, and I thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Bryan.

Next, is Senator Graham of Florida.

Senator GRAHAM. Thank you, Mr. Chairman.

I start by defining the problem that is before us as not one of Social Security reform, but one of retirement security reform, because I see Social Security and those other Federal policies, primarily in the Tax Code, which encourage employer-based pension retirement savings as all being part of the totality that an American would look at in terms of their financial security in retirement, and the changes in one program raise questions as to the necessity of changes in other programs.

It is for that reason that I think the idea of encouraging individual retirement accounts is a good idea. It broadens the debate as to what the range of concerns are and potential strategies or tactics to deal with those concerns.

Looking at this through the prism of the American worker who is about to retire, is there currently a policy as to what, as between Social Security, personal savings, and employer-based pension retirement, an American worker should expect to have in retirement as a percentage of their final income?

Mr. WALKER. Senator, it would vary based upon the individual's income level. You generally hear the number 70 percent mentioned quite a bit, 70 percent of pre- retirement earnings. But, as we know, averages can be very misleading. You can go anywhere from 40 percent to 80 percent, depending upon the income level of the individual.

Senator GRAHAM. Using that 70 percent number, today Social Security, particularly for the middle and lower income worker, will provide something in the range of 45 to 50 percent of their last employment, is that correct?

Mr. WALKER. I think, of average wage, that is correct.

Senator GRAHAM. Average. What proportion of that 70 percent do you believe should be from all of the combination of sources in what you would call the base of a defined benefit plan?

Mr. WALKER. Well, I would not have an exact percentage, Senator. But what I would tell you is, given the fact that, as you stated and I agree, that Social Security is really only one element of a broader question, what we are really dealing with here is retirement security, which means Social Security, private pensions, personal savings, and, I would also argue, Medicare and employer-provided health care, and other private insurance.

I think, given the fact that Social Security is the foundation, given the fact that we only have 50 percent of the full-time workforce covered by a voluntary private pension plan, given the fact that personal savings rates are very low and that the amount of financial assets that the average worker would have at retirement are very low, I think that would tell you that you need to make sure that a major part of the foundation, which is Social Security, has some type of defined benefit structure, or at least provides a certain and secure benefit from the individual's perspective.

Today, of course, all of Social Security is a defined benefit plan. So in the instance of the middle- to lower-income worker, they have more or less assurance that they will have a retirement of 50 percent of their final wages.

If you were to take one-sixth of the Social Security system and move it from a defined benefit to a defined contribution, you would commensurately be reducing from 50 percent to approximately 40 to 42 percent the level of assured income by that middle- to lower-income worker. Is that correct?

Mr. WALKER. Then the question would be, what kind of incremental rate of return can you get on that over time. Depending upon what the assumptions are, the workers could actually be better off. Potentially much better off.

Senator GRAHAM. I guess my question is, should Social Security not be continued as a fully defined benefit plan, and then use the other side of the equation, the non-Social Security aspects of retirement, as the place to have increased defined contribution plans and, therefore, the risk that is entailed in those?

Mr. WALKER. The only difficulty you are going to have, Senator, is right now we do not have a universal individual account mechanism. It does not exist. In the private sector, only 50 percent of employers offer these.

Yes, we have mutual funds and we have other savings vehicles, if you will, and they are structurally either for individual private sector plans or for individual savings arrangements. We are talking about an individual savings account program that could involve tens of millions of Americans under a standard program.

The question is, what is the best way to get that done, at the least cost and the most reliability that it will be administered consistently and in the interest of workers and retirees?

Senator GRAHAM. I guess my answer to that question would be to have a universal savings account which builds upon the existing private sector employer-based program and would create an incentive for a higher than 50 percent level of employees to be participants in those plans.

Mr. WALKER. I hear you, Senator. Thank you.

The CHAIRMAN. Senator Gramm of Texas.

Senator GRAMM. Mr. Chairman, first of all, I just want to make a general comment. Since David M. Walker became Comptroller General and Dr. Dan Krippen became CBO Director, we have had a phenomenal change in the clarity of the spoken word coming from both of those agencies.

I just want to simply say again, whether I agree with what you are saying or whether I do not, I very much appreciate government agencies that can say yes or no, or this is a good, workable idea, or this is one of the stupidest ideas currently floating on the planet.

Somehow, we have gotten caught up in the old days and thinking that, if you were CBO Director or you were the Comptroller of GAO, that part of being objective was being basically unwilling to give a straight answer, and I want to thank you personally for that.

Mr. WALKER. Thank you, Senator.

Senator GRAMM. I want to try to address a problem. You used the words here today, but I want to try to go back and see if I can get you to agree with me on correcting them. We say we have a trust fund which is an IOU from the Treasury to the Federal Reserve Bank actually housed in a metal filing cabinet in West Virginia. Based on those IOUs, we say Social Security is good through the year 2032.

But is it not true that, beginning roughly the year 2012, we will not have enough money to send out checks, and that that those IOUs just represent a commitment of the government to pay money, and they do not pay any benefits, nor are they capable of doing it, unless we raise taxes, cut benefits, or borrow more money, is that not right?

Mr. WALKER. That is true, Senator.

Senator GRAMM. Now, when you say that we are getting a certain rate of return on the current trust fund, that rate of return is interest paid by the Treasury in payments that do not count as an outlay of the Treasury. So we are simply adding more IOUs, which just means we are making more commitments to pay in the future, is that not right?

Mr. WALKER. That is correct.

Senator GRAMM. So, in a real sense, these interest earnings do not represent any real resources to be used to pay Social Security benefits in the future, but simply mean that we are more committed to raise taxes, cut spending, or borrow in the future than we are now, is that not right?

Mr. WALKER. They do not represent hard assets, and yes, they mean that it, in effect, creates a first claim on future general revenues, which ultimately has to be satisfied by either higher taxes, reduced benefits, incremental returns, or more debt.

Senator GRAMM. Let me tell you what I am trying to get to. We mislead the public when we act like this is a debate on the private

accounts, or investment-based Social Security, as I call it. It is a debate between the rate of return you get on those accounts invested in the stock market versus the rate of return you get on government bonds.

In reality, the government bond is an IOU asset which has no value. Until the government changes policy, it cannot pay benefits. Whereas, as an investment in equities is a real asset. So when it earns interest, it is what Einstein called the most powerful force in the universe, the power of compound interest.

So the real rate of return in terms of assets that can be used to pay benefits on the current trust fund is zero because the current trust fund is not an asset that can be used to pay benefits. Would you not agree with that?

Mr. WALKER. Well, Senator, when I think of rate of return it is not in the context that you are talking about. I think about it from the context of the worker, the retiree. What rate of return am I getting on my payroll tax contributions? Then the second issue on rate of return is, what rate of return is the "trust fund" getting, if you will, which is a different issue. As you know, this is not a typical trust fund. This is a budget account. It is a sub-account within the consolidated Federal budget. And you are right, we are really obligating future generations for this.

Senator GRAMM. My point, not to butt in, because I see that yellow light. My point is, to say we are actually getting interested on these government IOUs, the interest is itself an IOU and cannot be used to pay benefits.

So when you are looking at the economy as a whole and you are looking at our ability to pay benefits, it is not that the rate of return on the stock market is higher than on government bonds, it is that one is a real asset and the other is a paper IOU, is that not right?

Mr. WALKER. Clearly, you have to pay benefits with hard assets. And to the extent that you have a hard asset earning real rates of return, that is a direct way to do it. The other way, you are going to have to convert the bonds into a hard asset. You can only do that the three ways that you articulated.

Senator GRAMM. Well, Mr. Chairman, I just want to reiterate this point because I think it is so important. I am sure there are people out there that believe that we are talking about having real investment and real wealth created through stock and bond investments where the workers would own accounts in one of many different proposals, some made by members of this committee. What we are claiming, is the rate of return on that is higher than on these government bonds.

But the reality is, that is real wealth with a real rate of return, which can be used to pay benefits, whereas, the return on the current Social Security trust fund is simply another IOU that cannot be used to pay benefits. So, it is more debt versus more wealth.

I think that is a critically important point. People get hung up on the rate of return. The fact is, it is anything that is positive versus zero. That is the relevant comparison. I think if people understood this, it would affect the debate on what we are doing. Thank you very much, Mr. Chairman. Thank you.

The CHAIRMAN. Thank you, Senator Gramm.

Next, Senator Rockefeller.

Senator ROCKEFELLER. Thank you, Mr. Chairman. Two very quick questions. One, is that there are about five million small businesses that pay and file paper accounts on behalf of more than 60 million workers, reporting requirements, private accounts, et cetera. Now, if the IRS has to assume that obligation, is that a problem?

Mr. WALKER. You mean, to collect these different sums? Right now, obviously the IRS is already collecting the payroll taxes that are currently received for Social Security. To the extent that you end up creating individual accounts, there could be some expectation gaps created depending upon how you end up handling the administration.

Specifically, while the IRS can collect the money, by piggy-backing to a great extent on the existing mechanisms that exist for collecting payroll taxes, there are significant lags between the time that the IRS collects the money and the time that the information gets reported to the Social Security on behalf of individuals.

That significant lag would be of particular potential concern in an individual account environment because you are going to be investing these sums, and there could be a real lag between the time that the money is transmitted and the time that it actually gets credited to a person's individual account where they could have control.

There are ways to deal with that, through having interim investment options pending that allocation. But there are some administrative challenges associated with the record keeping part, not as much the collection.

Senator ROCKEFELLER. The second question. Alan Greenspan says that using budget surplus to pay down the national debt is a step in the right direction. Do you agree? Number one. Number two, does using the surplus to fund private accounts not divert that money that could, and should, be used to pay down the national debt?

Mr. WALKER. Well, first, we at GAO have been on record for many years saying that paying down debt held by the public has a number of positive economic consequences. I said that in my statement back on February 9, and we stand by it.

Second, you can only spend the money once. If you are going to use the money to pay down debt held by the public, that is one benefit. If you are going to use it to create individual accounts, there are other economic consequences associated with that, both individual and micro, but you cannot use it twice.

Senator ROCKEFELLER. Thank you.

The CHAIRMAN. Next, we have Senator Robb.

Senator ROBB. Thank you, Mr. Chairman. I apologize for not being able to be here earlier. I, among other things, joined the Ranking Member in paying tribute to the next junior member on the Minority side a few minutes ago on the floor for conspicuous gallantry above and beyond the call of duty some 30 years ago today, and I am very pleased to do that, and we have had some other hearings. So, I did not hear all of your testimony. But to come here and discuss some of these proposals requires a certain degree of courage, if not conspicuous gallantry, in any event.

Let me ask you, and I think it follows up on the one question I did hear from Senator Gramm having to do with wealth creation as opposed to other means of doing same. Could you suggest any alternative with respect to the Social Security where we can, in fact, create any wealth for those who might not otherwise be able to enjoy the fruits of wealth accumulation during their normal economic lifetime?

Mr. WALKER. Well, there are a number of ways in which you could create individual account concepts.

Senator ROBB. Within the Social Security context, I am talking about.

Mr. WALKER. Oh. You can enhance rates of return in ways that involve alternative investments without individual accounts, but that does not necessarily create any wealth. Because when you have a defined benefit program, by definition all you get is the benefit that you were promised.

Therefore, to the extent that you get incremental rates of return, that is used to help finance that promise. Unless you ended up having some type of participation on those incremental returns with individuals, you would not create wealth.

Senator ROBB. Would it be fair to equate it to a life estate or to an annuity that expires at the conclusion of the life of the individual who has a vested interest in it?

Mr. WALKER. It is similar. In effect, in Social Security you get an annuity. You get a defined benefit annuity which is protected against inflation. But there is a modest—extremely modest—net benefit. There is nothing to pass on to future generations. In some cases, if you die before you are in pay status you get nothing.

So one of the differences with the individual account is, you have hard assets that are available pre- or post- retirement for yourself or for your survivors.

Senator ROBB. But, really, the question I am asking is, is there any other plan where the assets that are accrued and the benefits that flow from it survive the death of the beneficiary?

Mr. WALKER. That is out there today?

Senator ROBB. That is out there today, or being proposed.

Mr. WALKER. That does not involve individual accounts? I am not aware of one.

Senator ROBB. All right. Thank you.

Just one other question. In terms of our consideration of the various approaches to “saving Social Security” or “restructuring Social Security,” first of all, is there anything on the table today that has been proposed, either by the administration or other plans of which you have some detailed knowledge, that actually makes the kind of structural changes that we could, in good conscience, call saving as opposed to perhaps postponing the day of reckoning?

Mr. WALKER. There are a number of plans out there, Senator, by various organizations and by individual members that assure the solvency and sustainability of the program, many of which increase rates of return. But they do that by making hard choices. They do that by recognizing that you are probably going to have to change the benefit structure for baby boomers and Generation X'ers in order to close the financing gap.

At the same point in time, many of these proposals would adopt individual accounts for those same Generation X'ers and baby boomers as a way to hopefully make up that difference and potentially make them better off in the future.

Senator ROBB. Can we do it without structural change?

Mr. WALKER. I do not think we can assure a sustainable and secure Social Security program for the long term without structural change.

Senator ROBB. One last question, if I might. Would we be better off in describing our obligation—I am going to use the word I am going to get to. Our responsibility, rather than in terms of a statutory law, but in terms of obligations?

Sometimes we are comparing apples and oranges, it seems to me, and making a distinction with respect to Social Security that we might benefit from looking at our implicit, either moral or legal, obligation to future beneficiaries and compare plans on that basis.

That is not quite framed as crisply as I would like it, but would we benefit from using the word "obligation" in preference to some of the other terminology that we have used so that we can make direct comparisons between the kinds of plans that we are discussing.

Mr WALKER. I think it is fair to say that, with regard to future Social Security payments, you are talking about obligations or commitments, not liabilities.

Senator ROBB. That is the distinction I am trying to make.

Mr. WALKER. I think the other thing we have to keep in mind, Senator, is that even if you talk about the current Social Security system, there is a difference between how much in benefits have been promised, which represent obligations or commitments, and how much have been funded.

Therefore, when you are analyzing various proposals, you have got to keep that in mind because not all of the promised benefits have been funded. So it is kind of comparing apples and oranges to compare, well, what kind of rates of return are you getting on a benefit that is only partially funded?

Senator ROBB. Which was precisely the point I wanted to make, even though the question was not as crisp as I would like it.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Robb.

We appreciate your being here today. Let me join Senator Gramm in applauding the excellence of your testimony. It is so good, we are looking forward to having you back next Thursday. Thank you very much, Mr. Walker.

Mr. WALKER. Thank you.

The CHAIRMAN. We will now proceed to our second panel, which is a very distinguished group of economic, pension, budget, and social policy experts. I would invite them to come forward.

Let me start out by introducing Sam Beard, who I am proud and pleased to say comes from my State of Delaware. He is the founder of Economic Security 2000, a nonpartisan, grass roots educational organization dedicated to saving Social Security.

Just let me publicly acknowledge the dedication of this man to this issue, to the question of saving Social Security. He has literally given, not days, not months, I would say years, of his time to this

most important issue. Even more important is the fact that his young daughter is here, Hillary, who frankly is his brains and right hand. We are happy to welcome her.

Next, I would like to welcome Dr. Martin Feldstein, who also comes here very often. He, of course, comes from Harvard, the National Bureau on Economic Research. He is one of the greater thinkers of our time and it is always a pleasure to welcome you, Martin.

Fred Goldberg, a former IRS Commissioner, often witness here, Treasury Assistant Secretary, and a great individual. We look forward to his testimony.

Then we have Sylvester Schieber, who, with Watson Wyatt, which is a leading pension consulting firm. He was a member of the Social Security Advisory Board, and he has been working on the nuts and bolts of accounts.

So we are, indeed, honored and pleased to have such a distinguished panel. Dr. Reischauer will be here in a few minutes. He, of course, was former head of the Congressional Budget Office.

Sam, we will go alphabetically. We will start with you.

STATEMENT OF SAM BEARD, PRESIDENT, ECONOMIC SECURITY 2000, NEW CASTLE, DE

Mr. BEARD. Mr. Chairman and all Senators, thank you very much for having me here today. Senator Roth, as you all know, has led a life-long fight to create a Nation of savers. Senator Moynihan is Mr. Social Security. Senator Kerrey, who is not here, chaired our group, Economic Security 2000. Senator Robb co-chaired our Billion Byte March. Fundamentally, I have had the privilege of working with many of you over the years, so it is an honor to be here.

My goal is to make three short points. First, we need to add savings and wealth accumulation to save Social Security. Second, we need creative financing approaches to allow all Americans to set aside at least $400 or $500 per year into savings accounts which they own, invested in the private sector.

Third, the Congressional Budget Office warns us in clear terms about the impact on our future economic growth and standard of living if we do not control entitlement spending. We cannot tax or borrow our way around 76 million baby boomers, and we need to act now.

So let me begin. Social Security is the best Federal program created in the 20th century. But Social Security is in trouble. The solution to save Social Security is to begin by saving the progressivity of President Roosevelt's guaranteed floor of protection, but let us add progressive individual savings accounts.

As we approach it, we see two problems. First, Social Security is in trouble. But we see a second problem. Two-thirds of all Americans have little or no chance to save or build wealth.

The Rand Corporation best defines the wealth disparity in America. One-third of all income comes from savings and wealth, but two-thirds of Americans are largely cut out of that opportunity.

The Rand study shows that the bottom half of America has less than 2 percent of the net financial assets. After a lifetime of work, half of Hispanic Americans and African Americans do not own a dime.

Here in America, the land of equal economic opportunity, the gap between the rich and the poor is the greatest of all modern economies. The top 10 percent owns 4,600 times the bottom 20 percent. In our judgment, it is strictly a matter of fairness and economic justice that we need to do better.

Now, there are two sources of income. One, is I get a job and I get paid. The second, is that money makes money. Now, if two-thirds of our society are largely cut out of the second pillar of income, I think we need to address that issue.

So why do we connect Social Security reform, which is essential, with solving wealth disparity? Let me look at the facts. Fifty-seven percent of workers earn $18,000 or less. These workers are paying $2,200 a year to Social Security. These workers simply do not have another $2,000 to put into any savings vehicle. So, through existing payroll taxes, these workers are huge savers and Social Security is their only chance to have savings in any meaningful way.

Now, my second point is that we need creative financing. America has the most sophisticated financial markets, and we are famous for our ingenuity, so let us use both. Leadership from Breaux-Gregg and 15 other plans show us how to set aside 2 percent of wage into individual savings accounts. It is clear, as testified this morning, there are no easy choices. We need structural change to do this.

Now, if the first 2 percent of wage is doable but hard, how do we get the next 2 percent of wage? How do we get four percent into these funded accounts? Fundamentally, where do the extra $60 billion come from?

In my written testimony, I discuss voluntary savings matches. There are two forms of them, and they can relate to an extra $30–60 billion per year. The Federal Thrift Savings Plan counts heavily on volunteer savings matches.

I then discussed Liberty bonds. The idea of a Liberty bond is, let us make it beneficial for affluent seniors to pass their Social Security checks tax-free to their heirs, but defer it 30 years. If affluent seniors defer their Social Security checks for 30 years, that creates an extra $30 billion which can go into the funded accounts today. It is just a question of being creative.

Thirty States, at the State level, create a lock box for unexpected State revenues. They set aside the extra revenue for special purposes. Let us use this at the Federal level, create a savings agenda, and, as the economy grows, let us agree now to put these in to finance the transition.

Let me just close by saying, the Congressional Budget Office warns us starkly, if we take the surpluses and do it with tax cuts or spend the money, the impact on the economy will be huge. Their numbers are very clear. By 2033, if we do that, our National debt will be $33 trillion, or 100 percent of GDP. It will grow to $86 trillion by 2040, 200 percent of GDP.

I view it as a huge hurdle, entitlement spending, which we need to overcome. We have to save our obligations to existing seniors, but we also have to pass on real economic opportunity to our grandchildren. Save Social Security, add wealth accumulation. Let us do it now. Thank you very much.

The CHAIRMAN. Thank you, Sam.

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

The CHAIRMAN. It is now my great pleasure to call on Dr. Feldstein. It is always an honor to have you here.

STATEMENT OF MARTIN S. FELDSTEIN, PH.D., GEORGE F. BAKER PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY, PRESIDENT, NATIONAL BUREAU ON ECONOMIC RESEARCH, CAMBRIDGE, MA

Dr. FELDSTEIN. Thank you very much, Mr. Chairman. It is very nice, again, to be in front of this committee. I have a written statement and a background appendix which I would like to just submit for the record.

The CHAIRMAN. The full statements of each of you will be included as if read.

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

Dr. FELDSTEIN. I think that combining the traditional tax-financed Social Security system with an investment-based system based on individual accounts is the best way to save Social Security. I think we can avoid cuts in benefits, both now and in the future.

I think we can avoid an increase in the tax rate, the 12.4 percent that is otherwise, as you know, scheduled to go to 18 percent not that many years into the future. This can be a permanent fix for 75 years, and beyond.

The budget surpluses really do change the environment in which Social Security policy can be made. Because of the surpluses, we can do these things. We can avoid a cut in benefits, we can avoid an increase in taxes, without putting new burdens on employers or employees, or on current or future beneficiaries.

In that sense, I think I disagree with what Mr. Walker said earlier about the need for benefit cuts as part of any Social Security reform. I think we can use the budget surpluses as an alternative for doing that.

Moreover, I think that putting funds into individual accounts would be the most effective way to save budget surpluses. I think simply trying to save them in the trust fund, experience shows, does not work. If we really want to add them to national saving, to national wealth, then I think taking them out and putting them into individual accounts is the best way.

The key idea is that every retiree, every dependent or survivor, would get the full benefits promised in current law from a combination of three sources: the traditional pay-as-you-go tax of 12.4 percent, the current rate; second, personal retirement account annuities invested in approved stock and bond mutual funds; and third, a potential government payment, if necessary, to top up those two so that all of the benefits promised in current law were delivered to all current and future retirees.

I think the rest are really all details. But let me, in the brief time that I have, summarize the specific way in which I would implement that.

Basically, if you are employed or self-employed, you would choose a stock and bond fund from an approved list and you would indicate the identification number of these funds on your tax return,

so you could change it once a year. There would be some kind of a default, like the Federal Thrift Savings Plan, for people who do not make a selection.

The government would then put 2.3 percent of your taxable wage in the previous year into those personal retirement accounts. There would be no extra administration burden because the government would be putting money in on the basis of information that was already collected from employers.

The aggregate amount of this would be a little less than 1 percent of GDP, nine-tenths of a percent of GDP, so that this could be financed from the projected surpluses with no difficulty, indeed, even taking into account the interest effects of this.

Eventually, the increase in capital formation made possible by these accounts would be enough so that the additional tax revenue that gets generated by the extra capital accumulated in this way would make the program self-financing.

After about 2030, there would be enough additional tax revenue so that the 2.3 percent of payroll, the nine- tenths of a percent of GDP, would be financed out of this extra revenue.

At retirement, individuals would convert their accumulated balances into a variable annuity. Three-quarters of each year's annuity would help to finance the individual's own benefit, the other 25 percent would be an extra bonus, something that individuals would receive on top of what they would otherwise have gotten from regular Social Security.

The Social Security benefit, therefore, would consist of these three elements, the pay-as-you-go part based on the 12.4 percent tax, the personal retirement account annuity, and the top-up to make the guarantee that everybody gets at least as much as they are promised in current law.

Of course, for the next several decades, this would remain overwhelmingly a pay-as-you-go system. Thirty years into the future, personal retirement accounts would represent less than one-sixth of the total payments. Even by the year 2050, personal retirement accounts would only be paying 6 percent of the roughly 18 percent cost of the program.

Even in the very long run when the full transition has occurred, this would still remain primarily a pay-as-you-go system. About 60 percent would be pay-as-you-go and 40 percent would be based on personal retirement accounts.

I hope that during the questions we can come back to some of the other issues that have been raised about requests, about risks, about national savings, about administrative costs.

But I just want to emphasize that I think that this combination of a pay-as-you-go system as we know it today, based on the current payroll tax, plus individual accounts funded with the available surpluses, is the best way to save the Social Security system and can do it in a way that does not require any future reductions in benefits. Thank you.

The CHAIRMAN. Thank you, Dr. Feldstein.

It is a pleasure to call on you, Mr. Goldberg.

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

Mr. GOLDBERG. Thank you, Mr. Chairman. I believe there are three keys to Social Security reform. First, is keeping faith with current retirees and those about to retire. Second, is maintaining the basic Social Security defined benefit structure and enhancing the safety net at the bottom end.

Third, is providing for a universal system of private accounts. You and your colleagues who endorse private accounts in one form or another as part of an effort to preserve Social Security are right on the mark.

The PRA, private accounts, are much more. I believe, structured properly, private accounts will be most beneficial to low-income workers, blue collar union members, single parents, working mothers, and minorities.

They will also provide the infrastructure for other policies to create wealth and create opportunity for all Americans. Now, private accounts may be terrific policy, but I think a threshold question is whether it is possible to implement a workable system.

During the past year I have had the pleasure of working with Professor Michael Graetz of the Yale Law School on a paper addressing in detail a design of a system of private accounts. A copy of that paper accompanies my testimony. In the spirit of full disclosure, it was published under the auspices of the NBEER, otherwise known as Professor Feldstein. [Laughter.]

By building on existing systems, a universal structure of private accounts can be implemented in a way that meets four criteria: it minimizes costs and distributes those costs fairly; it imposes no incremental burden on employers; it meets everyday Americans' expectations for simplicity, security, and control.

Finally, it is flexible enough to accommodate a wide range of policy choices, and changes in those choices over time. Now, due to time constraints I will not describe the system we propose, but would, of course, be happy to answer any questions.

In light of recent events and suggestions we have received and comments today, I would like to comment very briefly on a number of items. First, is the importance of flexibility. There are lots of different ideas that have been put forth by members of this committee and by others.

It is critical that whatever system is designed—and I am talking about the plumbing, the wiring, the HVAC, kind of the stuff of the system, how it works—needs to be able to accommodate a wide range of policy choices.

I have listed some of those choices in my testimony. Is it carve-out, is it add-on, is it general revenues, is it voluntary, is it mandatory, are there tax incentives for additional contributions?

All of those questions are difficult and have to be answered. But the design of the system has to be able to accommodate those choices and give you the freedom to change your mind about those choices down the road.

Second, with respect to administrative costs, all of the work that we have done, and I believe the work that others have done, suggest that, on a phased on basis, a simple, workable system of private accounts can be run at a cost of 30 to 60 basis points a year. That is a very inexpensive proposition relative to costs in the private sector, generally.

Third, there is a public goods feature to a universal structure of wealth creation. There are values that we get as a society by making it possible for all workers to create wealth. To the extent there is concern about administrative costs, it is certainly possible to cap the costs inside the system at 50 to 60 basis points and fund any incremental costs—and I do not believe there would be any—out of general revenues.

With respect to worker investment options, there are some who say that those options should be limited to two or three choices, administered through Social Security. There are others who suggest that the only choices should be investment with the private sector. Based on our work, we have concluded that a two-tier structure is most appropriate.

For most workers, most of the time, a simple set of easy choices with risks constrained is going to be the best option, but workers should be given the alternative to roll into regulated private sector accounts if they choose to do so.

I believe that, thanks to public and private sector systems, we can now institute and implement a system of private accounts that minimizes costs, distributes those costs fairly, imposes no additional burden on employers, and meets the expectations and needs of the American public. That was not true 20 years ago, and that surely was not true in 1935.

It is important to put these administrative challenges in context. When Social Security was enacted, there was no payroll tax withholding. There were no Social Security numbers. All information was gathered, entered, maintained by hand. There was no computer-based infrastructure and there was no financial markets infrastructure. That was hard. Imagine trying to do Social Security in 1935 with none of that.

Private accounts are hard to do. As David Walker said, there are lots of administrative issues. But, by comparison to Social Security, it is easy.

Thank you very much.

The CHAIRMAN. Thank you very much.

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

The CHAIRMAN. Now we will turn to Dr. Reischauer.

STATEMENT OF HON. ROBERT D. REISCHAUER, PH.D., SENIOR FELLOW, BROOKINGS INSTITUTION; FORMER DIRECTOR, CONGRESSIONAL BUDGET OFFICE, WASHINGTON, DC

Dr. REISCHAUER. Mr. Chairman, I appreciate the opportunity to participate in this hearing. Personal retirement accounts have a number of attractive dimensions which the other four panel members will extol at great length. I see my role as to focus on a number of concerns that are raised by such accounts, and I am going to mention, just briefly, four of those.

First, personal retirement accounts inevitably will exposure individual workers to risks that are currently shared more broadly across society under our Social Security system. Risk will arise from the variability of market performance. Some will do well, others will do poorly in their investments. Some whole cohorts will do well, and other cohorts do poorly.

Risk will also arise from the uncertainty of one's life span. Some will end up outliving the assets that they have accumulated in their personal accounts. Risk will also arise from unanticipated inflation that could erode the value of the balance or the pension provided by a personal account.

Now, all of these risks that I have mentioned can be reduced by limiting investment choices available to workers and restricting the uses of balance upon retirement. You can, as some of the other witnesses have suggested, require individuals to invest only in indexed mutual funds.

You can require them to convert their balances into inflation indexed annuities upon retirement, but such restrictions will detract from the appeal that many see in personal accounts, and the notion that these are the workers' own resources to do with as they will.

A second source of concern, is that personal retirement accounts will reduce our ability to provide social assistance through the Nation's mandatory pension system.

Under Social Security, low earners, spouses with limited or no labor force activity, survivors, divorcees, and large families get extra benefits relative to their contributions. This fact has had a huge impact on poverty rates in this country.

Under a system of personal retirement accounts, you cannot provide such social assistance through those accounts. That burden would be borne by the defined benefit component which almost all plans maintain.

But the defined benefit component will be a smaller boat carrying an equally large load, and that might undermine the political viability of the defined benefit program.

The third concern that I have, is that personal retirement accounts could entail increased administrative costs and unnecessary added complexity. If they are decentralized, fund management costs will be high and that will eat into the returns.

If they are decentralized, the cost imposed on employers to collect and distribute the contributions will be high. In fact, many small employers will probably find the task impossible to perform.

