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PROPOSALS TO CREATE PERSONAL SAVINGS ACCOUNTS UNDER SOCIAL SECURITY

HEARING

BEFORE THE

SUBCOMMITTEE ON
SOCIAL SECURITY AND FAMILY POLICY

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

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MONDAY, MAY 20, 1996

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

The hearing was convened, pursuant to notice, at 10:05 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Alan K. Simpson (chairman of the subcommittee) presiding.

Also present: Senators Nickles and Breaux.

OPENING STATEMENT OF HON. ALAN K. SIMPSON, A U.S. SENATOR FROM WYOMING, CHAIRMAN, SUBCOMMITTEE ON SOCIAL SECURITY AND FAMILY POLICY

Senator SIMPSON. The subcommittee hearing will come to order. I do appreciate the presence of my good colleague from the neighboring State of Nebraska and my good colleague from the far non-neighboring State of Louisiana, John Breaux, the ranking member of this subcommittee, whose presence and support and assistance I appreciate as in a tough issue, tough, political issue.

I realize that it is not June 1. I have my ice cream suit on which is not appropriate actually, but that is good. [Laughter.]

That is very appropriate I think, but when it gets 100 degrees, you do not care what the little protocols were that you learned wherever it was in the great far-flung early days of your secondary education: You can't wear that until June 1. That is hogwash.

To Don Nickles, one of my friends from Oklahoma, who also has a great continuing interest.

I have an opening statement of a bit of detail, but I know how this place works.

Senator Kerrey, I know that you have other things to do, but I welcome you to this subcommittee hearing on Social Security and Family Policy.

Today, we are going to hear from a group of distinguished witnesses about the potential role of personal savings accounts within, or even as a replacement for, much of the Social Security program.

We will be examining whether these accounts can help us to restore solvency to Social Security and also whether they may be an effective means to increase national savings.

Again, I want to thank John Breaux and also the ranking member of the full committee, Daniel Patrick Moynihan, for their continued and appreciated interests, and Senator Roth, the Chairman of the full committee who has given me extremely generous support in this work and because these people here and Senator Breaux and Senator Kerrey and Senator Nickles will have to carry on and have the opportunity in future sessions of Congress to tackle this eternal problem. We will continue to benefit from their stewardship.

We will surely need their valuable dedication to ensure that Social Security is there for future generations and that the retirement lifestyle of future seniors remains at a level that is hopefully comparable to that enjoyed by today's retirees.

I am going to add the rest of my remarks at the conclusion of Senator Kerrey's remarks so that he might be on his way with three other competing subcommittee meetings or committee meetings or whatever it may be.

So welcome to the subcommittee. We look forward to your remarks, my friend.

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

Senator KERREY. Thank you very much. Chairman Simpson and Senator Breaux and Senator Nickles, I appreciate a chance to once again appear before your subcommittee and specifically this opportunity to talk about S. 825, the personal investment plan, also called the Strengthening Social Security Act of 1995.

Mr. Chairman and members of the committee, I see the PIP, the Personal Investment Plan in S. 825, as not only an innovative way to strengthen the Social Security program, but an important way, a very important way to allow Americans, especially middle-income Americans to accumulate wealth.

Most Americans or at least many Americans have been misled perhaps by our own political rhetoric about the current state of the United States' economy. They presume, listening to us talk, that America is either bankrupt or that we are poorer today than we were 10 years ago, 20, 30, 40 years ago.

Mr. Chairman, this country is neither bankrupt nor is it poorer than we were 10, 20, 30, 40 years ago. It is considerably wealthier than any other nation and considerably wealthier than we were even a decade ago, let alone 20 years, or a generation ago.

Why are we wealthier? Well, Mr. Chairman, although it is simple to say, it is not simple to do. We are wealthier because Americans have invested. We are wealthier because we have produced. We are wealthier because we have created that wealth, created it with innovation, created it with hard work. We have created a wealthier place to live.

A second myth that we have perpetuated on the American people is that the Federal taxes as a percent of our economy is growing.

They are not. The proportion of taxes that have been collected by the Federal Government, except for World War II and a brief period of time during the Vietnam War, is approximately the same as it has always been, about 19 percent of GDP.

Our economy is strong. We are wealthier than we were 10, 20, 30, 40 years ago. Yet our people feel more vulnerable and insecure about their financial future.

Now, many have argued and I have found myself in that camp as well, that if we balance our budget, we will create savings and promote economic growth.

While I believe strongly that that is indeed a necessary and a very important step toward addressing our financial problems, I believe it is only part of the problem.

A much larger problem, Mr. Chairman, is that we neither collect our taxes with savings and productivity in mind nor spend it with the goal of promoting long-term economic growth.

As to the way we should be collecting our taxes, let me simply say that I am an advocate of replacing our current income tax system with a progressive consumption tax that would not only promote economic growth, but also promote an opportunity for Americans to generate personal savings and personal wealth.

However, I would like instead of talking about the tax side this morning, since you have invited me talk about the Personal Investment Plan, to point to another problem, in many ways, larger than the problem of the budget deficit itself, because the difficulty, the degree of difficulty of solving the problem is much larger.

That is that entitlement spending and specifically middle-class entitlement spending, Mr. Chairman, as a percent of our budget continues to grow.

In fact, entitlement spending will grow to a point by the year 2012, which is not very far from now, to devour the entire Federal budget along with interest on the debt. The entire Federal Government will be reduced to a virtual automatic transfer machine, transferring money out to mostly middle class people.

Now, the Federal Government has not always spent its money that way. In 1963, when President Kennedy was in office, for each dollar the Government spent, it had discretion over $.70.

Such amounts were spent on technology, education, infrastructure, NASA, defense, et cetera, typically future-oriented expenditures that promoted future economic growth.

Thirty cents in 1963 was immediately obligated for paying off past debts and entitlement programs. By the year 2003, however, our priorities will have completely reversed.

Seventy-two cents of each dollar the Federal Government spends will be going to entitlements, with a mere $.23 on the dollar going toward the programs that endow our future. Most help our economy to grow.

This fiscal imbalance threatens our implicit intergenerational compact to leave a prosperous and growing economy to the next generation of Americans.

The burden that existing Federal promises will impose on future generations is so great that it also threatens the very existence of the social safety net programs themselves.

This is not about big or smaller government. It is about something much more important. It is about the allocation of resources.

It is about a moral responsibility to the next generation. It is about deciding whether this generation wants to endow our children with a strong and vibrant economy as they enter the 21st century.

It is about taking action to put an end to today's policies which stifle wealth creation and productivity.

The assumption that the two biggest middle-class programs, Social Security and Medicare, are paybacks is false.

When you receive benefits under either one of these two programs, you are not getting back the money that you paid in, the money that is due to you. The amounts that are contributing to Social Security today are not being saved.

Make no mistake about it, the money young workers are being asked to pay into the Social Security system is being spent on benefits for the current elderly or is being borrowed by the Government which is spending it on other things.

The trust funds are Federal IOUs. To pay back those obligations in the future, the Federal Government has to borrow more money like check kiting or will have to raise revenues substantially in the future.

Accordingly, there is no addition to savings that occurs as a consequence of a 15-percent payroll tax. No money is being put aside for the retirement of these young people.

Instead, the Social Security program is a 60-year-old commitment by those of us who are working to allow a fixed percentage of our wages to be taxed to pay for benefits for those who have reached retirement age.

Mr. Chairman, please do not interpret, as I expect some will, that I do not support Social Security. I am a strong supporter of Social Security. I hope I don't have to talk for the next hour about the glories and what this program has done. But as you have so often pointed out, we do not have the same situation as we did in the 1930's, when Americans over the age of 65 were foraging in the alleys for food.

The Social Security trust fund merely represents claims based on the Federal Government's ability to tax or continue to borrow from the next generation of participants in the economy.

The Personal Investment Plan which I have cosponsored along with you, Mr. Chairman, would allow individuals to contribute 2 percentage points of their current payroll tax to a Personal Investment Plan, either an IRA style account or in a fund like the Thrift Savings Plan offered to Federal employees.

Unless you expect to inherit wealth or win the lottery or be a part of tomorrow's Microsoft Corporation, the only way for most Americans to generate wealth is a little bit of savings over a long period of time.

In an era of wage stagnation and diminished take-home pay, as well as an economy where we have taken inflation out and taken the expectation out that a home is going to be a principal source of wealth, it is very difficult for most middle-income Americans to accumulate their own wealth.

By allowing individuals to invest 2 percent of their payroll tax in investments other than Treasury bonds, such as equities, they can expect a higher rate of return and therefore increased wealth.

Instead of depending upon Congress to tell them how and under what circumstances they can use that money, this wealth will be theirs and will be available for more flexible annuity conversion.

I believe we can make Social Security an even more powerful and progressive way to provide retirement security and make it, as well, Mr. Chairman, more relevant to the retirement problems of the future.

The Private Investment Plan would also allow workers to experience the benefit of compounding interest rates. Recent studies have shown that individuals on average have to triple their current level of savings in order to retire in comfort. That assumes no curtailment of Social Security benefits.

The longer an individual waits, the harder it will be to acquire the appropriate nest egg. This is due to the power of compounding.

I would like to provide an example because I think it is very important for citizens who are suffering through this hearing to listen to the details of the difference in accumulating wealth if you start at various ages.

If an individual had invested $500 a year in 10-year Treasury bonds and reinvested the interest beginning at age 25 in 1956, the $20,000 that would be invested over that period of time would have grown to $134,883 by the time he or she turns 65 at the end of 1995.

If the same $20,000 had been invested beginning at age 35 in 1966 at a rate of $667 a year, a larger rate of contribution, that individual would have generated $91,000 at the end of 1995.

Now, if the individual waits until they are 45 and puts $1,000 a year away for $20,000, they still only had $54,000 at the end of 1995.

If, as many individuals do, they wait until their kids are through college and they start to save at that particular point in time at the age of 55, they now have to save $2,000 a year. And $2,000 a year will only generate $30,141 by 1995.

We have got to explain to people, Mr. Chairman, the magic compounding of interest. As you can see in this example, a penney saved can be worth much more than a penny earned.

The Personal Investment Plan would create real savings accounts from the first year an individual enters the workforce, providing for years of compounding interest.

In addition to increasing potential return to investors, the increased investment in the economy, maybe as much as $1 trillion in a single decade spread out over 137 million paychecks, would help provide much needed capital for private investment.

This increase in investment capital would help provide fuel for investment and productive equipment and economic expansion.

With such capital, America can invest in areas such as plants, equipment, technology, and worker training and continue to generate the wealth that we have over the last 40 or 50 years.

These investments lead to more jobs, higher wages, and increased standard of living for all Americans. Such economic expansion would also help address both stagnant wages and the growing trend in wage inequality.

Gary Burtlett of the Brookings Institute attributes much of the decline in wage growth to anemic economic growth.

Beginning in the mid-1970's, the growth and labor productivity in the U.S. slowed dramatically from nearly 3 percent to 1 percent a year, producing a long period of near stagnation of real wages.

Mr. Chairman, wages cannot grow faster than productivity allows. Productivity growth would be greatly enhanced by increasing our national savings rate and resulting investment.

Mr. Chairman, I point out that much of the insecurity in America in my judgment comes not from stagnating wages, but from the inability to put money aside, to save money, and generate the wealth that in the end will provide the stability and the security for Americans.

If an individual makes $500,000 and saves not a single penney over the course of their working life, they will be far more insecure than that wonderful woman in Hattiesburg, MI who made $6,000 or $7,000 a year and saved a very small amount over the course of her life; enough to be able to donate $150,000 to a college that had denied her access when she was a young woman.

That example of generation of wealth is also, I believe, the key to solving the problems of economic insecurity for Americans.

Finally, in addition to the direct upon personal investment plans and upon savings, it 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.

This objective cannot be overstated. Individuals who have a personal account, take interest in their investments, and are cognizant of growth in their wealth over time, they should start to break the yoke of economic anxiety over their future.

This will be a first step in helping to create the personal value of thrift in individuals and the country.

Mr. Chairman, few things irritate me more than to have critics of this proposal say that Americans are too stupid to engage in the kind of clear thinking that is required to make investments, that they simply don't have the talent, that government has got to do it for them, that the Social Security Administration is their only resource when it comes to making investment decisions.

I reject that as a simplistic analysis. I believe there is an increasing number of Americans that are, in fact, acquiring the skills and tools needed to make decisions about a retirement that they know is going to be longer, they know is going to be more difficult, and they know it is going to require them to generate resources in addition to what Social Security provides them.

The great demographic shift that will occur over the next 20 to 30 years will largely shape our Nation's future. It is without precedent.

Seventy-seven million baby boomers will begin to retire in the year 2008, Mr. Chairman. Those who advise that we wait ignore this demographic fact.

They ignore it not at their peril most likely. They ignore it at the peril of those who will retire. Most importantly, they ignore it at the peril of the children of those retired baby boomers.

When certain forces are overwhelming, change is inevitable. So it is with the demographic transformation of America.

The movement of the baby boom generation to retirement coupled with increasing longevity and a shrinking working age population presages a new social equation.

Our responses to those changes will determine the financial well being of our future elderly and the financial strength of our economy.

Individuals of all ages are not prepared to meet the cost associated with living longer. Middle-income Americans' extreme lack of personal savings is evidence of this.

America and Americans need to forge a new financial partnerships, a cooperative venture among businesses, government, and individuals.

The concept is not new, Mr. Chairman. Our system currently relies upon all three. The issue is one of equitable allocation for the future. We must take up the mantle of planning for our own financial needs.

The most direct approach to reducing the financial liabilities of longer life is to save a portion of the cost over a longer period of life beginning much, much earlier in that life.

Saving requires setting aside a portion of current income to provide future income. That is the basis for our personal investment plan.

The Private Investment Plan that you, Mr. Chairman, and I have put on the table is an essential ingredient to creating private wealth.

Some have referred to it as partial privatization, but I disagree. It is individualization of responsibility. It is providing the individual with power and responsibility to create his or her own wealth.

The plan will promote increased self-reliance, boost economic, increase national savings, and help create the wealth necessary to ensure a strong economy for our children as they enter the 21st century.

Mr. Chairman, again I thank you for your partnership in this matter. I thank the full committee for inviting me to testify.

Senator SIMPSON. Thank you very much, Senator Kerrey.

Let me just ask one question. Then, I will go to Senator Breaux if he has any. Obviously, we have presented the Kerrey-Simpson proposal.

There have been other proposals since then, in fact, quite a lot of interest in how to privatize or semi-privatize part of the program and allow personally managed retirement savings accounts.

Have you thought of differences and changes that could be taken with regard to our work based upon these new aspects, a lot of these new proposals?

Senator KERREY. I have, Mr. Chairman. Let me say that one of the things I think is helpful is to change slightly the terms of the debate.

Rather than this being a question of are you for radical change in the Social Security program or are you against radical change in the Social Security program and focusing only on a program that was created in 1935 to solve a problem, better it seems to me to focus on three separate problems that are connected.

The first problem is the one that I mentioned, the generation of wealth and the need to generate wealth.

Second, to change the nature of retirement and the increased insecurity that occurs, in that people face a different kind of retirement than was there in 1935 when normal life expectancy was 59 and the program benefits began at age 65.

Third is the disproportionate and growing disproportionate pattern of expenditures by the Federal Government both on our present and on our future.

What happens as we increase the amount of transfer payments that are paid out, we are decreasing the amount of money that we are spending to endow our future.

We are becoming an entitlement rather than an endowment society. We are, it seems to me, presented with an opportunity when we have a 15-percent payroll tax in place to consider, well, is there any change that we can make in that law so as, No. 1, to increase wealth, and No. 2, to increase retirement security.

Indeed, one of the things that I think can be done, Mr. Chairman, is to begin by saying I believe we should a presumption that whatever that tax is that all of it should either go for health or for retirement benefits at the moment that one becomes eligible.

If you begin with that presumption, one of the things that is available is to consider the possibility of taking the current, not 2 percent over levy, but we are generating, we have a 1 percent over levy. We are generating another 1 percent from interest income.

Take that 2 percent today and let Americans use it to invest. Let them begin to generate wealth now.

It will unquestionably shorten the due date of requiring us to take action with Social Security from about 35 years down to about 20 years.

But we generate tremendous amounts of wealth and I think answer the problem what do you do about wealth and security and retirement and security.

Senator SIMPSON. Let me recognize Senator Breaux who is the ranking member of the subcommittee.

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

Senator BREAUX. Well, thank you, Mr. Chairman. I would thank our colleague, Senator Kerrey, for his longstanding commitment in this area, the work that you all have both done on the entitlement commission.

It is appropriate I would say that we look today through these hearings at some of the options. Of course, privatization to some extent of the Social Security system is one of those options that I think needs to be fully explored. This indeed begins our effort in doing that.

So I commend both of you for your longstanding commitment in trying to find an answer now to what is a very serious problem.

I would just add as a note in thanking Senator Kerrey for his testimony that we have just received from Harry Ballantyne who is the chief actuary for the Social Security system a report on our consumer price index adjustment that we have in the so-called Centrist Coalition Budget Proposal that will be offered I think on the floor this evening and hopefully voted on in the near future.

That CPI adjustment in and of itself would extend the Social Security system's viability to the year 2036 which is a 6-year extension just by taking that step and no other steps.

So it is a complicated problem. There are a number of things that need to be explored. I happen to think that a CPI adjustment that more accurately reflects how much of an increase people who are benefiting from these entitlement programs are entitled to receive is a very important step.

I think that no one can or should argue against making sure that we accurately determine what increase it should be. So I thank you and I thank you Senator Kerrey for your major contribution in this area.

Senator SIMPSON. Thank you very much, John.

Now, Senator Nickles, do you have any comments?

STATEMENT OF HON. DON NICKLES, A U.S. SENATOR FROM OKLAHOMA

Senator NICKLES. Mr. Chairman, first I would like to compliment you and Senator Kerrey for your interest in talking about some of the challenges that we face regarding Social Security.

If I remember correctly, the report said that more money will be going out than coming in by the year 2013.

I think I heard you say, Senator Kerrey, that the so-called money that is in the trust fund is basically an IOU.

So we are going to have to borrow to pay off that IOU. So I think we are going to have real problems beginning much sooner than some people anticipate.

I also want to compliment you for your interest in what the focus of the hearing is today, the personal savings accounts.

I think there is a great deal of merit in taking at least a portion of the Social Security tax and allowing individuals—and correct me if I am wrong—but under your proposals, individuals will be able to invest those funds.

They would control the funds. They would invest those funds if they wished in a bank in Nebraska or in Wyoming, or Louisiana. Or if they wished, they could choose a mutual fund. Or they could choose a Treasury bill. They would have a multitude of options. Is that correct?

Senator KERREY. That is correct, Senator. There are three advantages in that environment. One is you own it, as opposed to a collective transfer as it is existing so that I can leave it to my heirs. It is my wealth. It is a part of my balance sheet.

The second is a much higher rate of return, even if you bought straight Treasury bonds, as opposed to the nonnegotiable Treasury instruments.

The only rate of return that we get today is from an over levy that began in 1983 or 1984. I don't know when the tax actually kicked in.

The design of the program is you buildup this big surplus by about the year 2013. Then, you draw it down over the next 25 or 30 years. That is basically what the program is designed to do.

Any interest that is accumulated is not as a consequence of—and this is a very important because I hear people all the time saying you are spending my money.

The idea was you generated an over levy. That money was supposed to be used for the collectivization. You still don't own it. There is no ownership.

So the first is you own it, a higher rate of return, and third, very importantly, Senator, is that you decide from the age of 59½, you decide how you want to convert that annuity.

The longer that life expectancies extend, the more relevant that fact is going to become because I don't wait until 67 which is what it will currently be for the post-baby boom generation.

I might not even wait until 65. I may want to start it earlier. Or I may want to take a late Social Security check which will enable me to get a larger check.

In other words, that source of wealth will enable me to tailor my retirement needs rather than having to lobby Congress for collective changes in a collective program.

Senator NICKLES. Senator Kerrey, again I compliment you. I think this is a very attractive component and part of the solution to the problem.

I do think by taking a percentage, I would hope that over some time we could allow individuals a lot more than 2 percent of the payroll tax. That is 2 percent of 15.3 if you included the HI.

I was looking at tax rates that we all pay. The 1970 total, HI, Social Security, and disability, in 1970, the total tax was $374. Well, I will say in 1993 because there is no limit now on HI. But that figure is $5,529, an astronomical increase in taxes, in payroll taxes.

So allowing individuals to take a portion and I would hope eventually at least for younger individuals, we could make it where it would be a greater portion of their payroll tax they could keep, invest that in their own bank or the mutual fund, in a fund you pointed out, Senator Kerrey, that they own, that they control. But if they invest wisely, if they choose wisely, they could have a significant appreciation.

Also, correct me if I am wrong, but also as that percentage would increase, Government liability, the Government's future promise of benefits would decrease.

When we had the Social Security Administrator here earlier, I asked what kind of unfunded liability do we have in Social Security. I think it is $9 trillion.

So for younger people, at least younger people, as I would say, give people that option to allow them to invest.

We could let them control a fund right now they are very suspect whether they will ever see. At the same time, reduce Government's outside liability, future unfunded liability which I think is important as well. So I compliment you for your work.

