

**THE STOCK MARKET AND SOCIAL SECURITY:
THE RISKS AND THE REWARDS**

**HEARING
BEFORE THE
SPECIAL COMMITTEE ON AGING
UNITED STATES SENATE
ONE HUNDRED FIFTH CONGRESS**

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WASHINGTON, DC

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THE STOCK MARKET AND SOCIAL SECURITY: THE RISKS AND THE REWARDS

WEDNESDAY, APRIL 22, 1998

**U.S. SENATE,
SPECIAL COMMITTEE ON AGING,
*Washington, DC.***

The committee met, pursuant to notice, at 1:08 p.m., in room SD-628, Dirksen Senate Office Building, Hon. Charles Grassley, (chairman of the committee), presiding.

Present: Senators Grassley, Hagel, Breaux, Wyden, and Reed.

OPENING STATEMENT OF SENATOR CHARLES GRASSLEY, CHAIRMAN

The CHAIRMAN. I would call the hearing to order and say good afternoon to everybody, particularly to our witnesses that have to work so hard to make their presentations, but also to everybody who is interested in this very important subject that affects, eventually, everybody in the country, because everybody is involved with the Social Security program. I thank you all for coming and showing your interest.

In recent weeks, Social Security reform has come to the forefront of discussion and debate in this country. Who would have predicted one year ago that President Clinton and other Congressional leaders would meet in Kansas City like they did a couple weeks ago to help educate Americans about the problems facing Social Security? I think we have come a long way, and I would like to applaud the President for his efforts to bring this debate to the level of national prominence which it requires and take some of the political sensitivity out of the issue.

The focus of today's hearing will highlight what I believe is one of the most difficult policy issues that we will confront in the debate over Social Security reform, and that is the issue of what role the stock market should have in the Social Security program. This is no longer considered a radical idea. As more and more proposals enter the arena, we can identify a common thread—utilizing this country's efficient capital market to help fund public retirement programs.

This debate is almost like trying to find a recipe for stew. There are many different kinds of stew, yet each recipe has pretty similar ingredients. Choosing the right recipe usually comes down to what ingredients you have on hand and what your taste buds are telling you.

Whether or not stock market investing is a good idea is no longer a non-starter. Now the questions are who should invest, the government or the individual, how much should be invested, and is it feasible from a cost-effective standpoint.

This question of feasibility is very important. This hearing will begin to answer some of these questions. However, a 2-hour hearing is not the right environment to explore the technical questions of what various agencies and the private sector would need to do to implement and administer a system of individual accounts.

I plan to convene a study group of public and private participants that would assess how individual accounts could be implemented at a reasonable cost. We are just 8 months away from the President's proposed White House Conference on Social Security. Once we start moving legislation, I hope the findings of this study group would cut down on the laundry list of issues that we are going to need to work through to achieve a consensus.

Investing trust fund revenue in a stock market is a move toward prefunding some of the retirement income promises that we have made to the country's retired workers, disabled workers, and their dependents and survivors. This afternoon's hearing will shed some light on the risks and the rewards of investing trust fund revenues in the stock market.

We are fortunate to have with us today two panels of experts who will explain different approaches to investing trust fund money in the stock market and the effects that investing will have on individuals, on the markets, and on savings.

Today, this committee is releasing a report prepared by the General Accounting Office which will help us sort through some of these issues. I believe the report does an excellent job of explaining the implications of government stock investing and many of the report's findings can be applied to the approach of individual investment accounts, as well.

We also have two economists on the panel who will discuss their views on how best to approach the issue of stock investing. Our second panel consists of three individuals who bring to the table unique perspectives on the feasibility of using the stock market to provide workers with some portion of their retirement income.

While stock market investing could play an important role in restoring confidence in the Social Security program, it is not a panacea. The demographic factors that have compelled us to take action on Social Security will be with us for a very long time. The ramifications for the workplace and the delivery of health care are just the beginning. The policy that we construct could help make it easier down the road to provide basic health and income guarantees for workers. If we ignore the demographic changes driving this reform effort and focus only on getting a good rate of return, the consequences could be disastrous.

[The prepared statement of Senator Grassley follows:]

PREPARED STATEMENT OF SENATOR CHARLES E. GRASSLEY, CHAIRMAN

Good afternoon. I call this hearing to order. In recent weeks Social Security reform has come to the forefront of discussion and debate in this country. Three weeks ago, President Clinton held the first of four national "town meetings" on Social Security reform in Kansas City. I want to applaud the President for his efforts to bring this debate to the level of national prominence which it requires. I also want to ap-

plaud the policymakers who have put forth proposals which provide a starting point for the national debate.

These proposals each entail similar components of reform: Raising the retirement age, extending the years of work used to calculate benefits, adjusting cost of living increases, and using the stock market as an investment vehicle to bring more money into the system.

I like to compare it to a group of bakers who have been charged with baking a chocolate cake. Each baker has a different cake recipe with altering amounts of similar ingredients. All of the recipes have certain ingredients in common—ingredients fundamental to baking a cake. Similarly, almost all of the reform proposals which have been put forth by policymakers, academics and legislators have elements in common. One of the most hotly debated elements that almost all the Social Security reform proposals have in common is the idea of investing all or part of the Social Security trust fund revenue in private markets. The focus of today's hearing is that very topic—the implications of investing trust fund money in the stock market.

Before we go any further I think it is worthwhile to explain the role of the trust funds. There has been a lot of misinformation and just plain ignorance over the years. Often by lawmakers—the very people charged with explaining the system to the American public—about how the trust funds work. That is unfortunate because it is difficult to honestly debate reform proposals when there is misinformation clouding the issue.

The Social Security trust funds are an accounting device used by the government in order to keep track of the money going in and the money coming out. Current workers pay taxes which fund the benefits of current beneficiaries. The system has always worked this way. This was not a problem in the early years of the program when the system was paying out in benefits what it took in in revenues. Back in the 1980's, this has changed. While still more or less pay as you go, we have a cash surplus in our unified budget, thanks to Social Security. This motivated my colleague Senator Moynihan to propose a payroll tax cut, to return the program to entirely pay-as-you-go.

But the pay-as-you-go scheme is being put into question. The idea of investing trust fund revenue in the stock market is a move toward pre-funding some of the retirement income promises we have made to the country's retired workers and those who are working age but are unable to work.

This afternoon's hearing will shed some light on the risks and the rewards of investing trust fund revenues in the stock market. We will focus on two approaches—letting the government invest in the market, or allowing workers to invest a portion of their payroll tax in an individually-owned account.

We are fortunate to have with us today two panels of experts who will explain different approaches to investing trust fund money in the stock market and the effects trust fund investing will have on individuals, the economy, and national savings.

There are a lot of questions that need to be addressed before we can begin investing trust fund monies in instruments other than special nonmarketable government bonds. Will there be individual accounts or will the pot of money be invested as a whole? How much individual control and how many investment options should be available? Should investments be restricted to domestic bond and stock markets or should there be investment options in foreign bond and stock markets as well? There are advantages and disadvantages to each of these approaches.

To help us sort through these questions, we asked the General Accounting Office to testify. The GAO and the Aging Committee are releasing a report today that analyzes the implications of allowing a change in trust fund investment policy from special Treasury securities to permitting investment in the stock market. We have two economists also on the panel who will discuss their views on how best to approach the issue of stock investing.

The second panel consists of three individuals who bring to the table unique perspectives on the feasibility of using the stock market to provide workers with some portion of their retirement income.

The CHAIRMAN. I would now like to ask my colleagues to start, and I am going to start with Senator Breaux.

STATEMENT OF SENATOR JOHN BREAUX

Senator BREAUX. Thank you very much, Mr. Chairman, for once again having a hearing which I think is incredibly important to all Americans, not just Americans who find themselves in the category

of senior citizens, but also for their children, their grandchildren, and also for future generations.

We are in a period where the stock market is high and the Social Security trust fund is low. But to merely talk about even combining the two scares most Americans to death. I think that the hearing today is very important towards helping to educate people about some of the problems we have, and also some of the solutions that might be considered to solve those problems.

This hearing is also an effort to move beyond defining what the problem is into a substantive debate towards finding what the solutions to those problems truly are. Everybody knows what the problem is. There is no magic in defining it anymore. The changing face of America has produced the ingredients that have produced the problem—smaller families, fewer workers, higher benefits, longer life spans. Many of those things are very good for society, but also create potential problems for retirees.

There are 77 million baby boomers waiting to become retirees, beginning in the year 2010. Many of those baby boomers believe more in UFO's than they believe in the fact that Social Security will be there when they are ready to retire. I feel very strongly that we have made some steps towards improving the situation, but these steps are not sufficient.

The question is no longer whether real entitlement reform will come about, but rather when will it happen and how it will happen. The current financial problems facing the Social Security system, as I said, are not new. We do not need to spend months and months debating on how to simply restore solvency. If we only want to balance the books, we can rely on the same traditional fixes. However, I think that we owe it to future generations to do much more than that.

I spent the entire last year looking at some of these Social Security issues as part of the National Commission on Retirement Policy, which I am proud to co-chair. I have become convinced that we can and that we must do better than simply reduce benefits or simply raise taxes or simply increase Federal borrowing and call it a solution. If the only thing we do is that, we will only see the value of Social Security to the average American retiree continue to decline.

Future generations should feel confident that Social Security will not only be there for them, but that it is also a worthy investment for them. We need to offer individuals more control, to offer them more choices and an opportunity for a better rate of return. We need, I think, to rethink what we want our public retirement system to look like in the 21st century.

Mr. Chairman, that is what this hearing will help us to do. As we look to additional sources of revenues to help strengthen Social Security, we must also look to higher rates of return from market investments. This hearing, I think, will help us find out how to make this happen, and I thank all of our witnesses who have agreed to be with us today.

[The prepared statement of Senator Breaux follows:]

PREPARED STATEMENT OF SENATOR JOHN BREAUX

For generations, Social Security has provided a pillar of support for many millions of Americans. It has come to represent how a social contract between citizens and their government can and should work.

But despite its great success over the last six decades, there are also profound concerns about its future. Many questions about the "security" of Social Security have come about due to a growing awareness of demographic trends in our society. As "baby-boomers"—those 77 million Americans born between 1946 and 1964—begin to retire, there will be fewer workers contributing into the system in comparison to those retiring and drawing Social Security benefits. In 1950, there were 16 workers paying for every one Social Security beneficiary. In 2030, there will be only two workers paying for every beneficiary.

In 1950, when people reached 65, they were expected to live only about 13 more years. In 2030, they will be expected to live another 19 years. It is good that people are living longer. But we must begin dealing realistically with this demographic shift in order to keep the "security" in the program.

I am currently working in conjunction with the NCRP on a Social Security modernization plan to take the program into the new millennium. We hope to have a specific proposal by late May. Obviously, this is not 1935, the year Social Security was signed into law. So, it isn't reasonable to think that as 2000 rapidly approaches, we can operate the program the same way we did then.

Any attempt to restore Social Security's solvency must begin with this premise: the safety net that it provides to millions of Americans must be maintained. As we struggle to pay for the demographic shifts in this country, however, we see that Social Security is becoming a less attractive deal for many Americans. Workers who retired in 1980 at age 65 took 2.8 years to recover their investment into Social Security. Retirees in 2025 will take 26 years. This has resulted in decreased confidence in the program.

As we look to Social Security reform, we must begin to think about how to increase its value for average Americans. As now structured, we invest the trust fund in government securities, where they yield approximately a 2.7 rate of return. With the economy we have today, such a low return simply does not make sense. Over the span of the 20th century, the stock market has yielded an average rate of return of 7 percent and over the last 15 years, the rate of return has been 15 percent. This is not to say that everyone should take all of their Social Security money and invest it freely in the stock market. This is only to say it is time to explore giving individuals more choice, more control, and an opportunity for a better rate of return. But this is only possible if it is in a structured and safe way.

For example, individuals could be given the opportunity to invest a small portion of their current payroll tax of 6.2 percent. The model of investment could be based on the Thrift Savings Plan (TSP) offered to Federal employees. All Federal employees have the option of putting funds into a high-risk account (stocks), a moderate-risk account (bonds), or a low-risk account (government securities). The rates of return for the three funds respectively from 1988–1996, was 16 percent, 8 percent and 7 percent. Federal employees can place all their TSP funds into a single account or divide it among all three, based on their individual needs and long-term financial goals.

Again, we are only beginning what I hope will be a national debate on this critical issue. But the debate must go well beyond just getting the books to balance—it must involve the larger issue of what we want our nation's public retirement system to look like in the 21st Century.

I applaud the President and Congress for putting the issue of Social Security modernization at the top of the national agenda this year. And I thank our chairman, Senator Grassley, for calling this hearing and all our witnesses for being here. The time to take action is now, while the economy is stronger than it's ever been in history and before there is an immediate or impending crisis. I hope Americans of all generations will join in the debate over Social Security and help us reach the consensus we will need to make fundamental changes.

While there is no immediate crisis threatening Social Security, acting sooner rather than later is vital if we want to avoid disaster 31 years down the road. And what a wonderful example our actions today would be for demonstrating to the American people that political leaders can indeed be bold, strategic, and far-reaching in their approach to governing and in doing what is right for the country.

The CHAIRMAN. The Senator from Nebraska.

STATEMENT OF SENATOR CHUCK HAGEL

Senator HAGEL. Mr. Chairman, thank you. I, too, wish to commend your leadership. I think what you and Senator Breaux, Senator Kerrey, and others have done to enlighten our public on this issue is critically important and I would submit a statement for the record, Mr. Chairman.

I would also say that as we debate this restructuring of our entitlement programs to prepare our nation for the next century, we should not be locked into pedestrian thinking. We should not be intimidated by the magnitude of the task before us. But we should, as we are, explore bold solutions, and I think what you are doing and under the leadership of Senator Breaux and others, we will get there.

Thank you for an opportunity, and I will submit a statement for the record, Mr. Chairman.

[The prepared statement of Senator Hagel follows:]

PREPARED STATEMENT OF SENATOR CHUCK HAGEL

Good afternoon, Mr. Chairman. Thank you for calling this timely and important hearing.

The debate over what to do with America's entitlement programs is one of the most vital that our nation faces. There is no one in America, or in this room, that will not be touched by this debate and its ultimate decisions. And the voices of our next generations are perhaps the most critical in this debate. The decisions America makes on these issues will profoundly affect their future.

This is a spectacular opportunity. Not since many of our government programs were created have we had a chance to look at them in total and ask some very basic questions. What do we want these programs to do for us and at what cost? What should be the role of government in these programs?

Social Security is the largest single program in the Federal government. In 1998, the Congressional Budget Office estimates that the Social Security Trust Fund will pay out 381 billion in benefits. But this debate is not just about dollars, it's about people.

This discussion is not about finding solutions for the short-term. It's about finding long-term solutions. We all want the same thing—to keep our Social Security strong and secure.

What are the facts facing Social Security? Today, 34 million Americans are over the age of 65. Looking ahead to the year 2020, an estimated 53.2 million Americans will be over 65 and in the year 2030, the number is projected to reach 69.4 million Americans. How do these figures affect the Social Security system? The number of retired people drawing Social Security benefits is expected to double over the next three decades, from almost 44 million today to over 81 million by 2030.

In contrast, the number of workers whose taxes finance Social Security benefits is projected to grow by only 15 percent. In 1950, there were 16 workers paying into the system for each retiree drawing from it. Today, that ratio is about 3-to-1 and early in the next century it will be 2-to-1.

If we do not restructure the Social Security system, by 2029 it will be unable to pay the same retirement benefits being paid out to our seniors today. That sounds like a long way off, but it's only 31 years.

So what do we do? If we sit around and wait for this to become a crisis, we'll have two options—raise taxes or cut benefits. We could take more out of the paychecks of hard-working Americans or pay less in benefits to those who rely on Social Security. Both are unacceptable. We can do better.

So where does that leave us? With a world of options and opportunities, we've started the debate. Everything is possible. We have to be willing to be creative. We must not allow ourselves to be locked into examining limited options. We must explore bold solutions. We must not be intimidated by the magnitude of the task.

As we look at possible ways to restructure Social Security, we must remember the original intent of the program when it was created in the 1930's. Social Security was never meant to be the sole source of retirement income. It was created to guarantee a basic level of income to retirees, a supplement to what they had saved.

It was—and still is—the personal responsibility of Americans to save for their retirement. It's not the government responsibility to provide for your retirement. Over

the years we've drifted from the original intent of Social Security and allowed it to become—and be expected to become—the sole means of supporting the retirement of many Americans. However we choose to restructure Social Security we need to get back to the idea of personal responsibility. We need to create a system that encourages and incentivizes people to save, and to build their own personal wealth for their retirement. After all, whose taxes are we taking to pay for this pay-as-you go program? It's the workers', the people's, money, not the government's!

Changing a system, however, is more difficult and complicated than establishing a new one.

The benefits of a new system must be clearly defined for the public. If the American people don't believe a restructured Social Security system will be better for them and for their children, they won't support making changes. Americans will need to understand that they will have more money, and more independence, if they're given the opportunity to take part of their payroll taxes and invest them for themselves.

Not only is it important for Americans to see the potential for more security and more money for their retirement, they also need to be assured that they won't lose their money. When most people talk about giving individuals the opportunity to invest their own money, they're not talking about wild-eyed schemes or risky fly-by-night investments. They're talking about conservative, solid investments, ones that would produce real income when invested over time.

For those currently on the system, their benefits must be guaranteed. I'm not talking about making changes for those currently on or soon to come on Social Security, I'm talking about changes for the future.

We can create a system that still provides a safety net for those most vulnerable in our society, and offers younger workers the opportunity to save for the future and create wealth for their retirement years.

Personal retirement accounts would harness the power of private markets and compound interest, giving individuals ownership of their retirement savings. Americans want more power, more choice, more responsibility in deciding their own future and economic well-being. It's their money!

We have a unique opportunity to change course. We can restructure Social Security in a way that will give individuals an opportunity to invest in their own future, and get more money in return . . . and give the American people less government, less governments, interference, more personal freedom, more retirement income and an opportunity to build wealth and more personal security.

We all have a stake in how this works out. These are great challenges, but with great challenges come splendid opportunities. I look forward to hearing this afternoon's testimony on some of these opportunities relating to investment in private markets.

How we engage the challenges before us will determine the future of our nation. Failure is not an option. Strong, dynamic, imaginative leadership will be required. We are up to the task.

Thank you, Mr. Chairman.

The CHAIRMAN. I am just about ready to introduce our first panel, but I want to recognize Congressman Nick Smith from Michigan who is with us at the end of the dias here. He has submitted a statement that I am going to include in the record, and a summary of a bill that he introduced in the 104th Congress, re-introduced last year as H.R. 3082, and is characterized as the only House bill that has been scored by the Social Security Administration as restoring the solvency of the system. I will be communicating with Congressman Smith in the near future about appearing at a future hearing which focuses more on the philosophy of investing the trust funds.

Mr. SMITH. Thank you, Mr. Chairman.

The CHAIRMAN. You can stay with us as long as you feel comfortable—well, you should feel comfortable here all the time. You can stay as long as you have time to stay.

Mr. SMITH. I want to learn how, Mr. Chairman. [Laughter.]

Statement

of

Nick Smith

Congressman
(Michigan - 7th)

The Stock Market and Social Security

United States Senate
Special Committee on Aging

April 22, 1998

The Future of Social Security for this Generation and the Next

Social Security is in financial trouble. In a recent poll, 34% of the people responding say Social Security should be Washington's top policy priority and 51% say it should have high priority. Almost everyone agrees dramatic steps must be taken to assure Social Security's solvency. Social Security can meet its cash flow requirements today, but will run growing cash flow deficits beginning in 2012. Government economists estimate that Social Security needs \$4 trillion more than it will collect in order to pay expected retirement benefits.

Social Security is not a good deal for anybody that has not retired. The Social Security Administration's own projections show that beneficiaries born in 1940 and later

have a negative rate of return on their contributions if the current system is not changed (see attached chart). Baby boomers born in 1965 will receive almost \$40,000 less than the value of their payroll taxes. Men and women retiring in the 21st century will receive thousands of dollars less than they might have received if their contributions had been invested in stocks, bonds, bank certificates of deposits. Through its ups and downs from the 1920s to the 1990s, the stock market has yielded an average return of 9 percent. **We must reform Social Security -- making it a good deal for all Americans.**

Social Security reform must guarantee a fair return for workers and continue equitable retiree benefits. Most Americans who are retired depend on Social Security for a major part of their retirement income. Today, fully 80 percent of Americans depend on Social Security for at least 50 percent of their retirement income. Without Social Security reform, the financial future of America's seniors is in jeopardy.

In 1935, the Social Security Act was enacted to provide a government guarantee against poverty. Unfortunately, many people believe that Social Security is backed by a trust fund filled with the surpluses from years of Social Security tax payments. The trust fund is filled with government IOUs. Social Security was designed as a pay-as-you-go system where current workers pay taxes to fund current retirees' benefits.

Changing demographics threaten the solvency of the pay-as-you-go system. In 1950, there were 17 workers paying taxes to support the system for each retiree. Today there are only three workers per retiree, and by 2029 this ratio will drop to 2:1. This change was caused by a combination of longer life spans and lower retirement ages. In 1935 the retirement age for Social Security was 65 and life expectancy was 63. Today, the early retirement age is 62 and life expectancy is 76.

To make up for this falling ratio of tax paying workers to retirees, Congress has continually raised taxes. In 1950 only 3 percent of a worker's first \$3,000 in earnings was taxed. Today we tax 12.4% of a worker's first \$68,400 in earnings. Social Security taxes have been raised 37 times since 1970. **My Social Security bill stops the federal government from future raids on surplus money coming into the trust fund.**

The Social Security "fix" can only be accomplished in three ways--

- ▶ increase revenues by improving the rate of return on contributions
- ▶ reduce benefits
- ▶ increase revenues by raising taxes

My Social Security Solvency Act emphasizes the first option by creating worker-owned accounts and using a combination of many small changes to achieve fiscal solvency for Social Security over at least the next 75 years. My bill is the only legislation that has been introduced in the House that is certified by the Social Security Administration's actuaries as keeping Social Security solvent.

I have ruled out tax increases, additional debt, and changes in benefits for essentially all current retirees or those over 57. My Social Security Solvency Act slows the increase in benefits for higher income seniors and allows individual workers to invest some of their tax dollars in their own personal retirement savings accounts (PRSAs). Workers would be able to save, in their own personal accounts, 2.5% initially, rising to 10%, from their 12.4% percent FICA tax. Workers could choose to invest up to 10% more of gross wages into their personal retirement savings account. Private investment choices will be limited to conservative alternatives, similar to the restrictions for IRAs. If a worker earns a rate of return on his investments that matches the seventy-year average rate of return, he will get back more from Social Security under my legislation than under the existing program.

It is necessary to begin reforming Social Security this year. We are running out of time. By 2010, members of the huge baby-boom generation will start to retire and draw benefits from the government's three biggest entitlement programs -- Social Security, Medicare, and Medicaid. First, we must find retirement security alternatives.

The Advisory Council on Social Security unanimously agreed that Social Security's financial problems are manageable and that part of the solution is to invest in stocks and bonds. These are compelling reasons to pilot test private investment options. I have introduced the Social Security Solvency Pilot Program Act of 1998 (H.R. 3560) to help determine how we build a reformed Social Security system that works for workers and retirees, and can be administered easily and fairly.

Various state and local systems have set up retirement programs that return more than Social Security. A study by economists at the Florida State University and Miami University found that the state and local government employee systems -- covering 1.9 million workers -- pay retirement benefits of 2.5 to 7 times more than Social Security.

It is time to demonstrate that Americans can have retirement security options -- letting workers take greater control of their future.

The Social Security Solvency Act of 1997
H.R. 3082

- ▶ **No Tax Increase**
- ▶ **Establishes Personal Retirement Savings Accounts.** Individual savings accounts (PRSAs) will accumulate considerable sums resulting in higher retirement benefits. The surpluses coming into the trust fund allow private investments (PRSAs) to start at 2.5% of payroll and increase to 10.2% percent of payroll in the year 2070.
- ▶ **Social Security will have sufficient funds to honor all retirement benefit commitments** as it transitions from pay-as-you-go to private savings accounts
- ▶ **Gradually reduces the increase in benefits for high income retirees**
- ▶ **Allows private investment account withdrawals at age 59-1/2**
- ▶ **Increases retirement age two additional years over fifteen years, then indexes the retirement age to life expectancy**
- ▶ **Balances the Social Security System for the next 75 years**
- ▶ **Newly hired State and local government employees join Social Security**
- ▶ **Couples receive a minimum of 133% of higher benefit, and widows/widowers receive minimum 110% of married benefit payment**

Social Security Solvency Pilot Program Act of 1998
H.R. 3560

Pilot demonstrations will

- ▶ **provide testing of the feasibility and popularity of worker-owned accounts; and**
- ▶ **reduce accrued liabilities of the Social Security trust fund;**
- ▶ **be implemented with no reduction in payroll tax receipts by Social Security Administration;**
- ▶ **require no new compliance measures for employers.**

The CHAIRMAN. I would also like to insert into the record a statement from Senator Harry Reid of Nevada.

