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SOCIAL SECURITY REFORM OPTIONS: PREPARING FOR THE 21ST CENTURY

HEARING

BEFORE THE

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TUESDAY, SEPTEMBER 24, 1996

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

The committee met, pursuant to notice, at 9:07 a.m. in room 628, Senate Dirksen Building, Hon. William S. Cohen (chairman of the committee) presiding.

Present: Senators Cohen, Reid, Grassley, Warner, and Burns.

Staff present: Mary Berry Gerwin, Liz, Liess, Sally Ehrenfried, Lindsey Ledwin, Ken Cohen, Jerry Reed, Ted Totman, Paul Van Remortel, Chip Wallace, and Rem Dickinson.

OPENING STATEMENT OF SENATOR WILLIAM S. COHEN, CHAIRMAN

The CHAIRMAN. I'm going to go ahead and begin so that we won't lose too much more time.

Today the Special Committee on Aging is holding a hearing on the future of Social Security retirement system as we enter the 21st century. As the main plank of President Roosevelt's New Deal economic agenda, the Social Security Trust Fund was first created to provide support for retired workers and their dependents to protect Americans against a poverty-ridden old age.

The size and promises of the Social Security system have grown dramatically since the ink first dried on this legislation. Two decades after its passage, the program was expanded to cover workers who became disabled. Another decade passed, and Medicaid was created to help pay the health care bills of elderly and disabled Americans. Now, just 60 years after its creation, Social Security has become the Nation's largest Federal program, touching the lives of nearly every individual in this country. Social Security pays out over $350 billion, or almost $1 billion dollars each and every day in benefits.

This year, the Aging Committee has devoted much attention to the problems plaguing the disability portion of the Social Security system—namely, the Social Security Disability Insurance Program, or SSDI, and the Supplemental Security Income Program, SSI. As we have revealed in past hearings, the disability caseloads are mushrooming out of control. They've grown nearly 70 percent in the past decade alone. Younger beneficiaries are getting on the rolls, younger each year, and very few ever return to work. It's not unusual, for example, for a typical SSDI recipient to spend nearly a third of his or her life on the disability rolls.

Today's hearing is going to focus on the other major crisis facing Social Security: the aging of the population and the pressures that these numbers are going to be placing on the Social Security retirement system. By the year 2015, when the baby boomers begin entering their mid-60's, the number of persons receiving benefits will reach over 50 million, or one-third greater than those receiving benefits in 1995.

By the year 2040, the percent of the U.S. population over the age of 65 will have doubled. Like the disability program, people will be staying on the rolls longer once they become eligible for benefits, due to their longer life spans. For example, a 65-year-old male who began receiving benefits in 1940 was expected to live, on average, an additional 12 years. By the year 2015, the life expectancy of a 65-year-old male will have increased by over a third, resulting in much higher retirement costs for the Social Security system as a whole.

The crush of baby boomers on the system is intensified further by two additional factors. First, the number of workers paying into the system as the baby boomers collect benefits is shrinking. In 1950, we had over 16 workers paying into the system per beneficiary, 9 years from now there will be only 2.6 workers paying Social Security taxes per each beneficiary. So the number of people carrying the load will diminish, while the load continues to expand.

Second, the net savings rate of the country has dropped dramatically. As this chart shows, the national net savings rate has dropped by 50 percent over the past 30 years, placing even more pressure on the Social Security system as a major source of retirement income for an aging population.

Welcome, Senator Simpson. We appreciate your being here this morning.

Senator SIMPSON. Just go ahead, please.

The CHAIRMAN. Despite the inherent political risk, the message is clear. We must do something to fix Social Security, since the program is on the road to insolvency. Trustees of the Social Security Trust Fund have sounded the alarm that retirement and disability trust funds will be depleted by the year 2029.

Now, this may seem like light years away to our channel-surfing, fast-food, short-attention-span society, but if we don't prepare today, the consequences tomorrow, both on individuals and the economy as a whole are going to be catastrophic. The debate on how to reform Social Security is emerging.

Many of these proposals would "privatize" Social Security, although there's no consensus on exactly what this would mean. Some point to the experience of Chile. This would involve replacing the current system entirely with a system of personal investment accounts, in which the individual would control his or her investment decisions for retirement.

Other options involve the adoption of a two-tier system, composed of a flat rate benefit supplemented by a personal savings account, or earmark a portion of Social Security payroll taxes for deposit in personal savings account. Still other voices call for an investment board that would invest the Social Security trust funds in the financial markets, rather than giving total control to individuals over investment decisions.

Today we're going to hear some testimony about several of the major proposals on how to revise the system in order to keep the promise of a secure retirement for millions of Americans, and consider what factors are necessary to guide us as we undertake this debate.

First, we're going to hear from our distinguished colleague from Wyoming, Senator Alan Simpson, who along with Senator Bob Kerrey, served on the Bipartisan Commission on Entitlement and Tax Reform. Senator Simpson and Senator Kerrey have co-sponsored legislation which calls for major Social Security reforms.

We're then going to hear from Michael Tanner of the CATO Institute, and Paul Hewitt, of the Taxpayers Union Foundation, each of whom advocate proposals to privatize Social Security. Robert Myers, a former chief actuary of the Social Security Administration, will discuss changes which can be made within the Social Security program to ensure solvency over the long term.

We'll also hear from retirement policy experts who will provide us with a set of criteria we ought to consider in approaching reform. Eugene Steuerle, of the Urban Institute and Martha Phillips of the Concord Coalition, an organization committed to controlling the growth of entitlement spending are going to provide us with the guiding principle that they believe are important for reform.

Estelle James, an economist at the World Bank, will draw on lessons learned in other countries who have set out to reform their retirement systems. Finally, Paul Yakoboski, of the Employee Benefit Research Institute, will describe recent findings on the investment experiences of workers who participate in 401(k) plans.

There are major philosophical, economic, and practical issues posed by the Social Security privatization and restructuring proposals. For example, who should make retirement investment decisions? What kinds of basic benefits should be provided? How do we account for poor investment decisions? How do we deal with the transitional period of changing to a new system? How can we increase the national savings rate? What are the economic effects of various privatization proposals? How do we regulate any new system to guard against those who would prey on the unsophisticated investors?

There's no time remaining in this Congress to act on any of these issues. But I hope the hearing will at least serve as a forerunner to the kind of hearings that are going to set the stage for, I think, a discussion not only in Congress but also for the dinner tables of America, how we're going to reform Social Security.

I also want to say just a couple of other words, since this is the last official hearing of the Aging Committee. We're going to have a joint committee meeting on Thursday with the Appropriations Committee. But I want to say something about the politics involved in all of this.

Social Security is said to be the third rail of politics. We all know that that has been the case in the past. Medicare was said to be a third rail of politics. Catastrophic health care was another third rail of politics. I think the image of senior citizens beating on the rooftop of former Congressman Dan Rostenkowski is probably in the minds of many people in this Congress.

The fact is that the country is riding the third rail of politics. Medicare trustees indicated last year that we need to take action now and not defer action any longer if we're going to maintain the solvency of the Medicare trust fund. Without in any way trying to politicize this particular committee hearing, I must say that it's disappointing that no action has been forthcoming to in fact reign in the growth in spending in the program in order to ensure its solvency.

We can't afford to defer it much longer. I suspect that what's going to happen after the elections, we will see a so-called bipartisan or blue ribbon commission being formed. This commission will resolve what we're either incapable, or unwilling, or lacking the courage to resolve and the same thing may be necessary as far as Social Security itself is concerned. There is no deferring this issue much longer. The longer we wait, it's only going to put that much more pressure on future contributors to the program and beneficiaries as well.

[The prepared statement of Senator Cohen follows:

PREPARED STATEMENT OF SENATOR WILLIAM S. COHEN

Today the Special Committee on Aging is holding a hearing on the future of the Social Security retirement system as we enter the 21st century. As the main plank of President Roosevelt's New Deal economic agenda, Social Security was first created to provide support for retired workers and their dependents, and to protect Americans against a poverty ridden old age.

The size and promises of the Social Security system have grown dramatically since the ink first dried on this legislation. Two decades after passage, the program was expanded to cover workers who became disabled. Another decade passed, and Medicare was created to help pay the health care bills of elderly and disabled Americans.

Now, just over 60 years after its creation, Social Security has become the Nation's largest Federal program, touching the lives of nearly every individual in this country. Social Security pays out over $350 billion—or almost $1 billion each and every day—in benefits.

This year the Aging Committee has devoted much attention to the problems plaguing the disability portion of the Social Security program—namely, the Social Security Disability Insurance Program (SSDI) and the Supplemental Security Income Program (SSI).

As we have revealed in past hearings, the disability caseloads are mushrooming out of control, and have grown nearly 70 percent in the past decade alone. Younger beneficiaries are getting on the rolls younger and very few ever return to work. It is not unusual, for example, for a typical SSDI recipient to spend nearly a third of his or her entire adult life on the disability rolls.

Today's hearing will focus on the other major crisis facing Social Security: the aging of the population and pressures that these numbers will place on the social security retirement system.

By the year 2015 when the baby boomers begin entering their mid-60's, the number of persons receiving benefits will reach over 50 million—or one-third greater than those persons receiving benefits in 1995. By the year 2040, the percent of the U.S. population aged 65 and older will have doubled.

Like the disability program, people will be staying on the rolls longer once they become eligible for benefits, due to their longer life spans. For example, a 65-year-old male who began receiving benefits in 1940 was expected to live, on average, an additional 12 years. By the year 2015, the life expectancy of a 65-year-old male will have increased by over a third, resulting in much higher retirement costs for the Social Security system as a whole.

The crush of baby boomers on the system is intensified further by two factors.

First, the number of workers paying into the system as the baby boomers collect benefits is shrinking. While in 1950 we had over 16 workers paying into the system per beneficiary, 9 years, from now there will be only 2.6 workers paying Social Security taxes for each beneficiary.

Second, the net savings rate of the country has dropped dramatically. As this chart shows, the national net savings rate has dropped by 50 percent over the last 30 years, placing even more pressure on the Social Security system as a major source of retirement income for an aging population.

Despite the inherent political risks, the message is clear: we must do something to fix Social Security, since the program is on the road to insolvency. The Trustees of the Social Security Trust Funds have sounded the alarm that the retirement and disability trust funds will be depleted by the year 2029.

This may seem like light-years away to our channel-surfing, fast-food, short-attention-span society, but if we do not prepare today, the consequences tomorrow, both on individuals and on our economy as a whole, will be catastrophic.

The debate on how to reform Social Security is emerging. Many of these proposals would "privatize" social security, although there is no consensus on what this would mean. Some, pointing to the experience of Chile, would replace the current system entirely with a system of personal investment accounts in which the individual would control his or her own investment decisions for retirement.

Other options would adopt a two-tier system composed of a flat-rate benefit supplemented by a personal savings account or earmark a portion of Social Security payroll taxes for deposit in personal savings accounts.

Still other voices call for an investment board thought would invest Social Security trust funds in the financial markets, rather than giving total control to individuals over investment decisions.

Today we will hear testimony about some major proposals on how to revise Social Security in order to keep the pension promise for millions of Americans, and consider what factors should guide us as we undertake this debate.

First we will hear from my distinguished colleague from Wyoming, Senator Alan Simpson, who, along with Senator Bob Kerrey, served on the Bipartisan Commission on Entitlement & Tax Reform. Senator Simpson and Senator Kerrey have cosponsored legislation which calls for major Social Security reforms.

We will then hear from Michael Tanner of Cato Institute and Paul Hewitt of the Taxpayer Union Foundation, each of whom advocate proposals to privatize Social Security. Robert Myers, a former Chief Actuary of the Social Security Administration, will discuss changes which can be made within the Social Security program to ensure solvency over the long term.

We will also hear from retirement policy experts who will provide us with considerations we should make in guiding our reforms. Eugene Steuerle of the Urban Institute, and Martha Phillips of the Concord Coalition—an organization committed to controlling the growth of entitlement spending—will provide us with criteria they believe are important for reform. Estelle James, an economist at the World Bank, will draw on lessons learned in other countries who have set out to reform their retirement systems. Finally, Paul Yakoboski of the Employee Benefit Research Institute will describe recent findings on the investment experiences of workers who participate in 401(k) plans.

There are major philosophical, economic, and practical issues posed by Social Security privatization and restructuring proposals.

For example,

Who should make retirement investment decisions?

What kind of basic benefit should be provided?

How do we account for poor investment decisions?

How do we deal with a transitional period if we change to a new system?

How can we increase the national savings rate and what is the economic effects of various privatization proposals?

How do we regulate any new system to guard against those who would prey on unsophisticated investors?

While there is no time remaining in this Congress to act on any of these issues, I hope that this hearing, as well as work Senator Simpson has devoted to this issue in the Finance Committee, will set the stage for discussion in the next Congress—and over the dinner tables of America—on how to plan for the retirement of millions of Americans.

Now I'll yield to Senator Reid.

STATEMENT OF SENATOR HARRY REID

Senator REID. Thank you, Mr. Chairman, for holding this hearing.

Social Security is, in my opinion, the original contract with America. It's functioned successfully for some 60-odd years. It's the most important source of income for the elderly, and is received by 92 percent of retirees. It is, in my opinion, what has allowed the seniors in this country to enjoy a quality of life that is beyond comparison in the past.

So we all, I think, intend to maintain the Social Security as an important quality of life issue for senior citizens.

There are numerous proposals as to what we should do about Social Security. We're going to hear from some of these this morning, and I compliment, Mr. Chairman, you and the staff for setting up these panels. Many of these proposals have come from the Social Security Advisory Council, who will soon release its official report.

Some of these proposals include minor adjustments to the current system; investing a portion of the current trust fund in the equity market; or establishing personal savings accounts similar to a 401(k) plan. There is even one proposal which calls for total privatization. Consequences and impacts of any of these proposals are significant.

As such, this debate warrants this committee's careful attention and review. We need to study this issue, as well as the proposed solutions and impacts, before we hastily rush to solve what at this point is appropriately described as a long-term problem.

The future of Social Security and its solvency clearly warrants our attention. Mr. Chairman, I served with our first witness as a member of the Entitlement Commission. It's clear that we have a lot of problems in the entitlement programs in our country. I think that as far as Social Security goes, we've heard the old adage, if it isn't broken, don't fix it. I personally believe there are some things in Social Security that need to be fixed. But we need to make sure that we know what is broke before we start trying to fix it and that's the reason why with this hearing and others like it, we need to focus our utmost attention to.

The Social Security trustees and Medicare trustees have almost every year they've been in existence, in fact, Medicare, the only time they haven't, out of the 27 years we've had Medicare, there has only been 2 years they haven't called for financial rejuvenation. Now, this is not a plea for inaction with Social Security. I think we have to do something. We just have to make sure we do the right thing.

I think that we have to in this hearing explain to current beneficiaries that their benefits aren't in jeopardy. We need to look at this, if we don't do something with this Social Security trust fund, funds, I should say, everyone's going to have some problems. It's important that we address the problems as we see them.

There will be some that may have a tendency to share their perspective in a way that I think scapegoats the elderly, and framing this debate as an intergenerational conflict which benefits seniors at the expense of younger members of our society simply won't work. In the words of the late Claude Pepper, who I had the good fortune to serve with in the House, "These Social Security insurance programs are intergenerational, and all Americans benefit from their success."

So I encourage all, Mr. Chairman, to remember the words of Senator Pepper, and refrain from looking to place blame on a particular group or organization and come together in seeking solutions.

While the Social Security program enjoys a surplus today, this is not a license for current beneficiaries to not participate in the debate. We have a national issue being discussed here that affects future beneficiaries. What better group to be part of the debate than seniors who are the beneficiaries, those who have contributed so much to our society in the past, whose collective expertise has solved so many of our Nation's past challenges.

I again call upon them to offer their expertise and their thoughts and views as we engage in this debate. I believe that all members of the American family, grandparents, parents and children, the public and private sector, advocacy organizations, should pull together, consider all the options and collectively solve this problem by developing a solution that's fair and equitable.

Sure, Mr. Chairman, Social Security may be different in the future than it is today, but so, too, is the world of today different than it was when Social Security was first established 60 years ago. Whatever the outcome of our debate, we owe it to our current beneficiaries, their children, and their grandchildren to protect the vital social insurance aspects of the program. Let us not forget that Social Security insures workers and their spouses and dependents against the possibility of living a very long life, and exhausting their assets. It's also designed to provide some insurance against unforeseen events that interrupt a worker's flow of income, such as disability or death.

Mr. Chairman, I visited a Social Security office a few months ago in North Las Vegas, NV. This was during the Government shutdown. When I went there, the workers were concerned, of course, about the shutdown. But they're concerned about having certain reforms in the program.