Senator KERREY. Another thing I should say, Senator, is that my own view of it is that for people that are currently 65 years of age and over that are already eligible beneficiaries, they would be unaffected by the proposal.

Unfortunately, those are typically the people to whom we turn to ask, well, what do you think of this proposal?

It is far more relevant to go and ask someone who is 50 years of age. You are making $30,000 a year now. What do you think of this proposal?

What does that mean? Is my bread done?

Senator SIMPSON. You are out of here. [Laughter.]

There is an objection.

Senator KERREY. Am I testifying or cooking here? What's the deal? [Laughter.]

Well, ask someone who is making $30,000 a year today who is at the forward edge of the baby boom generation, 48 years of age. Say to them, OK, you have a proposal on the table.

In fact, we could under current law, let a person who is making $30,000 a year take $600 a year from 1996 until they retire some 15 to 17 years later.

Ask them what do you think about that proposal to be allowed to actually take $600.

I agree with you, Senator, it would be nice to be able to get the dollar amount larger, particularly for lower income.

For people like myself that profess to be Democrats and concerned about lower-income people constantly and middle-income people constantly, there is only one short of hitting the lottery that they are going to become wealthy. That is to set aside a relatively small amount, that full 12 percent they have set aside still with the collective promise.

I am not talking about repealing the collective promise. I still think there is going to be a need for some kind of collective program. But that $1,200 could give that individual a substantial amount of wealth.

So far more relevant for us I think would be ask somebody today, what if we changed the law right now? Yes, it would bring the due date on Social Security closer. It would change the terms and conditions under which we are operating Social Security.

But ask that person who is 48 years of age and with $30,000 a year income, how would you like to have $600 a year that is going into a savings plan that you are going to own with a higher rate of return that you can convert into a flexible instrument?

Just try to look at the numbers for that individual and younger because those are the ones who are going to be affected, not people that are my age and older. We are going to be largely unaffected by this transaction.

Senator SIMPSON. Well, I thank you, Senator Kerrey. After getting on the Entitlements Commission with you and Senator Danforth, I know one of the things that truly frustrated us all is what message we have for today's young people and how to get them involved and interested. That is a critical point because no one over 51, I believe is the figure, is really affected in any significant way by what we are trying to do.

That is the puzzle for those of us who are in the generation above that is to, how to get them involved, get them in the game because the seniors are in the game and they are not.

I thank you very much. You have been very helpful as always. It is a great privilege and pleasure to work with you.

Senator KERREY. Thank you, Mr. Chairman.

Senator SIMPSON. Now, the second panel consisting of Hon. Pete du Pont, the former Governor of the State of Delaware and the policy chairman of the National Center for Policy Analysis in Wilmington, DE, and Stanford G. Ross, former public trustee of the Federal Hospital Insurance and Federal Supplementary Insurance Trust Funds and former commissioner of Social Security in the year 1978 and 1979 of Washington, DC.

It is a great privilege to have you both come before us and share your thoughts with the subcommittee and proceed in the form as on the witness list.

It is nice to see you again, Pete. You have been in this game a long time. They are finally listening. So give it again with music.

STATEMENT OF HON. PETE DU PONT, FORMER GOVERNOR OF DELAWARE, AND POLICY CHAIRMAN, NATIONAL CENTER FOR POLICY ANALYSIS, WILMINGTON, DE

Mr. DU PONT. Thank you, Mr. Chairman, for the opportunity of joining you for a few minutes today to talk about a subject that as you point out I have been talking about for a long while.

It was 10 years ago that I made a proposal for something called financial savings accounts. Our proposal was very simple, that the money you put into your Social Security, the Social Security taxes that you pay, you would continue to pay, but that you could put a like amount, an equal amount into an IRA, a financial security account.

You would get a tax credit on your income tax. So it would be a wash to you. You would begin to buildup savings in your private account. The Social Security benefits that you receive when you retire would proportionately decline for each year that you participated in this financial security account program.

Well, the proposal was made and greeted with genuine and general derision by all concerned.

But now, 10 years have gone by. Three things have changed. First, Mr. Chairman, you and Senator Kerrey have decided to exert some leadership here in the Senate. You have captured the attention of the Senate and the attention of young Americans all across the country. That is an enormous change from 10 years ago.

Second, people have begun to understand the demographic changes that are going on. Americans are healthier. Life expectancy in 1950 was 69 years. By 2020, it will be 79 years. That is a huge demographic change.

The fertility rate of women is declining. Again, in 1950, it was 3.45 births in a lifetime. By 2020, it will be 1.80. So these two statistics taken together are showing less taxpayers in the Social Security system and many more pensioners at the other end. That demographic shift is dramatic.

The other thing that has happened among young Americans is a recognition that the current Social Security system is not going to serve them very well.

I use this example. Suppose your uncle made you a bet. He said, I'll tell you what, young Senator Simpson, you put in $250 a month for the rest of your life. When you retire, I'll give you back 90 percent of it.

Not many of us would take that bet, but that is the bet that your Uncle Sam is forcing you by law to accept if you are a 20-year-old entering the workforce at a $20,000-a-year wage.

Young people, as we know, have greater faith that they will see a UFO than they will ever see a Social Security check which has caused me to revise my opinion of the American education system. Perhaps it is doing somewhat better than I previously had thought.

The third change that has occurred in the 10 years since I made my original is that in Chile in South America, we now have 15 years of experience with a private pension system.

Chile was the first nation in the western hemisphere to create a Social Security system. It then became in 1981 the first nation anywhere on Earth to dismantle it. Instead of having a pay-as-you-go system, it adopted a private savings account system.

Under the Chilean system, employees must put 10 percent of their wages into an IRA, a private savings account. They may put in another 10 percent if they choose.

That plan is wildly popular in Chile. Ninety percent of the workers in the economy have chosen to go into the private system, as opposed to staying in the government system.

The savings rate is 26 percent compared to America's 4 percent. The investment capital has allowed the Chilean economy to grow at 7 percent annually while the United States is averaging less than 3 percent.

In other words, there are private savings alternatives to pay-as-you-go government systems that are working around the world, in Chile, in Singapore, in Great Britain. There is no reason we could not have one work here in the United States.

As Senator Kerrey eloquently pointed out, it would enormously increase the retirement benefits for young Americans. It is an idea whose time has come.

My time has come also. I appreciate the opportunity to make some comments to you this morning.

Thank you.

Senator SIMPSON. Thank you very much. We will look forward to your responses to questions.

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

Senator SIMPSON. Now, Mr. Ross, please.

STATEMENT OF STANFORD G. ROSS, FORMER PUBLIC TRUSTEE, FEDERAL HOSPITAL INSURANCE AND FEDERAL SUPPLEMENTARY INSURANCE TRUST FUNDS, AND FORMER COMMISSIONER OF SOCIAL SECURITY, WASHINGTON, DC

Mr. ROSS. Thank you, Mr. Chairman and members of the subcommittee. I am pleased that you have invited me to testify at this hearing on Proposals to Create Personal Savings Accounts Under Social Security.

I welcome this opportunity to contribute to the important effort you are making to secure the future of Social Security.

The views I will be offering today reflect my individual views. I would appreciate it if my formal statement could be entered into the record. I will then summarize it.

Senator SIMPSON. Without objection, it is so ordered.

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

Mr. ROSS. Thank you, sir.

There is a great need to maintain one's perspective as Social Security reform is undertaken. It is necessary to look at Social Security, Medicare, and tax reform together and to develop a strategic vision.

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The Hospital Insurance Trust Fund of Medicare will be exhausted in 2001, a mere 5 years now. That reform cannot wait.

When I testified as a public trustee last year, it was 7 years. There has been a deterioration of 2 years in the horizon. I am sure that after the election takes place, the next Congress will have to turn to Medicare reform.

As I spell out in my written testimony, there are inevitable interactions that must be taken into account in doing these reforms in Social Security, Medicare, and taxes.

Social Security is far less urgent. The OASI Trust Fund is not expected to be exhausted until about 2030, some 35 years from now.

Nonetheless, I assume Social Security will be reformed in its own right in due course and would like to give my thoughts about how this should be done.

Social Security is very critical to many persons in our society. It has served the country well for the past 60 years.

Nonetheless, the program needs to be brought up to date and set right for the future based on present circumstances.

However, in doing this, I would urge caution and an incremental approach so that we do not lose the values and good features in the program at the same time as we try to improve it.

The present financial imbalance in Social Security is a little more than 2 percent of payroll. A good deal of this financial imbalance could be rectified by relatively noncontroversial changes in the program as outlined in my written testimony.

However, I would go beyond such changes to adapt the program to current circumstances. Adding a personal savings account element could well be part of that process.

The average replacement rate under present law is about 42 percent, but will decline to 36 percent by 2030. Ending the present financial imbalance within the present 12.4 percent of payroll tax devoted to Social Security would further reduce that average replacement rate to about 29 percent.

In contrast, attempting to achieve financial balance at 10.4 percent, so as to free up 2 percent of payroll for a personal savings account which is the approach of the Simpson-Kerrey bill last year, would further lower the average replacement rate to about 22 percent.

I believe that an average replacement rate of 22 percent is too low to maintain the traditional values and the many good features of the Social Security program. It may also lead to increases in SSI means-tested benefits, which would have adverse affects on the budget deficit.

I also believe that it would be unwise to increase the payroll tax for any purpose related to achieving financial balance in the Social Security program.

Accordingly, I urge that consideration be given to a voluntary plan. For example, individuals covered by Social Security could be allowed to contribute 2 percent of their wages up to some maximum limit to a personal investment plan in which the benefits would be available on a basis coterminous with Social Security.

If properly designed and implemented, such a voluntary plan would provide valuable experience with adding a personal savings plan element to Social Security.

It would help with the massive public education that is necessary. It would test the interest of younger workers to put away money conterminously with Social Security for retirement.

I spell out details of this plan in my written testimony. I would be happy to respond to questions. But since the yellow light is on, I am going to finish by saying that I would emphasize that any changes to the Social Security system should be evolved on a broadly bipartisan basis.

I commend Senators Simpson and Kerrey for pursuing this subject on that basis.

I would also urge that non-partisan professional expertise be employed in the design and implementation of the program because there will be many difficult issues to resolve. They cannot be satisfactorily answered in a partisan atmosphere.

Finally, bipartisanship at the political and non-partisanship at the technical level would help to build the broad public support that will be necessary in all events before changes in this area can be made successfully.

I appreciate the opportunity to testify before you once again and would be happy to answer any questions you may have about my testimony or the subject matter generally.

Senator SIMPSON. Thank you very much, Mr. Ross. You are always very helpful in what you present to us.

Let me ask a question for Governor du Pont. I was intrigued to see in your testimony the reference to a stack of IOUs which will not enable us to meet the demands of the baby boom retirement.

I keep saying that as people keep getting up and talking about the sacredness of the trust fund. You keep telling them or I do that there is no trust fund. It is just IOUs.

Could you explain that so that they think there are others that at least hopefully share that view? Explain that for the record for us.

Mr. DU PONT. Well, Mr. Chairman, I am afraid that it is true this morning, that most Americans think there is a shoe box or a safe deposit box somewhere in a big building in Washington, perhaps something that looks like the Pentagon.

It is very heavily defended and that in there it says that Breaux or Simpson or Nickles or du Pont. In there, is a pile of $20 bills that we have been contributed to over our working lifetimes.

There may have once been a box. It didn't have any individual's name on it. But the problem today is that the money goes into that box when we pay our Social Security tax each month or every 2 weeks, but later in the afternoon, the money goes out again.

It is there maybe for an hour or two. It goes out to pay our grandmother's benefits. It goes out to fund the operations of the national government.

When it goes out, the national government gives a little IOU signed by the House and the Senate and the President that says when you need your next $20 bill back, just bring this piece over and we will redeem it. I am confident that the Government will redeem it. But when the time comes to redeem the first $20, where are you going to get it?

We are not running a surplus in Washington. So you are either going to get it by borrowing it, selling more bonds to people or you are going to get it by raising taxes on people and thus generating more revenue to pay the $20 back.

But the shoe box mentality is very much with us. One of the good things coming out of these hearings is that we begin to educate people that there in fact is no shoe box, that the money is all spent, and that when the IOUs must be called, either taxes or borrowing must go up.

Senator SIMPSON. I think the people have trouble realizing, too, that they will say, well, there is money in that system.

Indeed, there is. There is a surplus in Social Security. It is $70 billion or whatever it may be. It is going to be huge.

In the year 2010, it could get to $2 trillion, but draw down time on interest comes about 2012, 2013. That message just seems to escape.

Mr. Ross, we know as Pete has testified and you testified that young workers have lost faith in the current system because they cannot expect to receive the rate of return on their contributions to the system as it is currently received by today's retirees. That is a fair concern.

My question, do you believe that today's retirees, today's who have made out the best, I mean, people who retired in the 1980's got all of theirs back plus interest in 2½ years, do you feel that today's retirees who made out the best should be held harmless as we try to restore solvency to the system? Would that be fair to the younger workers?

Mr. ROSS. I think that is basically right, although among the incremental changes I would be in favor of would be more appropriate taxation of Social Security benefits so that it is a form of income and some of the limitations on the way we tax Social Security benefits I would be in favor of reducing so that the increased revenue from greater taxation could be recycled back through the trust funds and used to pay benefits through the system.

So I think I would be in favor of increased taxation. In that sense, that would affect people who are already on Social Security.

But this is a crisis, as you and Senator Kerrey have said. Some changes which would be prospective only, such as that, I think could be made.

Senator SIMPSON. Well, there is a difficulty. We have not many options. We either increase the payroll tax or reduce the benefits and/or combinations thereof and with an unfunded liability of $8 trillion to $9 trillion in this system.

It is regrettable that the public does not seem to understand that or grasp it.

One final question, Governor du Pont, you talked about Chile. Prior to changing to that system, a privatized system, Chile encountered a great number of problems in their economy, in their Social Security program that made their program unsustainable.

They had rampant inflation, high administrative costs, uneven pension payments based on occupation, political tampering, all sorts of things.

In addition, at the time of the conversion, Chile was enjoying a period of government surpluses making the transition somewhat easier. None of those factors are present in the United States.

How would those differing factors impact on a conversion to a privatized system?

Mr. DU PONT. Well, Chile had a number of different circumstances, one of which was a dictatorship at the time.

So there was not the legislative give and take. They simply decreed that this new system was going to be imposed. Fortunately, for the Chileans, the military leadership was correct. It worked.

We don't have that system here in America I am happy to say. So our challenge is to create within the public an understanding.

We don't have the emergency yet. As you well know, Senator, from your experience in Washington, not much happens until the barbarians are at the gates.

When they start down Pennsylvania Avenue, something will happen. But the longer we wait, the longer we postpone action, the more severe the action will have to be in terms of either payroll taxes or benefit cuts.

So I would say compared to Chile, we are very fortunate. We have a period in which we can educate the American public. We can change the shoe box mentality. We can illustrate, particularly to young people the catastrophe that is coming to them in the Social Security system.

So I think we have a better opportunity than the Chileans did to solve our retirement system problem.

Senator SIMPSON. Thank you very much.

Mr. ROSS. Senator Simpson, could I add one comment on the Chilean experience?

Senator SIMPSON. Yes, please.

Mr. ROSS. I think the Chilean system is probably all right for the Chileans, but there are features of it which I think would be totally unacceptable in this country.

The Government really authorizes something like 20 companies to do the investment and prescribes the terms for the investment.

There are very high administrative costs. The individual choices that one has are very restrictive. I do not find the Chilean model, a small country of I think about 8 million with a background of dictatorship, I do not find that analogy at all helpful myself to thinking about the problems of the American Social Security system where we have a track record of 60 years of satisfactory performance.

We have problems sure, but they are not the kind of problems they had in Chile.

Senator SIMPSON. Well, that is why it is good that the two of you are sitting there together in a cordial way. I appreciate that.

I know you have a differing view. I understand that, but I appreciate the civility both of you bring to this.

Senator Breaux.

Senator BREAUX. We need them in Congress.

Senator SIMPSON. Yes, we do indeed.

Senator BREAUX. Welcome back to both of the witnesses, particularly our former colleague, Pete du Pont whom I admire for his continued work in this area. He could be doing a lot of other things, but his contribution is very valuable and very important.

I would agree, Mr. Ross, with your comments about just because it worked well in Chile, it is not to say *ipso facto* it works well in this country.

I mean, they had a surplus in their budget that helped them finance the transition. The transition cost are astronomical. We have not yet found the solution to how we fund the transition cost as we move to a privatized system if in fact that is what we are going to do.

I would like some discussion as to what should our concerns and our questions be regarding the problem. If we have a system that guarantees benefits and then we have a system which allows the individuals to privately invest some or all of their funds into funds that are not guaranteed to bring back a certain amount of funds to give them what they are entitled to, how do we do that?

I mean, the question how do we guarantee good investments? I mean, how much should the Government be involved in where these funds are invested?

What happens when people who have never invested, all of a sudden start making bad investments?

We were joking back here, suppose someone decides that their investment should be in the river boats in New Orleans, for example. It turns out to be a total bust.

I mean, give me some discussion on how we guarantee that the investments will in fact produce the necessary funds to guarantee people the retirement benefits that they are entitled to.

Mr. DU PONT. Well, I would make three observations, Senator Breaux. First of all, the Congress has addressed that problem once before when IRAs were first adopted. As you well know, you adopted some broad guidelines about what IRA contributions could be invested in.

I would assume that in a private option within Social Security that there will be similar requirements, that you couldn't invest it not to discriminate against Louisiana river boat gamblers to be sure, but that you had to invest in traditional financial instruments.

Second, in spite of Mr. Ross' comment about Chile, one of the advantages of the system was that they chartered the 21 investment vehicles.

Now, 21 is a small number in America, but there is no reason that the Administration, the Social Security Administration couldn't certify investment advisors, mutual funds, banks as eligible for these investments.

Finally, the Government could serve as a guarantor of a minimum benefit. Social Security has never been advertised as a full retirement vehicle for Americans. It is a supplemental system to retirement efforts they are supposed to be making on their own.

The Government could guarantee a minimum amount of benefits. If your investment didn't work out, you could rely on those benefits perhaps something on the nature of a minimum of the benefit we have today.

Finally, I suppose you could require—and I'm not an actuary, so you will have to take this as an amateur's observation, but there would be a way to require that the financial security accounts carry some kind of investment insurance with them.

Senator BREAUX. Mr. Ross, would you comment on that?

Mr. ROSS. Yes, sir. First of all, based on the work I've done, I think the Simpson-Kerrey bill with a 2 percent personal investment plan comes about the closest of any plan I've seen to a transition into some personal saving accounts and handling the transition cost within the existing 12.4 percent.

When you get up toward like a 5 percent plan, it is almost inevitable that you are going to have a tax of a pretty substantial size to pay for, or borrowing which amounts to a tax because the borrowing will have to be paid back some time, in order to get through the transition period. So I think that is a major problem.

I also am very worried because as a person who has been involved in this a number of years, I know the Congress might follow the path it has in the past when it comes to Medicare.

Some of that Social Security tax that underlies the Social Security program, and I'm not for it, might be shifted over under Medicare. That certainly is what happened to the disability program 2 years ago.

If that were to happen, balancing the books on Social Security with even less than 12.4 percent would be very difficult.

So that is why I urge caution about going ahead with Social Security reform in attempting to solve this financial imbalance problem in terms that might jeopardize the program when we come around to looking at Medicare reform and tax reform.

I do feel that there are real values in a personal investment plan. That is why I came out for a voluntary approach which will give us some valuable experience in how it might work and to get it started. It would also test the interest of younger workers as to whether they want to put away additional monies for retirement.

Senator BREAUX. I appreciate the answers. I think one of the concerns in looking at the overall fiscal policy is if we allow Social Security funds to be redirected to private accounts and private investment accounts, it takes that much more away from the Government using the Social Security Trust Fund as a borrowing mechanism for deficit reduction and what have you.

Have you given any thoughts to the overall effect of doing this? I mean, the Federal Government will go back in the private market I guess to borrow additional funds to finance other government deeds.

Are we helping here and hurting here? Is that a legitimate concern that we should be worried about?

Mr. DU PONT. Well, yes, you should, but remember that the Government already owes the money. This is not a new obligation that you are imposing on the Social Security system.

The Government has already promised every contributor to every taxpayer in the Social Security tax system that after, what is it, 10 quarters, a very small——

Mr. ROSS. Forty quarters.

Mr. DU PONT. Forty quarters that you are guaranteed benefits. So these trillions of dollars of debt out there are already owed.

What you are talking about is having to deal with some of that debt at the front end instead of the back end. So I think that, yes, that probably the Social Security system would be a wash.

But short term, it would increase the deficit here in this year's budget and in next year's budget. But that, it seems to me, is preferable to allowing this crisis to get to the point where you are either going to have to double taxes or halve benefits which is where it is leading some time after the year 2020.

Senator BREAUX. It is sort of off the topic, I might ask, do either of you have any comment about the thought of making an adjustment in the consumer price index?

Mr. ROSS. I think some adjustment is in order. The exact amount I think has to await completion of certain studies. But clearly, that is also part of the incremental plan I would have for balancing within the 12.4 percent.

