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PRIVATIZATION OF THE SOCIAL SECURITY OLD AGE AND SURVIVORS INSURANCE PROGRAM

HEARING

BEFORE THE

SUBCOMMITTEE ON SOCIAL SECURITY AND FAMILY POLICY

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

ONE HUNDRED FOURTH CONGRESS

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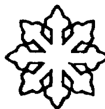

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PRIVATIZATION OF THE SOCIAL SECURITY OLD AGE AND SURVIVORS INSURANCE PROGRAM

WEDNESDAY, AUGUST 2, 1995

U.S. SENATE,
SUBCOMMITTEE ON SOCIAL SECURITY
AND FAMILY POLICY,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 9:35 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Alan K. Simpson (chairman of the subcommittee) presiding.

Also present: Senator Nickles.

OPENING STATEMENT OF HON. ALAN K. SIMPSON, A U.S. SENATOR FROM WYOMING, CHAIRMAN OF THE SUBCOMMITTEE

Senator SIMPSON. Good morning. I am pleased to convene this hearing of the Subcommittee on Social Security and Family Policy.

We are here this morning to discuss the merits of privatizing the Social Security system, a rather provocative idea, you would admit, that I think deserves our consideration as we look for ways to strengthen Social Security.

I believe any discussion of Social Security has to begin with the premise that the present system is unsustainable over the long term as it is currently structured. The Social Security Board of Trustees are the ones who are advising us of this. They came before this subcommittee earlier this year and outlined this stark reality in the clearest possible terms.

Of course, when we speak of Social Security in these hallowed halls a sea of colleagues stream to the hearing room, as they have again today. Lovely people, but you see both parties have said that Social Security is off the table.

There are two of us, at least—Senator Bob Kerrey and myself—in a bipartisan way are saying it is not off the table. It is a rather lonely crusade, to say the least, by a hardy pair of ragamuffins. But we feel that we have some proposals that deserve consideration, and they are being considered by this panel, and others, to restore solvency to the Social Security system which, as I say ironically enough, is off the table when it is actually $360 billion of the stuff on the table. You cannot very well deal with the issues that confront us on the deficit and the debt ceiling unless we deal with an item costing $360 billion.

But, specifically, the trustees told us that the combined Social Security Retirement and Disability Trust Funds will simply go broke in the year 2030, 2031. Some express joy and they say, well, it is not 2030, it is 2031. Well, that is not much solace because, if you remember, when we corrected this under the good auspices of Senator Pat Moynihan of this committee back in the early 1980's by simply raising the payroll tax and some other adjustments, you will recall that we were then told that those adjustments would assure that Social Security would be "viable" until the year 2036.

Today we are told, just 14, 15 years later, that the system will be "viable" until only the year 2031. So we have moved up the doomsday date some 30 years, 32 years, in just 15 years. What will be the surprise next year, that it will go broke in 2025? It could well be. That could be the news because it is "unsustainable."

But even more troubling was the trustees' revelation that Social Security expenses will begin to exceed revenues by the year 2013. So even though black-out day is 2031, in the year 2013, at that time, the government will begin cashing in the IOU's in the trust fund because the government does not hold any earmarked assets for this contingency. The government will then be forced to raise taxes or cut benefits to pay off the IOU's; pick your poison. These are sobering projections.

Given the reality that we face, it is clearly a long-term problem. We know that. I believe, then, we must consider long-term solutions. And, as I say, Senator Kerrey and I have introduced legislation that calls for a number of significant reforms in Social Security, one of which would allow individuals to direct 2 percentage points of their Social Security payroll tax toward a Personal Investment Plan, a PIP, as we call it, and it is a pip, of course.

I believe that incorporating this element of privatization into the Social Security program could greatly strengthen the public's confidence in Social Security. Each individual can make his or her own decision as to how these funds would be invested. We in the Congress would be spared finally from having to listen to the ancient babble about the trust funds being embezzled or "looted" or stolen, or thugged, or whatever is most dramatic, to raise money for the groups using it.

I would emphasize that Senator Kerrey and I are not proposing that Social Security be dismantled. Under our legislation, the core of the program would remain in place. Those who choose to establish personal investment plans would receive proportionately smaller benefits, but they will also receive and reap greater earnings from their personal investment plans. The exact amount of the earnings will depend on the investment decisions each individual makes.

Essentially, what we are talking about is empowering Americans to have more control over their own retirement income. I am convinced that this proposal would vastly improve the financial well-being of future generations of retirees, but, more importantly, I also sense a very genuine spirit and enthusiasm for this approach among younger Americans.

I have three children. They are 38, 36 and 32. They all have serious doubts about the future of Social Security, and they share that with me. No wonder. I think that in any kind of proposal that gives

them some out when they know that there is going to be nothing in it for them and they are still smiling while they are pouring into it more and more—I think the figure is that three-quarters of all workers today are currently paying more in Social Security than in Federal income taxes. Somehow they are still wandering around smiling.

I think anyone between 18 and 45 that does not get organized and begin to think about what is going to happen to them is surely wandering in the wilderness. Maybe they had better band together. I think it would be good.

There are several groups that have testified before the Entitlements Commission and before this panel; young, enthusiastic, spirited people who believe that they have to form a political base so that then they will have the power to walk into a Congressperson's office and say the usual pitch, which is, there are blank million of us and we vote. Until those people between 18 and 45 have figured that out, I will have no sympathy, no sorrow, no remorse about what will become of them in this process.

I will vote on a debt limit within a few weeks of $5 trillion. I have no concept of what that is, nor does anyone. The deficit is $230 billion, headed for $300 billion, for $400 billion. And, if the great effort does not succeed in these next months of trying simply to slow the growth in programs and not cut anything, then we will see what happens.

Those of the other political faith can pick up the traces, and any figures the Social Security people have given us, or anyone else, you can just accelerate by 50 percent. They will just go broke faster. The pitch will be, why, we would not let those people do that to you, we saved you. We would not let them cut Medicare, we would not let them cut Medicaid, we would not let them toy with Social Security.

Whatever the doomsday scenario is that has been presented by trustees appointed by this President and members of his Cabinet will simply be accelerated and come in a more swift and tremendously savage way, because at that point we will simply raise the payroll taxes or cut the benefits.

Guess which one will go first? The groups that plead for the raising of the payroll tax do not pay them. Those are the retired, and the seniors. Largely, most of them have passed the plateau of paying payroll taxes. You can bet they will not be for reducing any of the benefits.

So, with these exciting things that thrill my colleagues till they nearly pale, we will go forward. I always enjoy this role in the sense that my colleagues go to the floor and say, we cannot touch Social Security, it is evil, cruel, and we will not stand for it, yet in the long run they will admit that there are serious problems.

I always say to them, well, you know, we are having some hearings in the Subcommittee on Social Security and Family Policy, and they go, oh, yes? I say, yes; drop by sometime and tell us how you would like to restore solvency to the program. Well, I will tell you, they are like squashed vines in the wintertime: gone.

So, here we go. Today, I think, we have a provocative issue, a hearing on privatization of the Social Security Old Age and Survivors Insurance Program.

The first witness was to be my good colleague—I do not think he is here—the Honorable John Porter, a Representative from the 10th District of Illinois. He has Floor duties in the House. We will just kind of adjust for John when he gets here and take his testimony at the time.

But we have an excellent panel. I am very interesting in hearing their work, and their recommendations, their thoughts, their criticisms. So, if they would come to the table.

We have David S. Koitz, Income Maintenance Section Head of the Congressional Research Service of Washington, DC; Steven J. Entin, Resident Scholar, the Institute for Research on the Economics of Taxation, Washington, DC; Robert J. Myers, Former Chief Actuary of the Social Security Administration, Washington, DC; Michael D. Tanner, the director of Health and Welfare Studies of the Cato Institute of Washington, DC; and Matthew P. Fink, president of the Investment Company Institute of Washington, DC.

I am very pleased to have you here, and we will go forward and hear your testimony in the order of the appearance as evidenced on the witness list.

So, in that, Mr. Koitz.

STATEMENT OF DAVID S. KOITZ, INCOME MAINTENANCE SECTION HEAD, CONGRESSIONAL RESEARCH SERVICE, WASHINGTON, DC

Mr. KOITZ. Mr. Chairman, I was asked to lead off this panel by briefly summarizing and commenting on recent ideas to privatize the system.

While interest in privatization of Social Security has grown, there is no consensus about what it means. At one end of the spectrum is the idea that people should make economic choices totally on their own, including whether or not to prepare at all for retirement, death, or disability.

At the other end is the notion that the government should mandate that people prepare for these circumstances, but not necessarily through a government-run system.

There are few people today who would suggest that there is no need for society to prepare for retirement, death, and disability and that the government should be totally uninvolved.

But there is growing interest in expanding the role of the private sector, while reducing the government's. The seeds for this discontent probably date back to the mid-1970's when changing economic and demographic circumstances began straining the existing system.

Although there was little interest in wholesale reform, a new wave of privatizing ideas began to emerge. One proposal designed and circulated on the Hill in the early 1980's by the Insurance Company of North American would have permitted workers to contribute up to $6,000 a year to an IRA-like account, and then take an immediate income tax deduction for the contribution. For each $1,000 workers deposited in their accounts, they would forfeit a half of one percent of their eventual Social Security benefits.

A similar plan authored by Peter Ferrara and promoted by the Cato Institute would have given workers an income tax credit of up

to 20 percent of their payroll taxes for equivalent deposits in what he called "super IRA's."

Another plan devised by Michael Boskin and promoted by the National Federation of Independent Business would have not privatized any part of the program per se, but transformed it into a two-tiered system, with the second tier fashioned after a traditional insurance annuity plan. Representative Archer offered this proposal in a House Ways and Means Committee mark-up in 1983, but it was defeated.

In 1986, Representative Gingrich developed a plan to eliminate the payroll tax and have workers under age 40 mandatorily contribute to IRA's instead of Social Security; older workers were to be grandfathered under the existing system, and a new program was to be created to guarantee seniors a poverty line income. A VAT was to be levied to provide the needed revenues.

In the last two Congresses, Representative Porter introduced bills to privatize the Social Security surpluses by mandating that 2 percentage points of the payroll tax be deposited in IRA-like accounts. Former Senator Simms, when serving on this committee, had proposed a similar plan. Both were offered as alternatives to the payroll tax cut proposed by Senator Moynihan in 1990.

Your proposals, Mr. Chairman, that you recently co-sponsored with Senators Bob Kerrey and Robb, also are similar. S. 824, which is an optional arrangement, and S. 825, which is mandatory, would have people set aside two percentage points of the payroll tax in a Personal Investment Plan, also modeled after an IRA. In return, they would be required to take lower Social Security benefits when they retire.

Representative Solomon recently proposed another variant that would require the creation of an investment board, with a broad mandate to manage Social Security funds, including authority to invest them in stocks and bonds. His arrangement would be like that used for the Federal Employees Thrift Savings Plan. It is run by an investment board offering Federal employees three types of investment options. Two of them are market-based funds managed by the Wells-Fargo Company and Nikko Securities.

The Chilean system offers yet another model. In 1981, Chile engaged in a sweeping rapid reform of its system, under which private pension accounts managed by investment companies were established to replace much of the government-run program.

Beginning in 1983, new labor force entrants were brought into the system and existing workers were given strong inducements to join. It has been estimated that some 90 percent of the work force is now under the new system.

Although the political issues with privatization are enormous, perhaps the foremost issue involves a very practical consideration: how to finance the transition from the old to new system. There are 43 million people today who receive almost 40 percent of their income through Social Security. Although there are some surplus Social Security taxes flowing into the government, the system is still basically pay-as-you-go.

If we told workers that next year they were to put their taxes into private savings plans instead, how would we continue to fi-

nance the $340 billion in current benefits? The cash surplus today is only about $30 billion a year.

To put this in perspective, foregoing taxes equal to 2 percent of payroll would result in an annual revenue loss of $60 billion. Even if people were required to take reductions in their eventual Social Security benefits, this would not slow the system's outgo for many years. However, the revenue loss would be immediate. A decade's worth of foregoing these taxes would result in $1 trillion in lost receipts and new interest.

Even if it were accepted that the Social Security system could forego these receipts, for instance, by allowing it to tap into the Treasury if its financing were endangered, there is still the question of how the government would make up for the revenue loss.

Excess Social Security taxes now flow into the Treasury. If the Treasury no longer received them, it would have to borrow the funds. In effect, the money would flow into the Nation's investment markets through one door, only to be borrowed back through another. If borrowing is not an option, the question for policy makers is, what taxes are going to be raised, or what spending cuts made, to cover the revenue loss?

My intent here is not to minimize the philosophic issues about privatizing. Removing the social aspects of Social Security, introducing the risks inherent in private savings, and potentially foregoing inflation protection strike at the heart of the system. But those issues all become academic unless some means can be devised to deal with the transition.

In 1987, CRS did an analysis for this committee of one of the privatization proposals circulating then, and last week we issued a new report on the Chilean system. Both go into the issues in more depth than I can here.

With your permissions, Mr. Chairman, I would submit them for the record.

Senator SIMPSON. Thank you very much.

[The analysis and report, referred to and the prepared statement of Mr. Koitz appears in the appendix.]

Senator SIMPSON. Now, Mr. Entin, please. I will give you 6 minutes there, instead of 5.

STATEMENT OF STEPHEN J. ENTIN, RESIDENT SCHOLAR, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION, WASHINGTON, DC

Mr. ENTIN. Thank you, Mr. Chairman. It is a pleasure to be with you this morning. My name is Steve Entin. I am with the Institute for Research on the Economics of Taxation.

Prior to joining IRET I was at the Treasury Department. It was my pleasure to work on the Trustees Reports for 8 years with the Office of the Actuaries, the finest group of researchers, I think, in the city. Prior to that I was with the Congressional Joint Economic Committee, where I also dealt with Social Security matters.

I must say that I think OASI—the Old Age and Survivors Insurance—system has been a tragedy. It has kept the elderly out of poverty, but in doing so it has unnecessarily reduced the income of the rest of the population.

It is a tax transfer system. It has caused a substantial drop in the personal saving rate, and, by cutting capital formation, has reduced incomes all across the board. The primary goal of any reform of OASI should be to replace it with a system of real private saving and insurance, with an appropriate safety net for the poor.

When OASI takes a dollar of payroll tax from current workers it gives a dollar to current retirees; there is no saving. By contrast, workers who set aside income over 40 years in bank accounts, mutual funds, stocks, and bonds are saving that income. At a 7 percent rate of return, $1 saved at age 20 would be worth $16 at age 60, and $32 at age 70. No tax transfer system can do that. Furthermore, saving boosts investment, wages, and employment. Workers do not have to wait until they retire to benefit.

The tax transfer system has another drawback. The tax on payroll is an excise tax on labor. It raises labor costs and discourages hiring. By contrast, a saving program, even a mandatory one, is not a tax. If the payroll tax were transformed into personal saving, the tax would become a deferred wage and the disincentive to work would vanish, U.S. labor costs would fall, U.S. employment output and GDP would rise.

One means of encouraging saving and moving toward privatization of OASI would be to allow workers to divert part of their payroll taxes into private saving plans, perhaps modeled on IRA's, in exchange for reduced OASI benefits. Examples include the Kerrey-Danforth proposal in the report of the Bipartisan Commission on Entitlement and Tax Reform, your own bills that you have introduced with Senator Kerrey, and the proposal of Representative Porter.

The more that can be done along these lines the better. If a 1.5 percent transfer of payroll to a saving plan, as in Kerrey-Danforth, can more than make up for the associated OASI benefit reductions, then 2 percent, 4 percent, or 6 percent transfers can put young workers even further ahead.

Deeper cuts in the payroll tax rate would require further trimming of Social Security benefits and replacement rates over time, but in each case the added annuity value of the resulting saving plans would boost total retirement income.

If the diversion of the payroll tax into private saving were large enough, then the annuity alone would produce more than sufficient retirement income. Over time, OASI benefits could be phased out entirely, along with most of the remaining OASI payroll tax, with some delay, of course, during the transition to cover the benefits of current retirees.

Chart 3 in my testimony illustrates this. For example, the annuity available after the 4-percentage point diversion, which is just over one-third, by the way, of the OASI share of the payroll tax rate, would provide an annuity worth three times projected funded OASI benefits.

Retirees could get three times the benefits for one-third the cost through a real saving program. That is, if OASI were their only source of retirement income, this reform could triple that income, while taxing them less all their working lives. If pensions and saving and wages constitute about half of their retirement income, then this reform would roughly double their retirement income.

A policy change that could double or triple people's incomes for 20 years of retirement—a quarter of a lifetime, a third of an adult lifetime—is a very urgent and worthwhile policy change.

I think the table illustrates two points. First, there is a higher yield in stock and people should be encouraged to invest in stock rather than government bonds. Second, because you want the saving to finance added plant and equipment, and to raise productivity and wages, you really do not want to pay for this with government borrowing because then people would have to buy the bonds instead of the stock.

My paper discusses a social safety net. A remaining portion of the OASI tax might be used to make certain that people's annuities were brought up to a minimum standard for people who had intermittent wage histories or low wages.

I have discussed the transition that would need to be made for older workers. I will not go into these details in these six minutes, but I think all of these things can be worked out without too much trouble.

There would be some added responsibilities for workers. If OASI benefits, including survivors benefits, were trimmed, workers would have to make certain they had adequate life insurance. If the DI program were reformed along similar lines, people would need some private disability plans.

The focus of all of these debates seems to be on how to pay for the transition. The budget rules, unfortunately, have been written to forbid policy changes from diminishing the projected actuarial balance of OASI, and that means finding spending cuts or tax increases to offset program changes that would otherwise worsen the balance, within the confines of OASI.

That has often led to proposals to trim the benefits for current retirees. That is not strictly necessary. There need not be, and I think there should not be, any effect from privatization on current beneficiaries. Their benefits should continue as under current law, and so should the benefits for people about to retire.

To protect people about to retire you need to find cuts in the general budget to allow a transfer from the general fund to Social Security. You could think of it as "redeeming the raided trust fund" if you like, although I share your view as to what that means.

The transfer would only need to be about a point of GDP for a 2- or 3-percentage point transfer of the payroll tax into private saving. I cannot think of any Federal spending program, however, that would do as much for people as tripling or doubling their retirement incomes. I would say, cut anything you can find, because people would be better off if you did that than keeping the Federal budget going the way it is.

I think the biggest difficulty in making the transfer is not the technical one; the actuaries can help you design that. The chief one is one of political will. I know you want us to be frank as we appear before you, and since there is no other member present, I can say, present company very definitely excepted, the problem is one of political will.

What is needed is willingness to sacrifice. I do not mean sacrifice by the voters who would gain substantial increases in retirement and lifetime incomes. I mean sacrifice by the Congress, which

would have to agree to a moderate amount of Federal spending restraint, give back a large portion of the payroll tax, and trust the public enough to give them back control of their lives. This is the chief obstacle I see to privatization.

Thank you.

Senator SIMPSON. Well, I thank you.

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

Senator SIMPSON. I know that we will have some provocative discussion; the next witness will assure that. Our friend, Mr. Myers, who is certainly highly-regarded and respected, and often presents us with things we do not want to hear, and things we should hear. I appreciate your remarks, all of you, and what is to come.

So, Mr. Myers, nice to have you here, sir.

STATEMENT OF ROBERT J. MYERS, FORMER CHIEF ACTUARY, SOCIAL SECURITY ADMINISTRATION, WASHINGTON, DC

Mr. MYERS. Thank you, Mr. Chairman.

First, I would like to say that I agree strongly with you that Social Security should be on the table. I have been arguing for at least the last 5 or 6 years that something should be done about the long range financing deficit that appears to be present.

As you may recall, I worked closely with the distinguished Senator from New York, Senator Moynihan, on his pay-as-you-go proposal. That solved the problem completely by the tax method. I do not hold to that; I believe that it can be solved by benefit reductions as well. But my main concern would be to solve it and have confidence in the system restored.

I am afraid that I may not be in complete agreement with the distinguished Chairman about privatization, but let us take that up.

First of all, what does privatization of Social Security mean? There are many different ways. It can be compulsory, or it can be voluntary; it can be partial, or it can be complete, as in Chile; it can be gradual, or it can be instantaneous, again, as in Chile. I have gone into some details on this in my prepared testimony.

My philosophy as to the Social Security program is that it should provide a broad universal floor of protection with everybody covered who is employed. There should be weighted benefits so that the lower-paid are not as likely to need public assistance as in a straight individual equity system. I do not like public assistance, not only because of its demeaning nature, but also it is subject to high administrative expenses, and also fraud and abuse.

As to the Chilean system, which many people talk about as being such a great success, I had the privilege of being invited there twice by the Chilean Social Security system to give my objective views on what I thought of it.

In summary, I might say that the Chilean system is not what many U.S. advocates say it is, or want it to be. It is a fine system for Chile, it solved the problems they had, but that does not necessarily mean that it is a good system for every other country. Each country has its own problems.

One great advantage that Chile had is that it had mammoth general revenues available—in other words, budget surpluses available—to finance the transition to pay for prior service costs and,

for all time to come, to pay for a very high minimum benefit, one that amounts to about 30–35 percent of the average wage.

How did Chile have that situation? For one thing, they had just privatized many of their industries, so the Chilean Government had excess monies available for this transition. Now, that brings me to why the Chilean model is not at all for the U.S., because we do not have budget surpluses. Instead, we have mammoth and appalling deficits, and you cannot finance things with deficits.

What are the problems with privatizing the U.S. Social Security system? First of all, there is the technical problem of providing reasonable disability and survivor benefits. This can be done, but it is rather difficult.

Second, there are the anti-selections possible if it is optional. In other words, the low-cost cases will opt out of Social Security, while the high-cost cases will remain in it. The costs of Social Security will boom, and there may well be a much larger public assistance cost.

Also, the administrative expenses under a privatized system are high. In Chile, the administrative expenses for the retirement-benefits portion of the system are about 13 percent of contributions, and they will be higher in the future as more people retire, and monthly payments are made. In the U.S. system, as you well know, the administrative expenses are slightly less than one percent of contributions. So, this is at least a partial offset to the higher possible rates of return that might be obtained under privatization.

Also, I believe that the higher rates of return, under some privatization proposals, are overstated. I do not think that they will be achievable over the long-run, especially if there is a great degree of privatization. It is true, that we should have more savings in this country, and we could have more economic development, but there is a limit where there is too much money to invest and not enough places to invest it, and that can produce fraud, abuse, and waste.

What do I think should be done? I think that Social Security should be modified to put it on a sound basis over the long-run. There are many ways that I think the system could be changed to be affordable and to be reasonable. I think that it is best to have a combination, as was done in 1983—part done through taxes, and part through benefit reductions.

The benefit reduction that I favor the most and which I think is in your proposal is to raise the retirement age, the so-called "normal" retirement age at which unreduced benefits are first payable. This only makes sense. People are living longer, and demographic problems should be solved with demographic solutions.

Second, I think that there should be much more encouragement of private savings to be built on top of Social Security. I do not like mixing private savings and Social Security; it is like mixing oil and water.

But I think there could be much more encouragement of private savings through more liberal provisions for IRA's and for Keogh plans, and so forth. Perhaps, even, I think that consideration might be given to building on top of a reformed Social Security program a mandatory privatized savings program.

In other words, there could be an additional contribution rate of, say, 2 percent, 3 percent, or even 4 percent, and have that invested through the same approaches that many of the advocates of privatization want to do through the private sector.

I also would point out, in concluding, that, if any privatization is to be done like that, something should be done so that small amounts are not put into this system because the administrative expenses of handling $50 a year, or $100 a year from the millions of people who have low earnings just would eat up the principal.

I am on the board of trustees of two large mutual funds, so I am most certainly in favor of private savings. But, as I say, I want to keep them separate, have them built on top of a sound, durable, Social Security system.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Mr. Myers.

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

Senator SIMPSON. Now, Mr. Tanner, please.

STATEMENT OF MICHAEL D. TANNER, DIRECTOR OF HEALTH AND WELFARE STUDIES, CATO INSTITUTE, WASHINGTON, DC

Mr. TANNER. Well, thank you, Mr. Chairman. I am Michael Tanner. I am the director of Health and Welfare Studies at the Cato Institute, and I am also director of Cato's project on Social Security Privatization.

I want to thank the Chairman for holding these hearings and for having the political courage to address an issue which a lot of his colleagues have not been able to address yet, but which is going to be very important for the future of this country.

In less than two weeks, Social Security will celebrate its 60th anniversary. As it does so, I believe it is an institution in profound crisis. As recent public opinion polls have shown, more young Americans believe in UFOs than believe they will receive their Social Security benefits. The unfortunate fact is that, while their views on extraterrestrial visitation are problematic, their opinion on Social Security may be perilously close to correct.

I will not go into all of the fiscal problems with the system. I believe, Mr. Chairman, you summed that up very well in your opening statement. But what I do want to point out is that one issue that is not necessarily addressed in just the problems of the fiscal situation is that, even if you could correct the actuarial problems with Social Security, the system remains a bad deal for most Americans. Payroll taxes are already so high for today's young workers that the promised benefits that these workers will receive amount to a low below-market return on those taxes. In short, Social Security is a bad investment.

In fact, studies show that for most young workers such benefits amount to a real rate of return of 1 percent or less on their required taxes, and for many workers the rate of return is actually zero, or even negative rates of return. They would be better off stuffing the money in a mattress. These workers can get far higher returns through the private savings, investment, and insurance markets today.

In a forthcoming study by the Cato Institute, financial analyst William Shipman of State Street Global Advisors considers the potential investment return under a variety of scenarios.

He considers examples for both high- and low-wage earners born at three different dates—1930, 1950, and 1970—and compares the actual Social Security benefits that those individuals would receive under current law, with the potential return that the individual would have received if he or she had been allowed to invest in an amount equivalent to the payroll tax in either the stock or bond market using actual historical rates of return, and then projected rates slightly lower than the historical rates of return.

He found that in every single case the return was higher for the individual in the private markets than what they were actually receiving or going to receive from Social Security.

If the proposed reforms that we hear talked about—raising payroll taxes and cutting benefits—are adopted, the rates of return become even less and the investment becomes even worse for today's young worker.

The only viable alternative is to privatize the Social Security system. In my written remarks I go into considerably more detail about how that can be achieved, how to finance the transition, and what would a privatized system would look like.

However, I would like to suggest that the concept of Social Security privatization is not untested; we do have the example of Chile. And, while I certainly would not want to see that system adopted in its entirety in the U.S., there are many differences between our systems economically and culturally, and there are some things that I think that they did not do right that I would like to have seen them done differently.

But we should know that their system has been privatized and has been successful. Chile's Social Security system actually predated ours, having started in 1926. They were the first in this hemisphere with a public pension system. It was a pay-as-you-go scheme, just like ours; a basic deposit scheme. It ran into demographic problems. In the late 1970's, its benefit payments were greater than its taxes and it had no fund reserves.

Based upon the anticipated decline in the benefit/support ratio, the problems were going to get worse, much as ours are, so Chile decided to fundamentally restructure its system, and not merely reform the flawed pay-as-you-go system.

The new system is one of forced savings. It required workers to contribute 10 percent of their wages to their own accounts at a pension fund company, called AFPs, which invest the wages in securities, such as stocks and bonds. Contributions and investment returns are not taxed, but withdrawals are.

Upon retirement, affiliates have the option of purchasing a lifelong annuity, withdrawing a monthly benefit from their AFP account, or purchasing an annuity that is effective at a future specified date. Participants also have the right to contribute an additional 10 percent of after-tax wages to their accounts, which compound tax-free.

The AFPs are single-purpose companies. They are licensed and regulated by the government. Among other obligations, they are required to invest their contributions, distribute the benefits, offer in-

surance, conduct participant recordkeeping, and keeping a certain level of reserves.

Much like our mutual fund industry, the workers assets are separate from the AFP assets. If an AFP were to go out of business, affiliates' assets would be transferred to another AFP. Individuals have the right to choose and change their AFP, moving their accounts between them.

The success of Chile's public pension privatization can be measured in many ways. Whereas, in the late 1970's there were virtually no savings, now the cumulative assets managed by AFPs are about $23 billion, or about 41 percent of GDP; during the past decade, Chile's real GDP growth has averaged over 6 percent, more than double that in the U.S.; and for the 5 years ending in 1994, the annualized return from the Chilean stock market was 48.6 percent versus 8.7 percent in the U.S. market.

But, most importantly, beneficiaries are now receiving a much higher benefit for much lower taxes than before. Since the privatized system became fully operational on May 1, 1981, the average rate of return on investment has been 14 percent per year. As a result, the typical retiree is receiving a benefit equal to 80 percent of the average annual income over the last 10 years of his working life, almost double the replacement value of the U.S. worker.

Now, no one suggests that we will receive 14 percent rates of growth in the United States, but our studies do show that, given historical rates of return, workers here can receive five, six, or seven times the rate of benefits that they can expect to get from Social Security.

The Chilean's reforms have been such a success that they have been copied throughout the world: in Latin America, in Argentina, Peru, Columbia; in Britain they are allowing people to opt out of the top tier of benefits; Italy has begun some privatization of the Social Security system.

In short, this is a system that has been taken around the world and modeled, and done in relevance to the own economic conditions in each country. We should be following the same or similar route in this country. It is the only way to preserve retirement dignity and a retirement future for America's workers.

Thank you.

Senator SIMPSON. Thank you very much.

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

Senator SIMPSON. Mr. Fink, please.

STATEMENT OF MATTHEW P. FINK, PRESIDENT, INVESTMENT COMPANY INSTITUTE, WASHINGTON, DC

Mr. FINK. Thank you, Mr. Chairman. I am Matthew Fink, president of the Investment Company Institute, which is the national association of the mutual fund industry.

Mutual funds increasingly serve as the investment of choice for all types of retirement plans, including both employee benefit plans and IRA's. At the end of last year, approximately $760 billion—35 percent—of mutual fund assets were held by various types of retirement vehicles.

Our industry believes that the legislation that you and Senator Kerrey have introduced is a thoughtful and timely proposal to enhance our current pay-as-you-go Social Security system by introducing for the first time an element of personal savings.

By giving workers the option to invest 2 percentage points of their OASDI taxes in personal investment plans the bill begins to address the two key problems: the impending solvency crisis that you mentioned in your opening remarks, and also the widespread lack of confidence that you also mentioned.

I must say, last night I did my own test case and asked my two teenaged children, ages 19 and 17, did they believe they would ever collect from Social Security? The answer was, no. So, based on my sample, I think Generation X does not think it is going to collect.

We believe that a self-directed account which would incorporate the best features of the current individual retirement account, like your proposed PIP, is the optimal way of achieving partial funding of the system for a number of reasons.

First, it would allow workers, for the first time, to receive the benefits of compounding in their PIP accounts. Second, contributions, as other witnesses have mentioned, can be invested in assets such as equities, which historically produce higher returns than Treasury bills. Third, the investments into stocks, bonds, and mutual funds will provide private capital for the country's economic growth.

Fourth, it would help encourage a personal savings habit as an American habit. Fifth, it would give every American a better idea of his or her personal responsibility to save for the future. And finally, going back to what begins this all, I think it would start to give people better confidence in the Social Security system.

We think that these goals could be accomplished by a PIP that would be created and marketed by private financial institutions, such as brokerage firms, mutual funds, banks, and insurance companies.

We know from the IRA and the 401(k) experience that if you allow this in the private marketplace, these institutions will have their own interests in vigorously promoting the PIP and educating investors about it. Another benefit is what individual Americans, rather than the government, will be responsible for directing capital flows.

A number of witnesses at other hearings and this morning have noted the very serious transition problems that would occur if you were to attempt to fully privatize the Social Security system.

I would note that these problems would be less, of course, in the case of a partial funding proposal, such as the PIP. According to the material, Mr. Chairman, that you released when the legislation was introduced, the PIP proposal "would have no impact on the long-term solvency of the OASDI trust fund." That is true. There will, however, be short-term problems.

But the first thing is to try to get a handle on the extent of those short-term problems, and in doing this I do not think it is fair to start with the supposition that 100 percent of covered workers will all elect to move their 2 percent out of the Social Security system into the PIP.

One of the other witnesses assumed that in his testimony; I think that is an exaggerated view. So I would suggest as a starting point some actuarial work to attempt to assess how many people are indeed likely to move the 2 percent out of the current system into the PIP.

A second criticism we have heard from other witnesses is that workers would be terribly confused because there would be such a variety of funding media. We have had actual experience in this country since 1974 with IRA's, for which all kinds of media are permitted, and I do not think there is much evidence of confusion. In fact, we found financial institutions, for their own reasons, doing a pretty good job of education.

A third criticism which we have heard this morning of the PIP is the alleged heavy administrative expenses with the small accounts involved. I must say here, the mutual fund industry does have very good experience because we are vehicles that are specifically designed to pool the investments of thousands of investors in order to obtain economies of scale and operation.

We think mutual funds, and probably other institutions, are well-equipped to handle small accounts and small contributions in an effective manner, and I would think that particular criticism probably could be handled pretty easily.

I do not want to minimize these concerns about the transition, but I think far worse would be a failure to initiate any reforms, to simply throw up our hands and do nothing.

Thank you.

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

Senator SIMPSON. Thank you very much, all of you. That is very helpful and of great interest, for the record.