There will also be a cost of educating the work force. The debate that is taking place right now is a debate among the financial cognizente, it is not among the average Americans. Twelve percent of Americans do not know the difference between a load and a no-load fund; 16 percent know what an IRA is, 84 percent do not; 50 percent of the American adult population does not know the difference between a stock and a bond.

I have been doing a little survey among my friends on, what is an annuity? I find a shocking lack of knowledge about a simple, but important, element right there. If we have these accounts and the pensions are integrated with Social Security, as Senator Graham's proposal requires and the proposal put forward by Professor Feldstein, there will be added administration costs for the government

to do this coordination. All in all, if not done very carefully, proposals that rely on personal accounts could see a lot of the benefits eaten up by added costs.

My last concern is that personal retirement accounts could unleash political forces that, in the long run, could undermine the political consensus behind a system that provides adequate pensions to all without exposing the government to increased financial risk.

If we required annuitization of account balances, those who have adequate private pensions and private savings would undoubtedly chafe and demand that they be freed from those restrictions. It would be impossible then not to allow others that same latitude. We will find that increasing numbers of people reach retirement without adequate resources. They dispose of their resources too soon.

Pressure will also grow to allow workers to tap into their accounts before retirement for worthwhile uses. They will start probably with the notion that certainly we should allow individuals to tap into their balances to pay for life-saving medical treatment, and they will grow from there. We will find that people reach retirement without the resources we expected.

Let me conclude by saying that I believe personal investment accounts should play a significant role in the retirement plans of American workers, but their contribution should be made through employer-sponsored pensions such as 401(k)s and through personal retirement savings vehicles like IRAs, not through the Nation's mandatory pension program, which should assure the basic retirement income that can serve as the foundation upon which these other sources, these other less secure sources, of retirement income can be built.

Thank you.

The CHAIRMAN. Thank you, Dr. Reischauer.

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

The CHAIRMAN. Dr. Schieber?

STATEMENT OF SYLVESTER SCHIEBER, PH.D., VICE PRESIDENT, DIRECTOR OF RESEARCH AND INFORMATION, WATSON WYATT WORLDWIDE; MEMBER, SOCIAL SECURITY ADVISORY BOARD; MEMBER, 1994-1996 ADVISORY COUNCIL ON SOCIAL SECURITY, BETHESDA, MD

Dr. SCHIEBER. Thank you, Mr. Chairman. I am pleased to appear here this morning to talk about Social Security reform. I have appeared before the committee before talking about the work that I have done at the Social Security Advisory Council on specific proposals, and I am not going to re-plow that ground.

Today I intend to talk about two related matters. The first, is the transition costs associated with Social Security reform. The second, is a mechanism for administering a reformed Social Security system that would include individual accounts.

Several Social Security reform proposals have been put forward recently, many with highly varied features. I believe that the costs associated with these proposals are misunderstood because they have not been consistently laid out. I believe it is important to un-

derstand these costs and their distributions if you are to judge between these reform alternatives.

The actuaries estimate that Social Security is under-funded by the equivalent of $3.1 trillion, in present value terms, over the next 75 years. As Mr. Walker pointed out this morning, that is not the ongoing costs of rebalancing the system, but let us start there to begin with.

These imbalances have to be serviced. The bottom line is that we have to make at least $3.1 trillion in adjustments to the current system. We can cut benefits, we can raise revenues, or some combination of the two, but there is no zero-sum game of restoring balance. Reducing benefits or raising revenues will cost someone relative to current law.

President Clinton's Social Security proposal would use budget surpluses to cover part of the Social Security $3.1 trillion shortfall. While his proposal might permit us to technically diminish the program's financing problems without having to raise payroll taxes or cut benefits as much as otherwise, no one should believe that using general revenues somehow eliminates transition costs. Every dollar of general revenue that is transferred to Social Security is a dollar of revenue that could be used for some other purpose.

As public policy makers, I encourage you to think carefully about diverting most of the current budget surplus to Social Security financing of future benefits through the mechanism that the President has recommended. I believe that at least part of the contentiousness at the heart of policy deliberations today is the result of the shift in government spending to mandatory obligations, primarily entitlement programs.

Policy makers are increasingly fighting to support their ideas and programs to improve our society with a diminishing share of national resources. Under the President's proposal, future Congresses are likely to be more constrained than you are today. I believe that would be unfair to your successors and to the American electorate of the next century.

The proposal that Senators Kerrey and Moynihan have put forward would impose most of the transition costs of rebalancing the system on the benefits side of the program. The National Commission on Retirement Policy plan would go further in reducing benefits in order to finance individual accounts worth 2 percent of covered payroll.

I personally favor an add-on contribution to finance at least some part of this transition cost. I do so because of the differences in the relative number of retirees and workers and discrepancies between benefit and earnings levels.

But the point here is that every approach to Social Security reform has some transition costs associated with it, even if you want to stay with something that looks very much like the status quo.

I am convinced that we cannot avoid the transition costs in Social Security reform, we can only determine its distribution. The distribution of these costs raises tremendous equity questions that are not being squarely faced by some reform advocates.

It seems imperative that you have the Congressional Budget Office, the GAO, or someone devise a consistent way of scoring transi-

tion costs for all proposals so you understand the magnitude of these costs and where they are going to fall.

If Social Security reform includes some element of individual account, I believe the account should be held independently of government control if they are to be an effective retirement security funding device.

Some people would have us believe that one of the primary reasons we cannot adopt such a reform option is that we cannot devise an efficient way to administer such a system. I believe that is simply wrong. The system that I have laid out in my prepared remarks would be structured to give workers regulated control over investment of their retirement funds.

Giving workers some control over their assets is important for two reasons. First, competitive markets tend to produce better packages of services and prices than government. Second, giving workers and active role in the investment and retirement savings is likely to spur even more savings. I think that is important.

While the over-riding goals behind my administration proposal are to give workers control of their savings in a regulated and efficient environment, several additional goals are important.

The system would limit the burden on employers, especially small ones. The system would meet the needs of a diversified public in regards to fund security, operational simplicity, and worker control. The system would be easy to explain and navigate.

There would be limits on the concentration of wealth, minimizing pressures to divert system assets to other uses than securing retirement income. The system would be structured to control administrative costs at reasonable levels and to distribute them fairly across participants.

It is more complicated than the Thrift Savings Plan that is available to Federal workers, but I believe it would make the system more competitive, which gives value to consumers. While it is more diverse than the TSP, I believe it would be more efficient than 401(k) systems, or even the Australian system, which has proven to be extremely efficient, within less than a half decade of operation.

If you wish to discuss the specifics of my proposal during the question and answer session, I would be happy to do so. Thank you very much.

The CHAIRMAN. Thank you, Dr. Schieber.

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

The CHAIRMAN. Dr. Feldstein, as you well know, your proposal has several attractive features. It promises larger benefits, a Social Security program whose books are permanently balanced.

But, given that people must buy annuities, benefit guarantees that depend on investing 60/40 stock and bonds, the fact that account balances will not pass to an individual's estate, does your proposal really create privately owned accounts, or are the account holders simply custodians of mini trust funds?

Dr. FELDSTEIN. No, I think it does create real wealth for individuals. They would get a certain percentage of the value of the accounts. The number that I have worked with is 25 percent, so they

have a direct stake and an ability to increase their retirement income.

The plan could easily be modified to allow for bequests. If you wanted to allow people to receive a bequest of the entire amount that was in their personal retirement account if they died before retirement age, it would increase the cost.

If you made no other changes, it would increase the cost from 2.3 percent to 2.7 percent of payroll. But obviously ways could be found to offset that by other changes, in the 25 percent, or in some other feature of the program. There would be comparable costs of making adjustments if you wanted to have post-retirement bequests in addition to having the pure annuity form. So, I think these do create real wealth for individuals.

The CHAIRMAN. Let me turn to you, Sam. You heard Dr. Reischauer mention four risks of private savings plans. As a leading advocate of the personal retirement accounts, how would you answer those risks?

Mr. BEARD. One of the things that Dr. Reischauer talks about is the administrative costs. We have researched that. The President's Social Security Advisory Council researched that. At the Federal Thrift Savings Plan, the administrative costs are 0.1 percent, a tenth of a percent.

So it could be designed wrong and you could have high administrative costs, but I think it is completely unnecessary. So if you limit choices, administrative costs come in at one-tenth of a percent. Now turn to the fact that people do not know the difference between bonds, and puts and calls, and shoves, and all the rest. I do not either. There are now 45 million Americans who participate in our pension system. There is about $7 trillion in the pension system.

People do not have to know how to invest or own stuff. I make a joke out of it. If you took every affluent person that does not know anything about investment, just take their money away. There are an awful lot of people who have a lot of money who are dumber than boards.

So what you do, is you design a system where you have very limited choice. The key issue, is the ownership. People do not have to know how to invest their money. So the greatest problem, to me, with Dr. Reischauer's part, is it is just narrow. There is such a desire, which everybody has, to save Social Security, that that is the only issue he puts on the table.

The issue I raise is, I am scared to death we are becoming the two separate societies. So let us save Social Security, but be imaginative. Let us put wealth on the table. Let us open up that one-third of income to all Americans.

The CHAIRMAN. Let me turn to you, Mr. Goldberg and Dr. Schieber. You both advocate an option where an individual could move his or her personal account to a private financial institution. Why do you think this option is important? What does it do to risk? What does it do to the complexity of the program?

Mr. GOLDBERG. I think, again, I want to emphasize, Mr. Chairman, we are advocating a two-tier system. I think for most workers a choice among two or three investment options. But I would also

permit the rolling out to a broader set of choices, and there are three reasons for that.

First, there are individuals who will want a greater range of choices, either in terms of investment options or accompanying services, and I think they should be permitted to make that choice.

Second, as a structural matter, letting those who want a different set of options choose them, it will be easier to keep the core system simple. And I think keeping the core system simple is critically important.

Well, instead of advocating greater complexity inside the core system, those relatively limited number of individuals who want other choices can go elsewhere.

A third reason, is that I think that if there is the option of rolling out to the private sector, I think on an all-in basis, that also reduces the risk of government interference in the capital markets, either through competition or through policy-directed investment choices. So I think, for those three reasons, allowing individuals to choose to roll into a private sector system, properly regulated, is the better way to go.

The CHAIRMAN. But all would have that choice, would they not?

Mr. GOLDBERG. Yes. I think you might want to require some number of years of participation before you can roll into the private sector, and I think that the investment options in the private sector would have to be regulated. I prefer a diversification and disclosure model of regulation in the private sector, but it is clear that the government would have to impose rules in that regard.

The CHAIRMAN. Dr. Schieber?

Dr. SCHIEBER. In the proposal that I have worked out with Professor John Shoven at Stanford University, we would start off with a limited number of accounts administered through a single recordkeeper. But, after a period of time, there would be a second phase where private vendors would be able to offer investment services to account holders.

There would still be the same kind of regulatory environment and limited number of options. One might end up with a system where a particular vendor would offer six or eight different funds, a bond fund, a money market fund, maybe world indexed funds, and a couple of other index equity funds. But workers would have choice.

Now, you might limit it to workers with a certain balance to deal with the efficiency issues and the concerns about small balances. You would limit people to dealing with one vendor at a time.

I believe, in our economy, we have proven time and time again that choice provides value. I think, if you look at the participation in our 401(k) system, employers have learned that choice provides value. I believe that competitive markets make for better services and they make for price competition.

If you look at the Australian experience, Australia started off their system in 1992. They started off with their accounts operated through employers or through unions. In most of those cases, they were offering a very restricted, and in most cases a single, portfolio.As the system has begun to mature, individuals who are investing want more choice.

They want some directive capability. I think it is exactly the same parallel as we have seen in the 401(k) world here. As people begin to accumulate a substantial amount of money, they want some capability in its direction. So I have tried to structure a system that would continue to be efficient, that would be regulated, but would give people choice.

The CHAIRMAN. Dr. Reischauer, you make a relatively strong case regarding the risks associated with personal retirement accounts. But would personal accounts not guard against another risk, and that is the risk of change to Social Security benefits? I think in your book on Social Security reform you support benefit cuts, increased taxation of benefits. Would personal accounts not help protect against this risk?

Dr. REISCHAUER. I do not agree with that. I agree with Dr. Schieber, who said to make Social Security or our mandatory retirement system whole, we are either going to have to raise taxes or cut spending, that there is no, in a sense, third way.

Professor Feldstein's proposal seemed to avoid that decision because they tap into the budget surpluses. But those budget surpluses have other uses. I think before we move in the direction that has been proposed by those two plans, we really have to answer three very basic questions.

The first of them, is should raising the pensions provided by the Nation's mandatory retirement system above the levels that are currently promised be regarded as a high-priority objective?

Second, if you say yes, you want to know whether that high priority should have first claim on projected budget surpluses, or should we raise other taxes or cut other benefits for that?

Remember, we have Medicare out there, which is arguably a larger and more immediate problem. We have claims on discretionary spending. We have a need to cover the 43 million Americans who lack health insurance. There are other uses for these resources.

Then if you decide you want to move in that direction, I think you have to ask whether using general revenues and budget surpluses to increase future pensions, more in percentage terms for high earners than for low earners, is an appropriate use of those funds. I would answer no to all three of those questions.

The CHAIRMAN. I am going to make a final word to Dr. Feldstein and Dr. Schieber. All right. Senator Moynihan has graciously said to let every comment.

Dr. Feldstein?

Dr. FELDSTEIN. I just wanted to comment on this last point that Bob Reischauer raised about whether you want to use these funds to increase benefits. I think Senator Gramm made a strong case. While you may want to increase benefits, I would say that only a very small fraction of the nine-tenths of a percent of GDP would actually go for increasing benefits.

We are talking about less than $20 billion a year of the amount of money that would be devoted to the increase in future benefits rather than maintaining benefits. I cannot see why Mr. Reischauer and others want to cut benefits for Social Security when it is not necessary to do so.

The CHAIRMAN. Dr. Schieber?

Dr. SCHIEBER. Part of the argument between individual accounts versus staying with the defined benefit system gives the impression that there are significant risks in one model and there is not very much risk in the other model.

I would like to challenge the point about there not being very much risk in the other model, and I would submit to the Chair a table that I brought along. It is looking at the wealth held by people who are on the cusp of retirement. It was developed by Olivia Mitchell and one of her students. She is a professor at the Wharton School at the University of Pennsylvania. I have taken out of her analysis the value of home owners' equity. But I am looking at the remainder of wealth in a group of households where the head was between the ages of 51 and 61 in 1992. They have converted all of their financial assets into a wealth measure so they have comparable values.

Now, when you look at people who are at the bottom tenth point on the wealth distribution, 94 percent of their wealth is held in the form of Social Security. As you move up the wealth distribution, one-third up from the bottom, still two-thirds of their wealth nearly are held in the form of Social Security. When you get to the top tenth, it is about 10 percent.

Now, when we talk about reducing Social Security benefits, I suggest to you that not everyone is facing the same risks here. There are tremendously different risks in terms of Social Security benefit cuts across the wealth distribution.

Somebody at the bottom said, if we raise retirement ages to age 70, if we cut across-the-board COLAs, we could be reducing their retirement income by 25 or 30 percent, where you would be reducing mine by a couple of percent.

I say this is a risky benefit. We are not talking about an environment where there is risk versus one where there is not risk, we are talking about two different kinds of risk. We are talking about diversifying risk.

The CHAIRMAN. Thank you.

Senator Moynihan?

Senator MOYNIHAN. First, thank you, Dr. Schieber. That is a very impressive number.

I would like to suggest, Mr. Chairman and my colleague Senator Gramm, that we are developing a new agenda here, which is the agenda of wealth. As Mr. Beard has so brilliantly stated, the Rand Corporation says that the bottom half of American families own less than two percent of the wealth. After a lifetime of work, half of the Hispanic and African American families do not own a dime.

I think it was you, Secretary Goldberg, who said that the personal retirement accounts will be most beneficial to low-income workers, blue collar, union members, single parents, working mothers, women, and minorities.

I see this as a sequence, as I mentioned a little earlier, that we start with Unemployment Insurance and then we go to retirement benefits, then we go to health benefits, and then we go to wealth creation. The issue of whether the workers are smart enough was around a long time ago.

It was Winston Churchill who moved the unemployment insurance in the liberal government in 1911. All manner of Tory gentle-

men stood opposite and said, the workers will spend it on drink. He said, "Well, it is their money." Indeed, once they got some money, they stopped spending it on drink, in a curious way.

Senator GRAMM. What's wrong with drink? [Laughter.]

Senator MOYNIHAN. A sense of ownership. I will tell just a tale here. Luther Guelick, who was a great professor of Public Administration at Columbia, a member of the Brownlow Commission, a friend of FDR's, was in town here about 1940, and he called on Roosevelt. He said, now, you have got the Social Security system up and running, but it is a pay-as-you-go system.

We have written in law what we are going to pay out. You do not need to keep all of those records by pencil and so forth; it is such a burden. And he wrote this all down, of course.

You could just see President Roosevelt saying, Luther, I am sure you are right on the economics, but, you know, I want every American worker to have a Social Security number of his own so that no damn politician can take it away from him. He was not wrong.

I once wondered what was happening in his later career. I looked up in Who Was Who?, and he was not there. I said, can it be that they never got him into Who Was Who? Then, just by random, I looked up in Who's Who, and there he was, 99 years old, living in a little village on the St. Lawrence River in Upstate New York, and died at 100, which people did, as Fred Mosteller demonstrated statistically years ago.

I would like to ask a question about bequests. Dr. Feldstein has said you could add his bequest into his proposal by raising the contribution rate by four-tenths of a point. Could I just go from Mr. Goldberg over to asking about, do you not think we ought to aspire to a system in which workers will leave some wealth—a bequest it will be theirs to leave?

Mr. GOLDBERG. I think it is essential, Senator, that we move in that direction.

Senator MOYNIHAN. Yes. Dr. Feldstein?

Dr. FELDSTEIN. It has a cost and it has a benefit. I can see the case for doing it. I can see people saying, is that the best use of those extra four-tenths of a percent of payroll costs.

Senator MOYNIHAN. There is an opportunity cost.

Dr. FELDSTEIN. Right. But I can see that it makes it very attractive for people to feel that this money that they have contributed to all of their life will not simply disappear if they die before they reach normal retirement age.

Senator MOYNIHAN. It makes children behave better to their parents. [Laughter.]

Dr. FELDSTEIN. There is a benefit well worth contemplating.

Senator MOYNIHAN. You cannot quantify it.

Dr. FELDSTEIN. And even older children are worth having improved behavior The cost of having a 10-year certain annuity, which a lot of people choose in private plans, so that even though you have annuitized, if you die, you annuitize at age 65, if you die before you are 75, the annuity continues until you are 75.

Senator MOYNIHAN. Yes.

Dr. FELDSTEIN. Very low cost. Very low cost.

Senator MOYNIHAN. Mr. Beard?

Mr. BEARD. Senator, I had the privilege to be born in New York. It happens to be a State you are quite familiar with. I worked with Bobby Kennedy in Bedford-Stuyvesant. So my whole thrust was to create wealth.

I wanted to cut everybody into a chance to own a stake in the economic growth of the country. I only got backwards into Social Security once I understood that 57 percent of Americans earned the $18,000 or less. So the whole goal that I want to raise is this wealth issue.

I think once you reach retirement age, and now you have a substantial nest egg, I think the worker should have the choice. You could buy an annuity.

Senator MOYNIHAN. But you could have a bequest.

Mr. BEARD. But you could also live off the income—let us assume that is a 5 percent rate of return—if you chose to leave all of it to your children.

Senator MOYNIHAN. To pass it on. Fine. Well, I think I know what Dr. Schieber and Dr. Reischauer think, so thank you very much.

Thank you, Mr. Chairman.

The CHAIRMAN. I will now turn to our resident economist, Senator Gramm.

Senator GRAMM. Well, thank you, Mr. Chairman. I think we ought to just write the plan with the eight people we have got here around the table. When you go through, I would have to say maybe there is something strange about me instead of the problem, but as you look at this thing more closely, it gets simpler, not more complicated. And it seems to me you can boil the whole debate now down to a handful of questions, really four questions.

Number one, do you want to slash benefits and raise taxes, or do you want to bring in the power of wealth creation and what Einstein called the most powerful force in the universe, the power of compound interest, to help at least pay for some of these benefits? The good news is, everybody at the table says you ought to do the latter. That is a dramatic change over the last two or 3 years. A dramatic change. It encourages me.

The second question is really two parts: who should do the investing is part A, and who should own the investments is Part B. Every one of them say the same thing on Part A, it ought to be professional money managers, and that the choice that the worker ought to have, if the worker owns it, is in choosing the professional money manager. If the government owns it, they ought to choose the professional money managers. So there is no disagreement whatsoever on who ought to do the investing: professional money managers.

By the way, let me say with regard to knowing what a stock is or what a bond is, I do not understand internal combustion engines either, but I got to work today with one. [Laughter.]

The second part of that question is, who ought to own the investments?

Dr. REISCHAUER. I will bet you have two cars.

Senator GRAMM. Yes, I do have two cars, and they have garages. I go get them to fix it if they break down.

Who ought to own the accounts? Four out of the five people say that it ought to be owned by the worker, one says it ought to be owned by the government.

The next question is where you have got some real differences. The question is, should you build the investment accounts into the existing system and capture the wealth creating part of it, or should you have two systems, the new accounts and then cut benefits in the old account, not only to keep it solvent, but to pay for the new accounts and then sort of hope that the benefits of the new investments will offset, or almost offset, or largely offset the cuts that you have got to make?

The problem is, they never match up. The big beneficiaries of the new accounts are young people. When you change spousal benefits beginning in the year 2000, you are affecting people right now that do not have time really to get into the account. So at least I think the answer to question three is pretty simple.

Many of these plans were written at different times when the surplus was quite different. But, given the size of the surplus now, it seems to me building the two into a joint plan so you do not have to pick and choose among winners and losers is probably the right way to go.

Question four, is what do you do with a $1.7 trillion of Social Security that we have got in the next 10 years? Now, the President says we will use it to buy down debt and issue a paper IOU to Social Security, which I think everybody here pretty much agrees, and most people now basically agree, that that IOU may have some moral suasion on Congress, but it does not pay any bills. You still have got to raise taxes, cut spending, or borrow money. So I think everybody here would say to use the $1.7 trillion to invest and create wealth, however they might differ on other things.

The point I am trying to make, Mr. Chairman, is we are not very far apart on a very important idea. But the thing that does worry me a little, is that people do not tend to take into account how time sensitive this all is. If we started today with an investment program and we used 3 percent instead of two, there is nothing magic about it.

In fact, under the new numbers which I just ran yesterday with the newest estimate of the surplus—and I think you will be shocked by this—just using the Social Security surplus, people under 40 could invest 3 percent of wages and people over 40 could invest 5 percent of wages. That is how much money you have got in the surplus today. Very different than when many of these plans were written two or 3 years ago. Very different.

But the point is, if we started this program today with a 3 percent—pick a middle number—the first baby boomers could pay about 10 percent of their benefits from the investments they made. That is, the first baby boomers that would retire. Then 10 years later, the last baby boomers could pay about 50 percent of the benefits that they get from the investments.

The problem is, if you wait two or 3 years it makes a tremendous difference to the economics of all of this stuff. Every day we wait to do something on this issue is more of a commitment on our part to raise taxes and cut benefits in the future.

So I guess my point, Mr. Chairman, with no questions and just a bunch of statements, is we are not really very far apart. I mean, you have got five of the smartest people who have studied this thing the longest and that represent a full range of views, and they really, on four questions, differ on one-half of one question. So I wish we could go ahead and do the bill while we are together here before we go to lunch at 12:30. Thank you.

The CHAIRMAN. Thank you, Senator Gramm. I will count on your help as we proceed with this most important problem.

I want to say how much we appreciate all five of you being here. It has been an excellent panel. There is a lot of consensus. It does give me hope that we can move ahead, and we will certainly count upon your advice in the future. Thank you very much.

Senator MOYNIHAN. Thank you, gentlemen.

The CHAIRMAN. The committee is in recess.

[Whereupon, at 12:25 p.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted for the Record

Prepared Statement of Sam Beard

Thank you so much for inviting me to testify today. I would like to begin by praising Senator Roth. Your leadership, Mr. Chairman, has created a nationwide focus on savings. Roth IRAs has opened savings and wealth to millions of Americans—an accomplishment which provides the framework for discussing Social Security. The Federal Thrift Savings Plan, IRAs, 401(k)s, mutual funds and private pensions have allowed millions of small investors to become stakeholders and owners in America's economic prosperity. Social Security can offer the same opportunity to all Americans.

Most of us will agree that it is time to fix Social Security. I come to the fix-Social-Security-table from a different perspective: America's economic prosperity in the 21st century will be defined by our ability to shrink the gap between rich and poor in America and retain economic opportunity for middle class working men and women.

I put this in the context of why Social Security itself was created: Early in this century, poverty among seniors was a defining social problem. To address it, we created Social Security. Today's parallel defining social problem is the growing disparity between the rich, the middle class and the poor. More than half of American workers live paycheck to paycheck. After paying their bills, most have no disposable income left for savings.

By contrast, twenty five percent of Americans are defined by their ownership of capital and savings. Money is an economic tool which should be open to all Americans. There are two sources of income: Income from wages (I get a job and I get paid) and income from savings. One third of all income comes from savings. Money makes money. Social Security provides the only major resource in letting money make money for everyone. Fifty-seven percent of American workers earn $18,000 a year or less. The $18,000 worker pays $2,232 to Social Security, and most have no extra money for savings. But, through these existing payroll taxes, all Americans are huge "savers."

The debate over adding Personal Retirement Accounts to Social Security focuses on whether these accounts will weaken or strengthen the future Social Security system as well as our essential guarantee of a decent retirement income for all. Personal Retirement Accounts actually strengthen our ability to pay future benefits and preserve the safety net. It is important to note that for every dollar individuals accumulate in their Personal Retirement Account, the future liability that Social Security faces is lessened.

There are two different approaches for building Personal Retirement Accounts:

Option One: Use current surpluses. Preserve the basic Social Security structure and maintain the current payroll tax at 12.4 percent. Add Personal Retirement Accounts on top of the guarantee. This approach would invest $30 to $60 billion a year, or 1–2 percent of payroll in Personal Retirement Accounts. Such incrementalism has great merits. The wiser path is often the slower one. By testing and making adjustments, expand the accounts only if the model works and gains acceptance by the American public. Since many serious leaders oppose Personal Retirement Accounts as a part of the existing payroll tax, let experience and the American public decide future policy.

Option Two: Start bigger. Address the entire Social Security problem head-on while we can still afford it. Implement policies today that surmount the entitlement hurdle—save Social Security and maintain future economic growth. Invest between $90 and $120 billion a year or 3–4 percent of payroll in Personal Retirement Ac-

counts. This policy option requires what FDR called "bold, persistent experimentation."

This is an economic growth agenda, restoring the savings leg to retirement security and creating an opportunity to double Social Security benefits for two-thirds of future retirees.

The prospect of finding 3–4 percent of payroll brings me to one of the major focal points in the Social Security debate: Where will Congress find the money to fund Personal Retirement Accounts, while preserving benefits to current seniors and a strong safety net for all Social Security recipients today and in the future?

First, there are no easy choices. However, the toughest choice results from doing nothing. The future economic prosperity of the United States and of all our citizens will be worse under this option. If we wait, entitlement deficits will threaten our future economic growth.

The January 1999 Congressional Budget Office report, "The Economic and Budget Outlook: Fiscal Years 2000–2009" reports with clarity that entitlement spending left unchecked seriously threatens our future economy. The CBO report shows that if tax cuts or spending increases eliminate the surpluses projected for the next ten years, federal debt will rise to $33 trillion or 100% of GDP by 2033; $86.4 trillion or 200% of GDP by 2040; and $225.9 trillion or 260% of GDP by 2043. This won't happen, but this is the major entitlement hurdle which we need to overcome beginning today.

I had the benefit of entering the Social Security debate in 1994 with no expertise in Social Security. As a result, I sought creative financing instruments so my numbers would work. I refused to stop until Steve Goss would sign off on my "system." The debate has moved quite a bit forward since then, with many plans that pave the way for reform.

These plans demonstrate how to work within the boundaries of the existing Social Security system and find the first 2 percent of payroll. They adjust bend points, index the Normal Retirement Age, adjust CPI inflation rates and slow calculations for 'real wage' growth. Do not be fooled by any plan that purports to make no tough choices. It is important not to jeopardize a dime of benefits to the disabled, to survivors or to low-income recipients. It is both feasible and imperative to keep progressive safety net promises.

To find the next 1–2 percent of wage requires creativity.

The projected Social Security surpluses can be helpful. Be careful. The actual cash surplus is only $55 billion per year and disappears in 2012. It does not exceed a total of $600 billion. The other half of the Social Security surpluses are attributed interest payments on the Trust Fund—money that has already been spent. This is a debt—an I.O.U. from the government viewpoint and not a spendable surplus.

I submit two ideas related to voluntary savings matches:

The first is worth $70 billion per year. The second is worth $30 to $40 billion per year.

Savings Match #1: The first is simple, but powerful. Offer a choice to all Americans: Choose to stay within a reduced pay-as-you-go system which will deliver the benefits it can afford at the existing 12.4% of payroll. Or, choose a remodeled system with Personal Retirement Accounts. Use Social Security surpluses and selected benefit cuts to allow 2% of wage to be invested in the accounts. To participate, individuals must voluntarily match, dollar-for-dollar on a progressive scale, the government savings match. Experience with employer-based 401(k) plans indicates that 75–80% of employees, including low, middle and high income workers, select the savings match. For lower income workers, surpluses can enhance the match. This choice increases the accounts to 4% of payroll and adds $70 billion per year to remodel Social Security.

Savings Match #2: The second voluntary savings match idea is also simple. It adds an estimated $35 to $40 billion in voluntary savings to Social Security. Offer workers a flat set-aside into their individual savings accounts. Assume $100 for lower income workers earning $10,000 to $15,000; $300 for moderate income workers earning $30,000, and $400 for higher income workers earning $40,000 and over. If lower income workers voluntarily agree to create a personal savings match of $2 per week, they will receive an additional $200 in their account. If moderate income workers voluntarily add a personal savings match of $6 per week, they will receive an additional $300 into their account. For higher income workers, if they voluntarily add $20 per week, they receive an additional $600 into their account.