One of the things that sticks in my mind is these people were so upset, these workers, about a program that's in existence, I guess all over the country, as part of the Social Security Disability program, where a parent, if they say to the school district, "my child has some learning problems," they can take that to Social Security, they need no doctor's certificate, they need nothing, and they start getting Social Security Disability benefits for those kids. They indicated there are families in North Las Vegas where six kids in a family get, I don't know how much money it was, about $300 a month, tax-free. They feel it's one of the biggest ripoffs in Government, these are the thoughts of people who work in the program.

So we tend to focus on the old age portion of Social Security, and we certainly need to focus on that heavily. But there are other parts of the Social Security program that are simply being abused in the minds of the people who work in the program every day, Social Security employees.

So, Mr. Chairman, Social Security we know protects workers from unexpected events that precipitate early retirement. Social Security has been and in my view must continue to be a viable part of the American story. There's no doubt that some type of reform is clearly needed when looking at the long term solvency of Social Security. The question is, what form should that reform take.

Again, I thank you for holding the hearing, and would ask unanimous consent that my entire statement be made part of the record.

[The prepared statement of Senator Reid follows:]

PREPARED STATEMENT OF SENATOR HARRY REID

Thank you Mr. Chairman for holding this important hearing today. It is appropriate that the Senate Special Committee on Aging conduct this hearing because we, as a Nation, are about to begin a stimulating and lengthy debate on what the future holds in store for our Social Security Program. Seniors, both in Nevada and across this great country, whose voice we represent on this committee, are going to read the papers, see news stories and become concerned about their benefits. We must assure them that we are active participants in this debate by communicating loud and clear the concerns of our senior citizens.

Social Security is a program that is described by many as the most successful social program ever designed. Social Security is the original "Contract with America." It has functioned successfully for more than 60 years, providing the opportunity to retire with dignity after years of hard work for millions of our citizens. Before Social Security, many seniors lived below the poverty line. In 1960, more than one-third of all elderly Americans lived below the poverty line. Today, less than 13 percent of the elderly are poor. This achievement is due to the credit of the Social Security Program. Americans should be proud of this accomplishment. Social Security is the most important source of income for the elderly and is received by 92 percent of retirees. As a result of Social Security and Medicare, and an array of other senior support services, our most senior members of American Society are able to enjoy a quality of life they so richly deserve. I intend to see that this remains the case. From the outset Mr. Chairman, let me state that I fully support the debate on Social Security reforms and encourage all parties with a point of view on this subject to engage actively in this debate. We need to hear from all voices on this issue so we can ensure a comprehensive review is accomplished before we rush to pass any reform legislation. While it is important to hear from the architects of these various reform proposals, let us not forget to listen loud and clear to the beneficiaries themselves in this debate. After all, it's their perspective that will convey to us the strengths and weaknesses of our current program first hand.

There are numerous proposals on Social Security Reform, some of which we will hear about this morning. Many of these proposals have come from the Social Security Advisory Council who will soon release its official report. Some of these proposals include minor adjustments to the current system; investing a portion of the current trust fund in the equity market; establishing personal savings accounts similar to a 401K plan; or even one proposal I've seen which calls for total privatization. The consequences and impacts of any of these proposals are significant and as such this debate warrants this committee's careful attention and review. We need to study this issue, as well as the proposed solutions and impacts, before we hastily rush to solve what at this point is appropriately described as a long-term problem. The future of Social Security and its solvency clearly warrants our attention, but does not in my view warrant a hastily prepared response. I'm reminded of the old adage "If it ain't broke don't fix it." Let's be sure we know what's broke, before we jump to conclusions on what to fix. Seniors in this country deserve to be assured that this is our solemn commitment.

I think it is important to point out from the onset that the solvency of Social Security is in no great immediate danger at this moment. The current system enjoys a significant reserve and this surplus is likely to exist well into the first decade of the 21st century. Mr. Chairman, this is not a plea for inaction, but an attempt to put the current problem in perspective. When the baby boomers begin to reach the retirement age in 2010, this increase in the retiree population will place a strain on the system, and fiscal prudence suggests that we conduct our review now to ensure we are prepared for the shift when it occurs.

I believe we owe it to current beneficiaries from the outset to explain that their benefits are not in jeopardy. This committee has a responsibility to communicate with seniors about issues that directly affect their well-being. The solvency issue we are discussing today really impacts future beneficiaries and the issue is how to make the program solvent in the long term. At some point in the future, modifications to our current Social Security structure will be necessary. I believe these modifications will apply to future beneficiaries and we should do what is necessary to make good on our contract with current recipients. Current projections predict sufficient funds to cover beneficiaries until the year 2030. This gives us time to study the issue and make the right decisions. However, if we fail to begin the debate now, transition or implementation of any changes which may be needed in the future will be more difficult as time progresses. An early start now will significantly reduce the ultimate cost.

Mr. Chairman, there will be some that may have a tendency to share their perspective in a way that scapegoats the elderly, and framing this debate as an intergenerational conflict which benefits seniors at the expense of younger members of our society. In the words of the late Senator Claude Pepper "these Social Insurance Programs are intergenerational and all Americans benefit from their success." I encourage all, Mr. Chairman, to remember the words of Senator Pepper and refrain from looking to place blame on a particular group and come together in seeking solutions. I for one will not sit idle and allow this generational scapegoating to occur. This emphasis on intergenerational conflict is not based on fact and it serves no useful purpose other than to muster support for a particular view and to cause ill-content between generations of our American family. We need honest, fair and intelligent debate on this issue from all, young and old alike.

While the Social Security Program enjoys a surplus today, this is not license for current beneficiaries to not participate in the debate. We have a national issue being discussed here that affects future beneficiaries. What better group to be part of the debate than seniors, those who have contributed so much to our society in the past whose collective expertise has solved so many of our Nation's past challenges. I again call upon them to offer their expertise and their thoughts and views as we engage in this debate. I believe that all members of the American family; grandparents, parents, and children, the public and private sector, advocacy organizations, should pull together, consider all the options and collectively solve this problem by developing a solution that is fair and equitable. Sure, Social Security may be different in the future than it is today, but so too is the world different today than it was when Social Security was first established more than 60 years ago. Whatever the outcome of our debate, we owe it to our current beneficiaries, their children and their grandchildren to protect the vital social insurance aspects of the program.

Let us not forget that Social Security insures workers and their spouses and dependents against the possibility of living a very long life and exhausting their assets. It is also designed to provide some insurance against unforeseen events that interrupt a worker's flow of income, such as disability or death. Social Security also protects workers from unexpected events that precipitate early retirement, such as workforce consolidations. Social Security has been, and in my view must continue to be, a viable part of the American story. There is no doubt that some type of reform is clearly needed when looking at the long-term solvency of Social Security, the question is * * * what form should that reform take?

Mr. Chairman I again thank you for holding this hearing today. I look forward to hearing the testimony of our witnesses and participating in this debate in the coming months. Social Security has many valuable attributes and it is a system in my judgment that is well worth preserving. As we engage in this debate we must not forget that Social Security has protected seniors from economic insecurity since its inception. This must be characterized as a success and whatever we ultimately decide to do, this achievement should be an essential ingredient of any solution.

The CHAIRMAN. It will certainly be included, Senator Reid. Senator Grassley.

STATEMENT OF SENATOR CHARLES GRASSLEY

Senator GRASSLEY. I'd like to take just 60 seconds, now that you're retiring, to thank you for your leadership of this committee. It's been outstanding, and particularly the work that you have done in regard to waste, fraud, and abuse, the work you've done on nursing home standards, the reform of the SSI and SSDI programs. It's just been outstanding.

Obviously, the Congress is going to miss your contribution, the people will, your colleagues will. We thank you for what you've done. Because this Special Committee on Aging has just done outstanding work because of your efforts and that of your excellent staff.

The CHAIRMAN. Thank you.

Senator GRASSLEY. I'm going to put most of my statement in the record, and just give the highlights. I want to highlight the fact that it's never too late to begin the necessary debate over the future of the Social Security system. We know that there's a problem and that the sooner we deal with it, the better.

Of course, given the potential magnitude of the program's long-term financing, it was probably inevitable that the debate would at least begin to discuss privatization. I know that this year, for the first time to my recollection, privatization got significant attention in the news media.

A significant minority of the current advisory council has suggested that individual taxpayers be able to invest their own funds. Others have suggested that money in the trust fund be invested in private instruments rather than T-bills. As a result, there's a healthy debate going on. I think that the advisory council members have contributed very much to that debate in thinking of alternative approaches to the system's future solvency problems.

I, for one, believe that we need to proceed carefully and deliberately and a hearing like this is a step in doing that. We need, particularly, analyses of possible consequences of privatization on beneficiaries, their families, on productivity, financial markets, and the economy more generally, and on the way the Government regulates.

We need to satisfy ourselves that privatization is really required. There is a responsible and respectable body of opinion that believes that such fundamental reform is not really necessary. This line of reasoning holds that there are many smaller steps that could be taken which would put the system on a sound financial footing over the long run, and which would not require major structural changes in the program.

Most of all, we must get the general public, and especially older people, engaged in the debate. Social Security reform of whatever kind is not something that we can begin without strong public backing of what we're about to do.

[The prepared statement of Senator Grassley follows:]

PREPARED STATEMENT OF SENATOR CHARLES GRASSLEY

Thank you, Mr. Chairman.

I have just a few comments.

The Social Security Retirement Program has been with us since 1935. It has been one of our most successful Federal programs, at least so far.

Now, as we look out over the long term and the retirement of the big baby-boom generation—which is just around the corner in 2008 or 2009—concerns are being raised about the financial viability of the system. The most recent report by the Social Security Trustees concluded that the retirement trust fund will be able to pay benefits for about the next 35 years—until the year 2031. At that time, according to their report, the current payroll tax would be able to generate only about 76 percent of benefits payable.

Of course, the problem is going to be on us well before that. In 2012 or 2013 the cash coming into the trust fund from the payroll tax will be less than what is needed to pay benefits. At that point, the administrators of the program have to reach into the Trust Fund. As we all know, the Trust Fund is a collection of I.O.U.'s. As a practical matter, therefore, the Government at that point will have to borrow more money or raise taxes to pay benefits. Thus, the point at which the program begins making substantially greater financial demands on the overall economy comes much earlier than 2031. So a necessary debate has begun over the future of the system.

Given the potential magnitude of the program's long-term financing problem, it was probably inevitable that the debate would turn to privatization of some or all of the program.

I think that this debate over privatization is important and necessary. I would only emphasize, at this early point in the debate, that we need to proceed carefully and deliberately. We need much more analysis of the possible consequences of privatization. On beneficiaries and their families. On productivity, financial markets, and the economy more generally. On the way government legislates and regulates.

We need to satisfy ourselves that privatization is really required. There is a respectable and responsible body of opinion that believes that such fundamental reform is not really necessary. This line of reasoning holds that there are many smaller steps that could be taken which would put the system on a sound financial footing over the long run and which would not require major structural changes in the program.

Most of all, we must get the general public, and especially older people, engaged in this debate. Social Security reform, of whatever kind, is not something we can begin without the public behind us.

The CHAIRMAN. Thank you very much, Senator Grassley.

Senator Warner.

STATEMENT OF SENATOR JOHN WARNER

Senator WARNER. Thank you, Mr. Chairman.

I join others in paying our profound respects to you, and speaking for myself, it will be a sad day when, hopefully, I rejoin the Senate next year and you're not seated next to me, as we have been these many, many years together, particularly on the Senate Armed Services Committee. You've made great contributions to this institution and national security and foreign affairs, and here in the Aging Committee. I've been on and off this committee with you for many years.

I can't think of anything more important. We talk a lot about the future, but let us never turn our eyes off those who enabled us to get to this point, namely our senior citizens, to where we can plan for a future. I see also my other distinguished colleague here Senator Simpson as a witness, we've been together these many years. While I have some general idea what you will say this morning, and I'm not about to say I endorse it fully, I'll wait.

But my concern is, of recent, we've seen across America, and I'm not going to point fingers at either party, scare tactics in connection with Medicare. We're scaring those very people that enabled us, *i.e.*, primarily the seniors, to get where we are today. As we work toward strengthening Social Security, I hope we would all pledge to one another not to indulge in scare tactics. Lay the facts out. Seniors are intelligent. Let them decide for themselves.

I feel that Social Security should have the full faith and credit of the U.S. Government behind it. There should be no greater security attached to the dollar bill than there is to Social Security. But within that framework of full faith and credit, we have an obligation to take into consideration that we're living longer, we're healthier, and that the coming generations are somewhat restive about the burdens that they have to carry. Also they just feel, many of them, that they'll never see a single dollar.

We've got to dispel those thoughts. I don't presume to have all the answers. But let's proceed in a very cautious, fair, open-minded way, and let's stay away from any scare tactics. I commend you for having what I guess will be our last hearing of the committee.

Thanks, Mr. Chairman.

[The prepared statement of Senator John Warner follows along with prepared statements of Senator Pryor, Craig, and Burns:]

PREPARED STATEMENT OF SENATOR JOHN WARNER

Mr. Chairman, I am pleased to join in this morning's hearing as the committee examines options for the future of the Social Security System.

I recall that in the landmark Social Security Reform Amendments of 1983—approved just 6 weeks prior to bankruptcy of the OASDI (Old Age, Survivors and Disability Insurance) Trust Fund—, we were able to refinance the program and restore solvency to the year 2029.

While there are certainly more pressing matters, such as the pending bankruptcy of the Medicare hospitalization fund in the year 2001, it is well that the Congress begin to explore strategies for the long term future of the Social Security retirement system.

I particularly look forward to hearing the remarks of our distinguished colleague from Wyoming, Senator Allan Simpson, Chairman of the Senate Finance Subcommittee on Social Security and Family Policy. Senator Simpson has made a special study of Social Security and other entitlement programs, so we are fortunate indeed to have the benefit of his recommendations.

I have a great deal of respect for the basic premise of Social Security. It is a true social insurance program providing income security for some 43 million Americans, 947,000 of whom are residents of Virginia. The FICA taxes workers pay today establish their entitlement for old age, survivors and disability benefits tomorrow.

It will be the job of future Congresses to assure that the "baby boom" generation, now entering middle age, will one day be able to realize fully the benefit of their long years of payroll taxes. Thankfully, the 1983 Amendments have put in place the necessary rate of FICA taxation to get us to the year 2029.

We therefore have the luxury of time—time to study privatization proposals, broader investment policies and additional retirement vehicles such as IRA's to determine the best direction for the seniors' of the 21st century. This should be a national dialog and one that should be above partisanship at this early stage.

Mr. Chairman, I look forward with anticipation to reviewing the results of today's findings into the future of America's Social Security System.

PREPARED STATEMENT OF SENATOR DAVID PRYOR

Mr. Chairman, thank you for holding today's hearing on the reform proposals of the Social Security Retirement program. Through the years, the committee has demonstrated a commitment to improving these programs and to ensuring their availability for the retirees of the future. That is one of the very vital functions through which this committee serves the Senate and our Nation. It has been my great pleasure to work with you in this area and on other important aging issues.

As we have learned from previous hearings, the aging baby boomer generation, coupled with increasing life expectancy and the declining ratio of workers to retirees, will place unprecedented strains on the Social Security program in the next century. According to a recent GAO report, "Effective Leadership Needed to Meet Daunting Challenges," beginning in 2012, program expenditures are projected to exceed tax revenue. By 2029, without corrective legislation, the trust funds are expected to be depleted leaving insufficient funds to pay the expected level of retirement, survivors, and Disability Insurance (DI) benefits. Mr. Chairman, I believe it is our bound duty to begin to take responsible steps to shore up our retirement sytem—and soon.

Today's witnesses will inform us on a variety of retirement reform options formulated by a broad array of groups. They represent a spectrum of ideas, but it is up to us and future Congresses to assess which of these solutions, or combination of solutions, reflects the best interests of the American population; because, it is possible that no one particular solution is the answer. My colleagues have recently put together the Simpson-Kerrey Retirement-Reform Bills. They should be commended on their effort and courage to better the current retirement program.

In particular, as we continue to move in new directions for solutions, I'm hopeful we will examine Social Security Administration initiatives that have provided for relief when earlier crises have occurred. According to Commissioner Shirley Chater, only 1 in 8 elderly people are living below the poverty line today, as compared to 1 in 3 in 1959. Mr. Chairman, I am confident that Social Security is fulfilling its mission as a base of security for needing Americans. It is, however, in need of programmatic changes coupled with the building blocks of new options for retirement savings.

I feel it is imperative to examine why we are faced with problems we are encountering today. The Social Security Reform Act of 1983 has been criticized as a Band-Aid for a system that needs true reform. That was not our expectation when we approved it. So I hope we can take additional steps to strengthen the Social Security program with a significant reform package that reflects ideas we will hear today, along with the assurance that those reforms will stand the test of time. I hope this can be done without dismantling a program that has not only survived for 60 years, but has also ensured protection for millions of Americans.

I also look forward to hearing about ways in which we can restructure the program so that it creates incentives for independent savings and additional retirement accounts such as 401(k)'s and IRA's so that beneficiaries can take measures to protect themselves along with their Social Security checks.