So let us have some discussion here and look at this issue of savings and investment, and what privatization might do there.

So, with regard to Mr. Fink and Mr. Tanner, both of you have stated in your remarks that investors can expect significant rates of return if the Social Security program is privatized. Yet, there has been discussion—and I think in my mind it is true—that Americans are largely very conservative investors.

Now, how can we, or should we even, encourage these investors to put their money into more lucrative, but perhaps higher-risk type investments?

Mr. FINK. I would think there is one thing that is needed and which we have urged the Department of Labor to do now, just with defined contribution plans. I would not have the government tell people how to invest, but I think I would simply provide Americans with historical information showing that, over long periods of time, 5 years, 10 years, or longer, in every period that is measured, equities will outperform bonds, and bonds will outperform short-term instruments. There will be greater volatility, but, as I said, there is a priority of long-term experience.

I think that information ought to be gotten out by both the private sector—which is being done—and by the government. Again, it is up to each person to decide how to invest, but I think there is some historical evidence here that ought to be out in the public domain.

Mr. TANNER. I would just add that, in terms of the actual result, even if an individual was as conservative as they could possibly be under a privatized system, they would still receive better returns than they would from future Social Security benefits, where they can expect to receive a negative return. Future workers, especially if you reduce benefits and raise payroll taxes, would be better off, as I say, stuffing it in a mattress. So even a conservative investment will be better.

The second, is the total question of what savings would effect. Economists would tell you are not going to get a total net change in savings because you are just transferring from the government sector to the private sector, but I would suggest the value of those savings and what those savings do for the economy, the quality, if you will, is vastly different when the private sector gets to invest money than when the government gets to invest the same amount of money.

Senator SIMPSON. Is it your thought, too, that if we did privatization in Social Security that that would increase savings and investments in other areas; is that what you are saying?

Mr. TANNER. It would improve the quality of investments available. If you are putting $400 billion available into the investment markets that is available for people to borrow to start businesses, to expand plants and equipment, and so on, you are going to benefit the entire economy in a way that you are not going to get if the money is being sucked up by the Federal Government.

Senator SIMPSON. Well, let us look at transition issues, getting from here to there, which will, of course, be a very difficult aspect of enacting any elements of privatization.

So let me ask Mr. Myers and Mr. Koitz, in your opinion, how do these administrative costs, under the current system, compare with the administrative costs under a private system? And, of course, you have touched on that. Would it matter if it was partially privatized or wholly privatized? You cite a figure of 13 times the administrative costs in Chile versus here.

What is your thought about that, both of you?

Mr. MYERS. Mr. Chairman, I think there is not only the administrative costs, which, as I said, is a partial offset to any higher rate of investment return, but also there is the transition costs involved in paying for the high-cost groups who stay in the Social Security system versus the low-cost groups that opt out.

All of the discussion to date has assumed that the employer tax belongs to the employee. The money's-worth analyses that are made which show that some people are getting low or even negative rates of return assume that. I would argue that that is not necessarily the case.

As you may recall, Mr. Chairman, the whole committee held hearings several years ago on the money's-worth aspect of Social Security, and I would refer back to those hearings. I do not think that it is proper to consider that the employer tax belongs to each employee individually. This is not done in private benefit plans, generally.

Under a defined-benefit pension plan that has an average cost of, say, 5 percent of payroll, each employee does not get benefits worth 5 percent; the older get more, while the younger get less.

It is the same way with school taxes. You pay school taxes whether you have children in school, or have had, or will have. I think that it is more reasonable to assume that the employer tax is pooled for the benefit of the lower-paid workers, for the benefit of workers with dependents, and so forth. If these money's-worth analyses are made just looking at the employee taxes, you get quite a different picture than some of the previous witnesses said.

If I might say, Mr. Chairman, you might be interested, since there has been discussion of the Chilean system, in putting into the record what I hope is a very objective piece that I wrote on the Chilean system that presents, I think, some facts that perhaps have not been brought out.

For one thing, Mr. Tanner said that the original Chilean system was a pay-as-you-go system. That was definitely not the case. It was a largely funded system. The trouble with it was, they had such inflation that all of the assets became worthless.

Thank you, Mr. Chairman.

Senator SIMPSON. Wow. A difference of opinion there. But it did start in 1926, if I recall, the Chilean experiment.

Mr. MYERS. Yes.

Senator SIMPSON. And whatever it was started then, and then deteriorated. Then, of course, the privatization you discussed of industry. But it is held up as an ideal through the country; people write of it and speak of it. But I think there are some very different things. Principally, is the tremendous debt of the United States. The debt limit is $5 trillion soon, with deficits. That is not the case with regard to Chile.

But, Mr. Koitz, did you have any comment on that question? It was kind of a dual address there.

Mr. KOITZ. Yes. I see two angles to it. One of them is dealing with the transition itself; to what extent are the administrative costs a financial burden? And then the other, is what was mentioned earlier, that the administrative costs of administering a private system versus Social Security. Let me hit that one, first.

It is almost by definition that the private system is going to cost more. The question for the individual is, will he or she get a better rate of return? The costs of promoting, advertising, and selling those systems is not something that is inherent in the current Social Security system. So, that is a difference.

In terms of the transition, to get directly to your question, there is going to be more administrative costs, for instance, in the government operating a new thrift board, as is proposed in S. 824 and S. 825. Is that going to be the real issue? No. The real issue is the transition cost caused by the lack of revenue, as I alluded to before.

To get a little dialogue going here, Mr. Fink said that I may have exaggerated when I mentioned the $1 trillion in lost receipts resulting from your proposal. S. 825 creates a mandatory 2 percent set-aside. So, if that were the route that is followed, based on the Social Security trustees' report, 2 percent of payroll foregone for 10 years is $1 trillion, with interest. I do agree that if you went the S. 824 route—the voluntary one—the costs would be lower.

The experience with 401(k)s, as Mr. Fink or others may have alluded to, is an example. They were enacted in the late 1970's, and the appeal was tremendous. They were promoted, and grabbed

onto. They still are. I think defined contribution plans, qualified plans, grew from 200,000 to 600,000 over the 1980's.

But Congress was so concerned in 1983 about the appeal of 401(k)s that it stepped in and said that they are no longer tax-deductible for Social Security purposes. So I think the appeal of your proposal would be strong. And, while a $1 trillion loss might be high on a voluntary basis, expecting 50 percent participation might not be, and that is a half a trillion. So I would pose the question, what is small enough, or what is too high?

Senator SIMPSON. Did you care to comment on that?

Mr. TANNER. Yes. Mr. Chairman, I think one of the things to remember in the discussion of the transition is that all of the assumptions of how there will be additional costs if people opt out and the fact that we will have to find ways to fund current benefits, or benefits for current recipients if you stop people paying in the payroll tax, are based on the assumption that we have the money to pay the current benefits now. The fact is, we do not. The trust fund is a polite fiction.

As you yourself noted, we are eventually going to have to start cashing in those bonds around 2012, 2013, and you are going to have to find money from general revenues in order to pay those bonds, and that situation is going to get continually worse.

Now, there are essentially four ways to fund the transition. One, is a default of any form. Everything essentially is a default, from raising the retirement age, or cutting COLAs are a form of default—they are a form of reducing benefits that have been promised--onto writing off a portion for people, for example, under the age of 40, let us say, who opt into the private system may get no credit for the previous contribution to Social Security. They would still be better off, but you may want to consider doing that.

The second, is to bond the debt out in some portion. I agree, we would not want to bond out the entire $7 trillion, but you may want to bond out some portion of it. You may wish to keep some small portion of the payroll tax continuing in, private 10 percent and keep 2.2 going in, or something like that. Or you may want to identify $350 billion or so in additional spending cuts and fund it out of general revenue.

The Cato Institute would be happy to provide you with $350 billion in spending cuts that we think you could make over and above the other ones. So, it would be some combination, no doubt, of those four methods.

There would be some default, some bonding, some continuation of the payroll tax, and some additional spending cuts. But it certainly is possible to do so.You are going to have to do so, going to have to make some adjustment, in order to pay current benefits because the money is not there now.

Senator SIMPSON. Well, you touch upon serious issues that the Entitlements Commission so well addressed. I commend Senator Kerrey and Senator Danforth again. We do not even vote on 63 percent of the Federal budget as Senators and Congressmen.

People cannot understand that one yet, but I hope they will eventually pick it up, because if we do not do something with the entitlements we will not be voting on 73 percent of the Federal budget within the next 10 years.

So guess what will get hit? All the things you read about in the newspaper. That is the only place to go. If you cannot hit Medicare, Medicaid, Social Security, Federal retirement, and interest on the debt, you cannot hit anything. It will not get us there. Unless that gets understood by the American people, it will be, indeed, as someone said about Social Security, a Ponzi game. Worse than that, we will be strapped in our ability to change things.

It is one of the most difficult things to have people coming to your office in these difficult budget times saying, well, we only needed $80 million for this program, or this remarkable thing for the kids, or for the seniors, or for the disenfranchised, or for someone who deeply needs it. It is only $80 million, or $40 million, or $50 million.

I said, yes. Well, if you would just help us try to peel a cost of living allowance off of people who earn over $40,000 a year and not let them receive that, or affluence test benefits, we can save $20 billion. Depending on the CPI and Social Security, that cost of living allowance is somewhere between $5–15 billion a year, going to people regardless of their net worth or their income. You could fund a lot of $80 million programs, but that has not sunk through the great consciousness yet as to what could be done there.

But I want to ask, if I could, Mr. Myers. Do you have anything to add about Mr. Koitz's statement that administrative costs would be higher but the rate of return would be higher and, therefore, some type of offset?

Mr. MYERS. I agree completely with what Mr. Koitz said on that subject.

Senator SIMPSON. Let me ask you, then. Let us get back to this Chilean ideal, because it keeps coming up. As I understand it, it was in 1926, and then they privatized the program in 1981. Oddly enough, that is about when we were bringing the life back into ours, through Senator Moynihan.

A privatized model required a mandatory contribution of 10 percent of earnings by all workers, then after they came in after 1982 they could choose whether they wanted to be covered under the new system or the old system. But employers are not required to pay into the system at all. They pay nothing for the system. In 1981, all employers were required to give a wage increase of 18 percent to all employees, approximating the increased cost to the employer.

Contributions then are invested in 21 different pension funds, and they compete against each other on the basis of returns and service. Mr. Fink would like that, I think. But they are very closely regulated by the government. They have to comply with government-mandated investment requirements. Only 30 percent of the pension fund can be invested in government-approved common stocks. But there is one that is very clear: pension funds have to invest at least 50 percent of their assets in government obligations. That makes you wonder how really privatized it is.

But it is also, I think, clear that investment houses would compete against each other if we were doing that, and, thus, the investment costs would be there. So it seems it would be difficult to pass along all the administrative costs to the worker. Would you

agree with that, Mr. Myers, Mr. Fink, or any of you, where we are on that? We will get to you all. I would ask you all that.

Mr. MYERS. Mr. Chairman, I think that you have given an excellent bird's-eye view of the Chilean system, unlike some people who talk about the Chilean system in this country. For instance, many people say that it is a great thing for industrial growth and development progress because the employer does not pay anything. Yet, as you pointed out, the employers gave a 17 percent pay increase at its inception. So, the question then comes, who is really paying for it? You just cannot trace it through.

Senator SIMPSON. Yes, Mr. Entin?

Mr. ENTIN. Two points, if I may. If you look at mutual funds today you find the management fees generally on the order of 0.5 to 1.5–2 percent. They are not significantly different from Social Security. If you go back to that issue of the wage, most economists would state that the whole payroll tax is currently coming out of the gross wage.

Remember, if you are a worker receiving a paycheck of $100, the gross wage is really nearly about $108 or $109. That $8 or $9 is the employer contribution to Social Security. But that is not reported to the worker, it is just simply done by the company.

What the Chileans did, in large measure, was simply tell the employers to tell the worker about the $8 or $9 on the pay stub. Today, what would happen is you would find a firm paying $108, reporting $100 to the worker, and then taking almost $8 out of the worker's check for the worker's share of the payroll tax and giving the worker a net of $92.

What the Chileans said was, tell the worker about the $108 and take out the full $16, then pay the worker the $92. It was simply a reporting change more than a real wage hike. There may have been some adjustments, but most of that was simply technical "what do you call it and where do you put it on the pay stub" kind of accounting change.

The firm does pay the entire payroll tax to Social Security, and the worker, having seen it come out of gross wage, gets that much less for his labor. Workers do bear the entire payroll tax. So that should not be an issue. The reason that you get the growth out of the system of privatization is that the worker's saving, insofar as the government is not borrowing it, goes into added plant and equipment. It is not that the employer does not have to pay the payroll tax.

Senator SIMPSON. Yes, Mr. Myers?

Mr. MYERS. If I might correct my good and able friend, Steve Entin, on just one point. The administrative expenses of mutual funds—I think Mr. Fink will agree—of 1–1.5 percent is not 1–1.5 percent of current contributions, but rather it is 1–1.5 percent of total assets. That is a different thing than measuring it against contributions, which, for Social Security, administrative expenses are about 0.8 of one percent of the current contributions. They are not measured against the total assets of the system.

Senator SIMPSON. Do you have any comments on these, Mr. Tanner and Mr. Fink?

Mr. FINK. I have no expertise in Chile, and I think countries differ. But two things occurred to me as I heard the other witnesses.

Chile apparently mandated how these 21 funds have to invest, or set parameters. That is not the kind of thing we do in this country. with 401(k)s, IRA's, Keogh plans. We have had very effective private systems without government-mandated portfolio guidelines. I would hope, if we move forward with the PIP, as I hope we do, that we follow that route and not a mandated route.

As far as expenses, I am a little lost because there are a lot of funds in this country that charge no administrative fees on contributions, the only fee is on the assets. So the average fund probably has an expense ratio of something like 1 percent, with no charge on money coming in. That is all the cost to the fund manager of processing the money coming in and out. It is all paid for by the annual 1 percent charge on the corpus. So I think it is a fair measurement to look at mutual funds expense ratios. They pay for the cost of the transfers.

Mr. MYERS. I was not saying that this is the wrong way to do it, but there are two different types of measurements. You cannot compare administrative expenses to contributions on the one hand and administrative expenses to assets on the other hand and say that they are comparable indices.

Mr. TANNER. Mr. Chairman, if I could suggest, it is irrelevant. It really does not matter what the administrative expense borne by the funds are. What is important is the return that the individual receives. If the individual is receiving only a 1-percent return, but the administrative expense is only 1-percent versus the 15 percent and 15 percent, the individual is better off no matter what the administrative expense is if he is getting a higher rate of return.

To return to, I guess, my big disagreement with Mr. Myers, is on the question of whether or not the employer portion of the payroll tax is part of the taxes paid by the individual. I think we have seen this debate on payroll taxes again and again in Congress. We saw it with the President's health care bill last year when he wanted to mandate that employers provide health insurance.

It is the fact that when you increase the total cost of compensation to a worker, the worker bears the cost. That money that comes out of the employer side to pay for the Social Security tax on the worker is money that the worker does not see in his paycheck as money that comes out of his total compensation and he does, in fact, pay that tax. It is merely a transfer mechanism or an accounting mechanism, as Mr. Entin said.

Senator SIMPSON. Mr. Koitz, would you like to mix it up a little here just for a moment in any of this particular aspect, or pass?

Mr. KOITZ. I basically agree with Mr. Tanner. Again, going right to your question, I mentioned that there were three different things—promotion, advertising, and selling expenses—but there also is the expense of maintaining an account over the lifetime of the individual. Mr. Fink is probably a better one to query on this, but people change what they want to invest in, in stocks, bonds. They switch bond funds.

The experience of the Federal thrift board might be something to look at, but the bottom line is it creates cost. And, whether you measure the administrative costs against current contributions or you measure the administrative costs against the assets of the fund, the bottom line is, somebody has to pay. Those are adminis-

trative expenses, and they are likely to be larger under a private plan. But the key question, as Mr. Tanner said, is, what is the rate of return people are going to get? And I do not think there is anybody at this table who would refute the notion that money's worth under Social Security will go down in the long run for the average wage earner. Thus, it is almost inherent, on average—and I emphasize that—that the private side would probably provide a better rate of return.

Senator SIMPSON. What is really interesting is, as we hear the peons' praise for the Chilean plan, is I think people do not realize that it is rather heavily government-controlled. I do think, as Mr. Fink has said, that Americans are going to sit still, at least in the investment community, to see regulation of investment funds by the Federal Government, specifically if they have to comply with government-mandated investment requirements, for instance, 30 percent of a pension fund, or 50 percent of the assets of the government. I think that one needs to be aired very clearly before we get too enamored of that as you read about it in its most simplistic form.

Yes. Did you have a comment? Then we will go to another question.

Mr. ENTIN. I would agree with you on that, sir. At the time that Chile privatized, of course, it had just gone through a series of political upheavals in which the government had nationalized most of the banks, the financial industry was in a shambles, and they had to, perhaps, set up this rather restrictive approach. We have thousands of banks, thousands of mutual funds, and a much more highly-developed financial community. I would think that would be easier for us to handle than it was in the Chilean case.

The one thing you do have to avoid is having the government to a great deal of bonding out of this because otherwise somebody in the society would be buying the added government debt, even if it were not the people who were putting the money into the retirement plans. One would not want to see that.

But to avoid that you would really need to have to slow Federal spending growth by only about 0.5 percent a year for about 8 years to cover the conversion, and I do not think that is beyond the realm of possibility, particularly if you can show people the potential benefits of the savings accounts.

Senator SIMPSON. Let me ask a couple of questions to Mr. Entin and Mr. Tanner. One of the biggest transition problems if we decided to partially or wholly privatize is determining how we can avoid the short-term deficit—and several of you have talked about that—in the trust fund.

For example, if we permit workers to divert payroll taxes away from their current trust fund and into their own private accounts, how do we continue to finance current and near future beneficiaries' retirement? I know that we say, well, we have a surplus. I know that, too. But that surplus is tissue paper come 2013, and we all know that, too, even though it is going to maybe get to $2 trillion.

So every time you go to a town meeting and you hear, well, what about all the surplus; what are you doing, you chiselers, looters, pillagers? You say, well, the surplus is there but every penny of it

is invested in something backed by the full faith and credit of the United States and is not at our disposal.

Then 2013 comes and you wander up to the window and say, all right, here we are, and we need to cash the bonds. We cannot make the payments, the green checks are not going out. That is the doomsday coming in 2013, not 2031. So how do we do this short-term?

I want to welcome Senator Nickles here, who is always very active in all things with regard to the Finance Committee. If he has any questions in a moment, he can certainly address those. I at least give him an A for courage to wander in here, into this giant trap. It is like a Venus fly trap. They open the door back there and they say, my God, get out. The staff says, do not come in, for God's sake. They will have a picture of you.

Yes?

Senator NICKLES. Let me just compliment you on holding the hearing. I apologize. As soon as I walked in I was beeped and said, please go to the Floor and speak on an amendment.

But I appreciate our witnesses. I am a quick study. Mr. Entin, I reviewed your comments and my staff tells me that Mr. Tanner and Mr. Fink both had made supportive statements for the idea of privatization, or at least partial privatization.

I also want to compliment you on your legislative effort, where you talked about having a percentage of the payroll tax set aside where individuals would allow, what is it, 2 percent?

Senator SIMPSON. Two percent.

Senator NICKLES. Two percent. I think there is a lot of merit to that, where individuals will be able to have that money. I am assuming it will be invested or controlled similar to an IRA and their control, where there really is real savings, where it is invested, unlike the system we have today.

I think there is so much misconception on the present system trust funds, what people have invested. It is so misleading that some movement towards allowing people to have a portion of the payroll tax actually under their control in real savings has a lot of merit to it, in taking the pressure off of the public system, but also in having real accountability and real savings. To me, that is exciting. So I compliment you for it, and I appreciate our panelists.

Mr. Myers, welcome. You have been before this committee maybe more than any other witness that I am aware of. I understand you have a little different viewpoint. I have not had a chance to review your statement wholly, but I am going to look at all these statements.

I think we owe it to the American people, one, to be truthful about the fact that the system as it is right now is very deceiving, where people think they have invested money and that that money is actually working for them, accumulating and taking care of them instead of basically being a system where it is basically an income transfer program. I think we have to be truthful with people, we have to let them know the facts.

I would like to have us have a real saving system, and maybe we could do that with some allotment of the payroll taxes going to individuals under their control, and commensurate with that they

could have a reduction in benefit from the public side, but have a real benefit coming from the private sector under their control.

I think a lot of individuals, and I will say, speaking as one of the younger members in the Senate, although I have been here awhile, younger generations are very skeptical of this system. I think maybe that would help alleviate some of the cynicism, some of the concerns of it.

So I compliment you for the hearing, and I appreciate our witnesses. I apologize that I am not able to really enter into more of a dialogue with our witnesses, but I will review these statements because I know you have done some good work on it, and I appreciate it.

Senator SIMPSON. Don, thank you very much for coming by. I appreciate your participation always in the committee and the subcommittee activities.

So let me go back to that question about, as we divert from payroll taxes from the current fund and into the private accounts, how do we best continue the current and near future retirement benefits, the cash flow? If we could start maybe with Mr. Koitz, and just go down the line. Do you have a quick thought?

Mr. KOITZ. Are you asking me what taxes to raise and spending to cut?

Senator SIMPSON. Yes, that is it.

Mr. KOITZ. I beg off, Mr. Chairman. [Laughter.]

Senator SIMPSON. Well, if we can do it, you can do it.

Mr. KOITZ. I did mention in my testimony that there was an aspect of the Chilean transition that might be worth looking at, and that is, initially, they required that government bonds be the heavy instrument used for investments.

Now, they made their transition quickly. Maybe we could look at the same kind of thing by mandating that these private accounts be heavily invested in government bonds, or totally invested in government bonds for awhile. You might react by saying, well, what does that do? If one accepts the premise that one of the reasons for doing this is that people feel more comfortable with defined contribution plans, you still deal with that even though developing a debt.

For example, I have a lot of money in the G-fund of the Federal thrift plan, and the fact that it is all government does not bother me at all. It is my account; it is a contractual arrangement. So if you accomplish nothing more, if we are dealing with trying to get people to reach a comfort level, that does it.

Senator SIMPSON. That is very interesting, because Senator Kerrey and I, in our proposal, are suggesting something along the Federal thrift or savings plan, or IRA's. That is our theme as we talk about the 2 percent.

I think we just finished picking time with regard to that, whether you stayed in the A or the G or the F, and it showed the rate of return and increase. It was very interesting. One was down 2 percent, or at 2 percent 2 years ago, and now has gone up 12. I mean, the volatility of all of them, you want to get a little in every one of them, I would guess. But that is very interesting.

Do you have any comment, Mr. Entin?

Mr. ENTIN. The less you do with government borrowing, of course, the more the money will go into promoting economic growth. That is the one drawback of having people having to put money into the government bonds—there is no private saving and investment occurring.

The volatility, for a young person, is not serious. If you are looking 40 years ahead, the stock market can go through very many cycles and the average return is simply much greater than you would get in bonds, so young people certainly should be investing in stocks.

Any reputable money management firm or brokerage house will advise younger workers to be heavily weighted in stocks and then shift them into bond funds as they approach retirement. That is the standard practice.

As for the funding, let me reiterate. You would have to cut Federal spending growth by about 0.5 percent for 8 years, which seems to me not to be out of the question, to handle the transfer of the payroll tax without borrowing beyond that point. It would be a purely temporary borrowing, if you had to do it at all.

There are other sources of funding, if you have to do it within Social Security—and again, I do not think the budget rules should be followed on that; if the whole economy benefits the whole budget should contribute, not just OASI. One could, as will have to be done eventually anyway, reform Disability Insurance, tying its benefits, perhaps, to the same sort of diminution as applies to OASI benefits when the normal retirement age is raised.

You can probably raise revenue while cutting marginal tax rates if you reform the tax treatment of Social Security benefits. You could probably raise some money by doing some easing of the earnings test. I think a lot more people would work if you did that.

But the main point should be that there is nothing else you are spending money on in the Federal Government that can double or triple people's retirement income for the last 20 years of their lives, or have anything like the present value of that.

I would go into most other areas of the government. I would take a hard look at virtually everything that Energy, Education, Transportation, and the Commerce Department do and ask, do we need these programs if we can get this great alternative instead?

Senator SIMPSON. I am going to ask a question of Mr. Myers while Mr. Nickles is here. Mr. Myers has been here so many times, he just kind of rocks back in his chair. He looks very comfortable; nearly a fixture. Quite comfortable, and he should be up here, perhaps. He has been here many times as a distinguished participant.

Now, with that, what is your answer to that question?

Mr. MYERS. Well, first of all, I thank you for those kind remarks. As it so happened, I counted up before I came in here. I have had the honor and pleasure of testifying before the Committee on Finance 35 times, beginning in 1950.

Senator NICKLES. I missed that one.

Mr. MYERS. I must also say, Senator, that I certainly agree with you that people do not understand what really underlies the financing of Social Security, and the more education that can be gotten across to people, the better it is.

Now, to get to the question of privatization, I think that the real Achilles' heel of any privatization proposal is how to finance the transition, considering that there will be many costs involved.

The low-cost cases will tend to opt out of Social Security and into privatization because it will fit them better. The high-cost cases will stay under Social Security, and the financing problems of Social Security will get worse. That is why I want to keep separate Social Security and savings in the private sector. I want to change Social Security so as to make it viable over the long-range by appropriate changes and, at the same time, build on top of it through privatization.

As I said before, this can either be by strengthening the present voluntary provisions so the people will save more, or else have a compulsory layer on top of Social Security of a privatization nature of the type where people invest in various mutual funds of their choice and can switch back and forth.

Senator SIMPSON. Thank you.

Mr. Tanner, do you have anything to add?

Mr. TANNER. Well, again, to return to my testimony, there are essentially four ways to fund the transition, and I suspect it will be done as a combination of all of them. There are forms of default ranging from raising the retirement age, which I think is very logical and should be done, down to writing off the contributions of people under a certain age who opt into the private system.

If I was allowed to go into the private system tomorrow and say there will be no credit for any of my past contributions to Social Security, it would be as fast as I could get my hands on a pen to do it. I think that most people under the age of 40 would take that option in a minute.

You can bond out some of the debt. Again, I think we should do as little as possible of that, but it is certainly possible and it is possible to have the requirement that the funds buy back a portion of that debt and sort of fund it in the back door that way. You can continue some portion of the payroll tax.

As I say, privatize 9–10 percent of it, keep some small portion going temporarily during the transition period to continue some revenue coming into the system, or you can come up with additional spending cuts. Cato has identified $88 billion a year in corporate welfare that we think could be a nice place to start cutting. There are certainly other possibilities. It could be some combination of that.

The other important thing to remember is that much of the costs that you are anticipating in the future of Social Security is a sum cost. You have those costs, whether or not we recognize them. They may not be funded, and they may not be explicitly recognized, but they are out there and we are going to have to pay many of those obligations.

We talked about young people believing more in UFOs than Social Security. I submit that Social Security is a UFO. It is an unfunded future obligation and it is sitting out there, and you are going to have to come up with much of this money, whether we privatize or not.

Senator SIMPSON. I did not hear that. What did you say? I really did not. Don was leaving. What did you say?

Mr. TANNER. I said that young people may believe more in UFOs than Social Security, but Social Security actually is a UFO, an unfunded future obligation, and you are going to have to come up with that money somewhere down the line, say, in 2012, 2013, when those bonds start looking to the general revenue, saying we are going to have to come up with that money. You are going to have to do some of these things anyway. This is a way to do it and give everybody more of a return at the same time.

Senator SIMPSON. Mr. Fink?

Mr. FINK. I guess I will just echo Mr. Tanner and some of the other colleagues on the panel. They have outlined the alternatives. I would just say, two of the advantages of your legislation are first, it is not total privatization, it is only 2 percent.

Second, it is optional, so not everyone will elect to invest the two percent, as I said earlier. What will happen is that some people will elect, so the fund will shrink faster than it is going to shrink without this proposal. But, as Mr. Tanner said, you are going to face the same problem of Social Security financing anyway. This may speed the year the problem hits up to 2008 instead of 2013, but the same question is going to be faced then.

This would speed it up when you have a financing problem, but I think it would be a better alternative. If nothing else, it will bring to the public's attention how the Social Security system actually works, and the problems with it, which is kind of masked now.

Senator SIMPSON. Well, I would wind down here. But, if nothing else, hopefully in a year people would know more about Social Security than they will know, and have known since 1950 when Mr. Myers was here. When I was in my 40's and 50's I paid not one whit of attention to what this is.

When I was practicing law in Cody, Wyoming in the 1970's and my older clients would come in and say, there must be a mistake here. Here is my Social Security, and it has gone up 12 percent. What does it mean? I said, I do not know. They are smart out there. So, whatever it is, just count on it, it is there; it is a wonderful thing.

It did that in the 1970's; 8-, 9-, 10-, 12-percent increase in your check per month. And people looked at it and said, I only put in nickels into this thing. People at that age did put in pennies and nickels, $5 a year, and things like that.

So I will remember this phrase, UFO, unfunded future obligation. Then when people always talk about, why do we not do something about these tax expenditures, we can nail these guys. Let us clean up the act over there. I always say, well, gosh. I am ready to do that. Why do we not take the two big ones? We should start with the big ones, should we not? Yes, you bet, get the tax expenditures. Well, the first big one is home mortgage interest deduction. They say, well, now, wait a minute; I was not thinking of that.

Then you say, well, let us take the second biggest one, which is employer deduction of employee health care premiums. And they say, oh, God, I do not want to do that either. So maybe we can get through that babble too and know that that will not get done, politically, anyway, or doing something to those overseas, which we have already done through the tax structure.

But with regard to Chile, I was going to ask some more questions. But I think we will just leave that at this point. You have added distinctive comments on that. But the Chilean system has elements of redistribution and I hope that, if nothing else, the people of America will realize that the Social Security system is a tremendously redistributional system.

And they do not understand that, because when you mention the replacement rate their eyes just glaze over. But they had better understand when you are talking about, who can get hurt the worst if we do not do something with Social Security, it will be the poor, not the rich. Do you all agree with that, each and every one of you?

That has seemed to escape people, that when you have a formula like we do today with a 42-percent replacement rate for an average Social Security recipient, that rate among the poorest is about 65 percent. That means 65 percent replacement of what they earned per month is coming to them in that check per month, while the replacement rate among wealthy recipients can go as low as about 30–32 percent. Do you all agree with that?

Mr. MYERS. I would say about 25–26 percent.

Senator SIMPSON. 25 percent. That was very good. I could not have asked a better question. Let the record show, 25 percent to the wealthy.

Now, if we cannot begin to turn it around and, say, do something really bizarre like monetize the debt, guess who will take the hits? The pension plans, the people with their money in what you are doing. If we cannot get that across through a bunch of dull-witted befoggers in the country, then we will have earned that great, great description of H.L. Menken that we truly are that great subspecies, boobus Americanus, which is a great Latin phrase which you do not find much.

Now, I have one final question since you are captive here and we are about to wind up. Let me ask you, and put you all on the spot, a little bit unrelated. In the coming weeks we are going to discuss how we can encourage savings and investment through the tax code. This committee will discuss the tax situation.

In your thoughtful backgrounds and what you know, do you think we can see any dramatic increase in savings and investment through an expanded IRA or a 401(k) plan, and why do you say that?

Mr. KOITZ. I think I will pass, Mr. Chairman.

Senator SIMPSON. Pass again. Well, we have passed on that one, too.

Yes?

Mr. ENTIN. Where people have maxxed out, that is, have made the maximum contribution to these plans, raising the lids would give them added incentive to save. But when they hit the new lid they would, again, have no added incentive to save beyond that point.

The major tax restructuring proposals that go to expensing of plant and equipment and, as in Nunn-Domenici, given IRA treatment at the front-end for all saving, or, as in the flat tax, give a back-ended IRA treatment, would stand a much better chance of giving additional saving incentives to everyone wherever they currently are in their saving patterns.

Expensing urges people to put more plant and equipment in place and offers a higher return to the saver; you get both a push and a pull. I think you would get quite a bit of additional saving. The saving rate may not go up because, as you get more plant and equipment and the economy grows, incomes will rise and so will consumption, but saving, consumption, and total incomes will all be higher if you could go to that kind of a system.

Senator SIMPSON. Yes?

Mr. MYERS. Mr. Chairman, I am certainly not an expert in this area, but I would most certainly agree that steps should be done to encourage savings through what I would call liberalized rules as to IRA's, 401(k)s, Keogh plans, and so forth. I think that this would be successful. Perhaps I think that it will be successful because I so much hope that it will be, because I believe that what this country needs is more savings, and anything that can do that is all to the good.

Senator SIMPSON. Mr. Tanner?

Mr. TANNER. Yes. I would strongly support those changes as well, and I think that anything that increases savings is good, and it is particularly good for the economy.

As far as individuals go, it does relate to how much discretionary income they have to make in additional savings and investment, so it is not going to benefit the low-wage earner as much.

To return to the topic of the hearing today, the fact is, those people, any extra income they have is being sucked out of them primarily by the payroll tax and they do not have the money to invest in additional IRA's or things of that nature. Therefore, privatization would be the biggest boon to the low-wage worker and the middle class worker than it would be to the wealthy who have the discretionary income to make secondary investments now.