With these savings matches, lower income workers set aside $400 per year, moderate income workers $900 per year, and higher income workers are setting aside $2,000 per year. Upon retirement, promised Social Security benefits are reduced, offset by the income from the principal. This cuts the tax dependence on future

workers, helps make Social Security solvent, and creates substantial nest eggs on a progressive basis for all Americans.

Government-issued bonds have historically been proven an effective tool in financing economic growth.

Liberty Bonds. On a voluntary basis, use the tax code to attract higher income seniors to defer their Social Security benefits. This can save $15 to $30 billion per year to finance up-front the funded accounts. Why will higher income seniors agree to defer their Social Security benefits? Be creative and use the tax code. Most higher income seniors are financially prepared for their retirement through savings and existing pensions. Allow them to transfer the $15,000–$16,000 per year they would receive from Social Security to go tax-free—beyond federal estate taxes—to their heirs. Create a Liberty Bond—a 30-year bond, with accumulated interest to benefit their heirs.

Special Issue Equity Right (ER) Bonds. Use the example of World War II, where the government issued E-Bonds to pay for War expenses, with the understanding that they would be paid back after the War. Do the same with Social Security. Authorize Social Security to issue special purpose zero-coupon bonds to strengthen the Trust Fund and to assist in underwriting the transition. Social Security will realize substantial future surplus revenues in a funded system. In future years, a large portion of Social Security benefits will be paid through Personal Retirement Accounts. At this point, we will be able to pay back these bonds.

Use the example of state budgets for use of extra unexpected annual revenues.

"Lockbox" a portion of expected future federal revenues. Another creative option would be to "lockbox" a portion of expected future federal revenues. The assumption is that increased savings in the Personal Retirement Accounts will generate economic growth. As a result, the federal government will receive revenues beyond existing constant dollar expenditures. Up front, commit half of these revenues to strengthening Social Security. This law exists in 30 states—State Tax and Expenditure Limits (TELS). States agree in advance not to spend a portion of unexpected extra revenue. These monies are set aside for special purposes.

Under a funded system, Social Security benefits will be paid through these Personal Retirement Accounts, and ultimately, lower the dependence on excessive payroll taxes on future generations under the outdated pay-as-you-go system.

Once the Personal Retirement Accounts begin to gain interest and grow substantial savings, Social Security benefits increasingly will be paid by the income from the Personal Retirement Accounts. As each dollar of benefits is paid from the Personal Retirement Accounts, reduce the pay-as-you-go current law benefit by 75 cents.

If we think creatively—we can find the means to build meaningful Personal Retirement Accounts for all Americans and at the same time meet our obligations to existing seniors, without entitlement spending crippling our economy of future standard of living.

The issue here is opportunity, not obstacles. We can surmount any obstacle, especially in today's economic climate. We have a tremendous opportunity, through Social Security, to extend the Roth IRA model to every working American. Once we agree on principles and a direction, it is possible to achieve anything.

Prepared Statement of Martin Feldstein

Summary: Combining an investment based system of Personal Retirement Accounts with the traditional tax-financed Social Security can eliminate the need for any increase in the payroll tax or decrease in Social Security benefits. The required PRA deposits of 2.3 % of covered earnings could be financed by the projected budget surpluses and by the future increases in corporate tax revenue that result from PRA saving.

The Problem of Increasing Social Security Costs

Under current law, Social Security benefits (OASDI) will rise from about 12% of covered payroll now to about 18% in 2030 (and will then keep rising).

The cause of this rise is increasing life expectancy, not just the baby boomers. The proportion of the population over age 65 will rise from 12 percent now to 20 percent in 2030.

The tax increase or the reduction in retirement incomes that would be inevitable with the current "pay as you go" system could be avoided completely by shifting in part to an investment-based system.

The projected budget surpluses provide an opportunity to do this without imposing new burdens on current employees or reducing benefits of retirees.

Investing Retirement Funds in Stocks and Bonds

A large number of American employees now invest in stocks and bonds through IRAs and 401k plans.

The idea of combining traditional pay-as-you-go Social Security with investment-based individual accounts was supported by a majority of the 1996 Quadrennial Social Security Advisory Council.

Many countries around the world have adopted such systems, including the UK, Australia, Sweden, Italy and several in Latin America.

These plans all feature increased national saving, invested in financial assets through individual accounts.

A Personal Retirement Account (PRA) Plan[1]

The government would put 2.3 percent of last year's taxable wage (up to the Social Security maximum, now $72,600) into a new Personal Retirement Account that individuals could invest in stock and bond mutual funds.

In effect, the individual gets a tax cut of 2.3 percent of payroll (up to $1757), with the tax cut deposited in the PRA. The PRA deposit is thus free to the individual.

The PRA deposits cost about 0.9% of GDP and can be financed with the projected budget surpluses.(CBO projects surpluses of 1.4% in 2000, 2.8% in 2009 and more than one percent until after 2020). Eventually the extra corporate tax revenue resulting from additional capital accumulation could finance the PRA deposits.

Combining the PRA and Traditional Social Security Benefits

When the individual reaches retirement age, the PRA balance is used to finance an annuity based on stock-bond investments.

The individual receives a combination of traditional tax-financed Social Security benefits and of the PRA annuity. The combination is guaranteed to be at least as large as the benefits projected by current law.

More specifically, the government pays each retiree the amount specified in current law reduced by 75 percent of the individual's PRA annuity.

If current law benefits are $1000 and the PRA annuity is $600, the individual gets $1150 but the cost to Social Security is only $550.

What a 2.3 percent of payroll PRA means for future Social Security financing

A portfolio of 60 percent stocks and 40 percent bonds earned a real 5.9 percent from 1946 through 1995. Subtracting administrative costs of 0.4 percent leaves a usable real return of 5.5 percent.

Using calculations based on demographic and economic projections of Social Security Administration, and assuming the 5.5 percent real return implies:

By 2030, PRA annuities would be 2.5% of payroll, reducing the required payroll tax by 1.91 percent of payroll.

By 2050, PRA annuities would be 7.7 % of payroll, reducing the required payroll tax by 5.74 percent of payroll.

By 2075, PRA annuities would be 10.7 % of payroll, reducing the required tax by 8.03 percent of payroll, from the projected 19.8 percent to 11.8 percent.

Would the PRA accumulation raise national saving?

Yes, if the projected budget surpluses would otherwise be used to increase government spending or to finance tax cuts that cause household spending to rise.

If the projected surpluses would otherwise be used exclusively to reduce the national debt, the PRA plan would have no direct effect on national saving.

[1] More details about this plan are provided in the attached paper, "Maintaining Social Security Benefits and Tax Rates through Personal Retirement Accounts: An Update Based on the 1998 Social Security Trustees Report" by Martin Feldstein and Andrew Samwick.

Table 1

Effects of PRA Deposits and Annuities on Social Security Outlays

	PRA Deposits ($ Billion*) (1)	PRA Annuities ($ Billion*) (2)	PRA Annuities (% of Earnings**) (3)	Social Security Outlay Reductions (% of Earnings**) (4)	Social Security Trust Fund (% of Earnings)
2000	81.15	0.00	0.00	0.00	25.45
2010	94.21	5.87	0.14	0.10	41.33
2020	106.05	40.88	0.89	0.67	43.85
2030	116.78	129.11	2.54	1.90	25.31
2040	130.66	273.01	4.80	3.60	4.36
2050	144.62	481.27	7.65	5.74	3.13
2060	159.23	690.07	9.97	7.48	19.38
2075	184.16	857.01	10.71	8.03	55.16

*Billions of dollars at the 1998 price level
** Percentage of Aggregate Covered Earnings

Table 2

PRA Assets and Increases in GDP and Corporate Tax Revenue

	PRA Assets ($ Billion*) (1)	PRA Assets % of GDP** (2)	GDP Increase $ Billion* (3)	GDP Increase % of GDP** (4)	Corporate Tax Increase $ Billion* (5)	Corporate Tax Increase % of GDP** (6)
2010	1239.7	12.1	105.3	1.03	26.3	0.26
2020	3140.8	27.2	266.9	2.31	66.7	0.58
2030	5728.4	45.1	486.9	3.84	121.7	0.96
2040	8679.7	61.1	737.8	5.19	184.4	1.30
2050	11542.2	73.4	981.1	6.24	245.3	1.56
2060	13722.0	79.3	1166.4	6.74	291.6	1.68
2075	16001.1	79.9	1360.1	6.79	340.0	1.69

* Billions of 1998 Dollars
** Percent of Baseline GDP forecasts

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SUMMARY

MAINTAINING SOCIAL SECURITY BENEFITS AND TAX RATES THROUGH PERSONAL RETIREMENT ACCOUNTS:

AN UPDATE BASED ON THE 1998 SOCIAL SECURITY TRUSTEES REPORT

Martin Feldstein,
Andrew Samwick,
Harvard University and NBER,
Dartmouth College and NBER

A program of Personal Retirement Accounts (PRAs) funded by deposits equal to 2.3 percent of earnings (up to the Social Security maximum) would permit retirees to receive more income in retirement than with the current Social Security program while at the same time making it unnecessary to increase the 12.4 percent payroll

tax in response to the aging of the population. The gross cost of these deposits, approximately 0.9 percent of GDP, could be financed for more than a decade out of the budget surpluses currently projected by the Congressional Budget Office.

By the year 2030, the additional corporate tax revenue that results from the enlarged capital stock financed by PRA assets would be able to finance fully these personal tax credits. During the intervening years (about 2020 to 2030), a reduction of other government spending or an increase in taxes would be needed if budget deficits are to be avoided.

If implemented, the PRA program would not only increase retirement income and stabilize the Social Security payroll tax, but would also substantially increase national saving and GDP.

March 1, 1999

Maintaining Social Security Benefits and Tax Rates through Personal Retirement Accounts: An Update Based on the 1998 Social Security Trustees Report*

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March 1, 1999

*This paper updates the simulations in our article, "Two Percent Personal Retirement Accounts: Their Potential Effects on Social Security Tax Rates and National Saving," (*Tax Notes* (May 4, 1998): 615-620; also NBER Working Paper 6540), to match the assumptions in the 1998 Social Security Trustees Report. We are grateful to Gary Burtless, Elena Ranguelova, Steve Zeldes, and participants at the twentieth annual APPAM conference for helpful suggestions. Any errors are our own.

MAINTAINING SOCIAL SECURITY BENEFITS AND TAX RATES THROUGH PERSONAL RETIREMENT ACCOUNTS:

AN UPDATE BASED ON THE 1998 SOCIAL SECURITY TRUSTEES REPORT

Martin Feldstein,
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Combining the existing pay-as-you-go unfunded Social Security system with a modest program of investment-based individual accounts can eliminate the need for any future increases in the payroll tax rate while also providing a higher level of retirement income than is implied by the existing Social Security law. In contrast, continuing the existing pay-as-you-go (PAYGO) system alone would require permanently raising the Social Security payroll tax rate (for retirement, survivor and disability benefits) from the current 12.4 percent to more than 18 percent, according to the Social Security actuaries.

This article analyzes a specific proposal[1] to create Personal Retirement Accounts (PRAs) in which 2.3 percent of each individual's earnings (up to the Social Security earnings limit, no $72,600) would be deposited.[2] In effect, the individual would receive a tax cut equal to 2.3 percent of earnings on the condition that the tax cut is saved in a Personal Retirement Account.[3]

These PRA funds would be invested in mutual funds chosen by each individual just as IRA and 401(k) deposits are today.[4] Although we originally discussed a plan involving deposits by each individual to his or her PRA account financed by a refundable tax credit, it would be administratively simpler and less costly for the government to send funds directly to fund managers to credit to individual accounts.[5]

When the individual reaches retirement age and withdraws payments from his or her PRA, the individual's Social Security benefit in that year would be reduced by 75 cents for every dollar of PRA withdrawal.[6] The individual would therefore have a combined benefit that is equal to the full amount of the Social Security benefit in current law plus 25 percent of the PRA annuity. Every retiree would therefore receive more than the benefits promised in current law. With the historic rate of return on a conservatively invested PRA account (60 percent in stocks and 40 percent in bonds), this plan would be sufficient to prevent the Social Security trust fund from being exhausted (as it would be in 2032 with the existing pure PAYGO system) and would permit the current 12.4 percent payroll tax rate to continue indefinitely without any increase.[7]

Because the earnings base to which the credit would apply is equal to about 40 percent of GDP, the 2.3 percent tax credit is equal to approximately 0.9 percent of GDP, less than the currently projected budget surpluses. When the projected budget surpluses end after about the year 2020, a portion of the 0.9 percent of GDP would temporarily have to be financed by new tax revenue or reduced government spend-

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[1] See Martin Feldstein, "Don't Waste the Budget Surplus," *The Wall Street Journal* November 4, 1997; Martin Feldstein, "Let's Really Save Social Security," *The Wall Street Journal* February 10, 1998; and Martin Feldstein, "Savings Grace," *The New Republic*, April 6, 1998. These articles can be found at www.nber.org/~msfeldst. Several related proposals to use the budget surplus to finance personal retirement accounts have recently been discussed by Congressional leaders including Bill Archer, Pete Domenici, Phil Gramm, Judd Gregg, John Kasich, Bob Kerrey, Daniel Patrick Moynihan and Bill Roth.

[2] In the original version of this paper, Feldstein and Samwick (1998), PRA contributions of 2 percent of payroll were sufficient to restore solvency to the system. That paper was based on the forecasts in the 1995 Social Security Trustees Report. As a result of changes in forecasted revenues in the 1998 Trustees Report (principally, greater near-term wage growth relative to long-term wage growth), the required PRA contribution is now 2.3 percent of payroll to avoid a zero balance in the Trust Fund. As a consequence of the higher PRA contribution rate, there is also a substantially larger Trust Fund available in the final years of the simulation.

[3] The deposits to individual accounts could in principle be some combination of an equal lump sum amount for everyone and a proportion of earnings less than 2.3 percent. Our calculations reflect only the fact that the aggregate deposits are equal to 2.3 percent of aggregate earnings. Using a lump sum would make the distribution more favorable to low income earners but would not have the same favorable effect on reducing the marginal tax rate.

[4] The government might impose more stringent regulations, requiring for example that the funds be invested in diversified mutual funds or bank deposits. A government fund similar to the Federal Employees Thrift Saving Plan might be available as a "default" option for those who do not make another choice.

[5] See Goldberg and Graetz (1999) for a discussion of ways to minimize administrative costs associated with personal retirement accounts.

[6] Because individuals' net retirement income therefore increased by only 25 percent of the value of the accumulated PRA assets, individuals may be tempted to make riskier portfolio choices than they otherwise would have made. While this may help to offset the extremely conservative investment strategies that have characterized many IRA and 401k investors, the possibility of excess risk taking suggests that the proper regulation of investment options in the new accounts deserves careful attention. As a starting point, any benefit guarantees could be based on the investment performance that would have been achieved had the individuals invested in a standard plan (e.g., 60 percent in a broad equity index and 40 percent in a corporate bond fund), rather than their chosen plans.

[7] Preserving the solvency of the Social Security system without any tax rate increase could also be achieved with a 50 percent offset (instead of the 75 percent offset) if some other change in benefits (like a future change in inflation indexing) was also made.

ing until about the year 2030 when the PRA plan itself would generate a sufficient budget surplus to be self-financing. We return to this budget arithmetic below.

The simple accounting calculations that underlie these statements are the subject of the present article. We begin by describing briefly the assumptions on which the calculations are based. We then report the evolution of aggregate PRA deposits and withdrawals and the consequent effects on the Social Security payouts, tax rates and trust fund balances. The analysis assumes no change in the gross Social Security benefits (i.e., the benefits before the offsets in response to PRA withdrawals). We also present estimates of the effects of the PRA program on national saving, on the level of gross domestic product (GDP), and on the government budget.

1. The Social Security Simulation Model[8]

The estimates presented in this paper use an accounting model developed in the course of our research in a broader National Bureau of Economic Research project on Social Security reform.[9] This model is calibrated so that with the current Social Security rules it closely approximates the basic time series of benefits, revenues, and trust fund assets predicted in the *1998 Social Security Trustees Report*.

The unit of analysis in these simulations is the individual. Benefits for spouses and survivors, as well as disability benefits, are subsumed in the individual benefit projections.

We incorporate the actual current age structure of the population, the Census Bureau projections of future births through 2050, and the projected cohort specific life tables for individuals born through that year. To reflect the net inflow of immigrants, we scale up the projected population at every age to coincide with the aggregate projections of the Social Security Administration.

The simulations simplify by assuming that individuals enter the labor force at age 21 and work until the year before they attain the Social Security normal retirement age legislated for their birth cohort (or death if that occurs sooner). The normal retirement age is currently 65 but will soon begin increasing gradually to 67. Since not everyone in the population actually works during those years, we adjust the labor force participation rate to obtain the number of covered workers in each year specified in the Social Security Administration projections.

We use the historic data for Social Security taxable payroll in years before 1998 and follow the forecast for taxable payroll based on the intermediate assumptions in the *1998 Social Security Trustees Report* for subsequent years. According to that forecast, the average real wage rises at 0.9 percent per year in the long term. The movements in the average real wage are assumed to reflect changes in the age structure of the labor force and differences among age groups in the rate of increase of wages as well as the overall rate of increase of age specific wage rates.

The investments in the Personal Retirement Accounts are assumed to earn a real rate of return of 5.5 percent after inflation. The average return on a portfolio invested 60 percent in the Standard and Poor's 500 portfolio of common stock and 40 percent in a portfolio of corporate bonds during the postwar period through 1995 achieved a return of 5.9 percent.[10] We deduct 0.4 percent per year to reflect the administrative costs of PRAs. Note that 5.9 percent is the return after the payment of corporate and property taxes. The full rate of return earned before all taxes during this same period was about 8.5 percent (Poterba, 1998). We return below to the implications of the taxes collected on incremental capital but not included in the return earned on PRA accounts. We follow the Social Security Trustees in assuming that the real return on the Social Security trust fund will decline gradually from the current level to a 2.8 percent real interest rate in the future.

Because we are interested in total benefit payments and not in their distribution by income and family type, we base our calculations on average taxable earnings in each year and do not distinguish income levels or family structures. Although we therefore cannot apply the actual Social Security benefit rules, we can calculate aggregate average benefits by attributing an implicit rate of return on the taxes paid by individuals in each birth cohort.(12) The cohort specific rates of return are estimated in a way that produces the same aggregate benefit amounts that the Social Security Trustees project for future years on the basis of current law.

2. Personal Retirement Account Deposits and Benefits

Our analysis assumes that the Personal Retirement Account (PRA) deposits begin with the year 2000. The PRA deposits in that year are projected to be $81.2 billion

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[8] Readers who want to go directly to the results of the analysis can skip this section. Those who want more details about the simulations should consult Feldstein and Samwick (1997).

[9] For more information on the model, see Feldstein and Samwick (1997).

[10] Including the more recent period would increase this rate of return.

(at the 1998 price level). The deposited amounts increase over time as earnings grow, reaching $94.2 billion in 2010, $116.8 billion in 2030, $144.6 billion in 2050 and $175.6 billion in 2070, the final year of our analysis. All of these amounts are in 1998 dollars. These figures are shown in column 1 of Table 1.

We assume that individuals receive payments from their PRAs at their normal retirement ages in the form of an annuity that earns the same 5.5 percent real rate of return. The first annuities are paid to the individuals who become 65 in the year 2001 and total only $80 million.[12] Total annuities grow rapidly, reaching $1.3 billion in 2005, $5.9 billion in 2010, $129.1 billion in 2030 and $826.0 billion in 2070, all in 1998 dollars. These figures and the amounts for selected intervening years are shown in column 2 of Table 1. The rapid rise in the annuity amounts reflect increases in the number of annuitants and rapid increases in the average annuity amount, which in turn reflects the increased number of years of PRA contributions.

These annuity withdrawals are shown in column 3 of Table 1 as a percent of the covered earnings of all individuals in each of the selected years. This amount rises from 0.14 percent of covered earnings in 2010 to 2.54 percent in 2030, 7.65 percent in 2050 and 10.82 percent in 2070. Each dollar of annuity that retirees receive reduces their regular Social Security benefits by 75 cents. Even with this Social Security benefit reduction the retirees are better off than they would have been without the PRA program. Their original PRA deposits were completely financed by dollar-for-dollar tax credits (making the deposit essentially free to the individual) while the individual's net retirement income increases by 25 percent of the annuity amount.[13] The projected reductions in Social Security outlays as a percentage of covered earnings are shown in column 4 of Table 1.

Note first that in the long run (i.e., in the year 2070) the reduction in Social Security outlays is 8.11 percent of total covered earnings, i.e., three-fourths of the 10.82 percent of earnings that annuities are projected to be in that year. Since the payroll tax rate required in a pure pay-as-you-go system with the current relation of benefits to past earnings (i.e., with no change in the current system) would be 18.70 percent in 2070, the reduction in benefit outlays of 8.11 percent of earnings reduces the amount to be financed by a pay-as-you-go tax to 10.59 percent of earnings. This figure is 1.8 percent of earnings less than the current 12.4 percent tax rate, suggesting that the PRA contribution can be lowered in the latter part of the simulation. It is set as high as 2.3 percent so that, during the early years, sufficient PRAs are accumulated to accommodate the rapid retirement of the Baby Boom generation. In later years, the 2.3 percent PRA contribution could be reduced; if it is maintained, the pay-as-you-go tax rate could be lowered from 12.4 percent.

The evolution of the Social Security trust fund itself is traced in column 5 of Table 1. In the early years, the trust fund grows because the sum of the pay-as-you-go tax rate and the interest on the existing trust fund (at the 2.8 percent real rate projected by the Social Security Trustees) exceeds the cost of the gross Social Security benefits (i.e., before any offsetting reductions) expressed as a percentage of earnings. The impact of the reductions in Social Security outlays in response to the PRA annuities is shown in column 4 of Table 1. This reduction of Social Security outlays is virtually irrelevant in the early decades of the program. But by 2030, when the Social Security trust fund would be nearly exhausted under current law, the 75 percent offsetting reductions have added a cumulative amount of $797 billion (again at 1998 prices) to the trust fund. These net additions, plus the resulting increase in the trust fund=s interest income, raise the trust fund in 2030 to $1285 billion or 25.32 percent of taxable earnings.

Note that even with the reduced benefit outlays the trust fund does decline from its peak in 2018. But the decline does not cause the trust fund to be exhausted because the reduction in Social Security outlays, shown in column 4 of Table 1, continue to grow in relative terms. This slows the decline of the trust fund and permits it to be an increasing share of earnings in the long-run if the pay-as-you-go tax rate is maintained at 12.4 percent.

If the benefit offset rate were less than 75 percent, the pay-as-you-go tax rate required in the long-run to finance the net benefits would be greater than 12.4 percent. For example, with a 50 percent benefit offset rate, the pay-as-you-go tax rate

[12] In practice, the program might require a minimum of, say, five years of deposits to avoid very small annual payments.

[13] In reality, the return of PRA accounts is uncertain and some individuals will earn more than a 5.5 percent return while others earn less. Individuals who had higher returns would have a higher combined PRA-plus-Social Security income than those with lower rates of return. All retirees would be better off than they would have been with Social Security alone. For simulations of a PRA programs that incorporate risk more explicitly, see Feldstein and Ranguelova (1998) and Feldstein, Ranguelova, and Samwick (1999).

can be maintained at 12.4 percent with a PRA contribution rate at 3.5 percent rather than 2.3 percent.

3. National Saving and Increased GDP

PRAs would increase national saving and capital accumulation. Unlike other tax cuts that might be financed with the projected budget surpluses, the PRA tax credits would be added to national saving.[14] Although some individuals might be tempted to reduce other saving in response to this new form of accumulation, the vast majority of Americans have too little in financial assets to do any such offsetting. In any case, the 75 percent benefit offset implies that 75 percent of the PRA balance "belongs" to the government and only 25 percent of the assets in the PRA accounts are net wealth of the individuals. Even if individuals reduced other saving by the full amount of their share of the PRA deposits (i.e., 25 percent of total PRA deposits), the growth of the nation's net capital stock would be substantially greater than it would otherwise have been. This section reports results under the assumption that the nation's capital stock increases by the full growth of the assets in PRA accounts; readers who believe that individuals would reduce their other saving can decrease these amounts by up to one-fourth of the total value.[15]

The aggregate value of the assets in the PRA accounts grows over time because of the difference between the PRA deposits and the annuity withdrawals. The primary source of the increase after the early years is, however, the 5.5 percent return that is earned on the net assets in the PRA accounts.

The magnitude of the PRA deposits and annuity withdrawals are shown in columns 1 and 2 of Table 1. The resulting growth of the PRA assets is shown in column 1 of table 2. These assets grow from $81 billion in the year 2000 (the first year of the program) to $1240 billion in 2010. By the year 2020, the assets are $3.1 trillion and by 2040, they are $8.7 trillion. These amounts are all in 1998 dollars. To put these numbers in perspective, they are expressed in column 2 as a percentage of the projected GDP. The ratio of assets to GDP rises from 12.0 percent in 2010 to 26.6 percent in 2020 and 57.3 percent in 2040.

What is the impact of this asset accumulation on economic growth and GDP? An increase in the PRA assets raises gross domestic product because the incremental capital that those assets represent earns a substantial rate of return. Using the 8.5 percent real rate of return on nonfinancial corporate capital that the United States has experienced during the past half century[16] implies that real GDP is increased by $105 billion in 2010 (i.e., 8.5 percent of the $1,240 billion increase in assets), by $267 billion in 2020 and by $738 billion in 2040. These figures are shown in column 3 of Table 2 and are expressed as percentages of the baseline projected GDP in column 4. These calculations imply that the PRA program raises real GDP by 2.3 percent in 2020, by 4.9 percent in 2040 and by 6.0 percent at the end of the 70 year forecast period. This is equivalent to an increase in the real rate of growth of about 0.08 per cent per year for 70 years.[17]

4. The Budget Impact

As we noted earlier, the taxable earnings on which the 2.3 percent PRA savings are based are currently equal to 40 percent of GDP. The PRA deposits therefore have a budget cost equal to 0.92 percent of GDP. The Congressional Budget Office now projects that the budget surplus will average 2.2 percent of GDP from 2000 to 2009 (the last year of their official budget forecast) when it will reach 2.8 percent

[14] We assume that in the absence of the PRA program the government would use the projected budget surpluses to finance various tax cuts and spending increases, bringing the economy back to budget balance. If the government used the entire budget surplus to retire existing national debt, the national saving rate would rise by an equal amount.

[15] Some readers may believe that individuals will be stimulated by these accounts to recognize the value of saving and will actually increase their other saving. We should note again that the impact on national saving assumes also that in the absence of the PRA program the projected budget surpluses will be used to cut taxes or increase government spending in ways that do not add to national saving.

[16] The increase in the capital stock would reduce the real return on capital by increasing the ratio of capital to labor. But even after 70 years when the additional capital is estimated to be 70 percent of the baseline GDP, this would only raise the currently projected capital stock by about 20 percent. A standard economic analysis would imply that this reduces the rate of return from 8.5 percent to about 6.9 percent. The lower capital income would be balanced by higher wage income, essentially maintaining GDP increase equal to the 8.5 percent rate of return.

[17] It is of course possible that the real rate of return earned on the incremental capital generated by the PRA assets would be less than 8.5 percent because some of those funds are used in housing construction (which earns a lower rate of return) or because some of the funds are invested abroad where the United States earns only the return net of the foreign corporate taxes.

of GDP. Although official annual CBO figures for the surplus after 2009 are not available, the CBO projects surpluses until after 2020. This implies that the PRA deposits of 2.3 percent of taxable payroll (0.92 percent of GDP) can be financed without a tax increase, a reduction in other government spending or a budget deficit until well past 2010. Before considering what happens when the increasing outlays for Social Security and Medicare bring the projected budget surpluses to an end, consider what happens in the more distant future.

The 5.5 percent real rate of return that the PRA accounts are assumed to receive has been the historic rate of return earned by portfolio investors after the corporations have paid corporate profits taxes and property taxes to federal, state and local governments. Since the total pretax return is 8.5 percent, the extra revenue collected by federal, state and local governments is equal to 3.0 percent of the PRA assets. Taking that extra revenue into account implies a more favorable overall budget impact of the PRA program.

The Federal government share of that revenue could be used to finance the tax credits for the PRA deposits. To get a sense of the potential importance of this additional tax revenue, consider the implication of assuming that the federal corporate tax on pretax earnings will be equivalent to 2 percent of the PRA balances in a given year. This corresponds to an effective tax rate of 2/8.5 or 23.53 percent, which is substantially below the statutory rate. This is the fraction of the 8.5 percent increase in GDP shown in columns 3 and 4 of Table 2 that we assume will be recovered by the federal corporate tax. By the year 2020, this revenue would be 0.53 percent of GDP, enough to finance more than half of the cost of the PRA tax credits (equal to 0.92 percent of GDP); see columns 5 and 6 of Table 2. By 2030, the extra corporate tax revenue would be 0.86 percent of GDP, essentially enough to finance the entire cost of the PRA tax credits. After that year, the additional corporate tax revenue would be more than enough to finance the PRA tax credits and could be used to expand the size of the PRA programs, raising retirement incomes, or further reducing the required pay-as-you-go tax rates.

5. Summary

A program of Personal Retirement Accounts (PRAs) funded by deposits equal to 2.3 percent of earnings (up to the Social Security maximum) would permit retirees to receive more income in retirement than with the current Social Security program while at the same time making it unnecessary to increase the 12.4 percent payroll tax in response to the aging of the population. The gross cost of the deposits, approximately 0.9 percent of GDP, could be financed for more than a decade out of the budget surpluses currently projected by the Congressional Budget Office. By the year 2030, the additional corporate tax revenue that results from the enlarged capital stock financed by PRA assets would be able to finance fully these personal tax credits. During the intervening years (about 2020 to 2030), a reduction of other government spending or an increase in taxes would be needed if budget deficits are to be avoided. If implemented, the PRA program would not only increase retirement income and stabilize the Social Security payroll tax. It would also cause a substantial increase in national saving and GDP.