[The prepared statement of Senator Reid follows along with prepared statements from Senators Burns, Enzi, and Shelby:]

PREPARED STATEMENT OF SENATOR HARRY REID

Good afternoon Mr. Chairman and distinguished panel of witnesses. As we engage in dialog in the coming year about the future of Social Security, we will hear much from citizens across the nation about the prospects of investing a portion of the Social Security Trust Fund in the stock market or whether we should reform the program to allow for the establishment of private accounts as a way to build retirement security. I have held several forums in the State of Nevada and I can assure you, these issues are of concern to my constituents.

Many today are singing the praises of the private accounts based on the performance of a strong stock market. Some amazingly even advocate full scale privatization of Social Security. When markets are performing so well, and setting records almost daily, it is easy to engage in such discussion. There have been times however, when markets were not so successful. We must remember that there was little discussion on privatization during these periods. We must also remember that a market that is up today is a market that could be down tomorrow. Let us not forget the economic condition which existed when Social Security was enacted in the first place. I believe we must be very careful before supporting any initiative which places the retirement security of our citizens in a system with such potential investment risk. I think we need to look very carefully before we leap into such territory.

Many in our society lack the financial experience to make such investments. My father clearly was in no position to understand the intricacies of the market. Far too many in this country make so little that the accumulation of any real wealth from such proposals is questionable. If such a system were established, it is possible that some may lose their retirement security should they make the wrong investment choice. There will surely be political pressure to allow individuals to tap into their funds for emergencies, education or housing. What happens then? Who will provide for retirement security?

That is why I believe we must preserve and protect the current Social Security program. It has a proven track record. We have a very successful program that for 63 years has provided a guaranteed source of retirement income for countless Americans. While it has made no one rich, it has provided a much needed base that has contributed in bringing the nation's poverty rate for seniors to around ten percent. Potential investment risk has not been a factor that seniors have had to contend with when counting on their Social Security check. Social Security is a guarantee seniors could depend on and one I believe we should protect as part of the overall retirement security for older Americans. Let me be clear that I fully support private savings initiatives and placing needed emphasis on the provision of pensions to American workers as the other two essential elements for a secure retirement. I must, however, caution that we not allow proponents of privatized individual accounts to describe the Social Security program as an investment program and thereby allow it to be judged as ineffective due to its poor investment performance. That was not the program's intent and to fault it for not delivering adequate returns is a misrepresentation of the program's purpose. What we should be discussing is the tremendous success of this program and the critical role it plays in replacing income lost due to death, disability or retirement. While vital for the income security of seniors, Social Security also provides vital coverage for children and disabled workers.

Mr. Chairman, I am interested in hearing testimony about investing a portion of the Social Security Trust Fund in the market. This is one proposal that came out of the Social Security Advisory Council Report that I believe warranted further study. I am pleased that you have included testimony on the merits of this proposal in today's hearing.

Let me close by again stating for the record that what we are really talking about today is risk. Risk that proponents of individuals accounts would shift to the individual. If we embark on a path which reforms the Social Security program by investing in the equity market, the real question becomes should this risk be assumed by the government or should we enact policies that pass this risk on to the individual? I have said before that I am concerned that when it comes to retirement planning we are placing far too much on the backs of the American worker. Personal savings are already the individual responsibility of the employees as they must be; many pension plans, for those lucky enough to have them, are shifting from defined benefit to defined contribution; and now many want to reform Social Security by es-

establishing personal accounts which claim to give the American worker a shot at a real wealth. I contend there is a point where we have shifted enough risk and responsibility on the backs of the employee and we should begin to recognize the true value of our social insurance program and seek to enact reform which mends Social Security and not support reform initiatives that are aimed at ending it.

PREPARED STATEMENT OF SENATOR CONRAD BURNS

I want to thank Chairman Grassley for holding this important hearing on the future of Social Security. The Committee on Aging has been leading the way in laying the foundation for fundamental reforms that will secure Social Security for future generations.

Today we will hear from some Social Security experts on the implications of investing Social Security trust funds in stocks. Based on the written testimony I've seen, the witnesses generally agree that some type of investment system is not only feasible but could extend the solvency of Social Security. They do acknowledge the risks inherent in investing, but, with one exception, agree that the benefits outweigh the costs.

Working Americans are pessimistic about receiving Social Security benefits when they retire, and the younger they are the more pessimistic they are. Most Americans are aware that the number of workers supporting each retiree is dropping rapidly: from 3.3 today to 2.0 in 2030. Because current workers support current retirees through the payroll tax, this increase in retirees means that, without changes, early next century benefits will have to be cut, payroll taxes will have to go up, or both. According to Social Security's projections, around 2019 tax revenue will be insufficient to pay benefits, and by 2029 all trust fund assets will be redeemed and the fund will be exhausted. At this point tax revenue will cover about 75 percent of benefits.

In its testimony today the General Accounting Office will discuss its analysis of government investment of Social Security funds. It did not look at individual investment accounts. The GAO states that the higher returns possible with stock investing would allow the trust fund to pay benefits longer. This is based on historical stock growth, which is by no means assured. But it adds that stock investing alone is unlikely to solve Social Security's long-term financing problems. And GAO raises several questions that need to be addressed, such as: How can the risk inherent in stock investments best be countered? How will investment of what is today 39 percent of all outstanding Treasury securities affect the stock market and the U.S. economy? How to deal with the short-term loss of revenue as stocks are purchased and held for the 10 to 15 year period for investment build-up?

These are just a few of the important questions that must be answered. But as we look at investment options for Social Security, I want to point out something else raised by GAO: in the third quarter of 1997, private pensions had 60 percent of their assets, or 3.4 trillion, in stocks, earning considerable revenue which would otherwise have to be contributed by employees and employers. In fact, pension funds own about a quarter of total U.S. stock holdings. So what we are talking about here is not a new concept. Many Americans already rely on stock investments for their retirement. We should look to the private pensions for some guidance as we assess the future of Social Security.

PREPARED STATEMENT OF SENATOR MICHAEL B. ENZI

Thank you, Mr. Chairman for holding this hearing to discuss the implications of investing Social Security funds in the stock market. It is well known that the current system is unsustainable and will be bankrupt in the year 2029. Therefore, it is inevitable that reforms will be necessary to save Social Security and to ensure that our children and grandchildren are not, as my predecessor Senator Al Simpson used to say, "picking grit with the chickens." Since Social Security is so important, it is vital that all proposals, from modest tinkering with the current system to large-scale overhauling, are evaluated in a careful, rational manner. This hearing will be extremely helpful as we continue to debate the best way to reform Social Security to save it from bankruptcy.

As we are all aware, the President's Advisory Council on Social Security issued a report last year on ways to solve the program's long-range financing problems. The Council was unable to reach a consensus on a particular approach, so the report contains three different proposals. They range from relatively minor adjustments in the current system to a major redesign that involves large-scale privatization. It is important to note that all three proposals recommend that a portion of the payroll

tax revenues be invested in the stock market. It is apparent that the concept of investing Social Security funds in the stock market has been gaining acceptance as a viable way of improving the long-term fiscal health of Social Security. I am very pleased that the Chairman is further highlighting this concept through this hearing.

I do believe that allowing some form of private investment will be necessary to help shore up the Social Security program. In fact, I am an original cosponsor of the "Strengthening Social Security Act of 1997," which was introduced by my colleague Senator Gregg. This bill would provide for the refund of one percent of the current employee Social Security payroll tax to be placed into personal investment accounts. Individual employees could choose—like in an IRA—how to invest these accounts via a menu of options similar to the federal employees' Thrift Savings Plan. The change would be instituted in a manner that enables the youngest workers to plan for this modification of the Social Security system while seniors currently over 55 would not have their benefits affected at all. This is a modest reform proposal that will give people a choice on how to invest their money for their retirement needs without fundamentally altering the Social Security program.

In addition, I cosponsored another bill offered by Senator Gregg that would require the Commissioner of the Social Security Administration to submit specific legislative recommendations that are deemed necessary to ensure the long-term solvency of the program. This will put the Administration on the record as to what legislation they would support for saving Social Security. Unfortunately, the President has been silent on the subject of Social Security reform, except for his vague demand that any budget surplus be set aside for Social Security until a reform plan is developed. The President needs to suit up, get in the game, and take some hits, rather than just standing on the sidelines yelling at the participants.

It is safe to say that whatever changes are made to the Social Security program will not please everyone. Social Security reform is a divisive, emotional issue. It has not been called the third rail of American politics for nothing. Fortunately, it has become increasingly evident that Congress is willing to take the necessary risk of evaluating the program and offering specific, substantive proposals to reform it. I am hopeful that the Administration will get actively involved when the time comes to enact legislative changes to Social Security and will not simply criticize the various proposals put forth, as they have done in the current tobacco debate. It is extremely important that we work together in a bipartisan manner in order to save Social Security.

Now is the best time to enact meaningful, long-term changes to our entitlement programs. Our economy is healthier than it has been in many, many years. We need to use the increased revenues in the government coffers to prepare for the future, and not squander it on various new spending programs or pet projects. And we need to act as soon as possible. The longer money stays in Washington without any direction, the more likely it will end up being directed toward another expensive federal spending program.

Once again, I thank the Chairman for holding this hearing. I appreciate our panelists taking the time to share their thoughts and views of how private investment could affect Social Security. I am aware that there are many different viewpoints concerning how we should reform the program. I remain confident, however, that some form of investment in the stock market will be able to restore long-term solvency to the Social Security program in a way that is fair and equitable to all retirees, both current and future.

PREPARED STATEMENT OF SENATOR RICHARD C. SHELBY

Good Afternoon. I want to thank Chairman Grassley for holding this hearing regarding such an important federal program. The latest report by the Social Security system's Board of Trustees provided new evidence of the program's growing financial problems. According to the trustees, Social Security will be insolvent by 2029, one year earlier than predicted in the previous year's report. This is the eighth time in the last 10 years that the projected insolvency date has been brought closer.

Like many members of Congress, I am still reviewing the numerous reform options. Many proposals include provisions that would allow for the investment of the Social Security trust fund in the stock market. Others propose to allow individuals to set up a personal account, much like the corporate 401(k) account, and place some portion of their payroll taxes into market based investments. Given the recent performance of the stock market, the prospect of investing in stocks clearly provides an attractive option to bolster the solvency of the program. We have seen the popularity and success of private 401(k) retirement plans, and although I do not know

whether we should emulate them exactly, I think we clearly need to look at them closely, and to keep all of our options open.

However, one option I will not consider is tax increases. Since the Social Security payroll tax was first levied in 1937, Congress has raised it more than twenty times. The payroll tax has grown from 2 percent to 15.3 percent. Yet, this has not solved any of the long term problems with the underlying structure of the system. If no other policy changes are made, payroll taxes must increase to 24.6 percent by 2030 to support program.

Although 2030 seems like a long time from now, we can not wait any longer to correct the structural problems of the system. The program actually will begin to pay out more money than it receives by 2012 due to the drain placed on it from the retirement of the baby boom generation. The longer we wait to reverse this trend, the more the financial integrity of the program will be compromised. The emerging budget surplus offers an opportunity to save the Social Security system not only for current retirees, but for their children and grandchildren. Therefore, we must have the courage to act now to protect our senior citizens and save the program for the generations to come. I want to thank Chairman Grassley again for holding this hearing and I look forward to working with my colleagues in a bi-partisan way to restore solvency to the Social Security system.

The CHAIRMAN. Our first witness will be Barbara Bovbjerg. She is Associate Director of Income Security Issues at the General Accounting Office. In that capacity, she oversees work on retirement income issues, including Social Security and private retirement income. She will present the findings of the GAO report and the implications of government investment of the trust fund money in the stock market.

Following her report, we are immediately going to go to Bruce MacLaury. He is trustee of the Committee for Economic Development and headed their Subcommittee on Social Security Reform. He is also the former President of the Brookings Institution. We then have Alicia Munnell, former member of President Clinton's Council on Economic Advisors. Before serving as an advisor to President Clinton, she served as an assistant secretary at the Department of Treasury. She is currently a professor at Boston College.

We will start with you and then we will have questioning after we get done with the three presentations. You will not have to ask to have your entire statement printed in the record. It will be, unless you tell us to the contrary, and we would ask you to summarize. Thank you. Proceed.

**STATEMENT OF BARBARA BOVBJERG, ASSOCIATE DIRECTOR,
INCOME SECURITY ISSUES, GENERAL ACCOUNTING OFFICE,
WASHINGTON, DC**

Ms. BOVBJERG. Thank you very much. Mr. Chairman, members of the committee, I am pleased to be here to discuss stock investing for the Social Security program. Although the report we are issuing to the committee today addresses only the questions raised by investing government funds in the stock market, your staff asked me also to touch upon issues pertaining to investing individually-owned accounts.

I would like to focus on three aspects of such investment. First, the risks and returns. Second, implications for the Federal budget and the economy. Finally, the issue of government influence.

First, risks and returns. Our work suggests that stock market investment would indeed extend the period of solvency, although even an aggressive investment policy might extend it by only a dec-

ade. Other changes to the program would be necessary to assure long-term solvency and avoid having to sell the portfolio to pay benefits.

But the only way for the trust funds to earn these higher returns is to take on higher risk. Stock returns fluctuate substantially from year to year. Hence, there is no guarantee that investing in the market, even over two or three decades, will yield the returns recent experience would suggest. Further, although stock returns usually exceed those of government securities, this experience varies from year to year, as well.

Under government stock ownership, both the risks and the returns would be shared collectively by taxpayers. Hence, fluctuations in market value would not themselves affect individual participants' retirement benefits. In contrast, individual account systems would pass both the returns and the risks to the individual owners. Some of the risk would be mitigated in the proposals that constrain individual investment choices.

But under all these proposals, individuals' retirement income would vary with the success of their investments, and further, because the social insurance aspects of Social Security would be reduced, individuals would, to some extent, also bear risks of early death, for example, that are insured today. In other words, some could do very well in such a system, but others might not.

Now I would like to turn to the second aspect, implications for the budget and the economy. Although over the long term, budget effects could largely be neutral, in the short term, budget results would be altered. If Social Security surpluses were to be invested in the stock market, the funds invested would no longer be available to the Treasury, as they are today, to finance other government spending. This would increase a unified budget deficit, or decrease a unified surplus. If this change brought the government into deficit, the Treasury would have to borrow more from the public to make up the difference unless policy makers chose to reduce spending or raise revenue instead. For individual accounts, the budget impact would be similar; to the extent that payroll taxes are redirected into private accounts.

As for the economy, stock investing would not directly affect saving, a fundamental precursor to economic growth. Although new investment would add money to the markets, the additional Federal borrowing would absorb capital, offsetting the investment. This exchange would constitute an asset shuffle among investors, and as a consequence, changing the investment strategy without raising additional funds would have no significant impact on saving, regardless of ownership.

Finally, government influence in the stock market could be mitigated by use of passively managed, broadly indexed investment funds, but the possibility could never be eliminated, as it could be with individual accounts.

In summary, simply shifting Social Security assets to the stock market, regardless of ownership, has the potential to increase returns to the program. However, such a change also increases risk and has no direct effect on national saving. Although stock investing could indeed delay trust fund exhaustion, clearly it cannot fix Social Security by itself. Restoring the program's long-term sol-

vency will still require difficult choices about benefit cuts and tax increases. Even if such investing is combined with other changes to restore solvency, such a policy would still benefit from attention to the inherent risks, how the risks are distributed, and how strong a safety net remains.

That concludes my remarks, Mr. Chairman.

[The prepared statement of Ms. Bovbjerg follows:]

GAO

**United States General Accounting Office
Testimony**

Before the Special Committee on Aging, U. S. Senate

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**SOCIAL SECURITY
FINANCING**

**Implications of Stock
Investing for the Trust
Fund, the Federal Budget,
and the Economy**

**Statement of Barbara D. Bovbjerg, Associate Director
Income Security Issues
Health, Education, and Human Services Division**



Mr. Chairman and Members of the Committee:

Thank you for inviting me to speak about the implications of stock investing for the Social Security program. Social Security faces a long-term financing shortfall—by 2029, it will only be able to pay about 75 percent of promised benefits. In order to address this shortfall, investing in the stock market has been proposed along with other reform options. Stock investing could potentially improve the investment earnings on retirement funds. Some reform proposals would fundamentally alter Social Security's structure to allow individuals to invest on their own behalf. Others would maintain the current program structure, permitting the government to invest some of Social Security's funds in the stock market. Regardless of ownership, investing in stocks or other assets outside of the government would be a new concept for Social Security.

You asked me to discuss the government stock investing option, the subject of a report we just completed for you.¹ More specifically, I would like to focus my remarks on (1) the implications of government stock investing for the Social Security trust fund,² (2) the impact of stock investing on the federal budget and national saving, and (3) implementation issues related to selecting and managing a stock portfolio that could affect the degree of government involvement in corporate affairs. Throughout this

¹Social Security Financing: Implications of Government Stock Investing for the Trust Fund, the Federal Budget, and the Economy, (GAO/AIMD/HEHS-98-74, April 22, 1998).

²The Social Security trust fund consists of two separate accounts: Old-Age and Survivors' Insurance (OASI) which funds retirement and survivor benefits and Disability Insurance (DI) which provides benefits to disabled workers and their families.

discussion, I will also touch upon important ways in which the government stock investing approach contrasts with the alternative of individual accounts.

Our report on government stock investing did not address any specific Social Security reform proposals. Instead, as discussed with Committee staff, we studied changing trust fund investment policy in isolation from any other program changes in Social Security. Although my testimony is based primarily on our report on government stock investing, it also draws on other work we have done on Social Security reform and budget issues.³

In summary, government stock investing is a complex proposal that has potential consequences for Social Security, the federal budget, and national saving. It also differs in key ways from proposals to establish individual accounts.

For the Social Security trust fund, government stock investing offers the prospect of higher returns but, by itself, is unlikely to solve the program's long-term financial imbalance, and it would be accompanied by greater risk. The key distinction between stock investing through the government and through individual accounts is that, under government stock investing, the risks and returns would be shared collectively through the government rather than borne individually. More generally, individual accounts proposals would alter Social Security's current structure and scale back the income redistribution aspect of the current program.

³A list of related GAO products appears at the end of this statement.

From a budget perspective, shifting a portion of trust fund assets into the stock market would raise deficits or diminish surpluses in the short term but would not significantly affect national saving. While government stock investing by itself has no direct effect on saving, it indirectly could prompt actions to raise saving by revealing the size of federal deficits excluding Social Security's temporary surpluses.

Implementing a government stock investing proposal would raise issues about stock selection, administrative costs, and shareholder voting rights that, conceptually, do not pose major obstacles. However, some of these issues could raise concerns about increased government influence over the private sector.

BACKGROUND

The Social Security system is largely a pay-as-you-go system under which each current working generation pays for the benefits of the retired generation. Under a pure pay-as-you-go system, annual tax revenues roughly match each year's benefits, while allowing for a contingency reserve to weather short-term economic downturns. However, as a result of previous financing reforms, Social Security currently receives more cash revenue each

year than it needs to pay current benefits, which is building up the trust fund's balance beyond the amount needed as a contingency reserve.⁴

By law, the Social Security trust fund currently invests solely in U.S. government securities—a policy that dates back to the program's origin in 1935 and is intended to ensure the safety of the trust fund's assets. Interest on the trust fund's Treasury securities is credited in the form of additional securities which add to the trust fund's balance available to finance future benefits. By 2012, Social Security's annual tax revenues are expected to be insufficient to cover its benefit payments. To cover the cash shortfall, the trust fund will begin drawing on the Treasury, first relying on its interest income and eventually drawing down its assets. The Treasury will need to raise the required cash through some combination of borrowing from the public⁵, spending cuts in other federal programs, or revenue increases.

A number of Social Security reform proposals would make the trust fund buildup even larger and other proposals would create individual accounts that would also build up the size of retirement funds. The prospect of building up retirement funds has brought

⁴In our work, we relied on data and actuarial projections from The 1997 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds. We used the intermediate assumptions, which reflect the Board of Trustees' best estimate. Due to the inherent uncertainty surrounding long-term projections, the Trustees' report also includes two other sets of assumptions, a high cost and a low cost alternative.

⁵If the unified budget were in surplus, then financing the excess benefits would require less debt redemption, rather than increased borrowing.

increased attention to stock market investing. On either publicly or privately held retirement funds, potentially higher investment earnings could help provide retirement income and complement other Social Security reforms. The larger the retirement funds, the more investment earnings they would have and the more the rate of return on investments matters. Under current policy, the buildup occurring in Social Security is relatively small in comparison to the program's expected future costs; therefore the rate of return received on investments has been less important.

To assess the implications of changes in investment policy and other reforms, it is important to understand how Social Security fits within the federal budget. Although the Social Security trust fund is technically excluded from the budget, its finances contribute to the government's impact on the economy. Therefore, Social Security is included, along with all other federal programs, in the commonly used "unified" budget measure. The unified budget is the means used to measure the government's current draw on financial markets. However, in considering the long-range implications of federal policies, it is also useful to consider the impact that Social Security's temporary surplus has on the government's unified budget. By reducing the Treasury's need to borrow from the public to finance government spending, Social Security's current cash surplus partially offsets the deficit in the rest of the government's accounts.⁶

⁶Interest credited on the trust fund's Treasury securities has no current effect on the unified federal deficit because it is a payment from one part of the government to another part.

Social Security has an important influence on the government's overall fiscal position, which, in turn, affects national saving, a key determinant of long-term economic growth.⁷ Raising saving and investment levels above today's relatively low levels would improve the long-term productivity of the economy, thereby boosting economic growth. A more robust economy would make it easier for future workers to meet the dual challenges of paying for the baby boomers' retirement and achieving a rising standard of living for themselves.

Social Security reform proposals that permit stock investing use one of three basic approaches. In the first, the government would own and control the Social Security trust fund's investments. In the second, the government would manage individually owned accounts. Such accounts might resemble the federal employees' Thrift Savings Plan (TSP). For TSP, Congress established several indexed investment options, and TSP participants allocate their balances among these options. In the third approach, individuals could control and manage their own accounts with greater discretion over how to invest them. These accounts might resemble existing individual retirement accounts (IRAs).

⁷National saving is composed of the private saving of individuals and businesses and saving (surplus) or dissaving (deficit) of all levels of government.

BALANCING RETURNS AND RISKS

Stock investing is one option to increase the trust fund's revenue but, by itself, it is not the solution to Social Security's financing problem. Higher investment returns could extend Social Security's long-range solvency somewhat, but their effectiveness is limited as long as the program remains largely pay-as-you-go. Also, in exchange for the prospect of higher returns, the Social Security trust fund would have to take on greater risk. This risk/return trade-off would also apply to individual accounts proposals, but it would apply to each worker individually rather than to all workers collectively as under government stock investing.

In our report, we developed two scenarios to illustrate potential effects on the trust fund of investment in the stock market assuming no other program changes. Under our more aggressive scenario, the trust fund would invest both its projected annual cash surplus and interest in the stock market, while maintaining a contingency reserve of special Treasury securities equal to at least the next year's expected expenditures. Under our alternative scenario, the trust fund would invest only the cash surplus, and Social Security's cash deficit, beginning in 2012, would be financed from stock earnings and sales. At our request, the Social Security Administration's (SSA) Office of the Chief Actuary simulated the potential outcomes of our two scenarios using the Social Security Trustees' 1997 intermediate actuarial assumptions and the 1994-1996 Advisory Council on Social Security's assumptions about stock returns and administrative costs. (See attachment I for more details.) The results of these simulations illustrate some outcomes

associated with two investment alternatives; they should not be interpreted as forecasts and are not intended to represent the full range of possible outcomes for the Social Security trust fund.

Higher investment returns would allow the trust fund, even without other program changes, to pay benefits longer before depleting its assets. Under the more aggressive scenario, assuming the historical average stock return, the trust fund's exhaustion could possibly be delayed by about a decade, from 2029 to 2040. This potential delay well into the baby boomers' retirement years would result only from the Social Security trust fund investing aggressively in the stock market. The trust fund would invest more than 70 percent of its assets in the stock market, which would be a dramatic shift from investing solely in Treasury securities. Under the cash surplus scenario, still assuming the historical average return, the possible delay in the trust fund's exhaustion would be only 3 years. The possible extension of the trust fund's solvency resulting from any stock investment scenario would be significantly shorter if the future stock returns are lower than the historical average of 7 percent after inflation.⁸ Moreover, if the return on stocks over the next 20 or 30 years averages less than the expected return on Treasury securities, the trust fund would be exhausted sooner than in 2029, exacerbating Social Security's long-term financial imbalance.

⁸As an illustration, if the future return on stocks is 1 percentage point lower, the delay in the trust fund's exhaustion under the aggressive scenario would be reduced to only 6 years. The delay under the cash surplus scenario assuming the real return is 1 percentage point lower would be 2 years.