Senator SIMPSON. Mr. Fink?

Mr. FINK. Mr. Chairman, I cannot say strongly enough, I think if you had to do one thing to encourage savings and capital formation in this country, it would be an expansion of IRA's and 401(k)s.

We know from the pre-1986 IRA experience, before they were cut back, they were much more popular than people had imagined. Every year more people were contributing and every year the income level of people contributing dropped. In other words, it started with the wealthiest, went to the upper middle class, and, as you got into 1986, it was dropping.

Another benefit is, as Professor Skinner and others have shown, that as people started contributing to IRA's they also started making other contributions to savings. They got the savings habit. That is one reason I think the PIP is such a good idea, because even if it is only a sliver of privatization it will awaken people to the need to save.

I think IRA expansion is probably the best thing you can do, sir.

Senator SIMPSON. Well, we have much to do as we get into the serious stuff after doing the budget resolution, which is not real hard voting yet. When we get to the hard stuff, and doing it here, it will be telling the American people how we are going to pay for it and where it is going to come from in this committee, with Senator Packwood and Senator Moynihan leading us.

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We must get the voices heard through the clutter, the tin that has been shot out, as they do in the military where they shoot the tin and the scraps out into the air to blunt the radar, to blunt the beam. The beam is, the trustees are telling us the truth and we have to respond and we have to do it beginning now.

Everyone has told us that, every trustee; the civilian trustees, the Democrat, the Republican, the appointed trustees by the President. The Entitlements Commission, by a determination of 30 of the 32 of us, said that unless these things are turned and begun to be resolved, that in the year 2030 people would be paying 40 percent of their income in payroll taxes to sustain the programs, and that was an agreed figure of 30 of 32 of us.

So it is serious stuff. You have helped us, again, with more information, more education, views that are very important to us. I thank you.

John Porter's remarks will be placed in the record. He is in full combat on the Floor of the House. I appreciate what he has done in the past. His remarks will be entered into the record, as will Mr. Myers statement, a very unbalanced view of Chile currently and its problems, and it will be edited by the rest of the panel. [Laughter.]

Senator SIMPSON. Sandra Green Swirski, thank you.

That will conclude our hearing.

[The prepared statement of Representative Porter appears in the appendix.].

[Whereupon, at 11:16 a.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED

PREPARED STATEMENT OF STEPHEN J. ENTIN

OVERVIEW

Social security is facing a crisis. The Federal Old-Age and Survivors Insurance program (OASI) and the Disability Insurance (DI) program deliver social security retirement, survivors, and disability benefits to some 38 million beneficiaries. These programs (jointly referred to as OASDI) face enormous deficits as the baby boom begins to retire. (See table 1, table 2, and chart 1.)

Rather than simply patching up the OASI and DI programs, consideration should be given to privatizing them. At the very least, the retirement benefit program should be converted to a system of private saving and insurance. The current OASI system is a tax-transfer program that depresses saving, income, and employment. The primary goal of any reform of the OASI system should be to replace it with a system of real private saving and insurance.

Individuals of even modest means can obtain large amounts of retirement income by conscientiously adhering to a lifetime saving program. One means of encouraging saving and moving toward privatization of OASI would be to allow workers to divert a portion of their payroll taxes into private saving accounts modeled on IRAs. Virtually all wage earners could save if they were given payroll tax relief. With compound interest, the amounts available at retirement would dwarf benefits available under social security and sharply increase the retirement income of future generations. The added saving would boost capital formation, wages, and employment, and benefit workers even before they reach retirement.

Reductions in payroll taxes would require reductions in OASI benefits. These benefit cuts would be more than matched by increased private retirement income. The potential retirement income from private saving is so great, assuming that even a modest percent of payroll tax can be redirected into private saving, that social security benefits could be phased out entirely for middle and upper income wage earners, along with most of the remaining OASI tax.

Ideally, the OASI system would evolve over time into a safety net for the elderly who would otherwise be at or below the poverty level. Retirement income would come primarily from private saving. Government assistance would be limited to augmenting the incomes of people whose retirement set-asides under the payroll tax reduction program were not enough to generate a specified minimum level of retirement income. The government would make up the difference between the income available from their retirement plans and the minimum benefit.

The great tragedy of the OASI program is that, in largely achieving its goal of keeping the elderly out of poverty, it has unnecessarily restricted income growth for the whole population. OASI has encouraged each recent generation to rely on the next generation for support in old age rather than on saving for its own needs. The program has crippled the biggest motive for personal saving and has caused a substantial drop in the personal saving rate. Relying on a tax-transfer system instead of real saving greatly increases the cost of providing for the elderly, and by reducing capital formation, reduces incomes of people of all ages. It is time to return to a system of real saving that will not only keep the elderly out of poverty, but will do so at a far lower cost and will raise incomes for the elderly and non-elderly alike.

REAL SAVING VERSUS TAX/TRANSFERS

When the OASI program takes a dollar of payroll tax from current workers, it gives a dollar to current retirees, who use it primarily for current consumption. There is no saving involved. Indeed, total saving is likely to decrease.

By contrast, workers who set aside income over forty years in bank accounts, mutual funds, stocks and bonds are saving that income. The compounded returns on that saving produce several dollars at retirement for every dollar of contribution. At a 7 percent real return, a dollar saved at age 20 would be worth $16 at age 60 and $32 at age 70. No tax/transfer system can give that kind of gain.

Furthermore, saving helps capital formation, raises worker productivity and wages, and raises employment. Workers do not even have to wait for retirement to benefit.

A tax-transfer system has another drawback. A tax on payroll is an excise tax on labor. It raises labor costs, and discourages work and hiring. A worker knows that he will never see those tax dollars again. His future social security benefit is tied to his earnings history, not to the amount of tax he paid in. The benefit formula and the tax rate have often been, and surely will again be, changed independently of one another.

By contrast, a saving program, even a mandatory one, in which some of one's wages are diverted into one's own retirement account, is not a tax. The money is still one's own. It cannot be taken away and given to someone else. One will have it back some day. If one dies, it does not vanish; it becomes part of one's estate. If the payroll tax were transformed into personal saving, the tax would become a deferred wage, and the disincentive to work would vanish. U.S. labor costs would fall. U.S. employment, output, and GDP would rise. In Chile, when personal saving account contributions replaced the payroll tax and the government social insurance program, these labor market effects were dramatic. The shift led to enough additional saving, investment, labor force participation, and employment to enable Chile to grow 14 percent per year in real terms for the last 14 years.

THE KERREY-DANFORTH PROPOSAL IN THE ENTITLEMENT COMMISSION REPORT

In the report of the Bipartisan Commission on Entitlement and Tax Reform, Senator Robert Kerrey (D-NE) and then-Senator John Danforth (R-MO) recommended using the power of private saving to deal with the impending OASI deficits. The Senators started with the presumption that payroll taxes would not be raised. Simply raising payroll tax rates to patch up OASDI is not the answer. The current payroll tax is 15.3 percent, half paid by the worker and half paid by the employer. Of that total, 12.4 percent funds OASDI and 2.9 percent funds Medicare Part A (Hospital Insurance, HI). If social security retirement and disability benefits grow at the rate provided under the current benefit formulas, the OASDI portion of the payroll tax rate would need to be hiked by nearly 6 percentage points over the next 75 years. A 6 percentage point increase in the tax bite on wages would depress employment by roughly 3 percent below levels that are now projected, equivalent to about 3.5 million jobs in today's economy, and to more than 4 million jobs in the larger labor force of the next century. The payroll tax is already larger than the income tax for the majority of American families, and is destroying their ability to save for a home, a college education, and retirement. Further increases in the payroll tax are flatly unacceptable. They observed that the existing payroll tax rate would cover a diminishing percent of promised rising real benefits over time, about 79 percent of promised benefits by 2020 and about 69 percent by 2070. Put another way, Social security currently promises benefits equal to 42 percent (the "replacement rate") of an average wage worker's pre-retirement wages at the normal retirement age. The funded replacement rate is only about 29 percent in the long run. The Senators assumed that replacement rates would have to be allowed to fall to hold benefit growth to the funded levels.

As the Bipartisan Commission on Entitlement and Tax Reform pointed out, the structure of the social security retirement and disability benefit formulas lead to promised real retirement benefits that rise 12.5% per generation for people with the same real income. In addition, real incomes are projected to increase, and benefits along with them. It is not possible to pay rising real benefits for a rising number of years of retirement with declining numbers of workers per beneficiary without substantial tax rate increases.

Per capita real benefits at the normal retirement age are projected to roughly double under current benefit formula rules between 1995 and 2072, and could be trimmed without harming future retirees. An average wage single worker retiring at age 65 in 1995 received over $10,300 in benefits, and over $15,000 with a spouse. An average wage two worker couple could receive over $20,600. A high income two

worker couple could receive over $28,800 in benefits. Looking ahead, benefits for an average-wage worker retiring at age 67 in 2072 are projected to be over $20,200 in 1995 dollars, over $30,300 with a spousal benefit; over $40,400 for an average-wage two-worker couple; up to about $64,000 for an upper-income two-worker couple. (See table 3.)

There is no need to double real benefits as rising real incomes over time make people better able to save for their own retirement. Yet the benefit formula is designed to keep "replacement rates" (initial benefits upon retirement as a percent of pre-retirement income) constant for each portion of the earnings distribution across the generations—at about 56% for low wage workers, 42% for average wage workers, and 27% for upper income workers. Benefits are projected to roughly double because real earnings are projected to roughly double all across the income distribution.

Trimming benefit growth would cost no jobs, would encourage work and saving, and would result in higher lifetime incomes for future generations. People are young before they are old. It makes no sense to lower their after-tax incomes, employment opportunities, and ability to save while they are of working age in order to give them higher transfer payments after they retire.

The Senators then suggested trimming benefits a bit further, to about a 25 percent replacement rate for an average wage worker, to permit the payroll tax to be cut by 1.5 percentage points. They proposed that the 1.5 percentage point payroll tax cut be shifted into individual tax deferred retirement saving accounts. Under conservative assumptions about real rates of return in such accounts (a three percent real return as on long term federal bonds), the accumulated assets in the accounts would provide more than enough retirement income to offset the extra benefit trimming, and would be able to offset a significant portion of the initial reduction in replacement rates to currently funded levels. Beneficiaries would be better off than with the amount of currently funded benefits alone. (See chart 2.)

For example, a worker saving 1.5 percent of wages from age 20 to 67, and investing in a tax deferred government bond fund yielding (historically) a 3 percent real return (above inflation), could acquire an annuity at retirement equal to about 7 percent of a year's pre-retirement wages. I have assumed throughout that wages rise 1 percent a year in real terms due to productivity advances, and that workers at age 20 receive 80 percent of their ultimate wage, rising to 100 percent over twenty years. The annuity plus the reduced social security benefit would give the retiree a combined replacement rate of 32 percent, greater than without the tax reduction and added benefit cuts.

Social security gives a higher benefit to one-earner married couples by means of the spousal benefit. The spousal benefit is 50 percent of the primary worker's benefit. The average wage one-earner couple effectively gets a 63 percent replacement rate. Saving in a stock fund with a higher rate of return, or cutting payroll taxes by a bit more than in the Kerrey-Danforth proposal, would enable those retired couples to come out ahead as well.

THE SIMPSON-KERREY BILL

Senators Alan Simpson (R-WY) and Robert Kerrey have introduced an important social security reform bill, the "Strengthening Social Security Act of 1995," S. 825. It expands on the insights of the Kerrey-Danforth section of the Entitlement Commission report. S. 825 would set aside 2 percentage points of the OASI payroll tax in personal investment plans for workers under age 55 beginning in 1998. The funds could be invested in stocks, bonds, or some combination in a federally managed plan, or in an IRA of one's own choosing. S. 825 would give workers the option of placing their payroll tax reduction in government managed bond, stock, or mixed asset funds, or in their own IRAs. Government should not acquire partial ownership of and voting rights in private corporations. Retirement savings accounts should not be managed by government officials; they should be managed as are IRAs, by workers and their chosen financial institutions or financial advisors. The federally-managed option in S. 825 would start by investing in index funds, spreading the investment over the whole stock market. The danger is that it could easily be converted into a vehicle for the government to be selecting stocks, favoring one company, industry, or type of investment over another (as with Secretary of Labor Robert Reich's socially targeted investment proposal). A similar objection applies to the provision in S. 825 that would require the trust fund balances to be invested in equities. Other provisions, including an increase in the normal retirement age and adjustments in the OASI benefit formulas, would balance OASI in spite of the payroll tax diversion. Some of the particulars of the bill for balancing the remaining portion

of the OASI system could be improved upon, but the basic direction of the bill is sound.

POTENTIAL BENEFITS OF INDIVIDUAL SAVING ACCOUNTS FOR YOUNG WORKERS

The more that can be done along the lines of Kerrey-Danforth or the Strengthening Social Security Act of 1995, the better. If saving 1.5 percent of payroll can more than make up for the associated benefit reduction, then saving two percent, four percent, or six percent can put young workers even further ahead. (See table 4 and chart 3.)

Deeper cuts in the payroll tax rate would require further trimming of social security replacement rates, but in each case, the added annuity value of the resulting savings plans would boost total retirement income. If the diversion of payroll tax into private saving were large enough, the annuity alone would produce more than sufficient retirement income. Over time, OASI benefits could be phased out entirely, along with most of the remaining OASI payroll tax (with some delay during the transition to cover the benefits of current retirees). All that needs to be kept in the way of benefits is a safety net for low income workers whose saving, due to low wages or intermittent work history, could not generate an annuity large enough to provide an adequate retirement income. Only a small portion of the OASI payroll tax would need to be kept to pay for the safety net. Alternatively, this welfare feature of the OASI system could be funded by income taxes.

Table 4 and chart 3 show the annuity values of IRAs at 3 percent and 7 percent real rates of return (expressed as a percent of pre-retirement income) if 2 percent, 4 percent, or 6 percent of payroll were diverted to IRAs between ages 20 and 67. The table also shows how much OASI replacement rates would have to be scaled back to accommodate the loss of the payroll tax revenue. These remaining OASI benefits are the most that could be provided under the remaining payroll tax, but they need not necessarily be paid. Instead, they could be eliminated to allow for further cuts in payroll taxes.

Diversions of 2 percent, 4 percent, or 6 percent of payroll tax to IRAs invested in relatively low-yielding government bonds could generate annuities at age 67 that would replace 10 percent, 20 percent, or 30 percent of pre-retirement income; if invested in stocks, the set-asides could replace 43 percent, 87 percent, or 130 percent of pre-retirement income. A mixed portfolio would produce results in between. Reduced OASI benefits that could be paid after these various payroll tax reductions would add between 14 percent and 24 percent to the replacement rate. The combined benefits would exceed currently funded OASI benefits averaging 29 percent of pre-retirement income.

The more generous the diversion and the more stocks in the investment mix, the less need there would be for any OASI payments at all. Young workers who would be in the diversion program most of their working lives would not need any OASI benefits to achieve a comfortable level of retirement income, and the benefits and most of the remaining OASI tax could be phased out completely over time. The annuity value from an IRA funded by diverting 2 percentage points of the payroll taxes would exceed the value of funded OASI benefits by nearly one half if the IRA were heavily weighted in stocks. If 4 percentage points were diverted, the annuity value would be double currently funded OASI benefits if the stock/bond split were 60 percent/40 percent. Invested entirely in stocks, a 4 percentage point diversion—just over one-third of the OASI share of the payroll tax rate—would provide an annuity worth three times projected funded OASI benefits. If the saving were invested in stock funds, the annuitized benefit might exceed pre-retirement income. Most people are not likely to want to replace in excess of 100% of pre-retirement income. People would be better off if they were allowed to do part of this saving outside of the retirement-restricted IRA to be able to obtain some additional income in earlier years. Alternatively, the saver should be allowed to begin drawing on the IRA before age 62, provided that the annuitized income exceeds the minimum safety net level the government had agreed to guarantee. (Taxpayers can withdraw money from current-law IRAs before the "minimum" withdrawal age of 59-1/2 without penalty if the withdrawals are at a rate consistent with exhausting the IRA over one's remaining life expectancy, as determined by IRS actuarial tables. At the very least, this degree of flexibility should be allowed in any new program.)

Furthermore, Social Security benefits account for only about 40% of the income of persons age 65 or older. Earnings from savings, pensions, and wages from continued work account for over half of the of the income of the elderly. Private income plus OASI benefits typically provide retirees with incomes of between 70% and 100% of pre-retirement earnings. When these other sources of income are added to the potential annuity value of the diverted payroll tax IRAs, retirees could replace

80% to well over 100% of their pre-retirement income, more than with current OASI outlays even if OASI outlays were eliminated. Retirees could get three times the benefits for one-third the cost through a real saving program.

The higher yield available in a stock mutual fund has two implications. First, workers should be encouraged to invest in stocks or stock mutual funds rather than put all their saving into federal bonds. Second, it reinforces the importance of paying for payroll tax reduction by cutting government spending, not by running larger federal deficits and issuing more government bonds that someone would have to buy. For best effect, the saving in the retirement plans should boost national saving, add to the stock of plant and equipment, raise productivity, and increase employment and wages (added gains for workers not factored into the returns calculated above). For that to happen, the private saving must not be diverted into financing additional government debt.

SAFETY NET RETAINED

Ideally, IRAs funded by diverted payroll taxes would exceed and replace currently funded OASI benefits. A worker's retirement benefit would be the annuitized value of the IRA at whatever age the worker decided to begin drawing benefits. There would be a safety net, however, for low wage workers or workers employed only intermittently. Insofar as the value of their annuities fell short of some minimum standard retirement level, OASI would make up the difference with a monthly payment. The OASI safety net could be paid for by retaining that part of the OASI payroll tax not diverted to IRAs, or out of general revenue.

OLDER WORKERS DURING THE TRANSITION

Workers currently in their fifties, forties, and thirties would be in the private saving system for only part of their working lives. They would have less time than younger workers to accumulate retirement saving, and would have smaller annuities at retirement, which might not fully offset the benefit reductions necessary to pay for immediate cuts in the payroll tax. For such workers, some portion (decreasing with youth) of current law OASI benefits would have to remain in place. Alternatively, such workers could receive a federal bond reflecting some portion of the benefits they have earned to date. The bond would be placed in their retirement saving accounts to augment their retirement annuities to ensure that the sum of the reduced OASI benefits and the annuities would be larger than currently funded OASI benefits. Future outlays to service and redeem the bonds should be covered by federal spending restraint, not by future borrowing.

FUNDING THE TRANSITION: EFFECT ON THE TRUST FUNDS AND ON CURRENT BENEFICIARIES

Any proposal to reduce the role of social security in providing retirement income and increasing the role of private sector saving must deal with a difficult transition period. How can a current cut in the payroll tax, or alternative saving incentives, be paid for while continuing to pay benefits to current and soon-to-be retirees and other beneficiaries? This is the critical hurdle that any proposal to partially or fully privatize social security has to face.

Myth of the trust funds. The Subcommittee's letter of invitation asked for the effect of privatization on the OASI trust fund. "Effect on the trust fund" must be regarded as a euphemism for the budget cost of the transition to a privatized system.

The OASI and DI trust funds are not a means of payment of benefits. Treasury must pay benefits from current taxes or borrowing whenever benefits are due. The trust funds are merely a sort of budget authority that SSA is granted to order Treasury to pay benefits without having to come back to the Congress for additional spending authorization and budget appropriation. The trust fund balances are in fact simply bookkeeping entries at the Treasury, containing Treasury securities, Federal I.O.U.s. These are liabilities, not assets, of the government. They represent past years' excesses of payroll taxes over benefits. That excess payroll tax revenue was "borrowed" from the trust funds and used to pay for other government programs in order to hold down borrowing from the credit markets when the rest of the budget was in deficit. Similarly, the Treasury's payment of interest to the trust funds was similarly "borrowed" back. Consequently, in 2013 and beyond, as the baby boom retires and the time comes to pay future retirement benefits out of interest or principal in the trust funds, the Treasury will have to use the taxes it is then receiving or borrow additional money in the credit market.

Long term issues are easy to deal with. Making room for significant payroll tax rate reduction is relatively simple in the long term, once OASI is brought into balance and individual retirement accounts are established to substitute for future ben-

efits. Balancing the current OASI system will require trimming benefit growth. For example, the biggest savings in the Kerrey-Danforth proposal and S. 825 would come from raising the normal retirement age to 70 by 2029, and from trimming the OASI benefit formula for average and above average wage workers over the next several decades (through 2035 under S. 825). These steps would roughly balance OASI at current tax rates. Deeper formula reductions before 2035, continuation of the formula trimming beyond 2035, or a more straightforward phase-out of benefits (except for the safety net) by some fixed date thereafter, could cover the additional reductions in benefits needed to pay for the payroll tax reductions in later decades, and could lead to virtual elimination of the OASI portion of the payroll tax eventually.

Near term transition costs are the hard part. For the near term, however, alternative means of providing for a payroll tax cut need to be found. The usual benefit trimming formulas and retirement age increases do not yield enough saving in the near term to accommodate a payroll tax reduction. There are numerous possible sources of funding for a payroll tax reduction. Some are within the OASDI program, and some are elsewhere in the budget. Some of the funding options relating to OASI could help current beneficiaries.

- *Trim on-budget federal spending.* Since the Omnibus Budget Reconciliation Act of 1990, any budget resolution that would diminish the projected levels of the trust funds is subject to a point of order in the Senate (requiring 60 votes to overcome). In the House, any bill that would reduce the 5 or 75 year balance of the OASDI trust funds is subject to a point of order (requiring a simple majority to overcome). These rules are intended to require outlay cuts or tax increases to offset OASDI program changes that would otherwise worsen deficits in the OASDI programs and the total federal budget. The rules require that the offsets be made within the confines of OASDI, rather than by means of cuts in on-budget discretionary federal spending or other entitlements.

A broader view should be taken. Privatization will help all current and future workers, future retirees, and the general economy. Higher private saving would raise incomes and would increase income and payroll taxes, and reduced OASI outlays would benefit the federal budget directly. Since most individuals and the broader federal budget will gain from privatization, privatization should be paid for by a general cutback in all federal spending, not just spending within the social security program area. Consequently, it makes sense to find spending reductions in the rest of the budget of sufficient size to enable the Treasury to pay for a portion of the payroll tax reduction out of general revenues without raising other taxes or borrowing additional money from the public.

One could regard these general revenue transfers as "redeeming the current trust fund." Actual transfers would have to be a bit larger than simply redeeming the trust fund, however, because the figure represented by the fund is not large enough to cover a 2 percent or greater reduction in the payroll tax for 40-plus years, until additional trimming of benefits beyond 2035 made the transfers unnecessary. A cut of 2 percentage points in the payroll tax would require a general revenue transfer of less than one percent of GDP. The transfer would need to begin as soon as the payroll tax were reduced (1998 under S. 825) and could start to taper off as younger generations build their IRAs and OASI benefits could be further reduced. The transfers could surely begin to taper off after about 2035, as the baby boom generation begins to pass on.

It may be difficult to imagine generating a general revenue surplus in addition to simply balancing the budget by 2002—and keeping it in balance as the OASI surpluses evaporate by 2013 as the baby boom begins to retire—in order to have some leeway to reduce payroll taxes. However, the spending cuts needed could be built up over a few years, and the eventual rewards to the budget and to American workers, retirees, and their families would be enormous. The potential income gains are another justification for holding government spending under tight control. Indeed, given the tax relief, retirement income increases, and increased job opportunities that workers could get from private saving, almost nothing that government spends money on (with the exception of basic national defense) is as valuable as diverting payroll taxes into IRAs.

- *Trim DI benefits as the normal retirement age rises.* Trimming the disability benefit formula in line with the reductions in OASI benefits at age 65 as retirement age increases would result in large savings over time, and is critical for balancing the DI program without raiding the OASI portion of the payroll tax.
- *Reform taxation of social security benefits.* Reform of the current flawed method of taxing social security benefits could increase the incentive to save for retirement while raising revenue to finance payroll tax reduction. Taxation of benefits is really a tax on other retirement income—interest, dividends, pensions, and

wages—at super-normal tax rates. Retirees subject to the taxation of benefits must add $0.50 or $0.85 in social security benefits to taxable income when income exceeds certain thresholds. Consequently, earning an extra dollar of income can add $1.50 to taxable income, and up to $1.85 since OBRA93, effectively increasing marginal tax rates to 1.5 or 1.85 times their normal levels. For someone in the 28 percent tax bracket, there is a marginal tax rate of 42 percent or 52 percent on an additional dollar of interest. On wages, with the payroll tax, marginal tax rates can reach 56 percent to 65 percent. Rates can range from 85 percent to 115 percent on wages when the worker is also subject to the earnings test.

Taxation of benefits should be decoupled from other income to eliminate the resulting spike in marginal tax rates. The 50 percent and 85 percent phase-ins of benefits into taxable income should be eliminated. Sheltering of lower income taxpayers from taxation of benefits could be achieved quite simply, and without the tax penalty on other retirement income, by an alternate method of benefit taxation. Some amount of benefits, say, $6,000 for a single retiree, $9,000 for a couple receiving the 50 percent spousal benefit, and up to $12,000 for a two-worker couple, could be made tax exempt. Benefits above the exempt amounts, up to half of benefits, would simply be added to taxable income. These exempt amounts and/or the percent of benefits subject to tax could be adjusted to produce the same or higher revenue, as desired.

Another approach to decoupling the taxation of benefits would be to tax all benefits in excess of an individual's lifetime tax "contributions," akin to the tax treatment of private pensions. Either approach to reforming taxation of benefits could sharply increase the incentive to save for retirement by reducing the marginal tax rate spikes while raising significant revenue to finance payroll tax reduction.

- *Ease the social security earnings test.* Substantial increases in the earnings test exempt amounts would encourage work, increase earnings, and raise income and payroll tax receipts by more than it would increase outlays on benefits. The earnings test imposes outrageous marginal tax rates on added earnings of the elderly. At incomes of only $15,000 to $25,000, marginal tax rates on wages can be pushed to between 65 percent and 85 percent by the earnings test. At incomes of $25,000 to $60,000, taxpayers may be subject to taxation of benefits and the earnings test. Their marginal tax rates can reach 85 percent to 115 percent, blatantly confiscatory. The economy loses the effort and skill of its most experienced workers.

FUNDING OPTIONS TO AVOID

- *Avoid benefit cuts for current retirees.* The transition to a private retirement saving program need not be and should not be funded with cuts in OASI or DI cost of living adjustments (COLAs) of current retirees or future retirees. Current retirees would not share in the higher future wages and saving income of younger workers that the privatization of social security would bring about, and should not be made to bear a disproportionate share of the cost.

Furthermore, COLA cuts are not good policy. If benefit growth is greater than society can afford, the benefit formula should be changed for future recipients with ample warning so that they may plan to work longer or to save more for retirement. Once people begin to receive benefits, the benefits should be fully protected by COLAs, not eroded randomly by inflation. If COLAs are curtailed, the purchasing power of benefits would decline unpredictably with the severity of inflation and the longevity of the recipient. The resulting uncertainty would greatly complicate retirement planning, which is what the COLA is designed to avoid.

- *Do not raise the minimum retirement age.* People who die young would lose all or most of their OASI benefits. People should still be allowed to draw benefits at age 62, provided that there is a full, actuarially fair reduction in benefits for the additional years of early retirement created as the normal retirement age rises.
- *Do not add new workers to the system.* New state and local government workers should not be required to join OASDI. Adding more workers to a bankrupt system is a bad idea. If a significant portion of OASDI is to be retained, their inclusion would raise tax receipts initially, but would drain funds after they began to get benefits. If OASI is to be substantially privatized, there is no reason to include them, except for some sharing of the cost of the safety net program.

SOME ADDED RESPONSIBILITIES FOR WORKERS

Social security provides benefits in addition to retirement income for workers and spouses. It gives additional income if the retiree has minor children. It offers survi-

vors insurance to widows and minor children, and disability benefits. If OASI benefits are trimmed, and especially if the cutbacks are extended to the Disability Insurance program, workers would need to beef up their life insurance policies to protect their spouses and children and to purchase private disability insurance. The workers would nonetheless be substantially better off with the private savings plans than with a patched-up social security program alone.

A PERFECT FIT WITH TAX RESTRUCTURING

Reducing payroll taxes for deposit into private tax deferred retirement savings accounts fits philosophically and technically with the major tax restructuring proposals that seek to eliminate the income tax bias against saving. These include the Domenici-Nunn bill, the Armey Flat Tax and its variants, and various national sales tax proposals. Privatization of social security fits all these plans, and interferes with none.

CONCLUSION

Privatizing social security would be far more beneficial to future workers and retirees than merely balancing the current program. It is time to return to the original purpose of the program, to keep the elderly from poverty, and to drop the pretense that social security is a national pension plan. A modest but ample guaranteed income floor should be set for the elderly, with strict means testing, paid for by general revenue or a diminished payroll tax. Retirement saving would be left to the individual, under tax deferred IRA or private pension provisions covering all private saving. Such saving plans could easily deliver several times more retirement income for future workers than the projected benefits payable by a patched-up social security system.

If government spending is reduced to accommodate such saving incentives, national saving would rise as well, boosting investment, productivity, and wages. People would benefit both before and after retirement. By doing less, government would be doing more for people of all incomes and all ages.

The prospect of much higher income for workers and retirees is the greatest justification for cutting government spending. Spending should be cut not simply for the abstract achievement of balancing the budget, nor the philosophical preference for smaller government, nor merely for the economic gains from reducing government waste of scarce resources on projects of low value. Spending should be cut in order to return their own money to the individuals and families of this country, so that they can save it, reap high returns in the private sector, and enjoy a far better future than any government program can give them.

Table 1. Old Age, Survivors, and Disability Insurance Surpluses and Deficits With and Without Interest ($ billions)						
calendar year	income excluding interest	outgo	surplus or deficit (-)	interest	surplus or def. (-) with interest	trust fund, end of year
1995	$369	$340	$29	$36	$65	$502
2000	474	440	33	65	98	936
2005	623	587	35	100	135	1,535
2010	826	801	25	137	162	2,308
2015	1,083	1,139	-57	184	127	3,056
2020	1,409	1,641	-232	202	-30	3,275
2030	2,371	3,136	-766	0	-766	0
2040	3,988	5,309	-1,321	0	-1,321	0
2050	6,601	8,843	-2,242	0	-2,242	0
2060	10,893	15,192	-4,299	0	-4,299	0
2070	17,962	25,707	-7,745	0	-7,745	0

Source: 1995 Social Security Trustees Report, tables III.B.3 and III.B.4, intermediate assumptions. Outlays exceed tax income (operating deficits begin) in 2013; some interest is then needed to pay benefits. Trust fund principal begins to be drawn in 2020; trust funds are exhausted in 2030.

Table 2. Old Age, Survivors, and Disability Insurance Surpluses and Deficits (-) Excluding Interest				
calendar year	current dollars (billions)	1995 dollars (billions)	percent of taxable payroll	percent of GDP
1995	$29	$29	1.09	0.41
2000	33	28	0.91	0.36
2005	35	24	0.75	0.29
2010	25	14	0.42	0.16
2015	-57	-27	-0.63	-0.27
2020	-232	-109	-2.09	-0.84
2030	-766	-200	-4.19	-1.64
2040	-1,321	-233	-4.32	-1.66
2050	-2,242	-267	-4.45	-1.67
2060	-4,299	-346	-5.20	-1.92
2070	-7,745	-421	-5.71	-2.06

Source: 1995 Social Security Trustees Report, tables IIIA.2, III.B.1, III.B.4, and III.C.1, intermediate assumptions. Current dollars converted to constant 1995 dollars using projected CPI.

Table 3. Estimated Pre-retirement Income and Real Benefit Amounts of Retired Single Workers Upon Retirement at Normal Retirement Age* With Various Pre-retirement Earnings Levels** Based on Alternative II Assumptions

	Benefits, constant 1995 Dollars			Percent of earnings			Pre-retirement income, 1994 dollars		
Year Attaining Age 65	Low Earnings	Average Earnings	Maximum Earnings	Low Earnings	Average Earnings	Maximum Earnings	Low Earnings	Average Earnings	Maximum Earnings
1995	6,255	10,322	14,424	58.2	43.2	23.8	11,845	23,894	60,605
2010	6,828	11,293	17,610	56.2	41.9	27.2	12,146	26,952	64,743
2040	9,152	15,160	24,025	56.0	41.8	27.6	16,343	36,268	87,047
2070	12,169	20,205	31,976	56.0	41.8	27.6	21,730	48,337	115,855

* Normal retirement age at which full benefits are payable is currently 65. This will rise to 66 in stages (two months per year) for those reaching age 62 between 2000 and 2005, and to 67 in stages for those reaching age 62 between 2022 and 2027. Line for 2010 shows benefits for an individual retiring at age 66 in 2011; for 2040 and 2070, retiring two years later at age 67.

** Low earnings equal 45 percent of average earnings. Average earnings assume worker earned national average covered earnings each year of working life. Maximum earnings assume worker earned the SSA contribution and benefit base (maximum covered earnings) each year of working life. Source: 1995 Annual Report of the Board of Trustees of the Federal Old Age and Survivors Insurance and Disability Insurance Trust Funds, Table III.B5.