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

Year	PRA Deposits ($ Billions)*	PRA Annuities ($ Billions)*	PRA Annuities (% of Payroll)**	SS Outlay Reductions (% of Payroll)**	SS Trust Fund (% of Payroll)**
2000	81.15	0.00	0.00	0.00	25.46
2010	94.21	5.87	0.14	0.11	41.33
2020	106.05	40.88	0.89	0.66	43.85
2030	116.78	129.11	2.54	1.91	25.32
2040	130.66	273.01	4.81	3.60	4.37
2050	144.62	481.30	7.65	5.74	3.14
2060	159.23	690.77	9.98	7.48	19.42
2070	175.60	825.98	10.82	8.11	43.06

Notes:

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

* Billions of dollars at the 1998 price level.
** Percentage of Social Security taxable payroll.

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

Year	PRA Assets ($ Billions)*	PRA Assets (% of GDP)**	GDP Increase ($ Billions)*	GDP Increase (% of GDP)**	Corporate Tax Revenue ($ Billions)*	Corporate Tax Revenue (% of GDP)**
2010	1239.68	11.98	105.37	1.02	24.79	0.24
2020	3140.83	26.55	266.97	2.26	62.82	0.53
2030	5728.44	43.14	486.92	3.67	114.57	0.86
2040	8679.73	57.30	737.78	4.87	173.59	1.15
2050	11542.09	67.53	981.08	5.74	230.84	1.35
2060	13718.59	71.51	1166.08	6.08	274.37	1.43
2070	15224.45	70.60	1294.08	6.00	304.49	1.41

Notes:

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

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

3) Corporate Tax Revenues are equal to 2 percent of the balance in Personal Retirement Accounts.

* Billions of dollars at the 1998 price level.
** Percentage of baseline GDP forecast

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PREPARED STATEMENT OF FRED T. GOLDBERG, JR.

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

Private Accounts

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

Direct Government Investment

Second, I agree with those who view direct government investment in the markets as a bad idea. All human experience teaches us that government is certain to misuse its ownership of private capital. Maybe not today, maybe not tomorrow, but someday for sure. Those who cite experience with the Thrift Savings Plan as proof that the government can make direct investments without political interference should know better. Their failure to cite contrary state experience is, at best, mis-

leading. It's also downright silly to suggest that what has been true (perhaps), must always be true. They fail to acknowledge the obvious individual workers own their Thrift Savings Plan accounts. It's theirs. The funds don't belong to the government. This is a primary reason why, at least to date, the Thrift Savings Plan has been able to resist pressures for politically correct investment policies. The Plan is not investing the government's money; it's investing the workers' money. Even if all the pitfalls of government investment could be avoided and they can't it would still be a bad idea because we would be walking away from the opportunity to adopt policies that would lead to the creation of wealth for all Americans.

A Workable System

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

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

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

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

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

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

The Cost of Private Accounts: All of the available data we have reviewed demon strates that, on a phased-in basis, the private account system we describe could be administered for 30–60 basis points. As such, it is an extremely inexpensive system whose costs could be fairly allocated among participants. Given the "public" benefits associated with a universal system of private accounts, it would also be appropriate to cap the costs at an acceptable level, and fund any difference from general revenues.

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

It is important to make clear, however, that under the system we describe, partici pants would not deal directly with the IRS on any matters relating to their PRAs.

Likewise, the IRS would not be involved in any way in the ongoing administration of accounts or providing information to participants.

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

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

Conclusion

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

As noted in our NBER paper, it is important to put the administrative challenge of private accounts in perspective. Recall what the world was like when Social Security was enacted. There were no Social Security numbers. There was no payroll tax withholding. Many Americans didn't have a telephone. There were no computers information was entered by hand, records were maintained on paper, correspondence was delivered by mail. There was no computer-based financial infrastructure.

Implementing Social Security under those conditions was hard; by comparison, implementing universal private accounts would be easy. Those who oppose private accounts today with claims that they are too risky and cost too much sound like those who opposed Social Security in 1935.

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

Attachment.

NBER WORKING PAPER SERIES

REFORMING SOCIAL SECURITY: A PRACTICAL AND WORKABLE SYSTEM OF PERSONAL RETIREMENT ACCOUNTS

Fred T. Goldberg, Jr.
Michael J. Graetz

Working Paper 6970
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Reforming Social Security: A Practical and
Workable System of Personal Retirement Accounts
Fred T. Goldberg, Jr. and Michael J. Graetz
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ABSTRACT

This paper details a method for implementing personal retirement accounts (PRAs) as a part of Social Security reform. The approach described here answers the following questions: how funds are collected and credited to each participants' retirement account; how money is invested; and how funds are distributed to retirees. It is designed to accommodate a variety of answers to a wide range of important policy questions; to minimize administrative costs and distribute those costs in a fair and reasonable way; to minimize the burden on employers, especially small employers who do not now maintain a qualified retirement plan; and to meet the expectations of Americans for simplicity, security, control, and independence in ways that are easy to explain and to understand. The system we describe relies on existing payroll and income tax mechanisms for collecting PRA funds and crediting PRA accounts. It provides two basic options for investments: (i) a simply system involving a limited number of funds sponsored by the Social Security Administration and managed by private companies, and (ii) privately sponsored funds with additional investment choices. It also provides two distribution alternatives if distributions are required to be annuitized: (i) an increase in Social Security benefits, and (ii) inflation-protected annuities provided directly to retirees by private companies.

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Abstract

This paper details a method for implementing personal retirement accounts (PRAs) as a part of Social Security reform. The approach described here answers the following questions: how funds are collected and credited to each participant's retirement account; how money is invested; and how funds are distributed to retirees. It is designed to accommodate a variety of answers to a wide range of important policy questions; to minimize administrative costs and distribute those costs in a fair and reasonable way, to minimize the burden on employers, especially small employees who do not now maintain a qualified retirement plan; and to meet the expectations of Americans for simplicity, security, control and independence in ways that are easy to explain and to understand. The system we describe relies on existing payroll and income tax mechanisms for collecting PRA funds and crediting PRA accounts. It provides two basic options for investments: (i) a simple system involving a limited number of funds sponsored by the Social Security Administration and managed by private companies and (ii) privately sponsored funds with additional investment choices. It also provides two distribution alternatives if distributions are required to be annuitized: (i) an increase in Social Security benefits and (ii) inflation-protected annuities provided directly to retirees by private companies.

Background

Since it was first enacted in 1935, Social Security has been enormously successful in improving the financial condition of the disabled and elderly. Despite this success, however, demographic trends make change inevitable. As the baby boomer generation approaches retirement and longevity increases, Social Security faces a funding shortfall. The accumulation of surplus, now being built up, is currently projected to be exhausted by the year 2032, and Social Security actuaries project that, during the 75 year period used to project revenues and benefits, a deficit equal to 2.19 percent of taxable earnings will occur.

Reflecting Social Security's extraordinary success and universal acceptance, most reform proposals start from the same fundamental premise: the system must maintain disability and survivor benefits and continue to provide a guaranteed benefit that keeps both the disabled and the elderly out of poverty. Consistent with these goals, and in order to achieve a broader participation in capital markets, especially by low and moderate wage workers, many recent proposals also

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embrace the idea of adding a defined contribution feature in the form of personal retirement accounts that would be owned and controlled by individual workers ("PRAs").[1] Polling data also suggest strong public support for making individual accounts a part of Social Security.[2] There are many variations on this theme, and PRA proponents justify their support on a wide variety of grounds:

- Over extended periods, PRAs should generate higher returns than the Social Security Trust Fund, thereby helping to maintain adequate retirement income.

- PRAs will provide a source of financial wealth (and stock market returns) to the roughly half of Americans who have none aside from the promised benefits of Social Security.

- Unlike the Social Security Trust Fund, the money in PRAs is "walled off" and cannot be used to fund other government expenditures; unlike Social Security benefits, PRAs are owned by individual participants and represent vested property rights.

- Social Security is a pure defined benefit program that is of most value to those who live the longest, while PRAs represent assets that are owned by participants. PRAs could be of particular benefit to the families of those who die early and groups with short life expectancies (for example, minorities and low income workers).

- Because single individuals, single parents, and two income married couples are relatively disadvantaged by the way that Social Security benefits are computed, PRAs may be of particular benefit to those groups.

- PRAs will provide a universal infrastructure to promote savings and help create wealth for all Americans.

To date, the PRA discussion has focused principally on policies and politics; not much has been written on ways to implement and administer such a program. The purpose of this paper is to address this latter question. While not a glamorous topic, the mechanics of PRAs will have a major impact on whether they become a part of this nation's national retirement policy. PRAs may be good policy and politics, but if they cannot work they will not happen.

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In addition, the ability to implement PRAs at a reasonable administrative cost is critical to their ultimate success. Large administrative expenses have the potential to substantially erode the earnings of PRAs, particularly for the large number of relatively small accounts that will exist.[3] Thus, a workable low-cost system is widely accepted as a pre-requisite for the successful implementation of PRAs.

While the PRA policy options are legion, our approach has been designed to satisfy three basic administrative criteria:

(1) To minimize administrative costs, and distribute those costs in a fair and reasonable way.

(2) To minimize the burden on employers, especially small employers who do not now maintain a qualified retirement plan.

(3) To meet the expectations of everyday Americans for simplicity, security, control and independence in ways that are easy to explain and easy to understand.

While they raise difficult administrative issues, this paper demonstrates that PRAs can work. It describes a practical system for implementing and administering PRAs — a system that meets the three criteria listed above.

While these three criteria are generally accepted, there is a fourth requirement that has not been considered by other commentators, but has influenced the design we describe. Because the policy and political debate over PRAs is just getting started in earnest, there is a premium on flexibility – the capacity to accommodate a wide range of funding options and policy objectives. The system we describe here will work:

- Whether PRAs are mandatory or voluntary;

- Whether PRAs are funded by allocating an existing portion of the payroll tax to PRAs (a so-called "carve out"), funded by collecting an additional amount from workers and/or employers (a so-called "add on"), or funded from general revenues;

- Whether or not PRAs are partially integrated with Social Security to help cover the funding short-fall when baby boomers begin to retire;
- Regardless of how administrative costs are funded (in particular, regardless of what costs are funded from general revenues);
- Regardless of the rights spouses and ex-spouses have with respect to PRAs (for example, some suggest that PRAs should be divided from the outset between the worker and his or her spouse);
- Whether or not workers are allowed to make additional, voluntary contributions to their PRAs; and
- Whatever investment and distribution options are available to participants, and however those options are regulated.

The system we describe would accommodate a wide range of potential answers to these policy issues. Of equal importance, the system would be flexible enough to accommodate *changes* in the ways these questions are answered over time, after the PRA program is put in place.

Overview

The most important point to keep in mind is size — both big and little. The PRA system will involve an enormous number of accounts, and the dollar amounts in many of those accounts will be quite small. For example, approximately 137 million workers would have been covered during 1996.[4]

- Following are the number of those covered workers at various levels of covered wages [5]

Workers (in millions and percent of total)		With annual covered wages of less than:
29,554	22%	$5,000
46,438	35%	$10,000
61,816	46%	$15,000
76,178	58%	$20,000
88,900	67%	$25,000
99,458	73%	$30,000
114,629	85%	$40,000
123,641	91%	$50,000
128,591	95%	$60,000
129,578	96%	$63,000
136,689	100%	All covered workers

- Assuming that the amount going to PRA's each year equaled 2% of wages covered by Social Security, accounts for nearly 62 million workers would have been credited $300 or less for 1996; accounts for the approximately 9 million part-time and seasonal workers making less than $3,000 would have been credited with less than $60. At 3% of covered wages, nearly 47 million workers would have been credited with $300 or less.

- The average amount of covered wages for 1996 was nearly $25,000. Thus, at 2% of covered wages, the *average* amount credited to accounts for 1996 would have been $500, and the aggregate amount of contributions for 1996 would have been approximately $68.5 billion.

This paper focuses on the three fundamental administrative functions that are common to all systems of personal retirement accounts:

(1) Collecting PRA funds and crediting funds to each participant's retirement account;

(2) Investing funds on behalf of individual participants; and

(3) Distributing funds from PRA accounts to participants and beneficiaries.

The Personal Retirement Accounts Program

A. Summary

Any system of PRAs will provide for funding of accounts, management and investment of funds, maintenance and dissemination of account information, and distribution of funds on retirement, disability or death. A brief summary of procedures follows, illustrating how to minimize administrative costs and the burden on employers, while providing participants with an understandable and workable system that will meet their needs for simplicity, security, independence and control:

- *Funding PRAs:* The current wage reporting, payroll tax and income tax systems provide an in-place vehicle for collecting PRA funds and crediting PRA accounts. Because these systems are already up and running, this aspect of the program will cost little to administer, will impose no additional burden on employers, and should be relatively easy to explain to participating workers.

- *Investing PRAs:* From the standpoint of investment options, a two-tier approach responds to the need for a simple and inexpensive system, and meets the desire to provide individuals with control over their PRAs and a wide range of investment options:

  First, all workers could elect to invest their PRAs in a limited number of funds sponsored by the Social Security Administration under a "no frills" system managed by the private sector ("Simple Personal Investment Funds" or "SPIFs").

  Alternatively, workers could direct that their funds be invested in one or more privately sponsored Qualified Private Funds ("Q-Funds"). Some regulation of Q-Funds will be necessary to limit investment options (as is now done with IRAs and 401(k) plans), to provide for times and methods for shifting investments, to ensure the solvency of fund managers, to provide for methods and times of disclosures to investors, and to regulate the allocation of administrative costs. The Treasury Department and the Labor Department, along with

the Federal Reserve and the SEC, have long been performing these functions for private investments and therefore have the expertise and experience to implement any necessary regulation of Q-Funds.

- *Distributing Funds from PRAs:* Workers could not gain access to their PRAs prior to disability, retirement or death—at which point it may be required that some or all of the PRA funds would have to be annuitized. As with the investment options, annuity alternatives should operate under a two-tiered approach. Workers could either elect to have their PRA balances transferred to the Social Security Administration in exchange for an appropriate increase in their monthly Social Security benefits, or, alternatively, workers could use their PRA balances to purchase qualified annuities from the private sector. Private companies that offer annuities should be required to provide all-comers annuities at the same age-based price to reduce costs and limit adverse selection problems.

B. Funding Personal Retirement Accounts

1. *In General.* An efficient and flexible mechanism for funding PRAs can be built off of the existing wage reporting, payroll tax and income tax systems. As explained below, this approach would involve four basic steps to direct funds into a personal retirement account for the benefit of an individual worker. These steps are summarized below, as they apply to employees (comparable procedures would apply with respect to self-employed workers):

Step One: Employers withhold payroll taxes from wages and deposit those taxes (together with the employer's share) with the Internal Revenue Service ("IRS"), as required under current law. If PRAs are funded through a carve-out of existing payroll taxes, or from general revenues, no additional collection mechanism would be necessary. If, on the other hand, PRAs are funded through an add-on in the form of additional withholding, the additional funds would be collected through the existing payroll tax system in the same manner as payroll taxes, but PRA amounts would be designated as such in employers' deposits of withheld taxes and PRA contributions. If PRAs are financed from general

revenues, the government would simply transfer the appropriate amounts into invididuals' PRAs.

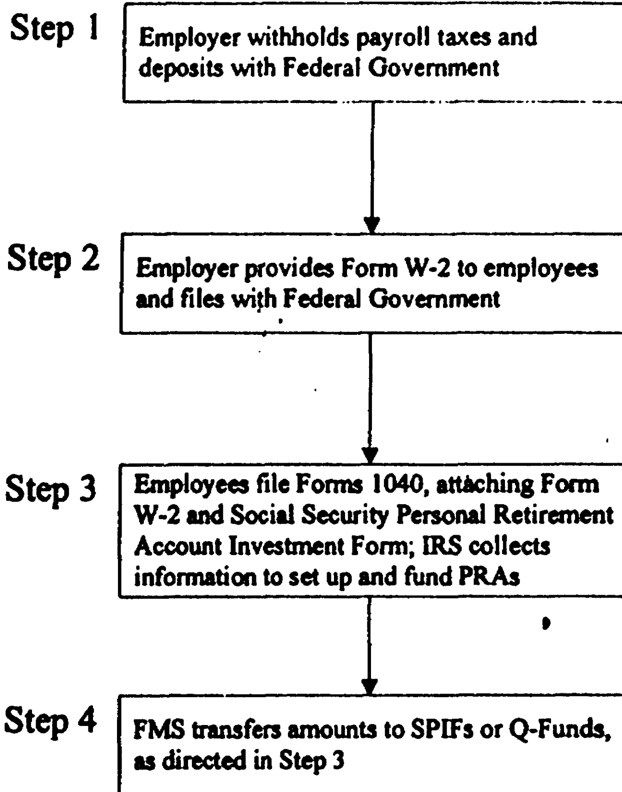
Step Two: Employers provide employees with Forms W-2 at the close of the calendar year and file those Forms with the IRS, as required under current law. If PRAs are funded through a carve out from existing payroll taxes, or from general revenues, no additional information would be required from employers. If PRAs are funded through an add-on, employers' Forms W-2 would include both payroll tax and PRA information for each employee.

Step Three: Employees file Forms 1040 with the IRS, attaching a copy of Form W-2, as required under current law. The employee would also indicate how to invest amounts to be deposited in the PRA, using a form filed with his or her tax return. The IRS would collect the information necessary to set up and fund PRAs. (Most of this information, other than worker investment choices is already collected by the IRS under current law in the processing of tax returns.)

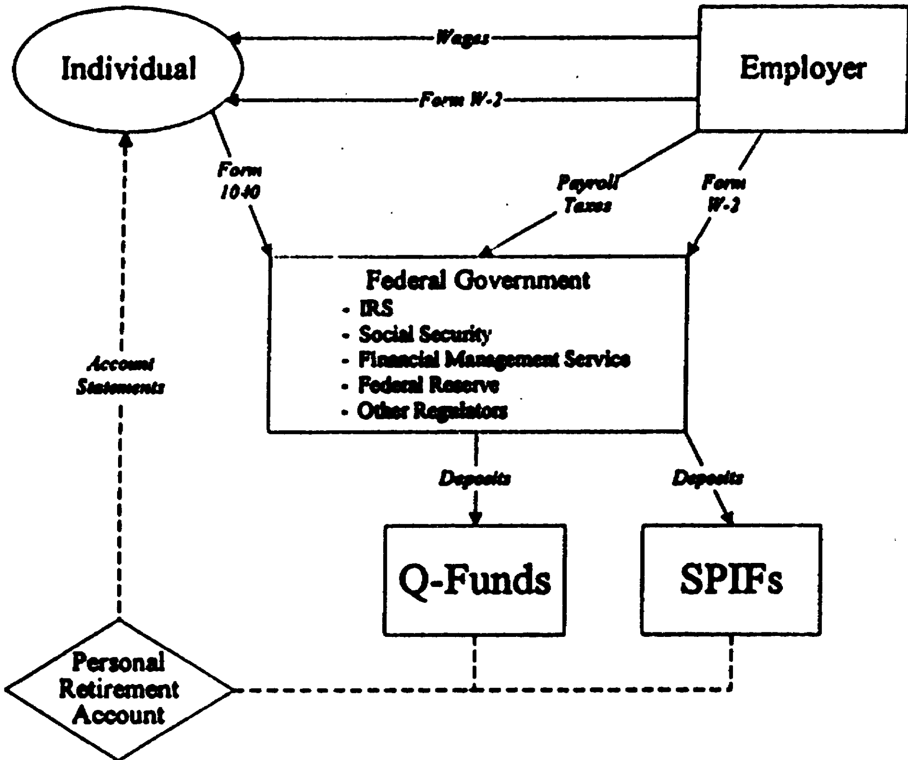
Step Four: Based on information collected in Step 3, the employee's PRA would be funded as directed, or funded as required by statute if the employee does not specify an investment option (presumably, into a specified SPIF fund).[6]

The flow if information and funds reflected in these four steps is summarized in the charts that follow:

Summary Chart: Flow of Funds and Information



Summary Chart: Flow of Funds and Information



Structuring PRAs around the existing system minimizes administrative costs and would impose no significant incremental burden on employers.[7] As under present law, employers would withhold payroll taxes from wages paid, and would deposit those funds with the IRS according to the applicable

deposit schedule. Similarly, self-employed individuals would continue to make payments of the self-employment tax to the IRS according to the applicable payment schedule. Because workers select their investment options when they file their tax returns, no additional burden is imposed on employers and the additional burden on workers is minimized. This approach for collecting funds and crediting accounts would minimize the costs of initiating a system of PRAs.

2. *Establishing Personal Retirement Accounts and Funding Investment Options.* Most of the information necessary to establish and fund each worker's personal retirement account—worker identifying information (name, social security number, and address) and amount of covered wages—is already provided to the IRS through employers' Forms W-2 and by workers filing their tax returns. The only additional step would be for each worker to select a particular investment option by completing a form that could be filed along with the worker's tax return. Some proponents of personal retirement accounts have expressed concerns that workers not have to deal with the IRS in connection with their personal retirement accounts. To address this concern, the form could be designed and labeled to make clear that this is a Social Security Personal Retirement Account Investment Form. (Of course, investment elections could be required to be made directly with SSA on a separate form apart from tax return filing, but we believe the additional burden and administrative costs of separate filings are unwarranted.)

The IRS would gather all of the necessary information relevant to PRAs as part of its routine processing of tax returns. Because the IRS already gathers most of this information, the additional costs of processing the Social Security Personal Retirement Account Investment Form would not be significant. As now occurs with respect to tax refunds, the IRS would provide each worker's personal retirement account information to the Treasury Department's Financial Management Service ("FMS"). In much the same way that it handles other funding activities on behalf of the Federal government, FMS would then wire transfer the appropriate amount to each worker's designated investment fund. Once again, because the funding mechanism builds on existing systems, this approach should minimize the government's additional cost and facilitate the implementation of PRAs.[8]

Funding accounts in connection with the processing of tax returns, and having participants designate their investment choices with those returns, accomplishes several objectives:

- Because substantially all workers already file income tax returns, it minimizes the burden on participants and the government's processing costs (as, for example, compared to a requirement that workers make a separate filing with Social Security). It also minimizes the start-up costs that would be associated with other systems of crediting accounts.

- It avoids imposing any additional burden on employers.

- The fact that most employers still file their W-2's with the IRS on paper is irrelevant. Paper filing causes no delay, and a very small number of corrections will have to be made.[9]

- It protects workers' privacy.

- Since wage reports filed by employers throughout the year do not identify wages allocable to each employee, the filing of the worker's tax return is the first occasion when the government has the information necessary to fund each participant's account.

- Taking the information from the participant's tax return minimizes the lag in funding.[10] This greatly simplifies crediting funds to workers' accounts because funding takes place once annually, rather than at each pay period. It also eliminates any need to "credit" PRAs for earnings prior to the time individual accounts are credited.[11]

- Any discrepancies between amounts reported on individual tax returns and amounts reflected through the reconciliation of W-2s by Social Security can be readily rectified through direct adjustments to PRAs. The only difficulty that can arise is when a downward adjustment is required to a PRA which has been defunded before the discrepancy is discovered. (Even in these rare cases, "transferee liability" similar to that now provided under the tax code could recapture erroneous amounts in virtually all circumstances.)

- IRS and Treasury's FMS experience with refunds generally, and with the electronic deposit of tax refunds in particular, demonstrate that the funding technology is already in place and can be implemented easily.

- This approach provides maximum flexibility. For example, it is well suited to any financing approach (whether through carve-out of payroll taxes, additional mandatory contributions or from general revenues) because each funding method requires the same information from participants (worker identification, covered wages, and investment choices). Likewise, using the tax return as an information source has substantial advantages in accommodating voluntary additional contributions, particularly if those contributions are encouraged by tax incentives.

We considered, but rejected, implementing PRAs by requiring employers to deposit withheld funds directly into their employees' investment accounts. Such an approach would substantially increase the burdens on employers, particularly small employers. Not only would they be responsible for monthly reporting and funding, but they also would be responsible for providing information, selecting among funds and correcting errors. We do not believe those additional burdens would produce adequate additional value.

Currently, 401(k) plans are offered to only 7 percent of workers in firms with fewer than 25 employees. Workers earning less than $15,000 a year account for just 8.3 percent of workers who participate in any 401(k) type retirement plans, and only 16 percent of participants in any type of employer-based defined contribution retirement plan.[12] In contrast, the 62 million workers with $15,000 or less of wages will comprise 46 percent of participants in PRAs. For those workers, the lag between the time when they earn wages and the funding of their PRAs will cost at most about $20 a year (the income lost from a 12 month delay at a 7 percent return following year-end is at most $20, or less than $2,100 over a lifetime).[13] To compensate for this loss of income, the government might credit individual PRAs with the return on Treasury borrowing for the period between earning the wages and funding the PRA. Alternatively, the government could remit an appropriate amount of aggregate PRA funds to a default SPIF with the income subsequently paid out to individual PRAs based on wage reports. We regard the first alternative, which is simpler, as adequate, but either of these options is preferable to requiring employers to deposit funds directly into their employees' PRAs.

3. *Workers Not Required to File; Error Correction; Workers Who Don't Make an Investment Election; Non-Compliance.* It is also necessary to provide for workers who choose not to file tax returns because their incomes are below the applicable filing thresholds.[14] The easiest way to address this issue is to permit these workers to file their Social Security Personal Retirement Account Investment Election Form, along with copies of their W-2s, with an IRS Service Center.[15]

At present, the IRS and Social Security are able to "perfect" the information regarding each worker's covered wages within approximately 18 months after the end of the calendar year. While the information on most workers' covered wages is accurate (and most of it is now filed electronically), there are a significant number of errors that must be corrected each year.

While the error numbers are large in absolute terms, they are small as a percentage of the entire program.[16] Moreover, because a system of personal retirement accounts would place a greater premium on timely and accurate information, it is possible that there would be fewer errors over time. What is important to note is that these errors occur—and have to be corrected—under current law. As a result, under the implementation scheme described above, no new information processing is required. The only additional step is that some adjustment in the funded accounts will be required (subject to *de minimis* tolerances). Because the PRA's that must be adjusted will virtually always exist, any over- or under-funding can be remedied with relative ease.[17] With respect to both over- and under-funding situations, it would be necessary to provide rules regarding actual or imputed earnings (or loss) prior to the correction date. Thus, for example, where accounts are over-funded, the withdrawal could reflect actual gains or losses; where accounts are under-funded, earnings could be credited at a specified rate, e.g., the Treasury rate applicable to the correction period.[18]

For any worker who does not designate an investment option, his or her PRA would be invested in the manner specified by statute. In the case of workers filing tax returns, the IRS would gather the necessary information (e.g., covered wages) from the Form 1040. In the case of workers not filing tax returns, the information would be gathered from Forms W-2 filed by employers. Because there could be a substantial lag in this latter context, it raises the issue of whether these accounts should be credited with imputed earnings.[19]

A more difficult issue arises where no information returns are filed with respect to a worker, there is no withholding with respect to that worker's earnings, and the worker fails to file income tax returns. Under these circumstances, crediting any amount to the worker's PRA will be virtually impossible without direct contact with the worker and/or the worker's employer. These cases will be quite rare and serve to show only that no law is 100 percent enforceable.

C. Investment Options

As noted above, a two-tier system of investment options seems most appropriate.

1. *Social Security-Sponsored Options.* Workers could elect to invest their PRAs in a limited number of funds sponsored by Social Security, with management and administration of the funds contracted out to the private sector ("Simple Personal Investment Funds" or "SPIFs"). From an investment and management standpoint, the Social Security-sponsored funds would operate similarly to the federal employees' Thrift Savings Plan ("TSP").[20] This alternative would be administered on a "no frills" basis. Obviously, there is a tradeoff between offering a varety of choices and keeping costs low. For example:

- SPIF investments could be limited to so-called lifestyle funds - a mix of debt and equity index fund investments with the proportion of equity adjusted to provide a level of risk appropriate to the participant's age.

- Alternatively, participants' investment options could be limited to the following: (1) one or two equity index funds, for example, one based on the Standard and Poor's 500 and one based on the Russell 2000 or Wilshire 5000;[21] and (2) one or two bond funds, one limited to U.S. Treasuries and the other based on corporate debt. Two default funds might be provided for people who fail to elect any investment option. The first — a 60% equity, 40% debt fund — would apply to all individuals under age 55. The second — an 80% debt, 20% equity fund — would apply to all individuals age 55 or over.

- Participants would receive their account statements once (or perhaps twice) each year (additional statements could be made available for a fee).

- Automated account information available at any time.

- Participants could reallocate funds twice (or perhaps four) times a year without any additional charge (additional changes could be permitted for a fee).

This configuration represents a reasonable balance among competing objectives: it keeps administrative costs low, while providing reasonable investment choices and market-comparable services to the millions of workers likely to participate in the SPIF. It would, of course, be possible to increase or decrease investment options and services in ways that would increase or decrease costs of administering the program. Given the large number of relatively small SPIF accounts, however, keeping costs low is important so that investment returns will not be eroded.

After a phase-in period (which we estimate to be up to 5 years), the annual costs of administering SPIFs in the configuration described above are expected to be in the range of 30 to 50 basis points.[22] By way of comparison, Appendix B provides more detailed information regarding current costs of a variety of investment funds.

Regardless of the specific configuration of investment options and account services, the SPIF approach raises a number of policy and administrative issues. For example:

(a) What portion of the administrative costs should be financed from direct charges to accounts? How should such amounts be allocated? Allocating such amounts based on the amount of assets in accounts, rather than on a fixed dollar per account basis, seems most consistent with the goal of broadening capital market participation by low and moderate income workers.

(b) What portion, if any, of the administrative costs should be financed from general revenues? In considering this question, two points are worth noting:

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(i) To deal with transition costs, it may be useful to cap administrative costs charged to PRAs at some level (e.g., 30 to 50 basis points), and fund any excess from general revenues.