But to address your first question, I would really recommend that the Social Security Trust Fund be separately stated from the budget, the way retirement plans are in most States and in most private companies, and regarded as a trusteed matter to the side and try to force the Government then to balance its own general budget without taking advantage of the surpluses which Social Security is presently generating which are about $70 billion a year.

I would not, however, invest it in private markets having put it to the side in trying to force the Government to balance its general budget.

I would not invest in private markets the trust fund's so-called surpluses or reserves because I am afraid that would politicize the program.

The experience in other countries of direct government investment in the markets of these Social Security funds is not good, like Japan and Sweden, two fairly large countries with a commitment to Social Security.

So I do think there are ways to address your concern, Senator Breaux, to try to get some real savings out of the Social Security program, but they would involve some fairly important institutional changes in the way the Federal Government does its business.

Mr. DU PONT. If I could add to that, I would like to strongly agree that having the Federal Government begin to invest funds in the private market is a prescription for political catastrophe because the temptation to do other than guarantee the best return for pensioners in a politicized system of that kind is very strong.

But, Senator Breaux, I think the issue here in regard to perhaps changing the COLA formula, that might postpone the day of reckoning as you suggested earlier another 6 years.

But that is not really the issue here. The issue here is the problem of Uncle Sam requiring you to make an investment that is going to lose you money if you are a young person.

You are required to contribute by law into a system that is going to give you less money back than you paid in if you are in your 20's or 30's today. That is just not right.

So the problem is correcting that wrong, not just balancing the books and the existing trust fund or this year's budget.

Mr. ROSS. Could I just contrast with that answer a little bit for the benefit of the committee? I think you have to recognize that Social Security is more than just an individual retirement program.

It is social insurance and provides insurance against risks that are best covered on a wide social basis, such as disability or dependent insurance for spouses and children.

A great deal of the Social Security program has nothing to do with individual retirement. There probably are other ways you could deal with that set of problems, but frankly Social Security has dealt with them rather well for almost 60 years.

So I think one has to be careful about conceptualizing this problem as one of rates of return for a particular group or income level. That can only be a part of the equation.

The real question is the total social return—somebody 20 doesn't know whether they are going to be rich or poor, disabled or not. I think you have to have a social protection mechanism in place in a country this large. Social Security does that.

Senator SIMPSON. Let me say that we appreciate this very much. This is very helpful I note, too, as we debate today on the floor of the Senate and tomorrow and vote that because of Senators Chafee and Breaux and their courage in dealing with a honest, totally upfront effort to balance the budget using real figures and dealing with real problems that are there, we will stop talking and start voting.

It will be interesting to see: do not bet the rent money, what will happen will happen there.

But at least people are going to step forward and vote. There will be other proposals. Since the Senate resolutions, the failure to deal with the reduction in the CPI in my mind is just most unfortunate.

Everyone testified right here in this room that it was overstated, everyone, every single witness from every single walk of life.

Then, of course, some of the groups got a hold of that one and talked about cheating the seniors and destroying everybody on Earth. Here, we go again. A selfish group they are.

So we are going to deal with incremental changes, CPI reform somewhere along the line, eligibility for reform somewhere along the line, what kind of savings to form, whether it will be like the thrift plan of the United States where you have a high risk, a low risk, or little risk.

Those things are all out there for us to deal with, but oddly enough, some people say that because of what we did in broadening Social Security beyond what it was originally intended, we have led to this destruction.

Some people say that education for minors, SSI, disability, that wasn't a part of the original package. The original package was for people and the average age was less than 65.

That was the way it was actuarially put together that few people, that 65 wasn't the average age of mortality. Now, of course, we are into 15 years, 17 years of benefits. There are serious problems. They are not getting addressed.

But thanks to people like Senator Breaux and Senator Chafee, Senator Moynihan, Senator Nickles, Senator Kerrey, there is a bipartisan movement stirring.

It is anybody between 18 and 40 that better hope and pray that it sure works.

Thank you very much. You are always very helpful.

Now, our final panel of the morning, Mr. Robert J. Myers, former chief actuary of the Social Security Administration from 1947 to 1970 from Silver Spring, MD; Robert J. Shapiro, Ph.D., vice president of the Progressive Policy Institute in Washington, DC; and Carolyn L. Weaver, Ph.D., the director of Social Security and Pension Studies of AEI, the American Enterprise Institute of Washington, DC.

In that order, we will appreciate hearing your remarks. Thank you very much.

And, Robert, you have never been before the committee ever before. [Laughter.]

Mr. MYERS. No, Mr. Chairman, I have had this honor only about 50 times over the last 40 years.

Senator SIMPSON. There is a reason for that. We will hear it again. I want to hear it.

Mr. MYERS. Thank you, Mr. Chairman.

Senator SIMPSON. It's good to have you, sir. I admire the way you continue to assist us all with your great background as chief actuary.

STATEMENT OF ROBERT J. MYERS, FORMER CHIEF ACTUARY, SOCIAL SECURITY ADMINISTRATION, SILVER SPRING, MD

Mr. MYERS. Thank you, Mr. Chairman.

First of all, I would like to mention briefly what some of the financing problems are now in connection with Social Security.

Most of the talk, of course, is always about the intermediate estimate, which I think is a reasonable one and the best one, but it should be realized that over a period of 75 years in the future, there can be variation.

The low-cost estimate actually shows that there is no problem, although I do not think that is very likely. The high-cost estimate shows that the problem is even greater.

But looking at the intermediate estimate, one measurement of the problem is that there is a long-range average deficiency over the 75 years of 2.17 percent of payroll.

This means, as one way of looking at it that, if the payroll tax rates were increased by this much beginning immediately, the problem would be solved. However, I think this would create more difficulties because it would mean building up a tremendous trust fund balance.

Another way of looking at it, which is perhaps easier to understand, is that in 2030, the trust funds will become exhausted and then there will be the problem of either more tax income or less benefits. Again, action shouldn't be deferred that long.

Still another critical year is 2019 when the trust fund balance reaches a maximum of about $3 trillion and then starts downhill.

Another year that is frequently mentioned, but that in my view is not valid, is the year 2012 when income from payroll taxes and income taxes on benefits first falls short of outgo for benefits and administrative expenses. This ignores the interest payments that are coming in currently and will continue to come in.

In fact, it is interesting to note that these interest payments on the trust fund investments, which come in in the form of checks, go into the trust funds just like checks from employers paying the payroll taxes.

Further, another interesting point that very few people realize is that each month in the past, in the present, and in the future, part of the benefit payments are financed by interest payments from the trust funds.

In other words, interest is being used today. I would be glad to go into that in detail later if you are interested.

Now, the public perception is, as has been pointed out, that there is certain bankruptcy ahead and that the system will disappear and that nobody will get any benefits.

I don't think this is the case. I think people should realize the system is flexible. It can be changed. It has been changed many times in the past. Sometimes, it has been liberalized. Sometimes, it has been cut back, depending on the financial status.

I think the reason people don't realize this is that bad news is newsworthy, whereas good news is not newsworthy. It is like the old story: man bites dog. That gets in the newspaper. When a dog bites a man, so what?

I think the Social Security Administration does a good job of trying to bring out the facts about the system, but I think they are rather limited in this respect in two ways.

First, there is the budgetary problem of how much money they can spend. Second of all, there is the criticism that they are just defending the system. What do you expect them to say?

Let me turn now to how can the financing problem be solved? The first thing I think is that it should be done as soon as possible in a reasonable deliberate way.

I think this should be done so as to restore the confidence of the American public in the long-range future of the program.

My strong preference for reforming it is the traditional one of partly doing it through additional financing and partly having benefit cost reduction.

I would reduce benefit cost by increasing the so-called normal retirement age, which is now 65, at which benefits are first payable on an unreduced basis. As you know, under present law, this is to gradually go up to 66 in the year 2009, stay there for about 10 years and then gradually go up to 67 in the year 2027.

I would start out the same way, but I would go straight on up until age 70 is reached in the year 2037. I think this is not a real benefit reduction. What this change does is to take into account that as people live longer, they should work longer.

I would also raise the payroll tax rate by a quarter of a percentage on employer and employee beginning in 2015 and do that every 5 years until the total increase is 1 percent each.

I would not means test benefits, as some people have proposed, for reasons that are brought out in my testimony.

As to privatization, as in Chile, which I testified on before the Subcommittee on Aging of the Senate Committee on Labor and Human Resources 6 days ago, it is very good there. But as some people have brought out, it is not very good here.

Partial privatization has many problems when it involves reducing Social Security benefits. The people who live a long time will exhaust their funds.

It is unfair to women because they can buy less with their private accounts than men can. It is unfair to one-worker couples because they have to divide the money up between the two of them.

It increases the budget deficit. In some proposals, taxes would be increased. The national debt would be increased.

Finally, I would like to see compulsory individual savings accounts, but I would like to see them on top of a revised Social Security program. I would like a plan where there is at least 2 or 3 percent put in on top of Social Security. I don't think people would object because it would be their own earmarked money. But I would also put in a provision that, if only small amounts are contributed, these would be refunded. I have had experience with mutual funds, being on the board of trustees of two large mutual funds for over a decade. So I am all in favor of them, but they can't handle small amounts. There are many people in this country who contribute under Social Security on wages that are only $2,000 or $3,000 a year, not because they are low paid, but because they are only part-time. Mutual funds just can't handle those small units of money.

Finally, as to whether people will get a proper return or get their money's worth, I don't think this is relevant in a social insurance program. I put forth the analogy of school taxes. Everybody pays school taxes, whether they have ever had kids or ever will have kids. There is a pooling.

I do not think that the employer's money belongs to the individual employee any more than it does in many private benefit plans where all employees do not share equally or do not get their money's worth from the average employer contribution.

Thank you, Mr. Chairman.

Senator SIMPSON. Thank you very much indeed, Mr. Myers. Now, Mr. Shapiro, please.

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

STATEMENT OF ROBERT J. SHAPIRO, PH.D., VICE PRESIDENT, PROGRESSIVE POLICY INSTITUTE, WASHINGTON, DC

Dr. SHAPIRO. Mr. Chairman, thank you for the opportunity to discuss with you today the reform of Social Security.

My written statement contains a detailed analysis outlining how we view the problem and the best ways of addressing it.

In my oral remarks, I would like to just touch on a few basic propositions. The first is that Social Security is worth saving.

In the post-war era, no other national program can point to a comparable achievement, for Social Security benefits have virtually ended poverty among the elderly, giving them the lowest poverty rate of any group in America and nearly in the world.

To preserve this achievement we must respect two basic elements of the current system. First, its character as a universal and mandatory program, based on a recognition that otherwise, millions of Americans would find themselves financially unprepared for retirement.

Second, its commitment to provide more favorable benefits for lower-income people, based on the recognition that if everyone received the same return, those with low incomes would have to bear very large burdens in their working years or depend on very modest benefits when they retire.

The second proposition is that for all of these strengths, the current system requires reform. First, as this committee knows well, the program cannot be sustained fiscally.

In fact, the fiscal problems are built into any system that, like Social Security, is unfunded and commits itself to provide everyone benefits exceeding the value of their contributions.

There are also economic issues at stake here which go beyond the budget. In particular, the current system adversely affects personal savings, a matter of increasing importance as slow income gains reduce the opportunities for personal savings by most Americans.

By providing large cash transfers to virtually everyone, Social Security has reduced the need to save. Economists disagree about the power of this effect but few doubt its existence.

The Government could have offset this effect by saving itself, the justification for running Social Security surpluses, but instead has chosen to spend those surpluses.

The current program also reduces savings in other ways. The system is financed by transferring income from those more likely to save, younger working families, to those more likely to consume, older retired persons.

Moreover, it provides these transfers in the form of annuity payments, which are more likely to be wholly consumed than assets.

Social Security reform should try to address the savings issue, along with the fiscal problem, in ways that will continue to ensure that every American has adequate resources for retirement.

In our view, this requires a two-tier system with a provision for both mandatory personal retirement saving and a publicly financed means tested pension benefit.

Under the first tier, everyone is required to save for his or her own retirement by very gradually shifting 6 to 8 percentage points of the payroll tax to mandatory personal savings accounts owned and managed by the contributor, shifting the major part of retirement security from an unfunded basis to a funded one.

As this occurred, publicly financed Social Security benefits would be reduced gradually across the board and on a means-tested basis.

At the end of the transition, the second tier of the system would maintain a supplementary, public financed pension for low-earning people financed by 4 percentage points of the current payroll tax and so preserve the system's social achievement.

Make no mistake, the transition problems here are daunting. How do we avoid asking current workers to pay twice, once for mandatory personal savings and again to pay for the benefits of existing and soon to be retirees?

Some say simply make the shift now and borrow to finance current benefits, but that would defeat the economic purpose of reform by reducing rather than raising national savings.

Others claim that privatization would so increase people's wealth that they would agree to pay for both or to write off their existing Social Security contributions.

The wealth projections underlining these claims, however, are not economically sound. Ultimately, the economy's rate of return cannot exceed its growth rate.

There is no economic basis for believing that privatization could effect the long-term growth rate by more than a very modest amount.

Moreover, under the law of diminishing returns, if mandatory personal saving does expand the supply of capital, the rate of return on capital must fall, not rise.

The same difficulties attach to proposals to have Government invest the current surplus in private equities.

This proposal simply cannot produce the windfalls its advocates claim. In addition, this approach could destabilize our financial markets, pushing up the share prices of firms that the market anticipate that the Government would invest in, and thereby forcing Government to pay an inflated price for the shares, and then driving down those prices when Government sold them to pay baby boomer benefits.

In the meantime, by making Government a major owner of private stock, the Government would quickly be injected into countless decisions affecting the management of our largest private firms.

In the end, the only responsible transition options involve phasing in the new system gradually and having Government provide everyone a little less than they have been promised under the current system.

Once again, I have detailed an approach to these transition changes in my written testimony which I will be happy to review.

Let me say in closing that any plan for reforming this great program should be subjected to the closest analysis and criticism possible.

Only in this way can we achieve genuine public agreement that both reform is needed and that a particular reform holds the most promise.

Here, I want to salute Senators Simpson and Kerrey for opening this debate. Their proposal is thoughtfully designed and its introduction is an act of genuine public spiritedness and foresight. Thank you.

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

Senator SIMPSON. Thank you very much.

Carolyn Weaver. Please, Dr. Weaver.

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

Dr. WEAVER. Thank you, Mr. Chairman. I will begin on the note on which Rob Shapiro ended, which is to say that I too commend you and Senator Kerrey for opening a debate on what I regard as a truly positive and fundamental reform of Social Security.

In my view, the traditional fixes Congress has used in the past, payroll tax increases and benefit reductions, just are not up to the challenges faced in the decades ahead, that of restoring public confidence in the long-term viability of the Social Security system and creating a system of real value for younger people.

I believe that the best way to secure Social Security may well lie in transforming the retirement program from a low-yielding income transfer system into a system of true pensions through personal savings accounts, such as you have proposed.

As you have heard, rates of return on individuals' taxes are falling rapidly under our pay-as-you-go system and are now expected to be lower, significantly lower, than the real return to private capital for younger workers.

From an economic perspective, this has two important implications. First, there are less savings and investment than there otherwise would be, and people are earning a lower rate of return on their investments in Social Security.

Second, Social Security amounts to a net tax on workers' wages, distorting labor market outcomes and altering workers' desired form of compensation.

Analysts disagree on the magnitude of the wealth losses, but they would generally agree that they exist.

Martin Feldstein of Harvard University has estimated the likely benefits of shifting entirely to a system of mandatory personal accounts. He finds that the net economic gains would be on the order of 3 percent of GDP annually forever or the equivalent of $15 trillion in present value terms.

There are many ways to move toward a system of personal security accounts, whether on a limited basis or a broad-scaled basis, as in Chile, or on a voluntary or a mandatory basis.

I would like to discuss the Social Security Advisory Council proposal and how it relates to your legislation.

As you have heard by now, 5 of the 13 members of the advisory council, including myself, endorse a proposal that would gradually privatize or move toward fully funded accounts for half of the retirement program.

The proposal, would set up a two-tiered system, where the first tier would offer a flat retirement benefit for full career workers.

Five percent of the payroll tax would go into tier 2 personal accounts. These would be owned by workers, and workers would be free to invest them in wide array of financial instruments and institutions.

These accounts would also be held and managed by private financial institutions, not by the Government.

One of the questions I was asked to address is the relatively large transition cost of this proposal relative to yours. In this regard, I would simply note that transition costs flow directly from Social Security's enormous unfunded liability. The more you wish to advance fund, the more you wish to reap the benefits of capital accumulation and higher rates of return, the larger the transition cost. This is because a greater share of outstanding liabilities must be met at the same time you are trying to advance fund.

Your bill would create personal accounts fully funded with 2 percent of the payroll tax, which is about one-fifth of the tax devoted to the retirement program.

The advisory council proposal would move 5 percent or half of the tax devoted to the retirement program into personal accounts.

In our view, it is highly desirable to move further in the direction of personal accounts than you do in your legislation.

There is the potential for higher benefits and a higher return for workers. In addition, larger accounts would give workers keener incentives to make sound investment decisions and to monitor their investment performance. Larger accounts would also be relatively less costly to administer for financial institutions.

In addition, your legislation chooses a mechanism for financing the transition internally, by scaling back Social Security benefits. The advisory council proposal finances the transition largely externally, through explicit borrowing and either reductions in Government spending or increases in taxation.

While there are advantages to your approach, in that it concentrates some of the burden on current older generations who have fared so well, there are also advantages to shifting some of that burden to future generations through debt financing, since they are the ones that stand to gain the most from the kind of Social Security reform we are discussing.

Another question you raise was about Americans being unsophisticated in making investment decisions and what kinds of protections they would have from inappropriate risks or guarantees they would have against inadequate returns.

The short answer is that in thinking about the personal accounts tier of our proposal, we were unconvinced that workers did not or could not with experience make sound financial decisions.

Good decisions come with education and information, and with experience and learning, all of which would be gained rapidly by workers making regular contributions to personal accounts.

May I take one more minute to wrap up?

Senator SIMPSON. You may.

Dr. WEAVER. Certainly, we recognize the Government's potential interest in limiting excessive risk taking and also recognize the possibility that some investment options might carry high administrative fees in relation to investment returns.

However, we had no consensus about the kinds of restrictions that would be appropriate in those situations or cost effective.

In general, we envision a regulatory environment consistent with a wide range of choices for workers, for example, a range consistent with the options now available to workers through 401(k) plans.

We envision the investment opportunities being offered by a wide array of financial institutions, not just banks, for example, but mutual funds as well.

We also saw education as being critical to improving investor performance rather than substituting Government decisions for individual decisions.

I would make one last point on the issue of guarantees or assurances to low-wage workers. I am not aware that there are any assurances in your legislation. Even more importantly, there are no such assurances under the present Social Security system. This is something that people get quite confused about. Many middle-aged and younger workers presently expect to earn negative rates of return under Social Security, and this is before factoring in the political risks that future benefits could be cut quite substantially.

Also, our proposal provides a first-tier benefit which replaces about two-thirds of the poverty line. This, according to the Social Security actuaries, would generate benefits which, together with two-tier accumulations, are at least sufficient to keep low-wage workers out of poverty. Thank you, Mr. Chairman.

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

Senator SIMPSON. I thank the panel. A serious issue and words like guarantee and keeping people out of poverty are the keys to what people believe about Social Security.

The most tragic determination of the word "guarantee" is that we have already presently guaranteed $8 trillion to the people in the future. How will we pay for that?

Eight trillion dollars is the unfunded liability of Social Security. Now, that is a guarantee. That one is seriously unsustainable, at least according to the entitlements commission.

But let me ask Mr. Myers because I have the greatest respect for you an actuary. I am not an accountant, but I have probed this. I have studied it since I have been in the entitlements commission.

I think until we get to a point where everybody is using the same definition, but this is the definition I have of Social Security and its, "trust fund," as Governor du Pont says.

As those of us have dealt with it at the entitlements commission, there is no shoe box, as Governor du Pont said, neither the trust fund principle nor the interest is a shoe box.

It is all in Treasury bills or securities backed by the full faith and credit of the United States. That is correct.

We are on the same wave length there, sir?

Mr. MYERS. Yes, Mr. Chairman.

Senator SIMPSON. Now, in the year 2013, we start dipping into interest. You bring up the issue of interest.

In the year 2020, we start dipping into principal. Those are according to the trustees of the Social Security system. Then, insolvency in the year 2029 or 2030.

But there is no ability, no fund to pay any the interest or principal except from the general fund. All of the obligation payments to, quote, trust funds, floating IOUs, will all come from general revenue at those times.

General revenue at those times must be from taxes or new borrowing or something. But until we are able to say it does not matter what it is, it all comes from general revenue.

Mr. MYERS. By and large, Mr. Chairman, I would agree with you, but let me point out how interest is currently used.

Like any good money manager, the Secretary of the Treasury, as he gets payroll taxes in each day, invests them in interest-bearing obligations.

Then, when you come to the third of the month when almost all benefits are payable, it is necessary to have roughly $28 billion of cash.

However, they do not cash in $28 billion of these IOUs or bonds, whatever you wish to call them, because these bonds carry accrued interest.

So they cash in perhaps $27.5 billion. The other half billion comes from the interest. So the interest is currently being used and always has been used.