Table 4. Replacement rate for average wage single worker from social security and private saving if payroll tax is reduced and diverted to tax deferred savings plan

	Replacement rate from social security		Replacement rate from annuity at retirement		Replacement rate, social security plus annuity	
	promised	funded	3% bond fund	7% stock fund	3% bond fund	7% stock fund
current law	42	29				
If payroll tax is cut:						
2%		24	10	43	34	67
4%		19	20	87	39	106
6%		14	30	130	44	144

Bond and stock funds assumed to yield 3 percent and 7 percent real returns (in excess of inflation). Worker saves indicated percent of wages from age 20 to age 67, reinvesting interest and dividends. Annuity is purchased at retirement, effectively returning earnings and principal over a 20 year average life expectancy.

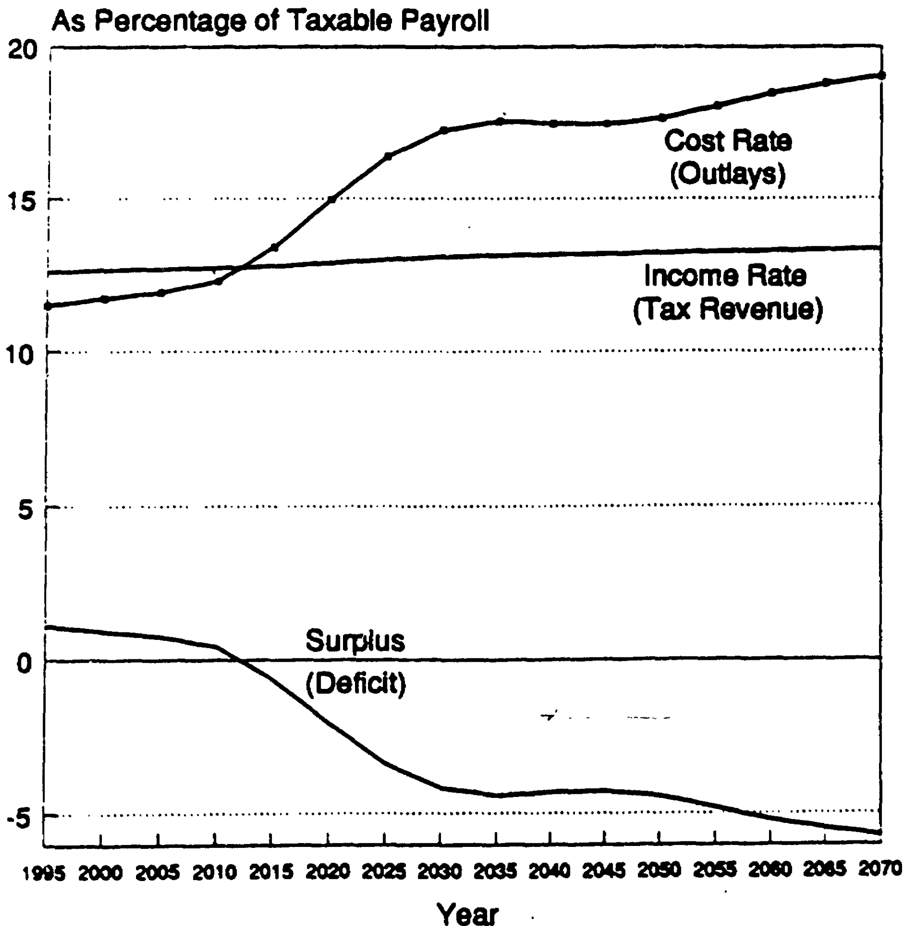
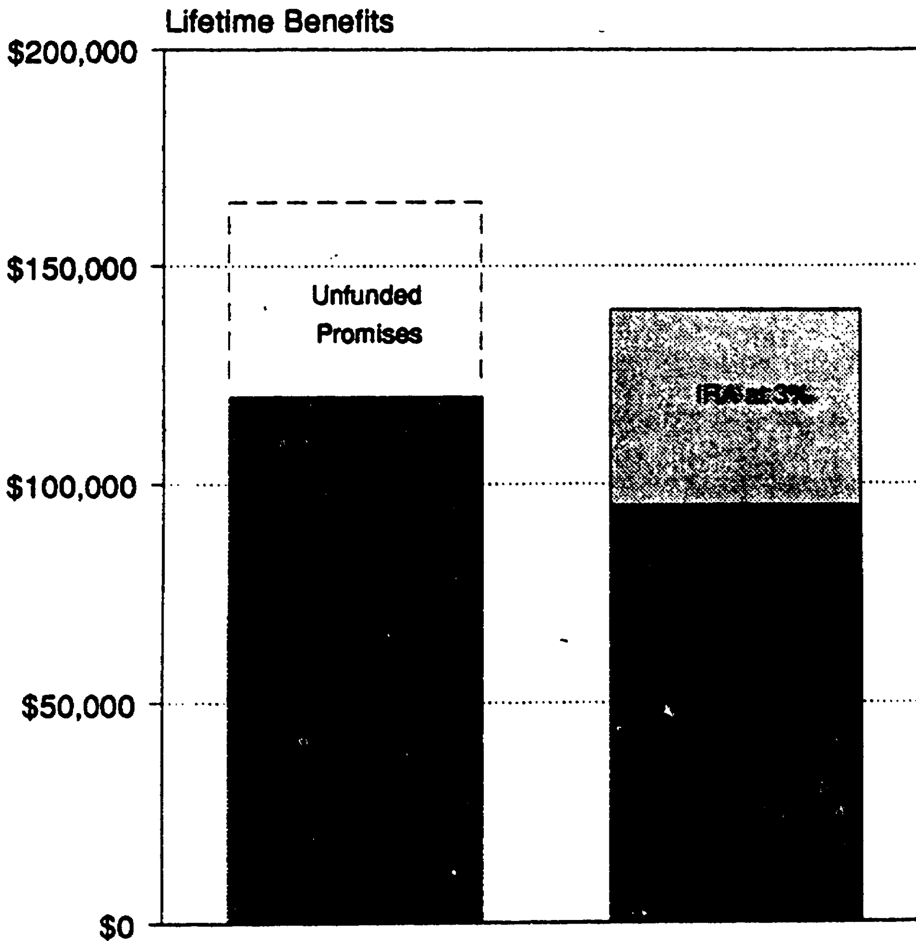
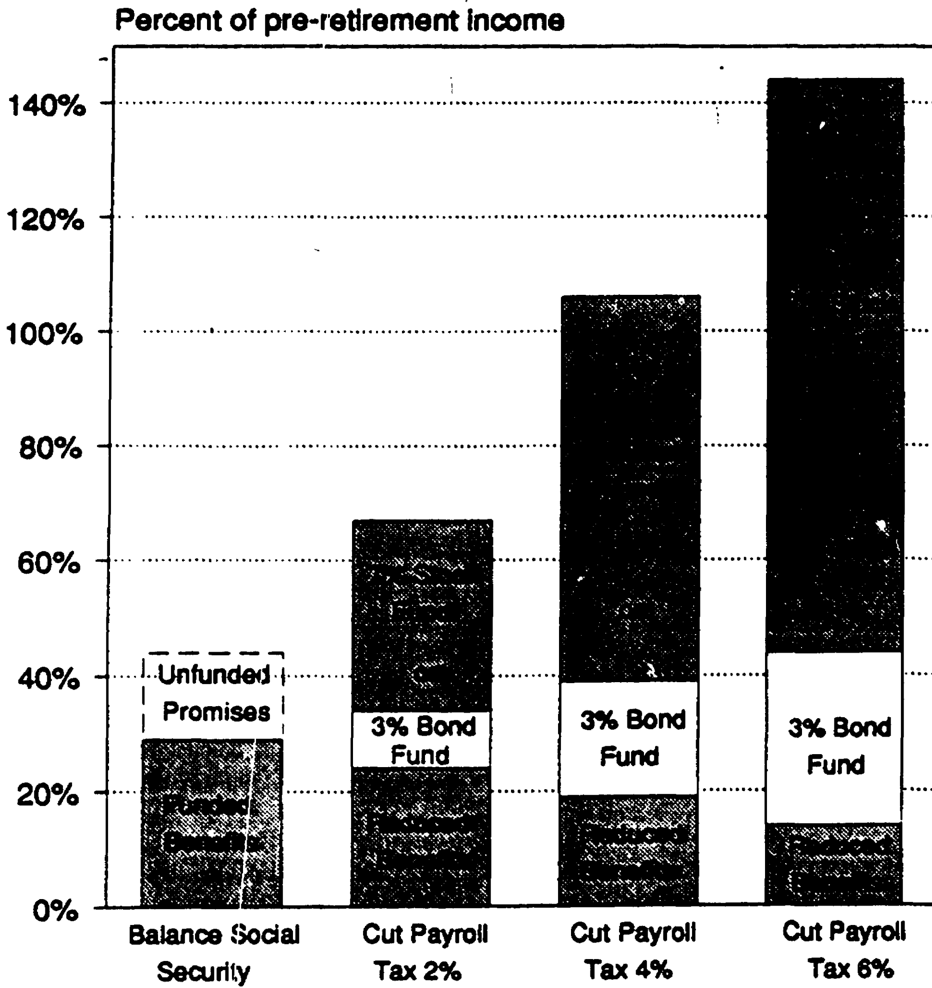


Chart 2 Trimming Government-Paid Benefits To Fund Personal IRAs Can Boost Retirement Income



Source: Final Report of the Bipartisan Commission on Entitlement and Tax Reform

Chart 3
Diverting Payroll Taxes To Personal Saving Raises Retirement Income



Source: Annuity values as percent of pre-retirement income, calculated by author

PREPARED STATEMENT OF MATTHEW P. FINK

I am Matthew P. Fink, President of the Investment Company Institute, the national association of America's mutual fund industry. The Institute's membership consists of over 5,000 mutual funds with assets of approximately $2.3 trillion. Increasingly, mutual funds serve as the investment medium of choice for retirement programs, including employer-sponsored retirement plans and IRAs. As of December 1994, approximately $760 billion, representing 35 percent of total fund assets, were held in such retirement vehicles. Of this amount, $147 billion is held in 401(k) plans, and over $285 billion are IRA assets. Mutual funds account for 28 percent of total 401(k) plan assets and 31 percent of total IRA assets.[1]

I appreciate this opportunity to testify today on S. 824, the Personal Investment Plan Act of 1995. This legislation represents a major step in addressing the impending retirement saving crisis, an issue of vital importance to our nation's future. It is a thoughtful and timely proposal to combine a social insurance system with a system of voluntary private saving, and it offers individuals the possibility of substantially higher retirement income than they are likely to achieve under the current Social Security program. Indeed, Institute calculations indicate that, had the PIP proposal been in place 40 years ago, an individual earning the maximum wage base and investing 2 percentage points of his contributions into a PIP tracking the S&P 500 would receive a benefit that is 57 percent greater than the benefit offered under our current system.

I. INTRODUCTION

My testimony today will address:

(1) the need for increased retirement saving, particularly in light of the impending retirement of the baby boom generation, whose benefit payments are projected to exhaust the Social Security Trust Fund by the year 2031;[2]

(2) the mutual fund industry's strong support for the reforms proposed by the Personal Investment Plan Act of 1995; and

(3) the benefits of using a self-directed, individual account, which reflects the best features of the IRA, for the accumulation social security saving.

Our industry's primary focus is on saving and long-term investment. Accordingly, the Institute has long supported legislative efforts designed to enhance both individual and employment-based retirement programs. For example, the Institute was a vigorous proponent of the 1981 universal IRA legislation and has more recently urged enactment of pending legislative proposals to enhance the IRA. The Institute also strongly supports legislation designed to simplify the complex and burdensome operational requirements applicable to employee retirement plans and to increase retirement plan coverage among small employers.

II. THE NEED FOR ENHANCING SOCIAL SECURITY THROUGH INDIVIDUAL SAVING

The Institute strongly supports S. 824, the Personal Investment Plan Act of 1995, as an essential and well-conceived element of a national program, building on our existing Social Security system, to assist all Americans to save for their own retirement. Our current pay-as-you-go system is dependent upon an ever-increasing workforce to finance benefits for retirees. Yet, in light of national birthrate trends, the workforce of the future will actually be smaller than the current workforce. When the so-called "baby boom" generation reaches retirement, the ratio of workers to retirees will be smaller than ever before. Today, for each person aged 65 and over, there are almost five persons between ages 20 and 64; when today's younger workers reach retirement age in 2040, there will be only an estimated 2.7 persons between 20 and 64 for each person 65 and older.[3] Furthermore, demographic projections reveal that future U.S. retirees will have a longer life expectancy and, therefore, a longer retirement, than prior generations. The Social Security Trustees report that the system is insufficiently funded in the long run and is conservatively projected to have a negative cash flow by approximately the year 2013.[4]

In light of these well-documented and widely reported projections concerning the upcoming crisis in the Social Security system, Americans understandably are losing confidence in the system. A survey released in December 1994 by the Employee

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[1] *Mutual Fund 1995 Fact Book,* Investment Company Institute (1995); "What's Pumping Up Mutual Funds," *Business Week,* (July 24, 1995) (citing Access Research Inc. survey).

[2] 1995 Report of the Social Security Board of Trustees.

[3] Board of Trustees, Federal Old-Age and Survivors Insurance and Disability Insurance Trust Fund, *1994 Annual Report* (U.S. Government Printing Office, 1994); Bipartisan Commission on Entitlement and Tax Reform, "Final Report to the President" (January 1995).

[4] Ibid.

Benefit Research Institute reports that roughly two-thirds of Americans age 26 and over are not confident that Social Security will continue to provide benefits of a value equal to those received by retirees today.[5] A similar survey conducted for the public policy research organization Public Agenda revealed that 72 percent of Americans think that their Social Security benefits will decline relative to those paid to current retirees or that they will receive no benefits at all.[6] This skepticism is most intense for those age 18-34; only 28 percent of this group believes that Social Security will still exist by the time they retire.[7]

Yet, even this widespread sense of "no confidence" in the current Social Security system has not led most Americans to increase or even begin saving for retirement on their own. Government statistics show that personal saving as a percent of disposable personal income has tumbled over the last decade—from a high of 8.0 percent in 1984, to a low of 4.0 percent in 1993.[8]

An Institute study released three years ago confirmed that, compared to other generations, the Baby Boom generation seems much less prepared financially for their retirement years. Despite a higher number of two-income families and a considerably higher per capita income than previous generations, their saving rates are lower than the two generations that preceded them. The study found that more than 6 out of every 10 Baby Boomers stated that they either were not or could not save for retirement, even though more than half expressed worry about meeting their financial needs during retirement.[9] Subsequent research confirms these alarming trends.[10]

III. THE REFORMS PROPOSED BY THE PERSONAL INVESTMENT PLAN ACT OF 1995 ARE SOUND AND URGENTLY NEEDED

In short, legislation addressing our retirement saving crisis is imperative. The Institute commends the Subcommittee for undertaking this effort. Sensible reforms that increase retirement saving must be among our highest national priorities. In this regard, the Personal Investment Plan Act of 1995 is an excellent place for starting this process of reform. The bill would allow workers the option of choosing to invest 2.0 percentage points of their OASDI payroll taxes in their own personal investment plans (PIPs). The funds in such PIPs would be invested in the private sector through either a program similar to the government employees thrift plan or an IRA type account.

For a number of reasons, a legislative proposal such as the PIP, which provides for partial funding of Social Security benefits, will enhance retirement security.

First, a program such as the PIP would allow workers to realize the power of positive compounding on the portion of their payroll tax contributions contributed to the PIP. Those contributions otherwise would be added to the Social Security Trust Fund, which, under the current pay-as-you-go-system, would soon be paid out in the form of benefits.

Second, contributions to the PIP could be invested in assets other than Treasury securities, such as equities. While the actual investment experience for PIPs cannot be projected, equities have traditionally produced a greater return than Treasury obligations.[11] For example, over the past 40 years, the Standard & Poor's 500-stock

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[5] Employee Benefit Research Institute, "Retirement Confidence In America: Getting Ready For Tomorrow," EBRI Special Report SR-27/Issue Brief No. 156 (December 1994).

[6] Public Agenda, "Promises to Keep: How Leaders and the Public Respond to Saving and Retirement" (1994).

[7] Third Millennium, "18-34 Survey" (1994). By contrast, 46 percent of those surveyed believe that UFOs exist.

[8] Economic Report of the President, Transmitted to the Congress February 1994 (U.S. Government Printing Office), Table B-27. Preliminary figures indicate that the personal savings rate may have risen slightly to 4.6 percent for the last quarter of 1994.

[9] "The Baby Boom Generation, A Financial Portrait," Investment Company Institute (Spring 1991).

[10] According to research performed for Merrill Lynch, half of American families currently only have approximately $1,000 in net financial assets. Anderson, Joseph M., "The Wealth of U.S. Families in 1991 and 1993," Capital Research Associates (December 1994). "Net financial assets" as used in the study included checking, savings and money market deposit accounts, CDs, stocks, bonds, mutual fund shares, IRA and Keogh accounts, 401(k) accounts, and other financial instruments, less unsecured debt (such as unpaid bills, bank debt and credit card balances) and debt secured by financial assets. Employer pension fund accruals are not included in net financial assets. See also, Employee Benefit Research Institute, "Retirement In The 21st Century—Ready or Not," EBRI Policy Forum (1994).

[11] In Chile, since 1981, the average return on investment for the social security personal savings accounts has been 14 percent. "The Chilean Private Pension System," the International Center for Pension Reform (1995).

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index has risen an average of 11% a year (with dividends reinvested), while long-term government bonds have risen an average of 5.6% a year. Over this 40-year period, a $1,000 investment in common stocks would have grown to $65,000 (as measured by the S&P 500 index). By comparison, a $1,000 investment in long-term government bonds would have grown to only $8,894.

Third, in addition to increasing potential investment return to PIP investors, the shifting of these funds from Treasuries into stocks, bonds and mutual funds would provide much needed capital for private industry. Indeed, the privatization of the Chilean system has been credited with helping to capitalize its stock market at a rate of 100 percent of gross domestic product.[12]

Fourth, the PIP program would increase the personal saving rate of Americans above their current inadequate levels.[13] Moreover, the use of PIPs may help Americans to develop a saving and investment "habit" that would carry over into their non-Social Security assets.[14] This factor is especially important for younger Americans who often do not recognize the need to save until they are too close to retirement to build up significant accumulations.

Fifth, in addition to their direct impact upon saving, PIPs would serve to promote American workers' sense of personal responsibility for their own financial future and provide a sense of empowerment for those who take individual control of their retirement investments. The habits ingrained in American workers through their the PIP investment program could result in less overall reliance on "big government." As such, the PIP proposal responds directly to the message sent last November by middle-class voters who want to reduce the role of government in their lives.

Finally, and perhaps most importantly, the PIP program would help to restore confidence in the Social Security system. The public policy organization Public Agenda surveyed the general public and asked them to rank the strength of various arguments for getting rid of Social Security. The survey respondents reacted most strongly to the following two arguments: (1) government is mismanaging the program so badly that money is going to waste; and (2) people can get a much better return if they invest retirement money on their own.[15] In addition, the Third Millennium survey of those age 18-34 reported that 82 percent would support a system that would "[a]llow Americans to direct part of their social security taxes to a personal retirement account, like an IRA, which could be kept at any financial institution you could choose."[16]

IV. FUNDING OF SOCIAL SECURITY WOULD BE BEST ACHIEVED THROUGH A SELF-DIRECTED INDIVIDUAL ACCOUNT SIMILAR TO THE IRA

As detailed above, the potential benefits of funding at least a portion of the Social Security obligations are both numerous and significant. Thus, the PIP program should be designed so as to maximize these benefits. For a number of reasons, the Institute believes that the use of a self-directed individual account similar to the IRA, such as that proposed for PIP investments under S. 824, would enhance the chances for this program's success.

First, our experience with the IRA demonstrates that the active support and participation of the private sector, with respect to both marketing and investment education, is critical to the success of any initiatives. When private sector financial institutions such as mutual funds, banks and insurance companies promote saving vehicles, they typically launch marketing campaigns that assure public awareness of the availability of these vehicles and the advantages of saving. Economic studies on IRAs have confirmed that such marketing efforts play an important role in IRA purchases.[17] Economist Jonathan Skinner cited the sharp decline after 1986 in both

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[12] Ibid.

[13] Again, the Chilean experience of a domestic saving rate of 26 percent of gross domestic product attests to the positive impact of private retirement accounts on saving. "A Social Security System That's Putting America's to Shame," Business Week (March 27, 1995).

[14] See J. Skinner & R.G. Hubbard, "The Effectiveness of Saving Incentives: A Review of the Evidence" (January 19, 1995) (finding that most researchers studying savings incentives agree that, in the long run, 401(k) plans and IRAS have an important positive impact on saving behavior); J. Skinner, "Individual Retirement Accounts: A Review of the Evidence," 54 *Tax Notes* 201 (January 1992) (concluding that IRAS are a good way for individuals to contribute to their saving by ingraining the saving habit).

[15] Public Agenda, "Promises to Keep: How Leaders and the Public Respond to Saving and Retirement" (1994).

[16] Third Millennium, "18–34 Survey" (1994).

[17] See, e.g., J. Skinner, "Individual Retirement Accounts: A Review of the Evidence," 54 *Tax Notes* 201 (January 1992).

IRA advertising and IRA contributions among those still eligible as evidence of the role of marketing in the growth of IRAs.

The private sector also has taken the lead in efforts to educate the public on investment issues. For several years, economists have expressed concern that Americans invest their retirement assets too conservatively by focusing on guaranteed investment contracts, certificates of deposit and money market funds to the exclusion of equities. Financial institutions have responded to the need for public education by providing to the public numerous resources designed to demonstrate the amount of money that an individual would need for a comfortable retirement and the level of saving and investment returns necessary to achieve that goal.

These public education efforts have produced positive results in the allocation of retirement assets among different categories of investments. IRA investments in equity mutual funds increased from 46.6 percent of all mutual fund IRA investments in 1989 to 53.9 percent in 1994, while the investments in money market mutual funds decreased from 22.9 percent to 18 percent over the same period.[18] (See Attachment A)

Americans also are investing their 401(k) plan assets with a more long-term perspective. 401(k) plan investments in stable value vehicles dropped from 38.2 percent of all 401(k) assets in 1990 to 29.8 percent in 1993, while 401(k) plan investments in equities, other than company stock, increased from 19.8 percent to 27.7 percent over the same period.[19] (See Attachment B)

As our experience with these other forms of retirement saving demonstrates, a private sector role in the PIP program would virtually guarantee that financial institutions will make American workers aware of the advantages of PIPs and will assist them in making prudent decisions about how best to invest their PIPs in order to meet their retirement needs. Such experience further indicates that Americans are eminently capable of directing the investment of their retirement assets, particularly when provided with appropriate private sector assistance.

Second, the current familiarity of Americans with the IRA would be very important in encouraging the use of PIPs. Regardless of the type of vehicle that is eventually used for the PIP, widespread public education will be necessary, and, as noted above, the private sector has the marketing and investment education expertise to launch a successful PIP program. The education effort would be simplified if the PIP used an IRA-type vehicle, because there is widespread public familiarity with the IRA. Americans have known about IRAs for over 20 years. They are available at virtually every financial institution and have been the subject of substantial marketing efforts.

Third, a PIP structured like an IRA can offer a wide variety of investment options. This flexibility would allow each worker to structure his PIP investments in the way that best suits his particular needs. For example, a younger worker might choose to invest more aggressively than an older worker close to retirement.

The success of the proposed PIP program depends upon its use by large numbers of American workers. We believe that the chances of success would be greatly enhanced through an IRA-type investment vehicle, which offers significant private sector marketing and education efforts, public familiarity and investment flexibility.

V. CONCLUSION

The Institute appreciates this opportunity to comment on the PIP proposal and looks forward to continuing to work with the Committee as it considers Social Security reform proposals. Efforts to convert our current pay-as-you-go system to a wholly or partially funded system raise a number of difficult but significant transition issues. These issues will be important to older workers who may rely primarily on our existing system, because they will not have had sufficient time to accumulate substantial amounts in a funded account. Transition issues will also be important to younger workers who could, under some circumstances, be subject to a double tax burden.

Although the resolution of these issues will be controversial, we have no choice but to deal with these problems. We commend Senators Simpson and Kerrey for being willing to confront the issues. The PIP proposal recognizes the need to squarely address our saving problem—it is a major step toward enhanced retirement security.

As this Subcommittee continues to work on legislative proposals to secure adequate retirement saving for all workers, we believe that our industry's extensive ex-

[18] *Mutual Fund 1995 Fact Book,* Investment Company Institute (1995).

[19] *Mutual Funds At Center Stage: Trends and Developments in the Investment Management Industry,* Investment Company Institute (Winter 1994/1995).

perience with IRAs and other funded retirement saving vehicles will help us to identify and resolve potential problems. We look forward to continuing to work with the Subcommittee and its staff.

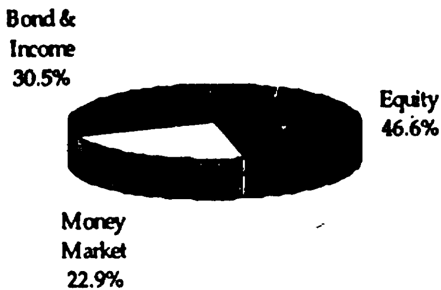
I would like to conclude by once again congratulating the subcommittee for its timely consideration of the PIP proposal. Adoption of this proposal would improve not only our Social Security system but our entire economy and thus the confidence of the American people in both.

Thank you again for permitting me to testify.

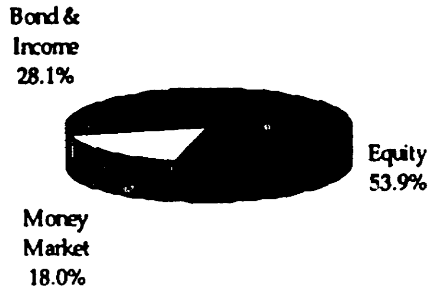
Attachment A

IRA Assets by Type of Mutual Fund

1989

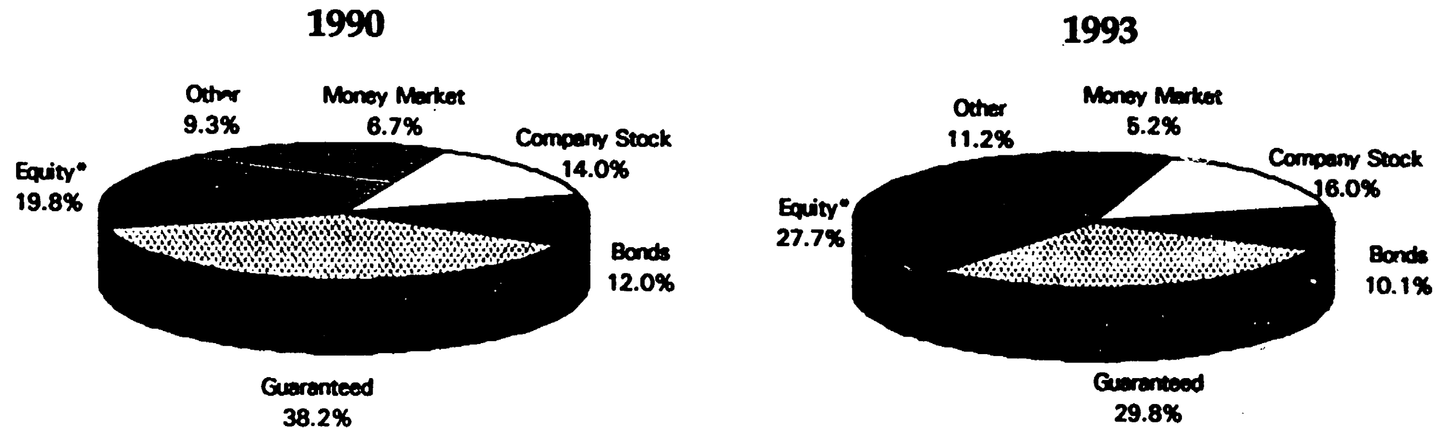


1994



Attachment B

Distribution of 401(k) Assets by Type of Investment



*Excluding CompanyStock

PREPARED STATEMENT OF DAVID KOITZ

Mr. Chairman and Members of the Committee, I was asked to summarize and comment briefly on ideas to privatize the Social Security system. While interest in privatization has grown, there is no consensus on what it means and how it could be done. At one end of the spectrum is the idea that people should make economic choices totally on their own, including whether or not to prepare at all for retirement, death, or disability. At the other end is the notion that the Government should mandate that people prepare for these circumstances, but not necessarily through a Government-run and financed social insurance system.

The debate really goes back to the inception of Social Security 60 years ago. Both the House and Senate considered and rejected amendments to delete the old-age benefits title from the Social Security Act of 1935. However, the Senate did adopt an amendment by Senator Clark that would have exempted workers from Social Security if their firms offered old-age pensions on their own. In the House and Senate conference that followed, the Clark amendment proved to be among the hardest issues to resolve, and in the end the conferees dropped it. When the conference bill came back to the House, an amendment was made to restore the provision, but it too was defeated, and the stage was set for our current system. I would note that this type of approach actually was adopted many years later by Great Britain for the second of its two-tiered national system.

There are few people today who would suggest that there is no need for society to mandate that people prepare for retirement, death, and disability and that the Government should be totally uninvolved, but there is growing interest in expanding the role of the private sector while reducing that of the Government.

For some, it is an ideological issue. They feel that with Social Security expenditures of $340 billion a year, the Government's role has gotten too big. For others, it an issue of uncertainty or a lack of confidence about the future of Social Security. They feel that too many workers do not believe that the program can survive in its current form, and that a more "reliable" means of savings must be adopted. For still others, it is an economic issue. They feel that the economy would be given a boost and would grow at a faster rate if people saved and invested privately in lieu of contributing to a Government system. Finally, there are those who believe the current system is inequitable because it has too many social features. They feel that retirement benefits should be more closely aligned with what people contribute toward them, and that Society's "social" needs should be dealt with through means-tested programs that explicitly measure whether people are in need.

The seeds for this discontent probably date back to the mid 1970s when it became apparent that changing economic and demographic circumstances were straining and would continue to strain the financial condition of the existing system. Although there was little congressional interest then in wholesale reform, a new wave of privatizing ideas began to emerge.

One proposal, designed and circulated on the Hill in the early 1980s by the Insurance Company of North America (INA), would have permitted workers to contribute up to $6,000 a year to an IRA or some similar plan and then take an immediate income tax deduction for the contribution. For each $1,000 workers deposited in their accounts, 0.5% of their eventual Social Security benefits would be forfeited. Workers who made the maximum $6,000 contribution for 331/3 years would forfeit all their benefits.

A similar plan, authored by Peter Ferrara and promoted by the CATO Institute in the mid-1980s, would have given workers an income tax credit of up to 20% of their Social Security taxes for equivalent deposits in what he called "super IRAs." Upon retirement, the worker's Social Security benefits would be reduced by an amount related to some proportion of the lifetime Social Security taxes that had been effectively refunded through the credits.

Another plan devised by former Chairman of the Council of Economic Advisers, Michael Boskin, and promoted by the National Federation of Independent Business (NFIB), would not have privatized any part of the program per se, but transformed it into a two-tiered system with the second tier fashioned after a traditional insurance annuity plan. He proposed that the Government administer it. Representative Archer offered this proposal in a House Ways and Means Committee markup on the 1983 Social Security Amendments, but it was defeated.

In recent years a number of Members have come forward with other ideas. In 1986, Representative Gingrich developed a plan to eliminate the payroll tax and have workers under age 40 mandatorily contribute to IRAs instead of Social Security. Older workers were to be grandfathered under the old system and a new retirement trust fund program was to be created to raise the income of all seniors above the poverty level. A VAT was to be levied to provide the needed revenues.

In the last two Congresses, Representative Porter introduced bills to privatize the Social Security surpluses by mandating that 2 percentage points of the payroll tax be deposited into an IRA-type account (1% from employee and employer each). Initially, it was proposed as an alternative to the pay-as-you-go tax cut plan offered by Senator Moynihan in 1990. Representative Porter envisioned some sort of eventual reduction in Social Security payments in recognition that people would be saving through these IRAs, but the means of reduction was not specified in his bills (HR 1647 and 2178 of the 102nd Congress and H.R. 306 in the 103rd Congress). Former Senator Symms, when serving on this Committee, had proposed a similar arrangement (S. 2026), but without the benefit reductions.

Representative Solomon has proposed yet another variant that would require the creation of a Social Security Investment Board with a broad mandate to manage surplus Social Security funds, including authority to invest them in stock and bonds as well as Government securities (H.R. 2152 of the 103rd Congress and H.R. 164 and 491 in the 104th Congress). His arrangement would be similar to that used for the Federal employees thrift savings plan. This plan is a salary-reduction savings program (similar to a 401(k)) that is run by an investment board offering Federal employees three types of investment options. Two of them are market-based funds managed by the Wells Fargo Co. and Nikko Securities.