(ii) It has been suggested that some or all administrative costs should be funded from general revenues on one or more of the following grounds: (i) it would increase the net return on PRAs; (ii) from a "fairness" standpoint, it would be progressive; (iii) PRAs are a "public good" (everyone benefits from increased savings and the creation of wealth for all workers); (iv) general revenues cover the administrative costs of similar government functions (e.g., Medicare, Social Security, and the IRS). On the other hand, fully funding administrative expenses from general revenues may remove any incentive for individual investors to see that such costs are minimized.

(c) By requiring that the SPIF investments be contracted out, we have sought to minimize the risks that the government will use these funds to interfere in the capital markets (e.g., by rewarding or punishing certain industries or companies; by competing with the private sector, or by making investment decisions to address fiscal, social or foreign policy issues).

(d) We have illustrated rules governing the choice of SPIF funds for workers who do not elect any investment option, but there are obviously other alternatives. Presumably, as we have noted, funds would be allocated based on an age-adjusted formula. Should the default formulas be specified in legislation, or left to the discretion of one or more regulatory bodies?

(e) Should anything be done to address concerns over stock market volatility, especially as workers approach retirement age? For example, in the context of the SPIF should there be rules mandating more conservative investment allocations as workers approach retirement age? Should the SPIF offer some kind of "risk insurance" or investment guarantee?

(f) What kind of information should be provided to workers regarding their investment options, who should provide that information, and how should the costs of providing that information be allocated? Consistent with our basic goal of minimizing burdens on employers, especially small employers, placing responsibility for education with the Social Security Administration seems an appropriate first step. As all workers become investors through their PRAs, it seems likely that other avenues of education, including by non-profit organizations, will emerge.

As a practical matter, answers to some of these questions may vary depending upon whether the accounts are funded through a carve-out, an add-on mechanism, or are funded from general revenues. We want to emphasize that the implementation system outlined here can accommodate a wide range of answers to these and other policy issues.

2. *Private Fund Options.* In addition to Social Security-sponsored SPIFs, the personal retirement account program could permit individuals to invest their funds with one or more privately sponsored Qualified Private Funds ("Q-Funds"). There are several reasons for making such an option available to workers.

- It allows individual workers to avail themselves of the wide range of investment alternatives and investment services offered by the private sector.[21]

- Because workers can take advantage of private sector options, it will be easier to maintain the SPIF as a low cost, easy-to-understand, limited-choice alternative.

- It will reduce the risk that the Federal government, through manipulating the SPIF, will "compete" with the private sector.

- Finally, it will reduce the risk that politicians and interest groups will seek to use the SPIF to pursue unrelated political, social, economic or foreign policy objectives.

As we have said, the financial institutions offering Q-Funds, and the Q-Funds themselves, will need to be regulated regarding permitted investments, financial solvency, and disclosure requirements. We expect existing regulatory mechanisms to be adequate fc. this purpose.[24] For example:

- As with qualified retirement plans and individual retirement accounts under current law, Q-Funds should be segregated from other investment funds (i.e., there should be no commingling of assets).

- The diversification requirements applicable to mutual funds (regulated investment companies), and the fiduciary obligations under ERISA, provide a starting point for addressing various risk-related issues. Q-Fund sponsors could be required to offer a minimum range of investments (for example, index equity funds and short and long term bond alternatives).[25]

- While any Q-Fund sponsors could offer a wide range of investment alternatives, limiting individuals to one PRA account may be appropriate to avoid the excessive administrative costs that multiple accounts would entail. This would mean that an individual's account would either be invested through SPIF or the Q-Funds of a single financial institution.

- The system could build on current reporting requirements to assure that the government receives the information necessary to monitor the Q-Funds and the status of individual workers' accounts.[26]

- There are two ways to determine which institutions would be permitted to offer Q-Funds, and the conditions under which those Q-Funds could be offered. One approach would be to impose a uniform set of licensing criteria that would be centrally administered by a single regulatory agency. Alternatively those same criteria could be administered separately by the agency now responsible for regulating the sponsoring financial institution. In either event, because the Federal government, rather than individual workers, would provide original transfers of funds to Q-Funds, workers would be protected from fraud by unauthorized promoters.

- As for the licensing requirements themselves, one approach would be to integrate them with existing regulatory standards regarding permitted investments, safety and soundness, and disclosure. In this context, the legislation could impose additional requirements that were deemed appropriate (e.g., bonding or insurance requirements, net worth requirements, etc.).

- From the standpoint of ongoing compliance, financial institutions and Q-Funds could be monitored by existing regulatory authorities as part of their overall responsibilities (e.g., the Departments of Treasury and Labor, the Federal Reserve Board, and the Securities and Exchange Commission). (Appendix C contains a table summarizing the current regulatory structure of financial institutions likely to offer Q-Funds.)

- This structure would also permit rules limiting and allocating administrative costs of Q-Funds. We believe that, in light of the SPIF alternative, these rules could be limited, and should focus on disclosure requirements. Nonetheless, in light of concerns about the potential for marketing costs to increase administrative costs and reduce investment returns, financial institutions offering Q-Funds might be limited in allocating marketing costs to Q-Funds, or offering "bonuses" for individuals to shift funds to a different offeror. In addition, as with SPIFs, Q-Fund sponsors could be required to allocate all costs within each fund on an asset, rather than fixed dollar per account basis.

- Some commentators have expressed the concern that Q-Funds might attract a disproportionate share of PRAs with relatively high dollar account balances, increasing the per account cost of SPIFs. One response might be to levy an asset-based charge on Q-Funds and/or their sponsors to defray the cost of administering SPIFs. Likewise, to limit skimming of large accounts by Q-Funds, it may be appropriate to require Q-Funds to accept PRAs above some asset value.

Once again, we want to emphasize that this administrative structure provides substantial flexibility to the Congress in addressing numerous policy issues

(e.g., bonding, insurance and/or net worth requirements applicable to the Q-Fund and the sponsoring institution; limitations, if any, on permitted investments; age-based portfolio requirements; rules governing spousal rights; the protection of workers' assets from creditors' claims; and disclosure requirements). Thus, while we believe that it is possible to keep any such regulation to a minimum and, to the extent possible, should be integrated with existing rules, the legislation authorizing Q-Funds could impose whatever regulatory requirements Congress deems appropriate.

Based on industry experience with 401(k) and IRA accounts, Q-Fund accounts should cost about $15-25 annually, depending on the amount and kind of service provided (e.g., frequency of statements, frequency of free telephone inquiries, etc.). In the system we describe here, such costs would be allocated based on assets, rather than per account. We have suggested that each individual have only one account, but people are permitted to elect to have multiple Q-Fund accounts with different financial institutions, they should bear the costs of such choices.

3. *SPIFs and Q-Funds Together.* Most of the commentators who have considered PRAs have proposed that all investments be made either through a simple investment vehicle (resembling our SPIF) or through privately-run accounts (resembling our Q-Fund). This naturally raises the question why both the SPIF and Q-Fund options are desirable. In our judgment, the SPIF and Q-Fund investment choices work together in important ways. Standing alone, each has the potential for problems that will be policed by the other if both options are made available. For example, the existence of the Q-Fund alternative makes it more likely that SPIF can be preserved as a simple, low cost system, with a limited selection of investment alternatives. It also reduces the risk -- which a government-contracted fund standing alone entails -- that SPIF will be used for political, social, or foreign policy purposes. At the same time, having the SPIF in place will keep pressure on Q-Fund sponsors to minimize costs and marketing abuses of the sort that have plagued some PRA systems abroad, while allowing Americans great independence and flexibility in their investment choices.[27] Likewise, having the SPIF in place will reduce pressures to impose detailed regulations on Q-Funds (e.g., a requirement that all Q-Fund sponsors offer SPIF-type funds; restrictions on fees). The balance provided by SPIFs and Q-Funds together makes the approach we are suggesting preferable to a PRA system limited to either alternative standing alone.

4. *Education and Error Correction*. As we have suggested, giving the Federal government primary responsibility for educating workers regarding all aspects of the PRA program, including basic information regarding eligible Q-Funds, accomplishes a number of objectives. Most notably, it minimizes the burden on employers and helps assure uniformity and quality control. One approach would be to give primary responsibility to the Social Security Administration (SSA). The SSA would work with other Federal agencies (e.g., the Departments of Treasury and Labor, the SEC, and the Federal Reserve), and have substantial latitude to contract out various activities to the private sector. Funding these efforts with general revenues seems appropriate. The nature of the program also makes it likely that a great deal of education would be provided at no cost to the program or the Federal government, and that a number of private non-profit organizations will participate in educating the public (e.g., popular and specialized media; educational institutions; employers, on a volunteer basis; sponsors of Q-Funds).

As noted, there is a high level of accuracy associated with wage reporting and the issuance of tax refunds under current law Nonetheless, in absolute terms, there are certain to be a sizable number of errors in the crediting of accounts and a significant number of inquiries regarding SPIF account-related matters.[28] One approach would be to give the Social Security Administration primary responsibility for handling these questions and resolving any account discrepancies. The SSA would work with other Federal agencies (primarily, the IRS), and have substantial latitude to contract out various activities to the private sector. While both the IRS and the SSA have substantial call site operations, the SSA may be better equipped to handle the likely range of inquiries (perhaps, subcontracting with the IRS to handle certain calls). This approach also avoids concerns over the appearance of telling participants that they have to resolve account issues with the IRS.

D. Distributions from Personal Retirement Accounts

1. *Policy Issues*. As a preliminary matter, it is important to note that the rules governing distributions from personal retirement accounts pose difficult policy issues. For example:

(a) To what extent, if any, should beneficiaries be required to annuitize their personal retirement accounts on retirement? Among the options are: (i) all PRA funds must be annuitized; (ii) no mandatory annuitization requirements; (iii) PRA funds must be annuitized to the extent necessary to provide some minimum income level (when combined with other Social Security benefits); and (iv) limited annuitization alternatives (e.g., for funding of joint-and-survivor long-term care coverage).

(b) If some type of annuitization is required, what form must those annuities take? Among the options are: (i) annuities should provide benefits parallel to existing Social Security benefits (e.g., inflation-adjusted; joint-and-survivor annuities, with reduced payments to the survivor); (ii) benefits parallel to the qualified plan/IRA rules (account balance divided by life expectancy); (iii) a limited number of acceptable annuity alternatives (e.g., the ability to include other beneficiaries under joint-and-survivor annuities; no reduction in payments to survivor; varied payment streams; term certain, on early retirement).

(c) When can workers first gain access to their PRAs? Among the options are: (i) at the normal Social Security retirement age (or when they qualify for Social Security disability payments); (ii) whenever they first begin collecting Social Security benefits; (iii) at their election, any time after they first begin collecting Social Security benefits (*i.e.*, permit continued accumulations); (iv) before they begin collecting Social Security benefits, if their PRA funds are sufficient to provide some minimum monthly payment (taking into account anticipated future Social Security benefits) (*i.e.*, use PRAs to facilitate early retirement).

(d) What will happen to personal retirement account contributions on behalf of several million individuals who continue working, and continue paying payroll taxes, after they begin collecting Social Security? If the worker continues to maintain a personal retirement account, then his or her

contributions would simply continue. If, however, the entire balance of the worker's personal retirement account has already gone to purchase some form of annuity, his or her withholding could be reduced by an amount that would otherwise go to fund the worker's PRA (for example, if PRAs are funded by an add-on or carve-out), funding could stop for the worker's PRA (if PRAs are funded from general revenues), or the worker could be given a refundable tax credit equal to the amount added to his or her PRA (if PRAs are funded by a carve-out or from general revenues).

(e) If personal retirement accounts are funded in whole or in part from general revenues, and/or integrated in some way with Social Security, how should that integration be structured? Among the options are: (i) mandatory annuitization of personal retirement accounts, with a partial offset against payments otherwise due under Social Security; or (ii) lump sum transfer of a specified portion of PRA balances to Social Security on the death, disability or retirement of the worker.

To some degree, the answers to these questions will depend on how personal retirement accounts are funded. As before, however, the goals of implementing any of these policy decisions will be to promote fairness, to keep administrative costs to a minimum, and to devise a system that the American people can easily understand. We discuss the options below.

2. *Social Security-Sponsored Annuity Option*. Under this alternative, a worker's personal retirement account funds would be transferred to Social Security when the worker first begins receiving Social Security benefits. The amount of the worker's and survivor's Social Security benefits would be increased based on the value of the worker's personal retirement account. In other words, the government would decide what amount of annuity to pay for a given PRA accumulation. The primary virtue of this alternative is its simplicity. From the worker's perspective, it requires no choices or decisions. The worker will receive only one monthly payment, and will deal with only one party making payments (the Social Security Administration). From the government's perspective, the only additional administrative costs occur at the outset: collecting the personal retirement account funds and making the appropriate adjustment to Social Security payments.

Social Security could implement this alternative by contracting out all aspects of the program (other than processing beneficiary payments) to the private sector, with the private sector setting the annuity amount (with indexing for inflation) and thereby bearing investment and mortality risks. We believe that contracting out is a better alternative than Social Security directly administering PRA-funded annuities. For example:

(a) What return would the government assume on the funds it received from the worker's personal retirement account – and would the government be permitted to invest those funds in the same way that private insurers invest premiums? Given the relatively long period of retirement that workers can now be expected to enjoy, depriving them of equity market returns during this entire period seems inconsistent with one key purpose of enacting personal retirement accounts in the first place: expanding low and moderate income workers' access to capital markets.

(b) Who would bear the risks if the government underprices its annuity (taxpayers or beneficiaries)—and what mechanism would be used to implement the allocation of risks?

(c) What impact, if any, would this role for the government have on the private annuities market?

Contracting out to the private sector under rules that protect against companies segmenting longevity risks permits the market to resolve the pricing issues and avoids any potential adverse impact of a government-run system on the private annuities market. The government's role would be limited to setting appropriate annuity specifications, processing payments, and regulating and supervising the private sector financial institutions responsible for the program.

In this regard, it is important to note that a market structure is already in place to implement this system. Thus, for example, most defined contribution plans offer annuity options which are provided by insurance carriers (rather than the plan itself).[29]

3. *Private Market Annuity Options.* Workers and their beneficiaries could also be permitted to purchase private annuity options so long as problems of adverse selection and risk segmentation are addressed.

1. Permitting individual workers and their beneficiaries to avail themselves of the wider range of annuity alternatives available from the private sector offers several advantages. For example, (i) a family may prefer a joint and survivor annuity with a pattern of payments that differs from the Social Security sponsored model; (ii) a family may prefer annuity payments that cover a disabled child or elderly parents; (iii) a worker may want to retire early, with a "retirement gap" annuity that runs for a term of years, until Social Security benefits begin.

2. By allowing workers to take advantage of private sector options, it will be possible to maintain a Social Security-Sponsored Annuity Option as a simple, low cost, easy-to-understand alternative.

It would be necessary to regulate the institutions offering private market annuities in exchange for PRA balances with regard to segmentation of longevity risks, safety and soundness, and disclosure.[1] Because insurance has been regulated historically at the state level, there is no existing Federal regime to regulate annuities. For this reason, a threshold decision is whether to rely on the existing state-based structure, create a new Federal structure, or create a hybrid system of Federal standards for qualifying annuities, enforced by the states.

It is also important that administrative costs of private annuities be kept to a minimum and allocated fairly. As with personal retirement accounts themselves, we believe this means that costs of the Social Security sponsored annuities should be allocated based on asset size, rather than on a per account basis. Because the administrative costs of individual annuities may be as much as 5 to 10 percent of the purchase price (even without premiums for adverse selection), we believe that it is appropriate for retirees who choose to purchase such annuities to bear these costs themselves.

Conclusion

Two conclusions emerge from the foregoing. First, any system of personal retirement accounts will have to resolve many difficult policy questions. The most fundamental are: (a) Should Federal retirement policy move in the direction of universal personal retirement accounts? (b) How should personal retirement accounts be funded (carve-out from payroll taxes, mandatory additional contributions, or from general revenues)? (c) What rules should govern distributions from personal retirement accounts?

Second, regardless of how these *policy* questions are answered, institutions and mechanisms already exist that make it feasible to introduce personal retirement accounts in a way that minimizes administrative costs, distributes those costs fairly and reasonably, imposes little or no incremental burden on employers, is easy to explain and easy to understand, and meets the expectations of everyday Americans for simplicity, security, independence and control.

We believe the system we have outlined above meets these criteria. There are no doubt other ways a system of personal retirement accounts might be implemented. However, most of the alternatives suggested to date impose greater burdens on employers than the system we have outlined here because they give employers responsibility for transferring their employees' funds directly into investment funds, and require employers to provide information about investment choices to their employees. These are burdens we have endeavored to avoid. There are also many possible variations on the themes we have outlined here. For example, some have suggested that—rather than permitting direct transfers of funds into Q-Funds, as we have suggested here—all funds should move directly into SPIFs, with rollovers permitted only after some period of time, or after the individual's PRA balance has reached some threshold amount. We do not view such a limitation as necessary, but, to be sure, this is the kind of issue over which reasonable people may differ.

The plan for implementing personal retirement accounts that we have offered here will work no matter how various policy questions are decided. It will work however PRAs are financed, whether from existing payroll taxes, from general revenues, or through new mandated savings; whether PRAs are mandatory or voluntary; whether PRAs are integrated with Social Security benefits or not;

whatever the regime of spousal rights; and whether or not distributions are required to be annuitized. And it will work at reasonable administrative costs with those costs allocated fairly among beneficiaries.

Building on existing public and private systems and existing regulatory structures -- as the approach we have described here does -- minimizes start-up costs and makes it more likely that the program can be implemented relatively quickly and smoothly. This approach also takes advantage of the fact that administrative, market and regulatory systems are dynamic; they tend to change in response to changed incentives. The system we have described creates incentives that are likely to improve current practices in a variety of areas. For example, all of the affected participants (workers, employers, the IRS, FMS, and the Social Security Administration) will be motivated to improve the timeliness and accuracy of W-2 reporting and the filing and processing of income tax returns. In turn, these improvements will benefit workers, employers and the government in ways that go well beyond PRAs. Other areas where improvements are likely include: increased financial literacy among workers and beneficiaries, growth and flexibility in the annuities markets, and perhaps unification and simplification of the regime for regulating financial intermediaries. Moreover, while the PRA program would encourage additional investment in technology and improving a variety of administrative operations, those additional investments are not a pre-requisite for the effective implementation of PRAs.

Our key point is simply this: if personal retirement accounts are wise public policy, they can be implemented at a reasonable cost in a manner that imposes relatively little stress on existing public and private institutions.

To put the administrative challenge of personal retirement accounts in context, it is worth recalling what the world was like when Social Security itself was introduced in 1935. There were no Social Security numbers. Many Americans didn't have a telephone. There were no computers— all records were maintained on paper; all information was entered by hand; all correspondence was sent and delivered by mail; there was no computer-based financial infrastructure. Implementing Social Security under these conditions was hard; by comparison, implementing personal retirement accounts today would be easy. While there are difficult administrative issues regarding PRAs, they are not insurmountable. Administrative concerns should not become an excuse for not implementing personal retirement accounts—the only question is whether personal retirement accounts are good policy.

Notes

1. See, e.g., National Commission on Retirement Policy, The 21st Century Retirement Security Plan (May 19, 1998); Report of 1994-1996 Advisory Council on Social Security (Jan. 6, 1997); legislation introduced in the 105th Congress by Sens. Moynihan and Kerrey (S. 1792), Sens. Gregg and Breaux (S. 2313), Sen. Roth (S. 2369), Sen. Grams (S. 2552), Rep. Porter (H.R. 2929), Rep. N. Smith (H.R. 3082), and Reps. Kolbe and Stenholm (H.R. 4824).

Other countries have already reformed their national retirement policies to implement personal retirement accounts. See Appendix A (summarizing personal retirement account programs in Australia, Chile, Sweden and the United Kingdom).

2. For example, 67 percent of the respondents to a poll conducted on behalf of the Democratic Leadership Council in August 1998 would prefer setting up personal retirement accounts. When asked about the risk of stock market downturns, which could diminish the value of personal retirement accounts, 55 percent of the respondents to the same poll still would prefer personal retirement accounts. Similarly, results from an August 1998 poll conducted on behalf of Americans Discuss Social Security indicate that approximately 58 percent of respondents with an opinion on proposals to reform Social Security by creating personal retirement accounts reacted favorably to such proposals.

3. Some have proposed direct investment of Social Security Trust Funds in stocks and bonds. While this change would achieve some of the advantages of PRAs, it would fail to achieve others and raises important additional questions. Discussing this alternative is beyond the scope of this paper. We do recognize, however, that the cost of administering such investments would be less than the cost of administering PRAs.

4. The term "covered workers" refers to workers who participate in the Social Security system and are liable for payroll taxes that fund Social Security and Medicare. While most workers are covered, there are exceptions—notably, approximately 3.7 million workers employed by state and local governments. The term "covered wages" refers to wages subject to the payroll tax—in general, wages of covered workers up to a cap of approximately $68,400 for 1998. Except as otherwise noted, data is from Social Security Annual Statistical Supplement, 1997.

5. National Academy of Social Insurance, Report of the Panel on Privatization of Social Security (November 1998).

6. If a worker's account is divided from the outset between the worker and his or her spouse, then the worker and the worker's spouse would designate their respective investment choices on their joint or separate tax returns.

7. As noted below, the task of informing workers regarding the operation and administration of personal retirement accounts (including information and education regarding investment options) should be the responsibility of the Social Security Administration and other Federal agencies.

8. The relative ease of this system is illustrated by the following: More than 80% of all taxpayers already file refund returns, and the IRS and FMS are generally able to issue those refunds within 2-4 weeks after returns are filed. Moreover, under current law, taxpayers may instruct the IRS to issue refunds through direct deposit to a bank account owned by the taxpayer, by including such instructions on the Form 1040. The information required from the taxpayer for this purpose, and the administrative burden on IRS and FMS, is similar to that which would be required in the context of PRAs. During the 1998 individual income tax filing season, approximately 19.1 million individuals—more than 20% of all those receiving refunds—used this direct deposit system. Similarly, the increasing reliance on electronic funds transfers in other contexts, e.g., the payment of welfare benefits, also suggests that the system described above can be implemented with relative ease.

9. Of the more than 1.1 billion information returns filed each year with the IRS, approximately 5 million, or less than one-half of one percent, are subsequently corrected. Applying this ratio to the more than 223 million Forms W-2 actually filed in 1997, all of which were required to be filed in magnetic media, electronic format or on scanable paper, we expect that only 1 million Forms W-2 would need correction.

10. For example, in 1998 approximately 32% of all individual returns were filed within two months after the end of the year and approximately 90% of all returns were filed by May 1, only four months after the end of the year. It now takes Social Security approximately 9 months after the end of the year to process most W-2's, and it generally takes the IRS and Social Security up to 18 months to complete reconciliation of W-2's.

11. We recognize that there is still some lag in funding (whether measured from the time taxes are withheld, or from the end of the year). Nonetheless, on an account-by-account basis, there is no feasible or practical alternative to the approach we recommend. Two other approaches have been suggested to minimize the impact of this lag: (i) credit all accounts with some kind of imputed earnings (e.g., the short-term Treasury rate, using a six month convention); or (ii) have the government invest funds on an aggregate basis during the year in the SPIFs, using estimated investment choices. The former would be workable (the contribution to each account would be "grossed up" by the same percentage). The latter would likely impose substantial additional administrative burdens.

12. Kelly A. Olsen and Dallas L. Salisbury, *Individual Social Security Accounts: Issues in Assessing Administration, Feasibility and Costs*, EBRI (November 1998).

13. A recent EBRI study shows that a once per year deposit of $1,200 after 40 years would yield $8,315 less than a once per month deposit of $100 at a 7 percent rate ($254,166 rather than $262,481. Id. For a $300 annual deposit, the lifetime loss would be only about $2,080.

14. While several million individuals file returns each year showing income below the applicable filing thresholds, and almost one million individuals file returns each year showing no adjusted gross income, several million individuals do not file returns at all because their income falls below the applicable filing thresholds.

15. While SSA does not process W-2s below a certain threshold, this procedure would enable all workers to get PRA credit for their earnings.

16. See note 10, supra.

17. As a practical matter, this would avoid many of the compliance problems encountered in other contexts (e.g., the Earned Income Tax Credit).

18. Presumably, Social Security (rather than the IRS) should have responsibility for these error correction activities, and the costs of this activity should be funded from general revenues.

19. See notes 4, 11 and 13, supra.

20. The TSP, which is a retirement savings and investment plan for federal employees that was established by Congress in the Federal Employees' Retirement System Act of 1986, is a defined contribution plan that provides federal employees with a choice of three investment options. First, employees can allocate all or a portion of their accounts to the "G Fund," which consists exclusively of investments in short-term non-marketable U.S. Treasury securities issued directly to the TSP by the U.S. Treasury. Second, employees can allocate all or a portion of their accounts to the "C Fund," which is invested in a Standard & Poor's 500 stock index fund. Third, employees can allocate all or a portion of their accounts to the "F Fund," which is invested in a Lehman Brothers Aggregate bond index fund. Presently, the Federal Retirement Thrift Investment Board, which is responsible for oversight and management of the TSP, contracts with Barclays Global Investors to manage and invest the amounts allocated to the C and F Funds by participants in the TSP. TSP also plans to add two additional investment options (a Russell 2000 index and a foreign stock index) in the near future.

21. By law, the TSP may make equity investments only in a "commonly recognized index" which is a "reasonably complete representation of United States equity markets."

22. Although we have seen cost estimates ranging from 5 to more than 100 basis points, this is similar to the range of costs estimated in the NASI Report, supra note 6. It is also similar to the range of costs estimated by representatives from State Street Bank and Fidelity at an EBRI-sponsored conference on the feasibility of PRAs (Beyond Ideology: Are Individual Social Security Accounts Feasible, EBRI-ERF Policy Forum, December 2, 1998, Washington, DC).

23. For the reasons noted above (e.g., the wire transfer of almost 20 million refunds), this alternative could be implemented at little incremental cost to the Federal government.

24. We also think it is preferable to rely on that structure to the maximum extent possible, rather than create yet another regulatory regime.

25. These alternatives are currently required by section 404(c) of ERISA.

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26. This latter requirement would be particularly important if personal retirement accounts are funded from general revenues, and those accounts are integrated in some manner with Social Security to address Social Security's funding short-fall.

27. For example, the SPIF alternative may be the most effective deterrent to the marketing cost concerns under the Chilean and U.K. systems.

28. Account related inquiries regarding Q-Funds would be handled directly by those Funds.

29. For more extensive discussion, see the paper by James Poterba and Mark Warshawsky prepared for this conference.

30. Likewise, as noted above, policy considerations may place constraints on the types of annuities that can be offered. It may be appropriate to impose some kind of minimum guarantee requirement on participating carriers to deal with credit and performance risks.

Appendix A: Background on Personal Retirement Accounts in Foreign Countries

Australia

The Australian retirement income system is a two pillar model. The first pillar provides a flat-rate, means-tested pension known as "age-pension." The second pillar is the private retirement provision and mandates compulsory concessionally taxed saving for retirement through an employment-based system known as the Superannuation Guarantee ("SG"). The second pillar, or SG, is a compulsory, occupational based, defined contribution superannuation system. Under the SG, employers are required to make on behalf of their employees prescribed minimum contributions to complying superannuation funds, or personal retirement accounts. By 2002, this minimum contribution will be 9% of employee earnings. Employees also contribute 3% of their earnings to the superannuation funds, and the government can make contributions of as much as 3% of pay for lower-paid employees.

Unlike the Chilean or Latin American model, the key feature of the Australian model is the fact that rather than having individual accounts with individual choice, the employer and/or union trustees choose the investment manager for the company or the occupational group as a whole. Superannuation funds are managed by professionals in the financial service industry. The superannuation system has only one fund per employer, but workers still have a choice of investment because each fund offers several investment options. Superannuation funds operate as trusts with the trustees being solely responsible for the prudential operation of their funds and for formulating and implementing an investment strategy. Superannuation funds face few investment restrictions; there are no asset requirements or floors, no minimum rate of return requirements, nor a Government guarantee of benefits. The prudential regulation of the superannuation system is currently the responsibility of the Insurance and Superannuation Commission.

Chile

Chile replaced social insurance with individual funded pensions in the early 1980s. Under Chile's Pension Savings Account ("PSA") system, neither the worker nor the employer pays a social security tax to the state. Nor does the worker collect a government-funded pension. Instead, during his working life, he automatically has

10 percent of his wages deposited by his employer each month in his own, individual PSA. This percentage applies only to the first $22,000 of annual income. A worker may also voluntarily make additional tax-deductible contributions of up to 10% of wages.

A worker chooses one of the 21 private Pension Fund Administration companies ("Administradoras de Fondos de Pensiones," or "AFPs") to manage his PSA. The companies were specifically created for this purpose and are not allowed to engage in other business or financial activities. They are also subject to government regulation intended to guarantee a diversified and low-risk portfolio and to prevent theft or fraud. A separate government entity, a highly technical "AFP Superintendency," provides oversight of these companies.

Each AFP operates the equivalent of a mutual fund that invests in stocks and bonds. Investment decisions are made by the AFP. Government regulation sets only maximum percentage limits both for specific types of instruments and for the overall mix of the portfolio; and the spirit of the reform is that those regulations should be reduced constantly with the passage of time and as the AFP companies gain experience. The AFPs are under no obligation to invest in government or any other type of bond. Legally, the AFP company and the mutual fund that it administers are two separate entities. Thus, should an AFP go under, the assets of the mutual fund–that is, the workers' investments should not be affected.

Workers are free to change from one AFP company to another on short notice. Each worker is given a PSA passbook and every three months receives a regular statement informing him how much money has been accumulated in his retirement account and how well his investment fund has performed.

The Chilean PSA system includes both private and public sector employees. All employed workers, with the exception of members of the police and armed forces, must have a PSA. Self-employed workers may enter the system at their option.

A worker who has contributed for at least 20 years but whose pension fund, upon reaching retirement age, is below the legally defined "minimum pension" receives benefits from the state once his PSA has been depleted. The PSA system also includes insurance against premature death and disability. Each AFP provides

this service to its clients by purchasing group life and disability coverage from private life insurance companies.