Now, furthermore, obviously when you come to 2020, and you have to start selling the trust funds down, not only monthly, but continuously, it is true that this is going to be a terrific problem for the Secretary of the Treasury.

But if the trust funds had not bought these bonds initially, currently buying $60 to $70 net each year, the general public would have had to have done so.

I have always thought that this is a bad idea to have these big so-called surpluses. I very much agreed with Senator Moynihan, who could not be here today, that the system should not have had those big surpluses, but rather should have adhered to a pay-as-you-go basis, which means that the public would have had to buy more Government bonds, which the trust funds instead bought.

Senator SIMPSON. I hear you indeed, but whoever bought them, it matters not because the money to pay the interest on them comes from the general treasury in the United States.

Mr. MYERS. That is correct.

Senator SIMPSON. That is correct. So when we come to double hit time, when there is not enough coming in to take care of it, then we are going to go back and say, well, now, we've got to cash, too, we've got to cash in some stock. That is double hit time.

Mr. MYERS. Mr. Chairman, I hope that time will not come. I hope that the Congress will do something about Social Security long before then so that the trust funds either do not build up as rapidly or if they do build up, they will be held at that level and not decrease. I am certain that neither you nor I would like to be Secretary of the Treasury at the time that the trust funds start down that slope. It is going to be a terrific refinancing job.

Senator SIMPSON. Well, we cannot even do anything with $7 a month on Part B premiums and means test which is totally voluntary. We cannot even get that number. We cannot deal with the CPI.

Mr. MYERS. Yes.

Senator SIMPSON. Until these young people get organized and are able to come in with a group and stand in front of a Congress person and say they are 10 million of us and we vote or 15 million of us and we vote because all we get in front of us are groups who say there are 30 million of us and we vote, at which time you are supposed to pitch forward on your head and creep out of there on your hands and knees.

Well, there are 10 million of us and we vote. These people are history. That is the troublesome part of it. We do not do these things. They are politically impossible.

It is just an act of good faith and friendship that my friend John Breaux sits here because it is easy to say, well, Simpson, you are not running again or someone else that is involved in this.

Senator Kerrey will be here. Senator Breaux will be here. Senator Nickles will be here and those of us today who will put up an amendment, Senator Brown and Senator Nunn which is the sense of the Senate that something has to be done in the future.

That is a very valid argument, but the point is, these things are unsustainable, totally unsustainable.

Mr. MYERS. Mr. Chairman, I certainly agree with you on both of those points. I think the CPI should be computed correctly.

I think that the Part B premium rates should be income related. I am a statesman on this matter because I am a relatively high-income person.

I pay the Part B premiums. I think it is quite proper that I should pay more, perhaps even all of the premium, because it is still good insurance.

Senator SIMPSON. Well, you are a good American first. Then, you have your own personal philosophies. That is what makes you a very remarkable man.

Dr. Shapiro, just a question, from a demographic standpoint, which Americans do you believe would be most receptive to the idea of the personal savings accounts? Which ones would be better positioned to manage such accounts in a profitable manner? Can you share that with us, voluntary versus mandatory?

Dr. SHAPIRO. Certainly. There are several issues involved here. I certainly think at this point, the people who would respond most positively are going to be younger people who, as we have learned, are very skeptical of the long-term soundness of the guarantee for Social Security.

It is my general view that mandatory personal savings accounts should be subject to significant restrictions on the objects in which they could be invested.

This is insofar as these accounts replace a significant part, or in the case of higher income or higher earning people, the entire amount of the Social Security guarantee.

In fact, to protect most people, the major part of these accounts should be indexed stock and bond funds or in Government securities.

I also think it would be prudent if there were a requirement that at the time of retirement, at least half of these accounts had to be annuitized; that is, exchanged for an annuity.

The fundamental principle here is to ensure that everyone has resources for the course of their retirement.

That is the great achievement of the Social Security system. It is one that we cannot sustain under the current arrangement. So we need to make new ones.

Senator SIMPSON. Just one question of Dr. Weaver and then to Senator Breaux. You state that Congress must move quickly. Almost everyone has shared that with us in these many months: move now, must do something, get started, incremental something, get cracking to shore up Social Security.

How much time do you think we have to enact any meaningful reforms without imposing unacceptable hardships? What is the cost of delaying reform, say, next year compared with 5 years down the road?

Dr. WEAVER. Well, I am glad you came back to this issue of 2013 and 2020 and 2030 because, as you were trying to point out, Social Security first becomes a hit on the Federal budget in 2013, not in 2020 or 2030. This is when there is not enough tax income projected to cover benefits and Social Security has to go to the general fund to help meet benefits.

One way to get perspective on how soon this is, is to think about the 1983 amendments. The significant change in this legislation was raising the retirement age from 65 to 67.

Congress provided 17 years' lead time before this even went into effect and another 23 years to phase it in. Congress gave 40 years' advance notice to people affected by age 67.

With retirement programs, you should be aiming for very long transition times. People cannot change their savings and work behavior late in life to make the adjustments necessary to offset significant reductions in Social Security benefits.

If you do not move in the direction of personal accounts, but stick with conventional measures, we are looking at 25 percent or larger reductions in future benefits for middle and high-wage workers.

To generate sufficient savings soon enough, without really undermining people's retirement income security, it is clear that you need to act now, which means I guess in 1997.

Senator SIMPSON. Senator Breaux.

Thank you very much.

Senator BREAUX. I thank the panel. You have all been very informative and very helpful.

Dr. Shapiro or whoever wants to comment on it, if we allow, say, 2 percent of the trust fund to be invested in private investments, that means that 2 percent is not going to be there for Government purposes.

That means according to CRS approximately a $60 billion shortfall doing what we call our transition period to get there.

Any thoughts about this problem? For every good there is an opposite reaction.

Dr. SHAPIRO. Right.

Senator BREAUX. That is one of the bad reactions.

Dr. SHAPIRO. Right. Absolutely. As you point out, no matter what we call the revenues, they are either there or they are not.

If they are not, then, we have to find some way to make it up, or else we have achieved nothing economically by shifting to personal savings accounts. We would only have decreased national saving by the amount we have to borrow.

As the former chairman of the parent organization of my institute, Senator Breaux, you are I'm sure very familiar with the approach that I would use to try to make up this shortfall.

The shortfall should be made up through spending reductions and revenue increases elsewhere in the budget in my view. I look first to industry-specific subsidies, both on the spending side and on the tax side.

The economic purpose of increasing personal savings is to try to affect the growth rate of the economy. If that is the purpose of Social Security reform and of deficit reduction generally, then we ought to start with those programs which tend to undermine the growth of the economy.

As a market economist, I look first at industry-specific subsidies, as programs and activities which tend to undermine the productivity and efficiency of the economy.

Senator BREAUX. You also commented on a CPI adjustment, too, I think?

Dr. SHAPIRO. Yes. I think that once again, if you are going to finance a transition to a personal savings system, there are only three ways to do it. You can raise revenues. You can cut spending. Or you can borrow it.

I think the borrowing option is not economically sound. It takes away with one hand everything you have gained with the other.

I think that the focus should be on spending reductions. In particular, to finance the transition in the retirement system, the focus should be on spending reductions within the retirement system.

I would start with an adjustment of the CPI. As has been commented before, there is no controversy in the economics profession over the fact that the CPI has over estimated inflation for some time. The debate is only about the degree to which it has.

I would suggest that we need to establish an authoritative commission of economists who could come to a consensus which in some sense could be binding on the decisionmaking process for adjusting the CPI.

Senator BREAUX. Thank you.

Let me ask this generic question in a sense about—I think Mr. Myers, you may have mentioned something—that if this new system is a voluntary system and you have high-wage earners and low-wage earners both voluntarily participating that you really end up with a sort of selection bias in the sense that low-wage earners may not choose to participate because they feel they may get a greater return by staying in the current system.

Whereas, high-wage earners may be very pleased to be able to invest in private investments. You really create a real selection bias in this.

Can anybody comment on this? Is this a problem? How do we correct it if in fact it is?

Mr. MYERS. Senator Breaux, I think that you have pointed out that this is a real problem of anti-selection. Over the years I have never been one who believes that the Government should do everything for everybody, but I do believe that the Government must have certain basic functions. In other words, establish, as in Social Security, a minimum floor of protection and expect people to build on it.

In the same way, I think that individual savings accounts are desirable. I am afraid that it is necessary to make it mandatory, except as I indicated for very low-wage earners.

Senator BREAUX. You think it is proper to make it mandatory?

Mr. MYERS. I think it is.

Senator BREAUX. All right. That would solve that problem.

Mr. MYERS. But, as I say, with this exception, as to the very low amounts, somehow or other, there should be a way that they are refunded to the people because it just is not economical for anybody concerned to deal with deposits of $50 or $100 a year.

Senator BREAUX. You would make it mandatory and have a guarantee?

Mr. MYERS. I would make it mandatory and have a refund. The employer would collect the money. But then, at the end of the year or whenever the W–2s are given out or when the employee leaves, if a certain amount, $200 or $300, has not been collected, give it back to the employee because surely, people who are very low paid will probably have better use for the money now than later on when they will probably have to get public assistance as well.

Senator BREAUX. I take it that the Chilean system is not mandatory and they are having a problem with contributions.

Mr. MYERS. As to the Chilean system, I have been there twice at their request to study it, and I concluded that for them it is working out quite well.

It was made compulsory for all new employees, regardless of wage level. All the old employees could join if they wanted. Some 95 percent did. But the story is not quite that simple.

They made the people who stayed in the old system pay a much higher tax rate. So the only ones who stayed in the old system were people who were about to retire.

But in the Chilean system, as in many Latin-American countries, there is very poor coverage compliance. Chile is not poor, but it has been estimated that only about 80 percent of the people pay who should pay. Every employer in the country is covered, except for the military. I will let you draw your own conclusions why the military with their better retirement system were not covered when there was a military dictator that put the new system in.

But in any event, the people are compulsorily covered, but even in the 80 percent who are covered, there is much under-reporting because the lowest paid arrange with their employers not to pay on their full salary because they know they are going to get the relatively high guaranteed minimum from the Government that is available if the account does not buy a certain amount; then, the Government will make up the difference.

So if a person is going to fall under that minimum, he or she might as well fall far under. So, the very lowest paid employees like household workers and agricultural workers often with the connivance of the employer report much less than the actual wages.

Senator BREAUX. Dr. Weaver, do you have a comment?

Dr. WEAVER. My personal view is that there is a lot of merit to trying to develop a voluntary approach. With a great big system like this, with a lot of misunderstandings and confusion about what it does and doesn't do, I think it would be far easier to sell these kinds of changes, from a practical political standpoint, if people knew they could rely on the current program.

Having said that, the proposal that the advisory council developed is mandatory. Part of the thinking was that benefit levels and rates of return are expected to be higher for all income levels under the partial privatization plan than under present law where you, for example, raise payroll taxes to maintain the current level of benefits or somehow scale back benefits to shore up the current system. There is much to be gained by moving to the new system.

Senator BREAUX. Well, there is a real balance here. We are talking about allowing individuals to make the investments or requiring them to make the investments, but then making sure that they make the right investments.

I mean, I am for giving the maximum flexibility to the individuals, but at the same time trying to protect their investments. The more you try to protect their investments, then it is back to the Government telling them how to do it. Why not have the Government do it in the first place?

Dr. SHAPIRO. Senator, even if you required that a large share of the resources be invested in indexed equity and bond funds, you would have competing index funds.

People would choose among a fairly wide range of index funds. So there would still be significant discretion and market competition to get the best return.

Mr. MYERS. If I might add, at least as far as mutual funds are concerned, there is very considerable Government regulation and guardianship through the SEC.

Senator SIMPSON. Thank you very much, Senator Breaux. I appreciate your presence and your participation at every level and especially what you and Senator Chafee are trying to do in which we will find out today whether people really want to get there.

I know that they all want to get there, but the political pressures will be so intense that it will be a study in courage. I admire you greatly.

One of the amendments over there on the floor, was sense of the Senate, will have to do with trying to find the most accurate measure to measure. Is it the CPI? Is it some other more accurate deflator?

There is this chain weighted GDP price index, an interesting concept, which has been averaging 0.4 percent closer to the mark than anything we have done yet for all appropriate spending and revenues, If we could get to that. CBO uses it. OMB uses it.

It sounds like a new menu somewhere in the vast score card of names, chain weighted GDP price index, but that is where this stuff goes.

People in America have it all figured out: if you spend more than you earn, you lose your butt. [Laughter.]

They do not really care about these things. They are smart. They know something is up. They know it will not be there.

Well, I will insert my statement in the record.

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

Senator SIMPSON. Just a quick summary, thank you so much. You added a great deal.

I think it was Dr. Weaver. In 1983, thanks to Pat Moynihan and company, the blue ribbon committee, we saved Social Security, saved the system until the year 2063. Remember that? Boy, I remember that, 2063. And 13 years later, we have seen 34 years run off the clock.

Really, the American people and the Government and the Congress, this is malfeasance of office. It is malpractice in the world of law.

Thirteen years later we have run 34 years off the clock. Last year, we ran six off the clock. Is that not correct?

In other words, instead of going broke in the year 2035, 34, it now has moved up to 2029. Wasn't that 1 year we ran? Two years. Two years, we ran. Two years, Robert. OK. In 2 years, we ran 5 years off the clock.

To think that people are thinking of counting on pensions when less than 50 percent are covered by pensions. Pensions on the average cover about one-third of actual earnings at the time and not indexed. Now, companies are wanting to get rid of pensions desperately, just kicking them off the edge of the ship. People changing jobs. Positions not calling for pensions. Companies getting out of it. People working part-time. Employers hiring part-time without obligations toward health care or pensions. A pile of IOUs floating around out here in the great beyond. The only way to do something is to start now.

Amazingly, to add the total, the final irony is that the baby boomers all want to retire now before 65. They don't want to stick around until 65. I mean, they are ready to boogie at 55 I guess. With no change, no change at all in the standard of living of present retirees. Now, that is a real feat considering their level of savings which is about zilch.

Well, on that cheery note, I won't say anything crude, but I am tempted. I won't. I won't. But wow.

I don't know why anybody 64 should be carrying the ball for these people. Someone asked me the other day, who speaks for us, an 18-year-old? I said, speak for yourselves.

We gave you the right to vote. You have not done a thing with it. So if only 15 or 20 percent of you are going to vote. You just kind of stand around like a cow before a new gate, I guess that is your business.

But I do think that the seniors who are the most affluent sector of society, certainly those, we must affluence test in that area if we are going to see anything for their children and grandchildren. That is a very difficult thing obviously, very contentious.

So I again thank Senator Breaux and thank the panel and Ron Niesing and thank you for your work and Chuck Blahous. It is very helpful.

This one is not going away. This is not going to be like it has been in the last 18 years that I have been where you just couldn't even hold a panel like this. No one would come. They would say, what are you doing? Stop.

Jake Pickle tried to do a little messing around with this years ago. They said, Jake, stop. Don't do that, Jake. It hurts us all. I admired him, a Democrat from Texas. Others have messed with this, Pete du Pont.

So it is heartening to see this, that we address it in ways that we never have in the past. I thank you very much. You have been very helpful. That concludes the hearing.

[Whereupon, at 12:06 p.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted for the Record

Prepared Statement of Pete du Pont

Almost 10 years ago, I proposed what I called the Financial Security Program to give Americans an option of saving for their own retirement while maintaining the Social Security program, guaranteeing Social Security benefits for those already retired or nearing retirement—and without increasing payroll taxes. At the time, I said, "For the past 15 years, Social Security has been the topic of a political discussion almost totally counterproductive. We have held strenuous political debates about making changes at the margins of this program."

Now, 10 years later, the same speech unfortunately is appropriate if we simply change the first phrase to read, "For the past 25 years . . . " The main change over the past decade is that the issue of what to do about Social Security has become a critical one—one that we are not going to be able to finesse much longer.

Our Social Security system—like the systems in most other countries— is on a pay-as-you-go basis. That is, taxes paid by today's workers are not saved and invested to finance their future retirement benefits. Instead, most of the money is paid out immediately in benefits for current retirees. Two worldwide demographic trends are going to make the pay-as-you-go approach untenable in the not too distant future. People are living longer and fertility rates are declining. Slightly more than 5 percent of the U. S. population was over 65 years of age in 1960; today the percentage is nearly 13—and by the year 2020 it is projected to be over 16 percent. The same trend is evident almost everywhere except in parts of the former Soviet Union. We need a fertility rate of about 2.1 lifetime births per woman to maintain a stable population. In the United States, the rate has declined from 3.45 in the early 1950s to 1.92 in the late 1980s. The only developed country in the world today with a fertility rate at 2.1 or higher is Ireland, and no others are projected to rise that high through the year 2020.

All of this means, of course, that the number of workers paying taxes to support retirees is shrinking quickly everywhere. In the United States, we had 16 workers for each retiree in 1950. Today it is 3.3 to 1 and by 2030 will be less than 2 to 1.

At present, taxes paid into the Social Security system exceed benefits paid out, and the surplus goes for a few hours into a trust fund. Then it goes right back out again in loans to the federal government, which uses the money to make the annual deficit appear lower than it really is. In return for the loans, the federal government issues special bonds to the trust fund. So what we have in the trust fund is IOUs. When benefits paid out begin exceeding taxes paid in sometime a few years from now, the trust fund must be tapped, the IOUs will be called, and the money to pay off the special bonds will have to come from taxpayers. This will mean additional taxes on top of existing payroll taxes.

Obviously we have a problem that will become more severe the longer we wait to deal with it. Basically we have three choices:

1. We can let things go on as they are until in about 25 years (or sooner) the combined burden of Social Security taxes and other taxes will be so high that there will be an employee revolt against such confiscatory taxation and it will be difficult or impossible to effect any kind of solution.
2. We can try to tweak the pay-as-you-go system at the margins again, enough to keep it staggering along, by raising the retirement age, reducing benefits and the like. Or,
3. We can convert Social Security to a fully funded system where each worker saves for his or her own retirement and the savings generate additional economic growth.

Clearly the third choice, to allow each worker to provide for himself or herself, is the choice we ought to make. The Financial Security Program I proposed in 1986 continues to be a viable approach, but there is a working model of Social Security reform—not unlike the Financial Security Program, incidentally—that I want to dwell on today. The working model is Chile, the first nation in the Western Hemisphere to adopt a social security system—and the first nation in the world to replace its system. Chile converted to a system of individual pension savings accounts, but it gave workers participating in the old system a choice of staying there or switching to the new system, and it ensured that pensions remained secure for those already retired. The change has resulted in both higher retirement benefits and greater economic growth for the country. Chile's reform is serving as the model for reform in several other countries, including Argentina, Bolivia, Colombia and Peru—and Mexico is preparing to move to a similar system. It behooves us to examine it as well.

PRIVATIZATION IN CHILE

Chile reformed its social security system in 1981 because it had little choice. The system was a mess. The payroll tax for employees and employers combined was well over 20 percent of wages, but 28 percent of benefits were still being paid for out of general revenues. There was widespread evasion of payroll taxes, political favoritism in the payment of benefits, bad management of funds and a decimation of the value of benefits because of rampant inflation.

The reform was carried out under the Pinochet dictatorship, but the new system of individual pension savings accounts has remained popular as Chile has become a democracy. Employees participating in the old system when it was reformed in 1981 could stay with the old system or could switch to the private system any time before 1986. Ninety percent chose the new private system. People entering the labor market after 1981 were required to participate in the private system.

How the Reformed System Works. Under the reformed system, each employee is required to contribute 10 percent of wages to an individual pension savings account, and can contribute up to another 10 percent, all tax deductible. The government has authorized 21 private investment companies called AFPs—Administradoras de Fondas de Pensiones—to administer and invest the funds. Workers have to have their accounts with one of the 21 companies, but can switch accounts up to four times a year, so the AFPs are competitive. Three times a year, each worker gets a statement of the value of his or her individual account. The AFPs are managed by private financial professionals, and by law must follow conservative, prudent and diversified investment rules and avoid political influence or personal favoritism. The government guarantees a minimum rate of return which is set as the average of the return earned by all 21 companies. The government guarantees this minimum return. The government also guarantees a minimum pension benefit to all workers, and supplements the private benefits as necessary from general revenues to reach the minimum.

In addition to the pension contribution, employees must contribute additional amounts to the AFP to buy private life and disability insurance and to cover administrative costs. The amount varies among AFPs, but averages about 1.5 percent of wages for the insurance and 1 to 2 percent for administrative costs. The government also guarantees minimum disability and survivors' benefits.

One of the criticisms of the Chilean system in its early years was that administrative costs were too high, in some cases exceeding 14 percent of total assets. However, as competition has grown among the funds the administrative costs have fallen to 2 percent or less.

Contributions and Benefits. Altogether, employees are required to pay about 13 percent of wages into the new system. (And, as mentioned earlier, they can contribute another 10 percent if they choose.) Individuals and their employers together paid 22 percent of wages into the old system. Employers don't pay payroll taxes under the new system. To make sure that this reduction in payroll taxes was passed on to employees immediately, employers were required to give all an 18 percent wage increase when the new system went into effect. The net result was that employees who chose the private system paid about 40 percent less in payroll taxes than they had under the old system.