The Chilean system represents yet another model. In 1981, Chile engaged on a sweeping, rapid reform of its Social Security system. Private retirement accounts managed by pension fund companies were established to replace much of the Government-run system. Beginning in 1983, new labor force entrants were brought into the new system and existing workers were given strong inducements to join through an 18% mandatory salary increase and so-called recognition bonds that reflected the accrued value of the old system's benefits. Employers were relieved of any payroll taxes. Workers were required to make at least a 10% of pay contribution toward retirement and 3.3% for survivor and disability protection. The Government oversees the investment companies and requires a minimum investment return. It also runs the old system for those who remain in it and guarantees a minimum benefit under the new one. It has been estimated that some 90% of the workforce is under the new system. Many analysts attribute the considerable economic growth that Chile experienced over the past decade to the new system.

Your proposal, Mr. Chairman, that you recently co-sponsored with Senators Bob Kerrey and Charles Robb, is probably somewhere in the middle of the pack. S. 824 and 825 would allow people to set aside 2 percentage points of the 12.4% Social Security tax in a Personal Investment Plan similar to an IRA. In return, they would be required to take lower Social Security benefits when they retire through reductions in the Social Security benefit formula that applies to them. The intent is to cover the long-run revenue loss through benefit formula reductions.

Although political issues with privatization, whether partial or whole, are enormous, perhaps the foremost issue involves a very practical consideration: how to finance the transition from the old to new system. There are 43 million people—one-sixth of the population—who receive almost 40% of their income today through Social Security. Although there are some surplus Social Security taxes flowing into the Government, the system is still basically pay-as-you-go. If we were to tell workers that next year they were to put these taxes into private savings plans instead, how would we continue to finance the $340 billion being paid under the current system? The cash surplus today (the excess of current revenues to the system over payments from it) is only about $30 billion a year. To put this in perspective, foregoing taxes equal to 2% of payroll would result in an annual revenue loss of $60 billion. Even if people were required to take reductions in their eventual Social Security benefits, those reductions would not amount to much until way off in the future and therefore would not slow the system's outgo for many years. However, the revenue loss would be immediate. A decade's worth of foregoing 2 percentage points of the payroll taxes would result in $1 trillion in lost receipts and interest.

Even if it were accepted that the Social Security system could forego these receipts, for instance, by allowing it to tap in or borrow from the Treasury if its financing were endangered during the transition, there is still the overall fiscal policy question of how the Government would make up for the revenue loss. Excess Social Security taxes now flow into the Treasury. If the Treasury no longer were to receive them, it would have to borrow the funds. In effect, the money would flow into the Nation's financial markets through one door—i.e., through worker deposits into their personal accounts—only to be borrowed back by the Government. If borrowing is not an option, the question for policymakers is how do we raise the revenue or make the spending cuts to cover the revenue loss?

Chile had a budget surplus at the time it engaged in its reforms, and it also mandated that initially all investments under the new system be made in Government

bonds. We obviously do not have a budget surplus to draw on, but the second mechanism—mandating that personal investments be in Government bonds for some period—may provide a partial model for how the problem could be addressed in this country.

My intent here is not to minimize the philosophic issues about privatizing. Removing the "social aspects" of Social Security, introducing the risks inherent in private savings, and foregoing inflation protection (which is not easily replicated under private arrangements) strike at the heart of the system. But those issues all become academic unless some mechanism can be devised to deal with the transition.

Mr. Chairman, in 1987 we did an analysis for this Committee of one of the privatization proposals circulating then and just last week we issued a new CRS report on the Chilean system. Both of them go into the issues in considerably more depth than I can here. With your permission, I would submit them for the record.

Attachment.

CRS Report for Congress—

AN ANALYSIS OF A PROPOSAL TO AUTHORIZE "SUPER IRA'S" AS AN ALTERNATIVE TO SOCIAL SECURITY BENEFITS [1]

THE PROPOSAL

A worker would be able to receive an income tax credit annually equal to part of his or her social security taxes. To be eligible for the credit, an individual would be required (1) to deposit an amount equal to the credit in a " super Individual Retirement Account (IRA)," and (2) upon retirement, forego part of his or her social security benefits in an amount related to some proportion of the lifetime social security taxes that had been effectively refunded through the credits.[2] The individual would be able to take additional tax credits for the purchase of private life, disability, and late-life health insurance.

Under one description of this proposal, the credit initially would be limited to no more than 20 percent of a worker's social security taxes and those made by his or her employer.[3] Thus, a worker, who with his or her employer paid $2,000 in social security taxes in a particular year, could receive an income tax credit of $400, assuming a $400 deposit was made to a super IRA.

The proposal envisions that Congress in later years would increase gradually the percent of social security taxes that could be refunded to an individual through this credit. Eventually, the law would permit an individual to take a credit for all of his or her social security taxes. In essence, the Government would be indirectly forgiving the individual from paying any social security taxes, so long as he or she deposited an equal amount in a super IRA. Under a fully implemented system an individual who made maximum use of this approach would receive no social security benefits, and would rely instead on his super IRA investments for retirement income. Hence, the proposal would set the foundation for a totally optional social security system.

BACKGROUND

Ideas of this sort have been emerging with increasing regularity in recent years in part because of the decline in public confidence in the social security system, which has been particularly acute among younger workers. In this regard, it should be noted that contrary to popular opinion, the social security cash benefit system is projected to be in sound financial condition in the near term and for many years into the future. This favorable scenario—reflected in the central forecasts of the last four annual reports of the social security trustees—is largely the result of the major amendments to the program enacted in 1983 and the relatively good economic conditions that have prevailed over the past few years. Problems could emerge in later decades because of the demographic shifts anticipated in the next century, but the trustees currently project the system to be in "rough actuarial balance" on average

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[1] For a lengthier description of this proposal, see Ferrara, Peter J. Prospects for Real Reform. Washington, Cato Institute, 1985. Mr. Ferrara is a Washington attorney and an Adjunct Scholar of the Cato Institute.

[2] It is not clear exactly how the "proportion" of social security benefits that the individual must forego would be determined.

[3] A later description of this proposal suggests that the author might now be envisioning a more gradual phase in, with perhaps a lower percentage credit to start with, in order to lessen the initial revenue losses for the Government resulting from the credits. Ferrara, Peter J. Intergenerational Transfers and Super IRA's. Cato Journal, spring/summer 1985.

over the "long run"—a period encompassing the next 75 years. (See CRS Report 86–674 EPW, *Social Security: Its Funding Outlook and Significance for Government Finance*, June 1, 1986).

Mr. Peter Ferrara, the author of this particular proposal, is skeptical of these projections, believing that the assumptions on which they are based are too optimistic (e.g., with regard to birth and mortality rates). He feels that the pessimistic forecast of the trustees is a more realistic one, and under that scenario the system is not projected to be in actuarial balance. Of greater significance, however, is that he also believes the "pay-as-you-go" nature of financing the social security system (i.e., collecting only so much taxes as are necessary to meet immediate expenditures) has been and continues to be bad for the economy, and that a fully funded private system that finances future commitments in advance and invests that "advance funding" in the economy is far preferable. He argues that the tax rates that the current system will ultimately require will be so large as to make the whole system—including the medicare portion—politically unpalatable. He contends that because the system's tax rates already have grown so large and will have to grow further, today's young and middle age workers could get much better returns on their social security retirement contributions if they invested them in the private sector instead.

His proposal is a variant of an idea suggested in the early 1980s by the Insurance Company of North America (INA). INA viewed its proposal as a means of extending the IRA form of savings to the bulk of the Nation's workforce, who at that time could not establish an IRA (before 1982 a worker could not establish an IRA if he or she already were participating in an employer-sponsored pension plan). INA's idea was to provide a tax deduction of up to 20 percent of a worker's earnings (to maximum of $6,000 a year) if the worker deposited a like sum in an IRA. Once again, a worker would have had to give up part of his or her eventual social security retirement benefits.

Although there were a number of technical differences from Mr. Ferrara's proposal, the main one was that INA would have called for a tax deduction rather than a 100 percent credit. In other words, a worker would not have been able to finance his or her entire IRA deposit with income tax "savings." A deduction would have permitted only partial financing of the IRA deposit through tax savings—the higher the individual's marginal tax bracket, the more his or her income tax savings would have been. Thus, an individual would have had to use "other" discretionary resources to make the IRA deposit.

There was interest in the INA proposal when the Senate debated the 1983 social security amendments, but nothing became of it.

PHILOSOPHICAL ARGUMENTS

Social security is not insurance or an annuity program in any form recognizable to the insurance industry, private actuaries, bankers, pension fund administrators, or other money managers in the private sector. It never has been, although many people attempt to cast its original 1935 form as such. However, it is frequently viewed as a very broad form of income protection called "social insurance." Under this concept, the group to be "insured"—in this case more than 90 percent of the Nation's workers—pools resources to meet an unconventionally wide variety of individual and family circumstances arising from the loss of a worker's earnings due to retirement, death, or disability. As such, the program has what many refer to as a mixture of "insurance" (or related annuity) and "welfare" features.

THE CRITICISMS

Mr. Ferrara's concern about the social security system basically revolves around its "welfare" features. He calls the unusual mix of insurance and welfare an "inherent contradiction."[4] He argues that because the system has welfare features, it creates major inequities among its recipients, thus distorting its insurance functions, and that because it has insurance features, the system carries out its welfare functions poorly. He and other critics point out that because the system has evolved largely on a "pay-as-you-go" basis (it spends what it receives rather than builds a fund to meet its commitments), the first few generations of recipients have and are benefiting at the expense of current and future workers, who have to finance the "unfunded costs" of providing benefits to past and current recipients. They also point out that single workers have to pay taxes to finance the auxiliary benefits of family members of other workers, and that above-average wage earners will soon get "poor rates of return on their contributions so that below-average wage earners

[4] See Ferrara, Peter J. Social Security: The Inherent Contradiction. Washington, Cato Institute, 1980.

can get "favorable" ones. Mr. Ferrara contends that many (if not most) people working today would be able to do much better by investing their social security dollars in the stock market, perhaps getting as much as a 12 percent "real" rate of return, in contrast to an estimated 1.5 percent average "real" return from social security (by his estimates).

He and others further argue that since social security does not have a means test, it performs its welfare functions inefficiently. Its tilted benefit structure distributes benefits to well-off segments of the population in part at the expense of younger workers with families who have to stretch to make ends meet. And it often provides large dependents' benefits to recipients who have substantial retirement incomes from other sources, once again at the expense of not-so-well-off younger workers.

Finally, he and others argue that on the theory that workers "anticipate" receiving social security benefits when they reach advanced age, they do not save individually as much as they would over their working years if social security did not exist, and since social security as a financial institution does not operate on a "funded" basis does not save), collectively the (it Nation saves less. Consequently, they argue that capital formation is impaired by the program and the Nation does not have the opportunity to achieve its full economic potential. The "Supporters'" View

Supporters of the program argue that it is the very mix of insurance and welfare features which has made social security successful. The system's role in establishing reasonably adequate standards of living for the elderly generally, and in bringing about a very substantial reduction in poverty among the elderly, could not have been accomplished unless workers understood that their support for the system would eventually establish certain rights for them—i.e., that their support has been contingent on having a stake in the system. The fact that the program lacks the high degree of individual equity and precision between contributions and benefits that exists in traditional forms of private insurance does not in their view outweigh the social value achieved by avoiding having a high degree of perceived "dependency" in the Nation. In a broad sense, they see the program as insuring society against the adverse social effects and individual deprivation of having a high proportion of the elderly in a clearly perceived state of dependency.

They contend that if the system's welfare functions were carried out by some other means-tested program, that other program would not be as successful at keeping down the overall level of "dependency" in society. Welfare programs do not fare well in the allocation of public resources. They argue that only by requiring all workers to participate in the system and giving them a stake in it could the system remain a strong vehicle for addressing the problems of poverty and dependency among the elderly.

Further, while recognizing that there may be some waste in the payment of certain social-type benefits to people of substantial means, they do not view this as a high price to pay to avoid requiring a means test. They feel that because it does not impose a means test, the system greatly lessens "income stratification" of the elderly. If income stratification were substantial, they would view it as a perverse situation, since many people would end up seeing themselves as "having to go on the dole" for some of their retirement income after having worked and been self-sufficient their whole lives.

Finally, they dispute the charge that social security encourages consumption over savings, arguing that the mere existence of social security has made people more aware of the need to save for their eventual retirement needs. They contend that statistical evidence obtained through economic studies has been ambiguous at best, and that depending upon the assumptions employed, it can be shown that social security has increased or decreased the Nation's savings rate.

FINANCING ISSUES

Under the super IRA proposal, both the worker and employer would continue to pay social security taxes at the same rate as under current law whether or not they participated in the new super IRA system. Thus, Mr. Ferrara points out that the social security trust funds would be credited with the same amount of income as under current law.[5] (The Government's losses would be with income taxes, not social security taxes.)

As time passed, this arrangement would appear to enrich the social security system to a much greater degree than could be anticipated under current law. The system would be credited with the same amount of social security taxes as scheduled

[5] Although the form is not totally clear, he also envisions the Government's giving all existing recipients a bond or some other legally enforceable tender to guarantee their benefit "package" as it exists under current law at the time of enactment of the super IRA proposal.

under current law, but its benefit payout eventually would be reduced as people, having forfeited a portion of their social security benefits, increasingly relied on their super IRAs for retirement income. However, the Government could find itself forfeiting considerable income tax receipts in the near term depending upon (1) the speed at which the new retirement system were implemented, and (2) the extent that workers chose to participate in it. Since a worker could use the new income tax credit to finance his or her entire super IRA deposit, the new system would not require him or her to give up any discretionary income to participate. This would appear to create a strong inducement to workers covered by social security to establish new super IRAs, and one might expect that "once the word was out," virtually all workers would do so.[6]

Without taking economic effects into account, one might expect that if a credit for 20 percent of social security taxes were provided initially, the revenue loss to the Government could approach an equal amount. In 1987, 20 percent of social security taxes would be a sum equal to about $45 billion. Even if the participation rate in the new super IRA program were only 75 percent, the loss of income tax revenue could be large—at $34 billion. This revenue loss would increase the deficit situation that the Government must continue to deal with in the years ahead. In other words, it would worsen the situation by increasing the imbalance between aggregate Government receipts and expenditures.

Mr. Ferrara acknowledges this revenue loss, but he contends that overall national savings would be no worse than under current law. He argues that the deposits people make to IRAs would increase national savings on the private side, and even if the Government were to borrow back the entire amount it gave up in revenues, the overall amount of savings in the Nation would be the same. He further argues that if in fact the Government reduced its outgo—instead of borrowing more—to make up for the revenue loss, national savings would rise.

The weakness in this line of reasoning, political implications aside of increasing the deficit, is that it assumes that people would not change the amount of their "other" savings to take advantage of the tax credit. If people were to view the money invested in the super IRA as a substitute for savings that they otherwise would have made in some other form, they would not be raising their savings. For instance, if they were going to buy stocks for long-term growth, it now would be to their advantage to specify the purchase as a super IRA investment, since they would get a new income tax credit for doing so. In other words, people who have the means are likely to substitute non tax-exempt income that may have gone into "investment" channels regardless, or to borrow money (for instance, through a home-equity loan), in order to increase their after-tax discretionary income (by taking advantage of the IRA tax credit). To the extent that people substituted their super IRAs for other forms of savings, national savings would be unaffected.[7] However, the Government through the new tax credit would have lost substantial revenue, and if it borrowed the commensurate amount from the public, it would have reduced national savings by absorbing more of the available investment dollars in the Nation than it otherwise would have. When both possible effects are taken into account—those caused by individuals and those caused by the Government—national savings could be lower than otherwise, while the Government's fiscal dilemma would have been increased.

The basic point here is not that Mr. Ferrara is wrong, but only that his accounting of the macro-economic outcome of his proposal is not the only intuitively logical one.

THE UNCERTAIN IMPLICATIONS OF THE INDIVIDUAL'S CHOICES

Mr. Ferrara correctly points out that future rates of return on social security contributions are likely to decline very significantly in the years ahead. Many workers retiring in the future will not get their "money's worth" from social security retirement contributions on a straight rate of return evaluation against possible private investments. Mr. Ferrara supports his super IRA approach by arguing that people could get back much more from their investments in the stock market and other

[6] It is not totally clear how a worker with little or no income tax liability would fare under the proposal, i.e., whether a worker whose credit was greater than his or her income tax liability would receive a refundable or "negative" income tax payment from the Government. Presumably, if one wanted to encourage such workers to participate, a "negative" income tax payment would be permitted.

[7] Even if there were to be a prohibition against doing this, it is not likely to be very enforceable because of the inability to observe how alternative investments would have been placed or to discern exactly how people use borrowed dollars in making consumption and savings decisions.

private endeavors than they will from social security. He uses statistics showing past rates of return on common stock to support his argument, saying that "real" yields of up to 12 percent annually are possible, and that nothing close to this will arise from social security.

Whether such an outcome is intuitively logical is highly debatable, but this is not a debate that can be improved much with facts about alternative investment opportunities. It is totally dominated by the assumptions one makes about the performance of the economy, interest rates, investment yields, how people will respond to taking risks, and the like. It is clear from most analyses in this area that social security's "real" rates of return are likely to fall substantially in the future from what they are today—where most people get back much more than they contributed—and it is possible that eventually a large segment of the population would not get back the full value of its social security retirement contributions even under less optimistic assumptions than Mr. Ferrara makes about the yields that private investments will render. However, it is not clear whether social security's return will be favorable or unfavorable on the average.

Moreover, making statements about what the "averages" are or will be ignores possible consequences for workers individually. Stock market investments can be highly risky. The fact that stock market yields have been of certain magnitudes on average does not mean everyone will earn them. Major pension funds, for instance, have come under considerable criticism in recent years because they have not performed as well with their investments as the stock market "averages" have. How then is a private individual going to fare on his own? Some people will do very well if they make wise or "lucky" investments, but others could do less well.

To the extent that a substantial number of people make bad investment choices or are unlucky, and as such do poorly in saving for retirement, society could find that a large number of elderly people have to rely heavily on welfare programs and their children. Social security is supposed to be a "floor of protection" against such an outcome. Today only 12 percent of the elderly fall below the poverty line. It is not clear what one can say about what the outcome would be of a system that was much more heavily "risk prone."

And to the extent that a large number of people who took advantage of the super IRA did have to rely on the Government's generosity through "welfare" programs, the "social" tax burden would have been made disproportionately larger for those who stay with the social security system (they would have to pay nonrefundable social security taxes while they work, and higher income taxes to sustain larger welfare programs for their peers whose private investments went sour).

The basic point here is that choices that individuals would make regarding super IRAs could have major implications for future social policy that cannot be observed or estimated today.

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CRS Report for Congress

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Social Security: The Chilean Example

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SUMMARY

In 1981, Chile began to phase out its state-run Social Security system in favor of mandatory individual private accounts. As Social Security programs in the United States and other countries increasingly experience long-range financing problems, interest has grown in the Chilean system, and some analysts have recommended it as a model for reforming the U.S Social Security program. This report describes Chile's new Social Security system and presents arguments that support or oppose using a similar approach in this country.[1]

Foremost among arguments for adopting the Chilean system are that by placing the responsibility and reward on the individual rather than the State, a privatized system would reduce future demands on the Government for financing the predicted high level of costs associated with the current system, it would provide ownership of retirement resources to a workforce that is increasingly skeptical that it will receive promised benefits, and it would enhance national saving and thus economic growth. The main arguments against adopting the Chilean system are that it would force a generation or two of workers to face a "double burden," i.e., they would have to pay simultaneously as workers contributed to private accounts while paying for the benefits of recipients under the old system, and that many workers could be worse off because they would face the risk of poor investment decisions and would lose the features of the current system that are designed to safeguard the more vulnerable in society.

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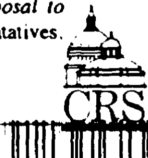
[1]This report was prepared in response to numerous requests for a description of the Chilean system and the ramifications of adopting it in this country, as several columnists and authors have advocated. Thus, the arguments presented address issues regarding replacement of the current Social Security program with a fully privatized system. The report does *not* focus on gradual and partial privatization of the U.S. system, which also has been advocated. For a discussion of these approaches see: U.S. Library of Congress. Congressional Research Service. *An Analysis of a Proposal to Authorize "Super IRAs" as an Alternative to Social Security Benefits*. CRS Report for Congress No. 87-14 EPW, by David Koitz; and U.S. General Accounting Office. *Social Security: Analysis of a Proposal to Privatize Trust Fund Reserves*; Report to the Honorable John E. Porter, House of Representatives. GAO HRD-91-22, Dec 1990 Washington, 1990.



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CHILE'S CHANGE TO ITS SOCIAL SECURITY SYSTEM

In 1981, Chile began to phase out its "traditional" state-run, pay-as-you-go Social Security system financed by employees and their employers in favor of mandatory individual private accounts. The old system had several major problems. First, it was fragmented, with over three dozen plans covering white and blue collar workers with different benefit structures. The self-employed, wage earners, and salaried workers paid different payroll tax rates (as did the employers of workers, usually at a rate higher than that applicable to employees). Second, it was widely seen to be inequitable, as the plans covering workers at the low end of the economic spectrum tended to provide the least generous benefits. Third, the multitude of systems and many methods of benefit computations led to high administrative inefficiencies and expenses. Fourth, many of the plans were under-financed, forcing the Government to make up the difference with general funds. These factors led to noncompliance and widespread contempt of the system.

To take its place, the law provided that, beginning in 1983, wage-earners and salaried employees entering the workforce were no longer covered by the old system. Instead, they were required to pay a proportion of their earnings to a private pension fund of their choice. Coverage for the self-employed was made voluntary. Workers under the old system were given the choice of joining the new system or remaining in the old one. However, if they stayed in the old system, they were made responsible for paying the full share of the payroll tax (i.e., there would be no employer contributions).

As part of the transition to the new system, and to help induce older workers to join it, employers were required to increase workers' wages and salaries by about 18% at the time the new system went into effect. The employer's burden in paying these higher wages and salaries was ameliorated by the elimination of the employer share of the payroll tax, and workers under the old system did not see any reduction in their pay when they picked up the employer's former share of the payroll tax (workers who switched to the new system usually received a substantial raise). Also, workers who switched were given "recognition bonds," to be redeemed at retirement, that represent the value of their rights accrued under the old system. About 10% of workers have remained in the old system.

To help finance the benefits of current recipients, Chile borrowed from the public. This was facilitated by a favorable fiscal situation (Chile enjoyed a budget surplus at the time) and by requiring that the contributions paid by participants in the new system to private pension plans had to be invested in Government bonds (which effectively gave the Government the use of the money). Investment requirements later were relaxed to permit purchase of stocks, corporate bonds, and some foreign securities.

Under the new system, the minimum contribution is 10% of earnings (up to a prescribed maximum) for old-age pensions, and the required contribution for disability and survivor benefits is about 3.3%, depending on the requirements of the individual pension fund. Contributions are tax-deductible. The amount of the pension is based on the value of the worker's contribution plus interest, but the Government guarantees (i.e., it bears the cost) that no benefit will be lower than 85% of the current minimum wage. The Government also guarantees (and bears the cost of) a minimum rate of return. At

retirement (age 65 for men, age 60 for women), the worker may elect to: (1) receive monthly payments from his or her account that are determined by the family members' life expectancy and the balance remaining in the account (and which are adjusted annually); (2) buy an annuity from a private insurance company; or (3) combine these two options. Earlier retirement is allowed if the funds are sufficient to provide adequate benefits, both in terms of monetary amounts and the rate of replacement of former earnings.

The pension funds are administered and invested by individual pension fund management companies under Government guidelines. Investment may be in either the private (stocks, bonds, bank certificates of deposit, etc.) or the public (Government securities) sector. As of November 1994, 62% of the funds were in private sector investments. The proportion of assets of each fund invested in stocks and bonds is limited: 37% for stocks; 50% for bonds. No more than 7% of a fund's assets can be invested in any one company, nor can a fund own more than 7% of a company's stock. Furthermore, the funds may purchase only those stocks that are on Government-approved list. The law allows 9% of a fund's investments to be in foreign securities.

Oversight by the Government is provided by the Superintendent of Pension Fund Management Companies. If a company does not maintain a minimum return on investments (net of allowed administrative expenses), it has to make up the difference out of its required contingency reserve fund. If that fund becomes depleted, the Government dissolves the company, makes up the difference, and distributes the individual accounts to other management companies. The most recent figures indicate there are 21 Pension Fund Management Companies, and at least one company had been liquidated.

ADOPTING THE CHILEAN APPROACH FOR U.S. SOCIAL SECURITY

Arguments For:

Proponents advocate adopting the Chilean system for various reasons. As a matter of philosophy, they generally prefer using the private rather than the public sector to achieve protection against the costs of retirement, disability, and death. However, what gives special impetus to their cause is the generally recognized need to address problems facing the current U.S. Social Security system. Of these, foremost is the program's recurring long-range financial imbalance. Under current projections, the present system is unsustainable without major changes, and traditional remedies such as raising payroll taxes or finding new groups of workers to bring into the system are less likely to work and be far more unpopular than in the past. Proponents argue that by placing the responsibility and reward on the individual rather than the State, a privatized system would reduce future demands on the Government for financing the predicted high level of costs associated with the current system. Eventually, it would relieve the Government of bearing much of the burden of supporting an increasingly elderly population.

Associated with the concern about Social Security's long-term solvency is the skepticism of workers, especially younger workers, that they will receive promised benefits, or any benefits at all. A recent Gallup poll showed that Americans are more confident about the availability throughout their retirement years of pension and savings

plans than Social Security. Proponents assert that a privatized Chilean-type system would allay this distrust by giving a sense of "ownership" of retirement resources to workers, who would have visible proof of their accumulating nest egg.

The current system also is criticized for creating an illusion that the Government is saving to pay for future benefits by holding current excess Social Security revenues in "trust funds," which the critics maintain are in reality nothing but Government IOUs. Currently, Social Security revenues go into the U.S. Treasury and its benefits are paid from the U.S. Treasury. When the system's income exceeds its outgo, as is projected to be the case for another two decades, the excess revenue is credited to the Social Security trusts funds in the form of U.S. securities. These securities are a promise to raise revenue in the future when the securities are redeemed--the money itself is spent by the Treasury on other Government services. Proponents of the Chilean system argue that placing retirement resources in the private sector would prevent the Government from using them to pay for other activities, and that eliminating this arrangement would "unmask" the real costs of other Government programs. They say that this could lead to increased spending cuts. Reduced Government expenditures means less money need be borrowed from the public, thus freeing up more resources in the private sector for investment, leading in turn to more economic growth and international competitiveness. In a similar vein, they contend that redirecting revenue from a state-run system, where the money is immediately spent, to a privately invested one would promote real savings.

Critics also contend that the benefits paid from the new system would be more equitable than those payable under the current system. They aver that Social Security currently has a contradictory mix of insurance and social welfare goals, and in trying to accomplish both, does neither well. For example, it attempts to correlate benefits with presumed need, so it redistributes income to families and lower-paid workers at the expense of single workers, two-earner couples, and higher-paid workers. However, it also relates benefit to past earnings, and imposes no means test. The result is characterized as a mishmash where windfalls accrue to some, while others suffer a net loss. In contrast, the benefits paid from the new system would be strictly in proportion to the amount saved. This would provide workers with the opportunity to earn a higher rate of return than under Social Security (the Chilean pension funds yielded an average real rate of return of 13% from 1981 through 1993). They claim that younger workers especially would be attracted because current forecasts predict worsening rates of return for them under the current system. It would induce them to focus on their likely resources in retirement and plan accordingly. They could track the performance of their funds and switch plans to maximize their rate of return. Thus, proponents say, workers would be more confident about the availability and fairness of their benefits.

Proponents point out that Chile's economy has enjoyed rapid growth since its Social Security system was changed. They say it is plausible that Chile's recent high economic growth rate could be duplicated by the United States if pension contributions were invested in private enterprises where innovation, inventiveness, and motivation would be unleashed. They contend the new system would enhance worker productivity by providing more incentive for workers to think about the future and to work harder to achieve real wealth. In addition, proponents argue that the decline in the cost of labor (because employers would no longer pay a share of the payroll tax) would lead to more jobs and lower costs of production.

Furthermore, they point out that once the new system became fully implemented, Federal involvement in providing retirement income would be greatly reduced. A vast Federal bureaucracy would not be needed to track employment histories, take and process claims using alternative benefit formulas, etc. Administration would be simpler because benefit computations would be straightforward and benefit categories would be fewer.

Arguments Against:

Opponents of adopting the Chilean system also do so for various reasons. Many of them philosophically distrust a private sector approach to social issues because they believe it often hurts the poor or unlucky. However, often at the head of their arguments is a practical issue; how would the transition from the old to the new system be accomplished? They maintain that the transition to such a system in the United States would be much more difficult to implement than in Chile.

First, they argue that society would face a "double burden" if young workers were to contribute to private accounts while commitments to current recipients and older workers were kept in place. Initially, the Social Security system (and the Federal Treasury) would lose the contributions of new workers and the younger workers who would volunteer to join the new systems. As each year went by, the number of these workers would increase. However, because few older workers would be likely to leave the Social Security system, the number of Social Security recipients would be virtually unaffected for many years. Absent other measures, keeping Social Security's commitments would require the Government to raise taxes, cut spending on other programs, or borrow more from private financial markets. Put another way, a generation or two would have to pay twice, bearing both the cost of pre-funding the new system and the costs of benefits under the old system. The United States already is faced with chronic budget deficit problems, leaving little or no room for the massive tax hikes or public borrowing that would be necessary (the Social Security Administration estimates if all workers currently under age 40 were to stop paying into Social Security, the system would need an infusion of $6.9 trillion in order to pay promised benefits to those remaining in the system). Also, in the current budgetary environment, reducing Social Security taxes by substituting contributions into the private sector would increase the Federal (unified) budget deficit at a time when Congress and the public want to reduce it.

Opponents also point out that Chile's situation in 1981, when its plan was enacted, was far different from ours. Chile's old system lacked social justice because different groups received widely disparate treatment. Its benefits were often heavily eroded by the double-digit inflation Chile suffered in the 1960s and 1970s (it was triple-digit in 1973-76). The multitude of systems, inadequate non-automated recordkeeping, and many methods of benefit computations caused poor (but expensive) administration, and great public dissatisfaction and derision. Many systems were financed from fixed-income assets that, because of Chile's high inflation over the years, were practically worthless. This forced the Government to intervene with general fund payments that were becoming so large, and projected to increase to unsustainable levels, that drastic reform was necessary. Moreover, Chile's radical approach was part of a wholesale reform of the domestic economy under a military dictatorship designed to roll back Socialism and ease foreign exchange controls. Opponents point out the Social Security system in the United States, while it does have long-range financing problems, is operating relatively smoothly and

enjoys broad public acceptance. Whereas the public in Chile overwhelmingly believed that the old system should be replaced, most Americans still support Social Security.

Opponents also express concern that self-interest would drive up costs during the transition. Because it would advantage them most, those switching to the new system most likely would be higher-paid workers. Conversely, participation of workers remaining in Social Security would likely be concentrated among those who expected to receive protection of greater value than their contributions. Critics believe a process of "adverse selection" would drive the per capita costs of Social Security upward.

Aside from the transition problems, opponents take issue with other virtues attributed to the Chilean system. They dispute that adopting the Chilean system necessarily would lead to increased national savings. They say that although the contributions into the private pension funds would increase private savings, if the Government compensated for the lost revenue by increased borrowing from the public, the net effect on saving would be nil. They point out that the Chilean government continues to bear heavy obligations (past service credits, the minimum guarantees for benefits and rate of return) under the new "privatized" system. Also, although employers might perceive that the cost of labor was lowered because they no longer would pay the employer share into Social Security, they might face additional costs if part of the burden of financing the old system were placed on them.

Opponents also argue that there would be controversy if, as under Chile's system, the Government were to set policy for how and in which instruments the funds were to be invested. There probably would be broad public interest in the use of these funds. Political pressure could be brought to bear to use these investments to shore up ailing industries or support social causes. That pressure also could be evident in cases where funds held stock in companies that pollute, make products objectionable to certain constituencies, or invest in countries with repugnant or unpopular policies.

Opponents also object to weakening the social welfare features of the current system. For example, the current benefit formula is progressive, replacing a higher percentage of earnings for lower-paid workers than for higher-paid workers. Also, dependent benefits are available at no additional cost to the worker. Opponents argue that, although the minimum guarantee would retain some progressivity in the system, adopting the Chilean approach would make most workers' benefits strictly a function of the amount of their earnings and the rate of return achieved by their plan's investments. Also, even if private investment produced an overall higher rate of return, the value of the portfolio could vary widely as the values of stocks and bonds rise and fall. Thus, they argue that it is possible that a substantial number of recipients under the new system could be worse off than under the current system.

Opponents also point out that the administrative costs of the Chilean system have been higher than those of the U.S. Social Security program. Since the beginning of the new system, they have averaged about 15% of contributions, in contrast to 1% for the U.S. Social Security system.

PREPARED STATEMENT OF ROBERT J. MYERS

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

In this testimony, I shall only address the subject of whether the Social Security program (Old-Age, Survivors, and Disability Insurance) should be privatized. It should be noted that several quite different approaches could be taken if this were to be done.

One approach would be immediate, complete privatization, applicable to all covered workers under retirement age. Thereunder, mandatorily, all covered workers would begin to contribute to various available private funds, at their choice (probably in the same amounts as at present under Social Security, along with the employer contributions), and the existing beneficiaries would have their benefits continued at the expense of the government.