The only way for the Social Security trust fund to earn the higher returns possible with stock investing is to take on greater risk. The trust fund would be particularly vulnerable to losses in the event of a general stock market downturn if stock investing is implemented in isolation from other program changes. Just as it will have to draw down its Treasury securities to cover Social Security's cash shortfall, the trust fund will have to liquidate its stocks to pay benefits. Riding out a stock market downturn could be difficult for the trust fund as it faces growing numbers of retirees. The more the trust fund is counting on stock sales to raise cash, the greater its vulnerability in the event of a general market downturn. In contrast to our scenarios, reform packages that include stock investments along with other changes to Social Security typically envision that the Social Security trust fund would hold its stock portfolio and mainly draw on its stock earnings. In this context, the trust fund would be less vulnerable to the risk inherent in liquidating stocks to pay promised benefits.

Caution is warranted in counting on future stock returns in designing Social Security reform. Historically, returns on stocks have exceeded returns on Treasury securities over the long term, averaging about 7 percent after inflation. However, an average over nearly a century obscures the reality that stock returns fluctuate substantially from year to year. Over the past 70 years or so, stock returns were negative in nearly 1 out of 4 years. There is no guarantee that investing in the stock market, even over 2 or 3 decades, will yield the long-term average return. However, even if future stock returns are lower than the historical average of 7 percent, the conventional wisdom is that stock returns would

be higher than those on Treasury securities over the long term. How much higher is uncertain. Indeed, investing in the stock market would not ensure a higher return than might be possible investing in bonds. The stock market could drop and stay depressed for a prolonged period of time.

With government stock ownership, the risk and potential returns would be shared collectively by workers and beneficiaries. As shown in our simulations, any gain would extend the trust fund's solvency and thus reduce the size of benefit cuts or tax increases that would otherwise be required. On the other hand, any shortfall might require further benefit cuts or tax increases. The distribution of any gains or losses across workers and beneficiaries would ultimately depend on the structure of the Social Security program and any changes to it.

For any system of individual accounts, the risk of stock investing would be borne by those individuals who chose to invest in the stock market. Reform proposals that use government managed accounts would constrain investment choices to reduce the risks that individuals could take and, thereby, could also moderate their returns. In contrast, under proposals that place few restrictions on investment choices, investors could take much greater risks and potentially earn greater returns. In either case, individuals would benefit directly from any higher returns, and their retirement income would vary depending on their investment decisions and the timing of their investments. Some individuals could do very well under such an approach, but others could experience a

significant drop in their expected retirement income. Those who are reluctant to invest in the stock market, such as appears to be the case with lower income individuals, may not benefit from the potentially higher returns of stock investing.

Focusing on the risks associated with stock investing in isolation ignores a significant impact that individual accounts proposals would have on other risks individuals would face. Individual accounts proposals would fundamentally alter the role of Social Security as a social insurance program and focus instead on providing a vehicle for retirement savings. Under a social insurance model, the government tries to help insure adequate income by largely taking responsibility for a wide variety of risks that individuals face. They face some risks individually, such as how long they will be able to work, how long they will live, whether they will be survived by spouses or dependents, and how much their lifetime earnings will be. They also face some risks collectively, such as the performance of the economy and inflation. Social insurance tends to minimize such risks to individuals. In the process, Social Security redistributes income in a variety of ways—for example from high to low earners—and lowers the rate of return some workers earn on their retirement contributions. In contrast, under an individual retirement savings model, individuals could have greater freedom and control over their income and have more to gain or lose from their own choices but they could face many of these risks alone.

EFFECTS OF GOVERNMENT STOCK INVESTMENTS
ON THE FEDERAL BUDGET AND NATIONAL SAVING

In the short term, under current budget scoring rules, government stock investing would increase reported budget deficits or decrease budget surpluses because stock purchases would be treated as outlays.^{9,10} Each dollar invested in stocks is a dollar no longer available to the Treasury to finance other government spending or reduce debt held by the public. Depending on how much the trust fund were to invest in stocks, the change in the reported deficit/surplus could exceed \$100 billion annually. If, after accounting for this effect the government were in deficit, the Treasury would have to borrow more from the public, unless action were taken to reduce other spending or raise revenues. If, instead, the government were running a budget surplus, the Treasury would have less cash available to reduce debt held by the public. To the extent that individual accounts proposals redirect existing payroll tax revenues into private accounts, the budgetary impact would be similar to the impact of government stock investing.

⁹Stock investing could also prevent a budget surplus from materializing, depending on the size of any expected surplus and the amount that the Social Security trust fund invests in stocks.

¹⁰ While stock purchases would be treated as outlays under current budget scoring rules, such rules could be changed for stock investing. However, such a change would conflict with the way most other asset purchases are treated in the budget and it would raise some complicated technical issues. If despite these considerations, stock purchases were not counted as outlays, stock investing would have no major impact on the reported budget deficit/surplus.

Over the long term, the impact of government stock investing on reported budget deficits/surpluses could largely be neutral. While stock purchases would mean money flowing out of the government, any stock sales would bring money into the government. So, when Social Security begins running cash deficits in the future, it could sell stocks to finance benefits, rather than drawing on the Treasury. This approach would result in smaller future budget deficits or larger future budget surpluses than under current policy. This longer-term improvement could offset the near-term deterioration in the deficit/surplus. If stock earnings were to exceed any increase in federal borrowing costs that might result from a stock investing policy, there could be at least a slight benefit for the budget. However, any improvement in the government's position would result from capturing a portion of stock returns that would otherwise have accrued to private investors.

The long-term impact of individual accounts proposals on budget deficits/surpluses would be different than the impact under government stock investing. Money would flow out of the government to fund the accounts, but it would not flow back in because the accounts would be owned by individuals, not the government. Recognizing this dynamic, individual accounts proposals typically would reduce the size of the guaranteed benefit provided by Social Security, which would reduce future government spending. The net outcome on future deficits/surpluses would depend on the specific provisions of the individual accounts proposal.

Despite the budget reporting effects, government stock investing would have no significant impact on national saving. Although any federal borrowing from the public to finance stock purchases would absorb money from capital markets, the stock investments themselves would add money to the markets, offsetting the effect of the additional borrowing. This exchange between the government and the financial markets would constitute an asset shuffle among investors—the Social Security trust fund would buy some stocks from private investors and private investors would buy more Treasury securities from the government. This asset shuffle would likely be accompanied by changes in bond and stock prices that might, to some extent, undercut the government's expected gain on stock investments and increase the government's cost of borrowing. The magnitude and duration of these price changes in the stock and bond markets is uncertain and could be small.

The fact that government stock investing does not significantly affect saving is important. It means that any higher returns earned by the Social Security trust fund would be offset by lower returns earned by other investors, who would hold fewer stocks and more bonds in their portfolios. A similar result could apply to some individual accounts proposals. Redirecting a portion of current payroll taxes from the Social Security trust fund into individual accounts, without any other changes in Social Security benefits or revenues, would have no appreciable effect on national saving. Some individual investors would undoubtedly achieve higher returns by investing in the stock market but, without any additional resources available for investment, others would receive lower returns. In

short, simply altering the ownership of financial assets among investors would not boost national saving and long-term economic growth.

While stock investing, by itself, does not have a significant effect on national saving, the higher reported budget deficits or lower surpluses could indirectly lead to fiscal changes that could boost saving. By reducing the Treasury's available cash, stock investing would make more visible the underlying condition of the government's finances excluding the Social Security surplus. Policymakers could react to a higher unified deficit by cutting spending and/or raising taxes. Such fiscal restraint could contribute to a higher level of national saving. Or, if instead of contributing to a unified deficit, stock investing were to reduce an anticipated unified surplus, policymakers might be reluctant to enact tax cuts or additional spending. In this case, fiscal restraint might not promote higher saving, but it would avoid policy actions that could cause saving to decline.

Though stock investing could help highlight the budget shortfall that exists when Social Security's surplus is excluded, it represents a circuitous way of essentially duplicating an existing measure—the on-budget deficit.¹¹ If policymakers wanted to take actions to boost national saving, they certainly could do so directly by running annual surpluses in the unified budget and devoting the surplus funds to reducing the level of outstanding debt

¹¹The on-budget deficit, which excludes Social Security, is the budget measure that is used as the basis for the budget controls under the Budget Enforcement Act. However, it is not as commonly used as the unified budget measure, which best reflects the current impact of federal finances on the economy.

held by the public. If the government ran a unified budget surplus equal to Social Security's cash surplus, the Treasury would no longer need to rely on Social Security revenues to finance federal spending on other activities. While attaining and sustaining surpluses could prove extremely challenging, such a policy would strengthen the fiscal position of the government and, by promoting higher saving, better position the economy to handle the baby boomers' retirement costs.

IMPLEMENTATION ISSUES ASSOCIATED WITH GOVERNMENT STOCK INVESTING

Government stock ownership, and to a lesser extent government management of individual accounts, would raise certain implementation issues, the most significant of which are stock selection and shareholder voting rights. Conceptually, these issues do not pose major obstacles. However, they could prove controversial to resolve because critics have expressed concern about increased government involvement in financial markets and corporate affairs.

For stock selection, proponents of government stock investing typically recommend investing in a broad-based stock index. An indexing approach could reduce (1) the costs of selecting and managing a stock portfolio, (2) the exposure to some investment risks, and (3) the likelihood of the government controlling the corporate affairs of individual companies.

Unlike active investment managers, an index manager generally does not incur high expenses in the process of doing research and trading individual stocks of companies with profit potential. As a result, the costs of managing an indexed portfolio tend to be significantly lower than an actively managed portfolio. Most of the cost of managing an index fund is incurred maintaining thousands of individual accounts. In contrast, the government, as a single investor, would incur negligible costs as a percentage of its assets. Therefore, investing collectively through the government would result in significant administrative savings compared to investing through individual accounts.¹² However, individual accounts' proponents argue that administrative costs would be consistent with the costs of existing private retirement investment accounts.

Given that a broad-based indexed portfolio would represent many different sectors of the economy and individual companies, the risk is greatly reduced that any loss related to an individual firm or group of companies would greatly affect the overall performance of the government's portfolio. However, stock index investing would be riskier than the government's current investment in special Treasury securities. Indexing across the stock market does not reduce the government's risk of loss in the event of a general stock market downturn.

¹²For its analysis, the Advisory Council assumed that the annual costs for government stock investments would be only one-half of a basis point of total assets. For individual accounts proposals, the Advisory Council assumed administrative costs of 10.5 basis points for accounts that would be centrally managed by the government and 100 basis points for accounts that would be set up by individuals through private financial institutions.

A broad-based indexing strategy would reduce the possibility of owning a significant percentage of the stocks of an individual company, thereby reducing the likelihood of influencing its corporate affairs. However, indexing does not eliminate the possibility that there could be pressure for the government to include or exclude companies based on nonfinancial objectives. Under individual accounts proposals, these pressures would probably be either less significant or non-existent. Even if government were responsible for selecting the investment options for individual accounts, it might likely choose widely recognized indexes like it did for TSP.

The issue of how to handle stock voting rights also must be addressed. Critics of government stock investing have expressed concerns that the government's right to vote its sizable number of shares would allow it to influence corporate decisions. To blunt such concerns, the government's stock voting rights could be restricted by statute, but any restriction would need to be designed carefully. For example, simply prohibiting the government from exercising its voting rights would favor other stockholders or investment managers by effectively increasing their voting rights.

These issues are somewhat different for individual accounts, depending on the structure of the accounts. Under a proposal for individual accounts managed centrally through the government, stock voting would likely be delegated to external investment managers (one of the options under government stock investing). Concerns about shifting power into the hands of a few investment managers selected by the government could be diminished

by spreading stock investments among many different managers. Under an alternative type of individual accounts proposal where individuals are free to invest funds as they wish, the government would have no influence over stock voting.

OBSERVATIONS

In the report we issued to you today, we looked in detail at investing a portion of Social Security trust fund assets in the stock market. In contrast, alternative proposals would allow individuals to invest in the stock market. I would like to conclude with four key observations about stock investing through the government and through individual accounts.

First, risk would be shared collectively under government stock investing, but individually with individual accounts. By the same token, any higher returns would also be distributed differently. Under government stock investing, the distribution of returns among taxpayers and beneficiaries would depend on the structure of the Social Security program and any changes to it. Under individual accounts, the distribution of any higher returns would vary according to each individual's investment choices and outcomes. Also, the degree of risk and size of potentially higher returns would depend on the range of investment choices permitted by the government.

Second, simply shifting assets from the trust fund into the stock market, either through the government or individual accounts, does not by itself increase national saving. Stock investing could indirectly prompt actions to raise saving by revealing the size of federal deficits excluding Social Security's temporary surpluses. However, saving could increase directly if reforms further build up either public or private retirement funds. Such a build-up could result from either increasing retirement contributions or decreasing benefits. However, even then saving would not increase if either the government or individuals responded by reducing saving elsewhere.

Third, administrative costs for government stock investing would be significantly less than for individual accounts. Costs as a share of assets are generally greater for smaller accounts than for larger ones, though stock indexing could reduce costs for both the government and individuals. Also, proponents of individual accounts believe that the cost issue does not outweigh the issues associated with the government owning and managing a sizable stock portfolio.

Fourth, critics of government stock investing have cited its potential to increase government influence over the private sector. Stock investing by the government could affect financial markets and raises the issue of how to handle stock voting rights on a sizable portfolio. Under individual accounts, such concerns would be reduced or eliminated. The government would only exert influence to the extent that it defines individuals' investment options and controls shareholder voting rights.

On a broader level, individual accounts proposals would fundamentally change Social Security in ways that are not directly related to permitting stock investment. Some proposals would substantially reduce the role of Social Security in helping ensure adequate income, sharing a variety of risks, and redistributing income. Other proposals would do so to a somewhat lesser degree.

Finally, although stock investing could delay the trust fund's exhaustion, it cannot fix Social Security by itself. Restoring the program's long-term solvency will still require difficult choices about benefit cuts and tax increases.

ASSUMPTIONS USED IN ESTIMATING HOW
HIGHER RETURNS AFFECT THE SOCIAL SECURITY TRUST FUND

For our report on government stock investing,¹³ we used simulations to illustrate how changing the investment policy can affect the future outcome for the Social Security trust fund. Simulations are useful for comparing alternative investment policies within a common framework but should not be interpreted as forecasts given the range of uncertainty about the amount and timing of any Social Security stock investments as well as about future stock returns and potential economic changes in response to government stock investing. While our report discussed potential stock investment alternatives, it did not suggest any particular course of action, since the choice of the most appropriate investment policy is a decision to be made by the Congress and the President.

We examined the potential effect of government stock investing in isolation from other changes in the Social Security program. At our request, the Social Security Administration's (SSA) Office of the Chief Actuary simulated the potential effect of higher returns from stock investing on the trust fund using the Social Security Trustees' 1997 intermediate assumptions about future program revenues and expenditures as well as

¹³Social Security Financing: Implications of Government Stock Investing for the Trust Fund, the Federal Budget, and the Economy (GAO/AIMD/HEHS-98-74, April 22, 1998).

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their demographic and economic assumptions. We did not audit or validate SSA's actuarial projections.

According to the Trustees' 1997 intermediate estimates, the trust fund expects to collect roughly \$30 billion more in cash than is needed to pay benefits each year from 1998 until 2008 and continue to receive some excess cash until 2012. In addition, the interest credited on the trust fund's special Treasury securities was roughly \$40 billion in 1997. We assumed that the trust fund would continue to hold a contingency reserve of special Treasury securities equal to at least 100 percent of the next year's expected expenditures, given that stock prices are highly variable in the short term. Given that the trust fund's balance now exceeds 150 percent of its annual expenses, we assumed that the Social Security trust fund could begin investing in the stock market in 1998. Under the Trustees' intermediate projections, the trust fund does not anticipate that it would need to tap its investment income and assets for nearly 15 years. By 2012, assuming no other program changes, Social Security's tax revenue will be insufficient to pay benefits each year, and the trust fund will have to finance the program's cash deficit by drawing on its investment income and eventually depleting its assets.

The potential gain from stock investing would depend on what future stock returns are. In the simulations, we used the historical average real yield on stocks assumed by the 1994-1996 Advisory Council on Social Security ("the Advisory Council") in estimating

future stock performance. The 7 percent long-term historical average return on stocks is 4.3 percentage points more than the ultimate 2.7 percent yield on special Treasury securities under the Trustee's 1997 intermediate assumptions. In light of the uncertainty about future stock returns, we also tested a stock return which is 1 percentage point lower than the historical average. This alternative return is intended only to demonstrate that stock investment simulation results are sensitive to the rate of return assumed and does not represent the worst or most likely return outcome for the Social Security trust fund. We also used the Advisory Council's assumption that the trust fund's annual administrative costs would be 0.5 basis points.¹⁴ Administrative costs would reduce the spread between the real yields on stocks and Treasury securities by 0.005.¹⁵ Based on the Trustees' 1997 intermediate assumption for inflation, the ultimate nominal yield on special Treasury securities would be 6.29 percent. Thus, the ultimate nominal yields on stocks would be 10.74 percent (assuming a 7 percent real yield) and 9.70 percent (assuming a 6 percent real yield).

The potential gain from stock investing would also depend on how much the Social Security trust fund invests in the stock market. We developed two stock investment scenarios: (1) an aggressive scenario investing both Social Security's future annual cash

¹⁴A basis point is 1/100 of 1 percentage point, so one-half of a basis point is 0.00005.

¹⁵The spread over the real yields on Treasury securities would be 4.295 percent under the 7 percent real stock return assumption and 3.295 percent under the 6 percent assumption.

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surplus and interest in the stock market, while maintaining a contingency reserve of special Treasury securities equal to at least 100 percent of the next year's expected expenditures, and (2) a more conservative scenario investing only Social Security's cash surplus. Under the aggressive scenario, the trust fund would hold its balance of special Treasury securities constant as of the beginning of 1998. From 1998 until 2008, all of Social Security's cash surplus and the interest on its special Treasury securities would be invested in the stock market. Beginning in 2008, the trust fund would need to begin investing more in Treasury securities to maintain a 100 percent reserve level. Under the cash surplus scenario, the trust fund would invest in the stock market until 2012 and then it would begin drawing on its stock earnings and sales to finance Social Security's cash deficit. In both scenarios, stock earnings are reinvested in the market unless the trust fund needs cash to pay benefits or to invest in Treasury securities to maintain its contingency reserve.

Table I.1 shows, under current law and the two stock investment scenarios, the years when (1) the trust fund would be exhausted, (2) its asset level would fall below 100 percent of expected annual expenditures, and (3) its asset level would fall below 150 percent. These simulation results illustrate some outcomes associated with two alternative investment policies. These results should not be interpreted as forecasts and do not represent the full range of possible outcomes for the Social Security trust fund.

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Table I.1: Key Dates Under Current Law and Two Stock Investment Scenarios

	Trust fund exhausted	Assets less than 100 percent of annual outgo	Assets less than 150 percent of annual outgo
Current law	2029	2025	2022
Aggressive scenario			
7 percent real yield	2040	2036	2034
6 percent real yield	2035	2032	2029
Cash surplus scenario			
7 percent real yield	2032	2028	2026
6 percent real yield	2031	2027	2025

Source: SSA, Office of the Chief Actuary.

RELATED GAO PRODUCTS

Social Security Financing: Implications of Government Stock Investing for the Trust Fund, the Federal Budget, and the Economy (GAO/AIMD/HEHS-98-74, April 22, 1998).

Budget Issues: Long-Term Fiscal Outlook (GAO/T-AIMD/OCE-98-83, February 25, 1998).

Social Security: Restoring Long-Term Solvency Will Require Difficult Choices (GAO/T-HEHS-98-95, February 10, 1998).

Social Security Reform: Implications for Women's Retirement Income (GAO/HEHS-98-42, December 31, 1997).

Social Security Reform: Demographic Trends Underlie Long-Term Financing Shortage (GAO/T-HEHS-98-43, November 20, 1997).

Budget Issues: Analysis of Long-Term Fiscal Outlook (GAO/AIMD/OCE-98-19, October 22, 1997).

Retirement Income: Implications of Demographic Trends for Social Security and Pension Reform (GAO/HEHS-97-81, July 11, 1997).

Federal Debt: Answers to Frequently Asked Questions (GAO/AIMD-97-12, November 27, 1996).

The CHAIRMAN. Mr. MacLaury.

STATEMENT OF BRUCE MACLAURY, CHAIRMAN, SUBCOMMITTEE ON SOCIAL SECURITY REFORM, COMMITTEE FOR ECONOMIC DEVELOPMENT, WASHINGTON, DC

Mr. MACLAURY. Thank you, Mr. Chairman. Ms. Bovbjerg has set a very good example in terms of timing. I hope I can match that.

The CHAIRMAN. It seemed to me like this first light came on before 4 minutes were up. I think we were operating with a lighting system that was way off, and I think we should have truth in timing. [Laughter.]

Will somebody check to make sure if it is actually 4 minutes and then 5 minutes? [Laughter.]

Mr. MACLAURY. As you said, Mr. Chairman, I am appearing before this committee today as a trustee of the Committee for Economic Development. At CED, I was chairman of a group of trustees that spent a year studying the Social Security system. A little more than a year ago, in February 1997, we issued a policy statement called "Fixing Social Security" that discussed its problems, specified various criteria that ought to be used in thinking about its improvement, and described an approach that we, the trustees, felt was the best one for reform. That statement has been provided to the committee today.

The specific issue today before this committee, as I understand it, is the ownership of private corporate stock by the Social Security trust funds themselves. That was discussed in the CED report, and after careful consideration, the CED strongly opposed proposals for Social Security trust funds as such to invest in stock of private corporations.

The primary reason for CED's opposition is that Federal Government ownership of private securities involves an undesirable risk of political interference with private business operations through investment decisions of the managers or through the exercise of stock voting rights.

In addition, we believe that government ownership of private securities is a less desirable approach for dealing with the Social Security problems than for individuals to supplement their retirement savings through tax-deferred personal savings accounts invested in private securities. I want to emphasize the point: the CED is in favor of supplementing Social Security by investing in private stocks, but by individuals rather than by the Social Security trust funds.

Advocates of Federal Government ownership of equity securities point out that State pension funds have invested in private securities for many years, but the record of these pension funds indicates that they are sometimes used to achieve unrelated political or social agendas. It is quite clear that some State pension fund managers have become more involved in corporate governance issues than is needed to satisfy fiduciary responsibilities.

CalPERS, for example, has guidelines that indicate, "Non-financial considerations cannot take precedence to pure risk return considerations in the evaluation of investment criteria." The guidelines nevertheless specify voting positions in considerable detail with respect to appointments of corporate boards, corporate capital struc-

tures, management compensation, and the like. There is no reason to believe that the Social Security Administration would be able to avoid those political pressures for investment decisions and how to vote corporate stock.

It is frequently pointed out that the Thrift Savings Plan, TSP, of the Federal Employment Retirement System has largely avoided these kinds of issues by delegating authority to vote its stock to the fund manager. Success of this policy may be due in part to the TSP being relatively small and not, therefore, as large a target as Social Security would very quickly become. In fact, it is worth pointing out that even TSP was not immune from manipulation, if I may use that phrase. In late 1995 when Congress refused to raise the Federal debt limit, Secretary Rubin turned to TSP for help, delaying interest payments to individual accounts and withdrawing funds from the government securities fund to avoid default on the national debt.

The objective of investing Social Security trust fund balances in private securities is to improve the fiscal position of the system. That is clear. But investing in private securities without other actions, as Ms. Bovbjerg has pointed out, would only postpone the need to liquidate fund balances by a few years, perhaps 10 years at most. Thereafter, Social Security, if it had invested, would have to disinvest in private securities markets. That might be all right if private securities markets were on the rise, but if they were falling, then the need to liquidate private securities as the Social Security trust fund as it ran out of balances would further exacerbate the pressures on the stock market at that time.

More important, although investments in equities could improve the fiscal position of the Social Security system as such, the Federal Government's overall fiscal position would not change. Because Social Security trust funds, as has been pointed out, would no longer be available to underwrite the Treasury debt, there would really only be a switch: an exchange of debt for private stock.

In any case, equity investments in the trust funds would not be a free lunch for the economy as a whole. The higher returns on equities would be transferred from private holders to the trust funds.

Let me finish with a word about national saving. In its study, CED placed great emphasis, in looking at the issues of fixing Social Security, on the need to take advantage of that fix to increase national saving at the same time. The proposals for the trust funds to invest in equity securities will do nothing for increasing national savings. It is simply a wash.

Mr. Chairman, I conclude that there are far better proposals for fixing Social Security than the proposal for the trust fund to invest in corporate stocks. The proposal put forth by CED, for example, would simultaneously restore Social Security solvency and raise national savings, and thereby reduce the burden on future generations, all without jeopardizing the independence of private industry.

Thank you, Mr. Chairman.

[The prepared statement of Mr. MacLaury follows:]

Statement of
Bruce K. MacLaury
Chairman of Subcommittee on Social Security Reform
Committee for Economic Development

Before the
Senate Special Committee on Aging

April 22, 1998

Introduction

Thank you Mr. Chairman. My name is Bruce MacLaury. I am President Emeritus of the Brookings Institution and currently serve as Chairman of the Emergency Transitional Education Board for the District of Columbia. However, today I am appearing before this Committee in my capacity as a Trustee of the Committee for Economic Development (CED), a research and policy organization whose Trustees are 210 national business and academic leaders.