Sweden

Sweden's social security system, known as a "notional account" system, is a pay-as-you-go, defined contribution system. Workers have individual accounts and passbooks that show accumulations and interest on accumulations, but, in reality, there is no money in the accounts; it is notional. The defined contribution scheme has a rate of 18.5% shared equally between employees and employers.

Beginning in 1999, there will be a small funded component to the system whereby employees can allocate 2.5% of their pension contributions to either a new pension fund, a new state-owned investment company or to an approved private investment fund. Collection and record-keeping for the funded component will be centralized and workers will choose the investment manager from a list of mutual funds. A guaranteed pension acts as a safety net at the bottom of the income scale.

United Kingdom

The United Kingdom model is similar to the Australian model. It has a two tier pension system which is funded on a pay-as-you-go basis. The first component of the system is a flat rate pension whereby both employees and employers contribute a fraction of the employees' earnings to the system. Employees receive the full flat rate benefit under the first tier of the system if they contribute to the system for the required number of qualifying years. The second tier of the system is the State Earnings Related Pension Scheme ("SERPS"), which provides benefits on a supplemental basis.

In the 1980's, employees were given the option of contracting out of the SERPS and taking a payroll tax cut of approximately 4.6% of their earnings and investing it in a private retirement account. In general, in order to opt-out, employees must receive a private, earnings-related pension at least as high as the pension they would have received had they fully participated in SERPS. Those who exercise the personal pension account option forgo their SERPS benefits. Britain allows only qualified institutions to accept and manage deposits made to personal pension accounts. At present, at least 1,700 mutual funds and investment funds can accept deposits. The system also places restrictions on the riskiness of investments, limiting the funds from investing more than 15 percent of their assets in commodities, futures or options.

Appendix B: Sample Average Total Expenses from Selected Types of Mutual Funds

Fund Category	Average total expenses
Growth	1.055%
Growth and income	0.832%
International	1.197%
Balanced	0.869%
Equity income	0.803%
Small cap	1.309%
Mid cap	1.174%
Global	1.243%
S&P 500	0.229%
Capital appreciation	1.103%
High current yield	1.119%
Municipal debt	0.742%
Investment grade debt	0.748%
Flexible portfolio	1.213%
GNMA	0.699%
A-Rated	0.797%
California municipal debt	0.702%
U.S. Government	1.131%

Source: Authors' calculations from Lipper Analytical Services, The Third White Paper: Are Mutual Fund Fees Reasonable? (September, 1997).

Appendix C: Regulation of Financial Institutions

The banking, securities and insurance companies that could offer Q-Funds presently are subject to extensive regulation and oversight by federal and/or state regulators, as well as self-regulatory organizations. The comparative chart and brief discussions that follow provide an overview comparison of the breadth and depth of the supervisory and regulatory framework governing insurance, banking and securities businesses.

Regulation	Banking	Insurance	Securities
Capital Adequacy	✘	✘	✘
Transactions with Affiliates	✘	✘	✘
Safety & Soundness	✘	✘	✘
Examination	✘	✘	✘
Record-Keeping	✘	✘	✘
Non-Discrimination & Fair-Dealing	✘	✘	✘

Banking. All depository institutions insured by the Federal Deposit Insurance Corporation (the "FDIC"), including national banks, state-chartered banks, federal and state-chartered thrift institutions and credit unions, are subject to comprehensive federal regulation, supervision and examination by their appropriate regulators. The appropriate regulators include the Office of the Comptroller of the Currency in the case of national banks; the FDIC and the Board of Governors of the Federal Reserve System in the case of state non-member and member banks, respectively; the Office of Thrift Supervision for federal and state thrift institutions; the National Credit Union Administration for credit unions; and various state regulators in the case of state-chartered institutions. The operations and financial condition of these institutions are subject to extensive regulation and supervision and to various requirements and restrictions under federal law, including requirements governing capital adequacy (tier 1 and total risk-based capital requirements, as well as a "leverage" capital requirement based on the ratio of tier 1 capital to total assets), activities and investments, bank transactions with affiliates, dividends, management practices, record keeping, and "Year 2000" compliance. Insured depository

institutions file annual, quarterly, monthly, and other reports with their regulators, which also perform on-site examinations. Federal and state regulators have broad enforcement authority over insured depository institutions, including the power to impose substantial fines and other civil penalties.

Securities.

Broker-Dealers and Investment Management Companies. These companies are regulated, supervised, and examined by the Securities and Exchange Commission (the "SEC"), the Commodities Futures Trading Commission, and/or self-regulatory organizations including the National Association of Securities Dealers, Inc. (the "NASD"), a registered securities association, and various national securities exchanges. In accordance with Section 15(b) of the Securities Exchange Act of 1934 (the "Exchange Act"), broker-dealers are members of the NASD and of various securities exchanges. Pursuant to delegated authority from the SEC, the NASD and the exchanges enforce the substantive Exchange Act rules and provide compliance oversight of the broker-dealer's activities.

Mutual Funds. Mutual funds are regulated, supervised and examined by the SEC under the Investment Company Act of 1940, as amended (the "1940 Act") and other federal securities laws. In addition, their major service providers are regulated, supervised and examined by the SEC, the Commodities Futures Trading Commission and/or self regulatory organizations such as the NASD and various national securities exchanges. The 1940 Act regulates, among other things, the amount of financial leverage that mutual funds may use, portfolio liquidity, investor redemption rights, record keeping, mutual fund disclosure and advertising practices, fees and transactions among a mutual fund and its affiliates. Mutual funds file reports with the SEC semi-annually and maintain continuously updated registrations for the sale of shares under the Securities Act of 1933, as amended. The SEC has extensive enforcement authority over mutual funds and their major service providers, including the power to impose substantial fines and other civil penalties, prohibiting violators from continued activities in the securities industry and referral to the justice department for criminal proceedings.

Insurance. Insurance companies are regulated, supervised, and examined by state insurance regulators. The primary regulator for a company generally is the state of its domicile, although there is an element of extraterritorial

application of investment and other insurance laws to companies not domiciled in a state. The National Association of Insurance Commissioners (the "NAIC") promulgates model laws and regulations that are generally followed by the state insurance departments. These include a formula and model law to implement risk-based capital requirements for life insurance companies and property and casualty insurance companies that are used as early warning tools by the NAIC and state regulatory agencies to identify insurance companies that merit further regulatory action. Insurance companies are also subject to various state statutory and regulatory restrictions on the amount of dividends or distributions they can make to their stockholders, as well as an extensive legislative and regulatory regime with respect to investment practices, strategies and procedures. The state insurance regulatory system incorporates tools to audit each insurance company domiciled within its state to determine that the insurance company is observing regulations regarding solvency, risk-based capital requirements, dividend and investment restrictions. In addition, individual products are reviewed by state regulators as to both forms and rates, and market conduct examinations are utilized by state regulators to insure that all of the consumer protection regulations governing products, prices, sales, advertising, agent licensing, claim handling and fraud detection are strictly observed by any insurance company selling life or property-casualty insurance products in the state.

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PREPARED STATEMENT OF HON. ORRIN G. HATCH

We have all heard a lot about the future of Social Security over the last couple of years. It is no secret that the demographics of our country are changing. We are living longer, having fewer children, and spending more of our time—an average of 1/3 of our lifetime—in retirement. All of these things affect our retirement system.

The need for Social Security reform is real—the need to save Social Security is not a scare tactic. We must change the way the system works, and we must do it now. It will be difficult to make tough political choices—especially when we hear dates like 2032. If you are like me, that sounds like light-years away. The only senator likely to still be in Congress is Strom Thurmond. It's a real temptation to keep putting off what we need to do.

Let's put the problem into perspective, however. A person who will reach 65 in 2032 was born in 1967 and is already 31 or 32 years old. If they are from my home state of Utah, they are probably married and have small children.

The financial solvency is not the only reason for us to address Social Security reform. Public confidence in the system is falling to an all-time low. More and more of these 31 or 32 year olds believe that Social Security will not be there for them by 2032 when they retire. They are even less likely to believe that they are getting their money's worth from the system. We need to fix this decline. We must create a public retirement program that the public believes in and is willing to support.

To do this, we should not be afraid to look at new ideas. There are several interesting, innovative reform proposals out there. One idea that is gaining popularity is the personal savings account. Even the President has jumped on the bandwagon with his USA proposal.

Personal savings accounts can help us strengthen the future of Social Security. They can improve the economic performance of our public retirement funds. They can improve the rate of return, especially for our younger workers, making them feel like they are getting their money's worth. Finally, these accounts can enhance individual accountability. Just what role these accounts play in any Social Security reform proposal must still be determined, however.

And, we must still answer several questions. First, how will these accounts work? What sort of investment options are available? Who makes the contributions and where? Who keeps the records and tracks these accounts? What happens to these accounts when a worker changes jobs? How are these accounts regulated? What happens to the account when a person retires or after they die?

Second, how much will these accounts cost to administer once they are set up? Who pays to collect contributions, maintain records, manage the investments, and pay out benefits?

Third, how do we transition to a system with private accounts? How much will this transaction cost? How do we pay for this?

Finally, we must look closely at the effects these accounts will have on employer-provided pension programs and individual retirement savings. Will these personal accounts drain the assets now going to private savings vehicles or will they be additional assets?

If we can answer these questions in the right way, personal accounts have tremendous potential to be an important part of Social Security reform. The testimony that the witnesses will give today will help to move us closer to the answers we seek. I look forward to hearing their testimony and thank the witnesses for being here today.

PREPARED STATEMENT OF ROBERT D. REISCHAUER*

Mr. Chairman and Members of the Committee, I appreciate this opportunity to discuss some of the issues raised by reform proposals that would establish personal retirement accounts as a key component of a restructured Social Security system. Advocates argue that such accounts will:

- increase the returns workers realize on their contributions to the nation's mandatory pension system,
- provide a vehicle for average workers to accumulate wealth that they can leave to heirs,
- ensure that the reserves accumulated by the mandatory pension system add to national saving and are not dissipated in tax cuts or spending increases, and
- instill in workers a taste for saving.

*Senior Fellow, The Brookings Institution. The views expressed in this statement should not be attributed to the Brookings Institution, its officers, or trustees.

My statement evaluates these arguments and discusses a number of concerns that supporters of the existing defined-benefit system, such as myself, have with reform proposals that would have personal retirement accounts play an integral role in a restructured mandatory pension system. In this context, personal retirement accounts could:

- subject some workers to risks they are ill-prepared to bear,
- reduce the social assistance now provided through the nation's mandatory pension system,
- introduce burdensome administrative costs and unnecessary complexity, and
- undermine the political consensus that, for over half a century, has supported adequate retirement pensions.

The seriousness of these concerns could be lessened if limits were placed on the form of the personal accounts and their uses. But such restrictions would be difficult to sustain and would negate many of the attributes that advocates of personal retirement accounts find most attractive.

Personal Retirement Accounts and Returns on Contributions

Claims to the contrary, personal retirement accounts would do nothing to increase the returns workers realize on their contributions to the nation's mandatory pension system. These returns are a function of the earnings of the assets in which the system's reserves are invested. This is true whether the reserves are held collectively in a trust fund or individually in personal retirement accounts. By law, Social Security's reserves are invested in special Treasury securities that, while riskless, yield relatively low rates of return. If the assets held by personal retirement accounts were restricted to Treasury securities, their return would be identical to that earned by Social Security on its reserves. If Social Security were permitted to invest trust fund balances in a diversified portfolio of private and government assets, as the president and others have suggested, the rate of return on Social Security's reserves would be similar to that projected for personal account balances invested in a balanced portfolio of stocks and bonds.

Many discussions of rates of return mistakenly contrast returns on personal account balances, which are assumed to equal the historic return of a balanced portfolio of private assets ignoring administrative costs, with the implicit return workers receive in the form of benefits from their payroll tax contributions. This is not even an apples to oranges comparison; rather it is a comparison of apples with elephants. Almost all—90 percent—of workers' payroll tax contributions are used to cover administrative costs and pay benefits to current retirees. Assuming the nation is not willing to renege on its commitment to the elderly, these benefits will have to be financed under a system with personal retirement accounts. Therefore, a proper comparison of returns should include or exclude, for both approaches, the return on the taxes needed to meet the system's unfunded liability.

Building Transferable Wealth Through Personal Retirement Accounts

It is true that workers could build private wealth in their personal retirement accounts that they could leave as bequests. For the vast majority, however, this should prove to be an empty opportunity because such transfers could occur only to the extent that workers chose not to use their account balances to purchase retirement annuities. Most workers enter their retirement years with limited personal financial assets and either a modest private pension or no pension at all. If they do not purchase annuities, they face a very real risk that they will deplete their assets prematurely and be dependent on welfare or family for support. For this reason, many reform plans that rely on private retirement accounts require that workers use their account balances to purchase annuities of at least a minimum value.

Personal Retirement Accounts and National Saving

Personal retirement accounts are often held up as the only foolproof way to ensure that the reserve accumulations generated by the nation's mandatory pension system contribute to national saving. Policy makers, it is argued, will try to do no more than maintain balance in the unified budget. Social Security surpluses, therefore, will be used to finance tax cuts or spending increases rather than to pay down debt held by the public and add to national saving. Because reserve accumulations in personal accounts would be outside the purview of the federal budget, they would not weaken fiscal discipline and, therefore, would contribute to national saving.

Widespread bipartisan support for the notion that Social Security surpluses should be used exclusively to reduce public debt should call the conventional wisdom into question. Policy makers may well be able to shift their fiscal policy target from one of maintaining balance in the unified budget to one of achieving balance in the government's non-Social Security accounts. If this effort is successful, reserve accumulations in Social Security will contribute to national saving as, or more, effec-

tively as accumulations in personal retirement accounts. The record of the past decade provides some reason for optimism. Between fiscal years 1990 and 1999, Social Security surpluses grew by $64 billion while, deficits in the non-Social Security accounts were reduced by $234 billion. Nevertheless, procedural safeguards should be legislated to reinforce the good intentions of policy makers.

Nor are accumulations in personal retirement accounts guaranteed to contribute fully to national saving. If workers regard the accounts as good substitutes for their other retirement saving, some may reduce their contributions to their 401(k) plans and IRAs. Others may feel wealthier and respond by increasing their debt or borrowing more against their home equity.

Personal Retirement Accounts and Individual Risk

To the extent that pensions are derived from the balances built up in workers' personal retirement accounts, more risk will be imposed on individuals than exists under the current defined-benefit Social Security system. Some may be ill equipped to shoulder these increased risks, which can come from a variety of sources.

Risk can arise from the uncertainties of life. The amount accumulated in a personal account at retirement, which will determine the size of a worker's pension, will depend, in part, upon how much was contributed to the account during the worker's career and when those contributions were made. Contributions made when a worker is young will matter more than contributions made close to retirement because the investment returns on early contributions will compound over many more years. This means that those with reduced labor force participation during their twenties and thirties—possibly because they are raising young children or are periodically unemployed because they lack the seniority needed to keep from being laid off during periods of economic weakness—could be at a disadvantage.

Market performance is another source of risk. Personal retirement account balances at retirement depend critically upon the type of assets in which the balances were invested and the strength of financial markets when the worker approaches retirement. Some will do well with their investments, others poorly. More experienced, savvier investors—often those with higher incomes and greater personal wealth—are likely to realize higher returns on their personal retirement accounts than those of more modest means. Workers covered by generous private pension plans and those with substantial personal wealth are more likely to invest their account balances in assets that, while riskier in the short run, yield higher returns over the long run than the assets chosen by those who feel they cannot bear such risk because they are not covered by a private pension plan or have few personal financial assets.

Entire cohorts of workers may be advantaged, others disadvantaged, if markets are particularly strong or weak when they retire or if interest rates are exceptionally high or low when they purchase an annuity. The past five years offers a vivid illustration of this point. Even without a dime of additional contributions, a worker retiring today whose entire personal account balance was invested in a total stock market index fund would receive a pension 167 percent larger than the one he would have received had he retired just five years ago.

The risks associated with personal retirement accounts do not cease when a worker retires. The worker or spouse may be blessed with a very long life and, therefore, run the risk of outliving the resources accumulated in the personal retirement account. Unexpected inflation may erode the purchasing power of the pension provided by the personal account.

To a greater or lesser degree, the risks to individuals that arise from a system of personal retirement accounts can be mitigated by restricting the degree of control workers have over their accounts. The variability in returns across individuals can be reduced by restricting permissible investments to a few index mutual funds or even to a single balanced portfolio of stocks and bonds. Inter-cohort variability in returns can be diminished by requiring workers to convert their account balances into pensions over the five or ten year period preceding their retirement. The risks that a worker and spouse might outlive their retirement assets or have the purchasing power of their pensions eroded by inflation can be eliminated by requiring that workers, upon retirement, convert their account balances into inflation-indexed, joint survivor annuities of at least a minimum size.

Such restrictions would make personal retirement accounts less attractive to many. They would limit the ability of workers to coordinate their personal retirement account investment strategy with their other retirement saving, diminish the feeling of ownership that workers have over their accounts, and reduce their opportunities to build wealth to leave to heirs.

There are, of course, risks inherent in the Social Security system, but they are not imposed on individual workers or retirees. Rather they are shared broadly

across workers and beneficiaries according to compromises worked out by the political system. When resources are not sufficient to support promised benefits, Congress and the president decide how to spread the unavoidable sacrifice among current and future taxpayers and beneficiaries. Adjustments can be phased in gradually, which is difficult to do in a system in which risk is borne by individuals.

Personal Retirement Accounts and Social Assistance

Relative to contributions, Social Security provides more generous pensions to those with relatively low average lifetime earnings, spouses who have not worked outside the home or who have had limited earnings, survivors, divorcees whose marriages lasted at least 10 years, and large families. This social assistance is the primary explanation for the profound impact that Social Security has had on the poverty rates of the elderly, the disabled, and the families of deceased workers. The program lifts more people out of poverty than all other federal income support programs—cash and in-kind—combined. Without their Social Security checks, close to half of the elderly would have been poor in 1997; with these pensions, only 10.5 percent of those age 65 or older were poor while 13.6 percent of the population under age 65 had incomes below the poverty threshold. Most importantly, Social Security has provided significant social assistance with little political controversy, unlike any of the nation's other redistributive programs except Medicare.

Personal retirement accounts cannot provide social assistance because they are individually, not societally, based. The balances in the accounts depend on individual contributions and the returns on those contributions. If all account holders were to invest in assets with the same return, pensions would be proportional to contributions. Those with low earnings and, hence, low contributions would receive proportionately smaller pensions from their personal accounts. Spouses with little or no experience in the paid labor force would receive little or no pension income from personal accounts. Large families would receive no more than small families with similar earnings.

The social assistance provided in systems with personal retirement accounts would be delivered through a separate, defined-benefit program. In some plans, this component would be a scaled-back Social Security benefit and, in others, it would be a flat or minimum benefit. If the amount of social assistance now provided through Social Security were to be maintained, the entire redistributive burden would be placed on a smaller program. The defined-benefit component would begin to look increasingly like a welfare program and political support for it may begin to erode. Poverty rates could begin to increase among low-earners, survivors, and divorcees.

The Administrative Costs and Complexity Associated with Personal Retirement Accounts

A system of personal retirement accounts could entail high administrative costs, charges that would reduce investment returns and diminish the size of account balances at retirement. If account management fees amounted to 100 basis points a year—which is less than the charge imposed by the average mutual fund—the account balance available at retirement would be roughly 20 percent smaller than it would be if such fees could be avoided.

Small accounts, of which there will be many, could pose particular administrative problems that would boost management costs. Each year, one in five workers—30 million—earns less than $5,000. Contributions to such workers' accounts would be small—a 2 percent contribution rate would mean a deposit of under $100 a year. Furthermore, many accounts will be inactive for periods when the account holder is unemployed or has stopped working to attend school, raise children, travel, or recover from an illness. In addition, many workers, particularly those with low earnings, have multiple employers during the year which could add to the administrative complexity of a system with personal retirement accounts.

Employers will incur expenses collecting and directing contributions to their workers' personal accounts unless these functions are carried out centrally through the existing payroll tax system. The 5.4 million employers—more than four in five—who do not use computerized payroll systems would probably find it impossible, or at least very costly, to collect and remit contributions to personal accounts in a decentralized system. Even large, sophisticated employers with direct deposit payroll systems would face difficulties making accurate and timely contributions to their workers' personal accounts if their employees could choose among thousands of fund managers and switch managers from time to time. A study of the British experience found that about 40 percent of workers changed investment managers at least once over a four year period.

Under a system of personal retirement accounts, the government will incur costs ensuring that the correct amounts are credited to the each account in a timely fashion. While these compliance costs can be minimized by having contributions made through the payroll tax system and the distribution of these contributions to investment managers made once a year after the tax records are due, the difficulties will not disappear. Under the current payroll tax system, over 11 million W-2 forms are submitted that don't match the Social Security Administration's (SSA) records. After various internal checks and communication with employers, about 4.5 million worker records remain with unresolved discrepancies. Roughly 500,000 employers fail to send their employer W-3 forms to SSA in a timely fashion or at all or send in unreadable records. Some employers fail to remit required payroll taxes because they have declared bankruptcy or gone out of business without making their final payment. Others are guilty of fraud.

In a defined-benefit system such as Social Security, these problems can be worked out over a number of years. When a problem cannot be resolved, the costs of correction can be shared broadly across the system. In a structure with personal retirement accounts, the solutions are not so simple. What happens when an employer fails to remit a contribution? Or when the contribution is remitted late—after the market has risen 5 percent? What happens when the contribution is credited to the wrong fund or account? Who takes the hit? Will personal retirement accounts be an invitation to millions of law suits?

Finally, there are the costs of educating workers about investing. According to a survey cited by the chairman of the Securities and Exchange Commission, Arthur Levitt, only 12 percent of the adult population knows the difference between a load and no load mutual fund, only 16 percent claims to know what an IRA is, half don't know the difference between a stock and a bond, and half have had little or no involvement in financial markets. A huge educational effort would clearly have to precede the introduction of personal retirement accounts. To the extent that workers are given control over the disposition of their account balances at retirement, a careful educational effort would also have to be undertaken to ensure that those approaching retirement are fully aware of the risks and consequences of the pension alternatives that are available to them.

A study of the British experience with personal retirement accounts (the Appropriate Personal Pension (APP) system), which was released earlier today by the Center on Budget and Policy Priorities, serves as a warning of the potential costs of a poorly designed system.[1] This research estimated that the costs of fund management, fund switching, and annuitization, in the British system would reduce the average account balance by 45 percent by retirement if reforms are not adopted.

The Sustainability of Adequate Pensions in a System with Personal Retirement Accounts

Every government program generates political interests that can either reinforce or undermine the program's purposes. A mandatory pension system that relies significantly on personal retirement accounts could well create pressures that, over the long run, lead to the erosion of pension adequacy. While restrictions may be imposed initially to ensure that personal account balances are devoted exclusively to providing retirement pensions, these limits will be difficult to sustain. Workers who have adequate retirement incomes from other sources, such as a generous private pension, will demand increased control over the disposition of their account balances at retirement. It will prove impossible to deny similar latitude to those with fewer retirement resources. The possibility that some will squander their balances, leaving them with inadequate retirement incomes, will rise.

Congress will also face increasing pressure to allow workers to tap into their account balances before retirement for worthwhile purposes. For example, future Congresses will almost certainly allow workers to use their account balances to pay for life saving medical treatment for themselves, a spouse, or a child. Similarly, during some future deep recession Congress will probably let unemployed workers dip into their personal retirement accounts to make mortgage payments if the alternative is foreclosure and a homeless family. What about the farmer trying to keep his land during a period of low commodity prices or the small businessman trying to rebuild after a fire, flood, or other natural disaster? What about letting workers borrow against their account balances for down payments on a first home or for educational expenses for a child? As the permissible uses of personal retirement account balances multiply, as they most certainly will, so too will the numbers of workers who reach retirement without the resources needed to provide an adequate pension.

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[1] Peter R. Orszag, Adminitrative Costs in Individual Accounts in the United Kingdom, Center on Budget an Policy Priorities, March 16, 1999.

While the defined-benefit component of the mandatory retirement system will cushion the fall of these unlucky individuals, an increased burden will be placed on the safety net—Supplemental Security Income, Medicaid, and food stamps—and public support for these programs could begin to erode as their rolls expand.

Even without such developments, popular support for the defined-benefit component of a system with personal accounts could weaken over time. A significant fraction of future workers will probably be quite comfortably off with the pensions provided by their private accounts, their employer-sponsored pensions, and their personal retirement savings. They might be willing to forgo the small annuities they receive from the defined-benefit component of the mandatory pension system in return for lower taxes. If so, the defined-benefit component could gradually evolve into a welfare program and income disparities among the retired could increase.

It is also possible that pressure will build to have the government compensate cohorts or individuals whose accounts have experienced exceptionally low returns. If the average pension of those retiring at the peak of a bull market were double those of cohorts retiring just a few years earlier or later—which, given the experience of the 1990s, is not an impossibility—the government might be called on to compensate those who came out on the short end of the stick through no fault of their own.

Conclusion

Personal investment accounts should play an important role in the retirement plans of American workers. But their contribution should be made through employer-sponsored pensions such as 401(k) and 403(b) plans and through personal retirement savings vehicles such as IRAs, not through the nation's mandatory pension program which should assure the basic retirement income that serves as the foundation upon which other, less secure, sources of retirement income can be built.

PREPARED STATEMENT OF SYLVESTER J. SCHIEBER, PH.D.

Mr. Chairman, I am pleased to appear before the Senate Finance Committee today to discuss personal retirement accounts as an element of Social Security reform. I have appeared before this Committee previously and have discussed the Personal Security Account (PSA) proposal that I helped develop as a member of the 1994–1996 Advisory Council on Social Security. I have recently done some further work developing a modified PSA proposal that will be described in a book that I have co-authored with Professor John Shoven of Stanford University that will be published by Yale University Press later this year.[1] The features of the sort of Social Security reform that I advocate today do not vary significantly from the PSA proposal that I worked on earlier when serving on the Advisory Council. Because I have already discussed my approach to Social Security reform with the Committee, I do not intend to restate the original or modified PSA proposals here.

Today, I intend to talk about two matters. The first is the transition cost associated with Social Security reform. The second is a mechanism for administering a reformed Social Security system that would include individual accounts. This latter discussion includes a statement of principles that I believe should be the starting point for setting up such an administrative system.

TRANSITION COSTS ASSOCIATED WITH SOCIAL SECURITY REFORM PROPOSALS

A host of Social Security reform proposals have been put on the table over the past two or three years with a highly varied set of features. I believe that the costs associated with many of these proposals have been widely misunderstood. Part of the reason these costs are misunderstood is that people often do not consider the starting point of current law with its existing unfunded liabilities. Part also results from the fact that the budget rules treat the costs and revenue flows differently under different proposals. Finally, part results from the fact that some proposals are presented without recognizing the economic costs associated with certain financing actions that are embedded in them. It is important to understand these costs if you are to judge between alternative Social Security reform approaches.

At the last formal valuation of Social Security as reported in the 1998 *Trustees Report*, the Social Security actuaries estimated that over the 75-year projection period the system was underfunded to the tune of 2.19 percent of covered payroll. In unpublished estimates, the actuaries estimate that this is the equivalent of $3.1 trillion in present value terms. In other words, if the trust funds had held an extra $3.1 trillion in government bonds at the end of the last fiscal year, the system would

[1] Sylvester J. Schieber and John B. Shoven, *The Real Deal: The History and Future of Social Security* (New Haven, Connecticut: Yale University Press, 1999).

not have been underfunded for the 75-year projection period. As we know, however, the 75-year valuation period itself masks the true long-term underfunding of the system. Stephen Goss, of the Social Security Administration's Office of the Actuary, has estimated that the 1996 deficit if the system had been valued in perpetuity, would have been 4.7 percent of covered payroll rather than the 75-year estimate of 2.19 percent that year.[2] This suggests that a permanent fix on the system under the current funding mechanism would require another 2.5 percent of covered payroll over the 2.19 percent. This would add another $3.5 trillion in funding shortfall over and above the first $3.1 trillion for the 75-year projection period to balance the system in perpetuity.

There is another aspect of Social Security funding that is equally if not more important to the actuarial imbalance that Congress is now discussing. That is the claim that the program will make on fiscal operations in the future. I believe there is a limit on the federal government's claim of our national product. At the extreme, the federal government could not possibly claim more than total domestic product. In actuality, we all know that its claim is much more limited than that. Over the past half-century, federal tax revenues have ranged roughly between 17.5 and 20 percent of gross domestic product (GDP) year in and year out. I believe a question that has been ignored in the crafting of some Social Security reform proposals is whether we can reasonably expect taxpayers to give government significantly more than that in the future.

The early architects of Social Security thought that the funding of the system by purchasing government bonds would allow each generation of workers to accumulate wealth during its working career that would be used to pay its benefits during retirement. There were critics of this form of funding for the system virtually from the moment the original Social Security Act was adopted in 1935. They argued that the accumulation of government bonds would not alter the true cost of the Social Security system on contemporary taxpayers at any particular point in time. If the system paid benefits of $450 billion dollars in 1999, it made little difference whether that was partially financed by redemption of bonds accumulated many years earlier or not. The redemption of bonds in 1999 was going to require the government raise the money from current taxpayers in 1999.

The early years of the program were partly characterized by long and contentious debates before this congressional committee and others about whether accumulating government bonds through the Social Security trust funds was truly funding or not. Those debates faded away as the system was gradually converted to pay-as-you-go financing. They have arisen again in recent years because of the actual and projected build-up in the trust funds following the adoption of the 1983 Social Security Amendments. The debate today is little different than that of the 1930s and 1940s. The exchange between Senator Robert Kerrey and Social Security Commissioner Ken Apfel before this Committee during August of 1998 was almost a precise paraphrasing of exchanges before the Senate Finance Committee between Senator Arthur Vandenberg and Social Security Commissioner Arthur Altmeyer nearly 60 years earlier.

Let us assume, for the moment, that Social Security can be funded through the mechanism of accumulating government bonds in one year and liquidating them some years later. Under this model, Social Security financing is out of balance. Staying with the 75-year estimates for this discussion, we have to make $3.1 trillion in adjustments to the current system to bring it back into balance. We can do it on the benefit side or the revenue side or some combination of the two. But there is no zero sum way of rebalancing the system without someone either giving up some benefits provided under current law or someone putting in more revenues. In either case that is a cost to someone relative to current law. Every one of the proposals for reforming Social Security has to begin with the existing imbalance. No one has shown a way to rebalance the system without closing the current imbalance.