How much an individual gets in retirement depends on the rate of return earned by the private accounts, but generally, retirement benefits have been anywhere from 50 to 70 percent higher under the new system, disability benefits at least twice as high and survivors' benefits at least 50 percent higher.

The normal retirement age is 65 for men and 60 for women. Retirees can buy an annuity with an insurance company, or they can leave the money with the AFP and make a scheduled series of periodic withdrawals. About two-thirds of the retirees have chosen the life annuity. People who have contributed more than 10 percent of their incomes can either receive a larger annuity payment or can retire early. Retirees pay taxes on what they receive, but usually at a lower rate than they would have paid while working.

Making the Transition. People remaining in the old system are guaranteed a minimum retirement benefit, which is paid out of general revenues. Since employers no longer pay the payroll tax, these employees have had to pay the full amount of the tax themselves, but they have had about the same take-home pay as before because of the required 18 percent wage increase.

Since Chile guaranteed that no retiree would suffer from the reform, the government commitments to pay pensions to those already retired and those retiring later was about 3 percent of the country's gross national product. The U.S. Social Security system currently spends 4.6 percent of GDP on all Social Security payments. Chile financed its transition by selling government assets—primarily state-owned enterprises—and was able to do so without causing a deficit or raising tax rates and without causing increased inflation or higher interest rates.

Economic Impact. Not only has the private pension system paid larger benefits to participants, but it also has helped to fuel economic growth in Chile. People have developed substantial ownership of the private business sector through investments by their AFPs. The pension funds now total more than $25 billion, which is about half Chile's gross domestic product. The net worth of the average Chilean today is about four times his or her average annual salary. By comparison, the net worth of the average American is about equal the average annual salary. Thanks to the private pension system, Chile has increased its savings rate to 26 percent of GNP. Its real economic growth rate has averaged more than 6 percent during the past 10 years.

LESSONS FOR THE UNITED STATES

We in the United States do not have to remain tied to a system that clearly is dragging the nation toward economic and social catastrophe. Chile has demonstrated by example that a pay-as-you-go social security system can be transformed into a private system, and in the process, a nation's economy can be strengthened and the social welfare of its citizens improved and made more stable.

Almost 40 percent of our Social Security benefits in the United States are payments to widows, children and the disabled. Until a private system is in effect long enough to provide these benefits through insurance—as in Chile—or through some other means, these benefits could be financed by retaining a portion of the payroll tax. As in Chile, government could remain the provider of last resort, guaranteeing minimum benefits.

We already have a multi-trillion dollar commitment to pay benefits to those who are retired, who are nearing retirement or who have paid into the current system. We can honor that commitment through a general fund commitment.

Just as it was a decade ago, the need for reform is urgent. But it is more urgent than it was 10 years ago. And we cannot wait another 10 years. Even if we could, what is the sense of doing so when the current system is dragging down economic growth, harming workers financially and creating fears among retirees and workers alike about whether the system will even survive?

STATEMENT BY ROBERT J. MYERS PRESENTED TO THE SUBCOMMITTEE ON SOCIAL SECURITY AND FAMILY POLICY, COMMITTEE ON FINANCE, U.S. SENATE, MAY 20, 1996 WITH REGARD TO PERSONAL INVESTMENT PLANS AND THEIR RELATIONSHIP TO SOCIAL SECURITY

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

In this testimony, I shall address only the subject of whether a legislated system of personal investment accounts should be established, and the Social Security program should be modified accordingly. 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).

It may be noted that the current Chilean social security program is of the first approach. Many people point to it as a model of perfection, without recognizing several important elements of it that could lead to quite different conclusions. I discussed this matter in some detail in my testimony before the Subcommittee on Aging of the Senate Committee on Labor and Human Resources on May 14. In brief, the Chilean system has operated reasonably well so far, but certain features of it do not make it suitable for the United States.

First, I will summarize my philosophy about the proper role of the Social Security program. Then, I will point out what I believe are irremediable features of the various privatization approaches and what I believe should instead be done to improve the present financial condition of the program.

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.

Problems with Initiating a System of Personal Savings Plans

One problem with privatizing the Social Security program by instituting a system of personal pension plans is in providing integrated, consistent disability and survivor benefits. This is possible to do, but it is often ignored in proposals 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.

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.

The benefit design of personal investment accounts presents some problems. If the accounts are not annuitized, retirees can outlive the proceeds. Or, if the accounts can be annuiized on an elective basis, the premium rates will be high, because those with likely long life expectancies will tend to do so, Also under annuitization, women will be unfairly treated as to the benefit amount, because of their longer life expectancy. Further, one-worker couples will receive lower benefits for the same accumulation than will single persons, again because of life-expectancy differences.

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.

How Should Social Security Be Changed?

The most important thing that should be done is to restore the long-range solvency of the Social Security program and this should be done as soon as possible. (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. Specifically, I suggest that the full-benefits retirement age should increase by two months each year beginning in 2003 (as in present law) until it reaches age 70 (for those reaching such age in 2037), unlike present law, under which it levels off at age 66 for about 10 years before rising to age 67 in 2027. Further, both the employer and employee tax rate should increase by ¼% in 2015, with similar increases in 2020, 2025, and 2030.

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 the administrative expense 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.

The imposition of such "additional" contributions would have no effect on the budget deficit or the National Debt. Some persons might view this as a new tax, but this is really not so, because the money involved always "belongs" to the individual.

In conclusion, it is my firm belief that, if the Social Security program is partially privatized by instituting a system of personal savings accounts and, at the same time, reducing the level of Social Security benefits, the inevitable result will be the destruction of the Social Security program. Higher-income persons will become less and less supportive, and the praiseworthy sharing of the economic-security risk in connection with retirement among persons of all income levels will be lost.

Prepared Statement of Stanford G. Ross

Mr. Chairman and members of the Subcommittee, I am pleased that you have invited me to testify at this hearing on proposals to create personal savings accounts under Social Security. I have testified previously before this Subcommittee and the full Committee as Commissioner of Social Security and as Public Trustee of the Social Security and Medicare Trust Funds. I welcome this further opportunity to contribute to the important effort you are making to secure the future of the Social Security program. The views I will be offering today reflect my individual views and should not be taken as reflecting the position of any organization that I am presently associated with or have been associated with previously.

I first take note of the bills introduced by Senators Kerrey and Simpson and commend them for the leadership they are demonstrating in exploring the possibility of introducing a personal investment plan element to the Social Security system. As a result of the hearings which you have held, we are all keenly aware of the problems of confidence in the Social Security system, particularly among younger workers. There is clearly a need to adapt the Social Security system to not only present circumstances but those that we expect to be present in the future. We are also all keenly aware that reasonable people have different positions on the issues that are raised by various proposals for change. Accordingly, I will address first what I think is a proper perspective in which to analyze proposals for change in the Social Security system.

There are three major domestic reform areas that are currently of major significance to the public. In addition to Social Security, there are the issues of Medicare/health care reform and tax reform. Of these three major areas, Social Security reform at present appears to be the least urgent. Medicare/health care reform is the most urgent; present information indicates that the HI trust fund will be exhausted in 2001, a scant five years from now, two years earlier than when the trustees reported last year. Tax reform is harder to gauge since opinions vary so widely, but if it emerges as a major issue in the elections this fall, it could well be a high priority in the next Congress. My point is not that Social Security does not need to be reformed; it clearly does require adaptation; but with the trust funds not scheduled to be exhausted for some 35 years, it pales when compared to Medicare/health care reform in terms of its urgency. Moreover, there are inevitable interactions between these three major domestic reform areas that need to be taken into account before reforms in any of these areas are undertaken.

The Medicare program is dramatically under-financed. The payroll tax underlying the HI trust fund does not begin to cover future costs. A feasible level of premium to be imposed on beneficiaries under the SMI program is inherently limited, which means that the ever-increasing general revenue contribution to the SMI trust fund is a major contributor to the budget deficit. I firmly believe Medicare needs a two-step strategy: short-term changes that are designed to keep the program going for the next 10 to 15 years, plus long-term restructuring for the period beginning in 2010, with both steps being taken in the context of overall health care reform. It seems entirely likely that either as part of the short-term or long-term reform plans that are developed, whatever resources are available for the Medicare program will be called upon. While I would not recommend the possibility, it is entirely possible that Congress will decide to shift some of the payroll tax that presently supports the Social Security program to the Medicare program. If this were to happen, Social Security reform would have to be undertaken in the light of an entirely different financial outlook. My point here is that as Medicare reform moves along, and it cannot wait, the parameters in which Social Security reform takes place may well shift dramatically.

Similarly, if fundamental tax reform takes place and, for example, some form of consumption tax were substituted for the income tax, the parameters for reform of Social Security and Medicare/health care reform would shift. Tax expenditures underpin a great deal of the present employer-provided pension systems and employer-sponsored health care systems, as well as tax favored savings mechanisms such as individual retirement accounts and 401(k) plans. If these income tax underpinnings were taken away, the context in which Social Security reform and Medicare/health care reform would take place would be entirely different.

In short, there are inevitable interactions and, unfortunately, unanticipated consequences, of reforms in any one of the three major domestic policy areas. Therefore, the sequencing of reforms is extremely important. It is critical that there be some strategic vision for reform of all three areas which is maintained as reforms go forward in any one of the three areas. Unfortunately, this strategic vision has been singularly lacking in debates we have been having in all three areas and I would recommend that attention be paid to the need to coordinate reform plans for Social

Security, Medicare/health care and taxes. The focus for proposals to date has been entirely too narrow. Finally, I would note that the implications for other domestic programs are great because unless the amount of resources devoted to the major programs are constrained, there is little capacity to meet new concerns or even existing needs.

Despite my basic concern for caution in going forward with Social Security reform at this time, I do assume that Social Security can and will be reformed in its own right at some point when it is timely and I would offer some guides to reform, particularly as they concern adding a personal investment plan element to the present system. First, the focus of any reforms should not be on reducing benefits or making so-called cuts to balance the budget or for any purpose other than to secure and improve the program. Social Security is above all a social insurance program, and only partly a retirement program, and a major portion of what it provides, such as protection for dependents (spouses, survivors and children) as well as disability coverage, cannot be readily replaced by any private market mechanisms. Unless we are careful in the way Social Security is reformed, means-tested programs such as SSI may well need to be expanded, with attendant increased demands on general revenues, and may not achieve our social objectives nearly as well as the Social Security system.

Second, the Social Security system needs to be brought up to date. May of the basic concepts were developed in the 1930's and significant improvements should be made in the structure of the program given societal changes in the last fifty years. A prime example would be spousal and dependent benefits which were based in the 1930's on a paradigm that there would be a male worker, a female homemaker who did not have earnings, and a nuclear family with two children on average. In fact, in the present world, most women work, even those with small children; there are many single parent families; and there are a variety of social patterns that were not contemplated in the 1930's. Increasingly, many married couples view themselves as an economic partnership and, in the case of family dissolution, there is a sharing of the assets accumulated during the marriage.

Third, a number of relatively noncontroversial changes can be made in the Social Security system which would largely eliminate the long-term deficit which is presently about 2.19 percent of payroll. For example, there could be an extension of coverage to state and local employees who are still excluded from the Social Security program; an increase in the period over which benefits are computed from 35 years to 38 years; changes in the taxation of Social Security benefits; corrections in the upward bias in the CPI; and perhaps similar changes that would be widely agreed upon. However, I do not offer this suggestion as an argument adverse to making changes that go well beyond these kinds of relatively noncontroversial solutions. I believe it would be good to undertake more fundamental restructuring as well as to consider the possibility of adding a personal investment plan element. However, I do make this point in order to again emphasize a perspective of prudence as opposed to undue haste in seeking to reform a fundamental program that has served the country well for almost sixty years.

Fourth, adding an individual savings element, I believe, could be a very useful part of any adaptation of the system, particularly because it might have great appeal to younger workers, provided it can be financed soundly and constructed reasonably. I now turn to offering some suggestions as to how a personal investment account element might be added consistently with an incremental adaptation of the Social Security program.

First, there appears to be insufficient capacity in the present 12.4 percent payroll tax for Social Security to find funds for introducing a personal investment plan without unduly reducing basic benefits. At present, the average replacement rate of the program is about 42 percent of prior wages and is expected to decline to about 36 percent under present law by 2030. A plan such as that proposed by Professor Gramlich, Chair of the Social Security Advisory Council, to eliminate the long-term deficit within the 12.4 percent roughly lowers that average replacement rate to about 29 percent. A plan such as that which was in the SimpsonKerrey bill to eliminate the long-term deficit and provide 2 percent of the tax for a personal investment plan within the 12.4 percent would appear to lower the average replacement rate to roughly 22 percent. I recognize that both in the Gramlich and SimpsonKerrey plans there are attempts to protect lower earning workers, and the returns from the personal investment plans are expected to increase replacement rates. However, in my judgment, there is a point at which the lowering on average of the basic benefits would compromise the traditional values embodied in the program.

The 5 percent personal savings plan proposed by Drs. Scheiber and Weaver and others on the Social Security Advisory Council would appear to lower the average replacement rate to about 21 percent and turn the basic Social Security benefit into a flat benefit, a suggestion to which I am adamantly opposed. Even at present with a 42 percent average replacement rate, the United States is in the lower ranks of the OECD countries in terms of the average replacement rates of its Social Security system. While I think some reductions would be possible without major damage to the program if they were part of an overall plan for adaptation, I would be cautious about going too far in this direction. Moreover, it would be desirable if a way can be found to basically maintain the present average level of benefits while improving the distribution of benefits within the system.

I would also note that because of some of the more radical proposals for introducing a personal investment plan that it is entirely possible that means-tested programs such as SSI would ultimately have to be dramatically expanded, with attendant demands on general revenues which would contribute to budget deficits, if either the returns to individual workers were lower than projected or the Social Security program failed to provide an adequate safety net. I think there is, again, a need for caution here before uprooting a program that basically serves the country well. Where this analysis leads me is that if one wants to introduce a personal investment plan there is either (1) a need to increase the payroll tax; or (2) do something tantamount to a tax increase like mandating a contribution to a savings plan which is a tax with simply another label; or (3) doing something on a voluntary basis.

If I judge correctly that there is a mounting interest in introducing a personal investment plan element to Social Security, I would urge that consideration be given to a voluntary plan. For example, any individuals covered by Social Security would be allowed to contribute two percent of their wages up to some maximum limit to a plan in which the benefits would be available on a basis coterminous with Social Security benefits. Unlike present IRA's, 401(k)'s and related savings plans, strict rules could be imposed so that the funds could not be borrowed or diverted or used for other than retirement purposes. Investments would be personally directed into an investment vehicle of the individual's choice subject only to necessary limitations. The contribution would be either deductible or creditable for income tax purposes; there would be no tax on the accumulations; and appropriate taxation would be imposed on distributions.

One of the elements of the Simpson-Kerrey bills last year was a voluntary system for a two percent contribution out of the 12.4 percent payroll tax supporting the Social Security system. Based on looking at what has happened with private savings accounts like IRA's and 401(k)'s, they are mainly taken advantage of by better-paid workers. It would seem entirely in order to allow those better-paid workers on a voluntary basis to contribute something beyond the 12.4 percent if they so desire. If they do not have sufficient concern for putting aside additional funds for their own retirement, they would simply not have to enter into the program. In all events, whether the 2 percent was within the present 12.4 percent or in addition to it, it would likely be only the better-paid workers who would elect to participate in the personal investment plan.

By making the 2 percent contribution in addition to the 12.4 percent, the moral hazard would be eliminated of someone making the election within the 12.4 and thereby receiving a reduced basic Social Security benefit that was inadequate and requiring means-tested SSI funds because their investments did not work out. Since the present level of Social Security benefits within the 12.4 percent payroll tax would be maintained, everyone would continue to be treated as reasonably as possible given existing financial constraints. Thus, I think there is a great deal to commend a voluntary 2 percent plan.

I would urge that the tax expenditure involved in a voluntary plan be financed by reducing some other tax expenditure under the tax system which would have a lower priority than helping individuals provide for their own retirement. There are many tax expenditures which could be reviewed and, if this approach were taken, there would be no increase in the amount of tax expenditures as a result of this proposal. I believe that in general tax expenditures should be reviewed and some tax reform undertaken even if it is not fundamental tax reform. Particularly if fundamental tax reform is not undertaken, incremental tax reform might well be more attractive if one of the goals was to introduce a new savings plan that would help younger workers to finance their own retirement.

I would also note that it is mainly younger workers who would benefit from a 2 percent-type of personal investment plan. Older workers would not have sufficient time to accumulate enough in the plans to greatly change their situation. Further, as experience is gained on a voluntary basis, and circumstances change in the country, the program could be changed. The program would in all events help educate the public as to the choices that must be faced and give many individuals experience with personal investment decisions. Most importantly, something would have been done on a incremental basis which would produce valuable experience and help to dispel some of the more uninformed thinking about what it takes to organize and manage a sound retirement system.

I find that many of the more grandiose plans for personal investment vehicles, such as those that would turn the entire Social Security system into a personal investment plan, or those that would have a 5 percent individual account, to be demonstrably unsound. For example, the 5 percent plan coming out of the Social Security Advisory Council would involve imposing a new tax of about one-and-half to two percent of GDP for about 75 years and borrowing against it for the first 3040 years to cover transition costs. Even the 1.6 percent payroll tax increase plan coming out of the Advisory Council involves a considerable new tax. I do not think the American public, given all of its needs, should be required to pay additional taxes to finance their retirement. I would much rather give the public the opportunity to direct additional money to this area on a voluntary basis. This will also avoid the very difficult transition problems that are inevitably involved in financing mandatory plans.

Another point that is important is that the accounts should be individually directed with as much personal choice as is feasible. I think limiting investments to broadly based indexed funds, such as exists with the federal thrift savings plan, does not have sufficient attractiveness for a personal investment account to be added to the Social Security system. The federal government has taken a great deal of time to evolve even three indexed funds and despite promises of evolving another couple of indexed funds, it is slow to happen. It might be possible to do something like what exists with the federal health plans in which there is some mechanism for providing eight to ten options so that contributors are not overwhelmed with the amount of choices. These are issues which can best be resolved after a decision is made on the basic issues of voluntary versus mandatory and level of contribution.

Another issue is evolving appropriate administrative mechanisms. I believe it will ultimately be necessary to work any plan through the federal tax system. The contribution will probably need to be recorded on some IRS form and there would have to be some recordkeeping by IRS andor SSA that would coordinate the new plan with the records kept for the basic Social Security system. I believe that these issues can be reasonably addressed, but I would not underestimate the difficulty involved and the need to construct necessary administrative mechanisms based on nonpartisan professional expertise.

A related proposal that has currency recently is that at least a portion of the reserves, perhaps 40 percent, in the Social Security trust funds should not be invested in U.S. Treasury securities backed by the full faith and credit of the United States government but should be invested in private markets to seek higher returns. It is hoped that these higher returns would provide more income to the program and thereby relieve long-term financing difficulties. It is also argued that this change will gain the benefits of higher private market returns for younger workers without the degree of risk that would be involved with individual investment accounts.

I have great doubts about this proposal. First, I do not think that private market investment by the Social Security trust funds is an adequate substitute for adding a personal investment plan to the program. Younger workers would not perceive it as an equivalent. It would continue to be the government investing the money and would not produce the element of individual responsibility and the direct access to private markets as with personal investment vehicles based on individual choice. Second, higher gains cannot be secured without higher risk and I think that Social Security trust funds should be invested in a risk averse way to maintain confidence in the program. Investment in U.S. Treasury securities assumes a reasonable rate of return with minimal risk. Third, if these funds are invested in private markets, they may displace investments by other persons in the private markets and the society as a whole may not be benefitting, for if there are greater returns, the trust funds would be benefiting at the expense of someone else.

Most importantly, political problems may be created for the Social Security program. If one Congress can decide to authorize investment in broadly based indexed funds, another Congress can decide to turn to social investments or other types of investments such as in state and local projects. Viewing international experience reinforces my view that political problems could be created by investment of the trust funds in private markets. Countries which are fully committed to Social Security and have systems with a long history, such as Japan and Sweden, have had many political difficulties arising from the investment of Social Security funds. Given all the other problems that surround the Social Security and Medicare/health care systems today, I do not see adding another problem with the economic and political dimensions that would inevitably be involved.

I think it would be desirable to give renewed consideration, as was proposed by Senator Moynihan a few years ago, to returning the Social Security trust funds to a pay-as-you-go basis, but with an appropriate contingency reserve, and avoiding the myriad problems of trust fund buildups and divestitures. If this were done, the program might have less of an impact on the general budget deficit problem and not lead to contentious political issues as to whether the Social Security surpluses should or should not be counted in this context. It is my own view that in all events the Social Security trust funds should be regarded as separate from the general budget but this, of course, will be easier if there are no surpluses which would mask a general deficit. However, even if the program continues to be based on partial funding, care must be taken to avoid unnecessarily large buildups of trust fund reserves. Thus, the whole question of investments for the trust funds involves considerations that go far beyond the notion of trying to secure a larger rate of return to alleviate financing problems.