Social Security was never intended to provide complete retirement protection. While there have always been a number of recipients who are not able to invest independently, a number of them might use independent means to invest, if they receive appropriate education and government incentives to increase personal investment. Clearly, the independence and self-esteem that can result from actively participating in a personal retirement investment plan is a positive step for retirees. It could also reduce Social Security obligations in the future.

Mr. Chairman, as my retirement from this governing body grows near, my role will soon be that of writing correspondence and communicating in a different way with the elected Congress. This hearing is laying important groundwork for thorny decisions that the 105th Congress will encounter. I want to thank all of our witnesses for taking time to be here with us today.

Prepared Statement of Senator Larry Craig

Mr. Chairman, thank you for holding this very important hearing. Today's topic is not only of particular relevance to our elderly population, but of significance to every working American who has paid into our Social Security System.

The modest surplus that the trust fund currently produces is deceptive. Although Social Security is financed a generation into the 21st century, the picture then turns bleak. Unless changes are made, the Social Security System is in danger of being unable to fulfill its commitments in the future, as the baby boom generation reaches retirement age and the pool of eligible beneficiaries skyrockets.

I am deeply concerned that without considering new ways to sustain Social Security, our already over burdened taxpayers—both young and old—will be asked to surrender an even larger portion of their paychecks to support future obligations. In Idaho alone, there are more than 174,000 residents who rely on Social Security Benefits. I know that Idahoans, like most other Americans, can't afford to give up any more of their paychecks to higher payroll taxes.

Many are now suggesting privatization may be a viable option to save the system. They argue that investing in U.S. corporations is not only likely to yield greater revenues but, more important, it would decrease dependency on government revenues for funding.

However, privatization does bring several complex issues to the forefront. It is crucial that any plan to reform the current system avoid potential conflicts of interest, unwanted government influence in the private sector, and overly optimistic assessment of the stock market.

I thank our distinguished witnesses in advance for their help in bringing this issue to the attention of the Senate, and I look forward to hearing about their findings and their recommendations for policy options in the future.

Prepared Statement of Senator Conrad Burns

Mr. Chairman, I thank you for holding this important hearing. It is high time that the future of Social Security is put on the front burner by policymakers and in the real world beyond the Washington beltway. I think most Americans realize we have a problem, judging from the polls which show nearly two-thirds of Americans under 55 have little confidence in the system. But for the most part, Social Security is not yet on the national radar screen. I commend you, Mr. Chairman, for taking on these issues in a bipartisan and straightforward manner.

We are here today because Social Security is in trouble. Now, the danger may not be immediate—not next year or even the next 10 years—but it is imminent, and the time to start developing solutions is now.

The problem is this: although currently Social Security's income exceeds its outgo by about $65 billion, in 2012 the Social Security trust funds will begin losing money, and by 2029 they will be fully depleted and the system will be insolvent. The explanation for this is simple: the aging "baby boomers", lower birth rates, and higher life expectancies are creating an older society. By 2025, the number of people 65 and older is predicted to nearly double. At the same time, the number of workers who finance Social Security is projected to grow by only 17 percent. The result is that the ratio of workers to Social Security recipients is projected to fall from 3.2 to 1 today to 2.0 to 1 in 2030.

So this is the problem we face today. To put it in perspective, Social Security protects more than 141 million workers and pays benefits to 43 million people. As I just noted, these numbers will nearly double early next century.

Our witnesses today will discuss some options for ensuring the long-term soundness of Social Security. We must approach each of these options with an open mind, but we must not lose sight of this ultimate goal: to ensure the long-term health of Social Security while protecting the benefits of retirees, survivors, and the disabled.

I look forward to hearing the following testimony from some of the experts on Social Security. Today's hearing, along with the forthcoming report from the Advisory Council on Social Security, will add to the groundwork on which Social Security reform will be built.

Thank you, Mr. Chairman.

Senator REID. Mr. Chairman.

The CHAIRMAN. Senator Reid.

Senator REID. Just so that, I know you know this, but so everyone in the audience and others, this is not a partisan issue complimenting you. I have, as you know, in these meetings; and on a number of other occasions—

The CHAIRMAN. You've been over-generous in your compliments.

Senator REID. That's what I was afraid of.

But I just wanted the record to make sure it reflected that feelings about you are bipartisan, as they are about our dear friend Alan Simpson. His humor and wisdom on this committee, and as we served for a number of years together on the Environment and Public Works Committee, will certainly be missed.

There are certain statements I'll never forget of Simpson, of course. One was, he walked into the hearing and there weren't seven cameras there. He started his lecture about a seven camera hearing, I'll always remember that.

But anyway, the issue relating to Senator Cohen and Senator Simpson are not partisan in nature. Democrats and Republicans both admire and respect the work that you've done.

The CHAIRMAN. Thank you very much, Senator Reid. Senator Simpson, you'll keep in mind, I think it was Shakespeare's observation that in lapidary inscriptions not under oath, the same might be said for final committee hearings about chairmen and their colleagues who are now departing.

But I appreciate the generosity of what has been offered here.

A couple of quick words before you testify, Senator Simpson. We should make it clear, no one is attempting to fix blame for the potential and future insolvency of the Social Security system. We have to look at those charts at either end of the podium here. The percentage of the people over the age of 65 is going to double. Look at that chart over there and see that our savings have been cut in half and that can spell only great trouble and disaster for future beneficiaries.

Second, we have made some changes in various aspects of the Social Security program. SSI, disability insurance, both of them were filled with fraudulent activities and waste. We have corrected that. Health care fraud was mentioned by Senator Grassley.

I say this because in recognition, I think without this committee's existence, we really wouldn't have dealt with those issues in the way that we have to keep the pressure up. This is not a legislative committee. We do not legislate in this committee. But it has been a forum which has raised the issue of the abuses under the SSI program, the abuses under the disability insurance program, the health care fraud which costs roughly $100 billion out of our total health care system every single year.

If it were not for this committee, I frankly must tell my colleagues, I know there is some disagreement about this, if not for this committee, I don't believe those changes would have been made.

So I hope that following my departure from this Congress that the committee will stay in existence. I hope it will have the support of Republican colleagues. I know that many want to downsize Government and downsize Congress' portion of that reduction. But this is one committee I think that is going to be even more important in the future, as we have an aging population with all the attendant problems. We ought to have one forum where we can try to at least raise the issues, ventilate them, and then make our recommendations known to our colleagues who have legislative functions.

Now, with that said, let me defer.

Senator WARNER. Mr. Chairman, I want it to be noted, I agree with what the Chair has said on this. We're about to receive the wisdom of our distinguished colleague Senator Simpson.

It's too bad we have to wait until we get ready to leave, often, to tell it as it is. But I know you'll do that.

We thank the Chair, those of us that hopefully will stay here will assure you, Mr. Chairman, this committee will remain a viable part of the U.S. Senate.

The CHAIRMAN. Thank you, Senator Warner.

Let me also indicate that we don't have to wait for people to leave in order to tell it like it is. Senator Simpson, I must say, who is not only a member of this committee, but of the Finance Committee, has been a longstanding, I should say tall-standing, advocate for reform on some of the most politically volatile issues that we've ever had to confront. So he's been out there a long time getting his roof tapped upon by a lot of different groups, not only our seniors, but veterans and others. Because he's been pretty much telling it like it is as far as he is concerned.

So this is not a departing display of courage on his part. He's been out there on the front lines for a long, long time.

Senator WARNER. Well, he's one of a kind, Mr. Chairman.

The CHAIRMAN. That's true.

Senator SIMPSON. Is it noon yet?

Senator WARNER. Did I hear corroboration from the other side? [Laughter.]

The CHAIRMAN. You can see why we started a little bit ahead of schedule, before your arrival, to make sure we'd have plenty of time to toss you some accolades.

Senator SIMPSON. Oh, I've loved it.

The CHAIRMAN. We'd love to hear your final departing words. There are armed guards standing at the door to escort you out. [Laughter.]

STATEMENT OF HON. ALAN SIMPSON, A UNITED STATES SENATOR FROM THE STATE OF WYOMING

Senator SIMPSON. Well, Mr. Chairman, my friend, and Senators Grassley, Reid, and Warner, it is a treat to come by. Of course there is a burning question of the day, and that is, where the hell is Kerrey? [Laughter.]

Oh, excuse me. I take that back.

Let me tell you, Bob Kerrey and I have been doing this little road show together for many months. He's a splendid colleague. He's just as rambunctious and partisan as I am.

But the point is, something must be done, and it must be done soon. Not the soul that has spoken here this morning, isn't saying we're going to do something. The only trouble is, we don't do anything.

Now, that's a wonderful bipartisan approach, but that's what's happening: nothing. I have spoken about this for years, during election years of my own, and non-election years. I've been very proud to be a part of this panel. I think Senator Pryor, before you, Mr. Chairman, did yeoman work in the area of fraud and the abuses in the system.

But yes, I've been involved in it. When I came here, my hair was lightly dusted, of luxuriant brownish hue. Now, I'm emaciated and white-haired and eligible for Social Security.

The CHAIRMAN. You haven't changed a bit since the day you arrived. [Laughter.]

Senator SIMPSON. I don't use anything on my hair at all, just hoping it will come back. I have used bag balm on my face at certain times, but that's a different story. [Laughter.]

Let me tell you, in 1 minute you can tell what's happening to Social Security. I could take it now, I practiced law for 18 years, Harry, I remember when Harry was practicing in Wyoming, too, on a case or two. In my most productive years, 18 years practicing law, I never put in over $874 a year, and neither did any gray haired cat in America.

Now, that's what people can't understand. If I were to retire and take Social Security—you and I aren't going to retire, we're just going to reclaim a share of our own lives—if I were to retire, I'll get $1,140 a month. Now, you tell me how it is possible for such a scheme to work. It can't work. You know it and I know it.

Now I'm putting in about $4,500 a year, really getting nailed. But if I wait until 70 and retire, I get $1,540 a month. So does every other gray haired cat my age.

So you can talk all day long, into the vapors, but there's the issue. They say, oh, you can't talk like that, we all put in, it's the great contract, oh, my Lord. Sure it is. But who would ever dream that it would, that you could put in that little and get out that much? It can't succeed. It cannot succeed.

Who's telling us this? Well, there's an interesting group, it comes from Robert Reich, Robert Rubin, Donna Shalala, Shirley Chater, and two public trustees, one a Democrat and one a Republican, saying that Social Security in the year 2029 will be flat broke, and begin its swan song in the year 2012. You know that and I know that. Every one of us in this room knows that.

But of course, then the patter is, oh, we're going to fix it, we'll do it right. Mumble, mumble. There's only two ways to fix it. You either cut the benefits or raise the payroll tax. I guess you could do both, so we'll say there are three choices, three magnificent choices. Cut the benefits back, raise the payroll taxes or a combination of both. There is no other way, none, to escape this.

So there's certainly little need to restate the detailed case for reform. I'll sure put in a plug for Pat Moynihan, who back in the early 1980's chaired the Blue Ribbon Commission to "do something about it." But remember, when they finished, they said they had done something very good and they did. They said that they had made the Social Security system solvent until the year 2063. Do you remember that?

Well, it's only solvent until 2029 now, because they keep moving up the doomsday date about 4 or 5 years every year. We all know that. You know that and I know that.

It is not a partisan issue in any way. It is not an unsubstantiated allegation. It is the truth, and it is in the trustees' report. The reason the extremity is coming is because the baby boomers will be starting to retire, and we have absolutely no idea how to foot the bill for those benefits for them. Oh, the promises are magnificent. But the payroll taxes coming into the system will be inadequate, totally inadequate, to pay for them.

So if we fail to fundamentally transform Social Security, we will have only these two options: cut benefits, raise payroll taxes. Mr. Chairman, there really is something actually worse in the scenario. It's a double whammy. You don't hear anybody talking about this one, and there's no escape from this one. Today's young people between 18 and 40 really are lost in the swamps. The other day some mouth-breathing arthropod with his hat on backwards, looking like this, he said, who speaks for us? I said, why don't you speak for yourselves? We gave you the right to vote when you were 18, and only 15 percent of you use it. Don't come whining around to me. Well, that was an interesting conversation and then he turned, in a note of disdain, turned his hat forward, the bill, and looked at me with evil eyes—well, no, where were we.

So the double whammy is that these fine young people today, and boy, there are plenty of them paying attention now, the Third Millennium, and other groups, very proud of that. At the same time their payroll taxes will have to be raised unless we do something about benefit growth, the Federal Government will be paying off this huge number of IOU's to Social Security. It is secured by the full faith and credit of the United States, which means they're going to have to cough it up some day and that's cash the bonds, and you know that, and I know that.

So when people talk about the money and the Social Security trust funds, what they really mean is a big stack of IOU's, nothing more, nothing less. There is no money in a shoe box. There is no money in your account in a special little slot down there at the system, only a promise backed by the full faith and credit of the United States to pay back the IOU's to Social Security. Where will the Federal Government get the money to do that? One place, general revenues coming into the Treasury, from guess who? Taxpayers. From guess who? The young workers pay payroll tax not the seniors, who don't pay payroll tax. That's who.

So I could specify many more of these dazzling projections for you, but that would take the committee's time. I'll restrain myself.

Instead, I will note the prestige of the witnesses that are here today. I've heard from many of them myself at such hearings as this. Robert Myers, a former Social Security actuary, Martha Phillips of the Concord Coalition, Paul Hewitt of the National Taxpayers Union Foundation and so many other fine people as well, that may agree with me or may not. But they all are very dedicated.

So I have one earnest suggestion for you, old friend. Regarding thoughts to keep in mind as you listen—yes, yes, you young friend. You're much younger than I, well, not that much. But you still could pitch baseball, and I gave that up.

So just one suggestion to keep in mind as you listen to the testimony, and as you prepare questions. The questions you posed at the beginning are good ones. Get those answers. I'll be anxious—not anxious, eager—to see them.

Now, first, this is not a long list. There is a very good reason to be very wary of any and all proposed solutions to the problem that you will hear today. This is the reason why that is so. There is no free lunch. There is no free lunch here. Our aim is to move from a system in which we have no plan for funding tomorrow's retirement benefits and currently stand instead to simply collect them via tomorrow's taxation, and try to move toward a system in which we are more genuinely saving for the future. I know you're going to talk about that, looking at the charts.

That means huge new costs today, got to consume less, got to save more, you will review those. I won't go on, you're going to discuss that. But discuss the burdens placed on American citizens. Be very skeptical, if you will. If a plan promises that there are no new burdens, then it is most likely suggesting that we trade one form of debt for another form of debt. There is no free lunch.

Because of the demands made on the system by the rapid and accelerating rate of aging and the population, the old ways simply won't get us there. Sixteen people were paying into this system when I was at the University of Wyoming, and one person taking out. Today there are three people paying into the system and one person taking out. In 20 years, there will be 2 people paying in and 1 taking out. You know that, and I know that.

Payroll taxes have to climb through the roof to make it all work, and the choices are stark. None of those choices will get us there by itself, but fundamental reform is necessary to avoid this crushing burden.

The Kerrey-Simpson plan is not a proposal for complete overhaul or privatization of Social Security. It is not that. It only goes so far toward that objective as we believe was possible to go, considering existing constraints in the nature of politics. That's why the bill was in eight little packages. Because after they ate up six of them, there still would be something left after they savaged the stack.

Of course, there are several things in it, but of course the big one is to allow 2 percentage points of the current FICA taxes, that's the portion paid by the individual, to be diverted into a personal investment account, PIP. It would be similar to an IRA, a thrift savings plan you're currently in, or the employees' 401(k), and could not be spent by the Government. Why didn't we go further than 2 percent? Because there would be cash-flow problems. Of course there will.

As you begin to divert a larger share of OASDI taxes, for example, 4 or 5 percentage points, you no longer have enough money available to fund current benefits for retirees. We know that, you know that. That means you have to find another tax to pay those benefits. Some would propose to sell bonds to finance those benefits. I'm not here to argue for or against such a proposal.

But remember, when you sell new bonds to finance current benefits, you have another debt instrument in your hands which must be paid off in the future. You know that, I know that. I personally feel if we simply exchange one form of debt for another, we remain in much the same predicament. Thus I believe the only way to reduce the amount of future debts staring at us is to reduce the promised growth and benefits under current law.

There's one provision in there that Bob Kerrey and I thought would be like falling off a log, and that was to do something with the CPI. You know that, and I know that. That was a good bipartisan approach. We would reduce it by half a percent. On the Finance Committee, where I did all my work, we heard every single witness come before us, an endless stream of witnesses, economic experts, telling us that absolutely must reform CPI, as it overstates inflation by anywhere from 0.7 percent to 2.2 percent, and nobody said any different. Nobody, on any side of the issue. The overstatement leads to untold billions going out the window in excess COLA's, and no means testing of COLA's, of course, it would be an evil thing, good heavens, to think that you could—well, enough of that. I won't get into those groups.