Some people argue that we don't have to do all of the rebalancing through the current financing and benefit structures. Indeed, some people argue that we could use current budget surpluses to cover the financing imbalances. President Clinton's proposal laid out in his State of the Union speech earlier this year would directly transfer budget surpluses to the trust funds to bolster the current mechanism. The essence of what he proposes to do is to buy government bonds now held by the public and to put them in the trust fund. While using budget surpluses to rescue Social Security might permit us to solve its financing problems without having to explicitly adjust the program as much as without such general revenue infusions, no one

[2] Stephen C. Goss, "Measuring Solvency in the Social Security System," in Olivia S. Mitchell, Robert J. Myers, and Howard Young, eds., *Prospects for Social Security Reform* (Philadelphia: University of Pennsylvania Press, 1999), p. 22.

should believe that using general revenues somehow eliminates transition costs. Every dollar of general revenue that is transferred to Social Security is a dollar of revenue that could be used for some other purpose. The fact of the matter is that the money that makes up the current surplus is the taxpayers' money. If given the choice, I believe most taxpayers would suggest using the surplus for something other than Social Security financing. Some might want tax cuts. Many might question the wisdom of transferring most of the current budget surplus to Social Security if they knew it could potentially drastically limit government's ability to fulfill its other functions 30 years from now.

The President's proposal does not address the issue of whether the accumulation of government bonds in the trust funds is truly funding for the system. Will the accumulation of those bonds allow federal government to claim a larger share of the national output of future generations than congresses have been able to claim over the past half century? If it will not, then the President's funding proposal will simply complicate further the congressional prerogatives on what government can do and how it can allocate its limited resources. As public policymakers, I would encourage you to think very carefully about diverting most of the current budget surplus to Social Security financing of future benefits through the mechanism the President has recommended.

In the early 1960s roughly two out of every three dollars spent by the federal government was money over which Congress had discretionary control. Today, roughly two out of every three dollars spent by the federal government is spent on entitlement programs or interest payments over which Congress has little or no control. I believe that at least part of the contentiousness that seems to lay at the heart of much of policy deliberation today is the result of this shift. Policymakers are increasingly fighting to support their ideas and programs to improve our society with a diminishing share of national resources. If we devote most of current budget surpluses to secure future entitlement claims, we will see future Congresses in even more constrained circumstances than you are today. I believe that would be unfair to your successors and to the American electorate of the next century.

As I said, however, the President's proposal does not resolve the issue of whether the accumulation of government bonds truly funds future Social Security benefits. Clearly, the exchange between Senator Kerrey and Commissioner Apfel mentioned earlier suggests that the Senator does not believe accumulating government bonds is funding. Indeed, the Social Security reform proposal that has been put forward by Senators Robert Kerrey and Daniel Patrick Moynihan would legislate the return to pay-as-you-go financing of the system. But their proposal also includes very significant transition costs. They would impose most of the cost of rebalancing Social Security's financing on the benefit side of the program. The actuaries estimate that the long-term effect of their revenue proposal would reduce the 75-year tax collections under current law by 0.71 percent of covered payroll. In order to offset this reduction in the present value of tax collections, they propose to cut benefits by an amount equivalent to 2.9 percent of covered payroll—or $3.5 trillion in present value terms—over the period. While their plan would reduce the present value of payroll tax collections over the 75-year projection period, that does not mean that all future taxpayers would pay less taxes under their proposal than under current law. Their proposal would reduce taxes in the short term but raise them in the long term.

Senators Kerry and Moynihan's proposal shows that transitions not only distribute the costs of rebalancing the system differently across the revenue and benefit sides of the program but also distributes the costs of the system differently across generations than current law. In practical terms, the benefit reductions in their proposal would distribute in roughly proportional terms across the earnings spectrum. This would occur because the major elements of benefit reduction in their plan are increases in the retirement age and reductions in the cost of living adjustments (COLAs). Without getting into the sticky details of varying life expectancy across the income spectrum, these adjustments would affect both low and high earners in a similar fashion.

Some people have taken the historical debate about Social Security funding and the resulting congressional actions to the conclusion that the system will never be significantly funded through the bond financing structure traditionally used. They have come to advocate that we find alternative ways to fund the system. Funding of a retirement program means saving some portion of one's earnings while working and investing them for future liquidation after one has retired. Funding means to save. Some people have confused the discussion about Social Security funding with a debate over whether to invest in the stock market. Let's assume for a moment that society was made up of only one family—my wife, me, and our children. Let's say that my wife and I worked out an arrangement when we married that we would save some portion of our earnings and she would invest her savings in bonds and

I would invest mine in stocks. Between us, we buy up all of the stocks and bonds in our little society. After some years she sees that my stocks pay a higher return most years than her bonds and she concludes that this is not fair. So being a loving couple, we work out a deal that she will buy some of the stocks that I have been buying. Given that we live in a finite economy, I will have to buy the bonds that she is no longer purchasing. Has my family become any better off because of that? Absolutely not. Simply reshuffling our portfolio will not lighten the macroeconomic burden that our Social Security system will impose on future generations.

Since more funding of Social Security means added savings, the creation of individual accounts does not eliminate the transition costs that are imbedded in other proposals. For example, the proposal developed by the National Commission on Retirement Policy (NCRP) would impose substantial transition costs on Social Security participants. First of all, it would close the funding imbalance in current law by reducing benefits. It would do so by reducing benefits more for workers with higher earnings levels than those at low earnings levels. In that regard, it is distinctly different than Senators Kerrey and Moynihan's proposal. In addition to reducing benefits to rebalance the existing system, the NCRP plan would go further in reducing benefits in order to finance individual accounts worth 2 percent of covered payroll. This type of proposal often is characterized as a "carve out" of benefits from Social Security because the 2 percent contribution to the individual account is financed by a benefit reduction from the traditional system.

An alternative mechanism for financing the transition to an individual account system is by including an "add on" to the existing system. This is an approach that I have favored. Under the PSA plan that I helped develop at the Advisory Council we called for an added 1.52 percent transition tax. In the proposal that I have developed with John Shoven, we call for workers to contribute an added 2.5 percent of covered payroll, over and above currently legislated tax rates, that would be matched dollar for dollar by Social Security bringing the total account contribution up to 5 percent of covered payroll. I favor the add-on approach because I think that it is fairer and more tolerable than a carve-out approach. I come to this conclusion because of the differences in the relative size of the retiree and worker populations and the discrepancies between current law benefits and earnings levels. You see I am convinced we cannot avoid the transition costs in Social Security reform. We can only determine their distribution. And I think that how we distribute them raises tremendous equity questions that are not being squarely faced by some of the proponents of specific reform proposals.

Today, there are slightly more than three workers for every retiree. If we want to finance a 2 percent contribution on the earnings side it would cost workers an added 2 percent of payroll. Assuming benefits were equal to earnings, since there are three times as many workers as retirees, a carve out would have to equal 6 percent of benefits to generate sufficient funds to finance accounts equal to 2 percent of earnings. But the average benefit is only about 30 percent of average earnings, so the total benefit reduction would have to be about 18 percent—i.e., 6 percent divided by 30 percent—of current benefit levels to finance a 2 percent account program. Remember, this is a reduction on top of the benefit reduction called for to initially close the 2.19 percent of payroll imbalance in the current system. I believe the combined benefit reductions are so large they will not be politically sustainable. I keep seeing a rerun of the pieces that Walter Cronkite used to run on the evening news in the 1960s about old people eating dog food because they couldn't afford a regular diet.

I believe that it is imperative that you have the Congressional Budget Office come up with a consistent way of scoring all of the Social Security reform options that you consider. Make sure that you fully understand the transition costs in each of them before you jump to choose one or the other. My own personal attempts at trying to understand these costs, their distribution within generations and across generations, and how we might finance them has led me to propose the sort of reform options that I have. My own preference is for reform that includes some element of individual account. Because of the government's inability to accumulate wealth to fund Social Security obligations dating back to the 1930s, I believe these accounts have to be held independently of government control if they are to be an effective funding device for the retirement security of future generations. Some people would have us believe that one of the primary reasons that we cannot adopt such a reform option is that we cannot devise a reasonable way to administer such a system. I believe that is simply wrong.

AN ADMINISTRATIVE STRUCTURE FOR PERSONAL SECURITY ACCOUNTS

In this section I lay out a proposal for administering a system of individual accounts.[3] The system is structured to give workers considerable control over the investment of their retirement funds. In that regard it is different than legislative proposals that would create individual accounts but retain all portfolio choice in the hands of government managers. Giving workers some control over the investment of their assets may be important for two reasons. First, competitive markets tend to produce more optimal packages of services and prices than government programs. Second, giving workers control or an active role in the investment of their retirement savings is likely to spur more retirement savings just as it has done in the 401(k) environment.

There are a number of issues that must be addressed in structuring a system of self-administered accounts at the national level. One overriding issue is whether the administration system is appended to an existing government agency or set up as a separate entity. The separate entity could be quasi-governmental, such as the Federal Reserve Board, or administratively independent of the government except to the extent that it is regulated by the government, such as the Teacher Insurance Annuity Association and College Retirement Equity Fund (TIAA/CREF). There are a number of considerations for choosing one route or the other in resolving the issue of integrated or separate administration. The resolution of this issue depends, in part, on one's perception about other reform matters. Primary among these is the set of goals that should be met in structuring an administrative system for a national program of Personal Security Accounts. In addition, there are a number of practical issues that must be addressed in devising a system. These include such things as getting contributions from employers into individual accounts, record keeping, setting up a structure to allow workers to make investment choices, choices of investment managers, communicating the program, controlling administrative costs, and the like. The following discussion presents a step-by-step description of a system that would address most of these issues. After describing the administrative framework, I return to the matter of whether the system should be integrated with existing government agencies or set up independently.

ISSUES IN STRUCTURING A PSA ADMINISTRATION SYSTEM

Social Security is a national program and any program of mandatory PSAs would replace some part of the existing system on a national basis. To the extent there is some remaining element of Social Security there will have to be coordination between the remaining system and any new mechanisms that would be put in place. Also, to the extent there are continuing payroll limits on contributions, there would have to be some centralized clearing of amounts earned and contributed across an extremely dynamic workforce and employer environment. This suggests that some sort of administrative entity will need to fill an oversight role. Some people conclude that Social Security should fill that role because it is already administering a national retirement system. While it is possible that Social Security could serve that role, the SSA's current activities and those in an individual-account, retirement-wealth accumulation system are significantly different.

One consideration in setting up a PSA system that would either be independent or a new administrative assignment for SSA is the extent to which the benefits provided by the two are directly intertwined. If the reform of Social Security includes benefit offsets under the current program based on benefit accumulations in the PSA accounts, it would likely make more sense to have the two systems fully integrated. If the reform of Social Security includes independent benefits, albeit coordinated benefits structures through the design of contribution and benefit policies, there is less reason for the administration of the two systems to be handled by the same agency. To begin let us simply describe an administrative entity that we will call PSA Central. The question of where it resides relative to government will be addressed later.

The overriding goal in setting up a system to administer PSA accounts is to give workers control of their retirement accumulations in a regulated environment that aims for efficient management of the assets involved. Beyond that a set of specific set of goals can be stipulated for such a system. The first of these for many people is that the system limits the burden on employers, especially small ones without sophisticated salary administration systems and staffs to support cumbersome report-

[3] This part of the testimony draws heavily on a paper by Sylvester J. Schieber and John B. Shoven, "Administering a Cost Effective National Program of Personal Security Accounts," presented at the National Bureau of Economic Research Conference on the Administrative Costs of Individual Accounts as Part of Social Security Reform, December 4, 1998.

ing requirements. Second, the system must meet the needs of a diversified public in regards to security of funds accumulated through the system, simplicity of operation, and ownership and control of accumulating wealth to the extent appropriate in the context of a nationally mandated retirement system. Third, the administrative structure should be reasonably easy to explain and navigate. Fourth, there should be limits on the concentration of wealth control in order to minimize the significant pressures to divert the system's assets to uses other than the efficient accumulation and securing of retirement income. Fifth, the system should be structured to control administrative costs at reasonable levels and to distribute them fairly and reasonably across the participant population.

Regardless of whether the PSA Central is organized within or outside government, it is possible to specify its administrative roles and functions in the operation of the PSA system. If it is organized inside of government, it might serve as regulator as well as administrator. If it is organized outside of government, the regulatory function would continue to be fulfilled by a government agency. We are not addressing the role of the regulatory body in the development of the administration system that is laid out here. Throughout the implementation of the system and its continuing operations, PSA Central would be responsible for all record keeping associated with the accumulation of individual accounts.

DEPOSITING CONTRIBUTIONS AND ALLOCATING THEM TO INDIVIDUAL ACCOUNTS

Today, every employer required to withhold income tax from wages or liable for taxes under the Federal Insurance Contributions Act (FICA) must file a quarterly tax return using Form 941, unless the wages paid are for domestic service or agricultural labor. In the latter case, the tax return is filed annually on Schedule H with the employer's annual 1040 filing. Wage information is reported annually on Form W-2. FICA returns and tax payments on Form 941 are due on or before the last day of the month after the calendar quarter for which the return is filed. Deposits of accumulated taxes must be made more frequently. If an employer accumulates $100,000 or more of such taxes on wages paid, the taxes must be deposited the next banking day. Smaller employers are required to deposit either monthly or semi-weekly. The actual requirement for a particular business depends on past tax liabilities. The determination is made by looking back over a 12-month period each June 30. Employers who reported a liability of $50,000 or less can deposit monthly. Those with a past liability of more than $50,000, report semi-weekly.

Following the process that is now used in filing payroll taxes, the quarterly filing of Form 941 occurs by April 30, July 31, October 31, in the year in which a worker's earnings are paid, and on January 31 in the year following wages paid up through December 31. By mid-January, the Social Security Administration (SSA) begins receiving W-2 and W-3 statements from employers. In mid-February it begins processing paper reports. In mid-March it begins processing magnetic reports. In April of the year after wages are earned, SSA begins mailing notices back to employers about unverified Social Security numbers (SSNs) and names. In mid-April most self employed file their individual tax returns with IRS. In the May-June time frame SSA receives quarterly tax return data from IRS and simultaneously sends W-2 data to IRS. The two agencies compare data and begin a reconciliation process. By July 1 of the year following the year in which wages were earned, 98 percent of magnetic reports are fully processed and workers are credited with their past year's earnings. In the July-August time frame, IRS sends SSA tapes for posting of self-employment earnings and earnings for domestic workers. By the end of September, 98.5 percent of both paper and magnetic reports are fully processed and most workers are credited with their earnings from the past year. At this juncture, a reconciliation process of the remaining open cases begins. This process stretches out until April of the third year after the year in which an affected worker's wages were earned.

In the start-up phase of a PSA system payroll contributions would continue to be collected the way they have been in the past. As workers' earnings records are posted electronically at Social Security, they would be transmitted to PSA Central. Once PSA Central has the earnings records, it would allocate contributions to workers' accounts. The allocation process is described in the next section. Before turning to that, however, it is important to note, that during the initial phase of the system, actual allocation of roughly 98 percent of all workers contributions could take place within 9 months after the close of a calendar year. For some workers, that means contributions made in January of one year are not posted until nine months after the close of that year, 20 months after they are made. In the electronic age in which we live, that will be unacceptable to many workers.

After getting initial operations up and running, PSA Central will develop an alternative mechanism for reporting workers' earnings. Essentially, any employer willing to file monthly wage earnings records electronically on individual workers will be allowed to file in that fashion. Virtually all employers who have defined contribution systems are already compiling and filing this information with administrators of their plans. Many other employers using widely available salary administration systems could also provide this information with little effort and small marginal costs. PSA Central will reconcile monthly filings after the end of the year with the complete electronic filings it receives from SSA as it goes through its normal wage posting. For those workers who have their monthly earnings reported, PSA Central will allocate contributions to their individual accounts on a monthly basis. This policy will undoubtedly arouse employee pressure on those employers not reporting wages on a monthly basis to do so. As long as the decision whether or not to report on a monthly basis is left between each employer and its workers, it would be hard to make a case that this policy mandates any increased burden over and above current earnings reporting.

For workers with multiple jobs over a year whose covered earnings reach the maximum level of taxable earnings, their additional contributions would be held in a suspense account invested in government bonds. As these workers file their annual tax returns for the year, their excess contributions would be returned to them as a tax refund just as they are today. If a worker in this category earns a part of his or her annual wages through an employer that is reporting on a monthly basis, and part through an employer reporting under current procedures through SSA, the part reported on a monthly basis would be treated as first earnings for allocation purposes. The excess from the SSA allocation process would be the source of refund to the worker after the end of the tax year.

INVESTING THE FUNDS IN THE INDIVIDUAL ACCOUNTS

At the outset of a PSA program, as payroll tax contributions are deposited with the government, the share that would ultimately be invested in individual accounts could be segregated and invested in a government bond account and immediately begin to accrue interest. Allocation of PSA funds into individual accounts could be done at the time by the same date that wage records are posted with relatively low marginal administrative expense. The share of the fund representing records that have not been fully reconciled at any point could remain in the government bond fund as the remainder of the reconciliation process is completed. As outstanding cases are resolved, the fund could be allocated to the appropriate individual accounts.

This process does raise a slight equity issue in that someone who worked only in January of a year earning $10,000 would be credited exactly the same rate of interest on their contributions as someone who worked only in December of the year earning $10,000. The equity issues raised because of the inability to actually post wages on a month-to-month basis under current operating procedures is relatively trivial relative to a wide range of other equity issues that exist in the current system. While this situation is not optimal, it is the price to be paid for not imposing new administrative burdens on employers not willing to file wage records on a monthly basis.

It would facilitate the implementation of a PSA program and be more efficient if the administrative structure of the system was evolutionary. There should be two major phases to this evolution with the second one proceeding for some substantial period of time. In other words, the evolution would not be two discreet steps, with the full evolution of the system being completed at the time of the move to the second step. In the first phase of the evolution of the administration system, PSA Central would create a limited set of funds that workers could designate for the investment of their contributions under the personal account system. These would be structured to encourage minimal administrative and investment costs. They would also be structured to facilitate workers' understanding and efficient utilization of the system. It would give those with considerable experience in self-directed investment the opportunity to choose among asset classes and diversify risk. But it would also offer a limited environment to navigate for those without investment experience.

Let's assume, for the sake of discussion, that the system will initially offer six funds: a money market fund, a government bond fund, a corporate bond fund, a broad domestic large cap equity index fund, a broad domestic small-cap equity fund, and an international equity fund. The Board of Governors of PSA Central will put out a request for proposals (RFP) to the investment management community to manage funds in each of these asset classes. A group of managers will be chosen in each category on the basis of their proposed investment strategy in a given asset

class and on the basis of their charges for doing so. Some minimum number of managers will be chosen to manage the assets in each class of assets. Having multiple managers in each area, over time, will encourage efficiencies that arise out of competition. Such a policy will also preclude the necessity of completely replacing one investment manager with another with the periodic re-solicitation of vendors' bids to remain a manager under the system.

For the participant in the plan, this mode of operation would allow selection across a broad range of asset classes, but would simplify the amount of information that would be required to actually direct the investment of personal accounts. Having multiple vendors would minimize the concentration of assets in the hand of any individual investment manager or under the direct control of the managers of PSA Central. The investment fees under the system should be extremely low, because the structure of the system would encourage broad ownership of a class of assets and minimal churning of particular assets within the class. Record administration of the system should be quite efficient because of the economies of scale that can be realized from a large system as we have shown earlier.

In the second phase of evolution of PSA Central, individual fund managers would be able to offer a family of funds to individual workers. Their fund offerings would parallel those initially offered by PSA Central. Each fund manager in the system would have to offer a full range of funds. Although many managers would likely manage assets in the full range of asset classes included, some might offer several of the classes and contract with other managers to manage the others. Workers would be restricted in their ability to shift the management of their funds from the PSA Central group of funds to individual managers based on their account balances. The limits on being able to move to individual managers might be set at $1,000, $5,000, $10,000 or some other reasonable level. No individual worker would be allowed to have his or her fund invested with more than one manager at a time. Fund managers would be chosen to enter the system on the basis of an RFP process that would focus on investment strategy within each class of funds, security, and fees for asset management.

It is possible that some entirely new groups of fund managers might arise under this approach somewhat along the lines experienced in Australia. For example, it is likely that organizations like the AFLCIO, or even one of its affiliate members, might organize a set of funds to offer to union members. Such a fund might actually pursue investment policies that would serve its clientele's preferences—e.g., avoiding investing in anti-union companies. The pursuit of such policies would be permitted as long as the equity fund offered under this manager was broadly diversified across the total range of assets in economy and structured to operate efficiently. Over time, if it was deemed desirable, additional funds might be offered. The funds going to individual managers would still be flowing to those managers on a pooled basis. All record keeping would still be performed through PSA Central.

For the participant in the plan, this mode of operations would allow selection of both a broad range of asset classes and asset managers as well. Not implementing this phase of operations until after a couple of years of operation will give workers time to become familiar with the process of making choices in investing their own retirement money. Requiring that workers have a minimum balance will also increase the likelihood that workers have had some time and experience dealing with choice in the base system. The investment fees under the system should remain low because the structure of the system would still encourage broad ownership of each class of assets and minimal churning of particular assets. The record administration of the system should continue to be efficient because it is still centrally operated.

WORKER ALLOCATION OF FUNDS

Initial allocation of workers' assets to particular funds could be accomplished in several ways. After wage records are posted and the initial allocation of funds to individual workers is accomplished, they would make their individual investment choices. The three media that are used for doing this in 401(k) and similar plans are paper-based systems, voice response systems, and internet systems. We suggest that initial allocations would be permitted in all three media. Information relevant to workers' choices and their making them would be distributed through employers.

One of the questions that would have to be addressed at the outset is how frequently workers will be allowed to reallocate their assets in the system. The experience that Watson Wyatt Worldwide's consultants have had in the design, implementation, and administration of defined contribution plans where workers direct the investment of their own assets is that allowing workers the option of moving their money across funds on a daily basis actually results in fewer asset transfers than where assets can be moved less frequently. Initially the volume of work involved in

start-up activities might preclude the option of allowing workers to move their assets daily. Ultimately, however, the value of giving workers true control of the investment of their assets and the fact that they exhibit more stable tendencies in the freer environment suggests that daily allocation is the best way to proceed.

Another question that must be addressed at the outset is how to invest the assets of workers who fail to allocate their own assets in the system. This is a policy question that may result in a wide range of answers. The point of this discussion is not to resolve all of the policy questions associated with a PSA system, but to broadly specify an administrative system that provides policymakers with maximum flexibility. The range of choices would seem to go from allocating nonresponsive workers' assets into one particular fund, probably the bond index fund, to allocating them on some pro rata basis across the range of funds. The latter approach might actually alter the pro rata distribution of assets based on the age of the worker. This system would seem to accommodate all of the range of options or possibilities on an efficient basis.

COMMUNICATING THE SYSTEM

During the start-up phase of the system there would be a media blitz telling all workers of the implementation of the PSA system. Explanatory materials could be provided through all forms of news outlets, employers, the postal service, banks, churches, and other relevant community organizations. The asset allocation materials would be distributed through employers. Presumably, the federal government has the names and addresses of all employers who are currently contributing payroll taxes on workers so this would seem to be the most direct way to get to workers. Indeed, going through employers was the mechanism used in 1936 to register workers for assignment of the original set of Social Security numbers and resulted in significantly higher initial registration for such numbers than had been anticipated.

After the initial phase-in of the program, PSA Central would send workers periodic statements of their accounts. The statement would include information on contributions in the most recent period including the allocation of contributions by asset class, returns earned in each case, total cumulative balances in each class of asset and in total, and rate of return information for relevant comparison periods. Participants could also gather such information through a voice response system or the internet.

As the second phase of the investment options open to workers is introduced, it is likely that some communications would come from fund managers offering investment services directly to individual workers. Under this phase of operations, when the worker calls with questions regarding his or her balances, the call would either go directly to the particular vendor, let's call it Investco, or would be routed there through a call to PSA Central. The service representatives at Investco's would be plugged into the administrative record database at PSA Central and would have access to all PSA records being managed by Investco.

At least once a year, PSA Central would mail participants in the PSA system a report on all of the investment managers in the system. This report would break down the costs of administering the various elements of the system that were charged against the assets in the system. This would include specific charges related to administration and record keeping by PSA Central, communications costs, and asset management fees charged by PSA Central for its fund offerings and those of each individual fund manager with individual accounts.

Under this structuring of the system, it is likely that asset management fees will continue to be relatively low. Keep in mind that asset managers are not actually acquiring funds directly from individual workers. The money invested in their funds would flow to them on a pooled basis through PSA Central. If the individual managers' fees get to be too high, it is likely that workers would revert back to PSA Central. On the other hand, workers might be willing to pay somewhat higher management fees for using a particular investment manager because of the services provided. We propose limiting fund vendors fees to a level such that total administration cost of the system, including all central administration operations, is no more than 100 basis points. Our expectation is that most vendors would offer services at cost rates well below the ceiling. The fund manager would be required to annually report all costs associated with the operation of each of the funds offered and the returns on the fund. PSA Central would make this information available to the general public in a summary form through the news media and the internet. Investco's call center would handle all queries about account balances, asset allocations, and the like, for PSA balances being managed by Investco.

PAYING BENEFITS TO PARTICIPANTS

One of the other policy issues relative to the consideration of a PSA system is how benefits are to be distributed. In the case of retirement benefits, the issue is whether workers will be required to annuitize some or all of their PSA balance. Once again, this system is structured to give policymakers maximum flexibility in choosing among the options available to them. Since PSA Central will have a full accounting of all account balances and where they are invested, it would be quite easy as a worker retires and begins to claim benefits to sequester a portion of the accumulation for purchase of an annuity. Indeed it is possible that PSA Central could provide participants in the system with a list of current annuity vendors and the pricing of their products on a easily comparable basis if annuities are to be offered through private markets. If they are offered through the government by Social Security, the necessary funds could be transferred from the PSA system into an indexed bond portfolio.

START-UP FINANCING

Once the system that we have described is up and running, we believe the full costs of its operations should be borne by the assets in the system. During the start-up phase, however, we believe that the government should appropriate the funds to put the system in place. The need for this system is related to the goals of national governmental policies. The start-up phase of the system will create initial investment costs that should not have to be borne solely by the set of workers who are initially required to participate in it.

SUMMARY COMMENTS

There are some proponents of individual account reform of Social Security who are now advocating that the administration of the accounts be handled through a system as restrictive as the Thrift Savings Plan (TSP) available to federal workers. The system that has been proposed here is clearly more complicated than that. We offer this system for two reasons. The first is that competition in markets creates value for consumers. If there is any marketplace in the world that should fully appreciate that lesson, it should the one in which we live. The second reason is that the citizens of market-based societies prefer options, especially when it comes to the disposition of their own money. One of the lessons that is evolving from the Australian experience with its national mandated individual accounts system is that as workers accumulate wealth in their own accounts, they want some discretion in how that money is invested. Indeed, many of the participants in the TSP plan are unhappy with the set of investment options and service they receive under their employer based plan.

The system laid out here is meant to take advantage of existing technology, systems, and approaches to providing retirement benefits. No employer will be forced to make payments through any new mechanisms or file any reports not already required by law. They can continue to send their tax payments and periodic reporting statements exactly the way they do now. SSA and IRS can continue to do their processing exactly the way they do now. The existing system only needs to be changed at the point where contributions are allocated to specific accounts. But allocating accumulated contributions to individuals will be the price for actually implementing an individual account system in any event. The proposed structure here should be highly efficient from an administrative point of view. In addition to individual account administration, sending money to trustees will require administrative and control mechanisms. But if trustees can perform their functions for fractions of a basis point for a 401(k) with 2,000 participants, we believe PSA Central can do the same for a system covering millions of workers.

The new internal record keeping of accounts at PSA Central will create some new activities for our national retirement system. But by keeping the process essentially mechanical it should minimize costs. PSA Central should be able to buy a record keeping system almost virtually off the shelf to do the data processing required. Is there an existing system that can handle the volume of accounts that would be created under a national PSA program today? There is not, but parallel processing techniques should allow the creation of a system that is at least as efficient as the largest systems being widely used by plan administrators today. By keeping the level of services relatively low, the system is structured to encourage workers to move their money to private fund managers as quickly as possible.

Employers, including small employers, will undoubtedly feel pressure from their workers to disclose workers' wages on a regular monthly basis. That is why the proposal is structured the way it is. Encouraging employers to report electronically is

highly desirable because it is the most efficient and accurate way to report such information. That is really the only new pressure this system would impose on small employers. Frankly, we believe that many of the small employers in this country, and especially the self-employed would relish the opportunity to contribute a portion of their payroll taxes into their own and their workers accounts rather than sending it off to the SSA.

A system of the sort laid out here may require more communications than the system we have now, at least to the extent that some workers today are not participating in voluntary contributory retirement plans. But the distribution of general materials required by the system proposed and the distribution costs should be relatively minuscule compared to the overall scope of matters under consideration. The government could develop financial education programs that would run periodically on public broadcasting stations and encourage commercial stations to use them.

Table 22.1 Distribution of Wealth among the Near Elderly

Position in the Wealth Holding Distribution	Retirement Purchasing Power from: Personal Financial Wealth (percent)	Social Security Wealth (percent)	Pension Wealth (percent)	Total Wealth (percent)
Bottom 10th	3.4	93.6	3.0	100.0
1/3 from bottom	18.1	63.4	18.5	100.0
2/3 from bottom	29.9	35.7	34.4	100.0
Top 10th	65.2	10.2	24.6	100.0

Source: Derived by Sylvester J. Schieber from James F. Moore and Olivia S. Mitchell, "Projected Retirement Wealth and Savings Adequacy in the Health and Retirement Study," presented at the 1998 Pension Research Council Symposium, *Forecasting Retirement Needs and Retirement Wealth* (April 27, 1998).