A second approach would be immediate privatization applicable only to all current covered workers under a certain age (such as 40) and future new workers. The present system would continue for the existing beneficiaries and all other covered workers, again with the residual costs met by the government. All other workers would mandatorily contribute to the various available private funds, at their choice (probably in the same amounts as at present, along with the employer contribution).

A third approach would be immediate, partial privatization, with all current covered workers (or perhaps only those under a certain age) and all future new workers having their employee Social Security taxes being reduced by a certain number of percentage points (say, 2%) and being required to put this money into the various available private funds. Benefits under the present Social Security program for those who thus contribute to a private fund would be reduced to reflect the lower contributions going to the Social Security trust funds. An alternative to this approach, the reduction of the employee Social Security taxes and the transfer of such amount to a private fund could be on a voluntary basis, perhaps by a one-time irrevocable election by each individual (and perhaps available only for current workers).

First I will summarize my philosophy about the proper role of the Social Security Program. Then, I will discuss the Chilean social security program, which many people in this country point to as a model of perfection, without recognizing several important elements in it that could lead to quite different conclusions. Finally, I will point out what I believe are irremediable features of the various privatization approaches and what I believe should be done to improve the present situation.

MY PHILOSOPHY ABOUT THE ROLE OF THE SOCIAL SECURITY PROGRAM

In brief, I believe that the Social Security program should provide cash benefits in event of retirement, disability, or death of the breadwinner which provide a floor of protection. On this floor, individuals can and should build through private-sector methods, such as home ownership, individual investments, and private pension plans. The present Social Security program is doing this successfully.

I do not favor the expansionist approach under which a governmental plan would provide complete economic security protection for the vast majority of the population. This would be deleterious for the character of the country and for its economic development.

Nor do I favor the elimination of a governmental plan providing a basic floor of economic protection for all—one that is not solely based on individual-equity principles (so that everybody gets exactly their money's worth, no more and no less), but rather provides relatively higher benefits for low-earnings persons and for those near retirement age when their coverage began. Such elimination would mean that an extensive public assistance program would be needed, with the resultant inhumaneness of a means test, fraud and abuse, high administrative costs, and even reduced savings by many when they realize that anything they do for themselves will only reduce their public assistance payments.

NATURE OF THE CHILEAN SOCIAL SECURITY PROGRAM

Many people, adversely critical of the U.S. Social Security program, praise the Chilean system and contend that we should replace our program with it.

The Chilean system replaced a traditional social insurance program. The latter's investments had been destroyed by inflation, its administration was poor, and cov-

erage compliance was bad. Large payments from general governmental revenues became necessary.

The basic feature of the Chilean system is privatization. Some 21 private companies sell individual investment accounts, just as our mutual funds sell Individual Retirement Accounts. At retirement, these accounts can be converted to annuities or periodic payments. All covered persons contribute 10% of their wages to a selected company, plus about 3-1/2% for administrative expenses and disability and survivor benefits. Employers do not contribute, unlike the old system, which had high employer contributions.

The government has a very substantial financial role. First, it provides large amounts as prior-service credits. Second, relatively large minimum-pension guarantees are made by the government.

The new system is working well, although other solutions would have been possible. Some assert that the absence of employer contributions is good for economic growth. Actually, when the new plan was established, all employers were required to give a 17% pay increase, which more than offset the new 13-1/2% employee contribution rate.

The assertation is made that the funds accumulating in the investment companies are used to develop the economy. Actually, much of them are "laundered back" to the government to meet the large costs of prior service credits and the minimum pensions (about 40% of the investment portfolio is in government bonds).

It is often ignored that such large amounts of general revenues are needed, for all time to come. Where would the U.S. if it were to adopt the Chilean approach get such monies?

The administrative expenses of the investment companies are about 13% of the contributions for retirement pensions, where ours are slightly less than 1%.

Coverage compliance is poor, with only about 80% of those who should contribute doing so. Many low earners contribute on much less than actual wages, because the minimum pension will be payable anyhow.

The financing assumes that, over the long range, the 10% contribution rate will provide adequate retirement benefits. However, this will occur only if an average "real" annual interest rate of about 7% can be obtained. This does not seem likely in an economically well-developed country.

The Chilean system has worked out reasonably well so far. Certain features of it do not make it suitable for the U.S.

PROBLEMS WITH PRIVATIZING THE SOCIAL SECURITY PROGRAM

One problem with privatizing the Social Security program is in providing integrated, consistent disability and survivor benefits. This is quite possible to do, but it is often ignored in proposals which are made.

A much more significant problem in any type of privatization proposal is the huge transition costs involved in order to give proper and equitable treatment to present beneficiaries and those near retirement age at the time of change. Those who make such proposals are usually silent on this point. This problem exists, over the long run, even in proposals which gradually and partially phase in privatization and eventually reduce Social Security benefits to offset the reduced Social Security contributions.

Proposals that would privatize Social Security by permitting individuals to elect to withdraw from it, either completely or partially, have the problem that those who would do so would, in general, be the low-cost cases (e.g., young, high-paid persons with no dependents). On the other hand, the high-cost cases (e.g., older, low-paid persons with dependents) would remain in the Social Security program, and its relative costs would soar, quite likely necessitating large costs to the General Fund of the Treasury. The law of actuarial anti-selection cannot be repealed! Moreover, the necessarily wide spread of funds which can be elected would cause great confusion and difficulty for the covered workers.

Privatization proposals that involve only partial transfer of the Social Security contribution rate (such as 2%) have the problem of very high administrative expenses with regard to low earners. As a result, relatively small net amounts are available to accumulate to purchase retirement protection. Accordingly, such persons will need supplementation by public assistance, whose cost coming from general revenues will be met by the high earners, who thought that they were doing so much better through the privatization procedure.

The advocates of privatization of the Social Security program argue that the high real rates of investment return will far more than offset the additional administrative expenses. As a result, they assert that much higher retirement protection will be provided than under Social Security. However, often when quoting the numerical

results, a much higher real interest rate is used than really seems possible under the circumstances. If such huge amounts of money were available for investment in common stocks, then it is likely that rates of return will be lower than historical ones. I recognize that such massive new investment would produce some desirable economic growth, but there are limits to this effect.

It is true that many persons would fare better under a completely privatized plan, under which everybody always receives their money's worth—no more and no less. But it is also true that the reverse would occur for many other persons. And often the benefits would be so small as to require public assistance supplementation, with all of its drawbacks, as indicated previously. Then, the higher earners, who would seem to be doing better under privatization, would have some of this advantage be offset by the taxes that they would pay to meet the cost of the expanded public assistance. The Social Security program, like school taxes, desirably involves some income redistribution but, at the same time, provides reasonable benefit protection for all on a social insurance basis.

WHAT SHOULD BE DONE RATHER THAN PRIVATIZATION

The most important thing that should be done now is to restore the long-range solvency of the Social Security program. (No financing problem is likely in the next 20 years.) To do so, benefit outgo over the long run could be reduced, contribution income could be increased by higher tax rates some years hence, or a combination of these two elements could be done. I prefer the combination approach such as raising the full-benefits retirement age somewhat higher and slightly more rapidly than under present law and increasing the ultimate tax rate on both employers and employees by 1.5% each several decades from now, but doing so in several steps.

At the same time, measures should be taken to strongly encourage individuals to establish private-sector retirement savings accounts, possibly by favorable tax treatment. Alternatively, it might be desirable to establish a mandatory program of this nature that is built upon the Social Security program, by requiring "additional" contributions which would be directed to selected private-sector funds. If this were done, it would be essential to exclude small payments, because of the element of administrative expenses being too high relatively. This could be done by having the employer refund the "additional" contributions to the employee at the end of the year if they amounted to, say, less than $200, instead of transmitting them to the selected private-sector fund.

Chile's Social Security Reform, *After Ten Years*

by Robert J. Myers

▶ **Chile established a radically new social insurance system in 1981, financed entirely through employee contributions.** *The author finds the new Chilean system successfully addresses the longstanding difficulties of the old system. Its approach, however, would not be desirable for the United States.* ◀

In 1981, Chile "fired a shot that was heard around the entire social security world" when it privatized its long-established "traditional" social insurance program. And now, ten years later, the "shot" is still being heard, as experts from many countries are visiting Chile and studying the operation of its new, unique program. Delegations have come from many South American and Central American nations, as well as from Poland and the Soviet Union.

Social security experts, even those of a conservative bent, usually hold the fundamental belief that a social insurance program must be administered by the government under prescribed rules as to the benefits payable. The basic reason is that, in order to accomplish its social purposes, the system must provide benefits that are heavily weighted in favor of certain categories, such as low income workers and insured persons near retirement age at the start of the program.

It is especially noteworthy that Chile initiated its original system (the "old" one) as early as 1924. In fact, it was the first social insurance program in the Americas. This lends even more importance to the radical departure from tradition that Chile apparently made in 1981. When considering social security programs—as with most things in life—there is not usually one "perfect" way to operate. Two countries may each take a different path, with both of them having good programs. Also, when problems arise, usually several different satisfactory ways are available to solve them.

The original Chilean program will first be described. Then the problems that arose, starting in the 1950s, causing the need for significant reform, will be discussed. Then the new program will be addressed, particularly with regard to how it solved the problems.[1] Finally, attention will be devoted to the applicability of the Chilean approach to the Old-Age, Survivors, and Disability Insurance (OASDI) program of the United States. The discussion will be limited to pension benefits and will not deal with cash sickness (or temporary disability) benefits or with medical care benefits.

GENESIS AND NATURE OF ORIGINAL SYSTEM

In 1924, Chile adopted a far-ranging social security program of pensions for old age, disability and death (and also cash sickness and med-

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ical care benefits)[2] Chile was far ahead of any other American nation in taking this action and, with the help of the International Labor Office, during the 1920s and 1930s patterned its program after those prevalent in the continental European countries. As a result of these precedents, the original Chilean program had certain major characteristics that are considerably different from those now usually favored worldwide as appropriate for social insurance systems.

"Over the years, the original system developed certain weaknesses. One of the primary faults was the lack of social solidarity, or social justice, because so many systems for different occupational groups developed."

The coverage under the original program was not nationwide but rather was subdivided by occupation. Eventually, there were three large systems—for manual workers, for salaried employees and for government employees—plus about 30 smaller systems for various employment categories (such as bank employees in a particular city). As a result, the benefit provisions differed considerably, and the groups with the greatest economic and political power had the most generous benefit provisions—and vice versa.

The benefit provisions laid great stress on individual equity, rather than social adequacy, although not nearly as much so as under the system now in effect, insofar as the direct contributions thereunder for current service are concerned. Eligibility conditions were stringent, requiring a large number of weekly or monthly contributions. Benefit amounts were directly proportional to the individual's earnings level (although a minimum benefit of substantial size was later provided). Furthermore, the retirement ages were relatively low in many of the systems. The net effect was that outgo would be very low in the early decades of operation, but that very high cost levels would eventually occur.

The various systems were financed essentially by level contribution rates from the start, rather than by schedules of rates that would increase over a period of years. The consequence of long deferment of benefits and a high immediate level of financing was intended to produce large accumulated funds. Although full actuarial reserves, which would at least equal the accrued liabilities at any time, would not be developed, a very high level of funding was anticipated nonetheless.

It is widely stated in Chile that the old system was financed on a pay-as-you-go basis (under which income and outgo are approximately equal each year and only a relatively small fund is accumulated and maintained). This was not the intention of the original system. However, over the years, the experience was such that large fund balances (in real terms) did not develop, for reasons that will be discussed later, and the system in actuality operated on a pay-as-you-go basis. Although many supporters of the new system assert that the old one failed because it was financed on a pay-as-you-go basis, this is not necessarily true (as will be brought out later).

Shortcomings of the Old System

Over the years, the original system developed certain weaknesses. One of the primary faults was the lack of social solidarity, or social justice, because so many systems for different occupational groups developed. The difficulty was that those groups that were in the best economic circumstances had the most liberal systems (as to benefit amounts and benefit proportions and as to low retirement ages). The three largest ones—for government employees, for most salaried employees in private industry and for most manual workers in private industry—covered about 90% of the workers. The many small systems had overly generous benefit protection.

The general system for manual workers, who are at the low end of the economic ladder, was by far the least generous. For example, the maximum pension rate was never in excess of 70% of "final" wage, compared with 100% of "final" salary for the general system for salaried workers. Even more important, the "final wage" under the manual workers system was computed over the last five years before retirement with an unusual method of indexing, which quite often ran well below the CPI, thereby resulting in undesirably low real pensions. On the other hand, the "final wage" under the salaried workers sys-

tervene to meet the growing deficits of outgo over income for most systems (including the cost of the minimum pension provision, which was principally applicable under the general system for manual workers). By 1980, about 28% of the outgo of all of the systems combined came from the deficit payments by the government. It was estimated that this proportion would rise greatly over future years, and so some drastic reform steps were necessary (and were taken). Specifically, the very low retirement ages in some systems have been gradually increased and will eventually be age 65 for men and age 60 for women.

GENERAL IMPRESSIONS AND CONCLUSIONS ABOUT NEW SYSTEM

The main feature of the new system, which began operations on May 1, 1981, is a defined contribution pension plan based on mandatory contributions of 10% of earnings from all employment categories except the armed forces. This contribution is paid entirely by the employee—or appears to be. However, in actuality, as discussed later, the incidence of the contributions is not at all clear. When the new system began, those under the old system were permitted to change over to it. After 1982, all new employees must join the new system. About 90-95% of all persons under the old system have shifted to the new system. Self-employed persons can participate in the new system on a voluntary basis. However, it is important to note that, despite the virtually universal coverage (all workers except the members of the armed forces and the self-employed), only 79% of the labor force of 4.73 million at the end of 1990 were in the new system; this indicates a significant amount of noncompliance.

At first glance, it seems inequitable that the new system requires the participants to pay the entire cost, whereas under the old system the employers and the workers shared the cost (although not equally, because the employer usually paid more than one-half). However, at the time that the new system went into effect, employers were required to give a wage increase of 18%, which approximately met the increased cost to the workers (not only the 10% for pensions but also the other costs passed on to the workers for disability and survivor benefits and for health insurance). On balance, persons who shifted to the new system had about a 10% increase in their take-home pay after considering all contributions they were required to make, while those who remained under the old system were left in about the same financial situation as to take-home pay.

The foregoing situation as to who pays the contributions and as to net take-home pay clearly illustrates that, in broad economic and actuarial terms, it is difficult, if not impossible, to determine which party is really paying social security contributions. However, there were very good psychological reasons for making this shift. To the workers, there appeared to be reassurance of seeing an accumulated balance in their retirement accounts, which are "their own."

Currently, some unions are discontented with the apparent employee-pay-all nature of the system and believe that employers should pay part of its cost. They especially believe that this should be done in hazardous industries (such as mining) so as to provide higher pensions or permit retirement at a younger age.

Many workers shifted over to the new system because of their lack of confidence in the administration of the old system. Then too, the general level of benefits under the old system was often low, because only the minimum benefit was payable in many cases. Under the new system, the retirement benefits will always be at least such minimum for persons who have at least 20 years of contributions and eventually generally will be much larger. The disability and survivor benefits are much higher under the new system than under the old (because they are determined from the basic rate of 70% of final salary, computed on an indexed basis, in the last month of covered employment before disability or death and the preceding 11 months). Some persons did not join the new system because the qualifications for the minimum pension are higher than under the old one, or because they planned to retire before they could meet the contribution requirement under the new system.

If only the defined contribution retirement benefits are considered, the new system appears very inadequate during the next two decades because it will provide relatively small pensions for those who retire then. However, this is compensated for by two features, described later. Individuals retiring in the near future will generally receive total pensions that will be at least the minimum pension (although often that), and so will be no worse off than under the old system.

The great advantage of the new system is that it provides much more social solidarity and social justice than did the old one. All categories of workers have the same benefit provisions, rather

tem was calculated over the same period, but with price indexing of the first two years. In the period of runaway inflation that Chile experienced in the early and mid-1970s (see Table I), the pensions actually payable on this "final salary" basis were very small fractions of last pay—even more so for the manual workers system than for the salaried workers one. However, even in earlier and later years, the annual rate of inflation was quite high—often 30-70%—and so this dilution of pension amounts was always present to a considerable extent.

Another problem with the old system was the opportunity that some persons had to obtain pensions under more than one system (especially as between the system for public employees and all other systems). Such costly duplication of benefits benefited some persons, but at substantial cost to the national economy.

Still another difficulty was the low retirement ages that were present in some systems. Full pensions were paid after 35 years of service, regardless of age, under the general system for salaried workers. Similarly, the service requirement for retirement pensions (regardless of age) was 30 years for government employees, 24 years for bank employees and 15 years for legislators. On the other hand, manual workers could not receive pensions until age 65.

Moreover, the multitude of systems, the extensive recordkeeping necessary to maintain lifetime histories (without the availability of modern electronic devices) and the many methods of benefit computation produced poor administration, public dissatisfaction and great expense.

Further, very considerable noncompliance with the coverage requirements occurred, especially in the general system for manual workers. Many workers and employers knowingly did not pay contributions—or else paid them on a much lower wage than actually received—because the minimum pension would be paid regardless of the level of salary on which contributions were paid. Also, in some systems, contributions were paid by many workers on much smaller amounts than their earnings until the last five years of service, because the earnings before then were not used to compute the pension amount.[3]

Finally, and perhaps most importantly, many systems were financed on a partial capitalization basis and had built up a large amount of nominal assets. However, these assets were in fixed income investments, such as bonds and mortgages on buildings, which were in terms of monetary units and not indexed. Thus, with the severe inflation over the years, these assets became practically worthless.

Because of the foregoing shortcomings, the government found it necessary over the years to in-

TABLE I

Percentage Increase in Consumer Price Index[a] From Previous Year, Chile

Year	Increase	Year	Increase	Year	Increase
1930	−0.8%	1950	15.2%	1970	32.5%
1931	−1.4	1951	22.3	1971	20.1
1932	7.3	1952	22.2	1972	77.8
1933	23.4	1953	25.3	1973	352.8
1934	0.2	1954	72.3	1974	504.7
1935	2.0	1955	75.2	1975	374.7
1936	8.5	1956	56.0	1976	211.9
1937	12.5	1957	33.2	1977	92.0
1938	4.5	1958	20.0	1978	40.1
1039	1.3	1959	38.6	1979	33.5
1940	12.6	1960	11.6	1980	35.1
1941	15.2	1961	7.7	1981	19.7
1942	25.8	1962	13.9	1982	9.9
1943	16.2	1963	44.2	1983	27.2
1944	11.6	1964	46.0	1984	19.9
1945	8.8	1965	28.8	1985	30.7
1946	16.0	1966	22.5	1986	19.5
1947	33.7	1967	18.1	1987	19.9
1948	14.5	1968	26.6	1988	14.7
1949	18.7	1969	30.6	1989	17.0
				1990	26.1[b]

[a]The Consumer Price Index for a year is derived as the average of the 12 monthly figures.
[b]If the index for 1929 were to be considered as 100, that for 1990 would be 60.7 million. The corresponding figure for the United States is 750.

Source: National Bureau of Statistics, Santiago, Chile.

The Author

Robert J. Myers has served as chairman, Commission on Railroad Retirement Reform, 1988-1990; executive director, National Commission on Social Security Reform, 1982-1983; deputy commissioner, Social Security Administration, 1981-1982; member, National Commission on Social Security, 1979-1981; chief actuary, Social Security Administration, 1947-1970. He is currently professor emeritus, Temple University.

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Many workers shifted over to the new system because of their lack of confidence in the administration of the old system. Then too, the general level of benefits under the old system was often low, because only the minimum benefit was payable in many cases. Under the new system, the retirement benefits will always be at least such minimum for persons who have at least 20 years of contributions and eventually generally will be much larger. The disability and survivor benefits are much higher under the new system than under the old (because they are determined from the basic rate of 70% of final salary, computed on an indexed basis, in the last month of covered employment before disability or death and the preceding 11 months). Some persons did not join the new system because the qualifications for the minimum pension are higher than under the old one, or because they planned to retire before they could meet the contribution requirement under the new system.

If only the defined contribution retirement benefits are considered, the new system appears very inadequate during the next two decades because it will provide relatively small pensions for those who retire then. However, this is compensated for by two features, described later. Individuals retiring in the near future will generally receive total pensions that will be at least the minimum pension (although often that), and so will be no worse off than under the old system.

The great advantage of the new system is that it provides much more social solidarity and social justice than did the old one. All categories of workers have the same benefit provisions, rather

than the lowest paid (the manual workers) having the poorest protection. Furthermore, the new system, considered in its entirety, contains a number of elements of social adequacy and thus is by no means entirely on an individual equity (or money purchase) basis, as it appears at first glance. Specifically, these elements are the minimum benefit provision, the *bonos* provision (prior service recognition bonds, as discussed later), and the disability and survivor benefits. The latter have a uniform percentage contribution rate but provide varying protection for different types of workers, such as married workers as against single ones, and older workers as against younger ones.

It also appears that the new system is much more efficiently operated than the old one, because it has successfully used computers from its inception. Although its administrative expenses may seem relatively high (as discussed later), this arises in part because of the startup expenses and because of the excellent service provided to participants (e.g., the prompt, thorough statements of accumulated contributions that are distributed every four months). At least in part, such higher administrative expenses are offset by the excellent, high rates of investment return. The administrative expenses of a social security program should neither be too low (so that poor service is provided), nor too high (so that too little money remains to provide benefits).

In summary, the new system—both as to its design and as to its performance—is excellent. At the very least, it is a great improvement over the old system. Further, the new system desirably contains significant elements of social adequacy in addition to those of individual equity. However, this is not to say that the program is without problems or that it is a perfect one, as will be discussed in more detail later.

General Structure of New System

All employees in the country, except for members of the armed forces, are compulsorily covered under the new system if they did not remain in the old system. All new workers entering the labor force after 1982 are required to enter the new system. Self-employed persons are covered on a voluntary basis.

The keystone of the new system is a defined contribution (money purchase) old age retirement pension.

The retirement pensions are provided through private organizations referred to as *Administradoras de Fondos de Pensiones* (administrators of pension funds or AFPs), of which there were 14 in early 1991. The AFPs are, in essence, pension investment companies that must meet certain financial and other requirements and are strictly supervised by the government. Each individual worker decides to which AFP the contributions are to be sent (with changes for subsequent contributions being possible, and then with transfer of past accumulated contributions). The AFPs invest the contributions after making a deduction for administrative expenses, which is composed of (1) a flat amount per month and (2) a percentage of earnings (formerly, also a percentage of the accumulated contributions—i.e., the count of the individual's account) and a deduction for the cost of the survivors and disability benefits,which is a percentage of earnings. The flat amount varies among the AFPs, generally being between 100 and 300 pesos in early 1991 (but as high as 497 pesos in one AFP and zero in three AFPs, one of which, however—unlike any other—deducts 1% of any accounts that are transferred to another AFP).

The charges made by the AFPs and their investment results are widely publicized, so that covered workers have a basis for making the choice of an AFP (or for making a change). The investment results are based on the performance after the accumulated accounts are considered in terms of investment units (or, as the equivalent, in terms of what is, in essence, a second national currency unit in Chile, *Unidades de Fomento* or UF).

The AFPs are permitted to invest in government obligations and other investments guaranteed by the government (including mortgage bonds) and in certificates of deposit of banks. Investment in bonds of private and publicly owned businesses is possible up to 50% of the funds available. Common stocks can be held, up to 30% of the assets of the fund (and with a limit of 7% on the stock of a particular company and also with a limit of 7% of the fund's assets being in any one company's stock). Initially, only the stocks of government corporations could be bought but, gradually, over six years, private company stocks were permitted to be bought. Furthermore, only stocks that are on a governmentally approved list can be purchased. The law authorizes a small amount of investment in foreign securities, but the governmental supervisory body (the *Superintendencia* of the AFPs) has not yet permitted this; in the author's opinion, such investment would be

desirable—not so much as to obtain better rates of return, but rather as a means of having more diversification, and thus more stability of investment results over time.[4]

When the program was initiated in 1981, there were 12 AFPs. In the ensuing years, two new AFPs were formed and two of the original ones combined. In addition, another AFP was created in 1990, but it was not successful and apparently was under liquidation in early 1991. Some of the AFPs are organized by or for certain industries or professions (e.g., agriculture, banking, copper mining, construction, steel, teachers and textiles), although membership in the AFP is not limited to employees thereof. The other AFPs are operated by private Chilean financial groups or by international banks or insurance companies (but with minority ownership by Chileans).

"The entire new system of retirement pensions, including the maximum taxable earnings base, is operated on an indexed basis."

The Superintendencia strongly controls the operations of the AFPs in many respects. It obtains current operating and investment data from each AFP and promptly publishes the information monthly (with only about a three-month lag, which is an excellent record).

The mandatory contribution rate is 10% on all earnings up to a prescribed maximum, which is on an indexed basis and is about 5.25 times the average salary of all covered workers.[5] In addition, a contribution is levied for the financing of disability benefits and preretirement survivor benefits and for part of the general administrative expenses of the AFP. The rate of this contribution varies among AFPs, generally being between 2.95% and 3.5% (with a low of 2.5% and a high of 3.74%). Roughly one-half of such contribution rate goes to pay the cost of the disability and survivor benefits (actually, all in four AFPs and from 44% to 63% in the other AFPs). The contribution rate is payable entirely by the employee (with additional voluntary contributions possible). For those remaining in the old system, the financing has been changed so that the relatively high contribution rates are payable *solely* by the employee rather than, as previously, in large part by the employer. The apparent shift in the financing from the employer and the employee combined to the latter alone was somewhat more than offset by a governmentally required increase of 18% in wages and salaries when the new system went into effect.[6]

The entire new system of retirement pensions, including the maximum taxable earnings base, is operated on an indexed basis. The monetary amounts (in pesos) of the contributions going to the individual accounts are, more or less immediately, translated into investment units, whose value is (a) the total current value (in pesos) of the total funds of all of the members of the particular AFP, divided by (b) the total number of investment units of all such members on such date.[7] Also operable for a number of purposes is the alternative Chilean form of currency, *Unidad de Fomento* (UF). The value of the UF changes each month (and also each day within a month) according to variations in the official Consumer Price Index. For example, at the end of 1990, the UF was 7,043 pesos (or US$21.34); at the same time, the investment unit of one of the largest AFPs was valued at 1,870 pesos (or .2655 UF or US$5.68); on May 1, 1991, the value of the UF was 7,195 pesos (or US$21.16). Similarly, the value of the pension accumulations and then the benefits flowing from them are expressed in terms of UFs. At present, the investments in which the individual accounts are made (other than common stocks) are almost entirely in securities whose principal and interest are expressed in UFs. Also, the maximum monthly earnings on which contributions are payable is in UFs (namely, 60).

The retirement pensions are available at age 65 for men and age 60 for women. They are also available at earlier ages if the pension payable is at least both (a) 50% of the average earnings of the individual (in terms of UFs) in the last ten years (which will occur only when earnings in the last ten years were unusually low as compared with previous ones or unless the person had made relatively large voluntary additional contributions) and (b) 110% of the legal minimum monthly wage (in December 1990, 26,000 pesos or US$76.46,

although likely to be raised to 33,000 pesos at some time in 1991).[8] Because the system is on the defined contribution basis, the pension amount is, on the whole, merely that which is actuarially determined from the accumulated contributions. As a result, it is really immaterial from a cost standpoint whether there are retirement conditions to be met as to age, because each participant receives merely her or his own money's worth.

Actually, there are three separate procedures for determining the amount of the purchasable pension (which is in UFs). Under the first approach, the accumulated contributions are turned over to a regular insurance company for the purchase, on an actuarial basis, of a life annuity that includes prescribed survivor benefits for the dependents of the retired worker. Under the second approach, the retiree receives a monthly payment from the AFP, determined by the life expectancy of the family group and the balance remaining in the account, which is adjusted annually; this procedure is similar to what is done in the United States with regard to minimum withdrawals from Individual Retirement Accounts after age 70½ if tax penalties are to be avoided. The third approach is a combination of the other two methods; part of the accumulated contributions is used to purchase a deferred life annuity from an insurance company, and the remainder is used to provide such payments as are possible during the deferral period from the funds left with the AFP.

Under any of these procedures, the payment to be made must continue for the lifetime of not only the retiree, but also a portion thereof to the surviving dependents (spouse, children and parents). For example, the proportion of the worker's pension that is payable to the surviving spouse or parent is 60%; if one child is present, the spouse receives 65%, and an additional 15% is paid for each additional child.

Under the method of pension payments being made from the accumulated account, the annual redetermination of the monthly payments takes into account the family composition at the time and the balance in the account then. Thus, for example, considering a married pensioner with no other dependents than the spouse, the amount payable reflects the ages of the member and the spouse, as well as the 60% proportion of the worker's pension that is payable to the surviving spouse. If the spouse should die in a particular year, the amount of the pension for the following year would be higher because only one person's life expectancy (that of the retired worker) would be taken into account. In any event, if the investment experience is favorable and the amount in the accumulated account is relatively high, the redetermined pension amount would increase—and vice versa.

If the only retirement benefits available under the new system were the money purchase ones just described, there would be no question but that the program would provide inadequate pensions for many years to come. The obvious reason for this is that it will take some years before the individual accounts based on contributions beginning in 1981 would be sufficiently large to provide sizable pensions. The advocates for the program believe that eventually the pension level will be about 70% of final salary, with its value being maintained by the indexing procedure. They readily recognize, however, that such an ultimate goal will not be achieved for retirees in the next few decades by the "purchased" pensions alone.

What saves the situation and makes the program quite suitable is that two other features affect retirement pensions. First, so-called *bonos de reconocimiento* (recognition bonds) are provided; these have the purpose of recognizing service under the old system for those who transfer to the new one. Second, minimum pensions are provided in the event that the pension obtainable from the direct contributions to the AFPs plus that available from the *bonos* does not equal a prescribed amount.

The *bonos* are available to all persons who had at least 12 months of coverage under the old system in the 60-month period ending October 1980. The amount for persons with at least 35 years of contribution to the old system is 80% of the total salary in the last 12 months before July 1979, with CPI indexing from the last month of such wages up to the month of entry into the new system, with the result then being multiplied by an annuity purchase factor (10.35 for men and 11.36 for women).[9] A further adjustment is made for men who entered the new system at age 61 or over and for women at age 42 or over; the foregoing amounts are increased by 2% for men age 61, up to 11% for men age 65 or over, and by 1% for women age 42, up to 31% for women age 60 or over. After the date of entry into the new system, the amount of the *bonos* is expressed in terms of UFs and is accumulated at 4% annual interest. The *bonos* are also available under a special method of calculation (based on 10% of the aggregate wages

in the applicable period) for those who contributed to the old system after July 1970 and until entry into the new system, even though they did not meet the foregoing "12 contributions in November 1975 to October 1980" requirement.

The *bonos* lump-sum amount is payable by the government out of general revenues (or borrowing through the issuance of bonds), but not until the time that the individual is actually retired at or after the normal retirement age of 65 for men and 60 for women. The attempt, thus, is to provide a lump sum at the time of the normal retirement age in recognition of the value of the accrued pension under the old system. Such lump sum is then utilized, along with the accumulated contributions to the AFPs, to provide retirement income to those who transferred from the old system to the new one.

"It is most significant that the amount of the minimum pension is relatively high—85% of the legal minimum wage (increased to 90% for those age 70 and over), which in turn is about one-half the average wage in the country."

The minimum pension for age retirement cases is available to individuals who have at least 20 years of contributions to the old and new systems combined. In disability cases, the service requirement is two years of contributions in the last four years (with at least six months of contributions under the new system).

It is most significant that the amount of the minimum pension is relatively high—85% of the legal minimum wage (increased to 90% for those age 70 and over), which in turn is about one-half the average wage in the country. In other words, a worker with average wages is guaranteed a pension of about 40% of earnings, which is a relatively high standard.[10] Although the amount of the minimum pension is not directly indexed, it is reasonable to consider that it is, in effect, indexed, because it is tied to the legal minimum wage. The latter, although not indexed by law, has tended to increase with the rise in the general level of wages expressed in monetary terms—and likely will continue to do so.

From the foregoing discussion, it may be seen that, considering all elements of the new system, including the *bonos* and the minimum pension provision, the result will generally be quite adequate retirement pension amounts. However, the new defined contribution system will not bear anywhere near the entire load for providing economic security in retirement for many years. At the same time, however, it must be recognized that, for many years to come, there will be very high costs to the government (for the *bonos* and the minimum pensions). In fact, there will always be some such cost for minimum pensions for low wage persons.

Payment of only retirement pensions under the new system would not be sufficient, either of itself or in replacement of the old system. Disability and survivor benefits are provided by an additional contribution rate, which varies among AFPs (in addition to the contribution rates used for retirement pensions and for administrative expenses). Such rates varied from about 1.1% to 2.3% in early 1991 and averaged about 1.5%. Such rates do not vary by age, sex or family status of the participant. The AFP remits this additional contribution to an insurance company to provide the benefits, but later any excess of the "assessed" contributions over the actual cost of the insurance is reimbursed to the AFP.