At CED I was Chairman of a group of Trustees that spent a year studying Social Security and proposals for reforming the system. In February 1997 we issued a policy statement, entitled ***Fixing Social Security***, that discussed Social Security's problems, specified criteria for evaluating proposed changes in the system, and described an approach to structural reform recommended by CED Trustees. The statement has been distributed to the Committee today.

The specific issue now before this Committee -- the ownership of private corporate stock by Social Security trust funds -- was discussed by the CED subcommittee and addressed in our policy statement (pp. 44 to 47). After careful consideration, **the CED strongly opposed proposals for the Social Security trust fund to invest in the stock of private corporations.** The primary reason for CED's opposition is that federal government ownership of private securities involves an undesirable risk of political interference with private business operations primarily through investment decisions of fund managers and the exercise of stock voting rights. In addition, we believe that government ownership of private securities is a less desirable approach for dealing with the Social Security problem arising from the aging of the American population than for individuals to supplement their retirement savings through tax-deferred Personal Savings Accounts invested in private securities.

Corporate Governance

Advocates of federal government ownership of equity securities issued by private corporations point out that state pension funds have invested in private securities for many years. But the record of these pension funds indicates that they are sometimes used to achieve an unrelated political or social agenda. In some cases, these funds have not been able to avoid political pressures to select investments according to criteria other than the expected return on investments, or to exercise voting rights in a way that is inconsistent with their fiduciary responsibilities. Such behavior can be damaging not only to the pension funds themselves but to economic progress more generally, because it may divert resources away from the most productive uses.

It is quite clear that some state government pension fund managers have become more involved in corporate governance issues than is needed to satisfy their fiduciary responsibilities. Some states have detailed policies pertaining to the exercise of employee pension fund voting rights. For example, the California Public Employee's Retirement System (CalPERS), which is the largest state employee pension fund, has developed

comprehensive guidelines on a wide range of governance issues. Although, the guidelines indicate that "...nonfinancial considerations cannot take precedence to pure risk/return considerations in the evaluation of investment decisions," the guidelines specify voting positions in considerable detail with respect to appointments to corporate boards, corporate capital structure, management compensation, and other issues of corporate governance, including limited involvement in corporate social responsibilities.¹ Should any company not meet CalPERS criteria, the Board is authorized to take action including "...as a last resort, liquidation of system holdings in the company, if the sale is consistent with sound investment policy."² In a number of instances CalPERS, like other state pensions, has been required by the state legislature to use its power in pursuit of specific social objectives.³

There is no reason to believe that the Social Security Administration could avoid political pressures in investment decisions and in the voting of corporate stock. The current debates in Congress concerning appropriate public policy toward tobacco companies offers a glimpse of the possibilities. Indeed, because of its size, special interests would find the Social Security trust fund a more attractive target than state pensions systems. Limiting equity investments to broad-based indexed funds would not eliminate the possibility of political interference, as some have suggested. Congress could simply enact legislation to exclude investments in "inappropriate" activities. Moreover, managers of indexed funds might feel a great need to apply pressure on corporate management when voting stocks, because they could not pursue their fiduciary goals by avoiding investments in particular stocks included in the index.

It has frequently been pointed out that the Thrift Savings Plan (TSP) of the Federal Employee's Retirement System has largely avoided these issues by delegating authority to vote its stock to the Fund Manager. The success of this policy may be due to the fact that the TSP is still a relatively small fund and offers limited investment options. Moreover, it is worth pointing out that the TSP has not been immune from manipulation. In late 1995, when Congress refused to raise the federal debt limit, Treasury Secretary Rubin turned to the TSP for help, delaying interest payments in individual accounts and withdrawing funds from the "G Fund" (government securities) to avoid default on the national debt.

If Social Security invested a significant portion of the trust fund surplus in private securities, these investments would be extremely large, giving the federal government effective controlling interest in many private companies. It is hard to believe that some future Congress would not take advantage of the opportunity to achieve political and social objectives through these investments. The potential adverse effects could be severe, given the size of the Social Security system.

¹ See California Public Employee's Retirement System, "Domestic Proxy Voting Guidelines," March 17, 1997.

² *Ibid.*, p.9.

³ The point here is not that the objectives were bad in all cases, but that the potential for abuse is very great.

Investing in private securities without other actions would only postpone need to liquidate trust fund balances by a few years. Moreover, if Social Security first invested, then disinvested, in private equities as would be required, equity markets would be whipsawed, at best, and at worst the markets would be devastated if disinvestment occurred during a decline in the market.

Budget

The objective of investing Social Security trust fund balances in private securities is to improve the fiscal position of the system. Based on long-term historical trends, the return on a stock portfolio is expected to exceed the return on the Treasury's special issues, now held by the trust funds. But, as noted above, a portfolio of corporate stocks would merely provide temporary relief and postpone bankruptcy.⁴ Furthermore, higher returns are associated with higher risks; there is no guarantee that the performance of a stock portfolio -- including a broad-based, indexed portfolio -- will match past experience.

More importantly, although investments in equities could improve the fiscal position of the Social Security system, the federal government's overall fiscal position would not change when looked at from an economic perspective. Because Social Security surplus funds will no longer be available to finance other spending, the Treasury would find it necessary to issue additional debt to the public, unless other spending were cut or taxes raised. The government (as a whole) would be neither richer nor poorer because it would merely exchange additional public debt for private stock. But with present budgetary conventions, the purchase of corporate equities by the trust funds would be recorded as an outlay in the federal budget, which would raise the reported unified budget deficit.⁵ (The unified budget is intended to provide a guide to future borrowing by the Treasury). This fact has led some to propose a change in budgetary definitions to discontinue the practice of classifying the purchase of equities as an outlay. One problem with this idea is that other more questionable "investments" might also be excluded from outlays, leading to much budgetary mischief.

In any case, equity investments by the Trust Fund would not be a "free lunch" for society: the higher returns on equities would be transferred from private holders of equities to the Trust Fund. The increased sale of Treasury debt to the public might also raise interest rates and the cost of public borrowing by the Treasury.

⁴ One estimate is that a portfolio of 40 percent stocks (by 2015) would reduce the seventy-five year actuarial deficit by 36 percent.

⁵ In the unified budget, cash payments from government to agents outside of government generally affect total outlays, but payments between government agencies do not. Thus, the acquisition of corporate stock would affect outlays, while the distribution of special issues to Social Security does not affect total outlays. (The special Treasury issues held in the Social Security trust funds are not included in the federal debt held by the public, though they are included in the gross federal debt).

National Saving

CED believes that it is critically important that Social Security reform generate a significant increase in national saving. Increased saving will raise worker productivity, and a larger economic pie will make it easier for a reduced ratio of future workers to bear the burden arising from an aging population. This criterion was a very important consideration in the choice of recommendations contained in *Fixing Social Security*.

The proposal for Social Security to invest in equities fails to raise saving at all. The purchase of equities by the Social Security Administration does not in itself affect the government's net fiscal position. Nor would it directly affect private saving. Equity investing would not enlarge the national economic pie.⁶

Conclusion

Mr. Chairman, I conclude that there are far better proposals for fixing Social Security than the proposal for the trust funds to invest in corporate stocks. The proposal put forth by CED, for example, would simultaneously restore Social Security's solvency and raise national saving and, thereby, reduce the burden on future generations -- all without jeopardizing the independence of private industry.

⁶ Of course, it is possible that government investments in equities will induce secondary savings effects -- changes in the behavior elsewhere or in government. But these effects are quite speculative. Individuals might even save less if they believe that Social Security benefits are more certain due to the investments in equities. Government, on the other hand, might cut spending or raise taxes in response to the increased non-Social Security deficits.

The CHAIRMAN. Professor Munnell.

STATEMENT OF ALICIA MUNNELL, FORMER MEMBER, COUNCIL OF ECONOMIC ADVISORS; PETER F. DRUCKER PROFESSOR OF MANAGEMENT SCIENCES, BOSTON COLLEGE, BOSTON, MA

Ms. MUNNELL. Chairman Grassley, Senator Breaux, members of the committee, I am delighted to be here today. I think the question of the impact of equity investment on the Social Security trust funds is extremely important in the context of the Social Security debate.

Although it has taken me some time to come to the conclusion, I am now convinced that allowing the Social Security trust funds to invest in equities would be good for participants and would be good for the Social Security program. Let me make very clear that this conclusion does not rest on the claim that such a portfolio shift would increase national saving or investment. Rather, it rests on the fact that it would allow young people and others with very little wealth who are not particularly risk averse to have access to high return, high risk equity investment, and it would provide that access, and this is what is important, with the least threat to the predictability of their retirement income and at the least possible cost.

Let me just explain how I see the issue before us today. The question before us today is not how much saving we should do. Everyone agrees that we should do some prefunding of Social Security obligations. All three Advisory Council plans and most other proposals involve some buildup of reserves, and this is probably a good idea.

Moreover, the question before us today is not whether it is desirable for government-mandated saving to be invested in equity. All three Advisory Council proposals and most other proposals recommend investing in equities in one way or the other.

Rather, the question before us today is, given a buildup in reserves and the desire to invest in equities, is it better done through the Social Security trust funds or through individual accounts? In my view, investing in equities through individual accounts has little to recommend it. The most extreme version, whereby individuals have their own IRA-type account and can invest in anything they want, raises the most serious problems.

First, individuals with their own accounts would have to bear the full risk associated with their stock investments. Their retirement income would be very uncertain. It would depend completely on what they bought and when they bought it and when they sold it.

Second, this most extreme IRA-type proposal would be very costly. The lowest estimate presented by the Social Security Advisory Council is that it would cost one percent of assets each year. Over an average 40-year work life, that means that total accumulations would be reduced by 20 percent and benefits would be 20 percent lower than they would have been without these transactions costs. Data from the U.K. and from Chile suggests that costs could be even higher than this minimum estimate.

Third, the most extreme IRA-type approach also would create the most pressure for individuals to gain access to their accounts for

medical expenses, education, and other worthy causes. This would mean that retirees could end up at retirement with inadequate retirement income.

Finally, the IRA-type proposals typically do not require the individuals to buy annuities. This means that retirees risk outliving their retirement reserves or living unnecessarily frugal lives in order to conserve their meager resources.

If the extreme IRA approach is too risky and too costly, then you might ask, how about the 401(k) or TSP approach? My view is that equity investment through the 401(k) or Thrift Savings Plan approach buys you virtually nothing over direct trust fund investment and costs you more.

First, it would double the cost of today's Social Security program. Second, it still involves unpredictability in retirement income. Third, it creates the same pressure as the extreme version for individuals to get access to their money before retirement.

For those who are concerned about government involvement, this approach has the government picking the funds and holding the money. I do not view this as a particular problem. I am simply saying that this 401(k) approach raises most of the same issues as investments by the central trust funds themselves.

My view is that investing in equities through the trust funds is the most sensible strategy. By keeping investments together and maintaining a defined benefit structure, the Social Security program can spread risks across the population and across generations. In other words, this approach to investing in equities ensures the most predictability in terms of retirement income.

Second, pooling investments and eliminating individual choice keeps transactions and reporting costs to a minimum, ensuring on average higher net returns on equity investments through the trust funds than people could gain through individual accounts.

Finally, my view is that critics' concerns about government interfering in private business could be met by setting up an independent investment board, investing in a broad index, and delegating voting rights to fund managers, and I have to admit that my own reluctance to support equity investment by the trust fund was based on the experience of State and local funds, where I had been concerned about managers taking their eyes off the prize of earning the maximum return. I just do not think that you will see that same kind of problem at the Federal level. There is just much more sunshine there. The positive experience of TSP is also very encouraging in that light.

In short, investing the trust funds in equities is feasible. I think that is what the GAO concludes. It is cost effective, and it is desirable on economic grounds. Canada is in the process of setting up a Board for equity investment. I think that it merits serious consideration in the debate about the future of the Social Security program.

Thank you very much.

[The prepared statement of Ms. Munnell follows:]

IMPACT OF EQUITY INVESTMENTS ON THE SOCIAL SECURITY PROGRAM

**Testimony before
The Senate Select Committee on Aging
April 22, 1998**

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Prior to her position at Boston College, Dr. Munnell was a Member of the President's Council of Economic Advisers (1995-1997). At the Council she focused on domestic macroeconomic issues as well as health, labor, and environmental topics.

Prior to joining the Council, Dr. Munnell served for nearly three years (1993-1995) as Assistant Secretary of the Treasury for Economic Policy. In that capacity, she and her staff contributed to nearly every aspect of Administration policy.

Dr. Munnell spent most of her professional career at the Federal Reserve Bank of Boston. She joined the staff of the Boston Fed's Research Department as an economist in 1973 and became Senior Vice President and Director of Research in 1984. While at the Boston Fed, Dr. Munnell wrote extensively on tax policy, social security, public and private pensions, and productivity. She published many articles, authored numerous books, and edited several volumes on these topics. In addition, Dr. Munnell was responsible for assessing the competitive aspects of bank mergers and acquisitions and working with Senior management to resolve bank-wide issues.

Among many other affiliations, Dr. Munnell was co-founder and first President of the National Academy of Social Insurance. She has also participated on numerous advisory boards and panels. She is currently a member of the Institute of Medicine, the National Academy of Public Administration, and the Pension Research Council at Wharton. She also serves on the Boards of the Twentieth Century Fund, the National Tax Association, and the Pension Rights Center, and is on the Editorial Board of The American Prospect.

Dr. Munnell earned her B.A. from Wellesley College, an M.A. from Boston University, and her Ph.D. from Harvard University.

Chairman Grassley, Senator Breaux, members of the Committee, I am delighted to have the opportunity to appear before you today to discuss the important topic of the impact of stock market investment on the Social Security program.

As you know, all three groups on the Social Security Advisory Council proposed investing a portion of Social Security funds in equities, albeit through quite different mechanisms. Thus, the question seems not to be whether it is desirable for government-mandated retirement saving to be invested in equities but rather whether this should occur under the auspices of the current defined-benefit Social Security system, or in the context of one of the individual account arrangements.

It is important to keep in mind that this is not a debate over whether or not to prefund Social Security obligations. All three Advisory Council plans involve a substantial buildup of reserves. How much to prefund is an important question. It raises tough issues of how heavily to burden this generation in order to improve the welfare of future generations. Undoubtedly eliminating Social Security's financing gap will produce some prefunding. But that is not the topic for today's hearing. The question today assumes some prefunding and a desire to invest in equities and asks if this is better done in the central Social Security trust funds or in individual accounts.

My conclusions are as follows:

Investing some portion of Social Security in equities is a good idea.

It allows the young and those with little wealth to have access to the higher returns afforded by a diversified portfolio.

By spreading risk more widely, it increases the efficiency of capital markets and reduces the risk premium.

Equity investment through mandatory IRA-type accounts puts retirement income at risk, would be very costly, and may well not be technically feasible.

The significant investment risk associated with equities would make retirement income very uncertain, dependent on when individuals buy and sell their stocks.

Mandatory IRA-type accounts would be extremely costly. The lowest estimate is 100 basis points per year, which reduces total accumulations over a 40-year work-life by 20 percent. Data from the United Kingdom and Chile suggest that costs could be even higher.

Account holders would inevitably pressure Congress for access to these accounts for worthy purposes such as medical expenses, education etc., leaving retirees with inadequate retirement income.

In the absence of mandatory annuitization, individuals risk outliving their retirement reserves or living unnecessarily frugal lives in order to conserve their resources.

Equity investment through 401(k) or Thrift Savings Plan approach buys you nothing and raises costs.

For those concerned about government involvement, this approach requires that the government designate appropriate equity funds and retain control of investments.

This approach would double the cost of the current Social Security system.

This approach introduces the political risk that individuals will get access to their funds before retirement and end up with inadequate retirement income.

This approach introduces unpredictability into retirement income and reduces disability benefits.

Investing in equities through the Social Security trust funds is the most sensible strategy.

Keeping investments together and maintaining a defined benefit structure enable the system to spread risks across the population and over generations, ensuring predictable retirement incomes.

Pooling investments and eliminating individual choice keeps transaction and reporting costs to a minimum, ensuring higher net returns on equity investments than individual accounts.

Setting up independent investment board, investing in a broad index, and delegating voting rights to fund managers should avoid any interference with private sector activity.

Let me explain my reasoning behind these conclusions.

I. The Case for Investing Social Security Trust Funds in Equities

Let me make clear from the outset that the case for investing the trust fund in equities does not rest on the claim that such a portfolio shift would increase saving or investment in the economy as a whole. To a first approximation higher returns in Social Security would be offset by lower returns in the rest of the economy. If all we are talking about is a portfolio shift, then you might ask, "Why bother?"

The reason that all three groups of the Social Security Advisory Council recommended equity investment is that they were caught in a dilemma. They were faced with a system that had drifted out of long-run balance. They were also faced with the fact that many younger workers and workers in future generations would receive low or even negative returns on their Social Security. They quickly recognized that any move to close the financing gap by raising taxes or cutting benefits would only worsen the rate-of-return calculations. The solution to which all three groups resorted, in one form or another, was to find a new source of revenue. That new source was the higher expected return on equity investment.

In my view, allowing government-mandated retirement saving to be invested in equities is a good idea. Many young people and others with little wealth are not particularly risk averse, but they have no mechanism for taking advantage of higher-risk/higher-return equity investment. Those covered by private pension plans and state and local pensions have their contributions invested in balanced portfolio that includes a significant equity component. But more than half the work force, primarily the lower paid, are not covered by supplementary pensions and therefore do not have access to equity investment. The Social Security program is the only place where they can earn the higher returns. Broadening Social Security's investments to include equities would provide participants with a more appropriate portfolio and allow them to earn higher

returns on their contributions.

From an economist's perspective, spreading the risk associated with equities more widely, by adding low-income and young workers to the risk bearing pool, also has beneficial implications for the economy. Spreading a given amount of risk among more people increases the efficiency of capital markets and lowers the risk premium. If borrowers can borrow at lower rates, they will be more willing to undertake risky investments.

While the economics argue clearly for a diversified portfolio for Social Security, the question is whether this is better accomplished through the central trust funds or individual accounts.

II. How Would Individuals Fare Under Different Mechanisms For Investing In Equities?

To answer this questions requires considering how individuals would be affected by risks under alternative arrangements, how much would different approaches cost, and how would people protect themselves against outliving their resources.

Risk Bearing

With regard to risk, it is useful to think of two types of risk that individuals face in their retirement investments. The first is market risk, which includes both risk of return during the accumulation phase and interest rate risk associated with the purchase of an annuity. Many people have done simulations showing how unpredictable people's retirement incomes will be if their benefits reflect their individual investment decisions. One study by Gary Burtless of the Brookings Institution showed that benefits could vary from 20 percent of pre-retirement earnings to 100 percent of pre-retirement earnings

depending on when individuals retired. Attempting to eliminate this variation would require constant tinkering with contribution rates.

Under Social Security's defined benefit plan, even if the aggregate trust funds were invested in equities, individuals could avoid most of the risk. They do not have to cash out their holdings at any particular time and they would receive a defined benefit under the program. If the market were down temporarily relative to expectations, the trust fund and investment earnings would be low. But the Social Security trust funds would be quite large by that time and even a substantial--but temporary drop--in the stock market should not require a benefit cut or tax increase. In other words, the government should be in a good position to weather fluctuations by either using some trust fund reserves or borrowing temporarily.

The discussion so far has assumed that equities continue to earn a real return of roughly 7 percent and has focused on the implications of variations around that mean. The second type of risk could be called "equity premium risk"--that is stock market returns turn out to be lower than those experienced in the past. This is quite possible. But the issue is whether such a decline would be more disruptive if equities were held in separate accounts or in the trust funds. In both cases income would be inadequate to finance future benefits; the question is who would bear the residual risk. As constructed, individuals under the individual account proposals would simply have to live with lower benefits. In contrast, the implication of retaining the current system is that younger workers would be required to pay higher taxes. In all likelihood neither extreme would emerge in the political process. The pure market outcome under the individual arrangements would probably be mitigated by some taxpayer contributions to bolster benefit levels; the defined benefit commitment would probably be modified by dividing the shortfall between beneficiaries and workers. No one has the answer to how the economy would respond if the equity premium declined, and it is unclear whether the possibility of a decline argues

for individual or collective arrangements.

Transaction Costs

A second factor that requires careful consideration when assessing alternative ways to invest in equities is transaction costs. The Advisory Council estimates that a truly individual approach would cost 100 basis points per year. A 100-basis point annual charge reduces total accumulations and benefits by roughly 20 percent over a 40-year work life. The 100-basis-point estimate includes the cost of marketing, tracking, and maintaining the account but does not include brokerage fees. If the individual does not select an index fund, then transaction costs may be twice as high. Indeed, costs actually experienced in Chile and the United Kingdom, both of which have systems of individual accounts, have been considerably higher than the Advisory Council estimate. The comparable cost for investing in equities through the trust fund is estimated to be 1 basis point a year. This would reduce asset accumulations and benefits by less than 1 percent.

The Issue of Annuities

The third factor to consider when deciding to invest in equities through the central trust funds is the question of transforming accumulated reserves into annuities. Without such a transformation, individuals stand a good chance of out living their savings. But costs are high in the private annuity market, because of adverse selection: people who think that they will live for a long time purchase annuities, whereas those with, say, a serious illness keep their cash. Moreover, the private annuity market would have a hard time providing inflation adjusted benefits. In contrast, by keeping everyone together and forcing them to convert their funds to annuity, social security gets around the problem of adverse selection and is in a good position to provide inflation-adjusted benefits.

Putting together market risk, transaction costs, and annuity considerations suggests that individuals would almost certainly fare better if equities were held centrally

in the Social Security trust funds than if they were held in individual accounts.

III. Is Investing through the Social Security Trust Funds Feasible?

Feasibility involves two issues: the impact of trust fund accumulations on financial markets and the potential impact of large trust fund investments on the business sector.

Impact on Financial Markets

The starting point for answering that question is to determine whether the investment of Social Security in equities would overwhelm and destabilize the market. For example, if the trust funds were going to hold 50 percent or more of all equities, this would eliminate the need for further analysis. On the other hand, if the magnitudes are manageable, then we need to address other issues.

The Social Security Administration actuaries present estimates of the build-up of equity holdings under each of the three Advisory Council plans. To determine the impact on capital markets requires estimating the growth rate of total equity holdings. If the real value of total equities grew at the rate it grew over the period 1952-95 (5 percent), and if 40 percent of Social Security trust fund assets were invested in equities as recommended under the Maintenance of Benefits plan, then Social Security trust fund holdings would equal roughly 5 percent of the total market in 2020. (The IA proposal would produce equity holding of 3 percent and the PSA plan holdings of 11.1 percent.) In other words, the total equity market is likely to grow fast enough to absorb without much disruption the build up of equity reserves in the trust funds.

Even if such an accumulation would not disrupt the markets, could it have a substantial effect on relative rates of return, perhaps driving up government borrowing costs? The portfolio restructuring should have some effect. The equity premium should

decline to reflect the increased efficiency of risk bearing in the economy. Some movement would also be expected in interest rates. The one study that has estimated the effect on relative returns concluded that the shift to equities in the trust funds would lower the equity premium by 10 basis points and, and raise the interest on Treasury securities by roughly the same amount. With current levels of federal debt, this increase in Treasury rates should have a relatively small effect on the unified budget. As the economy grows and the debt declines, the effect should be negligible.

Impact on the Business Sector

But many people are concerned that Social Security investment in equities could lead to government interference with the allocation of capital in the economy and with corporate activity. At this point, it is important to emphasize that these concerns, to the extent that they are valid, should apply equally to the IA and MB proposal. Under the IA proposal the government would hold individual contributions in defined benefit accounts and designate a series of index equity funds for investment. Hence, questions about which stocks to include in the indexes, and how shares are to be voted are just as much issues for the individual account proposal as for the centrally managed approach.

Public pension funds provide a range of evidence regarding the desirability of allowing Social Security to invest in equities. Supporters point to the success of federal plans. The federal Thrift Savings Plan has established a highly efficient stock index fund. The plan also has steered clear of any issues of social investing--that is, investing in projects with less than market returns for a given level of risk. Divestiture of stocks for social or political reasons has also not been an important problem. It has addressed the concern about government control of private corporations by pushing proxy decisions down to the level of the individual portfolio managers.

Opponents point to state and local pension funds. Indeed one does see pressure

from investment boards or states for state and local pension funds to undertake investments that serve other interests, often at a sacrifice in return. State and local funds have also been pressured to divest certain stocks in order to demonstrate that they do not support some perceived immoral or unethical behavior.

My view is that such pressures are less likely to occur at the federal level. Much of state-local plan activity is conducted in relative secrecy, while Social Security investments would be subjected to much public scrutiny. In any event, any loss in return, undesirable as it may be, would probably be trivial compared to the savings in transaction accounts of administering a single fund as opposed to roughly 200 million individual accounts. Nevertheless the issues of social investing and corporate governance are the major arguments that can be used against investment in equities and they have raised considerable concern.