But untold billions in excess COLA's are paid to Social Security beneficiaries because of the CPI. It's a technical error, and it must be corrected. It makes no sense to any of us, certainly not to Bob and I, that we should continue to force those who are shelling out the payroll taxes to finance benefit growth far in excess of the intent of the law, simply to perpetuate an acknowledged error.

One half of 1 percent over 7 years on CPI I think is something around $180 billion, or $200 billion off of the deficit. But in 10 years, it's much, much more if you did 1 percent reduction in CPI, 10 years, 1 percent. Then you try to do something with that, and then they talk about breaking the contract and all the stuff that goes with that. I also think we're going to have to make a change in the normal retirement age. We propose to gradually raise it to 70 by the year 2029. Nobody would be hurt in that process. I re-mind everyone here again that this would not affect one penny of benefits for anyone over 50 years of age, not one. The only individuals who would have to wait until 70 to get full benefits are those who are currently going to get nothing from a bankrupt system. Now, that's one we absolutely have to do.

We proposed other changes on the benefit side, in order to ensure there was always enough of a cushion to permit the diversion of the 2 percentage points into the personal accounts. There are very important, philosophical reasons why we felt the need to maintain that feature.

One was that simply, every single traditional solution hurts the very people who currently stand to get a rotten deal out of the system. If you raise the retirement age, which indeed we must do, you effectively reduce the benefits for today's young workers, those who are already being punished severely by the system, many paying in more in Social Security than they pay in income tax. We all know that.

We have a moral obligation to give something back to them. One way would be the personal investment account, which might produce a decent rate on their investment. The other reason, as I conclude, for freeing up at least some of the money into personal investment accounts is simply that this system must get a better return than the eternal investment in T-bills. Eternal T-bill investment is not getting us there. Failing to improve the rate of return means we cut more deeply into the benefit level and take ever more away from those in the system through payroll taxes.

Finally, Mr. Chairman, I hope as these solutions come before you that you will ask them all how they propose to move from today's system into one which accrues more savings for tomorrow. Where will they get the money today to put away to save for tomorrow? Where do these costs fall, on Government, employers or individuals? Can we sustain the costs? Are they politically tenable? If we do not accept those costs today, are we not simply retaining the same debt crisis that currently faces us?

But please ask them, Mr. Chairman, what are the transition costs, what they might be, they will be sizable, and how they should be paid. Should they be paid by reducing the growth of benefits to today's seniors? Now, here's the one that, as I summarize 18 years here, we have a tendency around here to rush to these microphones to say a singular thing, a talisman, the great banner we unfurl, "Seniors today will not be affected." Then the huzzahs and the cheers ring through the city.

Well, I'm sure trying hard to figure that one out. Why are we saying that the only generation that isn't going to take a hit is the living generation which made out the best, which smuggled it out of here in sacks? If you retired in 1980, you got all your bucks back in 2½ years, ladies and gentlemen, and you know that and I know that. Now if you go out, you get it all back in about 6½ years.

I don't understand that. That's not the way it's going to be in the future, but it is the way it was in the past. Those are irrefutable statistics.

That doesn't make much economic or moral sense to me, placing all burdens on young workers who are the most unknowing, the most vulnerable, the most out of touch and not paying attention generation in the history of the world. That has nothing to do with good policy and everything to do with politics, and we certainly ought to stop that one as soon as we can.

Be skeptical, be wary, and this skepticism needs to be heavily applied to the status quo. Because these proposals for reform contain risks and unanswered questions. But the status quo promises certain disaster. Thus even with all the uncertainties of reform we must press forward. Otherwise, we're consigning our posterity to certain bankruptcy. We know that, and they know that.

So I commend you, Mr. Chairman, my old sidekick and this country owes you a great deal. You've brought wisdom and intellect and loyalty and yes, patriotism, too, to this special arena. I have so enjoyed in you many, many ways, and we'll do a little more of that in the future, with these two noble women that have chosen to take up their lot with us, you and I severely over-married. [Laughter.]

We'll continue our good works out in the public venue.

Thank you so much.

The CHAIRMAN. Well, thank you, Senator Simpson, for your typically understated and humorless presentation. [Laughter.]

A couple of quick words about your statement. In addition to either cutting benefits or increasing payroll taxes, the Medicare system, which I think is one example of an abdication of responsibility on the part of the executive branch and the congressional branch, we either have a choice of slowing the growth of Medicare or we can increase payroll taxes by another 40 percent, or a combination of the two, as you've indicated with Social Security. There are no other ways of dealing with Medicare in addition to the Social Security issue.

I take a little bit of heart, however, when we talk about CPI. Because 46 members, I was astonished, but 46 members of the Senate voted for a bipartisan budget proposal which included changes to the CPI. I hope, some evidence of the kind of changes we hope to see in the next Congress with leaders such as the AWOL Bob Kerrey, who couldn't be here today, but who's been by your side for these debates and discussions. That's a remarkable achievement.

Just a few years ago, we had something called the Nunn-Domenici amendment that sought to reign in the growth of entitlement spending. There were only 26 or 27 members who voted for that. Three or four years later, we now have 46 members of the Senate voting for a bipartisan balanced budget proposal, which includes some pretty tough choices, including slowing the growth of Medicare, including cutting back on the CPI one half of 1 percent.

Pat Moynihan, of course, the distinguished Senator from New York, has advocated a full percentage point in the past. But we're in an election year right now, and nothing is going to happen, we know that. But as soon as the election is over, there is not much time that should be wasted in bringing back some of those key players to make those recommendations.

I noticed in today's Washington Post that Secretary Rubin is now talking about T-bills. I think I saw something to the effect of an inflation factor that's going to be built into T-bills now. Maybe we'll index it to inflation. It hasn't been spelled out yet in terms of how that's going to play in the markets.

One quick question, and I'll yield to Conrad Burns, who hasn't made an opening statement. But we talk about public education, and for those in the audience who don't realize this, Senator Simpson is going to be doing at least a 6-month stint at Harvard. Ted Kennedy has pointed out Harvard will never be the same. Harvard will never be the same following Senator Simpson's participation in those hallowed halls. [Laughter.]

But it raises the issue of education and you called upon the Trustees' report to point out that they are aware of the tidal wave of demographics heading toward our shores. You cited the trustees, but I notice that the Commissioner of the Social Security Administration sent out a fact sheet to all the employees after the Trustees' report was issued, and let me just read part of her message.

She said, in 2029 the trust funds will be exhausted. But contrary to what many people think, the Social Security system will not be broke in 2029. In fact, even though we will have spent the principal by that time, payroll taxes will be able to pay for 77 percent of the benefits. She goes on to say that while some changes need to be made in the program, there's ample time to discuss the issues and develop a solution that will have the full support of the American people.

It seems to me that's a little bit of Scarlett O'Hara, don't worry, we'll take care of it some time tomorrow. GAO, by the way, just issued a report, it came out in September, which looks at that kind of attitude. It says, "we are concerned that the Social Security Administration has not seized the opportunity as an independent agency to speak out on the importance of addressing long term financing issues sooner rather than later. As we've noted in our previous work, the sooner action is taken to resolve the future funding shortfall, the smaller the changes in the system will be needed, and more time individuals will have to adjust their financial retirement plans."

Here we have the Commissioner of an independent agency saying, it may be broke, but don't worry. We'll still have enough payroll taxes to take care of 77 percent. Do you have a reaction to that?

Senator SIMPSON. Well, Mr. Chairman, that is a very sad situation and this lady, who is a very pleasant and wonderful person, will never be confirmed by this body, because she will not tell us what to do. I think that there are others of both parties who will, so this is not a partisan thing, I can assure you, I have sat and listened to her testify, and Senator Moynihan and all of us on the panel say, what is it you are recommending? Because you know better than anyone in the world what needs to be done, you are the commissioner, acting commissioner should be the phrase, because she has not been confirmed and she will not be. It won't matter whether I'm here or not.

Because we made the Social Security Administration an independent agency, within the executive branch and separate from the legislature. She insists that she still has some fealty toward the executive branch. We don't. She tells us nothing, absolutely nothing. Then she is spreading an educational package through the school systems, in a great big folio, about how the children of America should just relax, that nothing's going to happen, and they are the ones being stuck. It is beyond my comprehension how you can do that and do it under the auspices of the Federal Government.

So this is, that is one of the great puzzlements of my time here, was to see Commissioner Shirley Chater, and if she were here today, maybe she is, I have not turned, if she were here today, she would be as pleasant and courteous and articulate as you can imagine, and never tell you a thing. Not a thing about what should we do, what would you recommend to us, you know better than anybody, what is it? She would just say, we're going to take care of it, it's going to be slow, it will be incremental, but how are you going to do it?

I know politics, and this is a tough political year here. But it was the same 2 years ago. It is very unfortunate that we have that happening, and very sad.

The CHAIRMAN. Senator Burns.

Senator BURNS. Thank you, Mr. Chairman.

I don't want to get ahead of my colleagues who beat me here. I just have a statement I want to put in the record.

I want to thank my good friend and neighbor from Wyoming for today. I like it when most of us in politics, we want to do something about this, we know the urgency, we know the problem and it carries with it great urgency. But it's kind of like running a track, I suppose, we all race up there to the starting line, we stick our feet in the blocks, a guy shoots the gun and nobody leaves because of the political land mines that are around that track, so to speak.

But you've chosen to run that track, and I congratulate you for it.

If I could just ask a couple of questions. There's two different bills, Senator Simpson, 824 and 825. One of them is the mandatory 2 percent checkoff out of your FICA, and one is a voluntary. Would you just give me your version, are there any other differences in those bills, or just one mandatory and one voluntary?

Senator SIMPSON. Senator Burns, I don't remember numbers of bills, but if one of those is in the package——

Senator BURNS. I don't remember which is which, either.

Senator SIMPSON. If one of them is in the Simpson-Kerrey package, there were eight bills, there were seven separate bills and then a very comprehensive umbrella bill. But ours is a 2 percent, and they would choose to enter that by reduction of, instead of paying 6.2 percent payroll taxes, 2 percentage of points would go into this personal investment account, which is inherited by their heirs.

Senator BURNS. That means of the 6.5 percent they're taking, in other words, 4.5 percent is going to go into the pot?

Senator SIMPSON. No, a third. In other words, we're taking, when we say, I think there's a 6.2 percent and we're saying that one-third of that would go into the personal investment account, in other words, 2 percent of the increment.

Senator BURNS. My statement is, you're going to be missed here, especially on this issue, and we wish you happy trails and all that. I'll see you in Cody, WY. I'll venture down there about the 4th of July.

Senator SIMPSON. There are people still looking for you about those horses you sold them there about 20 years ago. [Laughter.]

Senator BURNS. That's the reason I don't show up any day but the 4th of July.

Senator SIMPSON. Come on the 4th.

Senator BURNS. You've got to check your gun before you get to town. [Laughter.]

Senator SIMPSON. Let me just say a final thing. It's been wonderful serving with you all, and I'm going to teach a course at Harvard, of course it's not just a fellowship, this is a visiting professorship, I hope you have the full extent of that, the appropriate stipend. I'm preparing a syllabus, whatever the hell that is. The course is entitled The Creating of Legislation, Congress and the Press. [Laughter.]

I can't wait.

But I tell you what I'm going to tell them probably the first day. I'm going to say, you're the best in the world in one of the finest institutions in the world, and if all you're doing is training yourself to knock on those of us who do this kind of work, you'll be picking grit with the chickens when you're 65. [Laughter.]

Because if all they do is come out of these marvelous institutions and make fun of the Kennedys of the world or the Simpsons of the world or the Reids, the Cohens, the Grassleys, or the Burns, or the Warners of the world, and think they are accomplishing something, they are accomplishing nothing. They'd better get off their cans and get in the game and participate in this rambunctious life of politics, instead of just sitting there with a supercilious and cynical grin and saying nothing works. Get in the game. Get wet all over. It won't cut it just to sit it out. They're going to hear a lot of that theme from this professor.

Senator BURNS. Anything about a gazoo in that course?

Senator SIMPSON. No, that's the name of my book. It's coming out. You're an author. I've only done one, and it will be the last one. The title of that book is, In The Old Gazoo, Observations from a Lifetime of Scrapping With the Press. The first blank page says, gazoo, noun, slang, south end of a horse going north. [Laughter.]

It's not a bitter book, but it certainly does stick it in their ear. [Laughter.]

The CHAIRMAN. You're not through yet.

Senator REID. Before you leave, a couple of rapid fire questions. Senator Simpson, you tell us what you think, three or four things we should do for Social Security.

The CHAIRMAN. The expurgated version, please.

Senator SIMPSON. No, Harry, I would immediately do something with the CPI. I would just say CPI minus half, minus half a percent. Just do that one. Forget what the shrieking is going on with the senior groups, and I'm not naming the singular name you thought I would today. Just silence them and go ahead and say, here's the testimony of every single witness that said this is overstated. Do that one. CPI minus one half of 1 percent.

Then raise the retirement age incrementally from 65 to 70 for regular retirement, and from 60 to 65 for early retirement, recognizing there are people, we're not talking about coal miners. Somebody always comes up and says, how can you do that to people who really grub it out? I say, we're not talking about them, we can make those adjustments.

Then the personal investment account I think is very important. For heaven's sakes let's do something with the COLA. If we can't do something with the cost of living allowance, and what Bob and I are suggesting is that the lowest 30 percent of people in society will get a full COLA, and then everybody else will receive no more than that dollar amount. In other words, if the full COLA for the lowest 30 percentile is, I don't know what the figure might be, then the guys who are loaded up at the top aren't going to get any more than that dollar amount.

Then even though it doesn't have anything to do with Social Security, it has a lot to do with getting the Government back on its feet, and that's means to begin test Part B premiums on Medicare. That is the phoniest thing I have ever seen in all of public life, where right now you have a situation where the beneficiary is paying 25 percent of the premium for Part B and the people working in the kitchen at the Senate dining room are paying 75 percent of the premium, and we haven't done a thing about it.

We tried to in committee, in a bipartisan way. Splendid, but that one, that's the phoniest one of all. You've got guys paying $60 a month, or $80 a month, for their premiums. If you stuck them for the whole load, stick them for the whole load of the premium, it would be about $180 or $190 a month. These are people who, you know, drive a BMW to Perkins Restaurant to get the 10 percent off. They drive you crazy.

So it's sad, that one has to be corrected. Then we have to do something about our own pensions. Now, grab on—they won't let us get away with this one unless we do something. So Bob and I are suggesting we change the accrual rate, it's a small thing. But you can't do this to the American people and not do it to yourselves. It means that the pension in the future would drop about 40 percent. But I leave here after 18 years with a very tidy pension, adding my military service in the infantry. It's stunning and every year I guess if there's a COLA I'll get that.

It doesn't fit. It doesn't work.

The CHAIRMAN. Senator Grassley.

Senator GRASSLEY. In your bill, you set up a personal investment account into which people can set aside 2 percent of their payroll tax obligation. In your discussions leading up to that legislation, how do you deal with the inevitable problems that many people may mismanage their account or be just plain unlucky, and then eventually, particularly if that's on a fairly large scale, they are going to be coming back to the Federal Government demanding to be made whole? Did you think about that, and if you thought of it, what did you think about it?

Senator SIMPSON. Well, we did, Chuck and we thought about it, we also looked into the Chilean plan in Chile. People talk about it a lot, and they say, why don't we do that. Well, there's a lot of difference between Chile and the United States of America with regard to the "privatization" and investment aspect of it with an average individual income of $3,200 in Chile versus this one here. We did talk about it and it's one of the questions we asked. We say there will be people, for every one that ever talked to you or me about making a killing in the market, there are as many people who say, I lost everything in the market.

So we would hope, and that's why you see the investment community really banging this thing. I'm amazed how they are running ads in every single paper about privatization, because they know what it means to them. They will be the advisors to these people, and that's what will happen in my mind. You'll say, OK, now we're taking a third of your payroll tax and putting it into a personal investment account, and it's all yours. You have to make the decisions as to whether to put it in T-bills or equities or bonds and they're going to look at you and say, I don't even know what you're talking about.

At that point, they will go to investment bankers and investment counselors. Yes, they will. Those that don't could get really burned and eventually come back to be a burden on us. You're very right.

Senator GRASSLEY. The last question I would ask would pick up on something I said in my opening statement about the necessity of involving the public in this debate, if we're to be in a position to accomplish everything that needs to be done. Is it your suggestion that that be done, or is the situation so bad you don't worry about public involvement, just go ahead and do it?

Senator SIMPSON. Well, knowing your history of service to Iowa and knowing your popularity, and you take tough decisions, and having campaigned with you and found out that you got more votes than Ike Eisenhower, I'm not worried about you out there telling them what they need to know.

But it seems to me that we do, we must stop the Commissioner of Social Security sending out these huge leaden notebooks to the teaching community in America to tell them that all is well. That's got to stop. That's a good educational process right there, to stop her educational process immediately, if there is a way.