Disability pensions are payable for life and are financed both by the foregoing described contributions and by the transfer of the accumulated account in the AFP (including any *bonos* available) to the insurance company. The disability benefit for persons who have lost at least two-thirds of their earning capacity (total disability) is 70% of the average indexed salary during the last ten years of work. Partial disability pensions are paid at the rate of 50% of the average indexed salary over the last ten years of work for persons who have lost at least 50% of their earning capacity, even though less than two-thirds thereof.

Persons who become unemployed and no longer contribute have their disability (and survivor) benefit protection continued for 12 months after ceasing to be employed. However, the pension rate for total disability in such cases is 50% (instead of 70%), while that for partial disability is 30% (instead of 50%). Individuals can voluntarily con-

tribute more so as to obtain a higher benefit rate (up to a maximum of 80% of average salary).

Survivor pensions are similarly payable, both for deaths in active service and for deaths while on the disability pension roll (during which time the contributions are waived). In essence, those dying in active service are considered as having become disabled on the date of death. The amounts of the survivor pensions depend on the family composition of the survivors and are the same proportions of the basic disability pension as described previously in connection with the retirement pensions. A lump-sum funeral benefit of 15 UF is available (financed from the accumulated account with the AFP). Any accumulated contributions held by the AFP that are not needed to purchase the disability and survivor pensions and the funeral benefit are available to the estate of the deceased individual as a lump sum.

Table II presents data for AFPs individually as to the contributions for disability and survivor benefits and for administrative expenses (which are generally both flat monetary amounts and percentages of pay) for several wage levels in relation to wages. In general, these cost percentages decrease as the wage increases; this is a natural result of the individual equity principles that underlie the new system and is in conflict with social adequacy principles (of favoring relatively the lower paid workers). The cost percentages for most AFPs fall in the range of 3% to 3.5%, with lows in the neighborhood of slightly under 3% and highs of close to 4%.

OPERATING EXPERIENCE OF THE NEW SYSTEM

The number of active contributors under the new system has increased rapidly over the years—from 1.6 million at the end of 1981 to 3.7 million for 1990 (see Table III). Initially, about 50% of the labor force was covered under the new system, and this increased to almost 80% at the end of 1990. The proportion of the labor force that is covered is still well below 100%, although rapidly growing, for several reasons. First, members of the armed forces are not covered, and self-employed persons are covered only on a voluntary basis (and most do not participate). Second, some workers are still under the old system. Third, some coverage noncompliance occurs (e.g., for domestic workers).

About 36% of the 3.7 million contributors at the end of 1990 were women. The distribution by age was as shown in Figure 1. The relatively

TABLE II

Contributions for Disability and Survivor Benefits and for Administrative Expenses Expressed as a Percentage of Wage for Different Wage Levels, by AFP, March 1991

AFP	Monthly Wage[a] 5 UF	15 UF	60 UF
Bannuestra	3.30%	3.30%	3.30%
Concordia	4.13	3.70	3.53
Cuprum	2.99	2.99	2.99
El Libertador	3.90	3.57	3.44
Futuro	3.25	3.25	3.25
Habitat	3.19	3.03	2.97
Invierta	5.15	4.21	3.86
Magister	4.16	3.65	3.46
Planvital	4.49	3.96	3.76
Proteccion	3.27	3.27	3.27
Provida	3.15	2.72	2.55
Santa Maria	3.23	3.04	2.97
Summa	3.62	3.19	3.02
Union	4.52	3.97	3.77

[a]One UF equaled 7,064 pesos in March 1991. The minimum monthly wage was 26,000 pesos (or 3.68 UF), the average wage was about 81,000 pesos (or 11.4 UF) and the maximum wage on which contributions were made was 423,840 pesos (or 60 UF).

TABLE III

Numbers of Active Contributors and Total Assets of AFPs, by Year

Year	Number of Active Contributors at End of Year (thousands)[a]	Total Assets of AFPs at End of Year (billions of pesos): Amount	In 12/31/90 Pesos[b]
1981	1,605 (50%)	30	170
1982	1,741 (52%)	60	290
1983	[c]	110	420
1984	1,930 (49%)	200	630
1985	2,284 (57%)	310	770
1986	2,591 (61%)	480	1,020
1987	2,891 (66%)	660	1,150
1988	3,183 (70%)	910	1,410
1989	3,471 (74%)	1,350	1,720
1990	3,743 (79%)	2,249	2,249

[a]Figures in parentheses are contributors as percentage of total labor force.
[b]Adjusted by the Consumer Price Index.
[c]Not available.

FIGURE 1

Age Group	Percentage
Under 20	6.1%
20-29	41.3
30-39	29.2
40-49	15.5
50-59	6.4
60-64	1.1
65 and over	0.4
Total	100.0

FIGURE 2

Type of Investment	Proportion
Government-Guaranteed Investments (Treasury or Central Bank)	44.1%
Time Deposits (in banks)	17.4
Mortgage Bonds	16.1
Common Stocks	11.3
Bonds and Debentures	11.1
Total	100.0

TABLE IV

Distributions of Active Contributors and Assets, by AFP, End of 1990

AFP	Proportion of Total Active Contributors of All AFPs	Proportion of Total Assets of All AFPs
Bannuestra	—	0.1%
Concordia	3.4%	1.4
Cuprum	1.8	6.0
El Libertador	2.2	2.6
Futuro	0.2	0.7
Habitat	17.1	17.5
Invierta	3.9	2.4
Magister	1.7	2.2
Planvital	2.6	1.3
Proteccion	1.0	2.5
Provida	29.0	26.1
Santa Maria	20.1	19.3
Summa	8.0	9.6
Union	9.1	8.4
Total	100.0	100.0

Note Total active contributors were 3,739,500. Total assets were 2,249 billion pesos

young age distribution is evident, meaning that pension outlays will be much higher some decades from now.

Quite naturally, the assets in the hands of the AFPs have risen greatly over the first decade of operation—from 30 billion pesos at the end of 1981 to 2.2 trillion pesos for 1990 (or US$6.8 billion). A substantial part of this increase was due to inflation (the declining value of the peso). Nonetheless, when expressed in terms of 1990 pesos, the growth was thirteenfold.

The assets at the end of 1990 were invested as shown in Figure 2.

The magnitude of the total assets of the AFPs at the end of 1990 is indicated by the fact that this total when measured against the total assets of the entire banking system in Chile (including the Central Bank) was 24.9% thereof. In 1986 this proportion was only 6.7%.

It should be recognized that part of the almost half of the assets that are in government bonds can be attributed to loans to finance the *bonos* and minimum pension costs under the new system.

Table IV shows the numbers of contributors and the assets at the end of 1990 distributed relatively among the several AFPs. The largest three AFPs involved 66% of the contributors and 63% of the assets. Some of the AFPs were quite small but they serve special groups, and some of them (e.g., Cuprum, Futuro and Proteccion) have relatively much higher shares of the total assets than of contributors.

The real annual rates of investment return for each year since the inception of the new system in 1981 are shown in Table V. Also shown are the ranges of return for the individual AFPs. The high rates of return are noteworthy. Only in 1984 and 1987-1989 were rates of return as low as 4-7% obtained. Whether the average annual rate of return of 13% for the entire decade can be achieved (or even nearly achieved or halfway achieved) over the long run is a question.

The numbers of pensioners and the average monthly pensions, by type, for the new and old systems for September 1990 are shown in Table VI. As would be expected, the numbers of pensioners under the old system are much larger than under the new system—about a ninefold difference—because of the relative immaturity of the new system. The average monthly old-age pension—recognizing that averages can be misleading—is about the same under both systems, about 36,000 pesos (or US$115). On the

other hand, the average pension for disability and survivor cases is significantly higher under the new system than under the old one—because of the procedure of keeping the initial amount (and also the subsequent ones) up to date with recent wages and inflation.

The average operational cost (administrative expenses) per AFP member was 10,232 pesos (or about US$31) in December 1990. As compared with the average contribution per member for retirement benefits (10% of salary) then, this was an expense rate of 10.2%. The increasing efficiency of operations over the years is demonstrated by the fact that in 1981-1982 the average operational cost was about 15,000 pesos (in terms of December 1990 pesos).

Another way to look at relative administrative expenses is to compare the contribution rate that, on the average, is used for such purposes (1.5%) with the contribution rate for retirement benefits (10%), which gives an expense rate of 15%.

HOW THE NEW SYSTEM SOLVED THE PROBLEMS

The new program went far toward solving the many problems inherent in the old system. This is not to say that the new program is perfect, because it does have some weaknesses (which will be described later), but it is certainly a vast improvement.

The new system has the fundamental strength of providing equal, consistent and reasonable treatment of all types of workers, instead of highly favored, costly treatment for some workers—generally the higher paid ones. Then, too, efficient administration has been substituted for the extremely complex and poorly run old system. Workers now know much better where they stand financially, because they have individual accounts of their accumulated contributions (which are indexed to maintain their real value) and therefore have assurance of specific amounts accumulating toward their retirement needs. Also, they are promptly furnished statements of their accounts three times yearly and so have visible proof of their accumulated retirement protection.

Another important advantage is that the future demands on the government for financing the new system will be significantly reduced from the perhaps overwhelming level that would have prevailed if the old system had continued unchanged. And many years hence there will no longer be need for anywhere near as much general revenue financing. Nonetheless, there will be very large general revenue costs to the government for many years to come for maintaining the old system for those who remained in it (especially for existing pensioners), for guaranteeing a minimum pension to beneficiaries under the new system and for the *bonos*.

The new system has the strength that a substantial floor has been built under the retirement benefits payable from the accumulated contributions and any accompanying *bonos*—namely, the guarantee of a relatively large minimum pension. It is

TABLE V

Real Annual Rates of Investment Return as Measured Against UFs, by Year

Year	All AFPs Combined	Range Among AFPs
1981*	12.9%	9.5-16.6%
1982	28.5	23.2-30.2
1983	21.2	18.5-24.7
1984	3.6	2.2-4.4
1985	13.4	13.0-14.3
1986	12.3	11.5-15.5
1987	5.4	4.5-8.5
1988	6.5	5.9-7.8
1989	6.9	5.9-9.5
1990	15.6	13.3-19.4
1981-90	13.0	12.5-14.0

*July to December.

TABLE VI

Number of Pensioners and Average Monthly Pension, by Type, New and Old Systems, September 1990

	New System		Old System	
Type of Pension	Number of Pensioners	Average Pension[a]	Number of Pensioners	Average Pension[a]
Old Age	26,393	36,047	366,378	35,746
Disability	15,369	59,403	132,886	29,519
Widow	16,310	25,784	167,097	17,925
Orphan	21,593	8,766	36,469	6,749
Total	79,665	[b]	702,830	[b]

[a] In pesos.
[b] Not computed because not meaningful.

true that, because of this provision, many retirees in the next few years will receive only the same benefit as under the old system, but because of the better financial structure there is much more likelihood that benefit payments will be continued.

Finally, an important feature of the new system is that it provides substantially higher disability and survivor pensions than the old system. Thus, the average disability pension payable currently under the new system is somewhat more than double that under the old system, while the survivor pensions are almost 50% higher. In large part, this occurs because the new system bases pension amounts on the last salary and indexes them while on the roll, whereas pensions under the old system were based on a five-year average salary without full indexing.

PROBLEMS OF NEW SYSTEM

In this human world, no system of benefit payments is devoid of problems, and no solution is perfect. There are several areas where the new Chilean program has certain difficulties, either current or potential.

Coverage compliance, which is a necessary feature of any successful social security program, has been greatly improved under the new system, both as to the number of persons covered and as to accurate reporting of earnings. Nonetheless, there still seems to be less than full compliance. Continuing efforts will be necessary to improve this situation.

The normal retirement ages continue the differential by sex that had been present in the old system. This discrimination against men is not as serious as it was formerly if appropriate annuity purchase factors by age and sex are used. Nonetheless, it would seem desirable to have exactly the same retirement conditions apply for men and women.

A problem area as to the disability pensions is the lack of coordination and consistency of treatment between persons who become disabled shortly before the normal retirement age and those who reach such age. The disability benefit (which is payable for life) will be much higher in some cases than the retirement pension. This can be a great incentive to be adjudicated as being disabled just before attaining the normal retirement age. And at those ages, it is usually not difficult to be considered as disabled. A possible solution to this problem is to provide that the disability pension should be a temporary one, extending only up to the normal retirement age, and that thereafter the retirement pension from the AFP should take over. In conjunction with such a change, it would be necessary to augment the AFP account with presumed contributions during the period of disability (just as is done, in essence, in the *waiver of premium* provision in life insurance contracts).

The major problem over the long range is what will be the eventual level of the retirement pensions. Quite naturally, in a defined contribution plan, this depends to a great extent on the interest rate actually earned—or, in this particular case, on the *real* rate of investment return because the accumulations and purchasable benefits are all indexed. Some sponsors of the new system believe that the ultimate level of retirement pensions will be about 70% of salary (the average indexed salary over the last ten years of coverage). However, this is based on obtaining a relatively high real interest rate, such as 6% over the long-range future.

The experience to date in this respect has been relatively favorable. The real annual interest rate in the initial decade of operation on the net amounts credited to the individual accounts has averaged 13% (but only 8½% in the last four years). In the author's opinion, it is unlikely that a real interest rate of more than 2-3% will be possible over the long run, particularly when the investments are mainly in government bonds or bank certificates of deposit (as they have been). Accordingly, there is considerable question whether the eventual benefit replacement rates based on a 10% contribution rate will be as high as the goal of 70% of final salary.

One weakness with the new system with regard to the accumulation of contributions in the individual accounts is that the charge for administrative expenses is based, in part, on a flat monthly amount. The result is that low earners have a relatively smaller net contribution to accumulate than do high earners. Although there is logic in assessing expenses in this manner, it does seem to produce the undesirable result that benefits will be proportionately larger for high earners than for low earners (although this will sometimes be more than offset by the effect of the minimum pension provision). In the last few years, however, there has been a trend toward lessening the importance attached to the flat monthly charge.

From a social standpoint, it would be better to have an administrative expense charge related only to the size of the accumulated account (i.e., in essence, that a small portion of the investment rate

of return would be used for administrative expenses, as is the general practice in the operation of mutual investment funds in the United States). The difficulty with this approach is that AFPs would tend to seek only high earners as their members, and the AFPs that had low earners would appear to have worse operating experience and would not be able to pay as large a rate of interest on the accumulations. Perhaps some pooling arrangements or charge/credit among the AFPs would be possible in order to alleviate this situation.

ECONOMIC EFFECTS OF NEW PROGRAM

It has been argued that the new program will result in a great increase in private savings. It is true that this would occur if there were only the defined contribution pension plan. However, considering the effect of other elements (such as the cost to the government of the minimum benefits, the *bonos* and the deficits of the old system), this may well not be the case—or at least to only a limited extent. So much depends on what happens in other sectors of the economy that it is impossible to give any accurate answer to the question of the effect of the new system on private savings.

The argument has been made that, by shifting the employer contributions to the employees, a substantial reduction in production costs has been made. However, on the whole, this has been largely offset by the required 18% increase in pay that was made when the new system began.[11] But there was some real decrease in production costs with respect to those old systems that had very high benefit costs.

A considerable amount of government debt will be created in the future for meeting the deficits of the old system, for meeting the cost of the minimum pensions and for payment of the *bonos*. The latter are payable by the government to the AFPs, generally many years hence, when retirement or earlier death or disability occurs—along with appropriate adjustment for inflation and for real interest—and not at the present time, when these amounts payable are being determined.

It seems only reasonable that a considerable portion of this new debt will be purchased by the AFPs—and desirably so—because they are such an important source of new investment funds. Besides, this source of investment is desirable due to the indexing of both its principal and interest.

If this is done, it may well be argued that, from a broad macroeconomic viewpoint—and considering the pension system as a whole—no new savings are being created. One argument for the creation of the new system was to increase national savings. However, in the author's opinion, this should not be a major purpose of a social security program—and even may not result, as indicated previously.

Such an investment procedure in government securities would allay the fears of those who believe that the new system will eventually yield far too much power and control over the private sector of the economy to the AFPs. The investment of much of the assets in government bonds will have a neutral result in this connection.

It is possible that the investment of even a small portion of the assets of the AFPs in the private sector will have the desired stimulating effect, but this certainly is a matter that will be determined over a long period in the future. The principal advantage of the new system in the general economic picture is, in the author's opinion, the psychological one of persons feeling that a considerable specific amount of money that is indexed against inflation is all theirs.

Currently, some discussion is occurring as to the desirability of investing some of the assets abroad. The argument that the monies should remain in Chile to develop its economy is raised against this procedure. On the other hand, the author sees good reason to do this to a small extent, so as to have better diversification of investments (and, as an offset, considerable investment in Chile is currently being made by foreign interests).

Some people argue for participants being able to withdraw money from their retirement accounts with the AFPs for "serious" current needs. The author believes that this should not be permitted, because the funds are set aside solely for retirement needs (or prior disability or death). Further, it would be extremely difficult to determine administratively which "needs" would qualify.

APPLICABILITY OF APPROACH TO U.S. SOCIAL SECURITY PROGRAM

It is a truism that an excellent solution to the problems of a social security program in one country is not necessarily suitable for another country. Nonetheless, let us examine whether the approach taken in Chile, which has produced highly desirable results in solving the problems related to the old system, is applicable to the OASDI program in the United States.

From time to time in the past, proposals have been made to privatize OASDI, in whole or in part. Among the most ardent advocates has been Peter J. Ferrara, who has made several different proposals over the years. His book *Social Security: Averting the Crisis* (Ferrara 1982) sets forth a plan to phase out gradually the current traditional social insurance system to a privatized program based on individual accounts of accumulated contributions.[12] Subsequently, he modified this proposal so as to have only a partial phasing out (Ferrara 1984).

Others have recommended this general procedure, pointing out the imaginative and successful approach taken in Chile (e.g., see Kirkpatrick 1985). On the other hand, public opinion polls indicate that the U.S. public has little enthusiasm for this approach. For example, an Associated Press-NBC News poll taken in late 1982 showed that, although 75% of the respondents had little or no confidence that OASDI would continue to exist, 78% said that they would oppose phasing it out altogether (and have people rely on their own private retirement plans.[13] Further, in 1983 the National Commission on Social Security Reform considered, but unanimously rejected, transforming the program into one "under which benefits are a product exclusively of contributions paid" (National Commission on Social Security Reform 1983).

In the author's opinion, the situation in Chile is quite different from that in the United States. The old Chilean system was plagued with the financing problem of ever-growing amounts being needed from the general revenues of the government, as well as by great anomalies and inequitable discriminations in the benefit payments among various categories of workers. The solution adopted was not—as some American observers superficially conclude—to establish solely an individual equity program of personal accounts based on accumulated contributions. Rather, such an approach is only part of the total Chilean social security program, which continues to embody a mixture of individual equity and social adequacy, just as do traditional social insurance programs. The presence of a relatively high minimum benefit, the excess of which over the "purchased" annuity from the individual account is financed by the government from general revenues, represents an important social adequacy element. This is also the case with respect to the costly and extensive prior service credits (the *bonos*)—also financed by general revenues. A still further element of social adequacy occurs in connection with the disability and survivor benefits, which are financed by a uniform contribution rate, which is unrelated to age, sex or family status.

The effect of the new Chilean system is thus to provide social justice by having uniform benefits for all employment categories and by maintaining a mixture of individual equity and social adequacy principles. At the same time, the new plan has the beneficial effect on the national economy of considerably reducing, but by no means eliminating, the cost to the government for social security, which is met out of general revenues.

The situation in the United States as to OASDI is quite different. Relatively little of its financing is what might be termed *general revenue financing*.[14] In the author's opinion, it is highly undesirable to have any financing from this source. Rather, the necessary funds should be derived in a visible, direct manner from payroll taxes on workers and employers. Any phasing out of OASDI so that individual accounts would be used as the underlying basis would involve huge general revenue costs to the government. This would be necessary in order to finance the benefits for those now on the roll and for those within a decade or two of retirement age, whose individual accounts based on future contributions could not provide adequate benefits.

Moreover, OASDI is operating reasonably well and is providing a good package of benefit protection. Then too, it is apparently adequately financed over both the short run and the long range.[15]

Some poorly informed critics of the OASDI program make assertions that it may become bankrupt in the long run (or, even more erroneously, in the near future), whereas a privatized system like the Chilean one always has the accumulated individual accounts available. They go on to point out that the U.S. economy may not be able to support the growing population of the aged. What they fail to realize is that, on the one hand, a privatized, individual account system cannot "guarantee" either the future investment rate of return of the accounts or how much pension an individual unit of the account will purchase. Nor, on the other hand, do they recognize that a social insurance system is flexible and, if financial difficulties arise in the future, appropriate (and probably small) adjustments in contribution rates and/or benefit provisions can easily be made to rectify the situation.

Any attempt to completely change the structure of the OASDI system would produce chaos, both from the standpoint of the benefit design and from the general budgetary situation of the government. As to the latter, huge deficit problems already exist as a result of other programs, and they should not be exacerbated by taking on the additional liabilities and current tax losses that would occur under any of the proposals to phase out OASDI and move to individual savings accounts.

Furthermore, those who advocate this approach never clearly indicate how adequate disability and survivor protection would be provided. Nor would the necessary benefit protection be provided for low income persons through some social adequacy approach. As a result, this would likely result in a significant growth in means-tested payments, which are not cost effective and which involve substantial general revenue financing (which really falls back in the end on those higher paid persons who might believe that they would gain from the individual accounts procedure). ◀

Endnotes

1. The author made onsite studies of the Chilean program in December 1984 and April 1991. This paper updates and extends an earlier article (Myers 1985b). At the end of 1990, the exchange rate was approximately 330 pesos for US$1.

2. For a reasonably detailed description of the provisions of the program as it has changed over the years, see the various issues of *Social Security Throughout the World*, issued periodically (in recent years, biennially) by the U.S. Social Security Administration, with the first one issued under a somewhat different title in 1940.

3. Although basing pension amounts on average earnings over the last few years of employment (or, alternatively, the highest earnings over a consecutive period of years) works out quite satisfactorily in an employer's private pension plan, this procedure has grave dangers when used in a social insurance system. Under a private plan the employer, because of its responsibility (at least in large part) for financing the plan, will not engage in manipulation of the "final" earnings so as to produce larger benefit amounts. On the other hand, under a nationwide system, in which costs are borne primarily by "somebody else," the employer will have much less compunction about such manipulation. The same situation prevails as to underreporting of earnings at the younger and middle ages, so as to reduce contribution liabilities without affecting the amounts of the eventual retirement benefits.

The solution to the problem of having a reasonable basis for earnings for the determination of pension amounts when there has been an inflationary economy over the working lifetime of the beneficiary (even if only a mildly inflationary one) is to use an average over many years of earnings, with the earnings being *indexed* to bring them up to the current level of general earnings at (or near) the time of retirement. This procedure is followed in the U.S. OASDI program.

4. Although it could be argued that such monies should be kept in Chile to augment economic growth, this does not seem to be essential, because there is much foreign investment currently being made in Chile.

5. The corresponding multiple under the U.S. OASDI system is about 2.4 (which will be maintained at this level in the future by the automatic adjustment provisions).

6. In drawing this conclusion, the reasonable assumption is made by the author that the 18% increase in pay was built into the general earnings structure, for both existing workers and for new entrants into the labor force. It might be argued that this was not done and that existing workers will receive smaller wage and salary increases in the future than would otherwise have occurred, while new entrants are paid at the same rate as prevailed before the 18% increase. However, this cannot be proven (as is always the case in the economic area, when one tries to prove "what would have happened if something had not actually otherwise occurred").

7. This is the same procedure that is used in valuing the investment units of mutual funds in the United States, except that investment income and net realized capital gains are retained (and thus increase the size of the investment unit) instead of being distributed to the participants currently.

8. Because of the newness of the system, and despite the availability of the *bonos* (described later), it is not very likely that early retirement pensions of the size of 50% of average earnings will be available until many years hence, unless the earnings in the last ten years were unusually low as compared with previous ones or unless the person had made relatively large voluntary additional contributions.

9. An alternative method to computing the total salary in the last 12 months of coverage before July 1979 is provided if it is more favorable. The month-by-month wages in June 1974 through May 1979 are price indexed to July 1, 1979, and the total such indexed wages is divided by five to yield the alternative "total salary."

10. The OASDI program provides about this level of basic benefit to persons retiring at the normal retirement age (currently age 65).

11. See note 6 for further discussion.

12. Also contained is an excellent summary of other plans to privatize the Social Security program (see pp. 92-101).

13. This lack of confidence in the program's financial viability still seems to prevail to a certain extent, despite the passage of the 1983 act (which, the author believes, quite adequately and likely solved the financing problems that became apparent in 1981-1983).

14. For more details on this matter, see Myers 1984.

15. For more details on this matter, see Myers 1985a.

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Notes and Communications

Addendum to "Chile's Social Security Reform, After Ten Years"

by Robert J. Myers

This note amplifies and, in some instances, corrects the article "Chile's Social Security Reform, After Ten Years" (*Benefits Quarterly*, Third Quarter 1992).

The Author

Robert J. Myers has served as chairman, Commission on Railroad Retirement Reform, 1988-1990; executive director, National Commission on Social Security Reform, 1982-1983; deputy commissioner, Social Security Administration, 1981-1982; member, National Commission on Social Security, 1979-1981; chief actuary, Social Security Administration, 1947-1970. He is currently professor emeritus, Temple University.

1. *Page 44, second column, first full paragraph.* A practical reason for having only the employees pay contributions is that coverage compliance can be better enforced on this basis than if employer contributions are involved as well.

2. *Page 44, second column, fourth full paragraph.* It might have been mentioned that, in the next two decades, some retirees will have a second pension, because they will have one under the old system as well as under the new one.

3. *Page 45, second column, first partial paragraph.* The deduction of 1% for the one AFP that follows this procedure is on transfers from another AFP, not on transfers to another AFP.

4. *Page 45, second column, last paragraph.* The mortgage bonds are *not* guaranteed by the government, although there are governmental controls thereon. The approved stock list is prepared by a governmentally established commission, which consists of three government representatives and four representatives from AFPs. Recently the *Superintendencia* of the AFPs has granted permission to the AFPs to invest, in a limited way, in foreign securities.

5. *Page 46, first column, third full paragraph.* The ratio of the maximum earnings on which contributions are levied to the average salary of all covered workers is not a fixed quantity, because it depends on when it is measured. The ratio shown (5.25 times) could be as low as 4.7 times.

6. *Page 47, first column, first full paragraph.* As to the three separate procedures for determining the amount of the purchasable pension and the method of payment, the choice thereof is up to the retiree.

7. *Page 48, first column, last paragraph.* The relationship between the legal minimum wage and the average wage is not a fixed one, because the former is not automatically indexed to changes in the general wage level, but rather is increased on an ad hoc basis. The stated "one-half" relationship has at times been as low as "one-third."

8. *Page 48, second column, third full paragraph.* Recently, disability retirees have been allowed to use the other two alternatives for determining the amount of the purchasable pension and the method of payment that old-age retirees have (as per the first full paragraph of the first column on page 47). In other words, the insurance company transfers the annuity reserve, in whole or in part, to the AFP, which then disburses it in the same manner as for old-age retirees.

PREPARED STATEMENT OF JOHN EDWARD PORTER

Chairman Simpson, thank you for holding this hearing and for allowing me to testify before you today. I come before the Subcommittee on Social Security and Family Policy to discuss legislation that I plan to reintroduce in this Congress. My Individual Social Security Retirement Account Act, introduced as H.R. 306 in the 103rd Congress, would change current policy governing the management of the Social Security Trust Fund reserve in order to better preserve it for future retirees.

Mr. Chairman, last year, American workers paid $381 billion in taxes to the Social Security system. $323 billion was paid out in benefits to retirees. What happened to the $58 billion surplus? Congress used it to pay for deficit spending, effectively stealing future generation's benefits. This has been going on for years. If nothing is done soon to correct it, the baby boomers prediction that they will receive little in the way of benefits when they retire will basically come true.

Sixty years ago this month, the Social Security Act was signed into law. It was designed during the Great Depression as a way to protect elderly Americans from poverty and preserve their dignity through a pension system in which current workers would pay for the retirement of the generation before them. Over the sixty years of its existence, it has exceeded its founders' fondest expectations and largely eradicated senior poverty in America. But since it has never been a funded, vested system, but always depended upon current workers' support for retirees, changing demographics mean future serious trouble for the system. If the federal government continues to raid the Social Security Trust Fund to finance today's overspending, little will be available for Americans beginning to retire about thirty years from now.

Social Security has been able to pay benefits for sixty years because a large group of workers has supported a smaller group of beneficiaries. But unless something is done now, when the baby boomers begin to retire in 2015 a serious fiscal crisis will occur. These baby boomers have been paying, and continue to pay, high Social Security taxes that in theory, are being set aside in a Trust Fund reserve to help pay their benefits when they retire. In reality, the money is invested in federal debt instruments to finance ongoing federal deficits. When the boomers retire, the Social Security Administration will need cash—not I.O.U.s—to pay their retirement benefits, and the draw down will involve literally hundreds of billions of dollars in a very short time frame. The options will be: (1) a huge increase in payroll taxes, (2) substantial decreases in retirement benefits, or (3) massive additional government borrowing that will raise interest rates and siphon-off money needed for private investment. All are unacceptable.

Inside Washington, none of this is a secret. For several years, policy makers have made the correct diagnosis—that Congress was stealing the Social Security reserves—but no good prescription for recovery. My prescription: cut the tax and save and invest the proceeds.

HERE'S HOW MY PLAN WOULD WORK:

Social Security taxes would be reduced by the amount not necessary to pay current beneficiaries. This amount would be refunded annually into mandatory Individual Social Security Retirement Accounts, or ISSRAs, for every American worker. These IRA-like accounts would accrue and reinvest interest, tax-free, over the working lifetime of the individual. Individual recipients would own the accounts and would manage their ISSRA's investments, assisted by bonded trustees such as banks, insurance companies, brokers or other money managers. Only fiduciary type, non-speculative investments would be permitted, including federal, state and local government obligations, time deposits, AAA corporate bonds, and perhaps, certain mutual funds. The trustees would be criminally liable for breaches of fiduciary trust and would only be able to release the ISSRA funds to purchase an annuity when the owner reaches retirement age.

Upon retirement, workers would buy a lifetime annuity to supplement their adjusted Social Security benefit. Any surplus ISSRA funds, not needed to reach their unadjusted benefit level, could then be removed in a lump sum and consumed as the retiree sees fit. An individual's Social Security benefits would then consist of two parts: an adjusted payment from the Social Security Trust Fund and an annuity benefit purchased with the person's ISSRA funds. Social Security's progressive structure would be maintained by adjustment of the payment from the trust fund—the regular Social Security benefit. Such an approach would not affect today's retirees and would protect the future benefits of people currently paying Social Security payroll taxes by taking them out of the hands of Congress and putting them in the hands of those who earned them.

My ISSRA plan would make every American worker an investor in our nation's economy, with a tangible stake in its success. Every American, even those who had never saved a dime, would have a nest egg that would be theirs, that would grow and be available as part of their retirement. Because workers would own their ISSRA, if they died prior to retirement, their ISSRA would become part of their estate to pass to their family or designees.

In addition, my proposal would put $3 trillion, in 1990 dollars, into private investments, helping to drive down interest rates and speed future economic growth. Finally, the ISSRA plan would lay the groundwork for a completely portable, fully-funded and vested private pension system. Instead of a company or union paying into a pension fund (which may be mismanaged or stolen sometime in the future) the company or union may pay directly into an employee's ISSRA. Individuals would own and manage this fund guided by a powerful incentive—self-interest—to ensure their own retirement security.

Moreover, I believe very strongly that once American workers experience managing a portion of their retirement accounts, they will want to extend this concept to full control. If, during the Depression, we could have created a fully funded and vested Social Security system, we would have done so. But that was impossible. While it would take decades to move from our anachronistic system to an ideal one, there is no reason not to adopt this as a national policy goal now and work toward such a vested, fully-funded, employee-owned system in the future.

The Social Security system has been a central institution in American society for sixty years. We must ensure that it is as sound and strong in the future as it is today. Taking the Social Security reserve away from Congress and putting it into the hands of American workers through my ISSRA plan is the best way to do so.

I thank the Subcommittee for its time and would be happy to answer questions.

PREPARED STATEMENT OF MICHAEL TANNER

Mr. Chairman, distinguished Members of the Committee: I am Michael Tanner, director of health and welfare studies at the Cato Institute and director of Cato's Project on Social Security Privatization. I want to thank the committee for the opportunity to testify on what may be one of the most important public policy issues facing this country at the 20th century draws to a close.

In less than two weeks, Social Security will celebrate its 60th anniversary. As it does so, it is an institution in profound crisis. According to a recent public opinion poll, more young Americans believe in UFOs than believe they will receive their Social Security benefits.[1] The unfortunate fact is that, while their views on extra-terrestrial visitation may be problematic, their opinion on Social Security may be perilously close to correct.

Recently, the government's own actuaries reported that the Social Security Trust Fund will go broke in 2030.[2] However, this estimate itself may be unduly optimistic because the Social Security Trust Fund is really little more than a polite fiction. For years, the federal government has used the Trust Fund to disguise the actual size of the federal budget deficit, borrowing money from the Trust Fund to pay current operating expenses and replacing the money with government bonds. The real crisis starts, therefore, not when the trust funds run out, but when they peak and start to decline. At that point the trust funds must start turning in bonds to the federal government to obtain the cash needed to finance benefits. But the federal government has no cash or other assets to pay off these bonds. It can only obtain the cash by borrowing and running a bigger deficit, increasing taxes, or cutting other government spending.