V. How Would Social Security Investment Affect the Federal Budget?

One final note on how investment in equities would affect the federal budget. Under current budget rules, investment of trust fund assets in equities would be considered an outlay. This has two implications. First, it would reduce the reported federal surplus. The economic implications would be very different, of course, than a comparable reduction occurring as a result of a tax cut or spending increase. But reducing the reported surplus would be a mechanism to remove the temptation to spend the surpluses.

The second implication is that investing in equities would force a separation of Social Security from the rest of the budget. It would make it much harder for the government to mask the deficit in the non-social-security portion of the budget. This is crucial for the assumption made at the beginning of these remarks--namely, that prefunding can be accomplished equally well through the Social Security trust funds and

individual accounts. Only by reporting the deficit for the non-social-security portion of the budget separately and focussing the political debate on that number can we expect the trust funds to accumulate assets in a manner that could increase national savings. Investing the trust funds in equities would be very useful in this regard.

VI. Conclusion

Let me conclude. Investing the trust funds in equities appears to be a feasible strategy. It is also desirable on economic grounds. It would improve the distribution of risk bearing in the economy. It would enhance support for the Social Security program. It is true that higher returns for Social Security would result in lower returns elsewhere in the economy. But raising returns in Social Security and lowering them in private pension plans has significant distributional implications. Social Security provides proportionately higher benefits to low-wage workers, most of whom have no private pension coverage.

The other very important economic consideration is transaction costs. Estimates from the U.S., Chile, and U.K. suggest that pure individual accounts could reduce total accumulations by 20 percent. The comparable figure for trust fund investment in equities would be less than 1 percent. These numbers dwarf any estimated losses that might arise from accepting less than market returns, if some form of social investing should occur.

Although concern about government interference in private sector could probably be addressed through a careful structuring of the investment arrangements, this concern remains the major source of opposition to trust fund investment in equities.

On balance, my view is that investing the trust funds in equities is desirable on economic grounds and merits serious consideration.

The more important argument for investing Social Security reserves in equities is

that it would level the playing field for Social Security vis-a-vis other retirement programs. It would allow a higher payoff on people's basic pension contribution. This is not an issue of public relations. Disadvantaging Social Security in the arena of public opinion can end up hurting low-wage workers. These are the workers who benefit from Social Security's benefit progressive structure and who are generally not covered by private pension arrangements. If the role of Social Security's progressive defined benefit plan were diminished, the retirement income of many low-wage workers would be put at risk.

The CHAIRMAN. Thank you very much. I appreciate the testimony of all of you.

We will take 5-minute rounds for questioning for each of us and see how that goes. If we have more time, then we can take a second round.

I think one or two of you mentioned that this might not have anything whatsoever to do with enhancing national savings as a whole. I want to focus on that just a moment to see whether or not that stands the test of intellectual investigation. If it does, is there anything about this debate that ought to be connected with the issue of national savings and would it have any even secondary impact upon national savings, or whether that should even be a concern of ours?

I would ask all three of you to respond. Professor Munnell.

Ms. MUNNELL. I think the national savings issue is very important. I think that you can increase national savings either by building up reserves in the Social Security trust funds or by building up reserves in individual accounts. If you are going to try to do it through the Social Security trust funds, I think we need to really separate Social Security from the rest of the budget. I know it is in the law now, but we do not do that. We report everything in terms of the unified budget.

So I think you can decide on your level of funding or your level of increased saving as a separate issue, and then the question is, "How do you want to invest that money?" So I think there are really two separate issues involved here and that you can make your savings decision independent of your investment decision.

The CHAIRMAN. Mr. MacLaury.

Mr. MACLAURY. Mr. Chairman, we at CED felt that taking the opportunity of fixing Social Security to increase national savings should be one of the main criteria, and that a simple shift of assets from one form of investment to another does not do that.

Therefore, the CED proposal had a two-pronged approach. It tried to balance Social Security by diminishing the rate of growth in benefits, on the one hand, to cure the deficit in Social Security, and then to supplement it by a required savings plan involving 1.5 percent of payroll for both individuals and for corporations. That would then be invested in private accounts, invested in private securities. The reason that that raises national savings is, by definition, adding on 3 percent of income or payroll to a savings plan.

The CHAIRMAN. Ms. Bovbjerg.

Ms. BOVBJERG. Thank you. I would say that the saving decision is, in fact, independent of the investment decision, that simply taking money that we have now in the trust fund and investing it, whether in individual accounts or through the government in the stock market, does not raise savings. It simply moves capital around.

But saving should be a very important goal. Raising saving would help create the larger economic pie that we will need in the future so workers can continue to enjoy increasing standards of living and support retirees. But it is not the only goal of the Social Security program. Social Security was originally created to help assure adequate income to the elderly. So these things need to be considered together.

The CHAIRMAN. Ms. Bovbjerg, I want to ask you another question. The main objection seems to be that government stock ownership might be a potential for political influence or political objectives to influence investment or things of that nature. From your work at the GAO on this report, are there other steps or lessons that we can learn from State pensions or even from other countries that could minimize the potential for political influence and make stock selection easier?

Ms. BOVBJERG. There are many things to be learned from the States. The States have been investing successfully for years with their pension funds and have benefitted from the returns on those investments. About 60 percent of their assets are in the stock market.

There are other things to learn from the States, as well. Many States invest in indexed funds, but that has not prevented States from wanting to be involved in corporate governance to try to raise returns of a company that is part of their index. States have also been selective in some of their investments. They have precluded their managers from investing in certain types of companies or companies in certain countries where they disapprove of their human rights policy.

I think that what you can learn from the States is that they have been successful. They have been capturing returns. But indexing is not the panacea, that States, some States, do get involved in corporate governance issues. So I am not sure you could ever guarantee that that could not happen at the Federal level as well.

The CHAIRMAN. Senator Breaux.

Senator BREAU. I thank the panel for their testimony. It has been very interesting. You had three different ideas, which is what we always try to get, is differences of opinion.

I have come to the conclusion, and it has taken me an awful long time to do it. I have been in Congress for 26 years. But I have come to the conclusion that in two very important areas, I have a much better deal than the rest of Americans do, and I say "I" but I do not mean individual. I mean myself as a Federal employee, along with the other 9 million Federal employees.

The first area is in health care under the Federal Employees Health Benefit Plan. It is much better, in my opinion, in every way, shape, or form than Medicare is for the 40 million seniors in this country. The benefits are better. The cost increases are less. The information is more useful. It is based partially on competition and being able to negotiate for benefits. We do not do that in Medicare. We are short-changing seniors in this country in that area.

The second area is in the retirement plan. I think the Federal retirement plan is far superior than what we have for the rest of Americans. I do not see why, when we look at trying to improve and save Social Security, we cannot look at the model that we have under the Federal Employees Thrift Savings Plan. Every year, we get three ranges of options to invest in, a high risk, a low risk, a medium risk. Every one of those plans over the last 10 years, and even longer back than that, has returned substantially more than the 2.7 percent approximate rate of return for investments in government securities that we do in Social Security, and nobody in the Federal Government, Mr. MacLaury, is controlling any of these

companies that the money is being invested in. We have a system which categorizes what these investments are. I can put up to 10 percent each month into that retirement plan and the system is much more solvent.

So I guess the generic question to everybody is, why can we not propose a consideration that for Social Security trust funds, we set up a system that is similar to what we have done in the Federal employees' pension plan to get us a better rate of return, generate more money for future retirees, and not create the problems that many of you have expressed? Ms. Bovbjerg.

Ms. BOVBJERG. I think we have said that average returns have the potential to be greater in the stock market than in Treasury securities, and a TSP-style system could capture that additional return. Individuals would still bear market risk, that the entire market goes down, or—

Senator BREAUX. But what we are talking about is a percentage of it, not the whole investment, but just a percentage of what we contribute. So you do not put the whole 100 percent of your investment portfolio into the market, but you have a percentage of it that you could do, say 2 percent.

Ms. BOVBJERG. If you precluded people from investing their funds entirely in stock.

Senator BREAUX. Then you get more protection.

Mr. MacLaury, your main concern, it seems to me, is that the government should not own stock. We are going to be influencing company decisions and all of that. I appreciate that, but what we are suggesting is not the government doing it but giving individuals the authority to use some of their retirement benefits into some of these private investments.

Mr. MACLAURY. As I said, Senator, the CED proposal itself contemplates the investment in private market securities of social insurance, but it is called private savings accounts.

Senator BREAUX. So that relieves some of your concern about the government owning private businesses?

Mr. MACLAURY. Absolutely.

Senator BREAUX. I agree with that.

Mr. MACLAURY. Individuals have individual accounts. They take the risk and they have the voting rights for their shares and that is their business.

Senator BREAUX. You and I are in agreement on that.

Mr. MACLAURY. It is not the trust fund itself. It is not the government.

Senator BREAUX. Your main concern, I think, is that the government should not be owning private corporations because we could influence their decisions.

Mr. MACLAURY. That is our main concern.

Senator BREAUX. I appreciate that and am in agreement.

Ms. Munnell.

Ms. MUNNELL. Senator BreauX, I just am not persuaded that introducing risk into the basic Social Security benefit is desirable. Social Security benefits now average \$700 a month. I do not think we want to make any part of that uncertain. The TSP plan—

Senator BREAUX. It is all uncertain now. When we have 77 million people coming into the system, you talk about uncertainty. We

do not have enough money to pay them all. That is real uncertainty.

Ms. MUNNELL. There is a shortfall, but that shortfall—

Senator BREAUX. Shortfall? It is a collapse.

Ms. MUNNELL. Senator Breaux, I do not view it as a collapse. Even after the trust fund is exhausted there is enough revenue to pay 75 percent of benefits. What we are trying to do is figure out how to close that gap between 75 percent and 100. So we do have a problem and we need to fix it, I agree with you.

But when you talk about TSP, you are talking about a supplementary plan. I think the idea of investing in equities for a supplementary plan makes all the sense in the world. I am not sure that it makes sense to introduce that type of risk into people's basic retirement pensions.

Senator BREAUX. Well, the biggest risk is the system we have right now.

Ms. MUNNELL. It has been a great success story.

Senator BREAUX. Absolutely. I totally agree. But when you add 77 million more people to it, it changes the equation dramatically.

Ms. MUNNELL. Relative to GDP, the expenditures are scheduled to go from 4.7 percent of GDP today to 6.7 percent in the 2030's and stay at that level. That is a two percentage point of GDP increase in outlays. That is just not huge. We can deal with that.

Senator BREAUX. I will tell you what. A suggestion to raise the payroll taxes in order to cover that shortfall is something that I just do not think is in any way justifiable, and politically, it is not possible. Over 70 percent of Americans pay more now in payroll taxes than they pay in income taxes.

Ms. MUNNELL. I am not advocating a tax increase. I think there are lots of nips and tucks that we all know about—such as extending coverage to State and local employees, increasing the taxation of benefits, doing maybe a little bit on the CPI, and improving the return on the fund through investing in equities. So I do not see it as going all one way or the other. I think there are compromises.

Senator BREAUX. Nips and tucks may do it for some things, but I do not think it is going to do it for this. Thank you.

The CHAIRMAN. The Senator from Nebraska.

Senator HAGEL. Mr. Chairman, thank you. I, too, wish to add my thanks to our distinguished panelists.

Picking up on where Senator Breaux left off, and just an observation comment, I believe it was you, Ms. Munnell, who said in some reference that, well, gee, we might even look at or there is a possibility of, and I do not believe you framed it in a positive sense, separating Social Security from the rest of the budget. You made some reference to that. I happen to believe that that is what we are going to eventually have to do—

Ms. MUNNELL. I think it is a good idea.

Senator HAGEL. It is the only honest way to do this. And if we are, in fact, indeed going to restructure our entitlement programs, for all the reasons that my distinguished colleagues have talked about, and we all know more, then we are going to have to, I think, be honest about it and we are going to have to deal with CPI, we are going to have to deal with these issues that Senator Moynihan, Senator Kerrey, Senator Phil Gramm, and others are proposing.

Now, with that said, let me ask the three of you what you propose is the answer. What Senator Breaux is saying is real. If we step back for a moment and we look at payers versus payees, in 1950, it was 15-to-one. It will soon be 2-to-1. That means that we are, as my colleagues have stated and as you all know, one of these days, not too far away, we are either have to cut benefits or raise taxes.

I do not think politically that raising taxes is going to work, so where do we go? I would be interested to see if we can reverse course and the three of you tell me what we should do. Who would like to start?

Ms. MUNNELL. I am delighted to start.

Senator HAGEL. Thank you.

Ms. MUNNELL. I basically would argue that we should stay with the current system as a defined benefit plan and we should do a variety of relatively modest things, but when you add them together, would be enough to eliminate the deficit. You extend coverage to State and local employees. You increase the taxation of Social Security benefit so you tax Social Security benefits like you would private pension benefits. You make sure that all the technical adjustments on the CPI are reflective in the cost-of-living adjustments. You extend the averaging period for calculating benefits from 35 years to 38. This is a form of a benefit cut. You probably do something on the retirement age, maybe eliminate the hiatus at 66, and then perhaps do some indexing to life expectancy thereafter. You change the investments so that you get a higher return.

If you do all those things, you do eliminate the financing gap and you keep it as a defined benefit program in its current form. Social Security provides a modest retirement income and this would avoid putting that modest retirement income at risk.

Senator HAGEL. So a part of your answer is you include more people in coverage, whether they like it or not, and you essentially—that is an interesting option which I do not think is politically saleable or sustainable, nor should it be. But let me tell you why I think your system that you have just envisioned is probably not a good one.

As the world is moving from government, and you can take about any measure of that, more free people today, more democracies, and that is the shift of the world, and I think it is an appropriate shift, we are still stuck in too much government, in my opinion. I believe that there will come a day, and this panel of Senators may not see it, but I am not so sure some of us will not, when there will be some revolution in this country with the issue being the role of government and how much government do we want and do we really want government to continue to look after everybody and that will be the issue.

It seems to me that we have a fundamental opportunity here, with all the smart people like the three of you to help us, to figure out a better way to do it, and not just rearrange the chairs on the Titanic here and say, well, the answer is that we will just put more people in the system whether they like it or not. I do not think that is feasible.

I am using your time. Bruce.

Mr. MACLAURY. Thank you. I would agree with Alicia Munnell in the following sense. I think we first have to balance the defined benefits program. That is the program we have and we have to do it primarily, from the point of view of the CED, by slowing the rate of growth in benefits. The ways to do that are similar to those Ms. Munnell mentioned. We would also reduce the growth of initial benefits, so you would not maintain initial benefits for the two higher brackets ad infinitum.

Senator HAGEL. Senator Breaux is not going to like that when you get some of those deals.

Mr. MACLAURY. OK. He will argue his own case, I am sure. But you add a defined contribution plan with a higher rate of return on top of the defined benefit plan so they come out, on average, whole.

Senator HAGEL. I do not know whether you are making our lives any better by doing that. If you are going to reduce our benefits, those of us of this age—

Mr. MACLAURY. You are going to have to balance the Social Security program. The risk that Senator Breaux mentioned is a real risk. You can describe it as a catastrophe or not. I would not so describe it. I agree with Professor Munnell. It has to be fixed, but it is not happening tomorrow.

Senator HAGEL. But how do you fix a system when you are saying, well, the way we are going to fix it is you are just going to take less benefits, after you have paid in for 40 years, 45 years.

Mr. MACLAURY. I think the question is, how are you going to continue to pay the rate of benefits promised today? That is the issue.

Senator HAGEL. I think we can do better by exploring a lot of different options.

I am sorry to take so much of your time. Would you care to offer any suggestions, Ms. Bovbjerg.

Ms. BOVBJERG. I would like to say that GAO provides analysis and we try to leave the policy decisions to the Senators.

Senator HAGEL. Oh, very interesting. [Laughter.]

Ms. BOVBJERG. I would also like to say that I think restoring solvency is a policy decision. We can provide analysis that can help you know some of the implications of these changes, but in the end, any choice that Congress makes will be balancing the adequacy of the benefit against the equity of what kinds of returns do people get for their contributions. They will be balancing risk versus those returns. What are the effects on savings? How do changes affect individuals in the system, workers, retirees, subgroups like women, minorities, how are they affected differentially?

So the answer is really one of what goals do we have as a society for this retirement program—if we could sort that out, we might be able to make some of these choices.

Senator HAGEL. Well, we had better, do you not think? We had better get that down.

Thank you.

The CHAIRMAN. Senator Reed.

Senator REED. Thank you, Mr. Chairman.

It seems to me that the two sort of general arguments for enhanced market participation of Social Security are: one, individual choice, that individuals should have these choices, et cetera, much

as we have, as Senator Breaux talked about, in our Federal retirement plan; and two, improving the fiscal solvency of the fund.

Let me just ask both Mr. MacLaury and Professor Munnell, if we were to open up the Social Security system to investment in the market, would that in and of itself solve the fiscal problem facing us in Social Security?

Ms. MUNNELL. There is no difference among this panel in terms of whether this portfolio shift, having the Social Security system hold more equities and have private pension plans hold fewer equities, that in itself is not going to increase the level of saving or investment or anything in this economy. If you put together a package of proposals to close the financing gap and you include investment equities as one of that, that will help close the financing gap.

Senator REED. But that alone, simply by opening up the Social Security system—

Ms. MUNNELL. No. No. No.

Senator REED [continuing]. To investment in the market will not, in your opinion, make the system solvent and avoid all the difficult political choices that we have to make about benefits and taxes. It is not the magic—

Ms. MUNNELL. No. No. It is just that the focus of today's hearing is that particular topic, but that is only one of many decisions you have got to make.

Senator REED. I understand that. But I think in the broader debate, there are some people running around saying that all we have to do is open up the Social Security system to private markets and the private market will raise us up to this great height and will do all those things.

Ms. MUNNELL. No.

Senator REED. But you all agree about that? OK. The other argument, generally speaking, is, well, individuals should have choices. Look how well they are doing now in the market. Look how well we are doing. But I would presume, also, from the context of your testimony, that the administration of 140 million individual market accounts would be so daunting that that itself is not appealing. Is that true?

Ms. MUNNELL. That is certainly my view.

Senator REED. Mr. MacLaury.

Mr. MACLAURY. I cannot say yes or no to that question, Senator Reed. The answer is that one should seek the least-cost way of getting private accounts, and I think the Federal Thrift Plan is one of the ways in which that can be done. I think that the individual IRA account is the most expensive way that it could be done. So CED, the Committee for Economic Development, did not choose amongst these except to issue the edict that it ought to be least cost method. TSP, the Thrift Savings Plan, is one of the least cost.

Senator REED. But again, we are going from a number of Federal employees, which is being advertised as less and less each day to 140 million Americans, some of whom would be joining a privatized system later in their working lives. I would assume that Wall Street would not do this as a contribution to our well-being—

Mr. MACLAURY. Not anyone I have met there recently would, no. [Laughter.]

Senator REED. You have met my broker, I guess. [Laughter.]

Let me just also raise another issue, which I think you alluded to, Mr. MacLaury. That is the impact of a significant shift of Social Security assets into the market. What percentage of the market, if we took all this money pouring into the Social Security Trust Fund and suddenly said, "let us invest in the market," what impact would that have on the market going in, and then you might suggest coming out, too.

Mr. MACLAURY. I wish I could give you an answer to that. I cannot. I have only the qualitative answer that you picked up in my comments, that we are going to have a growing prefinancing of the trust fund over the next 10 years, 15 years, and then it is going to be diminishing. I do not know how anybody can tell you the exact cost, or maybe Ms. Munnell can.

Senator REED. Professor Munnell.

Ms. MUNNELL. There has been one study done that looked at the proposal, the maintenance of benefits plan proposal that came out of the Social Security Advisory Council. They show that by the year 2020, that if we follow that plan, that the Social Security trust funds would hold roughly 5 percent of total equities.

Senator REED. Which you would assume would be—

Ms. MUNNELL. I do not think that would be destabilizing. Also, we are not talking about going into the equity market or not going into the market. The whole debate now is whether you go in through the central trust funds or you go in through the individual accounts. So in either case, you have got the same increase in demand. It is a question of how you do it.

Senator REED. I think Mr. MacLaury is a little more sensitive to the potential deficiencies longer term about having such a position in the market, and you do not seem to express the same concerns, or—

Ms. MUNNELL. I have actually worried a lot about the State and local issues. I did a study many years ago that looked at their investment in housing, in mortgages, where you could see the States really passing up higher returns for a given amount of risk because they were trying to achieve social objectives.

My conclusion now is that that is much less likely to happen at the Federal level. There is more sunshine here. It is harder to do. Also, you have a good track record. There is already 500 billion in the trust fund and no one has mucked with that.

Mr. MACLAURY. No, nor has it been invested in private equity securities. It is invested in a private issue government security. The issue is not the same. Similarly, I think that if you have individual accounts invested in the stock market, they are going to be coming due over a range of times. By contrast, the trust fund is going to have a buildup and then a build-down as it is used up as it is now structured.

Ms. MUNNELL. Senator, could I just respond to that? Senator Grassley, would that be all right?

The CHAIRMAN. Yes, please.

Ms. MUNNELL. I agree. It would be kind of silly to invest in equities if we were going to stay with the projections under current law, because the idea of building up and then drawing down does not make any sense. It would probably be very disruptive. I think, certainly I was talking about in the context of a total reform pack-

age, where you build up a trust fund and you keep a trust fund, and if you are interested in saving, that is what you have to do. So I agree with Bruce completely.

Senator REED. Thank you all very much for your testimony. Thank you, too, Mr. Chairman.

The CHAIRMAN. Senator Wyden.

Senator WYDEN. Thank you very much, Mr. Chairman.

We all know we have a demographic tsunami coming, 75 million baby boomers. At home, I can tell you, more of the young people think they are going to have a date with an extraterrestrial than to get a Social Security check. I mean, that is essentially the landscape I find at home.

I think 1999 is an historic opportunity for our country on a bipartisan basis to take action on this issue. In my view, both political parties, after playing games with this issue for years and years, have staked out a very responsible approach in the last year. The President, in my view, has done a fine job in terms of laying this out, and it seems to me a lot of folks on the other side of the aisle have met him halfway in terms of this discussion.

My first question to you is, if Congress muffs the opportunity in 1999, and let us say does not get at it until the baby boomers come along in 2010, basically just putzes around for 10 years afterwards, how much more serious will the problem be if Congress misses the opportunity in 1999 and then suddenly gets back to it in 2010?

Ms. MUNNELL. I think it would be a shame to miss this opportunity. I do not think anyone who cares about this issue would argue that we should not take action early. The deficit balloons. The options that you have get smaller. You need to give people a lot of lead time if you are going to phase in major changes. So I think we would all urge everyone involved to try to take action as early as possible.

Senator WYDEN. Do either of you two want to add?

Ms. BOVBJERG. May I respond to that? I would just also like to add that I think that acting earlier would have the additional advantage that you would capture the participation of the baby boom generation before they leave the workforce, which I think would be very important because of the point that Dr. Munnell just made about needing time to plan for the future.

Mr. MACLAURY. There was a table in the CED report that showed that if you wanted to fix the gap in the current promised payroll deduction system, it would take a two percentage point increase in payroll taxes if you did that in 1996. It would take a 4 percent increase in payroll taxes if you waited until 2022, and you can scale that in between those years. So the longer you wait, the bigger the jolt you are going to have either on benefit reduction or tax increases.

Senator WYDEN. Here is what I think is the key issue. I think what the American people want is to keep the historic feature of Social Security, which was protection against risk. There was a program there to protect against risk, protect against being wiped out, and at the same time, they want higher yields on their Social Security investment, and you all have gone through the comparisons with respect to the stock market and the small yields that Social Security gets.

My question to you is, what is the best mix of policy that would allow us to bring those two worlds together and still keep it as close to pay-as-you-go as we possibly can, because my sense is if you do not do that, particularly at the outset, what you are going to do is find it very hard credibly to bring these two worlds together.

In other words, the first thing people are going to say is the very first group is going to say, you are making us pay twice. You are making us pay for our folks and ourselves. I think if you get off to that kind of start, it is going to be hard to keep this momentum alive.

Now, Pat Moynihan, I think, would argue that his approach tries to bring those two worlds together and still keep something resembling something close to pay-as-you-go, but why do we not just go right down the row, and just for purposes of my question, assume you want to try to bring those two worlds together and you want to keep it as close to pay-as-you-go as you can. Ms. Munnell.

Ms. MUNNELL. I think your goal is almost impossible to achieve, Senator Wyden. If you want to increase returns, you need to have assets to invest, and the only way you are going to get assets to invest is to have people to fulfill their commitments to those already retired plus increase their savings on their own, and that is part of the savings argument. So the only way to increase the return is to make this generation pay twice to some extent, and it is a big, hard intergenerational equity issue to figure out how much to make them pay to build up reserves so that generations in the future can have higher returns. It is a tough issue.