PREPARED STATEMENT OF DAVID M. WALKER

Mr. Chairman and Members of the Committee:

Thank you for inviting me here today to continue the ongoing discussion on how best to ensure the long-term viability of our nation's Social Security program. Demographic trends threaten the program's solvency such that assets could be depleted by 2032. Numerous proposals to restore the Social Security program's solvency have been put forth; as one element of reform, many of these include individual accounts which could provide greater individual choice in retirement investment and increased rates of return.

In my remarks today, I will discuss several different approaches to restoring the Social Security program's solvency and sustainability and the various factors that must be considered in determining whether individual accounts should play a role as an element of Social Security reform. My comments are based on several recent GAO reports and testimonies, as well as our ongoing work.

In summary, Social Security forms the foundation for our retirement income structure and, in so doing, provides critical benefits to millions of Americans. Yet, problems facing this program pose significant policy challenges that we need to address soon in order to lessen the need for more dramatic reforms in the future and to demonstrate the federal government's ability to deal with a known major problem before it reaches crisis proportions. Some proposals suggest adding individual accounts—which are similar to defined contribution plans—to the current defined benefit program. These individual accounts offer the potential for increased investment returns, but they cannot by themselves restore Social Security's solvency without additional changes to the current system. In assessing these proposals, policymakers must consider the extent to which the proposals offer sustainable financing for the system. Also, they must consider how to balance improvements in individual equity (i.e., rates of return on individual contributions) while maintaining adequacy (i.e.,

benefit levels, certainty) of retirement income for those individuals who rely on Social Security as their primary or sole source of income. And finally, choosing whether to incorporate individual accounts into our Social Security system will require careful consideration of a number of design and implementation issues to determine if such a system would function effectively at a reasonable cost.

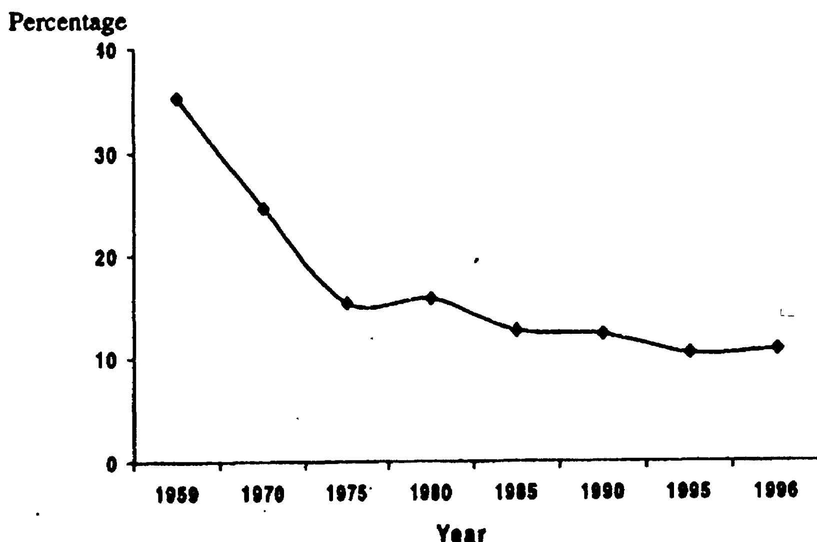
MANY PROPOSALS TO RESTORE SOLVENCY INCLUDE INDIVIDUAL ACCOUNTS

—Social Security's fundamental role in ensuring the income security of our nation's elderly;
—the nature, extent, and timing of Social Security's financing problem; and
—the differences between the current program and a program that might include individual accounts.

SOCIAL SECURITY IS THE FOUNDATION OF OUR NATION'S RETIREMENT INCOME SYSTEM

Social Security[1] has long served as the foundation of our nation's retirement income system. That system has traditionally comprised three parts: Social Security, employer-sponsored pensions (both public and private), and personal savings in the form of real and financial assets.[2] Social Security is viewed as providing a floor of income protection that the voluntary forms of employer pensions and individual savings should build upon to provide a secure retirement. However, private pension plans cover only about 50 percent of the full-time work force, and a significant portion of the American public does not have any other significant personal savings. In addition, Social Security is the sole source of retirement income for almost a fifth of its beneficiaries. Given Social Security's importance as the foundation of retirement income security, it has been a major contributor to the dramatic reduction in poverty among the elderly population. Since 1959, poverty rates for the elderly have fallen from nearly 35 percent to 10.5 percent. (See fig. 1.)

Figure 1: Poverty Rates for the Elderly Have Fallen Since 1959



Social Security represents a retirement income insurance program that helps workers collectively pool the risks associated with loss of earnings due to old age, disability, and death. It is a mandatory and almost universal program. As a result,

[1] Social Security refers here to the Old-Age, Survivors, and Disability Insurance program, also referrred to as OASDI.

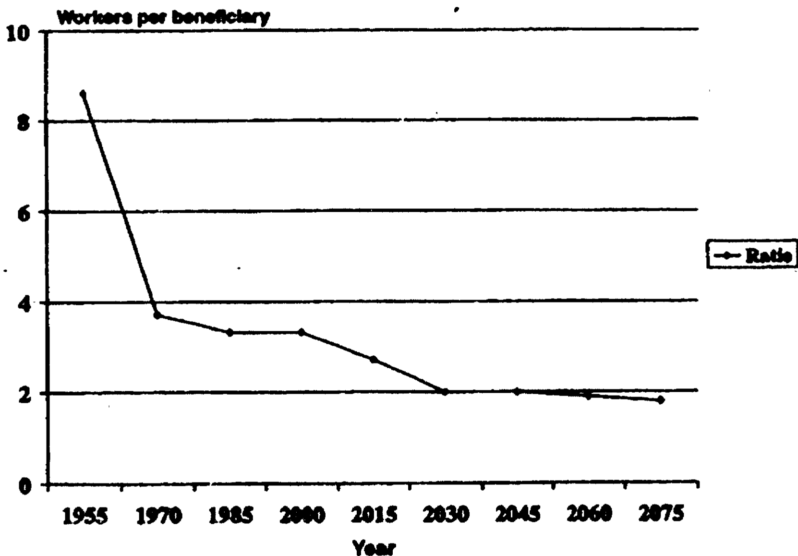
[2] For a dicussion of this traditional approach to retirement income, see *Retirement Income: Implications of Demographic Trends for Social Security and Pension Reform* (GAO/HEHS–97–81, July 11, 1997).

the vast majority of American workers take Social Security credits with them when they change jobs. Social Security also provides inflation-protected benefits for the life of the retiree. No matter how long they live, under the current program design retirees continue to receive Social Security benefits uneroded by inflation. The program, which provides benefits not generally available as a package in the private market, includes benefits for retired workers, their spouses and dependents, and their survivors as well as for the disabled.

THE FINANCING PROBLEM NEEDS TO BE ADDRESSED NOW

The Social Security system has required changes in the past to ensure future solvency. Indeed, the Congress has always taken the actions necessary to do this when faced with an immediate solvency crisis. However, the program faces demographic conditions that require action now to avoid unfairly burdening future generations with the program's rising costs and to give these individuals time to make the necessary adjustments to their retirement planning. Social Security's financial condition is directly affected by the relative size of the populations of covered workers and beneficiaries. Historically, this relationship has been favorable. Now, however, the covered worker-to-retiree ratio and other demographic factors, such as life expectancy, have changed in ways that threaten the financial solvency and sustainability of this important national program (see fig. 2).

Figure 2: Ratio of Workers to Beneficiaries is Declining



Thus, although the program was put in 75-year actuarial balance just 15 years ago, the Trust Fund balances now are projected to be exhausted in 2032 (as estimated in the 1998 Trustees' Report). In addition, the program will begin to experience a negative cash flow in 2013, which will accelerate with the passage of time. Absent meaningful program reform, this will place increased pressure on the federal budget to raise the resources necessary to meet the program's ongoing costs.[3] To restore solvency to the program today, we would need to immediately increase annual program revenues by 16 percent or reduce annual benefit payments by 14 percent across the board.

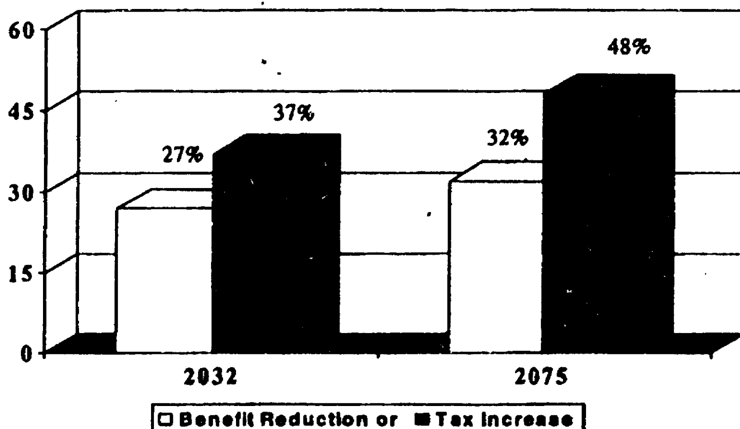
Even if such actions were taken today, attention would need to be given to their sustainability. We measure solvency in this program over a 75-year period. As each year passes, because the system is in temporary surplus, a year of surplus is

[3] *Social Security: What the President's Proposal Does and Does Not Do* (GAO/T-AIMD/HEHS-99-76, Feb. 9, 1999).

dropped from the calculation and a year of deficit is added into the 75-year average. Hence, changes made today that restore solvency only for the 75-year period will result in future actuarial imbalances nearly immediately. For this reason, we must consider what is needed to put the program on a path toward sustainable solvency so we will not face these difficult questions on a recurring basis.

Another way to understand the magnitude of the problem is to consider what the system will cost as a percentage of taxable payroll in the future. If we did nothing and let the Trust Funds run out in 2032, resources equivalent to 18 percent of taxable payroll would be needed simply to finance the system in the following yearmore than 37 percent higher than the revenues projected to be available under the 12.4 percent payroll tax that currently finances the system (see fig. 3).

Figure 3: Changes Are Needed to Maintain Solvency



Note: Percentage changes are necessary to maintain solvency for the next year only.

By 2075, the end of the Trustees' current long-term projection period, resources equivalent to nearly 20 percent of payroll—or a 48-percent increase in projected revenues—will be necessary. Alternatively, if we were to address these gaps through benefit reductions, changes equal to 27 percent of benefits in 2032 and 32 percent in 2075 would be required. Clearly, these dates are far off and projections are fallible. For example, stronger economic growth than currently projected would make it possible to meet the program's commitments more easily. Health advances that extend life expectancy beyond current expectations, and other variables, however, could make things worse. In addition, these revenue or benefit changes relate only to one year's financing gap. The percentages would have to be considerably higher to make the program solvent and sustainable over an ensuing 75-year period.

If we do not take measures to recognize and address this entire financing gap, we will have to revisit this difficult debate time and time again. The program's future financial situation calls upon us to make prudent judgments today that will affect those in the future who will be asked to meet these benefit commitments. Importantly, since we can anticipate this situation, and because our economy is strong, we can act now to avoid more painful decisions in the future.

DIFFERENCES BETWEEN THE CURRENT PROGRAM AND A PROGRAM THAT MIGHT INCLUDE INDIVIDUAL ACCOUNTS

A wide spectrum of Social Security reform proposals has surfaced in this debate, and they reflect different perspectives and opinions about how best to address the program's financing problem. Let me describe briefly the two main perspectives on the appropriate benefit structure for Social Security, which are analogous to the distinction between defined benefit and defined contribution pension plans.

The current Social Security system's benefit structure is designed to address the twin goals of individual equity and retirement income adequacy. Individual equity means that there should be some relationship between contributions made and benefits received (i.e., rates of return on individual contributions). Retirement income adequacy is addressed by providing proportionately larger benefits (redistributive transfers) to lower earners and certain household types, such as those with dependents (i.e., benefit levels and certainty). The current benefit structure combines these twin goals—and the range of benefits Social Security provides—within a single defined benefit formula. Under this defined benefit program, workers' retirement benefits are based on the lifetime record of earnings, not directly on the payroll tax contributed. Given the current design of the Social Security program and known demographic trends, the rate of return individuals will receive on their contributions is declining. In addition, as noted previously, current promised benefits are not adequately funded over the 75-year projection period.

Alternatively, those who propose individual accounts as part of the financing solution emphasize the potential benefits of a defined contribution structure as an element of the Social Security program and/or financing reform. This approach to Social Security focuses on directly linking workers' contributions to the retirement benefits they will receive. Workers' contributions are invested in financial assets and earn market returns; and the accumulations in these accounts then provide income in retirement. The advantage of this approach is that individual workers have more control over their accounts and more choice in how the accounts are invested. This control enables individuals to earn a higher rate of return on their contributions than under current law. Of course, these opportunities for higher returns exist because investors assume some measure of risk that the return expected may not actually be realized.

To illustrate the differences between the current Social Security defined benefit structure and a primarily defined contribution structure, we recently studied the experience of three counties in Texas that withdrew from the Social Security system in 1981 and substituted a defined contribution plan for Social Security.[4] The Texas plans offer retirement, survivors, and disability benefits. Although contributions are somewhat higher than those of Social Security, they are roughly comparable when Social Security's financing gap is considered. Benefits are based on contributions and earnings from investments. Under the Texas plans, contributions are invested conservatively in fixed income securities that are readily marketable. We simulated the benefits that typical workers could receive under these plans and compared them with what would have been received under Social Security. We found that for higher income workers the Texas plans provided higher benefits, especially initially. However, because of the Social Security benefit formula "tilt" toward lower earners, many such workers could have done better under Social Security. Other features of Social Security, such as adjustments for inflation, also suggest that many median-wage workers might have done at least as well, if not better, had they stayed under Social Security. However, the Texas plans followed a relatively conservative investment strategy with lower returns than are usually assumed in most individual account proposals. Nonetheless, our analysis does suggest we need to be careful that those most reliant on Social Security are adequately protected.

Some reform proposals incorporating individual accounts address the need for such protection by combining defined contribution and defined benefit approaches into a "two-tiered" structure for Social Security. Under such a structure, individuals would receive a base defined benefit amount with a progressive benefit formula and a supplemental defined contribution account benefit. Individuals could be guaranteed a minimum monthly benefit. This approach, however, raises a number of risks and administrative issues which I will discuss later in this statement.

FINANCING SUSTAINABLE SOLVENCY

Financing a sustainable solution relates to how we bring long-range program costs and revenues into balance. Addressing the current projected financing imbalance requires either raising revenues or decreasing program costs. Funding future benefit commitments in light of changing demographics through higher investment returns can help make the needed measures less severe, and this is one of the reasons many reform proposals include individual accounts.

But, creating individual accounts does not by itself address the solvency problem. Although individual accounts offer the potential to capture higher investment returns, if the accounts are adopted without the higher returns being shared within

[4] *Social Security Reform: Experience of the Alternate Plans in Texas* (GAO/HEHS–99–31, Feb. 26, 1999).

the system or without accompanying benefit reductions, the solvency problem will not be alleviated.

The extent to which individual accounts affect long-term solvency depends in part upon whether the accounts are "added on" to the existing system or carved out of it. Some proposals add on individual accounts as a type of supplementary defined contribution tier. This approach effectively leaves the entire 12.4 percent payroll tax contribution available to finance the program while dedicating additional revenues for individual accounts. These additional revenues might come from a payroll tax increase or from future unified budget surpluses. However, this approach does nothing to help Social Security unless incremental investment income is used to either supplement Social Security revenues or offset current promised benefits.

The "carve out" approach involves creating and funding individual accounts with a portion of the existing payroll tax rate. Thus, from the current combined payroll tax rate of 12.4 percent, a portion could be carved out and allocated to individual accounts. The obvious effect is that less revenue is available to finance the current benefit structure, so the system's solvency is further eroded.

Thus, individual accounts represent a way of using higher rates of return to raise more revenues in the future than does the existing Social Security program. At the same time, including such accounts as an element of reform requires that we consider ways to share the increased returns with Social Security or revise the existing defined benefit structure for future beneficiaries. In other words, to improve Social Security solvency, individual accounts and Social Security reform must be considered together.

In addition, finding the appropriate balance between the defined contribution and defined benefit approaches also has implications for the near-term financing of the Social Security program and its payments to current retirees and those in the near future. If individual accounts reduce existing program revenues to finance higher returns over the long term, we must still be able to continue to finance ongoing benefits to retirees in the short term. This problem of "transition costs" means that we may have to devote additional resources to the program in the near term. The tradeoff is that in the long run individual accounts may, if structured properly, help finance the program in a more sustainable way.

BALANCING EQUITY AND ADEQUACY IN THE BENEFIT STRUCTURE

Because individual accounts cannot contribute to restoring solvency without combining with Social Security in some way, it is useful to focus on the implications of individual accounts for Social Security's defined benefit program. The existing program includes a mix of benefits covering disability, spouses and dependents, and survivors. It also includes transfers to lower earners and families. Some proposals that include individual accounts have been criticized for not fully considering these other benefits when touting the advantages of higher returns on defined contribution accounts. But most proposals address the defined benefit portion by making a number of changes and adjustments to the existing program, and some proposals incorporate a guarantee of current law benefits. I will discuss some elements of these proposals briefly and also address the issue of whether to make the individual accounts mandatory or voluntary.

Decisions about the appropriate balance between the defined contribution and defined benefit portions will need to consider the purpose of the original Social Security program. The altered defined benefit portion will still be relied upon to provide a foundation that ensures an adequate and certain retirement income level. Existing proposals attempt to revise this part of the program in a variety of ways, including revising the benefit formula (usually to make it more progressive), changing features of the program (such as lowering the cost-of-living adjustment), raising the age of eligibility for normal and early retirement, or revising ancillary benefits (such as those for spouses). Most of these proposed changes are structured so as to leave current and near-term retirees unaffected. In addition, many would include an individual account element only for workers under a stated age, often around 50.

There are also ways to determine offsets to the individual accounts that would raise revenue for the defined benefit program. For example, Social Security could reclaim a portion of the individual account accumulations. This reclaiming, or so-called "claw-back," could raise significant "expectation gap" issues with individuals. These expectation gaps might be addressed by pooling the investment accounts and other measures.

Another feature of some proposals involves a guarantee of a certain benefit level. This guarantee could be provided in tandem with other benefit structure changes such that the worker would be guaranteed a minimum benefit. One approach would guarantee the current defined benefit. If the individual account provided less than

the current benefit, then the system would ensure that benefits were provided to fill the gap. Such an arrangement might be desirable from a benefit adequacy perspective but would require safeguards against the government becoming an insurer of excessive risk-taking by individuals.

Clearly, the number of proposals and features make it difficult to sort out exactly what should be done. We need to study carefully what impacts any given proposal would have, not only on the overall cost of the system but also, very importantly, on individuals and families.

One basic feature in this regard concerns whether to make investment in individual accounts mandatory or voluntary. Insofar as individual accounts are intended to substitute for a portion of benefits provided under current law to make it easier to finance the program, most discussion has involved accounts that are mandatory. This is consistent with the stated goal of Social Security to ensure a measure of income protection in old age.

The notion of making the accounts voluntary has entered the debate through proposals that seek to maintain the existing benefit structure of the program. A voluntary account is an add-on approach that would supplement Social Security benefits and provide a measure of individual choice. But under such an approach the overall implications for retirement income would be uncertain. If the voluntary account was supplementary, then it might be difficult to determine whether a voluntary account added to total retirement income; it might merely substitute for other forms of saving.

Another potential result of creating a system of individual accounts would be the development of an infrastructure that would allow workers to build up additional savings to meet both income and health care cost needs in retirement. For example, workers not covered by a private pension could choose to contribute more to their individual accounts to augment their retirement savings. Workers could also contribute more to their accounts as part of any possible premium support plan to help pay health care costs after they retire. The accounts could thereby contribute to overall retirement security, not just retirement income security.

OPTIONS ARE AVAILABLE FOR INDIVIDUAL ACCOUNT DESIGN AND ADMINISTRATION

Not all proposals for individual accounts clearly delineate how these accounts would be administered, but those that do vary in three key areas: (1) who would manage the information and money flow needed to maintain a system of individual accounts, (2) how much choice and flexibility would individuals have over investment options and access to their accounts, and (3) what mechanisms would be used to pay out benefits upon retirement. Decisions in these areas would have a direct effect on system complexity and who would bear the costs and additional responsibilities of an individual account system as well as on the adequacy and certainty of retirement income for future retirees. Essentially, most of the decisions about the design of a system of individual accounts amount to trade-offs between individual choice and flexibility on the one hand and simplicity and standardization on the other. A full assessment of the implications of these trade-offs will be essential to the debate on whether and how to implement individual accounts. Table 1 summarizes some of the administrative functions that would accompany any system of individual accounts, the critical decisions associated with each function, and a partial list of the options that could be considered.

Table 1: Snapshot of Design and Administration Issues

ADMINISTRATIVE FUNCTION	CRITICAL DECISION/TRADE-OFF	OPTIONS TO CONSIDER
Managing the flow of information and money	Centralized or decentralized record-keeping	Build on current Social Security tax and payroll reporting structure Build on employer-based 401(k) structure Build on individually-controlled IRA structure
Choosing investment options	Maximize individual choice or minimize risk	Offer a small set of indexed funds Offer a broad range of investment options Combine the two options by requiring a minimum account balance before a broader range of options is available
Paying retirement benefits	Maximize individual choice or ensure preservation of retirement benefits	Require lifetime annuities Make annuities voluntary and permit lump sum and gradual account withdrawals Combine the two options by requiring annuitization to ensure at least a minimum retirement income, with added flexibility for remainder of account

MANAGING THE FLOW OF INFORMATION AND CONTRIBUTIONS

When considering the design of a system of individual accounts, the first important decision involves account administration and management—that is, where and how the information on individuals' contributions and the accompanying money flow would be recorded and managed. There are several ways in which this could be done, and the options span a continuum ranging from a centralized record-keeping system managed by the government to a completely decentralized system managed by various entities in the private sector. Each option offers advantages and challenges.

For example, a new system of individual accounts could build on the current tax collection and payroll reporting system of the government, with an agency such as the Social Security Administration assuming record-keeping responsibilities for individual accounts. Alternatively, some new centralized government clearinghouse could assume this responsibility. Managing this information centrally could help keep costs down by taking advantage of economies of scale. For example, administrative costs for the federal Thrift Savings Plan, which centralizes both the record-keeping and investment functions, are low—averaging about $17.00 per account in 1998. Centralizing these functions by building on the current system would not be without challenges, however. Under the current system, employers report earnings and contributions on an individual basis only once per year; it would take at least 7 to 22 months from the date an individual made a contribution to the date this information could be attributed to an individual's record. This time lag would likely make it necessary to pursue interim investment alternatives and to educate individuals on the nature and impact of the lag. Options to change the system to enable more timely recording and investing of contributions do exist, but they would require significant changes in the record-keeping systems of the government agencies, additional costs and reporting burdens for employers, or both.

If individual accounts were not centralized, they could be built upon a model similar to either the current 401(k) or Individual Retirement Account (IRA) systems.[5] While providing a wider range of alternatives for individuals, this approach would be accompanied by additional responsibilities and costs for employers, workers, or both. For example, under a 401(k) model, employers would bear the responsibility for creating an infrastructure to quickly deposit contributions and provide employees with links to and choices among investment managers. Building on an existing

[5] A 401(k) pension plan is an employer-sponsored defined-contribution plan that allows participants to contribute, before taxes, a portion of their salary to a qualified retirement account. An IRA is a personal, tax-deferred retirement account; IRA assets can be invested in almost any kind of financial instrument.

employer structure such as this would pose challenges and could prove costly to employers, however, because about 50 percent of the private sector workforce is not covered by an employer-provided retirement plan. Under an IRA approach, individual employees would bear the responsibility on their own to select an investment manager or managers and deposit their contributions. Under both of these decentralized options, the appropriate government oversight role would have to be weighed and considered.

PROVIDING FLEXIBILITY IN CHOOSING INVESTMENT OPTIONS

The next critical decision centers around how much choice or discretion individuals would have in selecting who would invest their funds and what the range of their investment options would be. Some proposals would allow unlimited investment choices, while others would offer a more limited range of choices. The primary consideration in deciding among the proposals would be finding the right balance between individual choice and the related risks and costs to the individual and the government. These inherent trade-offs should be considered carefully.

Proposals that build upon a centralized system often assume that the government or some independent oversight entity would select a fund manager (or managers) through a competitive bidding process. Individuals would then select from among the investment options offered by a designated party. Some propose that these options be limited to a small set of passive or indexed funds similar to those offered under the federal Thrift Savings Plan, thus minimizing risk to the individual while providing some degree of choice. Such an approach would also serve to minimize administrative costs and program complexity. However, a centralized system of individual accounts also raises the risk that investment decisions could become politicized, depending on the extent of government's role in selecting the funds and fund managers and in other investment or fund allocation decisions. There are, however, ways in which these risks could be mitigated (e.g., employing master trust concepts or creating individual participation pools).

Other proposals would permit individuals more discretion in selecting their fund manager or managers, either through their employers or directly in the private market. Under this model, individuals would be able to select from among a much broader range of investment options, thus providing individuals with wider latitude to maximize their returns and enhance their retirement incomes. However, with that wider range of choices would come the attendant risk to individuals that their retirement income would not be adequate, as well as risk to the government that individuals with inadequate retirement income would turn to the government for support from other programs. In addition, a wider range of choices could also lead to added administrative complexity and higher administrative costs, which, if not offset by significantly higher returns, would further undermine individuals' retirement income.

Regardless of whether individuals were offered a wide or limited range of investment choices, there would likely be a need for enhanced public education, especially if participation in individual accounts was mandatory. Some educational effort or mechanism would be needed to provide individuals with information they could use to make informed investment decisions and to understand the consequences of these decisions. For example, individuals would need information on basic investment principles, the risks associated with available choices, and the effect of choosing among alternatives offered for annuitizing or otherwise withdrawing or borrowing accumulations from the accounts. This would be especially important for individuals who are unfamiliar with making investment choices, for example, low-income and less well-educated individuals who may have limited investing experience. Moreover, the more choices offered, the more extensive the educational effort would need to be. If fewer investment choices were offered, the educational effort could be less costly. Who would provide such information to workers or who would bear the cost is not clear, but it might be possible to draw from experiences in the private pension system.

PRESERVING ACCOUNT RESOURCES FOR RETIREMENT

The final design element centers around how the accumulated earnings in individual accounts would be preserved for retirement. Ensuring that retirement income is available for the life of the retiree is a fundamental goal of Social Security. Two important decisions relate to preservation. The first is whether to allow access to the accounts by workers before retirement (e.g., through borrowing). For example, most 401(k) pension plans allow participants to borrow against their pension accounts at relatively low interest rates. In prior work, we reported that relatively few plan participants—less than 8 percent—had one or more loans from their pension

accounts at a specific point in time.[6] However, those plan participants who borrow from their pension accounts risk having substantially lower pension balances at retirement and, on average, may be less economically secure than nonborrowers. While some may argue that individuals should be allowed the freedom to optimize their lifetime income through borrowing from their accounts before retirement, the added complexity and potential diminution of retirement income need to be given serious consideration.

The second important decision is how much flexibility to permit workers when they retire and begin to draw on their accounts. Annuitization of individual accounts is one way to preserve benefits and ensure that benefits are available for the entire life of the retiree—no matter how long he or she lives. However, there are many questions to address in this area.

—Since these accounts would be the personal property of individuals, should annuities be required or should individuals have the option to withdraw their account balances in a lump sum or through gradual payments?

—Could the mechanisms that are currently available for purchasing annuities accommodate the significant increase in demand?

—Would new structures and additional oversight be needed?

—How would the various annuity options compare with those of the current system, and would they provide for survivors' benefits?

—Should annuities offer protection from inflation?

Once again, this is not an all-or-nothing proposition. For example, it would be possible to require that individuals annuitize that portion of their accounts which would ensure a minimum retirement income and then provide more flexibility for any funds remaining.

LEVEL OF ADMINISTRATIVE COSTS IS DEPENDENT UPON SYSTEM DESIGN

Many people have expressed concerns about the administrative costs of individual accounts and how these costs would affect accumulations, especially for the small account holder. Each of the decisions discussed above could have a significant effect on the costs of managing and administering individual accounts, and it will be important to consider their effect on the preservation of retirement income. Administrative costs would depend upon the design choices that were made. The more flexibility allowed, the more services provided to the investor, and the more investment options provided, the higher the administrative costs would be. For example, offering investors the option of frequently shifting assets from one investment vehicle to another or offering a toll-free 1–800 number for a range of customer investment and education services could significantly increase administrative costs. Moreover, in addition to decisions that affect the level of administrative costs, other factors would need to be carefully considered, such as who would bear the costs and how they would be distributed among large and small accounts.

When considering whether and how to include a system of individual accounts as a part of Social Security reform, vital decisions on the optimal design, administrative structure, and implementation schedule will need to be made with great care. A system of accounts that spans the current 148 million workers and the 6.5 million employers, regardless of its design, would be significantly larger than any system we have in place today. Such a change would take time and careful deliberation over each of the options and trade-offs mentioned above. In addition, any implementation of individual accounts would need to allow for sufficient lead time to ensure success. The Social Security system is one of our nation's most important and visible programs. Therefore, we cannot afford to incur major implementation or administration problems. This is especially true because individual accounts would be highly visible to individuals and would represent "their money."

CONCLUSIONS

The Congress faces significant challenges in restoring sustainable solvency to Social Security. We have a historic opportunity to meet these challenges because of the strength of our economy and future budget surpluses. We also have a historic responsibility—a fiduciary obligation, if you will—to leave our nation's future generations a financially stable system. I believe it is possible to craft a solution that will protect the Social Security benefits of the nation's current retirees while ensuring that the system will be there for future generations; and perhaps the answer does not lie solely in one approach or the other—defined benefit or defined contribution. Bridging the gap between these approaches is not beyond our ability. GAO and

[6] These issues are discussed in *401(k) Pension Plans: Loan Provisions Enhance Participation but May Affect Income Security for Some* (GAO/HEHS-98-5, Oct. 1, 1997).

I stand ready to provide the information and analysis that can help the Congress meet this challenge in a way that can exceed the expectations of all generations of Americans.