My final point about personal investment plans is that I do not think an element like this can be added to the Social Security system unless it evolves on a broadly bipartisan basis. Major changes in the major retirement system for Americans simply cannot be done in an atmosphere of partisan contention. Those forces that would attempt to convert the whole Social Security system to a personal investment plan, as well as those forces that would not be in favor of any significant change in the existing system, will have to accommodate themselves to the development of a broad centrist position that incrementally adapts the Social Security system. Unless bipartisanship can be developed and maintained, I am very doubtful that basic issues of policy and implementation will ever be resolved reasonably and that broad public support will be generated. In this regard, I commend Senators Simpson and Kerrey for their bipartisan approach and hope that others will understand the wisdom of proceeding on this basis and join with them to work constructively on this important area of domestic policy.

I want to thank you again for having invited me to this hearing and look forward to continuing to help you in any way I can. I will be happy to answer any questions you may have about my testimony or about the subject matter of the hearing. I thank you once again for the opportunity to appear before you today.

PROGRESSIVE POLICY INSTITUTE

Robert J. Shapiro
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**Statement before the United States Senate Committee on Finance
Subcommittee on Social Security and Family Policy**

**May 20, 1996
Washington, D.C.**

Mr. Chairman and members of this Committee, I want to first thank you for the opportunity to address you today on a matter of genuine social and economic importance: Reforming the Social Security system.

The only reason to alter a program as fundamental and widely supported as Social Security is that without change, it would not be able to maintain its mission. The first questions we must ask, therefore, are in what sense is the current Social Security system sound, and in what sense does it require change.

The strengths of Social Security are large and obvious. First and foremost, it helps ensure that millions of economically-vulnerable Americans can live in dignity. Elderly Americans today have the lowest poverty rate of any major group in the population, and rising Social Security benefits are the principal reason. This is a social achievement which no other federal or state program effort of the last half-century can match, and any change in these arrangements must preserve this achievement.

This record is built on two basic elements of the current Social Security system. First, the program is universal and mandatory, based on a recognition that without such universal and mandatory provisions, millions of unremarkably myopic people would find themselves financially unprepared for retirement. Second, in certain respects the program redistributes income by providing more favorable benefits for lower-income people. This means-based aspect of the system is based on the recognition that all persons received the same return, regardless of income, low-income people would either have to bear a very large tax burden in their working years or depend on very modest benefits when they retired. The contrast to a

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universal and progressive public system is the private annuity market, which cannot profitably cover those who are both most likely to need the coverage and least able to afford it.

Despite the current system's strengths, it requires fundamental reforms. First, Social Security is fiscally unsustainable under its current arrangements. These long-term fiscal problems can be traced to two basic features of the system: It has an unfunded basis; and its benefit schedule provides transfers to virtually everyone that exceed the value of their contributions. Such a system can sustain itself only so long as the number of workers and the economy's payroll tax base expand faster than the number of beneficiaries and the size of their benefits.

For a long time, that's roughly what occurred. First, the U.S. economy's growth rate accelerated sharply in the 1950s and 1960s; then, as growth slowed in the 1970s and 1980s, the size of the labor force expanded sharply. Yet even these two factors were not sufficient to maintain the system's benefit structure, because each year, as the numbers of retirees grew, each new cohort of beneficiaries received larger real cash benefits than those who had preceded them. To keep the system going over the last 40 years, the payroll tax rate used to finance benefits had to be raised by 2 to 3 percentage points every decade.

Looking ahead, these problems are likely to worsen. The demographic aspect is well known: The baby boom soon will begin to retire; and like their parents and grandparents, they can expect to live longer on Social Security than those who preceded them. Moreover, the system's capacity to provide their benefits is further threatened by the long-term slowdown in U.S. economic growth, which constrains the growth of the wage base financing the benefits.

Social Security reform cannot directly affect the demographics, but it may be able to do modestly influence the rate of economic growth on which the provision of depends. In particular, the system could be reformed to encourage higher personal saving, which in turn would support higher investment for stronger growth.

Economists generally agree that the two most important factors affecting people's propensity to save are opportunity and need. Opportunity comes first: People save more and save at higher rates when their incomes rise rapidly. That's the principal reason why the personal saving rate of Americans fell through the 1980s, despite expanding tax incentives for saving.

Furthermore, as slow income gains have reduced *opportunities* to save, the Social Security system itself has probably further dampened personal saving: By providing large net cash transfers to virtually all beneficiaries, the Social Security system has reduced the *need* to save. Economists disagree about the power of this effect, but few doubt its existence. I estimate that the current Social Security program cuts our personal saving rate by as much as one half; others such as Martin Feldstein believe this effect is much greater. The federal government could offset the lower personal saving rate by saving itself–the justification for running Social Security surpluses. Unfortunately, the government has not saved these surpluses, but rather spent them.

The current design of the Social Security program probably reduces personal saving in other ways as well. The system is financed by transferring income from younger working people, who are more likely to save, to older retried persons who are more likely to consume. In addition, the program these transfers in the form of annuity payments, which are more likely to be wholly consumed than assets.

Social Security reform should address these issues, along with the system's fiscal problems. In the end, any such reforms should continue to ensure that everyone can have adequate resources for retirement, provided in ways that are both fiscally sustainable and more economically sound.

In our view, achieving these goals will require a two-tier system, consisting of a provision for mandatory personal retirement saving on top of a publicly-financed means-tested pension benefit.

Under the first tier, everyone is required to save for his or her own retirement, using the existing payroll tax system. Most Americans believe that's what they are already doing when they pay the Social Security tax. The problem is that no actual saving occurs, since all payroll tax revenues are used immediately to pay for current retirement benefits and other government expenses. Mandatory personal saving would shift the major part of the system of retirement security from an unfunded basis to a funded one, by gradually shifting up to eight percentage points of the payroll tax to mandatory personal saving accounts owned and managed by the contributor. As this occurred, publicly-financed Social Security benefits would be reduced gradually, both across-the-board and on a means-tested basis.

The management of these accounts would be carefully regulated to ensure the general security of each person's retirement resources. The major part of these accounts could be invested only in index stock and bond funds; much of the remainder should be held in government securities. Contributors also should be required to retain their accounts without withdrawal until they retire. Furthermore, at retirement, at least half of the assets of a person's account should be dedicated to the purchase of an annuity. Finally, in the event of a economy-wide crisis that sharply reduced the value and income from all financial assets, the Treasury would guarantee the continuance of a basic annuity for retirees in need.

As these personal retirement accounts grow over time, Social Security's budgetary and economic burdens would lessen, since publicly-financed benefits would shrink and the economic resources for retirement support would not have to come out of current production. Furthermore, this strategy should help support higher economic growth, since it should elevate the nation's personal saving rate, even assuming that some of current voluntary saving would be displaced by mandatory saving.

The second tier of the new system would maintain a supplementary publicly-financed pension for low-earning people, preserving the progressivity of Social Security and its singular social achievement in alleviating poverty among elderly Americans. Under Social Security today, low-income workers are required to contribute at least the same percentage of their wages as much higher-earning people, and a larger share of their wages than those earning above the payroll tax cap. As a result, low-earning Americans make a greater relative sacrifice to the payroll tax than do more affluent people. The current benefit formula offsets some of this disproportionate burden on low-earning people, by providing benefits that represent a higher rate of return on the payroll taxes they paid, than provided to higher earners. Under the reform described here, four percentage points of the current payroll tax would be preserved to finance a supplementary public pension based on income, which would ensure that all low-income people would have sufficient resources in retirement.

The advantages of a prefunded, mandatory personal saving system are obvious and simple to describe; the difficulty lies in designing a workable transition from the current generous unfunded system in place today. In particular, how can we avoid asking current workers to pay twice--once into their own mandatory personal saving accounts, and then a second time to pay for the public pensions of all current and soon-to-be retired people.

There is no easy answer. Some proponents of privatization argue that current workers could shift immediately to personal saving, while the government maintained current benefits by borrowing the funds. This course sidesteps the political controversies but not the underlying economic costs. It would defeat the central economic purpose of reform, of higher national saving, since any new personal saving would be borrowed to make up for the lost revenues. Moreover, if mandatory personal saving displaced some of present voluntary saving, as expected, the total national saving rate would fall, further slowing investment and long-term growth.

Others claim that privatization would so increase people's long-term wealth that they will be willing to either pay for both or to write-off their existing investments in Social Security. However, the wealth projections underlying these claims are not economically sound. Typically, they involve projecting into the future the high rates of return achieved by certain equities over recent years. Rates of return on equities over longer periods are much less, as are rates of return on all financial assets over the period in question. Moreover, the law of diminishing returns, if mandatory personal saving did substantially expand the supply of capital, the rate of return to capital would inevitably *fall.*

Ultimately, the economy's long-term rate of return cannot exceed its long-term growth rate; and there is no basis in economics to believe that privatization could quickly affect the growth rate at all or affect it over a long term by more than a modest amount. The transition problem to a funded system cannot be solved through rates of return.

The best transition options available involve phasing in the new system gradually, and having government provide everyone a little *less* than they have been promised under the current system.

First, the shift from an unfunded public system to a two-tier, private-public arrangement would occur over a 20 year period. In the early years, the share of current payroll tax revenues exceeding current benefit payments--the so-called Social Security annual surplus--would be redirected to personal saving accounts. This shift should be accompanied by offsetting measures to reduce spending and raise revenues, so that the loss of these revenues does not simply expand federal borrowing and thus offset the gain to national saving from mandatory personal saving. In our view, these offsetting measures could best come from phasing-out many current industry spending and tax subsidies. Previously I have catalogued more than 100 instances of such subsidies in a Progressive Policy Institute report, *Cut and Invest: A Budget Strategy for the New Economy.* I would be happy to provide this information to the Committee.

Over time, the annual Social Security surplus will decline, and end entirely by the year 2013. In order to close this gap and support the redirection of larger shares of the payroll tax to personal saving accounts, Social Security benefits would also have to be revised. *Everyone* should share this burden. For example, all current retirees could be asked to accept a more soundly-based CPI for their future cost of living adjustments. High-income retirees could be further asked to accept a form of means-testing, beginning with smaller COLAs. Eugene Steurele of the Urban Institute has estimated that under existing law, current retirees who earned high-incomes while working will receive benefits that over the course of their retirements will exceed the value of their contributions, adjusted for both inflation and an average rate of return, by as much as $300,000. As a matter of social policy, retirees with substantial private resources do not need such large windfall benefits and can contribute some of that windfall to the transition effort. Over time, as people build up substantial personal assets in the saving accounts financed through payroll tax payments, the public pension benefits could even be phased out entirely for those in the top half of the income ladder.

Everyone working today also could contribute to the transition: The eligibility age for Social Security and Medicare benefits could be raised to reflect the fact that

Americans live longer, and healthier, than they used to. Under current law, the age of eligibility is scheduled to rise in three-month increments to age 66 by the year 2006 and age 67 by the year 2022. These increases could be accelerated to rise by three months a year until the age of eligibility reaches age 70.

In the end, any transition must be financed in some way by less spending, more revenues, or higher borrowing. I believe that all or most of the gap should be closed through gradual spending restraint focused chiefly on the retirement system itself; but other transition strategies are clearly available. For example, current workers could be asked to both continue paying the payroll tax to support current retirees and contribute to mandatory private saving accounts. Alternatively, current and prospective retirees could continue to receive the Social Security benefits promised under current law, and those benefits could be financed through a new national sales tax. Or, current spending could be cut by the amount provided in Social Security benefits.

Long before we face these transition issues, however, Americans must generally agree that basic reform is desirable. I want to salute Senators Kerrey and Simpson for opening this debate by proposing their "Personal Investment Plan." This plan has been thoughtfully designed, and its introduction is an act of genuine public spiritedness and rare foresight.

In closing, I would like to offer two cautions regarding some of the details of that proposal. First, the plan's provision for redirecting 2 percentage points of the current payroll tax to personal saving accounts on a *voluntary* basis raise issues of adverse selection. Higher-income workers are more likely to choose this option, reducing the system's capacity in the near term for maintaining the progressive redistribution that underlies the system's social achievement. In addition, since higher income people currently have higher saving rates than lower income people, this provision increases the likelihood that payroll tax-financed personal saving will simply displace current voluntary saving.

Second, while redirecting up to 2 percentage points of the current payroll tax to personal saving would not affect Social Security today, since 2 percentage points corresponds roughly to the current annual Social Security surplus, in coming years those annual surpluses will decline sharply as a share of annual payroll tax revenues. Therefore, this provision cannot be maintained without also reforming the benefit schedule in some way to reduce outlays for benefits. I recognize that the sponsors have spoken of means-testing and raising the retirement age, and their candor is commendable.

Despite these cautions, Senators Kerrey and Simpson should be saluted for their genuine political courage in making the case for basic reform. Thank you.

TOWARD PERSONAL SAVINGS ACCOUNTS UNDER SOCIAL SECURITY: SOME ISSUES AND OPTIONS

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Thank you, Mr. Chairman. I appreciate the opportunity to appear today to discuss the timely and important issue of personal savings accounts under social security, and I commend you and Senator Kerrey for having opened the debate on this fundamental reform. With the retirement of the baby-boom generation beginning in just 12 years, Congress needs to move quickly to shore up the financing of social security, restore public confidence in the long-term viability of the system, and, at the same time, take the steps necessary to create a system of real value for younger people. Traditional "fixes"--reductions in future benefits and increases in the payroll tax designed to restore actuarial balance--are not up to the challenge. They have not offered lasting solutions to the financing problems of the past and will only exacerbate the unfavorable treatment of younger workers and future generations.

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

In the testimony that follows, I discuss the general merits of replacing a portion of social security with personal savings accounts; describe the proposal for personal accounts that will be included in the Social Security Advisory Council report:[1] and then address the specific questions you addressed to me pertaining to transition costs, investor protections, and retirees' contributions to reform.

Why Personal Savings Accounts Make Sense

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

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

For example, under our current social security system, which is financed basically on a pay-as-you-go basis, workers amass claims to future benefits with no real capital backing up these claims. This results in a huge unfunded liability (benefit promises far in excess of assets on hand), estimated by the Social Security Administration actuaries to be on the order of $8 trillion in present value terms. This is debt, pure and simple, although it is not included in official federal budget accounts.

By retaining the pay-as-you-go structure, which amounts to an income transfer mechanism from workers to retirees rather than a retirement saving mechanism for workers, workers--and society more generally--forgo the opportunity to invest in real private capital and to earn the higher rate of return it would afford. The lost income stemming from the opportunity foregone, that of moving toward a fully funded pension system built on real capital investment, is a very real economic cost of perpetuating the status quo.

If not reversed somehow, the loss of potential wealth, particularly among younger workers, will certainly weaken political support for social security. Increasingly, young people ask "Why can't we put our taxes into higher yielding investments?" "Why can't we have retirement savings accounts that we can call our own, like IRAs?"

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

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

Evidently, quite apart from the costs that arise from failing to close trust fund deficits in a timely way, there are real costs to society from failing to reform social security--the costs that arise from the nation's opportunities foregone. Economists have attempted to quantify the lost income and wealth owing to these distortions in saving and work decisions, and the size of the estimates suggests that prompt action to reform social security could result in very large gains in economic well-being. Reforms that deal only with the imbalance of numbers--such as the reforms adopted in 1977 and 1983--would fail to tackle the most important problems confronting social security today and, in so doing, most surely would exacerbate them.

Social Security's Declining Rates of Return

One issue that is a source of both economic and political concern is the poor implicit rate of return workers can expect to earn on their social security taxes. Due to social security's pay-as-you-go method of finance, rates of return have fallen sharply since the program's inception and are expected to continue doing so in future decades. This is because workers' taxes are not saved and invested for the future, with each generation funding its own retirement, but rather are spent on benefits to current retirees. With pay-as-you-go financing, workers make transfers to older generations based on the expectation that younger generations will make transfers to them when they are old. Rates of return are determined not by the rate of return to private capital investment, but by the size of the transfers received by a generation in relation to the taxes it has paid. Inevitably, this relationship deteriorates as pay-as-you-go systems mature and workers pay taxes over an increasing share of their work lives. Ultimately, the best a pay-as-you-go system can offer is determined by the growth rate of taxable wages in the economy, which is a function of the growth rate of the population and of labor productivity.

Referring to Chart 1, whereas the average 1950 retiree (the 1885 birth cohort) received a real rate of return on his or her taxes exceeding 20%, the 1970 retiree (the 1905 birth cohort) received a real rate of return closer to 10%, and the 1990 retiree (the 1925 birth cohort) can expect to receive about 5%. That rate is projected to fall to just 1%-2%--the projected growth rate of taxable wages--for young workers and future generations.[2] This is much lower than the real return to private capital, which has been estimated to be on the order of 9.3 percent for society as a whole (the real pre-tax return to capital) and about 5.4 percent net of corporate taxes. Higher-income workers, two-earner couples, and single workers will fare even worse. Most studies show that workers under about age 45 will not get back the value of their taxes plus interest.

Obviously, payroll tax increases or benefit reductions that shift costs to future generations--and thus to the people expected to fare most poorly under social security--are unlikely to boost political support for the system among younger people, upon whom the survival of the system depends.

There are those who complain about rate of return calculations on the grounds that they are used to evaluate social security along the single dimension of "money's worth," ignoring other important functions of social insurance. However, it is hard to dismiss the money's worth issue when discussing a program whose primary function is to deliver retirement benefits to workers in direct relation to their past earnings (and thus to their tax contributions). Rates of return are one useful measure of performance and they confirm the simple fact that, as social security has matured, it has become relatively less effective at delivering retirement benefits in excess of taxes paid. With the population--and social security--aging, social security's ability to generate windfall gains to retirees, or benefits well in excess of taxes paid, is evaporating and wealth losses are now in the offing. To maintain political support in the decades ahead, social security will have to offer better value to younger generations for their very substantial tax contributions.

From an economic perspective, the fact that social security offers younger workers and future generations a rate of return on their taxes that is much lower than the real return to private capital has two important implications: First, as noted by Harvard University economist Martin Feldstein, there is less saving and investment than there otherwise would be and a lower return on workers' "investments" in social security. This translates into significant losses of real income and wealth not just for individual workers but also for society as a whole. In addition, social security amounts to a net tax on wages for the typical worker, causing distortions in labor market outcomes and in workers' desired form of compensation. This translates into additional significant losses of income and wealth.

Feldstein estimates that privatizing the social security retirement program--where this is taken to mean shifting entirely to a system of mandatory personal savings accounts, fully funded with workers' contributions--would result in net economic gains on the order of 3% of GDP forever, or the equivalent of $15 trillion in present value terms. His analysis assumes that social security's outstanding liability (its implicit debt) is met entirely by issuing explicit government debt.

In another study, which focusses on the gains to eliminating the labor market distortions arising from a weak or non-existent tax-benefit link, Boston University economist Laurence Kotlikoff finds that privatization can generate large long-run gains in output and real income. In this case, privatization is taken to mean shifting entirely to a system of mandatory 401(k) plans, and outstanding liabilities are assumed to be met by a consumption tax.

While these studies are certainly not the last word on the issue and do not attempt to quantify all the economic decisions that might be influenced by social security reform, they nevertheless provide powerful evidence that the economic gains to fully funded, personal accounts can be expected to be very large.

The benefits of personal savings accounts can generally be summarized as follows. Personal accounts would:

o replace a system of unfunded benefit promises that shifts the cost of elderly transfers to workers and future generations with a fully-funded system that requires each generation to save for its own retirement;

o create a direct link between the tax contributions workers make and the benefits to which they are ultimately entitled, eliminating the labor market distortions created by the payroll tax;

o replace a system whose solvency is highly sensitive to economic and demographic developments (both foreseen and unforeseen) with a system that basically runs on automatic pilot--personal accounts vary in value with changes in investment performance but remain fully funded at all times;

o eliminate the need for the retirement earnings test, which penalizes people who have invested mainly in human capital and derive their incomes mainly from wage earnings;

o eliminate the double taxation that applies to ordinary savings;

o allow individual workers and families to be directly involved in the investment decisions that will vitally influence their future wealth and income; and

o by giving workers real ownership claims over the contributions to and the proceeds of their accounts, substantially reduce the political uncertainty surrounding the size and cost of future benefits.

The Social Security Advisory Council Option

Faced with a serious and pressing financing problem, declining public confidence, and poor rates of return for younger generations, many of us on the Social Security Advisory Council recognized the need to move toward a fully funded component of social security with investment in private capital markets. We believe that both individuals and the economy as a whole stand to gain from a system built on real capital investment. In addition, most of us recognized the potential hazards of centralizing and possibly politicizing investment decisions, and some of us saw the need to design an investment policy that would be highly decentralized so as to leave the allocation of capital to be determined by market forces. Finally, most of us recognized the powerful effect that private ownership could have in building confidence about the future of social security. Not surprisingly, therefore, personal savings accounts are a key component of two of the three plans that will be offered by the Social Security Advisory Council.

While there are many ways that personal accounts might be incorporated into social security--on a limited basis as in the legislation offered by Senators Kerrey and Simpson, or on a broad-scale basis, as in Chile, or on a mandatory or voluntary basis--I will use one of the proposals developed by the Advisory Council to suggest the merits of the general approach.