Mr. MACLAURY. I would agree with Dr. Munnell and add this point. It seems to me what you should be seeking, if I may be so bold, is the combination of solving the solvency issue of Social Security and solving the rate of return to those who are investing in it. Those are the two issues; maintaining pay-as-you-go, frankly, is not one of my goals. I think you need to have a buildup of some sort of prefunded account for a whole variety of reasons, to increase national savings, to increase the rate of return on investments which can be invested in that trust fund.

So as I said before, the way to achieve that balance but not to achieve the goal that you stated, namely maintaining pay-as-you-go. I do not see that as a good goal to maintain. But you have a defined benefit system, such as we have, but you make it solvent by a variety of measures and you add on top of it a defined contribution plan, where you are putting into a trust fund, but I would call it a personal trust fund, my own trust fund for my retirement, a supplementary amount, which can be at risk.

Ms. BOVBJERG. You have left me little to add, but I would like to say that I agreed with your point, Dr. Munnell, about your need to build up some assets to increase returns, but that the reason that virtually every proposal that is out there in some way considers investing in the markets as part of it is because of this need for increased return, even not doing very much but having the government invest in the markets instead of in special Treasuries would raise returns to participants in the trust fund.

Senator WYDEN. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

If there is not any objection, I would like to go on to the next panel because we are going to have votes at 3 o'clock. I thank you all very much for your participation.

Mr. MACLAURY. Thank you.

Ms. BOVBJERG. Thank you.

Ms. MUNNEL. Thank you.

The CHAIRMAN. Our first witness on the second panel will be Dr. Olivia Mitchell, University of Pennsylvania, Wharton School of Business. Professor Mitchell provided very valuable assistance to the Advisory Council on Social Security in her capacity as Technical Advisory Panel Co-Chair.

We will next hear from James Phalen, Executive Vice President of State Street Global Advisors. Mr. Phalen joined State Street in 1992 after serving in positions with the Boston Financial Data Services and the Federal Reserve Bank in Boston.

The last person to testify today is Louis Enoff. Mr. Enoff worked for the Social Security Administration for 30 years and served as Commissioner of the Social Security Administration during both the Bush and Clinton administrations. Since his departure from government service, Mr. Enoff has served as consultant to the countries around the world on implementing and reforming public pension systems.

Ms. Mitchell, we will start with you.

STATEMENT OF OLIVIA S. MITCHELL, CO-CHAIR, SOCIAL SECURITY ADVISORY COUNCIL TECHNICAL PANEL; PROFESSOR OF INSURANCE AND RISK MANAGEMENT, WHARTON SCHOOL OF THE UNIVERSITY OF PENNSYLVANIA, PHILADELPHIA, PA

Ms. MITCHELL. Good afternoon. I am delighted to appear before this committee as we hear testimony on the issue of Social Security reforms and investment in private capital markets.

I have three points I would like to make today. First, I would like to talk a little bit about older Americans' retirement income preparedness. Second, I will talk about implications for Social Security investment. Then third, to offer some considerations regarding practical issues of investing in equities.

My first point: older Americans, I think we all know, are entering retirement with very little money to maintain their standard of living in old age. In a recent study of a valuable new data set known as the Health and Retirement Study, I have found out that the median older American household—this is people in their 50's at the verge of retirement—falls quite far short of retirement savings needs. Our projections indicate that the typical couple has to save one-quarter of its gross annual income in order to be able to smooth consumption into retirement. Now, this assumes that the current Social Security benefits will continue to be paid, but as we have just heard, Social Security benefits might turn out to be quite a bit lower than currently anticipated. So because these Social Security promises cannot probably be fully met, the issue of reform is before us.

The second point I would like to make has to do with the differentiation between so-called privatization and prefunding. I think it is important to keep these concepts separate. When many people

talk about privatization, what they mean is that individual accounts are established held in workers' names. The second concept, the one of prefunding, means that there is a reduction of outstanding debt associated with Social Security.

These sometimes come together, but sometimes they do not. For example, in Latvia, they have recently established so-called "virtual IRA's." These are accounts which have worker's individual names on them. You pay in every year. But there is no asset set aside and the government simply credits you with a nominal or virtual rate of return. So that is not a prefunded plan, though it is a privatized plan.

You also have the other option of reform, which might be to raise taxes and cut benefits so as to build up a trust fund, much like the one that Dr. Munnell was proposing.

This one would be invested by the government. That would be prefunded, but not privatized.

Or you can do both. For example, Mexico and Chile have mandated that workers pay into a defined contribution account and those investments are, in fact, held in the private capital market.

Discussing how the U.S. Social Security system ought to be reformed, and keeping these distinctions in mind, I would raise two issues. How should we deal with the problems we have inherited from the past, and how should we go forward to cover future accruals under the system?

As we know, the U.S. is mostly a pay-as-you-go Social Security system. The cumulative value of the trust fund in the OASI system is about 1.6 times the current year's payout. This trust fund is, of course, expected to grow and then decline, but a different way to look at it is that the unfunded present value that Social Security promises now stands at around 9 trillion.

I come from the private pension world. In the private pension world, we compare the pension fund's assets on hand with the liabilities we have promised. If we use that notion in Social Security, which some would argue we should not, we have about 6 percent of required assets needed to meet eventual benefit promises. So this is 6 percent versus what ERISA requires, which is 100 percent funding.

The obligation basically came from the fact that the Social Security system subsidized the first 50 to 60 groups of people, birth cohorts, that went through the system. That is, a hypothetical way to understand the size of this liability is to say, imagine that every worker today were taxed a lump sum of \$60,000 per capita not that they have it to pay. In round numbers, this would be sufficient to cover the liability due to past Social Security obligations. At that point, if everybody paid that tax, the system would be shut down. There would be no future benefit accruals. Simply, there would be enough money to pay retirees.

A more politically feasible way to do this might be to spread that tax over all current future working generations. Of course, this would pass more on to our children and grandchildren. If we spread the start-up costs so that each generation of workers paid about the same percentage of its payroll tax, it would require every cohort to give up about one-quarter of its current payroll tax, in other words, about 3 percent out of the 12.4 payroll tax.

So that is one way to understand why the Social Security rate of return is so low right now, namely that part of that contribution we are putting in is going to pay the past unfunded liabilities. It is not that the system is poorly managed, it is not that it is inefficient, it is simply that it was a massive transfer to older people today.

If we did invest Social Security taxes either through the government or through individual accounts in private markets, the question is, would we be able to do better? My answers are outlined in the testimony that I have submitted.

First, I would argue, you cannot necessarily use the rate of return on stocks to imagine what you would get from the system. The reason is we would still need to pay the transition costs for our parents and our grandparents. So our after-tax rate of return would be somewhat lower.

The second thing we have to worry about is the risk that has been alluded to earlier, and if you risk adjusted the stock market returns, they could quite be substantially lower.

There are some advantages of individual accounts. Earlier in this hearing, people have earlier mentioned choice. I think that is critical. I think that most people in the baby boom generation and younger really feel uncertain about what the future of Social Security will bring. Individual accounts help protect against that.

Also, I think that there is less likelihood that political factors will play a role in investment decisions if people are doing their own investment, versus having a central Federal investment board making those choices.

So to conclude, Mr. Chairman, I would argue that we understand savings shortfalls are critical. They do confront those on the verge of retirement as well as the baby boomers next in line. The fact that the stock market is performing so well makes everybody want to invest in stocks. That does not detract from the fact that we have to worry about paying the transition generation, no matter what kind of system we envision for the future.

I thank you for including me in this hearing and I stand by to help in any way I can. Thank you.

The CHAIRMAN. Thank you, Ms. Mitchell.

[The prepared statement of Ms. Mitchell follows:]

April 1998

**Testimony by Olivia S. Mitchell¹
before the Senate Special Committee on Aging**

I am pleased to appear before this Committee as it hears testimony on social security reforms including the option of investing in private capital markets. In my remarks, I first highlight issues regarding older Americans' retirement income prospects, second I discuss implications for social security investment, and finally I will describe some practical issues that arise in the contemplation of individual accounts.

Americans' Retirement Saving is Inadequate

Older Americans are entering retirement with too little money to maintain their consumption in old age. This conclusion is based on my study of a valuable new nationally representative data set known as the Health and Retirement Study (HRS),² a longitudinal survey of some 12,000 Americans first collected in 1992 and continuing every two years. Using this database, James Moore and I at the Wharton School find that the median older American household in its mid 50's falls far short of target retirement saving. Indeed, our projections show that the typical couple must save *one quarter* of its annual gross income over the next decade, to be able to preserve consumption levels into retirement.

This concern is exacerbated because there is reason to worry that life expectancies may increase faster than expected. Another concern is that social security benefits could turn out to be much lower than currently promised. Under current tax and benefit rules, social security will make up 40% of older Americans' retirement wealth, so any change in this program will have widespread effects. But as we know, these promises cannot be met and the system faces insolvency around the time the Baby Boom retires.

¹ Mitchell is International Foundation of Employee Benefit Plans Professor of Insurance & Risk Management, The Wharton School, University of Pennsylvania, and Executive Director of the Pension Research Council. She is also a Research Associate at the National Bureau of Economic Research. All opinions are solely those of the author and not those of any institutions with which she may be affiliated.

² For further information about the HRS see the web page at: www.umich.edu/~hrswwww; this project was funded by the National Institute on Aging with support from the Social Security Administration, the US Department of Labor, and several other agencies in conjunction with the University of Michigan.

*Privatizing versus Prefunding Social Security:*³

In discussing social security reform options, a wide range of proposals has been put forward. But an issue that is often unclear, one worth clarifying at the outset, is whether a given proposal seeks to **privatize** or to **prefund** social security. These two concepts are frequently confused in public debate but should be carefully separated. Let us define *privatization* to signify that individual accounts are established, held in workers' names, and *prefunding* to mean the reduction of outstanding implicit and explicit debt associated with social security.

It is important to distinguish between these, because they produce very different outcomes. For instance, one reform might establish individual accounts that lack assets: this has occurred, for instance, in Latvia which has mandated so-called "virtual" IRA's. Alternatively, a different reform would raise taxes and cut benefits so as to build up a huge Trust Fund, invested by the government. This second approach, I would argue, could then be seen as funded, but not privatized; it is the pattern taken by Malaysia, where the federal government manages the Employee Provident Fund centrally. Some countries do both: for instance, Chile mandates that workers hold assets in individual accounts, and the old system debt is being paid off over time.

How the social security system should be reformed in the US can beneficially be split into a discussion regarding what has happened in the past, and what could occur in the future.

Managing Past Social Security Obligations

The US social security system is mostly a pay-as-you-go system: that is, the bulk of the tax revenue collected each year is needed to pay benefit costs that same year. By law, any annual surplus – which totaled about \$70B in 1997 – is invested in special-issue Treasury obligations. The cumulative value of the OASI Trust Fund is currently about \$584B, or 1.6 times a single year's benefit payments. This Trust Fund is expected to grow and then be depleted over the next 30 years, when the Baby Boom generation retires.⁴

³ This discussion relies on ongoing research described in two working papers: John Geanakoplos, Olivia Mitchell, and Stephen Zeldes, "Would a Privatized Social Security System Really Pay a Higher Rate of Return?", Pension Research Council, The Wharton School, Revised April 1998; and John Geanakoplos, Steve Zeldes, and Olivia Mitchell, "Social Security Money's Worth", In Prospects for Social Security Reform, Eds. Olivia Mitchell, Robert Myers, and Howard Young, Pension Research Council, University of Pennsylvania Press, forthcoming.

⁴ OASI revenues in 1997 were estimated at \$392B, outlays at \$322B, for a net increase in the Trust Fund of \$70B; the Trust Fund at the end of 1997 was estimated at \$584B for further information see www.ssa.gov/OACT/TR/triif.html#1007839, Table II.F1.

The OASI system is far from fully funded: indeed, the unfunded present value of past social security promises stands at \$9 trillion.⁵ This computation assumes that liabilities are measured from the perspective of a "closed group" – that is, past promises are kept, but workers pay no future taxes and accrue no future benefits. From this perspective, the OASI system has a funding ratio of only 6.4%; this compares to a 100% funding ratio that private pension plans are mandated to have under ERISA.

Where did this obligation come from? The answer is that when the social security system was first set up, it was structured so as to provide the already-old with benefits, even though they had paid relatively little into the program. While this is not unusual for the early stages of a defined benefit pension system, it is not widely recognized that the subsidy continued for people born between about 1876 and 1936. This is 60 birth cohorts, if we define a cohort as those people born in a given calendar year. Specifically, the social security subsidy was on the order of \$10 trillion for workers born before 1936. But somebody must pay for these transfers, so on average, everyone born after 1936 must get back less than they pay in over their lifetimes. This process has already started: workers born after 1936 have already paid in about \$1 trillion more than they will receive, on average, thus reducing the system debt to its current \$9 trillion level.

A hypothetical way to visualize the size of the unfunded social security liability is to imagine that every worker today might be taxed a lump sum of about \$60,000 (not that everyone could pay it!). In round numbers, this would be sufficient to cover the liability due to past social security promises. At that point, the social security system would be funded on an accrual basis, and a strategy would have to be devised to manage that asset pool.

A more politically feasible way to allocate the burden of the social security subsidy might be one that allowed current workers to pay less.⁶ Of course, this would in turn pass more of the burden to future generations of workers. As an example, one could ask all workers to pay a constant percentage of their earnings to cover the past obligations owed to those born in 1936 and before. If we spread the start-up costs this way, it would require each cohort to give up about 25% of its current social security contribution, or in other words about 3 percentage points out of the current 12.4% payroll tax. So the ultimate result is that all current and future workers would have only three-quarters of their payroll tax left to invest in a funded account, after the needed tax levy is removed to pay for old promises. This is one reason that the perceived return from social security is lower now than for previous generations: current and future workers must pay for the net subsidy given to past workers. This state of affairs has not come about because of waste or inefficiency, but rather because

⁵ Steven Goss, "Measuring Solvency in the Social Security System", in Prospects for Social Security Reform, Eds. Olivia Mitchell, Robert Myers, and Howard Young, Pension Research Council, University of Pennsylvania Press, forthcoming.

⁶The unfunded liability could also be cut by reducing benefits paid to the already retired as well as the middle age who are not yet retired, but this too has major opponents.

social security provided substantial subsidies to the first 60 cohorts of retirees under the program.

Structuring Future Social Security Obligations

One commonly heard response to the social security system's projected solvency problem is to let people invest their social security taxes in the private capital market. The rationale usually given is that social security provides "even traditional families with children...a return of less than 3%. That's a rate that would get any director of any investment company fired."⁷ In other words, the argument is that investment of social security taxes – particularly in stocks – would generate higher retirement benefits than could be obtained from the current program.

One problem with this position is that many supporters bypass all discussion of the system's past obligations. Instead, they focus attention on how a national 401(k)-type scheme might work, one that would be the repository of future tax receipts going into individual funded accounts. This is in fact feasible: the old system could be shut down, and the government could simply issue recognition bonds that would pay off so as to exactly reproduce benefit payments under the old system. All new social security taxes would then go to these individual accounts, where people could invest them. The question that then arises is whether worker could do better with these investments than they could do under the old social security system.

An examination of historical stock returns shows that average stock yields were 9.4% over the period 1926-1996. Intermediate term government bonds yielded 2.3%. If the past forecasts the future, then both of these returns exceed projected paybacks from social security taxes. Thus internal rates of return for a (solvent) social security system are estimated to be about 2% for those born 1950-75, 1.8% for those born in 1975, and 1.5% for those born in 1998 and thereafter.⁸ So on the face of it, future cohorts could apparently do better by investing in private capital markets, particularly stocks.

But this perspective overlooks the fact that stocks are riskier than bonds, so holders of stock funds would have to use higher discount rates to make equities comparable to bond investments. Some households, if they were prevented from accessing the stock market on their own, might find that these extra returns in their individual accounts would outweigh the additional risks. Other families, however, would judge the risk-adjusted rates of return on stock investments to be comparable to returns on government bonds.

⁷ "Poor Returns", Wall Street Journal, 4/13/98: A22.

⁸ See Dean Leimer, "Cohort Specific Measures of Lifetime Net Social Security Transfers". ORS Working Paper No 59, Office of Research and Statistics, Social Security Administration, February 1994. These returns assume that taxes are raised to maintain system solvency; internal rates of return computed under current law do not take into account the fact that the current law system is insolvent.

Another caveat is that the current social security system provides workers with insurance benefits that might not be available to individual purchasers using individual account funds. These include insurance for disability, unexpected longevity, and inflation, among other things. The loss of these features is not generally accounted for in the simple "money's worth" comparisons, yet would (if properly valued) make the government-run defined benefit program worth more than commonly realized.

An additional consideration is that setting up individual accounts does not sidestep the question of who would be asked to pay for the \$9 trillion worth of past social security obligations. If taxes were raised to service the debt on the recognition bonds, these new taxes would likely eliminate the (risk-adjusted) gain to investing in private assets.⁹ Therefore, while it is true that returns to social security taxes will be low for future workers, there is likely to be few costless ways to raise them.¹⁰

Practical Issues Regarding Individual Accounts

There are several important advantages of individual accounts that bear mentioning. One is that Baby Boomers worry about whether they will have the will or desire to impose the huge taxes needed to sustain the current underfunded system on their children and grandchildren. Individual accounts will likely reduce workers' and retirees' political uncertainty in this regard.

A second advantage is that households would have greater choice and control over their retirement investment portfolios, in the individual account scenario. This has both economic and psychological aspects. As noted above, the economic advantage is that some households would be better off since their individual accounts would give them access to the stock market that they would not have access to on their own. The psychological advantage is that people would be constantly reminded of the need to save for retirement, and the need to exercise choice over their investments with the retirement target in mind. Indeed, recent research suggests that greater financial education enhances workers' pension participation and raises the equity share of their investment portfolios in their 401(k) plans.¹¹

A third advantage of individual accounts is that there is less likelihood that political factors will play a role in investment decisions. My research on public pension funds shows that state and local pensions have been influenced by

⁹ For more detail, see John Geanakoplos, Olivia Mitchell, and Stephen Zeldes. "Social Security Money's Worth", In Prospects for Social Security Reform, Eds. Olivia Mitchell, Robert Myers, and Howard Young, Pension Research Council, University of Pennsylvania Press, forthcoming.

¹⁰ Some contend that moving to a defined contribution system would improve market efficiency so as to generate higher labor productivity and saving. While this is possible, it is difficult to demonstrate empirically what the magnitude of these effects might be.

¹¹ See Robert Clark and Sylvester Schieber. "Factors Affecting Participation Rates and Contribution Levels in 401(k) Plans. In Living with Defined Contribution Pensions, Eds. Olivia Mitchell and Sylvester Schieber. Pension Research Council and University of Pennsylvania Press, forthcoming.

noneconomic ("social") investment rules, as well as the composition of the Boards governing the funds. Specifically, having retirees on the pension system Boards appears to reduce pension investment returns, and plans required to devote a portion of their assets to state-specific projects earn lower returns.¹² If the power to make investment decisions for billions (or possibly trillions) of dollars were granted to a politically appointed central Social Security Board, it is highly likely that many political pressures would come to bear.

One concern raised by opponents of social security privatization is that privately-managed systems would be more costly than public systems to manage. My research indicates that costs incurred by the current US Social Security Administration are lower than those of some private sector money managers, but the current Social Security system also provides fewer services to plan participants. A low-cost privately managed individual savings account managed through an existing mutual fund or 401(k) plan would likely require money management fees ranging between 1 and 20 basis points for a passively managed indexed portfolio, and administrative costs of under \$50 per year. A national TIAA-CREF-type or Federal Thrift-type plan would experience still lower investment costs, on the order of a basis point or less per year, with record-keeping costs around 20-30 basis points. Such additional expenses would make possible a system that handles the pension system's necessary functions with greater alacrity, while permitting workers to choose their investments, and if they wished, to undertake more active asset management in their retirement portfolios.¹³

Other Approaches To Keep In Mind:

What else might Congress do to help Americans confront a wider range of options that they can use to help them plan for, and live with, a healthy, well-financed retirement period? Several options should be considered:

- Changes in social security benefits and taxes must be announced soon – with sufficient lead time for workers to adjust their savings, consumption and retirement plans. To achieve this, it is important to legislate changes promptly and to allow some delay in implementation, so people can plan for the future. The desirability of delayed implementation only increases the need for swift action.

- Changes in social security taxes and benefits should be phased in over time, rather than implemented abruptly. Gradual implementation reduces the magnitudes of notches (different treatment of cohorts close in age) and perceptions of unfairness.

¹² See Olivia S. Mitchell and Ping-Lung Hsin. "Public Sector Pension Governance and Performance". In The Economics of Pensions: Principles, Policies, and International Experience. Salvador Valdes Prieto, Ed. Cambridge: Cambridge Univ. Press, 1997: 92-126.

¹³ See Olivia S. Mitchell. "Administrative Costs of Public and Private Pension Plans". In Privatizing Social Security. Ed. Martin Feldstein. NBER. *forthcoming*. [NBER Working Paper 5734. August 1996.]

- Policy regarding pensions and retirement saving is constantly changing and hard to anticipate. Regulations that are uniform, coherent, and less frequently changed would stabilize the environment for retirement savings decisions.

- Public policy should encourage new investment in a wide range of retirement assets. To survive a long retirement period, people need not only financial assets, but also investment in health assets (prevention and exercise in middle age are key), intellectual investment (ongoing education and training are essential for successful retirement), investment in our families (strong families supporting the young may translate into care for the old later on), and investment in our communities (involvement at all ages builds social support networks). Your Committee can do a great service by integrating this investment perspective into the policy discussion.

- People who can work longer should be encouraged to do so. The long term trend toward early retirement has abated slightly in the last decade, but the fact remains that most Americans retire around age 62 and even younger if possible. Since financing ever longer retirement periods is becoming fiscally unsustainable, raising the normal, and probably the early, retirement, age should be on the table.

- To better predict strategies for successful aging, it is essential to support continued data collection for in-depth surveys of older Americans, such as the Health and Retirement Study. Congressional understanding and sponsorship of these efforts is therefore essential, and support from this Committee will be crucial.

Conclusion

To conclude, saving shortfalls confront those now on the verge of retirement as well as the baby boomers next in line. The stock market's good performance over the last twenty years, the growth of 401(k) pensions, and the projected social security shortfalls have been instrumental in building support for an individual account system as a model for social security reform. Individual accounts have a great deal to offer, though structural concerns still need attention. Even so, the old unfunded liabilities of the social security system must be dealt with explicitly as we move toward new models of retirement income provision. And the sooner are the adjustments legislated, the better, because early notification of impending changes gives people time to adjust their savings and retirement plans accordingly. Thank you for including me in this hearing, and I commend the Committee for its interest in and concern about retirement issues.

Mean Value and Composition of HRS Wealth (1992) by Wealth Decile

Wealth Decile	Total Wealth	Net Housing Wealth	Net Financial Wealth	Soc. Sec. Wealth	Pension Wealth
1	\$ 39,470	\$ (5,719) -14%	\$ 1,520 4%	\$ 42,312 107%	\$ 1,356 3%
2	97,452	11,052 11%	10,579 11%	69,239 71%	6,583 7%
3	156,288	24,951 16%	18,235 12%	93,920 60%	19,181 12%
4	219,797	37,095 17%	32,632 15%	115,224 52%	34,845 16%
5	287,692	53,787 19%	55,020 19%	128,377 45%	50,509 18%
6	364,802	68,637 19%	75,793 21%	136,116 37%	84,255 23%
7	459,858	81,432 18%	109,811 24%	142,981 31%	125,635 27%
8	590,079	95,414 16%	159,054 27%	149,310 25%	186,301 32%
9	804,934	112,039 14%	265,967 33%	158,976 20%	267,953 33%
10	1,764,414	180,894 10%	1,032,049 58%	161,605 9%	389,865 22%
Overall Mean	478,313	65,940 14%	175,974 37%	119,793 25%	116,606 24%
Median 10%	325,157	59,746 18%	66,530 20%	133,606 41%	65,275 20%

James Moore & Olivia S. Mitchell. "Projected Retirement Wealth and Saving Adequacy in the Health & Retirement Study". NBER Working Paper 6240 October 1997.

The CHAIRMAN. Mr. Phalen.

STATEMENT OF JAMES PHALEN, MANAGING DIRECTOR, RETIREMENT INVESTMENT SERVICES; EXECUTIVE VICE PRESIDENT, STATE STREET GLOBAL ADVISORS, BOSTON, MA

Mr. PHALEN. Mr. Chairman, members of the committee, thank you very much for the opportunity to appear before you today.

Mr. Chairman, as a global financial services firm which holds some 4.4 trillion in customer assets in custody and manages about 458 billion, I think now, in customer funds, all of us at State Street applaud you and the members of the committee for exploring ways to strengthen and revitalize America's Social Security system.

As Congress considers the possibility of creating individual investment account options, I would like to share with you some of our experience with retirement finance systems, specifically defined contribution plans, and pension plans like 401(k)'s.