Then these groups, like the Third Millennium and other groups, who are young people, who are not anti-senior, they're simply pro young people and they're trying to tell a story. But I think as Bill says, that vote of 46, and that was 24 Democrats and 22 Republicans, that's what has to be done, and just join hands and lead the American people. That's the nascent beginnings of leading the American people, and that's what we're supposed to do here.

The CHAIRMAN. Senator Simpson, we have breached all the rules by keeping you here almost 45 minutes testifying. But it's a real tribute to the high regard and affection that we have for you. You have been the top matador in perhaps the greatest bull ring in the world. I mean that in its most sincere interpretation. You've been the chief bull fighter over the years. We're going to miss you a great deal, and I look forward to visiting you occasionally at the groves of academia at Harvard.

Senator SIMPSON. Do come on up, please do. Maybe we can get to the Moscow Circus again. That was interesting in itself.

Harry, thank you.

Senator REID. Mr. Chairman, I know that everyone has instructed us not to say these words. I just wanted to utter these letters as he left. A–A–R–P. [Laughter.]

Senator SIMPSON. Thank you, Harry. I had hoped someone would bring them up. Just wherever I mention seniors, insert that in the record. [Laughter.]

The CHAIRMAN. Next we're going to hear testimony from three witnesses who will describe their approaches to reforming the Social Security retirement program. We have with us Michael Tanner of the CATO Institute, who will discuss the merits of fully privatizing Social Security. Paul Hewitt, of the National Taxpayer Union Foundation, will focus on his organization's National Thrift Plan, that proposes a 5 percent individual personal investment account. Finally, we have Robert Myers, a former chief actuary of Social Security and a member of the National Academy of Social Insurance, who will testify about how to maintain the current security program with moderate adjustments.

Mr. Tanner, why don't you begin.

STATEMENT OF MICHAEL TANNER, DIRECTOR OF HEALTH AND WELFARE STUDIES, CATO INSTITUTE

Mr. TANNER. Thank you, Mr. Chairman, members of the committee.

I do appreciate the opportunity to address you today on what I think is going to be one of the big ticket items in the next few years that's going to face this country. It's always a daunting task to follow Senator Simpson, who is such an eloquent spokesman, and together with Senator Kerrey, has really provided incredible courage and leadership on this issue. Those of us who want to see changes in Social Security are very grateful to them for having taken a leadership role in this.

I want to start off by saying that although I favor privatization of Social Security, I do not criticize or attack Social Security. Social Security has done a wonderful job for 61 years now, and has done largely what it set out to do, which is to reduce poverty among the elderly and enable them to retire with dignity.

But to say that it's worked in the past does not mean that it will work in the future the same way. I sort of liken it to the gentleman who jumped off the top of the Empire State Building and as he was falling, people could gather at the windows on each floor and watch him go by. As he passed at each floor, they heard him say, well, so far, so good.

The problem, of course, is that at the bottom, you get a big splat, and the fact is, with Social Security, we are facing a big splat. It is coming much sooner than we commonly believe.

As Senator Simpson pointed out, we focus on 2029, the latest date that the Social Security trustees say the system will be insolvent. This is actually the eighth time in the last 10 years that they've lowered that date down to 2029 now. But the real problem begins as early as 2012, or in some scenarios as 2010, when Social Security begins to pay out more in benefits than it is bringing in revenue.

The trust fund consists essentially of IOU's and an accounting entry representing interest. While we can say that that's backed by the full faith and credit of the Federal Government, the fact is you will have to find money out of general revenues in order to make good on either the interest at the beginning and then ultimately the principal on those bonds. That is going to entail a tax increase on working Americans.

But the other point I want to make is that just focusing on solvency alone is not sufficient when dealing with Social Security. Because it is possible through cutting benefits or raising payroll tax to keep a system solvent.

But you have a second problem with Social Security, and that is, increasing Social Security is simply a bad deal for today's workers in terms of a retirement system. The fact is, as Senator Simpson pointed out, someone who retired in 1980 did very well under Social Security. Someone who retires this morning will receive back a rate of return on their Social Security taxes of a little over 2 percent.

But the young person who is out there today working, a 20-year-old or 25- or 30-year-old, is actually going to receive a negative rate of return on their Social Security taxes. As you point out, 71 percent of Americans pay more in Social Security taxes than they do in their Federal income taxes. So this is a very substantial investment they are making. They are actually going to receive back less in Social Security than they are paying into the system.

Proposed changes such as raising the retirement age, reducing COLA growth, reducing benefits in any way, while they probably should be done, will make that problem worse, as will raising the payroll tax.

I believe there is a better alternative to any of these proposals, and that is privatization, allowing people the freedom to invest their Social Security taxes in financial assets such as stocks and bonds. Essentially, a privatized Social Security system would be a mandatory savings program. The 10.52 percent payroll tax that is the current combined employer-employee contribution to OASI would be redirected to a Personal Security Account, chosen and owned by the individual employee.

Personal Security Accounts would operate much like current IRA's or 401(k)'s. Individuals would not be allowed to withdraw the money prior to retirement, and the money would be the property of the individual, and upon death, if they choose, that type of withdrawal program, any funds would be part of the individual's estate, or they could choose an annuity, in which case there would not be any residue.

PSA's would be managed by private investment industry, the same way that 401(k) plans are today, and individuals would be free to choose the fund manager that best meets their individual needs, and could change managers whenever they wish. The Government would establish regulations on portfolio risk to prevent speculation. You couldn't invest in Singapore derivatives, for example. But otherwise, they would simply have the role of requiring some sort of guarantee of solvency of the fund.

The Government would continue to guarantee a minimum pension benefit, but that would be done as a welfare function and be funded out of general revenues, rather than a regressive payroll tax.

I should also just simply say that the idea of privatizing the public pension system is neither new nor untried. Where privatization has been properly implemented, it has been remarkably successful. We can turn to the example of Chile as probably the first and best example of this. Chile's Social Security system predated ours, it actually started in 1926, before ours did. But by the late 1970's, its benefit payments were greater than its taxes, and it had no funded reserves. It then chose to privatize its system rather than to tinker with it through payroll increases and benefit cuts.

After 15 years of operation, Chile's experiment has proven itself. Pensions in the new private system are already 50 to 100 percent higher than they were in the state-run system. The resources administered by the private pension funds amount to $25 billion, or around 40 percent of Chile's gross national product.

By improving the functioning of both the capital and the labor markets, pension privatization has been one of the key reforms that has pushed the growth rate of the economy upward from the historical 3 percent a year to 7 percent a year on average during the last 10 years. The Chilean savings rate has increased to 27 percent of GNP, and the unemployment rate has decreased to 5 percent since the reform was undertaken.

The Chilean system operates much the way I just described the current system, or the proposed system for the United States. Under the Chilean system, what determines a worker's pension level is the amount of money he accumulates during his working years. He automatically has 10 percent of his wages deposited by his employer each month in his own individual account. He may contribute an additional 10 percent of his wages each month if he wishes, as a form of voluntary savings on a tax deductible basis. But generally a worker will contribute more than 10 percent of his salary if he wants to retire early, or if he wishes to obtain a higher pension.

The worker can choose from about 13 to 14 private pension fund administrators, there's free entry into the system. The number of pension fund administrators varies anywhere between 12 and 20, depending on mergers and other things that go on. But right now, there's about 14 private pension fund administration companies that manage this money. Each company operates the equivalent of a mutual fund and invests in stocks and bonds and other investments.

Investment decisions are made by the managing company, not the individual worker. He's not required to sit there with his equivalent of the Wall Street Journal and choose between General Motors and General Electric. The government regulations sets a maximum percentage for limits to ensure that there is a diversified portfolio. Workers are free to move from one company to another, so the companies compete based on higher return investment, better government service, or lower commissions.

This system has resulted in lower payroll taxes, higher pension rates, and an improved economy. In fact, if we followed the Chilean example, Martin Feldstein estimates that in the United States, the combination of improved labor market incentives and the higher real return on savings would result in a net present value gain of more than $15 trillion to the U.S. economy, equivalent to a permanent addition of 3 percentage points to the U.S. gross domestic product.

I would add that the Chilean reforms are now seen as such a huge success that they are being copied all over the world. Argentina, Peru, Colombia, Uruguay, and Mexico have all moved to a

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Chilean style system. In Europe, Britain has allowed people to opt out, has essentially a two-tier system in which there is a floor benefit and then people are allowed to opt out of the upper tier. Some 70 percent of Britons have opted out of the upper tier and are now in private accounts.

Italy has begun to privatize some aspects of its Social Security system. Estonia is moving toward a private Social Security system. Even Croatia is beginning to move in this direction. So we're seeing this all over the world. Much of Southeast Asia has a different form of a private system called a provident fund, which is evident in Singapore, Malaysia, and elsewhere.

Let me just suggest in closing that the alternatives, that while privatizing Social Security certainly entails risks, the alternatives are worse. Raising the payroll tax, and we're talking a substantial payroll tax increase of anywhere from between 3 to 10 percent, depending on which scenario you use, cutting benefits by as much as a third, or a combination of the two, is I think unacceptable to most young Americans today. It would simply make a bad deal worse.

Allowing the Government to take the money in the trust fund, assuming you can find actual money there, and invest that directly would allow the Government to become the owner of a majority of almost every major corporation in America, which entails substantial risks, in my opinion. In addition to huge social investing problems, after all, do you allow the trust fund to invest in tobacco stocks? Do you allow it to invest in companies that do business in Cuba, or make nuclear weapons, or don't have union labor, and on, and on, and on.

Given all those problems, I believe the only alternative you're left with that can assure that tomorrow's young worker will be able to retire with the same dignity that his parents and grandparents did is privatization.

I thank you very much.

[The prepared statement of Mr. Tanner follows:]

Testimony of

MICHAEL TANNER
Director of Health and Welfare Studies
Cato Institute

before the

SENATE SPECIAL COMMITTEE ON AGING

September 24, 1996

Mr. Chairman, distinguished members of the committee:

Thank you for the opportunity to appear before this committee and address one of the most important questions facing this country today: whether today's young workers will have the same opportunity for a dignified retirement as do today's seniors.

I do not want to begin by attacking Social Security. For 60 years, Social Security has largely accomplished its goal. It has significantly cut poverty among the elderly and enabled them to retire with dignity. But despite all the good that Social Security has accomplished, the system now faces irresistible demographic and fiscal pressures that threaten the future retirement security of today's young workers. Only by moving to a system of privately-invested, individually-owned accounts can a system of secure retirement be preserved.

Just a couple of months ago the Social Security system's Board of Trustees reported that the retirement system will be insolvent by 2029, down from 2030 in last year's report. This represents the eighth time in the last 10 years that insolvency date has been brought forward. But focusing exclusively on that date is misleading. The implication is that Social Security's financing is fine until 2030, at which point benefits will suddenly stop. The reality is much more complex.

Currently, Social Security taxes bring in more revenue than the system pays out in benefits. The surplus theoretically accumulates in the Social Security Trust Fund. However, the situation will reverse as early as 2012. Social Security will begin paying out more in benefits than it collects in revenues. To continue meeting its obligations, it will have to begin drawing on the surplus in the Trust Fund. However, at that point, we will discover that the Social Security Trust Fund is really little more than a polite fiction. For years, the federal government has used the Trust Fund to disguise the actual size of the federal budget deficit, borrowing money from the Trust Fund to pay current operating expenses and replacing the money with government bonds.

Beginning in 2012, Social Security will have to start turning in those bonds to the federal government to obtain the cash needed to finance benefits. But the federal government has no cash or other assets with which to pay off those bonds. Of course, the Social Security insists that those bonds are safe, comparing them to the government bonds in private investment portfolios. Those bonds are backed by the full faith and credit of the U.S. government. But this is irrelevant.

Pretend for a moment that there was no trust fund and no bonds. What would happen in 2012? The government would have to raise taxes to continue paying promised benefits. Now, consider what will happen with the trust fund. The government will have to raise taxes to make good on the bonds to continue paying promised benefits. Either way, the government can only pay benefits by raising taxes--or borrowing and running bigger deficits.

Even if Congress can find a way to redeem the bonds, the Trust Fund surplus will be completely exhausted by 2029. At that point, Social Security will have to rely solely on revenue from the payroll tax. But such revenues will not be sufficient to pay all promised benefits. If the government is going to make good on all the promised benefits under both Social Security and Medicare, payroll taxes will have to be increased to between 28 and 40 percent.

Social Security's financing problems are a result of its fundamentally flawed design, which is comparable to the type of pyramid scheme that is illegal in all 50 states. Today's benefits to the old are paid by today's taxes from the young. Tomorrow's benefits to today's young are to be paid by tomorrow's taxes from tomorrow's young.

Because the average recipient takes out more from the system than he or she paid in, Social Security works as long as there is an ever larger pool of workers paying into the system compared to beneficiaries taking out of the system. However, exactly the opposite is happening.

Life expectancy is increasing, while birth rates are declining. As recently as 1950, there were 16 workers for every Social Security beneficiary. Today there are only 3.3. By 2030, there will be fewer than two. The Social Security pyramid is unsustainable.

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

There is a better alternative. Social Security should be "privatized," allowing people the freedom to invest their Social Security taxes in financial assets such as stocks and bonds. A privatized Social Security system would essentially be a mandatory savings program. The 10.52 percent payroll tax that is the combined employer-employee contribution to OASI, the Old-Age and Survivors Insurance portion of the Social Security program, would be redirected toward a Personal Security Account (PSA) chosen by the individual employee.

PSAs would operate much like current Individual Retirement Accounts (IRAs). Individuals could not withdraw funds from their PSAs prior to retirement, determined either by age or PSA balance requirements. PSA funds would be the property of the individual, and upon death, remaining funds would become part of the individual's estate.

PSAs would be managed by the private investment industry in the same way as 401k plans or IRAs. Individuals would be free to choose the fund manager that best met their individual needs and could change managers whenever they wished. The government would establish regulations on portfolio risk to prevent speculation and protect consumers. Reinsurance mechanisms would be required to guarantee fund solvency.

The government would continue to guarantee a minimum pension benefit. The minimum pension could be set to a benchmark such as the minimum wage. If upon retirement the balance in an individual's PSA was insufficient to provide an actuarially determined retirement annuity equal to the minimum wage, the government would provide a supplement sufficient to bring the individual's monthly income up to the level of the minimum wage.

Given historic rates of return from the capital markets, even minimum wage earners would receive more than the minimum from the new system if they participated their entire working lives. Therefore, in the absence of a major financial collapse, the safety net would be required for few aside from the disabled and others outside the workforce.

The idea of privatizing a public pension system is neither new nor untried. Where privatization has been properly implemented it has been remarkably successful. One of the best examples is the experience of Chile.

Chile's social security system predated ours, having started in 1926. By the late 1970s its benefit payments were greater than its taxes and it had no funded reserves. On the advice of Milton Friedman and other free-market economists, Chile decided to privatize its system.

After 15 years of operation, Chile's experiment has proven itself. Pensions in the new private system already are 50 percent to 100 percent higher than they were in the state-run system. The resources administered by the private pension funds amount to $25 billion, or around 40 percent of GNP as of 1995. By improving the functioning of both the capital and the labor markets, pension privatization has been one of the key reforms that has pushed the growth rate of the economy upward from the historical 3 percent a year to 7 percent on average during the last 10 years. The Chilean savings rate has increased to 27 percent of GNP, and the unemployment rate has decreased to 5 percent since the reform was undertaken.

Under Chile's PSA system, what determines a worker's pension level is the amount of money he accumulates during his working years. Neither the worker nor the employer pays a social security tax to the state. Nor does the worker collect a government-funded pension. Instead, during his working life, he automatically has 10 percent of his wages deposited by his employer each month in his own, individual PSA.

A worker may contribute an additional 10 percent of his wages each month, which is also deductible from taxable income, as a form of voluntary savings. Generally, a worker will contribute more than 10 percent of his salary if he wants to retire early or obtain a higher pension.

A worker chooses one of about 20 private Pension Fund Administration companies to manage his PSA. Each company operates the equivalent of a mutual fund that invests in stocks and bonds. Investment decisions are made by the managing company. Government regulation sets only maximum percentage limits both for specific types of instruments and for the overall mix of the portfolio; and in the spirit of the reform, those regulations are to be reduced with the passage of time and as the companies gain experience. There is no obligation whatsoever to invest in government or any other type of bonds.

Workers are free to change from one company to another. For that reason there is competition among the companies to provide a higher return on investment, better customer service, or a lower commission. Each worker is given a PSA passbook and every three months receives a statement informing him of how much money has accumulated in his retirement account and how well his investment fund has performed. The account bears the worker's name, as his property, and will be used to pay his old age pension (with a provision for survivors' benefits).