Even if Social Security's financial difficulties can be fixed, the system remains a bad deal for most Americans, a situation that is growing worse for today's young workers. Payroll taxes are already so high that even if today's young workers receive the promised benefits, such benefits will amount to a low, below-market return for those taxes. Studies show that for most young workers such benefits would amount to a real return of one percent or less on the required taxes. For many, the real return would be zero or even negative. These workers can now get far higher returns and benefits through private savings, investment, and insurance.

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[1] "Generation X Believes UFOs but Laughs at Social Security," Washington Times, September 27, 1994.

[2] 1995 Annual report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Trust Funds (Washington, DC: Government Printing Office, April 11, 1995).

In a forthcoming study for the Cato Institute, financial analyst William Shipman considers the potential investment return under a variety of scenarios.[3] Mr. Shipman considered the examples of both high and low income wage earners born at three different dates (1930, 1950, and 1970). Shipman then compared the social security benefits that the individual would receive with the potential return that the individual would have received if he or she had been allowed to invest an amount equivalent to the payroll tax in either stocks or bonds.

If, as is likely, the system's impending financial crisis forces reforms such as raising the retirement age, means-testing benefits, or increasing the payroll tax, Social Security will become an even worse investment for today's young workers.

The only viable alternative that will continue to guarantee that older Americans will be able to retire with dignity is to privatize the Social Security system.

What would a privatized system would look like? While it is not necessary at this point to go into all the details of how such a system would function, the logical alternative would be some form of mandatory savings program.[4] For example, the 11.2% payroll tax that is the combined employer-employee contribution to OASDI, the Old-Age and Survivors Insurance and Disability Trust Fund portion of the Social Security program, could be redirected toward a Personal Retirement Account (PRA) that is chosen by the individual employee.

Under this scenerio, Personal Retirement Accounts would operate similar to current Individual Retirement Accounts (IRAs). Individuals could not withdraw funds from their PRA prior to retirement, determined either by age or PRA balance requirements. PRA funds are the property of the individual. Upon death, remaining funds would become part of the individual's estate.

PRAs would be managed by the private investment industry in the same way as 401k plans or IRAs. Individuals would be free to choose the fund manager that best met their individual needs and could change managers whenever they wished. The government would establish regulations on portfolio risk to prevent speculation and protect consumers. Reinsurance mechanisms would be required to guarantee fund solvency. One way to protect against excess risk would be to have PRA fund balances reported in two categories. All funds up to a calculated minimum requirement would be designated as "Basic" fund balances. "Basic" fund balance limitations would be calculated by determining 110% of the present value of the actuarially determined retirement annuity necessary to provide a real monthly income after retirement equivalent to the current national minimum wage. The future annuity cash flow could be discounted using the current 1-year T-Bill rate, providing an expected real rate of return without long-term inflationary expectations. "Basic" fund balances would be subject to asset allocation restrictions that would limit the risk to which they could be subjected. For example, there may be a limitation on how much of the portfolio could be placed in common stocks.[5] Funds accumulated above the "Basic" fund balance would be reported as "Discretionary" fund balances. "Discretionary" PRA balances would not be subject to the asset allocation restrictions of "Basic" balances and would, therefore, be eligible for a wider range of investment options.

In addition, the government could maintain a safety net, guaranteeing a minimum pension benefit. The minimum pension could be set to a benchmark such as the minimum wage. If upon retirement the balance in an individual's PRA is insufficient to provide an actuarially-determined retirement annuity which would provide a real monthly income equal to the minimum wage, the government would provide a supplement sufficient to bring the individual's monthly income up to the level of the minimum wage. Given historic rates of return from the capital markets, even

[3] William Shipman, "Retiring With Dignity: Social Security vs. Private Markets," Cato Institute Social Security Paper no. 2, August 14, 1995.

[4] For a detailed discussion of what a privatized Social Security system may look like, see Karl Borden, "Dismantling the Pyramid: The Why and How of Privatizing Social Security," Cato Institute Social Security Paper no. 1, August 14, 1995.

[5] There are many possible formulas to restrict such risk. For example, Karl Borden proposes the following: 100% of basic fund balances could be invested in a diversified portfolio of corporate and government bonds with a portfolio duration matched to a planned retirement age. No bond rating requirements would apply, but diversification must be adequate to eliminate 95% of non-systematic risk from the portfolio. No more than 25% of the fund could be invested in government securities, "agency" issues, or government-guaranteed debt. Up to 50% of the portfolio could be invested in diversified funds of equity securities. Equity securities would be limited to those traded on the New York, American, or NASDAQ exchanges, and portfolios must be sufficiently diversified to eliminate 95% of non-systematic risk. Although investment in broad-based index funds would be permitted, no trading in derivative securities would be allowed other than those necessary for hedging strategies associated with reducing cash demand risks and smoothing variances from index returns. Systematic risk for eligible portfolios would be limited to a portfolio maximum beta of 1.05.

a minimum wage earner will receive more than this minimum from the new system if he or she participates their entire life. Therefore, in the absence of a major financial collapse, the safety net would be required for few aside from the disabled and others outside the workforce.

Those presently in the workforce would have the option of remaining in the current Social Security system or switching to the new private system. Individuals entering the workforce after implementation of the private system would be required to participate in the new system. Thus, the current system would eventually be phased out.

It is important to realize that the idea of privatizing Social Security is not completely untested. Chile's Social Security system predated ours, having started in 1926. By 1981, Chile faced the same difficulties as presented by the U.S. Social Security system today. In response, Chile privatized its system.[6]

The new Chilean system which went into effect on May 1, 1981, is a true "defined contribution" pension plan with mandatory contributions of 10% of earnings for program participants. The pension available from the system is simply that which is actuarially computed from the accumulated contributions.

When the new system began, those in the old system were given the option of switching to the new. After 1982, all new employees were required to join the new system. As of 1992, approximately 90-95% of all persons under the old system had shifted.

Contributions to the system are paid entirely by the employee, with no employer payroll tax to support it. At the initiation of the system, however, all employers were required to give a wage increase of 18% to all employees, approximating the increased cost to the worker but less than the reduced cost to the employer of the new system.

Pension funds are invested in security portfolios administered by private organizations known as "Adminstradoras de Fondos de Pensiones" (administrators of pension funds, or AFPs). Twenty-one AFPs, which compete with each other on the basis of investment returns and service, are closely regulated, complying with government mandated financial and investment requirements. Each worker chooses the AFP in which he wants to participate, and may transfer fund balances at his own discretion up to four times per year. Like any other mutual fund, the AFP invests fund balances in a portfolio of securities, and charges the portfolio an administrative fee for its services. Fees are a combination of a flat monthly percentage plus a percentage of earnings, and the AFP fee charges are well publicized so that individual workers may consider the charges in their choice of funds. Fees average 1% of total wages, down from more than 2% since the system was started. Several of the funds, in fact, are owned and operated by U.S. investment firms. Provida, with 25% of the system's assets and the largest AFP, is 42% owned by New York-based Bankers Trust (acquired as part of a $45 million debt-for-equity swap in 1986), and Santa Maria, the second-largest AFP, is 51% owned by Aetna Life & Casualty of Hartford, Connecticut.

AFP asset allocation, however, is strictly regulated by the government. Portfolios must consist of no less than 50% investment in government obligations, "agency" issues of other government-guaranteed securities leaving no more than 50% of the portfolio that may be invested in private-sector securities. Common stocks may comprise a maximum of 30% of the portfolio (with no more than 7% of the total in any one company and no more than a 7% stake in any particular company). Finally, only stocks on a government-approved list may be purchased. No foreign securities have made the list.

The entire system provides for automatic market indexation by translating contributions into investment units. Investment unit value is calculated similarly to a mutual fun Net Asset Value (NAV), taking the total current value (in pesos) of the total funds of the AFP divided by the total number of investment units of all members at a point in time.

Minimum retirement ages are 65 for men and 60 for women. Participants may, however, retire earlier if the pensions payable is at least 50% of their average earnings over the previous 10 years and 100% of the legal minimum monthly wage.

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[6] For details of Chile's experience with privatizing Social Security, see Jose Pinera and Mark Klugmann, "The Chilean Private Pension System," International Center for Pension Reform, Santiago, Chile, 1995; Luis Larrain, "Social Security Reform," in Christian Larroulet, ed., *The Chilean Experience: Private Solutions to Public Problems* (Santiago, Chile: Center for International Private Enterprise, 1991); Marco Santamaria, "Privatizing Social Security: The Chilean Case," *Columbia Journal of World Business*, (Spring 1992); Robert Myers, "Chile's Social Security Reform After 10 Years," *Benefits Quarterly*, (Third Quarter 1992); and Saul Hansell, "The New Wave in Old Age Pensions" *Institutional Investor* (Nov. 1992).

Three alternative methods for determining the pension value are available at the participant's discretion: a. The accumulated contributions may be used to purchase a life annuity from a private insurance company. Annuities must be government approved and must include survivor benefits for dependents.

b. The retiree may elect to receive a pension paid from the AFP directly. It is calculated using the life expectancy of the family group applied to the balance remaining in the account, which continues to earn income based on the AFP's performance.

c. A partial withdrawal may be used to purchase a private annuity with the remaining paid out directly from the AFP.

Perhaps the most innovative feature was the means by which the Chilean government sought to provide for transition to the new system. The government issues "bonos de reconocimiento" (recognition bonds), which effectively recognize the value of the obligation incurred by the government (the taxpayers) to those who have participated in the old system.

"Bonos" are available to any worker who had at least 12 months of contributions to or coverage under the old system in the 60 months prior to the start of the new system. The calculation of the "bonos" due an individual system participant is technically complex, but provides the financial mechanism for the transition to the new system. An alternative method of calculation allows anyone who contributed to the old system after July, 1970, to receive value for the participation. "Bonos" are essentially government bonds that pay 4% annual interest and add to the accumulated contribution value of the AFPs at the time of retirement. Interest on the bonds is paid out of the government's general revenue fund and is in no way supported by the new pension system.

Finally, a minimum retirement pension is payable to individuals with at least 20 years of contributions to the old and new systems combined. Disability cases have a two year contribution requirement. The minimum pension is set at 85% of the government-mandated monthly minimum wage, but does not apply to workers in the "informal" labor market who have never contributed to a plan. Disability and survivor benefits are not paid from the 10% contribution to the AFP. An additional required contribution (variable by AFP and averaging about 1.5%) is collected by the AFPs and paid to private insurance companies to purchase private insurance coverage for the group of workers contributing to that AFP.

The success of Chile's public pension privatization can be measured in many ways. Whereas in the late 1970s there were virtually no savings, now the cumulative assets managed by AFPs are about $23 billion or roughly 41 percent of GDP. During the past decade Chile's Real GDP growth has averaged over 6 percent, more than double that of the U.S. And for the five years ending 1994 the annualized total return of the Chilean stock market was 48.6 percent versus 8.7 percent for the U.S. But most important, beneficiaries are receiving much higher benefits. Since the privatized system became fully operational, the average rate of return on investment has been 13 percent per year. As a result, the typical retiree is receiving a benefit equal to nearly 80 percent of his average annual income over the last 10 years of his working life, almost double the U.S. replacement value. Chile's reforms are seen as such a huge economic and political success that countries throughout Latin America, including Argentina, Peru, and Columbia, are beginning to implement similar changes.[7]

Obviously the Chilean model cannot be directly imported to the United States. There are many differences between the two countries economies and cultures. In addition, there are areas where the Cato Institute believes the Chileans were to restrictive or made other errors. However, the Chilean experience shows that the privatization of Social Security can be carried out successfully.

The most difficult question for any proposed privatization of Social Security is the issue of the transition.[8] Put quite simply, regardless of what system we choose for the future, we must continue benefits to today's recipients.

At the same time, however, we should understand that the design of a new system has nothing to do with the liabilities that (rightly or wrongly) have been accrued in the past. The government's obligation to current (and even future) retirees

[7] See Alexander Estrin, "Peru's Privatization Option for Pension and Health Systems," *Social Security Bulletin* 55, no. 3 (Fall 1992): 79; G. Ricardo Campbell, "Argentina Approves a Privatization Model for Social Security," Social Security Bulletin 56, no. 4, (Winter 1993): 99-100; and G. Ricardo Campbell, "Columbia Moves Closer to the Privatization of Social Security," *Social Security Bulletin* 56, no. 2, (Summer 1993): 52.

[8] The Social Security Administration puts the transition cost at $6.9 trillion. Geoffrey Kollman, "Social Security: The Chilean Example," CRS Report for Congress, 95-839 EPW, July 27, 1995.

is unchanged by a decision to privatize the system. What does change is the willingness to acknowledge currently unfunded liabilities. The commitments entered into by the federal government as a result of spending current Social Security receipts are what financial economists call a sunk cost. The liability has already accrued and exists whether we privatize the system or not. In the future the government, if it is to honor its commitments, will be forced to either tax or borrow additional funds from the private sector to finance the cash outflows necessary to meet these obligations.

Still proponents of privatization bear the responsibility for suggesting funding mechanisms for the transition. The reality is that the transition will probably involve some combination of four approaches.

The first of these is a partial default. Any change in future benefits amounts to a partial default. This could range from such mild options as raising the retirement age, reducing COLAs, or means-testing benefits to "writing off" obligations for individuals under a certain age who opt into the private system.[9]

For example, any individual under the age of thirty who chooses the private system may receive no credit for past contributions to Social Security.

The second solution to the problem of unfunded liabilities is one that provides for the recognition of the present value of those liabilities in the form of government bonds to be issued to current system participants and taxpayers. Once we have decided on the extent of the limited defaults the system will tolerate, it is not a difficult calculation to determine the moral (if not legal) stake each working American currently has in the implied promise of the current Social Security system to each of us. The system currently calculates a figure known as a "Primary Insurance Amount" (PIA) based on a review of the taxpayer's average monthly earnings from employment covered by the program. "The PIA is the benefit for a single retired worker who starts receiving his monthly Social Security check at the normal retirement age."[10] Normal retirement age is now 65, but will rise to 66 in 2008 and to 67 in 2027 (and could, as above, rise further with further system defaults). Benefit computations are based on earnings during the 35 years of highest covered earnings up to age 62 (or the worker's age when he or she applies for benefits, whichever is later), and the wages in each year of the earnings record before age 60 are multiplied by an index factor to take into account the growth in national average earnings since that year. The result is the individual's "average indexed monthly earnings" (AIME), which is then multiplied by percentages that are weighted to favor low-income earners to finally determine the Social Security benefit.

The AIME can be used to calculate for each American worker today his or her expected retirement benefit given tax "contributions" to the system to date. Current retirees' benefits are, of course, already determined. The present value of the actuarially-calculated annuity due each system participant may then be easily calculated discounting at the T-Bond rate, and each system participant can be issued zero-coupon T-Bonds maturing at their projected retirement date. The bonds would be placed in each individual's PRA.

It is important that these zero-coupon Treasury securities then be allowed, in turn, to trade on the secondary market. Within the limitations already described for Basic fund balances, both current retirees and prospective retirees should immediately begin to personally manage their PRAs according to their own risk preferences, thus increasing the diversification benefits of individual PRA portfolios and maximizing personal liberty. A third method of financing the transition would be continue a small portion of the current payroll tax. For example, workers could be allowed to invest 10 percent points of the current 12.2 percent OASDI payroll tax, with 2.2 percentage points continuing to fund a portion of current benefits.

Finally, Congress could identify additional spending cuts and use the funds to pay for the transition cost. For example, the Cato Institute has identified more than $80 billion in corporate welfare that could be eliminated.[11]

In conclusion, we must realize that Social Security is an unfunded pay-as-you-go system, fundamentally flawed and analogous in design to illegal pyramid schemes. Government accounting creates the illusion of a trust fund, but in fact the government spends excess receipts immediately. The liabilities already created are unrecognized by the government accounting system, but represent sunk costs that cannot

[9] The Supreme Court has already held in *Fleming* v. *Nestor* that workers have no property rights associated with the Social Security system, including no legal claim to either their accrued contributions or their anticipated benefits.

[10] Pamela M. Terrell, "Social Security: The Search for Fairness" *Editorial Research Reports by the Congressional Quarterly,* April 5, 1991.

[11] Stephen Moore and Dean Stansel, "Ending Corporate Welfare as We Know It," Cato Institute Policy Analysis no. 225, May 12, 1995.

be recovered. Only adjustments in spending patterns can pay for those commitments. The choice remaining is between continuing to support a bankrupt system, or building a financially sound structure for the future.

Only private pensions with individual property rights to accumulated fund balances can create a secure pension system. Evidence of such a system's effectiveness is available from the example of Chile, which privatized its system in 1981. The plan has been a success but stops short of full privatization. Various plans have been proposed for the U.S., but each suffers the effects of compromise with central-planning approaches.

A plan that achieves the dual objectives of security and personal liberty would divert current OASDI payments to private Personal Retirement Accounts, similar to Individual Retirement Accounts (IRAs), managed by the financial securities industry. Modern risk-management methods should be used to minimize risk for the portion of the account necessary to finance minimum retirement needs. Personal risk preferences should be allowed to guide the investment of fund balances in excess of the minimum.

Transition to a new system requires a recognition of current intergenerational commitments and makes choices that minimize transactions costs as we liquidate obligations to ourselves and integrate system liabilities into a privatized financial structure.

Thank you, I look forward to answering you questions.

COMMUNICATIONS

STATEMENT OF STEVE KOFAHL

SOCIAL SECURITY ADMINISTRATION CLAIMS REPRESENTATIVE

REPRESENTATING THE

AMERICAN FEDERATION OF GOVERNMENT EMPLOYEES

AFL–CIO, LOCAL 3937

AND

NATIONAL COUNCIL OF SSA FIELD OPERATIONS LOCALS

Mr. Chairman, Members of the Committee, thank you for the opportunity to offer this statement on behalf of the American Federation of Government Employees, AFL–CIO.

BACKGROUND

The Social Security Administration has been increasingly unable to properly fulfill its public service mission and stewardship responsibilities over the past 10 years. These problems have been well-documented in testimony by AFGE and others concerned about SSA. The Agency cut its workforce by 17,000 positions in the late 1980's, and made unrealistic forecasts that future systems improvements would make up for it. Automation could not make up for the losses, and the situation has worsened as disability workloads and other responsibilities have grown much faster than predicted. We are now faced with the prospect of another round of cuts, and more promises about the efficiencies to be realized from automation. The crisis has been exacerbated by a lack of strong, stable, responsible leadership and by the continued politicization of the Agency and its programs. Things would be far worse if not for the efforts of the dedicated, experienced employees who remain.

We wonder when SSA will start acting like an independent agency by asking Congress and the Administration for what is so desperately needed, authority to hire and train more direct public service workers. Social Security is too important to the public to be further crippled by the meat axe approach to cutting the Federal workforce. By refusing to invest in hiring and training, SSA is being "penny-wise" and "pound-foolish."

Disabled individuals wait far too long for medical decisions. On the other hand, we are entitling people who should not receive benefits, and keeping others on the rolls after they have recovered. We save "pennies" in administrative costs by keeping staffing too low, and waste "pounds" by net payout of excess benefits.

Quality and integrity reviews, already inadequate, are being further reduced. Investigation and prosecution of fraud and abuse gets little attention and almost no resources. This depletes the Disability Trust Fund for Title II, and the General Fund for Title XVI, and causes further loss of public confidence in these programs and in Government at large.

PRIVATIZATION IS NOT THE ANSWER

Unwilling to champion the clear need for substantial increases in staff, SSA leadership has turned to others who wish to do the Agency's work, and intends to expand this collaboration. SSA claims that 6%-7% of disability claims are currently taken by "third parties."

State and local government agencies, non-profit organizations, and for-profit businesses are involved. Most operate with little or no oversight from SSA, and their employees/volunteers typically have little or no training. None are as qualified as SSA's own employees, and they do not receive similar ongoing training and access

to instructions needed to properly take applications for our complex and constantly-changing programs. All are motivated to get their clients transferred from other income support and/or medical insurance programs to Social Security and/or SSI benefit rolls and Medicare and/or Medicaid.

For-profit businesses are paid well if they generate awards, little or nothing for taking claims which end up as denials. For instance, one of them receives $700 for an award and nothing for a disallowance, another a $125 filing fee only if the claim is denied but $1500 if allowed! These natural conflicts of interest distinguishes them from Federal employees whose duty it is to ensure that only eligible individuals become entitled, and then only to the amount in benefits due them under the Social Security Act.

It is also a conflict of interest for authorized representatives to "assist" SSA in taking initial claims, then represent the claimant against the Agency for a fee at a later hearing.

We know that allowing non-Federal employees to become involved in critical claims-related functions which are inherently governmental in nature can harm program administration, applicants, and taxpayers. The Agency has refused to code these "third party" claims for quality and integrity review purposes, to review the claims, or to conduct any cost-benefit analysis, despite the recommendations we have been making as this activity increased over the last 5 years.

Fortunately, we do know about the independent evaluation of the SSI Outreach Demonstration Program by Sociometrics Corporation, the expanding investigation of interpreter fraud in the SSI program, systems security risks identified by computer experts, Privacy Act issues, and the experiences of our own employees. On the basis of our knowledge and experience, we can evaluate the Allsup Inc. proposal and the Statement of Representative Tom Davis presented on May 24 to the Committee.

THE SSI OUTREACH DEMONSTRATION PROGRAM

Since 1990, Congress has appropriated at least $27 million in grants for the SSI Outreach Demonstration Program. Additional costs have been borne by local SSA field offices who train grantee personnel, correct obvious mistakes on forms received from them, and process the referrals or claims. SSA pays up to 95% of the administrative costs of agencies which are awarded contracts. Grantees once only screened and referred potential applicants; but have become increasingly involved in taking, developing, and documenting both SSI and Social Security Disability Insurance benefit applications. Non-profit, for-profit, and state or local government agencies are eligible to apply for grants under the latest version of the Program.

The Sociometrics Corporation's August 1994 Report revealed that after the first 4 years only 4,544 applicants had been awarded benefits through this Program! AFGE assures the Committee that SSA workers are far more productive, and is convinced that private sector efficiency would be worse yet due to the need to make a profit and the absence of any unpaid volunteer claim-takers. High turnover of grantee volunteers and employees, poor management, and underestimation of the difficulty of the work, were cited as problems in a number of the 31 projects which were evaluated. Large numbers of applicants were incorrectly "screened-in" as eligible by the grantees, causing a lot of unnecessary processing work for SSA's employees. Most alarming was the discovery that some applicants were incorrectly "screened-out" as ineligible, but later applied with SSA anyway and were determined to be eligible.

SSI INTERPRETER FRAUD

SSI fraud perpetrated by applicants, "middleman" interpreters (including state and non-profit agency employees), and physicians is currently being investigated by SSA employees serving on national and regional multi-component task forces. Middlemen complete the medical questionnaire part of the disability claim, arrange for the manufacture of medical and non-medical allegations and evidence, charge fees to applicants illegally, and accompany them to Social Security offices and medical exams. Applicants do not know that SSA will provide service directly without charging a fee, and many who are in fact disabled and eligible are taken advantage of by these third parties. Hundreds of individuals have been implicated in the Tacoma and Vancouver areas in Washington state alone, and millions of dollars paid out erroneously. The problem in Seattle appears to be bigger, but has not yet been fully investigated. Significant activity has been uncovered in Texas and California, and probably is occurring in many other states.

This scandal was the subject of a hearing of the House Ways & Means Committee Subcommittees on Oversight and Human Resources in February 1994. Commissioner Chater announced that one of SSA's administrative initiatives would be to

establish a database identifying available, reliable interpreters and translators for our employees to use. We are still waiting for the interpreter database, and we do not even have national directories of SSA employee interpreters and translators for our interviewers to use.

We have learned the following, and must not forget these lessons when considering other initiatives to privatize or collaborate with other organizations:

1. Given the opportunity, some people will steal from the most vulnerable individuals as well as the taxpayers at large.
2. SSA loses control of the claims process when others are involved in completing applications, recording information and documentation, and gathering evidence.
3. We cannot afford not to review cases. It took years for this scandal to be exposed. If we were doing timely continuing disability reviews and SSI Redeterminations in person, and comprehensive quality and integrity reviews, millions of taxpayer dollars would have been saved. Staff and resources, and a strong commitment from Management, is needed.

RISKS TO SYSTEMS SECURITY AND PRIVACY

SSA had planned to allow electronic filing by 3 Outreach Demonstration Project grantees beginning in April, and to other third party claim-takers as part of Disability Redesign beginning in August. These plans were put on hold due to concerns raised by AFGE and by a March 18 article in the Baltimore Sun. H&R Block, Allsup Inc., and other private sector entities have been lobbying for electronic access to file disability claims. SSA's REGO II initiatives call for electronic filing of retirement claims by businesses on behalf of their employees.

Computer experts insist that no "fire wall" can be built which would exclude skilled hackers from SSA's vast databases if electronic filing of applications by third parties is allowed. Numerous intrusions into supposedly secure systems have been documented in the media. There must be no tolerance for any initiative which compromises systems security and the privacy of individual Americans in any way.

Funds could be stolen electronically by setting up phony claim records in SSA systems, money diverted from existing records to "representative payees" and through direct deposit to bank accounts, data could be changed on existing records to change payments, and earnings records could be altered.

In violation of the Privacy Act, the Agency currently permits volunteers and non-SSA employees in SSA field offices to have direct access to many kinds of records. It has also given some state employees direct access to Social Security Number records and other electronic systems of records, and expects to open these private files to other states. These non-Federal employees are not subject to the Privacy Act, and could not be sanctioned for violating it. SSA intends to allow the public direct access to its earnings files next year via kiosks and the INTERNET. Long-range plans would allow everyone direct access to databases to file claims, and to change addresses and other information.

Agency leaders have shown irresponsible disregard for their duty to protect the privacy and financial security of Americans. Congress and the public must insist that records be secured and not compromised by SSA's reliance on third parties, or on individual self service, where there is any possibility that an individual could access records on others. It was reported that former Commissioner Dorcas Hardy lost her job in 1989, in part, because of an arrangement by which SSA verified Social Security Numbers for a credit agency. It seems that Agency leaders still do not take seriously their responsibilities to protect the extensive private information held in our files on virtually every American.

SSA EMPLOYEE EXPERIENCE WITH THIRD PARTY CLAIMS "ASSISTANCE"

The Agency has not been interested in determining how many people have lost benefits, been paid incorrect amounts, or received money not due, as a result of third party involvement. Claims are taken by people who have little or no training, and natural conflicts of interest. They are then submitted to our employees to be processed. Quality and integrity are traded off for the expediency of having someone else take applications, which is supposed to offer relief to our decimated workforce. In reality it often delays the process for the applicant, and creates more work for SSA employees.

Third parties frequently take weeks to get applications for benefits to SSA for processing, which delays initiation of development and the decision. The delay can cost the individual benefits if a filing date is not properly protected by the third party. Few of them know enough about Social Security child, spouse, and survivor benefits to identify potential entitlement; again causing potential loss of benefits.

Claims Representatives must load paper applications from third parties into automated systems, but normally take claims directly on the system themselves. Paper claim questions and format are different than those for automated claims, so do not translate perfectly. SSA employees must make another contact or guess at the answers, which is either inefficient or puts quality at risk.

Recontact with applicants is often necessary to complete the claim file and resolve obvious errors and inconsistencies. Our Claims Representatives recognize when supplemental forms are needed and have them available, and the need to ask necessary follow-up questions not on the forms. Cleaning up third party errors and omissions becomes especially difficult and delays case processing when we are required to deal with a third party serving as authorized representative. We are then required to go through them rather than deal direct with the claimant. An SSA employee may have to call Kansas to request information about an individual who lives in the employee's own small community in Washington state, for instance. This causes more delays.

Third party authorized representatives demand that SSA employees photocopy files for them, send copies of notices and computer screens, etc. This creates additional work for Claims Representatives, since we have virtually no clerical support in field offices, and takes us away from claims processing work.

A Social Security employee typically has no direct contact with the claimant, which raises concerns about identity and possible fraud. We are concerned that widespread program integrity problems similar to those being identified in the interpreter fraud investigations are occurring in other kinds of third party situations. It also means that claimants are not receiving proper and complete reporting instructions, and our employees increasingly report that this is causing more overpayments which cannot be recovered. Allegations of "without fault" by beneficiaries who were not advised of their responsibilities to report changes lead to decisions to waive overpayments rather than collect them.

Some specific problems reported to us regarding actions particular for-profit third parties involved in the claims process include:

1. intentionally failing to list all income on applications.
2. altering applications by changing answers without the applicant initialing the change.
3. persuading claimants to waive the right to an oral hearing, to save administrative (travel) costs for the authorized representative.
4. withholding medical evidence in early stages so that claims go through the entire appeals process before being allowed, thus increasing the fee that SSA authorizes as a percentage of back pay to the claimant representative.
5. overcharging claimants by assessing fees both within and outside the fee petition process.
6. selective medical documentation to ensure allowance of claims, because a contract claim-taker is paid by an insurance company only if allowed.
7. claimant representatives tape-recording initial claim interviews with SSA employees and creating a hostile, adversarial relationship between the claimant and SSA.
8. abuses in preparing, and charging fees for development of, Plan for Achieving Self Support (PASS) plans.

REGO II

The Agency's charge under REGO II, to increase the number of Social Security Retirement claims filed by employers for their employees, has not been well-received so far by businesses. They see no advantage for them to take on SSA's work and are suspicious that it will become mandatory in time. They offer integrated pension programs, where there is an offset due to Social Security, less often than in the past, so do not need to know the amount of the Social Security payment. They are concerned that they could be held liable if they do something wrong in taking, developing, or documenting a claim that would harm an individual. SSA intends to keep trying to generate interest.

THE MYTH OF THE SIMPLE CLAIM

Many people inside an outside of the Social Security Administration who do not themselves take, adjudicate, or review claims operate under false impression that certain kinds of claims are "simple." Retirement applications are often characterized this way. The implication is that these can be taken, developed, and documented properly by interviewers who have little training and experience. In reality there is no way to tell if any claim, no mater what kind it is or appears to be, will be "simple." Few turn out to be.

Social Security benefit applications are legal documents, and until each on is adjudicated, it is an application for all benefits which may be payable. Only careful interviewing by a fully-qualified SSA employee will ensure that entitlement to each type of benefit that exists is considered. A qualified interviewer must be knowledgeable about dozens of little-known benefits addition to the better-known retirement, disability, spouse, and survivor benefits. For example, entitlement may be available to a divorced individual on the record of living or deceased worker. We pay totalization benefits under a growing number of international agreements which credit workers for their coverage under social security systems of other countries.

Benefits can be lost when potential entitlement is not recognized and a claim not taken during what appears to be an early contact, because we cannot ordinarily pay benefits for months before the month of filing. Benefits based on age can begin before age 62, as early as age 60 or even 50 for certain benefits. Full-time employees, even those with high earnings who intend to stop or interrupt work later in a year, may need to fie while still employed in order to receive correct payments.

In order to entitle people to the proper check, our interviewers must know which benefits from other sources result in an offset, which types of payments from employers or from self-employment require withholding of benefits, and be trained to identify and correct earnings record posting problem. Earnings record problems create significant risk of payment error, particularly because of the need to credit military service and due to especially significant earnings posting problem for years before 1951 and after 1977.

CONCLUSION

Americans pay more and get less when the most sensitive, critical, complex responsibilities of the Social Security Administration are turned over to others.

Their charitable contributions must increase to support non-profit organizations who take, document, and develop benefit applications.

Their state and local taxes fund such activities by state and local government employees. Their fees to authorized representatives cost them up to $4,000 in retroactive benefits which they would otherwise receive. They pay more for goods,services, and insurance premiums when businesses' insurance companies pass along the cost of hiring private sector claim-takers to do SSA work. Federal taxes are increased to pay for demonstration projects and contracts which are far more expensive than increasing the number of SSA employee service providers.

Handling by third parties can add delays at various stages of the claim process, increase SSA administrative costs, and result in loss of benefits to individuals.

Fraud by "middlemen" has already cost all of us many millions of dollars in Washington state alone. This no doubt represents just the tip of the iceberg. SSA must finally take responsibility for evaluating and monitoring quality, integrity, and cost of third-party claims.

We have seen plenty of evidence in other agencies of the terrible risks involved when we rely too much on the private sector: those spendy Defense Department hammers were from a contractor, the U.S. mail was dumped in Chicago by contractors, the Space Shuttle "O" ring was from a contractor, and the $5 billion/year in fraudulent earned income tax credit refunds were obtained primarily through electronic filings via H&R Block and others in the private sector.

We cannot afford a similar disaster at SSA. We are at a crossroads, and absent responsible Agency leadership it is incumbent on Congress to lead us down the good government path.

There must be no tolerance for compromising systems security and privacy. Current violations must be dealt with immediately, and future initiatives planned very carefully to ensure that laws are adhered to, and individual rights protected.

I thank the Chairman and the Committee for considering this testimony, and welcome any requests for more information and documentation.

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