It is important to say at the outset that the technical and administrative difficulties of setting up a workable and practical system of individual accounts is significant and extremely demanding. For example, the system would have to reach more than 130 million current taxpayers, including about 30 million workers with reported incomes of less than \$5,000 annually. We at State Street, however, believe that the United States today has the experience and technical know-how and financial infrastructure needed to create and run a system of individual retirement security accounts for all working Americans and to do it at a reasonable cost.

Let me briefly discuss some of the lessons that we have learned in our defined contribution business and how these experiences might help in crafting some universal investment account system.

In the mid-1980's when most 401(k) participants at that time had few investment options, much, much fewer than they had today, they received infrequent statements and they were strictly limited on how often they could move their funds. Really, the participation was high at that level and satisfaction was high. The difference was that at that time, the balances were very low. So choice and really the service capabilities of the options that you had were not as important if the balance was low.

But through the years, the defined contribution account balances have grown dramatically and account holders are now demanding more choice and, clearly, also demanding more flexibility in the ability to move money. Today's 401(k) balances in the U.S. have exceeded now 1 trillion. The average 401(k) account balance is up above \$25,000.

The lesson of our 401(k) experience do point some real considerations in designing an individual investment account system linked to Social Security. One very basic lesson is choice has relatively little value in the early years of a program when balances are very low.

The second lesson is that large institutions with bargaining power have tremendous ability to drive down investment management administrative costs. It is clearly recognized by the difference by large companies in costs of 401(k) plans versus small companies' costs.

Clearly, the bargaining power of the trustees or administrators who might contract out some of Social Security's funds to investment managers would clearly be enormous. Competition would tend to keep these fees razor thin and significant economies of scale would be possible.

As you consider various individual account scenarios, one option may be to take an evolutionary approach, by creating a basic system with limited services and function but with the capacity to evolve as balances grow into a more sophisticated structure with more choice. Under this approach, you could begin with a very simple administrative system that maintains accounts potentially for every worker paying FICA taxes and with the Social Security Administration providing automated contribution data to the record keepers.

In many ways, the record keeping and the administration requirements to maintain such accounts would actually be simpler than a 401(k) account. The number of investment options and the method of selecting these options, however, would be major cost drivers and you would need to factor in early to your design ideas. In general, the greater the number of choices and services, the higher the cost. Over time, of course, as balances and total assets in the system grow, the cost of any given set of options and services declines as a percentage of the rising pool of assets.

All this suggests is that a solution built specifically to meet the requirements of individual accounts linked to Social Security could be crafted using commercially available technology, in essence a stripped-down version of a defined contribution system. The record keeping services themselves could be subcontracted to several firms chosen by competitive bid or operated by the Social Security Administration or by a well-established government service organization such as the Federal Reserve Bank.

If the policy calls for individual account holders to pay the administrative expense, the design requirements must consider the average account size that we would have as well as the levels of contributions from the less-well-paid, lowest-paid workers in the country. It needs to be a system that will work for both. One of the advantages of a universal investment account system, in fact, is that low-income Americans would be able to secure low-cost investment management services by participating in large pools with serious buying power.

The need to serve all Americans indicates the options and service features in an individual retirement account system should be very basic in the early years. As in the 401(k) experience, as balances grow, asset pools may support more choice and greater service.

To sum it up, we are confident that a system of individual investment accounts linked to Social Security is, indeed, feasible, that solutions can be designed to meet the record keeping and administrative needs at a reasonable cost, that the administrative costs associated with a national system would decline significantly as a percentage of total assets grow over time, and if we align investment choice and service features with the growth in balances, the expenses can be paid for by account holders without sacrificing the benefits that higher market-based returns would bring. Thank you.

The CHAIRMAN. Thank you, Mr. Phalen.

[The prepared statement of Mr. Phalen follows:]

**HEARING BEFORE THE
SPECIAL COMMITTEE ON AGING**

**THE UNITED STATES SENATE
APRIL 22, 1998**

**STATEMENT
BY JAMES S. PHALEN
PRINCIPAL,
STATE STREET GLOBAL ADVISORS**

STATEMENT
BY JAMES S. PHALEN
PRINCIPAL,
STATE STREET GLOBAL ADVISORS
SENATE SPECIAL COMMITTEE ON AGING
APRIL 22, 1998

Mr. Chairman, members of the committee, thank you for the opportunity to appear before you today. My name is James Phalen, and I am a principal at State Street Global Advisors, the investment management division of the State Street Corporation of Boston.

Overall, the State Street Corporation today holds some \$4.4 trillion in customers assets in custody and we directly manage \$458 billion in customer funds – the bulk of these in retirement assets. My job at State Street Global Advisors is to oversee our defined contribution retirement plan business – through which we service three million individual retirement accounts.

State Street's Chairman and Chief Executive Officer, Marshall N. Carter, has been engaged in the continuing national debate about how best to revitalize and re-secure Social Security for a number of years now and we at State Street stand willing to help you in your efforts in any way that we can.

As Congress considers the possibility of creating an individual investment account option within the context of Social Security, my purpose here today is not to offer a specific proposal for such a system.

It is, rather, to share with you some lessons from our experience in the defined contribution business in the hope that some of those lessons will be useful to you as you contemplate whether to establish individual accounts as part of the Social Security system.

But let me be clear. We at State Street do believe that creating individual accounts in connection with Social Security would provide an historic opportunity for millions of working Americans. Families who have never owned financial assets or directly benefited from the growth of our nation's dynamic financial markets would begin do so.

Such a reform would also create an enhanced awareness among all American taxpayers that they are saving for their own retirement security.

Principles for Engaging Individual Accounts In Any Social Security Solution

But if individual investment accounts are to be considered as an element of reform – we at State Street also believe that there are some real constraints on how they might be implemented.

- First, they must be strictly regulated and fees must be kept low by intense competition.
- Second, the assets must be soundly invested and diversified – across stocks, bonds and other instruments – and adjusted to suit a retiree's age and risk profile.

- To keep costs down, investment options must be minimal in the initial years of implementation – with a quite limited number of investment choices – similar to the Federal Employees Retirement System.
- Finally, such accounts must not impose heavy new costs or administrative burdens on employers – especially small businesses.

Technical and Administrative Challenges

In addition to these basic principles, there are also a series of demanding technical and administrative hurdles that must be addressed if the individual account option is to meet the test of economic and political viability.

As a company, a trust bank that does accounting for millions of accounts, we at State Street take the issue of practicality very seriously.

And when we talk about a universal program like Social Security – which must meet the needs of all Americans – the purely technical aspects of record-keeping, accounting, and investment management for something over 150 million people, is really daunting.

Let me give you some statistics to illustrate the scope of this challenge:

- 7 million U.S. employers still file their tax information on paper.

- Now, while full electronic reporting of these records is mandated – in theory – by 1999, total compliance could well stretch into the next century.
- More than 30 million employees – farm workers, part-time employees and others – have taxable income of less than \$5,000 annually.
- If an individual account investment option involved 2% of payroll, these people would be depositing just \$100 a year—barely \$5 per pay period into an individual investment account. Even at 5% of salary directed into an investment account, their annual contributions could be just \$250 or less.
- There is also a long time-lag – up to 18 months, longer in some cases – between collection and reporting of individual FICA taxes.
- Employers collect every pay-day, but they only report individual's contributions annually. Processing of this data by the IRS and SSA takes more time – before individual FICA contributions could be broken out and directed toward investments.
- A system of individual investment accounts would have to “piggy-back” on these existing information flows – in order to avoid heavy new costs for small employers.

Far from being a huge “bonanza” for Wall Street or financial service firms, as some have charged – taking on the task of record-keeping, reporting and managing millions of individually tiny accounts would test the capabilities of even the most sophisticated financial companies.

Nonetheless, we at State Street believe that in the United States today we have the experience, the technical know-how, and the financial infrastructure to meet these challenges and create a system of individual retirement security accounts for all working Americans.

If the Congress were to choose to establish such accounts, the possible approaches range from creating a basic structure with no investment choice for the individual and few account options to establishing an elaborate structure that offers a full range of services and choices similar to the most advanced defined contribution plans.

The most sophisticated defined contribution plans permit account-holders to make contributions each pay period, to shift their investments to any one of dozens, even hundreds of investment options including mutual funds, stocks, bonds and money markets.

These systems permit account holders virtually unlimited access to their accounts via telephone or the Internet.

They allow for loans against account balances and permit early withdrawals, annuity payouts and lump sum rollovers to IRAs. In most plans, statements are mailed to account holders on a quarterly basis and in some cases monthly.

The most difficult decisions for participants is determining how much to save and how to invest that savings.

Such plans require complex tax reporting, discrimination testing and extensive communications with account holders concerning investment and contribution options and asset allocation.

Plan sponsors typically spend considerable time and money to educate their account holders so that they make informed investment and contribution decisions given their age and investment goals.

One of the clearest lessons from America's defined contribution plan experience is that the more choice offered to account-holders, the more complex the system of individual accounts – the more expensive the system.

Partly for that reason, when considering a system of individual accounts linked to Social Security, I would caution you on a structure in the early years that offers extensive choice since it is choice more than anything that drives up the cost of fund administration.

And choice, in the early years of such a program when account balances would be quite small – would frankly offer limited value to account holders.

In this respect, the experience our country has had with defined contribution plans is instructive.

The 401(k) Experience

In the early 1980s, typical 401(k) accounts had relatively low balances. Back then, most account holders had limited investment choice, they received infrequent statements and were restricted on how often they could change their investment options.

But through the years, as defined contribution account balances have grown, account-holders have increased their demand for more choice and flexibility.

Today, 401(k) balances in the U.S. exceed \$1 trillion and the average 401(k) account balance is more than \$25,000.

With such amounts, choice has more value; investors can tailor their investments to meet their retirement planning needs and the total annual cost as a percentage of the account balance is relatively low – indeed, very low in the best plans.

One of the best examples of how funds can be practically pooled, then invested in market-based options – and at a reasonable cost – is the Thrift Savings Plan of the Federal Employees Retirement System.

TSP now covers 2.3 million federal employees – including almost all members of Congress, the Administration and their staffs. While not the largest pension plan in America, the program held assets of \$58 billion at the end of last year.

The TSP plan, which offers three basic investment options – a Treasury bond fund, a stock fund and a bond index fund – has provided median returns of about 8.5% – net of fees -- since its inception.

It enjoys a very low administrative overhead of about 1/10th of 1%. In financial jargon that's ten "basis points." In plain English, that's a dime a year on every \$100 invested.

Now, we've also had the benefit in this country of the experience of thousands of 401(k) plans – and their accompanying 457, 403(B) plans for the public sector. An estimated 32 million Americans held more than \$1 trillion through these plans by the end of 1996.

The number of 401(k)s has grown from 68,000 in 1988 to more than 220,000 by 1996 – with rising participation rates and more sophisticated investment patterns over time through employee education.

The best, most-cost effective 401(k) plans are generally established by large corporations. They offer participants not only investment management, but trust/trustee accounting, employee communications and a tremendous amount of investor education.

In fact, the trend in the industry is towards increased services – often including daily valuation of your funds, phone-centers on an 800 number that work 24 hours a day. And investment choices have grown from four options several years ago to generally eight options now.

Some companies, like Exxon, have been able to keep their administrative cost to as low as $1/20^{\text{th}}$ of one percent – five basis points – a nickel per year for each \$100 invested – by offering only a limited number of broadly-based funds.

We see the average, passively managed or “indexed” 401(k) plan, incurring a cost to the participants of only 15 to 20 basis points – 20 cents per year or less per \$100 invested.

As for the average actively managed 401(k), where they are actually picking stocks, costs for the best plans run in the 50 to 60 basis point range – just over half a dollar a year for each \$100 invested.

I don't mean to suggest that 401(k)-plans are any kind of panacea, because unlike Social Security, they are not universal.

Many part-timers have no access to them. Some allow lump-sum withdrawals or excessive loans – which undermine the purpose of retirement finance.

But the 401(k) experience does offer one clear lesson for us in thinking about how individual investment accounts might play a role in revitalizing Social Security.

The lesson is that *large institutions have the bargaining power to drive down administrative overhead costs and increase services for members.*

The bargaining power of the trustees or administrators who might contract out some Social Security funds to investment managers would, clearly, be enormous. Competition would tend to keep fees razor-thin, just as we've seen in every other aspect of the financial services industry.

If you're still paying 18 percent for your credit card, you'll probably want to look around. There are a lot of 7 or 8 percent cards out there. The same kind of thing would happen to these administrative services.

I cite these best practices – and these price-cutting competitive pressures – not as explicit models – but as strong evidence that a system of individual investment accounts within the Social Security context could be undertaken at quite reasonable costs.

An Evolutionary Approach

One option for initiating a system of individual investment accounts might be to take some of the lessons from the evolution of the defined contribution business and create what amounts to an evolutionary model: one that starts modestly and over time expands into a larger, more sophisticated structure with more choice.

Under this evolutionary approach, you could begin with a very simple administrative system that maintains accounts for every worker paying FICA taxes.

It would, of course, be necessary to fully automate the flow of contribution data from SSA to a record keeping system. It is imperative that the SSA be able to automate the flow of individual account records on a timely basis.

Initially, the account balance updates might only be done annually but the longer-term solution should entail more frequent updates.

Although there are similarities between Defined Contribution retirement accounts and the concept of individual investment accounts within Social Security, the record keeping and administration requirements to maintain an individual SSA account would actually be simpler in many ways than for today's 401(k) accounts.

With individual SSA accounts, there would be no need to maintain multiple sources of funds, employer match criteria, loan administration, merger/acquisition changes, integration to nonqualified plans, and plan discrimination testing.

All of these features add significantly to the cost of the 401(k) administration. None would apply to individual investment accounts linked to Social Security.

Other factors that will significantly influence the cost of administration are the design of any potential individual account option including the number of investment options, the method for selecting these options and the service features available – all of which are major cost drivers.

For example, service features such as frequency of statements, method of access (voice response, internet, customer service) as well as distribution options (annuities, roll-over, etc.) will significantly affect system costs in the near term – when balances are small.

Over time, of course, as account balances grow, these costs will decline as a percentage of rising pools of assets.

A Possible Design

Using commercially available technology, a system could be designed to meet the requirements of an individual account system.

It could be a custom-designed solution built specifically to meet the requirements of individual accounts linked to Social Security.

Essentially, it would be a stripped-down version of a defined contribution system but a system that needs to ultimately support the entire labor force, more than 130 million people at present.

The record keeping service itself could be subcontracted to several firms chosen by competitive bid, or, operated by the SSA, or by a well-established government service organization such as the Federal Reserve Bank.

The qualifications would include previous experience handling large-scale, high-volume, highly-automated data processing and service applications.

The cost for administration would, of course, vary widely depending upon the program's design.

If there were to be a desire to provide on "Day One" for service that is comparable to the most sophisticated 401(k) plans, such a system would be relatively expensive.

That is especially true when measured as a percentage of the likely account balances in the first years of a system of Social Security-linked individual accounts.

Remember the average 401(k) account today is over \$25,000. In the first year of individual accounts linked to Social Security, the typical account balance would probably be less than \$500.

With average 401(k) balances 50 times greater than the average SSA account on year one, 401(k) accounts can support much higher expenses.

An interesting note, however, is that the actual per account cost to support the SSA accounts will be significantly less than the 401(k) account though not 50 times less.

Therefore, if the policy is to pursue the individual account option with account holders paying the administrative expense, the design requirements must consider the average account size.

Options and service features should be very basic in the early years and, as balances grow, the assets will support the costs associated with more choice and services.

Again, this is what happened in the 401(k) experience and we think it makes sense here.

Conclusions

Based on our preliminary analysis we are confident:

- Individual Account scenarios linked to Social Security are, indeed, feasible.
- Solutions can be designed to meet the record-keeping and administrative needs.
- Private sector and government entities are available with the experience to handle large scale technology service applications.
- If we align investment choice and service features with the growth in balances the expenses can be paid for by the account holder – without sacrificing the benefits that higher market-based returns would bring.

Mr. Chairman, members of the committee, if you decide as a matter of policy that the American people would benefit from individual accounts, I believe strongly that America has the experience, the capability, and the financial services infrastructure to meet the challenge.

We also believe that this would be in the best interests of all Americans – and most of all of working and middle class families who would be enabled to build real, personal, inheritable wealth.

At State Street, we will be pleased to assist you in whatever way we can.

Thank you and I would welcome any questions you may have.

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The CHAIRMAN. Mr. Enoff.

STATEMENT OF LOUIS ENOFF, FORMER COMMISSIONER, SOCIAL SECURITY ADMINISTRATION; ENOFF ASSOCIATES, LIMITED, SYKESVILLE, MD

Mr. ENOFF. Thank you, Mr. Chairman, members of the committee. I appreciate the opportunity to be here today and I want to congratulate you on the timeliness of this hearing as well as your creation, as you announced earlier, of this work group. I think as the debate about Social Security reform intensifies, I believe the arguments are becoming less inflammatory and more informative, witness the discussion here today. This is a critical time to begin an extensive discussion about how an effective and efficient way to collect contributions for individual retirement accounts can be done and how to maintain accurate records about these accounts and the earnings they will accrue.

I think this issue is especially important when we talk about maintenance of individual accounts for relatively low-income workers, a group that is often overlooked when we discuss individual accounts.

Let me say at the outset that I believe that establishing, maintaining, and updating of individual worker accounts can be done, can be done effectively and efficiently, and I strongly believe that mandatory individual-funded accounts should be a part of the reforms to our Social Security program because I believe that this is the only way that we can restore confidence in this program, which is the bedrock of our retirement planning process.

I believe the most effective and efficient way to accomplish the creation of this type of individual account would be through the existing IRS-SSA employer collection and record keeping process. The framework and the work power are in place and these new individual accounts could be added to the existing process with a minimum of additional costs.

I believe it would be beneficial to ask for proposals from this work group that you have talked about representing the IRS, at least the IRS, the SSA, and some of the private sector who are likely to be the custodians. I do not want to prescribe in detail the operation of the process, but suffice it to say that a percentage of employer payroll to be designated for individual accounts could be collected and recorded in the existing FICA withholding and record keeping process and that portion could be forwarded on a schedule to the appropriate fund custodian. Obviously, as was mentioned earlier, the number of approved custodians and the opportunities for change in custodians by the workers would determine to a degree the complexity of the costs.

I see no problem with a flat across-the-board percentage charge, or even if the government might absorb the cost on a start-up basis for this process. I think this is especially true if we are talking about a mandatory process for all workers, and I believe that a mandatory savings component should be a part of the solution to the future of Social Security.

I also would urge that you strongly consider in your deliberations some kind of a subsidy for low-income workers to ensure that they are able to afford individual retirement accounts and do not have

to make the tough choices of looking else where in their budget. A funded mandatory pension tier will not only take pressure off the current unfunded liabilities, but I believe by increasing our overall savings rate, we will be adding to the prosperity of our future economy as a whole.

As a final point, I believe that to be viable, our Social Security system for the coming century must have a very carefully designed regulatory oversight body. At least in the initial stages, this system may have to have limits in the number of investment options and the opportunities to alter choices of investment. The designers must carefully set out the goals for such a body so as not to over-regulate, as we have seen in some countries, and not to underestimate the need, as we have seen in other countries. I have given you some examples in my full testimony that I think you can look at.

Mr. Chairman, upon looking closely at the desirable administrative structure for an effective and efficient Social Security system of the future, especially one that includes mandatory funded individual accounts, it is not likely that a fully privatized process would be viable. Rather, we should rely on the several government organizations that I mentioned in my testimony today to perform those tasks that they can best perform.

On the other hand, we should provide workers with the opportunity to benefit from privately managed, individually owned accounts so as to allow the best return on their retirement investments within a relatively safe environment. As Mr. Breaux pointed out, the Federal Government is an example, albeit a bit smaller.

Individually owned and funded accounts will not only restore confidence in our Social Security system, but will also rescue the current system from the path of insolvency and boost the overall savings rate of our economy. I believe that a strong bipartisan approach along these lines should also go a long way in restoring the trust in our government institutions.

Thank you again for the opportunity to testify and I would be happy to answer any questions and to work with the committee as you move ahead.

[The prepared statement of Mr. Enoff follows:]

CAN INDIVIDUAL RETIREMENT ACCOUNTS FOR ALL
WORKERS BE EFFICIENTLY AND EFFECTIVELY
IMPLEMENTED AND ADMINISTERED?

Statement of:

LOUIS D. ENOFF

SENATE SPECIAL COMMITTEE ON AGING

April 21, 1998

Mr. Chairman and members of the Committee, let me first take the opportunity to thank you for the invitation to testify on this most timely topic. I want to make clear at the outset that the views expressed are my own and do not represent any client or group. These are views garnered from my 30 years of government experience with this program and the experience working with other social security programs around the world over the past five years. I also would like to congratulate you on the timely nature of this hearing. As the debate about Social Security reform intensifies, and I believe the arguments are becoming less inflammatory and more informative, this is a critical time to begin extensive discussions about whether there is an effective and efficient way to collect contributions for individual retirement accounts and to maintain accurate records about these accounts and the earnings they will accrue. This issue is especially important when we discuss the maintenance of individual accounts for relatively low income workers, a group that are often overlooked when discussing individual accounts.

Even if the most optimistic pundits are correct and a solution to the pending insolvency of the current Social Security program is reached by the end of this year, it is likely that there would be another year before any collections for individual accounts would begin. It would be tragic if decision makers failed to include mandatory individual accounts as a part of the Social Security solution because they believed, based on inaccurate information, that individual accounts for low income workers were administratively too cumbersome or too expensive. Unfortunately, there are a number of commenters, some highly respected, who are publicly making this claim today. Whatever you believe to be the correct solution to the current solvency issue, it is imperative that a clear and accurate examination of the feasibility and cost of establishing, maintaining, and updating individual worker accounts should be done, and done now.

Let me say at the outset that I believe that establishing, maintaining, and updating of individual worker accounts can be done and can be done effectively and efficiently. I strongly believe that mandatory individual funded accounts should be a part of the reforms to our Social Security program, because I believe this is the only way to restore confidence in this program which is the bedrock of retirement planning for our country.

I believe the most effective and efficient way to accomplish the creation of this type of individual account would be through the existing

IRS/SSA/Employer collection and recordkeeping process. The framework and workpower are in place and these new individual accounts could be added to the existing process with a minimum of additional cost. In many ways, I believe that adding this new role could actually help to improve the existing process. I want to note that I have not discussed this approach recently with either of the federal agencies. I am confident that the capable managers and staff in both organizations, with the proper time and resources, can produce several options for consideration. Since any solution including individual accounts would likely involve private sector custodians, I believe it would be beneficial to ask for proposals from a workgroup representing at least these three entities. I do not want to prescribe in detail the operation of this process, but suffice it to say that the percentage of employee/employer payroll to be designated for individual accounts would be collected and recorded in the existing income tax/FICA withholding and recording process and that portion would be forwarded on a schedule to the appropriate fund custodian(s). Obviously, the number of approved custodians and the opportunities for change in custodians by workers, would determine to a degree, the complexity and cost. The cost of the procedure would also vary depending on whether a charge for the service would be made per individual account, per employer, per custodian, or if the cost is so minimal that it might be absorbed by the existing process or by the government.

I see no problem with a flat across the board percentage charge or even with the government absorbing the cost on a start-up or a continuous basis. This is especially true if we are talking about a mandatory process for all workers. I strongly believe that a mandatory savings component should be a part of the solution to the future of Social Security. I believe it must be mandated for the sake of low income workers. Voluntary IRAs simply have not been a powerful enough incentive to attract low income workers to choose saving over the other pressures on their tight budgets. In this area I would also like to suggest that as you consider the design of our future Social Security program that you strongly consider some kind of subsidy for low income workers to ensure that they are able to afford individual retirement accounts to supplement a basic Social Security payment. A funded mandatory pension tier will not only take pressure off of the current unfunded liabilities, but I believe by increasing our overall savings rate, we will be adding to the prosperity of our future economy as a whole.

When I mention improvements to the current process, I am thinking particularly of the W2 and the about to be fully implemented SSA Personal Earnings Benefits Estimates(PEBES) for all workers. This PEBES process has not yet been implemented for the entire workforce. I know that several Senators have expressed concern about some aspects of the information in the PEBES forms. The prospect for including information about individually owned retirement accounts in a similar format would provide another incentive for workers to track and validate their overall retirement contributions and hopefully to seek corrections for any erroneous reports. While the percent of incorrectly reported earnings in any given year is relatively small, this small percent against such a massive total volume can mask the severe problems for individual or small groups of workers or employers.

Another area worth exploring is the viability of establishing an insurance fund for approved pension funds in the new system. Depending on the volume of investment managers to be approved, it might be worthwhile to set aside a very small portion of funds to build an insurance pool. This pool would be used to offset the impact on individual workers should a specific pension fund fail to meet minimum standards. Obviously, we should try to avoid this potential to the extent possible by careful but not over regulation. A regulatory approach somewhere between that of the United Kingdom and that of Chile would seem to be in order.