A worker who has contributed for at least 20 years but whose pension fund, upon reaching retirement age, is below the legally defined "minimum pension" receives a pension from the state once his PSA has been depleted. What should be stressed here is that no one is defined as "poor" a priori. Only a posteriori, after his working life has ended and his PSA has been depleted, does a poor pensioner receive a government subsidy. (Those without 20 years of contributions can apply for a welfare-type pension at a much lower level.)

The PSA system also includes insurance against premature death and disability. Each company provides that service to its clients by taking out group life and disability coverage from private life insurance companies. That coverage is paid for by an additional worker contribution of around 2.9 percent of salary, which includes the commission to the managing company.

Upon retiring, a worker may choose from two general payout options. Under one option, a retiree may use the capital in his PSA to purchase an annuity from any private life insurance company. The annuity guarantees a constant monthly income for life, indexed to inflation, plus survivors' benefits for the worker's dependents. Alternatively, a retiree may leave his funds in the PSA and make programmed withdrawals, subject to limits based on the life expectancy of the retiree and his dependents. In the latter case, if he dies, the remaining funds in his account form a part of his estate. In both cases, he can withdraw as a lump sum the capital in excess of that needed to obtain an annuity or programmed withdrawal equal to 70 percent of his last wages.

In contrast to company-based private pension systems that generally impose costs on workers who leave before a given number of years and that sometimes result in bankruptcy of the workers' pension funds--thus depriving workers of both their jobs and their pension rights--the PSA system is completely independent of the company employing the worker. Since the PSA is tied to the worker, not the company where he works, the account is fully portable. The problem of "job lock" is entirely avoided.

One challenge is to define the permanent PSA system. Another is to manage the transition to a PSA system. In Chile there were three basic rules for the transition:

1. The government guaranteed those already receiving a pension that their pensions would be unaffected by the reform. That was important because it would be unfair to the elderly to change their benefits or expectations at this point in their lives.

2. Every worker already contributing to the pay-as-you-go system was given the choice of staying in that system or moving to the new PSA system. Those who left the old system were given a "recognition bond" that was deposited in their new PSAs. That bond reflected the rights the worker had already acquired in the pay-as-you-go system.

3. All new entrants to the labor force were required to enter the PSA system. The door was closed to the pay-as-you-go system because it was unsustainable. This requirement assures the complete end of the old system once the last worker who remains in it reaches retirement age (from then on, and during a limited period of time, the government has only to pay pensions to retirees of the old system). That is important because the most effective way to reduce the size of government is to end programs completely, not simply scale them back so that a new government may revive them at a later date.

The financing of the transition is a complex technical issue, which each country must address according to its own circumstances. Chile used five methods to finance the short-run fiscal costs of changing to a PSA system:

1. On the state's balance sheet (which showed the government's assets and liabilities), state pension obligations were offset to some extent by the value of state-owned enterprises and other types of assets. Therefore, privatization was not only one way to finance the transition but had several additional benefits such as increasing efficiency, spreading ownership, and depoliticizing the economy.

2. Since the contribution needed in a capitalization system to finance adequate pension levels is generally lower than current payroll taxes, a fraction of the difference between them can be used as a temporary transition tax without reducing net wages or increasing the cost of labor to the employer.

3. Using debt, the transition cost can be shared by future generations. In Chile roughly 40 percent of the cost has been financed by issuing government bonds at market rates of interest.

4. The need to finance the transition was a powerful incentive to reduce wasteful government spending. For years the budget director had been able to use this argument to kill unjustified new spending or to reduce wasteful government programs.

5. The increased economic growth that the PSA system promoted substantially increased tax revenues, especially those from the value-added tax. Only 15 years after the pension reform, Chile is running fiscal budget surpluses.

Since the system began to operate on May 1, 1981, the average real return on investment has been 12.8 percent per year (more than three times higher than the anticipated yield of 4 percent). Of course, the annual yield has shown the oscillations that are intrinsic to the free market--ranging from minus 3 percent to plus 30 percent in real terms--but the important yield is the average one over the long term.

Pensions under the new system have been significantly higher than under the old, state-administered system, which required a total payroll tax of around 25 percent. The typical retiree is receiving a benefit equal to nearly 80 percent of his average annual income over the last 10 years of his working life, almost double the U.S. replacement value.

The new pension system, therefore, has made a significant contribution to the reduction of poverty by increasing the size and certainty of old-age, survivors, and disability pensions and by the indirect, but very powerful, effect of promoting economic growth and employment.

What would happen if the United States followed Chile's example? The benefits to the U.S. economy would be substantial. The U.S. savings rate, the lowest in the industrialized world, would increase dramatically. In addition, the movement of so much capital into private markets would have a significant impact on economic growth. Harvard professor Martin Feldstein, for example, estimates that "the combination of the improved labor market incentives and the higher real return on savings (of moving to a fully funded Social Security system) has a net present value gain of more than $15 trillion, an amount equivalent to 3 percent of each future year's GDP forever."

Chile's reforms are seen as such a huge economic and political success that countries throughout Latin America, including Argentina, Peru, and Colombia, are beginning to implement similar changes. In Europe, Britain has allowed some people to opt out of its upper tier of benefits and Italy has begun to privatize some aspects of its social security system.

Obviously, privatization of Social Security in the United States would not come without questions and problems.

First, the current Social Security system involves several elements of social insurance that make it much more than a simple retirement system. For example, portions of the payroll tax support the Disability Insurance and Medicare programs. Transferring those programs to the private sector is both possible and desirable, but entails considerably more difficulty than privatizing the retirement portion of Social Security. Their fate should be decided separately.

Social Security also currently provides survivors' benefits that would disappear under a privatized system. But that would be largely offset because privatization would make benefits part of an individual's estate. In addition, it would be relatively easy to use a portion of PRA funds to purchase life insurance.

Finally, it's important to recognize the redistributional aspect of Social Security. Benefit formulas are calculated on a progressive basis that provides a relatively higher return to low-income workers than to higher. A privatized system would generally reverse that. High-wage individuals would receive a higher return on their investment, leading to greater income inequality.

Still, and far more important, low-wage workers would likely receive far more in benefits than they do under the current system. Because low-income workers are far more likely than the wealthy to rely on Social Security for all or most of their retirement income, the current system's low rate of return actually hurts them the most. Indeed, some studies show that because of the regressive nature of the payroll tax and the shorter life expectancy of the poor, they are the major victims of today's system.

The most difficult issue associated with any proposed privatization of Social Security is the transition. Put quite simply, regardless of what system we choose for the future, we have a moral obligation to continue benefits to today's recipients. But if current workers divert their payroll taxes to a private system, those taxes will no longer be available to pay benefits. The government will have to find a new source of funds. The Congressional Research Service estimates that cost at nearly $7 trillion over the next 35 years.

While that sounds like an intimidating figure, much of it is really just making explicit an already existing unfunded obligation. As noted above, the federal government already cannot fund as much as $4.9 trillion of Social Security's promised benefits. Those who claim we cannot afford to finance the transition have yet to explain how they will continue to fund benefits for our children.

Even so, proponents of privatization have an obligation to explain how they would fund the transition. The reality will probably involve some combination of four approaches.

The first of those is a partial default. Any change in future benefits amounts to a default. That could range from such mild options as raising the retirement age, reducing COLAs, or means testing benefits to "writing off" obligations to individuals under a certain age who opt into the private system. For example, any individual under the age of thirty who chooses the private system may receive no credit for past contributions to Social Security.

The second method of financing the transition is to continue a small portion of the current payroll tax. For example, rather than privatize the entire OASI portion of the payroll tax, workers would be allowed to invest 6 or 8 percentage points, with the remainder temporarily continuing to fund a portion of current benefits.

Third, Congress can identify additional spending cuts and use the funds to pay for the transition cost. Steve Entin, an economist with the Institute for Research on the Economics of Taxation (IRET), estimates that fully funding the transition would require slowing the rate of growth in federal spending by an additional one half percent beyond currently envisioned cuts, eventually reaching a reduction of $60-70 billion per year.

The final proposal often suggested for funding the transition is for the government to issue bonds to current system participants and taxpayers. The present value of the actuarially determined annuity due each system participant may be easily calculated and each system participant may be issued zero-coupon T-Bonds maturing at the participant's projected retirement date. The bonds would be placed in each individual's PSA. However, while that has the virtue of making explicit the government's long-term obligations, it is really simply and accounting gimmick. Ultimately, the government will still have to find the funds to make good on the bonds.

Let me conclude by saying something about the politics of Social Security privatization. Social Security has long been, in former House Speaker Tip O'Neill's words, the "third rail" of American politics--touch it and your political career dies. This was because of a perception that American voters would not tolerate any major change to the program.

However, according to a poll of registered voters conducted by Public Opinion Strategies on behalf of the Cato Project on Social Security Privatization, the public understands Social Security's problems and strongly supports efforts to privatize the system.

No one should doubt the continued popularity of Social Security. Our poll results clearly showed that Social Security remains one of the most popular of all government programs, with two-thirds of those polled holding a favorable view of the program. This popularity cuts across all age groups. Even among so-called baby-boomers and Generation X, groups that have expressed skepticism about the program's future, Social Security is viewed as a program that has succeeded for 60 years in ensuring a dignified retirement for America's elderly.

Beneath the surface, though, there is growing awareness that Social Security is faces significant problems and needs reform. Only 37 percent of Americans believe that the current Social Security system is fair. In addition, far more Americans describe the current system as risky than describe it as safe or secure. A majority of Americans, 56 percent, believe the system either is already in trouble or will be in trouble in the next five to 10 years.

That is why young people do not believe that Social Security will be there for them. Fully 60 percent of all individuals under the age of 65 express this belief, with larger majorities among younger voters. As a result, more than two-thirds believe that Social Security will require "major" or "radical" change within the next 20 years. Among younger voters, approximately half believe that major or radical change is needed today. The support for change cuts across ideological and party lines.

What about solutions to the Social Security crisis? Our poll showed that a majority of voters reject most traditional Social Security reforms such as raising the retirement age, raising payroll taxes, or reducing benefits. They correctly perceive that such tinkering with the system will simply make the system a worse deal for young workers, who will have to pay higher taxes for fewer benefits.

However, privatization does have strong popular support among voters. More than two-thirds of all voters, 69 percent, would support transforming the program into a privatized mandatory savings program. More than three-quarters of younger voters support privatization. Support for privatization, particularly among young voters, cut across party and ideological lines.

As this public support emerges into the political process, Social Security will no longer be the third rail of American politics. Indeed, if politicians refuse to deal with Social Security's problems, they may soon face a new third rail in their search for support among younger voters.

The CHAIRMAN. Thank you very much, Mr. Tanner.
Mr. Hewitt.

STATEMENT OF PAUL S. HEWITT, EXECUTIVE DIRECTOR, NATIONAL TAXPAYERS UNION FOUNDATION

Mr. HEWITT. Thank you, Chairman Cohen.

Thank you especially for your interest in our proposal to fund the Old Age Survivor's Insurance portion of Social Security. It is a proposal we have called the National Thrift Plan for the simple reason that the costs of transition—which Senator Simpson described as the key issue surrounding Social Security privatization—would be borne through an increase in private thrift, rather than higher taxes or higher deficits.

The word thrift derives from the verb, "to thrive." Indeed, the purpose of our plan is to restructure Social Security financing so that it reinforces, rather than retards, economic growth. At the end of the transition period, we would still have a Social Security system. That system would retain the progressive tilt of the existing Social Security system.

Guiding our approach is the recognition that the retirement policy is economic policy. Consumption by retirees makes up a large and growing share of our gross domestic product. Retirement savings comprise the bulk of household financial assets. Old age benefits, currently 40 percent of the budget, are growing rapidly and will account for most of the growth in the Federal budget in the future, for as far as we can see. Retirement policy plays a large role in our economy today, and will play a far larger role in the future.

Entirely separate from these policy issues are the economic implications of our aging demographics. Since 1975, two-thirds of the increase in our GDP has been attributable to the growth of the labor force. Yet the days of a rapidly swelling labor force are behind us. Between now and 2030, the working age population is projected to grow by less than 1 percent per year. A slowdown in labor force growth portends a tapering off of economic growth. Today, many are finding an annual growth rate of 2.5 percent politically unacceptable. Unless we dramatically expand our savings rate or find some other way to grow, in the next century, a 1.5 percent growth rate will seem robust.

Now is the time to ask ourselves whether our pay-as-you-go method of financing Social Security is the right economic policy for an aging society. The answer clearly is no. Unlike a real insurance program, OASI has no sinking fund to pay future benefits. Yet by guaranteeing people a stream of income in retirement, Social Security induces them to behave as though they had already funded much of their retirement.

Behind this phenomenon lies the fact that most retirement saving is target saving. For example, when employers integrate their defined benefit pensions with Social Security, they are being target savers. Their responsibilities are reduced dollar for dollar by the amount of the Social Security benefit.

Individuals similarly integrate Social Security into their retirement savings decisions. In a recent survey, we asked working people how they would respond to a cut in their future Social Security benefits. Two-thirds said they would save more.

One consequence, according to a recent study by RAND, is that the median household retires with just $17,000 in financial assets. The study concludes that Social Security has indeed helped make many of today's elderly very dependent on Government.

Economists have long recognized the positive relationship between per capita income growth and the supply of investment capital. The rule of thumb is that an increase in the savings rate of 5 to 8 percent of GDP will raise annual productivity growth by about 1 percent per year. Because of this relationship, dependency among the aged is not simply a matter of social policy. The failure of Americans to save for retirement is bad for the economy. It induces demand for high levels of spending while depriving industry of the capital it needs to capture and retain world markets.

On the one hand, it creates pressure for taxation. On the other, it undermines the wage base that supports those taxes.

America already has the lowest savings rate in the industrial world. But this problem could grow much, much worse. Indeed, it poses a threat to our very nationhood. On our current budget track, the Government Accounting Office foresees deficits of roughly 25 percent of GDP by 2026, an amount that not only would vastly exceed the net private savings of the United States in 1996, but the total capital exports of all industrial Nations. Even more alarmingly, the Congressional Budget Office has concluded that borrowing of this magnitude would set the economy on a downward spiral with no hope for recovery.

Theoretically, we could avoid this bleak future through a series of major tax increases. Yet, such actions would be more likely to crowd out, than improve private savings. As living standards stagnate, people would be likely to opt more for debt in order to maintain consumption levels.

A recent study by the National Taxpayers Union Foundation found, using the OASDI intermediate scenario, that the cost of supporting just the growth in Social Security, Medicare and Medicaid for the old could eliminate all after tax growth in living standards for the next 45 years. Under the so-called "high cost" scenario—which is more consistent with a low savings profile—after tax income would decline by 59 percent during this period.

Fortunately, there is a way to avoid the decline in living standards. In its recent study, *Averting the Old Age Crisis,* the World Bank points to several countries that have broken the cycle of dependency in old age. In these countries, thrift-based Social Security systems are boosting savings and promoting higher rates of productivity growth. Such systems have the added advantage that they disconnect retirement security from demography. When every worker is self-sufficient, there is no dependency ratio to worry about.

Early this year, the National Taxpayers Union Foundation and the Center for Public Policy at the University of Denver set out to design such a plan for America. The core of our National Thrift Plan is a requirement that every worker set aside 5 percent of his or her earnings into a personal thrift account. This amount would be over and above what workers already pay in FICA taxes. To supplement the savings of the working poor the Government would help with dollar for dollar matching contributions.

But under our plan, every worker must save and in return, the Government will guarantee to improvements in the supplemental security income program, that no senior citizen would ever again spend their old age in poverty.

At the same time, we would phase our earnings credits under the existing pay-as-you-go system at the rate of 5 percent a year. The first year people, for example, workers would receive 95 percent of the current wage credit, and in the 20th year they would receive 5 percent. So a worker who first enters the work force in the 21st year after implementation would accrue no benefits under the existing system.

The plan would seek modest sacrifices from today's retirees. We would cancel the Social Security COLA for 1 year, and then increase COLA's at one-half percent less than the CPI in subsequent years.

Finally, we would remove all tax preferences for Social Security income. I would note that such a change would merely move forward by a decade or so the tax policies already adopted in the 1983 reforms.

We conservatively project that this plan would boost national savings by 1.2 percent of GDP by the year 2000, by 2.6 percent of GDP by the year 2010, and by 5.9 percent of GDP by 2065. Within 25 years, there would be a pool of savings growing tax-free in personal thrift accounts equivalent to more than half of GDP.

We estimate that by 2050, productivity would be 26 percent higher than it would be otherwise. From an economic standpoint, these are huge returns.

Now, some will worry about the effect of this new forced savings on the consumption of lower income households. It's true that lower income families who save nothing now will see their consumption initially decline by 5 percent. Over time, stronger economic growth will replace this lost consumption for most families. Yet even in the early years of our plan, total compensation to low paid workers will rise, due to the Federal Government matching contributions. As a result, over the course of their working lives, even the humblest workers will accumulate significant financial wealth. The National Thrift Plan will do what no income transfer program has ever done: produce a more equal distribution of wealth in America.