Personal Security Accounts

The Social Security Advisory Council, unable to reach consensus on a single reform option, plans to issue a final report with three options, one of which would gradually convert half of the retirement program into fully funded, individualized retirement accounts. This option, endorsed by 5 members (including me), would gradually move toward a two-tiered system: the first tier would provide a flat retirement benefit for full-career workers, financed by 7.4 percent of the current social security payroll tax (now 12.4 percent, excluding medicare), and the second tier would amount to a system of mandatory personal savings accounts, referred to as Personal Security Accounts (PSAs), funded with the remaining 5 percent of the payroll tax. Workers would own these accounts and the interest thereon, they would be free to invest them in a wide range of investments and financial institutions, they could begin making tax-free withdrawals at 62--regardless of their income or work status, and they could include any balances in their estates. The 5% tax would be rebated for investment to workers or to the financial institutions of their choice; accounts would be held and managed by private financial institutions. (All workers under 55 would receive the 5% rebate for investment in a PSA; however, other aspects of the two-tiered system would take several decades to be phased in and would be fully effective only for workers under 25.)

This reform would turn the vast majority of social security's 130 million taxpayers into investors and, in the next decade alone, would release literally hundreds of billions of dollars of payroll taxes for investment in the private sector. As an indication of the magnitudes involved, taxable payroll in the U.S. is now about $3 trillion, 5% of which is $150 billion annually, with the amount of additional revenues available for investment each year growing at the rate of growth of total wages in the economy. With workers assumed to allocate half of their contributions to equities and half to U.S. government securities, the SSA actuaries project that the total accumulation of assets in personal accounts will be close to $6 trillion in 2020 and $10 trillion in 2030 (in constant 1995 dollars).

For purposes of comparison, the other two options the Advisory Council will offer are these:

-- Option 1, which has the support of 6 out of 13 members, is basically a "maintain benefits and increase revenues" option: it would increase benefit taxation, expand coverage, and increase tax rates in the distant future. This much is fairly conventional. In addition, however, this option would require the government to begin investing a portion of trust fund assets in private equities, that portion rising to about 40% within 15-20 years, the dollar equivalent of more than $1 trillion (in constant 1995 dollars) in centrally-managed equity holdings by 2020.

A significant portion of the long-range deficit is assumed to be closed by this change in investment policy and the assumption that it will increase the return to the trust funds' overall portfolio by more than half--from 2.3% to 3.8% real.

-- Option 2, supported by the Council chairman and one other member, is basically a "maintain the current payroll tax and scale back benefits" approach. It would, among other things, gradually raise the retirement age to 67 (then index it to changes in life expectancy) and slow the growth of benefits for future retirees. This too is fairly conventional, particularly since the trust funds would amass very large reserves invested entirely, as is the case today, in special-issue U.S. government bonds. In addition, however, this option would create mandatory individual accounts funded by a 1.6% increase in the payroll tax (bringing the combined social security and medicare tax to a whopping 16.9%). These accounts would be centrally managed by the federal government, with a narrow range of investment options available to workers, possibly a few stock or bond index funds. Workers would be required to withdraw their funds at retirement in the form of annuities.

On the surface, this latter option appears similar to the Kerrey-Simpson bill in that it would create personal accounts managed by the federal government, such as in the Thrift Saving Plan for federal employees. However, these accounts are funded by a dollar-for-dollar increase in the payroll tax rather than through reductions in the projected cost of the program; they are smaller (1.6% rather than 2%); and, as discussed below, the competitive checks on the performance of the government in managing these accounts are far weaker than in the Kerrey-Simpson bill or in the Thrift Savings Plan. In addition, workers are forced to purchase annuities with their accumulations rather than being given flexibility in the way they chose to withdraw their funds at retirement.

In our view, the system of personal accounts we propose, managed by private financial institutions and controlled by individual workers, would be more effective at addressing the weaknesses in the present system--and taking advantage of the opportunities in private markets--while avoiding the pitfalls of the other two Advisory Council options. It would fully fund a substantial portion of social security and create a mechanism for investing workers' taxes in higher-yielding private capital without centralizing or politicizing investment decisions--which would put taxpayers' monies (and retirees' benefits) at risk and likely distort the allocation of capital in the economy.

Transition Costs

There are no free lunches, of course. As with any proposal to advance fund a portion of social security, there is a transition cost of getting from where we are to where we would like to be. The reason is social security's enormous ($8 trillion) unfunded liability. Moving toward a fully funded component of social security--without reneging on expected benefits--requires that workers (or somebody!) meet the cost of benefits to retirees and older workers, and in addition begin paying for a portion of their own retirement benefits.

The transition cost of our proposal has been estimated by the social security actuaries to be the equivalent of a 1.5 percent payroll tax supplement over a 70-year period, supplemented during an intervening period of 35-40 years by issuing new public debt (totalling $1.2 trillion in 1995 dollars). Under SSA's projections, this debt would be fully repaid by the end of a 70-year transition, at which time the tax supplement would be repealed.

I would note that none of the members who support this proposal favor a payroll tax supplement. Among taxes, we would prefer a broad-based consumption tax, which would be paid by a broader segment of the population, including the elderly who have fared so well under the current pay-as-you-go system, create fewer labor market distortions, and be consistent with our more general goal of boosting saving. However, since the U.S. does not presently have such a tax, we concluded that the costs of setting up the administrative apparatus and layering this tax on top of the existing income tax structure would surely outweigh the gains. Should the U.S. tax system move in the direction of a consumption base, we would regard this as a highly preferable means of meeting part of the cost of transition.

We also would prefer to couple general spending reductions with any tax increase. Without being able to identify a specific set of spending reduction measures, however, the consensus was that an explicit tax was required.

We do believe that debt-financing part of the transition is desirable. This helps spread the burden to future generations, who stand to gain the most from these reforms, rather than concentrating it on current workers.

Having said this, we are aware that issuing bonds of this magnitude is not politically tantalizing. However, it basically amounts to making explicit a portion of the debt that already exists--in the form of outstanding, unfunded benefit promises. Adverse economic ramifications, such as might accompany a comparable increase in conventional debt, would only be expected to the extent financial markets were anticipating that the government would not meet outstanding benefit promises (beyond the extent necessary to restore long-range solvency). With earnings and labor force growth, new capital investment through accumulations in personal savings accounts would be undertaken at the same time the government was issuing new explicit debt. The tax, while no more tantalizing, establishes the means by which this debt will be repaid.

Transition costs can be met in other ways--through additional borrowing or further (social security or non-social security) tax increases or spending reductions--altering how the burden is distributed across people and over time, and thus the distribution of net gains across income classes and generations. But there is no getting away from the fact that if we are to move to a higher-yielding system built on real saving and capital accumulation, in which each generation saves for its own retirement rather than passing the cost along to future generations, there is a price to be paid--that price being the cost of meeting outstanding liabilities (or expected benefits) under the old system.

Making matters more difficult, social security is significantly underfunded on a pay-as-you-go basis. To make ends meet and also allow for personal accounts, this option includes a number of changes to reduce the ongoing cost of the program, such as raising the retirement age to 67 then indexing it to longevity, and creating the new tier 1 benefit capped at the equivalent of $410 monthly in 1996 dollars.

One of the questions you posed to me in your letter of invitation, Mr. Chairman, pertains to the advantages and disadvantages of the way the Kerrey-Simpson bill and our proposal handle transition costs. As you note, the Kerrey-Simpson bill involves smaller transition costs and, in addition, does not require a tax increase to fund the transition.

How large or small the transition costs are depends entirely on the extent to which social security becomes fully funded, in this case through personal saving accounts funded by workers' contributions. The Kerrey-Simpson bill creates a system of personal accounts that is fully funded with 2% of the payroll tax (about one-fifth of the overall tax devoted to the retirement program): our proposal creates such a system with 5% of the payroll tax (about one-half of the tax devoted to the retirement program). The larger cost of our proposal reflects the greater extent to which we move toward fully-funded personal accounts and make explicit and begin to pay off social security's unfunded liability.

In our view, it is highly desirable to move toward larger personal accounts than in the Kerrey-Simpson bill. Larger accounts offer workers the potential for higher benefits and a better rate of return on their social security taxes, and on net should result in significantly larger economic benefits. In addition, larger accounts would give workers keener incentives to make informed investment decisions and to monitor the performance of their investments. Larger accounts also would be relatively less costly for financial institutions to administer.

As for the means of financing the transition, the Kerrey-Simpson bill provides for what might be called "internal financing." Social security benefits are scaled back sufficiently to close the long-range deficit and, in addition, cover the cost of the 2% personal accounts. This cost, moreover, is met by a combination of reductions in future benefits for current recipients and for future recipients. As analyzed by SSA, our proposal finances the transition "externally"--through explicit government borrowing and a general tax increase or equivalent spending reductions. (Actually, our proposal includes substantial internal financing as well since, in recognition of the fact that individuals would be accumulating sizeable personal savings accounts, social security benefits are scaled back more than necessary to close the long-range deficit.[3] These benefit reductions would apply almost exclusively to future retirees.[4]) As a result, under the Kerrey-

Simpson bill. relatively more of the cost of transition is borne by current older generations. While there are advantages to this. in particular. reversing some of the · enormous wealth transfers that have taken place from younger to older generations. there also. as noted earlier. are advantages to spreading the burden to future generations who stand to gain the most from reform.

From a practical political standpoint. there was little support on the Advisory Council for modifying the cost-of-living adjustment (beyond the adjustments that will flow from measurement changes made by the Bureau of Labor Statistics). There was also no support in the our group for increasing the share of benefits subject to taxation (in fact, we propose reducing the share of benefits subject to taxation to 50%). As a result, there were few practical means of spreading the burden to current older generations except by way of the consumption tax. The one change affecting the elderly that our group did support--as did the other members of the Advisory Council--was a phase-out of the thresholds used for determining how much of an individual's benefits are taxable. Because of other features of the tax code that limit income tax liabilities for the low-income elderly, this change is expected to affect only a small share of beneficiaries.

A final point worth noting about the transition. in particular. the 1.5% payroll tax supplement, is that this tax bears no relationship to the 1.6% payroll tax increase contained in the Council chairman's proposal, despite the similarity of their magnitudes. Under our proposal. the payroll tax supplement (with bond financing) is a means to pay off accrued liabilities and to make possible the transition to fully-funded accounts that ultimately comprise half the retirement program. When the transition is passed, in about 70 years, there is no continuing tax liability. In addition. the 1.5% tax supplement is an estimate of the cost of transition based on projections that do not take into account any savings-induced increase in the capital stock or per capita income. If, as we expect, the reforms are beneficial to the economy, the transition tax would be lower. In the case of the Council chairman's proposal, on the other hand, 1.6% would be established in the law as the increase in the payroll tax used to fund the individual accounts. These accounts (and the tax) are permanent add-ons to the current retirement program, in contrast to our plan in which the accounts are a substitute for a portion of the program and the tax is transitional.

Investor Protections

Another concern you raised is that many Americans may be unsophisticated about making investment decisions. You ask what kinds of protections these workers would have from inappropriate risks and what kinds of assurances they would be given of an adequate rate of return.

To give you the short answer, in thinking about how to structure the personal account tier of our proposal, we were unconvinced that workers did not--or could not, with experience--make sound financial decisions. Good decisions come with education and information, and with experience and learning--all of which would be gained rapidly by workers making regular contributions to personal accounts offered by competing financial institutions. Investment decisions such as this are not like certain other major investment decisions--such as purchasing a new home or deciding whether or not to undergo some major surgery--which are made very infrequently, so little experience is gained that might improve future decisions, or which involve an element of urgency that precludes the acquisition of appropriate information. Market returns on workers' accounts would provide steady information on investment performance; the relative success of competing financial institutions would provide valuable information as well.

Our proposal contains only one proviso: that personal accounts be invested in financial instruments widely available in financial markets. While we recognize the government's (i.e., taxpayers') potential interest in limiting excessive risk taking, there was no consensus about the kinds of restrictions that might be needed or be found cost-effective. (And indeed, the concern expressed most frequently, in financial news and other coverage of retirement income planning issues, is that workers do not take enough risk.) We also recognized the possibility that with some investment options offered by some institutions, administrative fees could be high in relation to investment returns (leading someone to suggest capping the fees that could be charged and requiring licensing of financial institutions handling personal accounts, a suggestion without general support). The problem here, as in so many areas of government regulation, is making sure that there is a problem worthy of federal intervention, that there is a regulatory solution well-tailored to the problem, and that the regulations are likely to result in net economic gains.

For example, we were well aware of the concern that workers err on the side of taking too little risk in their investments for retirement and thus may not generate adequate retirement incomes. However, we were presented with evidence, based on experience with a sample of 401(k) plans, suggesting that this concern may be overstated because of the failure to disaggregate the data on the basis of workers' ages. The data suggested that asset allocation decisions are (appropriately) related to age: the older the worker, the smaller the share of assets allocated to equity and the larger the share allocated to fixed-income investments. The relatively high overall share of assets in fixed-income investments derives, at least in part, from the fact that older people hold a disproportionate share of total 401(k) assets.

More generally, in considering the population as a whole and the kinds of regulations that might be needed, it is unclear what benchmark one would use to determine whether workers were taking too much or too little risk. Certainly, the "right" way to allocate investments depends not only on one's age but also on the size and risk-return profile of non-pension assets, among other factors.

In general, we envision a regulatory environment consistent with a wide range of choices for workers--for example, a range of options comparable to that now available to workers through 401(k) plans--offered by a wide array of financial institutions competing for workers' business. (My own view is that it would be far preferable (if far more difficult) to delineate what is not acceptable in the way of investment options or institutions, leaving markets free to develop new ways of delivering retirement income security, than to define what is acceptable, effectively banning everything not so defined and potentially sharply curtailing innovations that could greatly improve the well-being of social security participants.) In addition, we believe that concerns about the investment decisions made by unsophisticated investors can be rectified most effectively by an educational effort, not by significantly restricting investment choices or by substituting government decisions for individual decisions.

As to the question of what assurances workers would be given of a "reasonable" return on their investments, the short answer is none. Neither (to my knowledge) are there any such assurances under the Kerrey-Simpson bill or under the Council chairman's proposal, which involves government-managed investment accounts. And, most importantly, there are no such assurances under the present social security system! As noted, many middle-aged and younger workers are projected to earn negative rates of return on their social security taxes--and this is before factoring in the political risk that future benefits for middle- and high-wage workers might be scaled back 25% or more, that the cost-of-living adjustment might be capped, reduced, or eliminated altogether (if only temporarily), that benefit taxation may be increased appreciably, or that benefits may one day be means-tested.

One of the features we find most appealing about personal accounts is that workers own their accounts, and the retirement savings they embody, and are thereby exposed to much less political risk than under the present system--political risks that, over the next 20, 30, or 40 years could easily dwarf the financial risks of a well-diversified portfolio.

Having said this, when discussing the adequacy of return or the adequacy of benefits, the first tier of our proposal (fully half of the social security retirement program) should not be ignored. The first tier embodies a high degree of redistribution from high to low wage workers--indeed, two workers with identical years of work, one of whom earns the minimum wage and the other of whom earns four times that (and pays four times the taxes) would get the same benefit. This redistribution is not hidden in complex benefit formulae and eligibility criterion, but is a straightforward result of moving toward a flat benefit for full-career workers, prorated only for years of work. As under present law, this benefit is fully cost-of-living adjusted.

The first tier benefit, which amounts to about two-thirds of the poverty level, is designed to ensure that, together with second tier accumulations, all full-career workers, regardless of income level, can expect to receive a minimally adequate retirement income from social security. By minimally adequate we mean enough so that even low-wage workers--and even workers who invest in relatively low-yielding assets--should not have to resort to means-tested poverty assistance. Our expectation is that workers will do considerably better than this.

Of course, tier 1 benefits are no more "guaranteed" than are social security benefits today. They may be more secure, however, by virtue of the fact that they can be financed at a significantly lower projected tax cost (7.4% as compared to 12.4%).

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

Also, with ownership of the contributions to personal accounts--and the interest thereon--workers would have keen incentives to make sound financial decisions, either by acquiring the needed expertise or seeking out those who have it.

This is not to say that with personal accounts everyone will make the best financial decisions, reaping the best possible rates of return. Some workers will take on too much risk; some workers will not take enough. We were in general agreement, however, that workers would fare better, ex ante, under this option than under the present inadequately-financed system, a shored up pay-as-you-go system, or either of the other two options developed by the Advisory Council.

Making the reasonable assumption that workers invest their taxes in roughly the same way as participants invest their funds in 401(k) plans--and that the relationship between stock and bond returns is comparable to its historical relationship--the SSA actuaries project that workers at all earnings' levels would earn higher benefits, and higher rates of return, under our proposal than under the other two options to be offered by the Advisory Council. (In certain cases, option 1, which basically maintains present-law benefits, is projected to perform better for workers with non-working spouses, but one-earner couples are expected to comprise a relatively small part of the beneficiary population in the next century. Moreover, we do not believe that the centralized investment of a massive reserve fund would be approved by Congress, meaning that the plan would very likely involve significant tax increases that are not included in the projections.)

The Thrift Saving Plan--A Poor Analogy for Centrally-Managed Accounts Under Social Security

The individual-accounts add-on to social security, created under option 2, has been likened to the Thrift Savings Plan for federal employees, which is held up as a model by some. In one sense the analogy is apt: the government would offer participants a narrow range of investment options, presumably including equity and bond index funds, and individual accounts would be managed by the federal government. But under the TSP, workers may invest in one or more of three passively managed index funds (a federal government bond fund, a corporate bond fund, and a commercial large capitalization stock fund). Under option 2, workers must invest in one or more of the funds offered. Under the TSP, contributions, which may be as high as 10% of earnings, are entirely voluntary: If displeased with restrictions imposed on, or the performance of, a particular fund, workers can shift their contributions and interest earnings to another fund, reduce the size of their contributions or stop making contributions altogether, and, in certain circumstances, withdraw their contributions and earnings. In a very real sense, the funds compete head-to-head with private funds and other private investments, not just with one another. The competition fostered by individual choice and the mobility of resources places real limits on the inefficiencies that can be imposed by Congress or by its designated governing board.

There is no similar competitive check under the individual-accounts add-on option. Option 2 mandates that workers invest a fixed amount of their earnings in one or more pre-selected funds; there is no freedom to reduce contributions, stop making contributions, or to reallocate them to privately managed investments.

It is interesting to note in this regard that the Kerrey-Simpson bill allows workers to invest either in one or more of a set of Thrift Saving-style funds held by the federal system or in individual retirement accounts. This gives workers a critically important escape hatch in the event the funds offered by the government fail to perform as expected, the information and management services are inadequate, or the range of investment options is too narrow to provide the desired mix of portfolio risk and return.

(A recent GAO report noted that the three index funds offered by the TSP did not reflect the range of investment options offered by private-sector 401(k) plans and supported the addition of two higher-risk/higher-return funds: an international stock fund and a domestic small capitalization stock fund.)

In addition, there is no comparison between the scale of operations of the TSP and that of social security--even now, let alone as projected under any of the personal account plans. As of January 1995, about one million workers were making voluntary contributions to the TSP, as compared to the 130 million who would begin making mandatory contributions under option 2, and total investments were $27 billion.[5] This compares to social security's *current* reserve fund of about one-half trillion dollars, which already exceeds by a factor of nearly 20-fold that of the TSP and dwarfs the largest corporate pension funds held by U.S. corporations, including such giants as IBM, AT&T, and General Motors. The problems of political management and control of investment funds and fund managers can be expected to increase exponentially with assets as large as those contemplated under the various proposals for centrally-managed personal accounts.

These problems must be weighed carefully against the supposed gains to sharply curtailing individual choice and competition in supply so as to prevent some workers from taking undue or inadequate risks (as defined by whom?). An effective--and effectively controlled--investment policy requires that competition be fostered wherever possible. Competition helps generate information on alternative investments, investment strategies, and investment managers that is needed by citizens and policymakers if resources are to flow to their highest valued uses.

An Historical Observation

As a final thought, in thinking about the question you posed to me regarding workers unsophisticated in financial matters, I reflected on the emergence of social security over a half century ago and the arguments that were made in the 1920s and 1930s about why the government needed to intervene in the retirement saving business. One of the key arguments was that industrial workers had low wages and couldn't afford to save adequately. Another was that private pensions were not generally available. And, of course, there was the Great Depression, which wiped out the means by which elderly Americans supported themselves--jobs were lost, accumulated savings were wiped out, and company pensions (which were still relatively new) were strained severely, causing benefits to be cut back in some cases and eliminated in others. To my knowledge, the idea that American workers could not make good, careful economic decisions--in the best interests of themselves and their families--is not one that surfaced, either explicitly or implicitly, at the time of social security's founding.

It is ironic that a concern about "unsophisticated investors" emerges now, in the presence of modern capital markets and sophisticated financial institutions working within a comprehensive regulatory framework, with large numbers of workers experienced with self-directed investment plans, and with a government safety-net that protects the elderly both directly (through programs such as Supplemental Security Income, Medicaid, and Food Stamps) and indirectly (through the insurance and regulation of financial institutions and company pensions).

Concluding Thoughts

When Congress takes up the issue of social security reform, it will be under pressure not only to close deficits but also to shore up public confidence and restore value for younger workers, while at the same time creating a tax and regulatory environment conducive to saving and economic growth. Reforms that move in the direction of creating a system of true pensions, with individually-controlled, fully funded retirement accounts, buttressed by a government safety net, hold real promise for the future.