A final point, I believe that to be viable our Social Security system for the coming century must have a very carefully designed regulatory oversight body. At least in the initial stages, this system may have to have limits in the number of investment options and the opportunity to alter choices of investments. The designers must carefully set out the goals for such an oversight group. A look at the experience of the Federal Retirement Thrift Investment Board shows that such a body can function effectively and without the threat of political manipulation of the funds. It would also be advisable to review the role played by the National Finance Center of the Department of Agriculture and the audit function performed by the Pension and Welfare Benefit Administration of the Department of Labor.

Mr. Chairman, upon looking closely at the desirable administrative structure for an effective and efficient Social Security system of the future, especially one that includes mandatory funded individual accounts, it is not

likely that a "privatized" process would be viable. Rather, we should rely on several government organizations that we have mentioned today to perform those tasks that they can best perform. On the other hand we should provide workers with the opportunity to benefit from privately managed individual accounts so as to allow the best return on their retirement investments within a relatively safe environment. For economic as well as political reasons the investment of these individually owned accounts should be by professionals. While the administrative costs for the investment function exceeds that for the current trust fund bond operations, the net benefit to the worker is significant.

I have not provided specific numerical estimates or comparisons of costs for the various functions I have discussed. These numbers are readily available to the Committee. I simply want to urge you to move expeditiously to charge someone, whether it is GAO or another body, to begin to document the options available and the relative merits of each as well as the cost considerations. If this is done Mr. Chairman, I am confident that we can establish a Social Security system for the future which will provide a better basis for retirement. Safe individually owned and funded accounts will not only restore confidence in our Social Security system, but will also rescue the current system from the path of insolvency and boost the overall savings rate of our economy. I believe that a strong bipartisan approach along these lines should also go a long way in restoring the trust in our government institutions. Employing private sector management and techniques in the investment area where they are most appropriate will allow all workers to benefit from the fruits of the market economy.

Thank you again for the opportunity to be here. I would be pleased to answer any questions you may have and to work with the Committee to further this effort.

The CHAIRMAN. I think I will start with you, Mr. Enoff. First of all, it is kind of encouraging to find somebody with the background you have in the Social Security Administration to say that there is a place for individual accounts in this system and to say it positively. You have consulted with other governments, I have been told, who are undertaking reforms and implementing public pension systems. How would you compare the ability of those countries to administer a system with individual accounts with the ability to implement a system here?

Mr. ENOFF. Well, I think we have seen a somewhat successful implementation in a couple of countries. Administrative costs, when we compare those, unfortunately, we are often comparing apples and oranges when we are comparing the cost of the investment along with the cost of collection and record keeping. So I think we have to clearly delineate what we are counting when we count administrative costs. I think when we net out the individually managed investments, we find that the worker is better off in the long run by having the individual management by the private sector, but as I say in my testimony, I think using the current existing system, at least for starters, is the most efficient way to go.

The CHAIRMAN. Mr. Phalen, one of the concerns with moving to individual accounts is that there would be millions of workers with small account balances. You put that number at about 30 million people, I believe, with less than \$5,000, taxable income of less than that amount. There is also a concern about people who report wages on an irregular basis, like seasonal employees. Are there any private sector models that already deal with tracking contributions for these type of workers?

Mr. PHALEN. No, Senator, there are not, and those clearly are going to be very significant challenges as we would build an individual account scenario. One of the things I think Mr. Enoff had indicated was that the pricing of administration or the way we would spread costs, the logical way to spread costs to avoid some of the problem on the smallest accounts would be on asset-based fees, and this is a common model that is used in the mutual fund industry today, where administrative costs are spread in the same way.

The CHAIRMAN. Ms. Mitchell, one of the issues that comes up in the discussion about how big of a percentage of payroll tax that could be put into an individual account is the need to retain insurance benefits that are in the present Social Security system. If we used a small percentage of payroll tax, say two or three percentage points, to create individual accounts, does that not leave enough funding to maintain disability and survivor portions at the current level?

Ms. MITCHELL. You raise a very important point which many advocates of Social Security reform do not focus on, which is the fact that there are several of elements of insurance under the OASDI system. There is life insurance for young workers that can help support their families if the worker should die, and disability insurance, which is very, very key for many people. There is widow(ers) insurance for older deceased workers whose spouses continue to live in retirement. There is also insurance under the current sys-

tem in the form of protection against inflation. That is, the current system provides a real annuity. Some people say it is overly indexed, but nonetheless, it is indexed. So all these types of risk, I think, have to be dealt with very squarely when you move to a different sort of a system.

It is my belief that there are private market alternatives for many of these. For example, now that the government has issued inflation indexed bonds, it is possible for people to design a portfolio which will help protect them against inflation. There are also private markets for life insurance for disability and so on. But I think that you really do need to focus on these pieces at the same time.

The CHAIRMAN. I think maybe you answered the second question I was going to ask about the insurance benefits of inflation, adjusted benefits, and longevity. Could we deal with that by requiring mandatory annuitization?

Ms. MITCHELL. Under the Social Security Advisory Council proposals, two of the three plans did, in fact, mandate annuitization at the point of retirement. There is perhaps another alternative which could be examined, that is to require some portion of the individual account be annuitized, perhaps enough to generate a minimum benefit, and then let people decide above and beyond that whether they want to annuitize. So it seems like there is a middle ground that could be examined.

The CHAIRMAN. Mr. Phalen, your testimony provided a very good foundation for us to continue to search for a feasible model to administer these programs. One of the questions that has been raised by opponents of individual accounts is that participants with low account balances would be paying the same dollar amount in administrative expenses as people with high account balances. In your testimony, you refer to basis points. Does that mean that the participants would be paying different dollar amounts based on the size of the account, and is that always going to be the case?

Mr. PHALEN. Yes, Senator. If we do decide to make the charges on asset-based fees, then basically you are paying off the size of your balance. If you have \$100 in your account, you are going to pay 50 cents if you are paying on five basis points, and obviously moving up to \$1,000 or whatever.

This is commonly used today in the mutual fund industry, as the example that I used. Administrative costs in that industry, the small account pays an asset-based charge expense ratio for its services, and the large account pays a percentage on its services. So there is a model out there that is a very popular model, obviously, today in American financial circles.

The CHAIRMAN. Senator Breaux, if you are ready.

Senator BREAU. Thank you. I am sorry I had to step out, but I have read your testimony and I appreciate your presentations and the dialog and discussion.

I guess there are a couple of questions that are always raised when we talk about investment, private investment accounts. Some people say, well, it would be too hard to administer. Others would say, well, it is too much risk. Others debate whether they should be mandatory or whether they should be voluntary.

I think Senator Moynihan has made a great contribution in the suggestion of the reduction in the payroll tax for voluntary accounts. I have some concern that if a person is given the choice of a tax reduction or an investment account, they are going to go for the tax cut in the short term and we are not going to have enough money.

Can I get some discussion on this? I have always looked at the Thrift Savings Plan that we as Federal employees have as sort of a model. We have three options, three ranges. It seems like they can administer it appropriately and properly and the return has been much greater than the government bond investments. But can I have some discussion on whether it should be mandatory or optional and can it be administered? Mr. Enoff.

Mr. ENOFF. Absolutely. I believe it has to be mandatory and I believe it has to be mandatory for the benefit especially of the low-income workers, and I think we can find a way to subsidize those workers if we have to, to ensure that they have an individually-owned account and that they do not get left out of this process.

Senator BREAUX. The concept would be to reduce their payroll tax a percentage to give them that money?

Mr. ENOFF. The same way we had the earned income tax credit idea. There is a way to supplement them, and I think we have to look out especially for low-income and seasonal kinds of workers, as we pointed out.

Senator BREAUX. But you think that could be done?

Mr. ENOFF. Absolutely, and I think there are models to look at for that, and I think it can be administered. We administer the tax program that way. For starters, I think we would probably use the existing setup that is there. That could be improved on, too, as I indicate, and I think by looking at this, we can improve not only the future system but what we have existing for the PEBES program and for the W-2 process that we have now. While the errors there are relatively small percentage wise, if you have an error in your individual account, it can be a whopper for you.

Senator BREAUX. Mr. Phalen, comments on that?

Mr. PHALEN. I would agree. I think there clearly are some benefits to a mandatory approach, particularly as it relates to those small accounts. I think, obviously, including them through that process is going to begin to create some retirement wealth and savings for them and I think that is—

Senator BREAUX. Is the concept of a range of investment options for the individuals, high risk, low risk, moderate risk, a concept that makes sense, in your opinion?

Mr. PHALEN. Yes. I think it is a concept that makes sense. I think what we need to do is it needs to be evolutionary. I think when you look at it, when this system opens, the average account balance is going to be \$500. So to provide a lot of choice for a system with a \$500 average account balance is very different than what is in the TSP today. I do not know what the average account balance is, but if it is close to 401(k), it is \$25,000 average account size. So again, choice, I think, adds cost and needs to be really brought in at the appropriate time, when it adds value for the participant.

Senator BREAUX. Ms. Mitchell.

Ms. MITCHELL. A couple of comments. It is my understanding that the TSP has been asked to allow more investment options down the road. They have been asked to institute an international fund. They have been asked to do more frequent valuation, mark to market, and so forth. So the model that you hold up as being the plain vanilla model is, in fact, itself evolving, perhaps in response to participant interest, and maybe that is the correct model.

The other thing I would mention is that all the programs that we have talked about and others we have not where Social Security has been reformed have always maintained this dual pillar approach, where you have a minimum pillar where the government maintains its commitment to a minimum benefit for the very low income, the people who are destitute in old age, and then the second pillar being the investment pillar. So I think that is what we have to keep in balance, that it is really a two pillar system. Few advocate a pure laissez-faire, letting the elderly go it alone.

Senator BREAUX. I thought, just in closing, one of the statistics that you pointed out about whether we have a problem with Social Security, in your testimony, Ms. Mitchell, you talked about how the system is far from fully funded. Indeed, unfunded present value of past Social Security promises stands at 9 trillion and the funding ratio is 6.4 percent. You have private pension plans that are required by ERISA, as you point out, to have a funding ratio of 100 percent. That is a problem.

Ms. MITCHELL. It is a problem in the sense that we and our children and our grandchildren bear the burden of that tremendous transfer to previous generations. I am not here to say whether that was right or wrong, but we are sitting here today with that obligation and we cannot avoid it.

Senator BREAUX. I appreciate very much your contributions. Mr. Enoff, you had a comment?

Mr. ENOFF. I was just going to say, and we are not even counting the other task force that you are chairing now and the costs—

Senator BREAUX. Yes. I am glad you mentioned that, because I was thinking about that. When you add the Medicare problem, which is a much more serious problem, and it is going to be much quicker than Social Security, when you add that to it, we have got some tough political decisions to make.

Mr. ENOFF. I think it argues more and more for the individually funded savings approach to Social Security and entering that gate now, to the extent that we can, while we build a fence around it to make it as safe and as easy as we can. It is not easy. There is a cost. We should not overlook that. But there are ways that we can help to ease that transition, and there is a cost to doing anything with the current system as well as there is a cost to going a new way, which I think the majority of people seem to think is a better approach.

Senator BREAUX. The good news is that the dialog has changed.

Mr. ENOFF. Absolutely.

Senator BREAUX. I mean, for years, we have had people who have come before this committee and the Finance Committee and Congress in general and say, fix Medicare, fix Social Security, but do not change it, but fix it. That does not equate. Thank you all.

The CHAIRMAN. Senator Hagel.

Senator HAGEL. Mr. Chairman, thank you. Again, I add my thanks to our panelists. You have helped us an awful lot and we will continue to call upon you. We are all grateful for your input.

I am particularly pleased that there has been some discussion, within this panel, at least, with a focus on creation of wealth, creation of wealth for our next generations, creation of wealth for our lower-income workers, getting beyond the small thinking box of, well, this is just a transfer payment system and we have a 9 trillion unfunded liability now and, gee, what do we do? I do not know. We are going to just do less.

That is not the answer, in my opinion. The answer is what Moynihan is looking at and Bob Kerrey and Phil Gramm and others, which the three of you have spoken to, and I think creation of wealth is the key to this.

I would ask each of you to range out a little bit. You take Kerrey-Moynihan's 2 percent off the top of the 12.4 percent payroll taxes. Gramm is going to come in with probably three to four in his legislation. Give me some idea of how much time through a transition process it would take to address the 9 trillion unfunded liability we have at some 2 to 4 percent set aside here to create individual accounts. Is it going to take 50 years, 75 years to get to an investment-based fund, or do we ever get there?

Mr. ENOFF. My answer, unfortunately, is it depends on how much we are willing to bite off. Are we willing to say—and I do not have to run for reelection, so I can say, well, I think we could increase the amount, because if we tell a person that it is mandatory savings, it is not a tax increase. I am not saying that is the way to go, but I think we have to look at those options. Can we take a part of the Social Security FICA tax right now and add to that? As long as the individual owns it as their own account, I think that has some merit.

I think we also have to look at what are we going to keep as a base, because I believe that we have to have a base. I would be willing to make that a flat base and say everybody is guaranteed some amount of money, which makes more of a transfer to low-income workers, but then allow them to build on that.

I think we do have to keep those insurance aspects that were talked about and I do not think the market is ready to offer the solution for all of those, because the young worker—we do not look at the impact that Social Security has had on keeping children whose parent, the income-earning parent, dies out of poverty, but that is a very large impact and I do not think we want to put that away.

The disability program has its own set of problems, but the benefits are not excessive there and I think the fix for that needs to be done separately, as well. So you have to maintain some of that amount. So I am going to say 20 to 25 years if you do it logically.

Senator HAGEL. Thank you. Mr. Phalen.

Mr. PHALEN. Senator, you are kind of beyond my area of expertise, which is more in the administration of the individual accounts area, so I will defer.

Ms. MITCHELL. One way of thinking about a current 12.4 percent FICA tax/payroll tax is that about three percentage points of that,

so roughly a quarter, goes to pay for our parents and our grandparents and everybody who came before us.

So then the question is, going forward, if you diverted a further portion of the payroll tax to individual accounts, how quickly could you build up the account? How much income would it be worth? That depends a lot on how you invest the money, what the rate of return on the stock market is. I understand markets are up again today, so that makes us all very complacent.

But if you took the Moynihan plan, simply took off two percentage points off the payroll tax and gave it back to people, the trust fund would grow less quickly. It would then be exhausted sooner, and so that does not resolve the problems that the Social Security Administration faces in looking down the road.

Senator HAGEL. Let me ask one other question. The Consumer Price Index, the CPI, we have not really heard any discussion about this. It is a big issue. We are going to have to deal with it. We have kind of deferred it, like we do a lot of things around here. Should we attach this to any legislation, not worry about it; or should we do something with it?

Ms. MITCHELL. It is my understanding that the Bureau of Labor Statistics is already moving towards a new statistic and basing it on very good science and very good analysis. So I think that events and perhaps the discussion of this that has happened around Capitol Hill has led to part of that solution already.

Mr. ENOFF. I would say it ought to be decided on its own, and I think it is being, as Professor Mitchell said. But I would like to add one comment. You mentioned the globalization aspect, and I do not want to get global on us because I think we are focused; but as we go out into the future, the aging process is going to put more and more pressure on the economy and I think building up that wealth and that savings is something that we have to have as one of the goals of our future system, and I think it is a point we cannot lose.

Senator HAGEL. Thank you. Mr. Phalen, would you like to respond?

Mr. PHALEN. No, I am fine.

Senator HAGEL. Would you like to say anything?

Mr. PHALEN. I think my expertise, again, is more in the ability of what it is going to cost and what it would take to build the administrative account and options that you are looking at for individual accounts.

Senator HAGEL. Thank you. Mr. Chairman, thank you.

The CHAIRMAN. Thank you.

Senator Reed.

Senator REED. I thank the chairman.

So Mr. Phalen does not feel left out, I will ask a couple of questions that I think are in his area of expertise.

Mr. PHALEN. Thank you, Senator.

Senator REED. Obviously, private brokerage firms and private investment firms are going to have to charge for managing these accounts the number of basis points has been estimated but that detracts from the overall money available to a retiree. Is that a problem that we should be concerned about?

Mr. PHALEN. I think it would be if, basically, we developed a model that was very much a retail-type model like is out there today. I would agree, it would be too expensive. But what we are clearly looking at is building a custom individual account scenario that has similarities to the TSP type product, that really we have to design very tightly relative to the amount of choice and the amount of service features we give it up front relative to what balance is at that account size again, because again, there has to be a relative cost-value relationship.

Senator REED. So we should not go into this process with the idea that every American worker is going to get the kind of flexibility, choice, and blue plate specials that—

Mr. PHALEN. Absolutely, Senator. If we do, the cost clearly will be well beyond the value.

Senator REED. Another aspect you talked about in your previous testimony, Mr. Phalen, is that, generally, you can see it with asset-based fees, five basis points. But when a high-income person starts accumulating several hundreds of thousands of dollars in his or her fund, and you have to be competitive in terms of appealing to them. Do you expect that the market or the brokerage will start reacting by giving discounts to high-income people in terms of administrative fees and that we will get into a disparate treatment of low-income and high-income?

Mr. PHALEN. I think the private sector would have a large challenge for a long time in competing with the type of scale that would be put together at this plan, because these are relatively, again, low-balance accounts for some number of years. We are talking about \$500 or \$600 in contributions going into these accounts for the above-average kind of worker in the plan. So it is going to take quite a few years before the brokerage industry, in particular, is interested in that account. Now, they may be interested in that account as incremental to your current—

Senator REED. I know Mr. Enoff has a comment, but just following up, so then you would assume that we would essentially have to mandate participation by brokerage firms?

Mr. PHALEN. Well, I do not think that is a requirement. No, no, not by brokerage firm. I think what we are saying is, the question that was raised relative to mandatory was, I think, is there a value to a mandatory system, and my comment was that the value to the mandatory system is that you get the lowest account holders, the lowest-income earners to participate, and you probably, otherwise, if there is an option, will not get those people to participate.

Senator REED. But just following up, let us assume we mandated that some portion, not entirely, but some portion has to go to individualized private accounts. Now, how do we ensure that we have a sufficient number of brokerage organizations that will handle these accounts, that will do so not on a cherry-picking process but take their share of the very low-income ones?

Mr. PHALEN. Again, our vision, or my vision was that it was closer to the TSP model, where, effectively, what we had was investment managers, institutional investment managers that we were selecting and getting very significant, very competitive fees on because of the total balances that we were making available to the universe as a whole, and the administration of those accounts

would be done, as we said, potentially by the Social Security, by a government agency, or by outsource to the private sector.

Senator REED. So to be clear about this, it is really a situation where someone would have a personalized account within the Social Security system being run by the Social Security Administration, but the Social Security Administration or someone would hire investment managers to manage the assets in the accounts?

Mr. PHALEN. Correct.

Senator REED. Mr. Enoff, you had a comment?

Mr. ENOFF. I think that is right, and I think the way you take care of the problems you mentioned is by the regulatory body that you put over it. As Mr. Breaux suggested, the TSP account, it works. Now, I think this is much bigger, but there is no reason that it cannot work and there cannot be more choices. I cannot imagine that we would not have a whole wealth of brokerage firms who would want to come in and participate and would have to compete to participate and would have to come under the regulatory scheme. We talked about the need for annuities, and the annuity market is not great in this country today. It will grow as that opportunity—

Senator REED. Let me just take your comment about the annuity status. Another technical question, perhaps, is that most people conceive of Social Security as an annuity, that it is going to come in if they live 2 years after retirement, if they live 50 years after retirement. When someone buys an annuity contract, it is priced competitively. Now, your sort of thinking ahead takes into consideration those people that want to have an annuity when they retire, versus just getting access to all of their built-up accounts?

Mr. ENOFF. I think that as we look at a two-tiered system, and I believe we have to have a two-tiered system for the transitional period if not forever, there is a basic benefit that guarantees some income through life for the person, and that is probably a pay-as-you-go process that we have now, but maybe it is not going to be the whole—it should not be the whole system. So whether or not you need an annuity, I think is a good debate, and it may depend on what assets you have to go into the future.

I do not like mandating to individuals that they have to have an annuity, on the one hand. On the other hand, if the alternative is the government supporting them, then maybe there are some thresholds that we have to look at.

Senator REED. Let me ask Ms. Mitchell.

Ms. MITCHELL. I wonder if I could add to that. On the annuity point, one model is to mandate that you must annuitize enough of your defined contribution or your IRA account to cover a minimum benefit, and then let people decide what they want to do above that. But at least the individual is minimally protected.

On the cost issue, even during the start-up phases of our current Social Security system, administrative costs were 10 to 15 times higher than they became very shortly after, about 10 years into the system. Start-up costs are always going to be high, and so I think you want to take those into account and recognize that in the long run, they will be lower.

The other point I would make is that TSP is one model. In my own pension plan, the TIAA-CREF Plan covering professors,

management charges around 28 basis points per year and that includes an annuity fee, investment management, record keeping, and so on. So I think there are private sector models out there that could, again, be part of the evolutionary process.

Senator REED. Let me ask you, in terms of this final question, if I may, as you look at these alternatives and you look at the fees that are built in, the other option of simply fixing the present system, would not a retiree be better off in the long run if we simply took some steps, and Professor Munnell mentioned some of the steps, to fix the present system vis-a-vis going into these partially or fully privatized options with the additional fees, even if they come down over time? Have you made an estimate in terms of your evaluation?

Ms. MITCHELL. We must ask how can we deal with the past, and how should we look at the future. We have to pay for the unfunded liability. You can levy it all on baby boomers, or you can try to spread it over the future generations. Depending on how you levy that burden, you will get different groups of voters, different cohorts of participants being more or less happy. The more you defer it to the future, the better baby boomers will like it. Of course, that may not be the economically and fiscally prudent thing to do.

In terms of looking forward, where we should go in the future, again, that is a political issue ultimately, but it is my sense that the people—and I am going to hazard a wild guess here—people under the age of perhaps 55—

Senator REED. Older than us.

Ms. MITCHELL. Older than us, tend to favor more of a privatized account and people who are quite close to retirement know and love the old system. I think that is because they are actually benefiting quite differentially from the current system.

Mr. ENOFF. I am a fan. I want to say that the current system has served us well, and I do not think we ought to go around knocking it. But that is not what we need for the next century and I think we have to look at what we need for the next century and how do we get from here to there, and that is what we are talking about.

So I think the answer is, yes, we do want to build savings. The current system does not build savings in our economy for individuals or for the government, and we need to do that. I would do it with individual accounts because I think it is an incentive for folks to save additionally on their own and we can build on that.

The other point is, when this system was created, we did not have Medicare. We did not have these other things that we have to look at in terms of how much is the government going to fund and how much dependency are we building. We do not want to build—I do not think it is a good idea to build dependency on government programs for individuals. I think we ought to allow people to care for themselves to the extent they can. We ought to help them. We ought to mandate some things. I think this is an opportunity that we should not pass up to move in that direction.

Senator BREAUX. Mr. Chairman? I have one more question.

The CHAIRMAN. Yes, Senator Breaux.

Senator BREAUX. Just one short point. I think it is important, and I think all of our discussion and dialog has been very, very

helpful and very important. What we are all talking about, I think, is not the total privatization of Social Security and just give people money and say, go invest it anywhere you want and good luck. What we are talking about is far different from that.

I have the privilege of co-chairing with Senator Judd Gregg the CSIS Commission on Retirement Issues and we have almost come to the conclusion that you can have individual retirement accounts linked to Social Security, patterned sort of after the Federal retirement plan, the Thrift Savings Plan that we operate under, and still keep this national commitment of taking care to make sure that people have sufficient funds to retire.

I think that there is a difference between just saying, here are your payroll taxes, go do what you want with it, and what we are trying to accomplish here, I think, are two entirely different things and the difference needs to be noted.

Thank you all very much.

The CHAIRMAN. I want to thank all of you for your participation, because I think that concludes today's hearing. I did want to mention for administrative purposes, and I should have told this to the first panel, you may get questions from people who could not be here for answers in writing or even from those of us who did not get all of our questions asked, so we would keep the record open for submissions for 2 weeks.

I appreciate all the work that went into the very thoughtful testimony that we have and your willingness to respond to the various questions we have. I will probably call upon you in the future as we work with this, because the next 12 months are pretty important on Social Security if we follow the President's timetable, and I hope we do because, as the President said at Kansas City, any changes that are made in the next 2 or 3 years are not going to hurt anybody. If we wait until this gets to a crisis situation, people are going to be hurt.

I think that, from the standpoint of my chairmanship here, I want to make sure that the future of Social Security and the discussions that are involved with it stay on track and I hope that the issues raised in this hearing and, of course, with the General Accounting Office report will keep this momentum building for the enactment of comprehensive reform early next year.

I want to once again remind everyone, at least Senator Reed did not hear me say that I plan to convene a study group of public and private participants that would assess how individual accounts can be implemented at a reasonable cost. I want to do that so that when we get done with the White House Conference on Social Security and we start moving legislation, that we will find a lot of the laundry list of complications we have to solve, maybe some of those can be solved ahead of time.

Thank you all very much for your participation. Thank you. Thank you, Senator Reed. The meeting is adjourned.

[Whereupon, at 2:59 p.m., the committee was adjourned.]

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