This is potent medicine. But our leaders face a trickier question, can it be sold to the public. Our preliminary polling suggests that perhaps, it can. Almost 9 in 10 Americans believe they should save more. Almost 8 in 10 believe that if they did save more, they would be helping not just themselves, but the economy.

Thrift, in other words, is widely perceived as an act of civic and personal responsibility. It wasn't long ago that thrift ranked high in our pantheon of economic values. The thrift ethic that was so essential to America's rise, when for more than a century we had the highest savings rate among the industrial Nations, has waned. We believe that the same public mood that is behind the expanding national debate about culture and values will embrace the reemergence of thrift as a cultural value as well.

There is a growing acknowledgement that the flip side of freedom is responsibility. People should be free to keep the fruits of their labor, but they cannot be free to burden society with the cost of their imprudence. The public supports laws that keep the uninsured off the road or that prescribe drug use or other anti-social activity. The Government has latitude to regulate economic behavior much more than it does to usurp it. We believe that this principle applies to retirement policy and urge the members of this committee to join with us in exploring this promising avenue of reform.

[The prepared statement of Mr. Hewitt follows:]

Statement by Paul S. Hewitt
Executive Director, National Taxpayers Union Foundation
on the Future of the Social Security Program
before the Special Committee on Aging
U.S. Senate

September 24, 1996

Mr. Chairman, thank you for holding these timely hearings on the future of Social Security. We especially appreciate your interest the National Taxpayers Union Foundation's transition blueprint for fully funding the Old Age Survivors Insurance (OASI) portion of Social Security.

We call our proposal the National Thrift Plan for the simple reason that the transition costs are financed through an increase in private thrift, rather than higher federal taxes or deficits. Let me stress that this proposal has nothing to do with ideology. It is a practical plan to restructure Social Security's financing so that it reinforces, rather than retards economic growth. At the end of the transition period, we would still have a social security system. And that system would have the same progressive tilt as the existing system.

The premise of our approach is that in our aging society, retirement policy is economic policy. Consumption by retirees makes up a large and growing share of our gross domestic product. Retirement savings comprise the bulk of household financial assets. Payroll taxes alone are a third of the federal tax take. Old age benefits, currently 40% of the budget, are growing rapidly. In fact, they account for all of the projected growth in spending, taxes, and deficits for as far the eye can see. Clearly, retirement policy plays a large role in our economy today. And it will play an even larger role in the future.

Completely separate are the economic implications of our aging demographics. Since 1975 two-thirds of the increase in our GDP has been attributable to the expansion of the labor force. Yet the days of a rapidly swelling work force are behind us. Between now and 2030, the working age population is projected to grow by only 25% -- less than one percent a year. A slowdown in labor force growth portends a tapering off of economic growth.

These effects are already apparent. Tight labor markets are emerging all around the country. In response, sooner or later, the Fed will hike interest rates in order to slow labor demand to non-inflationary levels. Today many find an annual growth rate of 2.5% politically unacceptable. But unless we dramatically expand our savings rate, in the next century a 1.5% growth rate will seem robust.

Now is the time to ask ourselves whether our pay-as-you-go method of financing Social Security is the right economic policy for our aging society. The answer clearly is no. Unlike a real insurance program, OASI has no sinking fund to pay future benefits; it is unfunded. Yet by guaranteeing people a stream of income in retirement, it induces them to behave as though they have already funded much of their retirement. The effect is to substitute public spending for private saving.

Behind this phenomenon lies the fact that most retirement saving is target-saving. For example, when employers integrate their defined-benefit pensions with Social Security, employer responsibilities are reduced dollar-for-dollar by the amount of the promised Social Security benefit. The larger the public benefit as a percentage pre-retirement income, the less the employer will set aside. Individuals similarly integrate Social Security into their savings decisions. In a recent survey, we asked working people how they would respond to a cut in future benefits. Two-thirds said they would save more.

One consequence, according to a recent RAND study, is that the median household retires with just $17,000 in financial assets. The study concludes that Social Security has helped make most of today's elderly very dependent on government.

Economists have long recognized a correlation between per capita income growth and the supply of investment capital. A rule of thumb is that an increase in the saving rate equal to 8% of GDP will raise annual productivity growth by 1%. Because of this relationship, dependency among the aged is not simply a matter of social policy. The failure of Americans to save for retirement is bad for the economy. It induces demands for high levels of spending, while depriving industry of the capital it needs to capture and retain world markets. On the one hand it creates pressure for taxation; on the other, it undermines the wage base that supports those taxes.

According to a couple of sobering reports, this problem could grow much worse. On our current budget track, the Government Accounting Office foresees deficits of roughly 25% of GDP by 2026 -- an amount that not only would vastly exceed the net private savings of the U.S. in 1996, but the total capital exports of all industrial nations. The Congressional Budget Office concludes in its May 1996 *Budget Outlook* (p. 79) that "With federal debt growing so rapidly, the economy would enter a period of accelerating decline."

Theoretically, we could avoid this bleak future through a series of major tax increases. But the savings rate would be unlikely to rise beyond its current meager level; indeed, it might fall. Based on the OASDI "intermediate" scenario, NTUF Chief Economist Neil Howe estimates that the payroll tax increases needed to finance just the growth of Social Security, Medicare, and Medicaid for seniors would erase all projected growth in real after-tax worker incomes over the next 45 years. Under the "high cost" scenario, after-tax incomes would decline 59 percent.

Fortunately, there is a way to avoid the stagnation -- or outright decline -- of living standards that these scenarios imply. In its recent study, "Averting the Old Age Crisis," the World Bank points to several countries that have successfully broken the cycle of dependency in old age. In these countries, thrift-based social security systems are boosting savings and promoting high rates of productivity growth. Such systems have the added advantage that they disconnect retirement security from the demographics of aging. When every worker is self-sufficient there is no dependency ratio to worry about.

Early this year, the National Taxpayers Union Foundation and the Center for Public Policy of the University of Denver set out to design such a plan for America. The core of the National Thrift Plan is a requirement that every worker set aside 5% of his or her earnings into a Personal Thrift Account. This amount would be over and above what workers already pay in FICA taxes. To supplement the savings of the working poor, the government would help with dollar-for-dollar matching contributions. But under our plan, every worker must save. And in return, the government would guarantee, through the Supplemental Security Income program, that no American would ever again spend their old age in poverty.

At the same time, we would phase out earnings credits under the existing pay-as-you-go system at a rate of 5% per year. Thus, a worker who first enters the work force in the 21st year after the implementation would accrue no benefits under the existing Social Security system. The plan would seek modest sacrifices from today's retirees. We would cancel the Social Security COLA for one year, and then increase COLAs at one-half percent less than the CPI in all subsequent years. Finally, we would remove all tax preferences for Social Security income. Such a change would merely move forward by a decade or so the tax policies already adopted in the 1983 reforms.

We conservatively project that this plan would boost savings by 1.2% of GDP by the year 2000; by 2.6% of GDP by 2010; and by 5.9% of GDP by 2065. Within 25 years there would a pool of savings growing tax-free in Personal Thrift Accounts equivalent to 50% of GDP. We estimate that by 2050 productivity would be 26% higher than it would be otherwise. From an economic standpoint, these are huge returns.

But no less important, every worker at every income level will retire with substantially more income than they would under the current Social Security system. And by the 2030s, when we would be sharply raising payroll taxes under Social Security, we will be cutting them under the National Thrift Plan.

Some will worry about the effect of this new forced-saving on the consumption of lower-income households. It is true that low-income families who save nothing now will see their consumption initially decline by 5%. Over time stronger economic growth will replace this lost consumption for most families. Yet, even in the early years of our plan, total compensation to low paid workers will rise due to government matching contributions. As a result, over the course of their working lives, even the humblest workers will accumulate significant financial wealth. The National Thrift Plan will do what no income transfer program is capable of doing: produce a more equal distribution of wealth in America.

The National Thrift Plan is potent medicine. But our nation's leaders must address a trickier question: Can it be sold to the public? Our preliminary polling suggests that it can. Almost nine in ten Americans believe they should save more. And almost eight in ten say that if they did save more, they would be helping not just themselves but the economy. Thrift, in other words, is widely perceived as an act of civic and personal responsibility. It wasn't long ago that thrift ranked high in the pantheon of American virtues. But the thrift ethic has waned. We believe that the same public mood that is behind the expanding national debate about culture and values will embrace the reemergence of thrift.

Even so, some critics say that the public will perceive a savings mandate as just another tax increase in disguise. We disagree. A tax requires you to surrender your wealth to government; a forced saving program simply requires you to accumulate, rather than spend your wealth.

The flip side of freedom is responsibility. People should be free to keep the fruits of their labor, but they cannot be free to burden society with the cost of their imprudence. The public supports laws that keep the uninsured off the road, that require children to wear helmets on bicycles, and that proscribe drug use and other anti-social activity. Government has more latitude to regulate economic behavior than it does to usurp it. We believe that this principle applies to retirement policy. And we urge the members of this committee to join with the National Taxpayers Union Foundation and the Center for Public Policy of the University of Denver in exploring this promising avenue of reform.

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

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

Mr. MYERS. Thank you, Mr. Chairman.

The CHAIRMAN. I saw you nodding to many of the points that Senator Simpson made and it will be interesting to find out from you what points he made that you disagree with.

Mr. MYERS. Thank you, Mr. Chairman. You're quite correct. I agree with many of the points that Senator Simpson made. On the other hand, as is natural among human beings, I have certain differences.

As has well been brought out here, the public widely views that the Social Security system is going to become bankrupt in 2029 and go out of existence. This is by no means a certainty. For one thing, any earlier dates that are given assume that the bonds and the interest on the bonds are not valid. I don't think this is so, because if the trust funds had not owned the bonds, people in the private sector would have owned them, and they would have been considered good investments.

One reason that it's not a certainty that the system is going to go bankrupt and out of existence in 2029 is that it's a flexible program and, as has been done at times in the past, it has been changed to meet changing conditions. Also, it should be noted that the actuaries at the Social Security Administration in preparing the trustees' report make a low-cost estimate that shows that the system will have no problems at all, even in the next century. Now, this is based on much higher economic growth, which people of course all want. It's based on mortality improving, but not improving as much as in the intermediate estimate, and so forth.

I think it's possible that the low-cost estimate could turn out, but it's by no means likely. Therefore, I believe it's prudent to act, and to act now, to make changes that are of a deferred, but gradual nature.

Many proposals have been made for changes. One of them is in regard to the CPI. I certainly agree the CPI should be made technically correct. However, I don't think it's desirable to make the COLA's be the CPI minus, say, 1 percent. The trouble with this is that it's cumulative, and therefore it hits hardest the very oldest beneficiaries, who probably need the money the most.

Other proposals have been so-called means testing or income testing. I don't think that this is desirable. I think it's divisive. I think it will promote a lot of fraud and abuse. People will hide their income and assets. Even most important of all, it will deter savings. People will say, why should I save. Particularly middle-income people will say, why should I save? It will just reduce my Social Security benefits. They tell me now it will just take part of them away, but how do I know? By the time I get there, they'll take all the benefits away. So people won't save, and we certainly need more savings.

Another problem with the individual accounts is that nobody seems to face the administrative problem for people with very low earnings, like children who earn a few dollars in the summer, or people that work just during the Christmas period. Mutual funds just cannot handle small amounts that come in intermittently. I know this, because I'm on the board of two large mutual funds. There are certain minimum deposits that have to be made to make them administratively efficient.

Another problem with many of the privatization proposals is, how do you annuitize the results. People get a huge sum of money at retirement, and what do they do with it prudently. If there's annuitization, it will be unfair to women, because for a given sum of money, women will get lower annuities than do men. The same result occurs also for one-worker families.

Furthermore, some of the proposals are to invest the trust fund assets in the private sector, at least in part. I think this is very undesirable. I don't believe, as Senator Moynihan also believes, that you should buildup large funds. I think that just creates problems.

But if a large amount of the trust funds over the years is invested in the private sector, really the net result would be socialism by the back door method, because the Government would control so much of industry.

Also, many of these privatization proposals would involve larger taxes and increases of the national debt. That doesn't seem to be what people are striving to do these days. Finally, all of these privatization proposals that I have seen to date would increase the general budget deficit by anywhere from $25 billion a year to as much as $125 billion a year. Yet all parties are trying to reduce the budget deficits, not increase them.

Now, what I would propose to do about the situation? The sooner it's done, the better. As many people have said, it's the traditional method of decreasing benefit costs some and increasing income some. In addition, I would propose a type of privatization proposal on top of a reformed Social Security system, rather than reducing the Social Security system.

First, I would increase the retirement age for full benefits from the present 65 to age 70 by 2037, instead of as under present law, to age 67 by 2027. The logic in back of this is that as people live longer, they should work longer. So that in a sense, it's not a real benefit cut. It does reduce benefit costs, though, very significantly.

Second, I would increase the Social Security tax rates by one-quarter of a percent each on the employer and the employee in 2015, and each of the next 5 years up through 2030, so that the total increase would be 1 percent each on the employer and the employee. Now, I know that saying increasing taxes is not a popular thing at this time. But I would say that such small tax increases could easily be absorbed by the increases in real wages, which are likely to be at least 1 percent per year, so that people will still have a net increase in real wages, despite paying slightly higher Social Security taxes.

Further, I would reduce the Social Security tax rate beginning next year and running through 2009 by 0.6 percent each on both the employer and the employee. I would transfer these monies to the Hospital Insurance system under Medicare, which badly needs the money, because there is a real crisis, as you well know, for this trust fund in the next 5 years. If this were done, I think it would benefit both programs. The Medicare Hospital Insurance Trust Fund would be solvent until 2009, instead of now only to 2001. But there still would be further action needed.

At the same time, the assets of the Social Security trust funds would continue to grow, but not nearly as rapidly. Even by 2009, the fund on hand would be more than 1 year's benefit outgo, which is a desirable criterion and a responsible pay-as-you-go financing method.

Finally, I would recommend that there be a supplementary mandatory individual savings account plan, using the same 2 percent rate that Senator Simpson said, except that I would exclude the very low-paid workers, because it just isn't worthwhile administratively handling such tiny amounts. I think that this would be very good to build on top of the existing Social Security structure.

Finally, I might say as to Chile, that I unfortunately take a little different view than Mr. Tanner. I went to Chile twice at the request of the Chilean government to make an objective study of their system in 1984 and 1992. I concluded that, considering their special circumstances, it was a very good thing that they did, but that it wasn't the only thing they could have done, but it has worked out well.

But I also concluded that it was not the thing to do for the United States, and probably not for most other countries.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Myers follows:]

STATEMENT BY ROBERT J. MYERS PRESENTED TO THE SPECIAL COMMITTEE ON AGING, U.S. SENATE, SEPTEMBER 24, 1996, WITH REGARD TO SOCIAL SECURITY REFORM PROPOSALS: PREPARING FOR THE 21ST CENTURY

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

In this testimony, I shall address three subjects: (1) whether a legislated system of personal investment accounts should be established, and the Social Security be reduced accordingly; (2) whether some of the investments of the Social Security trust funds should be invested in equities; and how I believe that the Social Security program, should be modified.

Present Financial Status of the Social Security Program

According to the intermediate-cost estimate in the 1996 Trustees Report, the Social Security program (Old-Age, Survivors, and Disability Insurance) has a significant long-range financing problem. In the next two decades, however, there is no problem, because outgo of the trust funds is estimated to exceed income every year. In brief, the fund balance builds up steadily, until reaching a peak of $2.9 trillion in 2019, but then it decreased rapidly until becoming exhausted in 2029. In subsequent years, the excess of outgo over income from payroll taxes and the income taxes on benefits represents about 4-5% of payroll.

Another way to look at the situation is to consider the long-range lack of actuarial balance over the 75-year valuation period. This is 2.19% of payroll, meaning that long-range balance would be restored if the combined employer-employee contribution rate were immediately increased by this amount.

It is not a certainty that there is a long-range financing problem. The low-cost estimate shows that none is present. Although it is possible that future experience could be along this line, it is not very likely. Accordingly, it is only prudent to take some reform action soon, although the changes could well be deferred to take effect some years in the future, as well as being instituted gradually.

My Philosophy About the Role of the Social Security Program

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

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

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

Various Approaches for Privatization Through Personal Investment Accounts

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

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

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

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

Problems with Initiating a System of Personal Savings Plans

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

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

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

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

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

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

The advocates of privatization of the Social Security program argue that the high real rates of investment return will far more than offset the additional administrative expenses. As a result, they assert that much higher retirement protection will be provided than under Social Security. However, often when quoting the numerical results, a much higher real estate rate is used than really seems possible under the circumstances. If such huge amounts of money were available for investment in common stocks, then it is likely that rates of return will be lower than historical ones. I recognize that such massive new investment would produce some desirable economic growth, but there are limits to this effect.