NOTES

1. The Social Security Advisory Council is a 13-member panel appointed in 1994 by Secretary of Health and Human Services Donna Shalala. It is charged with making recommendations on, among other things, the long-range financing problem. As of this writing, the Council has developed three reform options, none of which has majority support. The final report is being prepared, and, when completed, will be submitted to the Administration and to Congress.

2. Because of the demographic transition in the next several decades, during which time the system has to be adjusted to respond to the demographic shocks of the past, rates of return for younger workers are likely to fall below the long-term sustainable rate.

3. SSA estimates the transition cost as the general tax increase or spending reductions and the new borrowing required to keep the reformed program (including spending on old-law benefits for current retirees and older workers, on past service credits and tier 1 benefits for middle-aged workers, and on tier 1 benefits for young workers) solvent on a pay-as-you-go basis, after taking into account all proposed social security spending and revenue measures, including those required to restore solvency. This measure is both under- and over-inclusive: it ignores the social security changes in excess of those required to restore solvency, which help to offset the revenue loss--or to pay outstanding liabilities--in the transition to personal accounts, and it fails to net out the social security changes required to restore solvency, which must be made whether or not there is a shift to personal accounts.

From a fuller economic perspective, the cost of transitioning to personal accounts is the amount of outstanding liabilities that would not be met (or the windfall losses that would be borne) if the new system were implemented immediately, with no credit for past service or recognition of accumulated benefit obligations--and beginning from a baseline in which solvency had been restored. For example, in moving from an adequately-financed pay-as-you-go system to a fully-funded, fully privatized system, with all outstanding liabilities met through, say, recognition bonds, the transition cost would be the liabilities outstanding on the date of implementation.

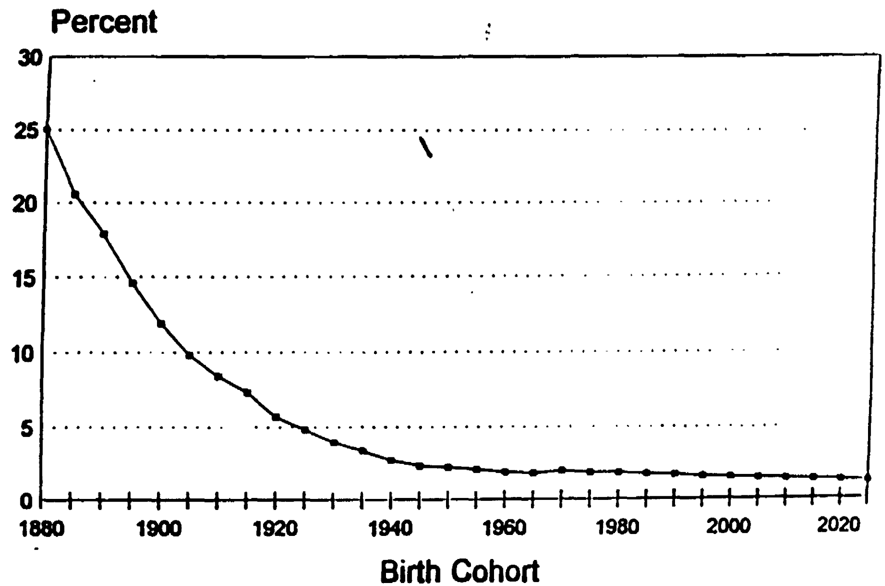
4. Only two provisions dealing with benefit taxation would affect current recipients: the elimination of the income thresholds used to determine the amount of benefits that are taxable and a reduction from 85% to 50% in the share of benefits that are taxable.

5. See U.S. General Accounting Office, Federal Pensions: Thrift Savings Plan Has Key Role in Retirement Benefits (October 1995), GAO/HEHS-96-1.

Chart 1

Real Internal Rates of Return under Social Security

Assumes Taxes Adjusted to Maintain Solvency



Source: SSA (6/25/95).
Notes: Average rate of return per cohort based on combined employee and employer taxes; excludes disability insurance [illegible] intermediate projections.

COMMUNICATIONS

AMERICAN ACADEMY *of* ACTUARIES

Subcommittee on Social Security and Family Policy
Committee on Finance
United States Senate

Hearing on Proposals to Create Personal Savings Accounts

Written Testimony Submitted by
American Academy of Actuaries
Committee on Social Insurance

May 20, 1996

The American Academy of Actuaries is the public policy organization for the actuarial profession, providing unbiased actuarial information to lawmakers and regulators. The Academy Committee on Social Insurance comprises leading actuaries with broad experience in the design and management of governmental social insurance programs. The committee has drafted two issue briefs "Social Security Privatization: Individual Accounts," and its companion "Social Security Privatization: Trust Fund Investments," as introductory guides to the debate on Social Security privatization. Other Academy Social Security issue briefs focus on benefit indexing; benefit levels; means testing; retirement age; and taxation of benefits.

Members of the Social Insurance Committee: Jerry Bogart, FSA, MAAA, Chairperson; James Beirne, ASA, MAAA; Richard Foster, FSA, MAAA; Stephen Goss, ASA, MAAA; Benjamin Gottlieb, FSA, MAAA; C. David Gustafson, EA, MAAA; Michael O. Khalil, FSA, MAAA; Julie Dianne Pope, ASA, MAAA; Gregory Savord, FSA, MAAA; Bruce Schobel, FSA, MAAA; Ronald Solomon, ASA, MAAA; Eric Stallard, ASA, MAAA; Kenneth Steiner, EA, FSA, MAAA; and Michael Sze, FSA, MAAA.

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Social Security Privatization: Individual Accounts

Retirement benefits under the existing U.S. Social Security program are funded at close to a pay-as-you-go level. Many analysts advocate increased levels of advanced funding, even to the extent of fully funding all accrued obligations. In this way, workers would pay for their own retirement benefits, instead of relying on transfer payments from future generations. Such a system would accumulate tremendous reserves, which many observers suggest should not be managed by the federal government. Various ways of moving the retirement system assets into private hands are generically referred to as privatization. (It is generally acknowledged that ancillary social insurance programs such as disability insurance and survivors' benefits would not lend themselves to privatization and would continue to be financed under existing methods.) A characteristic common to many privatization proposals is the use of individual accounts. The social insurance system in Chile was largely privatized early in the 1980s, and workers participating in the new system accumulate their contributions in individual accounts: this is often cited as an example of what could be done in the U.S.

What Is Privatization?

The existing Social Security program features a relatively small contingency reserve, invested entirely in U.S. government bonds. Many observers have advocated increasing the funding level and tapping into the higher rates of return available in private investment markets. The primary goal is to obtain a greater return on investment and ultimately permit lower taxes. An additional goal is to increase total national savings, so that the country can better afford to pay retirement benefits to the baby boomers and those who follow them. The broad concept of investing funds in the private sector, which in turn implies accumulating substantial advance funding, is known as privatization.

Individual Accounts

Privatization of asset investment could be achieved within the structure of the existing Social Security program simply by changing the law to provide for private-sector investment of funds. This would not change the funding philosophy—although the potentially higher returns eventually would result in a larger trust fund.

However, most proponents would privatize the system more directly through the use of individual accounts. A range of proposals currently exists that would allow (or require) workers to accumulate all or part of their retirement funds in accounts similar to today's individual retirement accounts. Although individually owned, the funds typically would be administered by professional investment managers. The government would likely restrict investment choices to some extent to provide workers with additional protection. The government also might provide FDIC-style insurance on principal up to a certain amount. However, individual fund owners would make the basic investment decisions—and accept the accompanying risks.

Voluntary or Mandatory?

One fundamental question for all privatization proposals is whether individual worker participation in the privatized system would be voluntary or mandatory. If voluntary, the old system would have to continue indefinitely. In this case, workers would choose the option most favorable to their specific circumstances, adding to program costs. Running dual programs also is more expensive administratively.

Some proposals would give current workers over a certain age—30, for example—the option of joining the new system. For younger workers and new entrants, however, participation would be mandatory.

Of course, dual programs would be required in any event if only part of the existing program were privatized. For example, the current program might be used to provide a much lower level of benefits, while some of the contributions might be diverted to individual accounts invested in the private sector. This government guaranteed minimum benefit would not vary by income level, while the private benefits would vary by both income level and investment results.

Investment of Funds

Under an individual account approach, investment risk shifts from the Social Security program to the individual. This transfer of risk could have significant impact on the success of an individual account program. Individual investors generally do not take a long-term view, due to liquidity needs and limited personal resources. Individuals also often lack adequate access to investment information to make effective investment decisions.

Additionally, individuals cannot absorb the amount of risk that the Social Security program can, especially during periods when market values drop sharply. For both financial and psychological reasons, individuals are less able to ride out cycles of poor economic performance. Individuals could become even more risk-averse if the Social Security safety net is reduced to a minimum benefit or eliminated altogether.

Absent a government guarantee, individuals are also more vulnerable to the loss of their principal. Principal can be lost due to an issuer's bankruptcy, inappropriate investment advice, or even securities fraud. (If the government restricts investments to certain approved financial institutions, net yields might be reduced, and a government guarantee program *still* might be necessary.)

For these reasons, individuals will generally steer a safe course in directing their investments. This is also the route to lower returns and smaller benefits. Retirees and workers near retirement are especially likely to adopt conservative investment practices and receive lower returns. Studies by a number of actuarial consulting firms have compared investment returns for traditional pension plans—where the employer assumes the investment risk—to returns on plans where individuals take the risk. Traditional plans outperform individual plans by 150 to 250 basis points each year. Such differences can have great impact on benefits. For example, a 200 basis point difference for a 35-year-old would translate into a 50% smaller pension beginning at age 65.

In summary, gross investment yields under an individual account approach may be greater than under the current Social Security program. However, it is not reasonable to assume that individuals will earn the historically high returns of equity markets or the returns realized by traditional pension plans. Workers will need investment education to ensure they recognize the opportunities as well as the risks of the private market.

Benefits

The existing Social Security program has a weighted benefit formula that favors low-income workers. Although the dollar amount of benefits increases with the level of earnings covered by the program, the rate of benefit increase declines, with the result that high-income workers receive a lower percentage of their previous earnings than low-income workers.

This weighted benefit formula embodies the program's historical balancing of "individual equity" against "social adequacy." With strict individual equity, all participants would get back their own taxes plus interest, but the low-paid might receive inadequate benefits. If social adequacy were the only consideration, everyone might get the same benefit or benefits for the wealthy might be reduced. The existing system strikes a balance between these considerations in its weighted formula.

With individual accounts, transfers from higher income to low-income workers of the same generation would disappear, raising the question of benefit adequacy for low-paid workers. Such a change would represent a marked departure from the current emphasis on social adequacy. Of course, if enough consistently high-yielding investments exist—and people invest in them—benefits from individual accounts theoretically could exceed Social Security benefits even for workers at the lowest earnings levels. Still, the high-paid would almost certainly receive relatively greater advantage from switching to individual accounts than the low-paid would.

At retirement, individual accounts could be converted into annuities that pay a fixed monthly amount. These annuities could be designed to pay increasing benefits, so that payments would approximately reflect changes in the cost of living. While Social Security benefits are indexed directly to the Consumer Price Index, such indexing of private annuity benefits is not currently available. CPI-based indexing could be made available with government participation, for example by issuing CPI-indexed bonds that workers could buy through their accounts. The extent to which the new system would include a safety net varies from proposal to proposal.

Preservation of capital during the working years is always a serious problem, as many workers with legitimate needs— health-care emergencies, unemployment, natural disasters, etc.—would seek to withdraw (or borrow) funds for non-retirement purposes. The evolution of loan provisions in current 401(k) plans illustrates the issues involved. Initially, 401(k) funds were off limits until retirement. If funds were withdrawn, a stiff tax penalty was imposed. Then, as workers clamored for access to meet important preretirement financial needs, loan provisions were enacted into law.

Unfortunately, if retirement funds cannot be preserved and used for actual retirement, workers could actually be worse off under a privatization arrangement than under the existing system, even with an increased level of funding and higher rates of return in the private equity markets. However, it might prove politically impossible to seal account funds off from workers who face financial need before retirement.

Preserving funds after retirement poses a problem. Individuals who do not convert their accounts into annuities at retirement risk the possibility of outliving their resources, especially if the individual account is their primary source of income. Without the restraint provided by a lifetime Social Security annuity or pension payment, some retirees may consume their individual accounts too rapidly. A large group of people with a sharply reduced standard of living could place heavy burdens on governmental safety nets.

Administrative Costs

Administrative costs of the existing Social Security program are very low—less than 1 percent of outgo. Critics of privatization question whether private-sector investment managers could match this. In addition, there would be new costs associated with marketing. The higher costs would at least partly offset the expected higher investment returns and ultimately affect the level of benefits available from the individual accounts.

Privatization advocates counter that Social Security's administrative costs are low partly because employers provide much of the administrative work free of charge. In any event, private-sector investment returns could be high enough that workers could pay higher administrative costs and still receive higher benefits than under the current program.

Transition

Because Social Security has been financed on close to a pay-as-you-go basis, the program's accumulated funds are nowhere near sufficient to cover its obligations to current and near-term beneficiaries. The program's continued existence depends on receiving future tax income to meet those obligations. To the extent that tax income is diverted into private accounts, the financial status of the current program is put in jeopardy. Moreover, to the extent that Social Security's fund build-up masks the government's deficit, any reduction in the build-up makes the deficit look worse.

For that reason, most privatization proposals would phase in over several decades, thus providing the existing program enough income to meet its needs, while simultaneously building up substantial private accounts for younger workers. People who already had benefits accrued under the existing program would be treated differently depending on age. The youngest workers—perhaps those under 30—might forfeit all accrued benefits under the existing program. Middle-aged workers might get some past-service credit but not accrue additional benefits. The oldest workers, those closest to retirement, would have their present-law benefits guaranteed. To pay benefits to these workers and to current retirees, additional revenue would be needed for several decades. In effect, several generations would have to finance their own retirement and maintain the existing program for their elders.

While the transition would be lengthy and expensive, a privatization plan based on individual accounts could be implemented.

Chile's Experience

In 1981, Chile converted its defined benefit pension system into a private savings plan in which pensions are largely determined by individual contributions and investment choices. Because the previous system was failing, about 90 percent of Chilean workers opted to join the new program. Since then, the private pension plans have surpassed their target rates of return.

At the same time, the government of Chile did not free itself of all social insurance obligations. It is still responsible for paying the accrued benefits under the old system. In addition, the government guarantees minimum rates of return and minimum benefit levels to participants in the new system. To date, neither guarantee has been triggered, because the performance of the private investment managers has been good. However, the potential liability to the government in the event of adverse experience is huge.

While Chile is often cited as a privatization success story, its unique social and economic conditions give its experience limited applicability to the United States.

Questions That Must Be Answered

A privatized system based on individual accounts could provide substantially higher benefits for most workers than the existing Social Security program. However, before a feasible system can be crafted, several major questions must be addressed:

- Will private-sector investments continue to yield higher rates of return?
- Will individual investors take advantage of those high rates?
- To what extent will higher costs erode rates of return?
- Will individuals be permitted to spend their accumulated funds before retirement?
- Will the cost of transition and its impact on the federal budget deficit create insurmountable political obstacles?
- Do the American people want to change Social Security's fundamental philosophy by shifting to individuals the responsibility and risks for their own retirement income security?

These questions must be resolved before a privatized system can be designed and successfully implemented.

STATEMENT OF KARL EGE

My name is Karl Ege and I am General Counsel and a member of the Board of Directors of Frank Russell Company, a global investment advisory and management firm headquartered in Tacoma, Washington. Russell is recognized as a premier global asset consultant and investment manager, providing investment strategy consulting on over $600 billion in assets to over 200 institutional investors worldwide, including domestic clients such as the pension plans of General Motors, IBM, AT&T, Xerox and Boeing, as well as similar-sized institutions overseas. In addition, Russell and its affiliates serve as investment managers for over $22 billion of collective investment funds, including mutual funds and commingled employee benefit funds.

As a leading adviser to the pension industry worldwide, we have become increasingly concerned that insufficient attention has been devoted to the developing crisis in our domestic Social Security system. We have observed the steps being taken in foreign countries to address the coming pension crisis in those jurisdictions, and we believe some of these approaches bear some measure of consideration as Congress faces what is likely to become the most serious fiscal challenge our nation will face during our lifetime.

The current Social Security program operates as a "pay-as-you-go" system. There is no separate "trust fund" for current and future beneficiaries under the current system. Contributions paid by workers today are used to pay the benefits for current retirees; any excess is applied to reduce the current year's fiscal deficit. The net result is that the public is misled into believing that there are funds "set aside" for their individual benefit (as is the case with state and local governmental and private corporate defined benefit plans). Without contributions from payroll taxes, the current year's fiscal deficit actually would be larger than that reported. Looking forward, the amount of the "unfunded liability" of the Social Security System is enormous, amounting to several trillions of dollars.

A pay-as-you-go system might have been appropriate during a period when the size of the workforce was increasing steadily and average life expectancies were not much different from the age at which benefits commenced. But as workforce growth has slowed, and life expectancies have continued to rise, benefit promises cannot be sustained without either significant and continuing increases in contribution rates or substantial overhaul of the existing system. Frank Russell Company believes that the latter course of action is the far more preferable alternative. The problem should be addressed now, rather than waiting for the dramatic impact on the system when "baby boomers" begin to retire early in the next century. Two facts concerning the Social Security System are generally accepted today: First, benefit outflows will exceed contributions commencing in about 2013; second, individuals retiring early in the next century will receive substantially below market or even "negative" returns on their contributions to the system. The combination of these two factors will have serious social, fiscal and political implications unless the problem is addressed now.

We believe the more prudent course of action for Congress to consider is a gradual privatization of the current Social Security system to a National Retirement Program. By transitioning to a fully-funded private system, we can provide our citizens with a better retirement safety net which is a boon, not a burden, to our national economy, and which provides significantly greater benefits to individuals.

We believe that the type of National Retirement Program that should be considered should have the following features:

- Contributions to the program would be mandatory and would be matched by employers.
- A portion of the contributions would be contributed to a true "safety net" such as the current Social Security system, to provide basic retirement benefits for those with little or no work history or the working poor.
- The remainder of the contributions would be contributed to an account maintained for the benefit of the individual, much like an individual IRA account. This account would be managed by a professional firm selected by the individual (perhaps from an approved list of organizations that meet certain standards).
- The employee would be fully-vested in this private account, and the account would follow the individual if s/he moved to another employer, or temporarily left the workforce. Because this account would be a personal asset, at death it would pass to heirs as part of the individual's estate.
- Because the assets in the privatized plan would be invested in an asset allocated mix of equity and fixed income securities, a National Retirement program would provide needed capital for job creation, thus stimulating the national economy.

- Individuals would be permitted to voluntarily contribute additional funds to this account, increasing savings and investment into the economy.
- Similar to Social Security, benefits could not be withdrawn from the account until the individual reaches retirement age, dies or becomes disabled.

Transition to a privatized national retirement program should be gradual so as not to impact adversely any current retirees or older workers who would have insufficient time to accumulate assets in the program to make up for the decline in benefits under the current Social Security system. Determining the pace of transition involves relatively straightforward actuarial calculations, and should not be a deterrent to implementation of this program. It will likely take from 20 to 30 years to move from our current system to a privatized program, depending on the level of safety net benefits that the government wishes to maintain for all Americans, and retirement age, life expectancy, investment return and inflation assumptions.

We believe that the move to a National Retirement program should be accompanied by the following additional reforms:

- There should be a gradual increase in the retirement age to 70 (or perhaps greater). When social security was adopted the average life expectancy of American citizens was less than the age of eligibility for benefits. Benefit promises were easy for the Government to keep—few people collected benefits, benefit levels were low, and those who did collect benefits received them for not more than a few years. Today there is an increasing disparity between the minimum age for benefits and the average life expectancy.
- There should be a gradual decrease in cost of living adjustments for the "safety net" portion of the national retirement program. As individuals increasingly receive investment returns for their contributions (which returns take into account inflationary effects), there is less need for "indexing" the benefits.
- Those benefits that are received which represent gain in excess of contributions should be taxed, similar to the manner in which IRA or 401(k) benefits are taxed. Basic safety net benefits should not be taxed.
- The present positive cash flow in the Social Security System should not be used to support government consumption, but rather to add to national savings.
- Government tax and regulatory policies should be altered to encourage private pension savings. We suggest that consideration be given to repealing the full-funding rules (such as those contained in OBRA87) that make it increasingly difficult for defined benefit plans to fund themselves appropriately.
- Discrimination rules should be streamlined and simplified.
- Employers should be encouraged to provide employees with appropriate investment guidance without risk of liability. For example, information provided by an employer or its adviser on past performance of financial markets should not make the employer or its adviser liable if future performance is inconsistent with past experience.

In summary, we believe that the foregoing action would serve to reduce the federal deficit considerably and would provide needed capital for investment into our nation's business, economic and social infrastructure. If this problem is not addressed now, any progress made today in reducing our national deficit will be greatly outweighed by the negative effects of the coming Social Security crisis in the early part of the next century. It would increase national savings and would improve the growth and competitiveness of the US economy.

We appreciate the opportunity to share with you our thoughts on this most important subject. We are willing to meet with members of the Subcommittee to discuss in greater detail the suggestions outlined above.

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