Problems With Investing Trust-Fund Assets in Common Stocks

Proposals have been made to invest a portion of the assets of the Social Security trust funds in common stocks, using an automatic indexed basis. The purpose is to have higher investment returns and thus necessitate smaller benefit reductions and/or contribution increases in order to restore financial soundness to the system. I believe that this procedure is not desirable, because once enacted, it is likely that the investment procedure would be weakened, and the government would have great power over the Nation's industry or "socialism by the backdoor method".

How Should Social Security Be Changed?

The most important thing that should be done is to restore the long-range solvency of the Social Security program and this should be done as soon as possible. (No financing problem is likely in the next 20 years.) To do so, benefit outgo over the long run could be reduced, contribution income could be increased by higher tax rates some years hence, or a combination of these two elements could be done. Specifically, I suggest that the full-benefits retirement age should increase by two months each year beginning in 2003 (as in present law) until it reaches age 70 (for those reaching such age in 2037), unlike present law, under which it levels off at age GG for about 10 years before rising to age 67 in 2027. Further, both the employer and employee tax rate should increase by 1/4% in 2015, with similar increases in 2020, 2025, and 2030.

In addition, I believe that the employer and employee tax rates for 1997 through 2009 should each be reduced by 0.6%, so that an excessively large fund balance will not be built up, and the program will be closer to responsible pay-as-you-go financing. Then, the question of how to invest the assets will be moot, because investment income would not be a significant factor in the financing of the program.

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

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

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

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

I think we've seen a pretty good cross section of the kind of diversity of opinion as to what needs to be done.

Mr. Myers, I assume that when you looked at the Chilean example, you saw that most of the people in that country were really fed up with the existing system, No. 1, and No. 2, you had a dictatorship, which makes fundamental change much easier in a dictatorship than it does in a democracy. But as Mr. Tanner indicated, there are other Latin American countries who seem to be following the Chilean example, even though you would recommend that other countries do not follow this example.

Are the situations different in the rest of Latin America that would make it easier for them to transform their current systems into something based upon the Chilean model?

Mr. MYERS. Yes, Mr. Chairman. The fact that there was a military dictatorship that put it in was just the instrument for doing it. But it was still, I think, a good thing for them to do. Their previous system was in shambles.

But it does have the problem that probably 20 percent of the people who should be covered by the system just don't contribute. Second of all, it involves huge government general-revenues input, because Chile has had budget surpluses, whereas we have had horrendous budget deficits. You can't finance things with deficits.

The CHAIRMAN. Mr. Tanner, how do you respond to Mr. Myers' statement, if you have middle income individuals, they will try to hide their income, in other words, you penalize them by saying, in addition to their savings, they now are, I guess maybe Mr. Hewitt would be the one to answer this, but if they in fact have savings, they are now going to be means tested, in which case they will seek to hide their income, much as we saw with the Medicare situation. Medicare does not, in fact, provide for long term care costs, nursing home costs. So you have to impoverish yourself in order to qualify for Medicaid. We found historically that people were either hiding assets, transferring assets in order to reduce their income status, in order to have the benefit of the Government-financed program that would care for them in nursing homes.

How do you deal with that issue?

Mr. HEWITT. We deal with it by mandating that people save. To the extent that saving is not voluntary, obviously, the incentive effect doesn't come into play.

But you have to make sure that people save enough to make themselves self-sufficient in retirement. The idea is that if even the humblest worker becomes self-sufficient through his or her saving over the course of a lifetime, very, very few people would ever qualify for any type of a means-tested benefit. Such a benefit program therefore would be relatively cheap to administer, and consequently can be quite generous.

The CHAIRMAN. Could each of you give me an example of where you think the cutoff line ought to be in terms of changing of the system? In other words, we have current retirees or those who are about to retire. Do we look at those who are under the age of 50, under the age of 45? Where would you recommend that we have the cutting off point when we start to reform the system, either through a complete privatization or a partial privatization that you, Mr. Myers, recommend?

Mr. HEWITT. Essentially, what we do is make a full transition from an unfunded to a funded system. Everybody takes part. We don't give people the opportunity to opt in or not opt in. This is to prevent people from making impulsive decisions that might not be in their best interests.

We simply change the structure of Social Security's financing. Under, our plan, nobody opts out of the Social Security system or has an option to participate or not participate in that funding. We found that nobody fared worse off under The National Thrift Plan than under the existing system. In fact, most people, especially the younger cohorts because they would be getting market returns to capital would do a lot better.

Mr. TANNER. I would suggest that it actually be made voluntary, that individuals over the age of 18 who are currently in the work force be given the option of remaining in the current system or of moving to the private system.

We believe that for just about anyone under the age of 44, even assuming the most conservative estimates of a 6 percent rate of return in the private capital, which is below what the private capital markets have actually generated over the last 50 or 60 years, they would receive the same benefit at retirement or more. The younger you are, the more you would receive. So they would be the most apt to switch.

But if individuals wanted, particularly higher income individuals who don't depend on Social Security and wanted to take a chance, that they should be able to opt out, even at higher ages.

For individuals under the age of 18, we believe everyone should move into the new private system, that eventually what you want to be able to do is shut down the current system altogether, and simply have the private system operating, since that's the one that will be solvent, rather than to perpetuate, basically forever, a system which does not pay for itself.

The CHAIRMAN. Mr. Hewitt, under your proposal, would the Government be making the investment choices?

Mr. HEWITT. No. However, it would be a highly regulated system. We expected that, along the lines of the FERS system that civil servants pay into. There would be an "open season" and people would be able to shift their accounts among approved funds. But these funds would have fairly strict fiduciary requirements that would include, among other things, a requirement that as people neared retirement, a larger component of their retirement accounts be in bonds.

We ran our economic model through a 1929-like scenario in 2029. We found that, given the rate of recovery that occurred in 1929, 11 years before the market regained its former high, everybody still retired with more money than they would under the current system. This is Social Security, not a 401(k) plan. We simply accomplish the funding of Social Security through regulatory mechanisms. These funds would be privately owned and invested. The World Bank found that when Government is investing the funds, as in the case of Singapore's Provident Fund, the rate of return is substantially less than in those cases where the private sector is making the investment decisions. But we endorse government prescriptions on how those funds can be invested.

The CHAIRMAN. How does your approach differ from Mr. Tanner's in terms of protecting the individual either from himself or herself from making improvident investments?

Mr. HEWITT. We would incorporate fiduciary restrictions so that you couldn't invest in stamp collections or other kinds of nonsense.

The CHAIRMAN. Or junk bonds. [Laughter.]

Mr. HEWITT. Well, too many junk bonds, anyway——

The CHAIRMAN. If I'm going to be the investor, say I've got an account, let me do the choosing, if I choose unwisely, what?

Mr. HEWITT. Actually, there would be some limit on choosing unwisely. But to the extent that you had bad luck, because bad luck can happen even if you choose wisely, there would be this expanded SSI program that would ensure that nobody lives their old age in poverty.

The CHAIRMAN. Mr. Tanner.

Mr. TANNER. I was just going to suggest that a model for requiring a diversified portfolio would be something along the lines of what's currently required under ERISA, I believe it's section 404–D, (I might have that number wrong), model. It essentially sets out requirements for what constitutes a sufficiently diversified portfolio. You can't invest more than a certain percentage in a single stock or single industry or even in shares as opposed to fixed assets income. Those sorts of restrictions.

The CHAIRMAN. Do you envision any kind of reinsurance program?

Mr. TANNER. Yes, probably a privately funded reinsurance program. But there would certainly be a requirement that the investment management firms be able to prove a certain level of solvency before they are allowed to be certified to offer plans.

Mr. HEWITT. If I could add one last point. If there is an "open season," annually, and people perceive that their funds are not doing well, then obviously they would have an opportunity to change. I would envision certain performance requirements as well. For example, if a particular fund underperforms the average over a certain period of time, the fund would be decertified.

The CHAIRMAN. Senator Grassley.

Senator GRASSLEY. I didn't get a chance to ask Senator Simpson this question. I would have asked you to comment on it as well, Mr. Hewitt, and Mr. Tanner. Could you address the argument that there is no real crisis in Social Security funding from the standpoint that you can put it on a sound footing by the year 2050, or thereabouts, with a few relatively small corrective actions. You obviously know some members of the Advisory Council have suggested that. They've suggested a list of changes. Their numbers seem to add up. These are experienced, knowledgeable people worth paying attention to. If they're wrong, why are they?

Mr. TANNER. Most of the changes suggested are not necessarily that small, with the exception, I believe, of six members of the committee under Chairman Ball who will advise a small payroll tax increase and investing the current trust fund in the stock market essentially, or in private capital.

The investment of the current trust fund entails a great many problems. First of all, the fact that the trust fund isn't actually there. So you actually have to go back and make good on the money out of general revenues in order to find the money to then invest. Beyond that, there's the question, as I think Mr. Myers said, that this is socialism by the back door. In essence, you're allowing the Federal Government to buy a majority interest in every major company in America. The trust fund will total over $3 trillion at its peak, even allowing 40 percent of that, which is what the advisory committee will recommend to be invested privately, would allow the purchase of a majority interest in every one of the Fortune 100 corporations in America, for example. I think that's a bad deal.

Plus, the social investing problems, as I mentioned earlier to you, do you buy tobacco stock and so on. Around the world, wherever this has been allowed, the political tapping of those things to make politically correct investments, whether in public housing or old age housing, or propping up State enterprises and so on has occurred. So I think that's a major problem.

If you rely just on tax increases alone or just on cutting benefits alone or a combination of the two, you can do them. I think it's fairly substantial benefit cuts and fairly substantial tax increases. But insolvency also is not the only problem. You still have this problem with the fact that the young worker today is going to receive a negative rate of return on his Social Security taxes and simply raising his taxes and cutting his return is not going to solve that problem. So you have to do both simultaneously if you're going to be fair to that young worker.

Mr. MYERS. I think that Mr. Tanner understates his case. The trust fund, under Mr. Ball's proposal, the trust fund is going to be much larger than $3 trillion, because he has some benefit cuts immediately that will result in the trust fund being even greater.

Mr. TANNER. Right.

Mr. HEWITT. Some of the more sanguine analyses should be examined closely with respect to their underlying assumptions. In many cases these are projections that assume all things remain equal. Since 1973, real per capita income growth has averaged about one-half percent per year. The going forward projections, as Mr. Myers pointed out, are that it will grow at 1 percent per year. Those going forward projections also assume we don't have a recession.

Under SSA's so-called "high cost" projections, which assume that at some point during the latter part of this decade we do have a mild recession, Social Security begins running cash deficits in 2000. So, these estimates are all very contingent on good news. We would argue that real income growth in the modern era is probably more accurately reflected by the one-half percent annual increase than by the going forward projections, upon which Mr. Ball bases his projections.

In addition, we believe that America faces an assault on its market share internationally that is being hastened, not retarded, by the expansion of technology. The Internet makes it possible to send entire processes around the world in a data blip. The ability to capture markets is going to be determined increasingly by which countries have the capital to acquire technology, which is freely and openly available to an increasing extent.

So it's our sense that the current Social Security system limits its own potential for solvency. It undermines savings. Essentially, it substitutes public spending for private savings. To that extent, in this global economic environment, I think it is setting us up for continued economic disappointment. Senator Simpson mentioned that in 1983 when Congress saved Social Security, they projected that they had saved it until 2063. Now we are looking at bankruptcy in 2029. If we have a recession any time in the reasonable near future—which would seem likely in light of the fact that we're now entering into a very, very long peacetime expansion—that that date will move forward considerably.

So we would argue that in fact, these kinds of estimates are very optimistic and do not take into account the negative feedback that the existing system creates for the savings rate.

Senator GRASSLEY. Mr. Myers, my last question.

Mr. MYERS. Yes, sir.

Senator GRASSLEY. On another subject, but one that's been discussed here partly.

In your quote about socialism by the back door method, you say something to the effect that, it's likely that the investment procedure would be weakened. Does our experience with FERS now allay some of your concern about that?

Mr. MYERS. Senator Grassley, if I might first say something personal which perhaps will be of interest to you. Just 62 years ago today, I came, after just graduating from the University of Iowa, to work for the Committee on Economic Security that made the study setting up the Social Security Act.

Senator GRASSLEY. Thank you for that. Were you born in Iowa, too?

Mr. MYERS. No. I'm sorry. Just educated there.

I think it's quite true that the FERS system has worked out reasonably well. But I'm just afraid of the magnitude of the trust fund investments that would be in the private sector if this were done. In other words, FERS works out well because it's just a small influence on the market. Whereas, the trust funds, particularly if they grow greatly, would have such a controlling interest on the private economy.

One of the key features of the actuarial estimates for the future is the rate of economic growth, as Mr. Hewitt has said. It's true, if the economic rate of growth in the future is like it's been in the past, the intermediate estimate that's widely quoted is too optimistic.

However, I note that both Presidential candidates have strongly urged that if they get elected, they will increase the rate of economic growth of the country greatly. If they do, this would certainly be a great help to the Social Security system's financing.

Senator GRASSLEY. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. Just a couple of final points.

Mr. Tanner, I think you indicated that you would allow anyone currently in the system to opt out of the system. As I understand it, under the British system, it's a bit different. They have a two-tier system, so that even those who choose to go into the private investment as such nonetheless have to continue to pay into the public system.

Mr. TANNER. They in essence take a tax credit for an expanded IRA which is charged back again. So it's not 100 percent loss. But they offset a large portion of their contribution.

The CHAIRMAN. Just some final observations. In this committee and also the Government Affairs Committee, in which I sit, we have looked over the years at various issues affecting ERISA. You touched upon this. But we have criticized, in fact, some of the private fund managers under ERISA for not being aggressive enough in some of the corporate governance issues. In other words, not being aggressive enough in ways that would maximize the return on investment or being much too modest in what they have done.

You're talking about a $1 trillion fund in the private sector. I can imagine the kind of governance issues that would be raised when we talk about $3 trillion as far as Social Security is concerned.

So these are issues that we are going to have to deal with as part of the performance of the current system.

Mr. TANNER. I would agree that that's been the history that we've had, people talk about too aggressive, too much speculation. The history of saving in this country is that we are not aggressive enough, that people tend to not save enough.

But I just want to add one last thing. In terms of the FERS program, it has been relatively successful, but if you look at State employee pension systems, they've been subject to enormous political pressure, whether it was investment in South Africa or the Sullivan Rules in Northern Ireland, can't do business in Cuba, there's a proposal now in Massachusetts to divest some companies doing business in Burma. The State of Connecticut recently, tried to debate a gun control bill and found out its State employees owned 15 percent of Colt Arms. That involved all sorts of entanglements. So the State employee retirement systems, I think, have shown that there's a great many problems with allowing the Government to buy into private capital.

The CHAIRMAN. We also had efforts made on the Senate floor to use these funds for construction of housing projects as well. So I think your point is well taken.

Gentlemen, thank you very much for your testimony. As I indicated before, this is not a legislative committee, and we certainly don't anticipate any action before the November elections. It will probably take a lot longer than that to sort out exactly where we need to go and will go in the future.

But I think a very strong educational program has to be undertaken, that we, as has been suggested, we depoliticize this issue. Senator Warner talked about this. Because when dealing with Medicare and Social Security, the history has been, all you have to do is demonize the other party, and suddenly you've got a hot political issue in which you can destroy your political opponent. The problem with all of that is that we don't have time enough to continue this particular practice. I think the road to political success has been paved with the IOU's of our children. That can no longer be the road to political success. It ought to be the road to political defeat. It's going to take a lot of public education for us to re-educate our public in terms of what needs to be done. Your testimony, I think, will be helpful in setting the stage for the debates in the next Congress.

Thank you very much.

Our final panel consists of four retirement pension and budget policy experts. This testimony will focus on the major issues that have to be addressed in evaluating a shift to a privatized system. Dr. Gene Steuerle, who is the author of Retooling Social Security for the 21st Century. We have Martha Phillips of the Concord Coalition, Estelle James of the World Bank, and Paul Yakoboski, of the Employee Benefit Research Institute.

Ladies and gentlemen, thank you for appearing. Dr. Steuerle.

STATEMENT OF C. EUGENE STEUERLE, SENIOR FELLOW, THE URBAN INSTITUTE

Mr. STEUERLE. Thank you, Mr. Chairman.

Despite remarkable success at reducing poverty, Social Security and other government programs for the elderly and near-elderly have several related problems. First, they put to pasture a large number of extraordinarily talented people, thereby reducing significantly the productive capacity of the Nation. Second, devotion of an increasingly larger budget shares to support higher levels of consumption and more years out of the work force, rather than devotion of similar resources to our youth and other longer term objectives, is a prescription for national decline.

Third, Social Security and other programs are very inflexible. They actually do a poor job of taking care of the elderly poor, and they create a large number of inequities for second earners in families. Finally, there is good reason to believe that Social Security may reduce societal savings.

Although this list of problems requires some difficult and fundamental decisions to be made in the future, we could exaggerate the impact of change on the elderly. Reform could still mean that almost all future retirees receive greater or equal lifetime benefits than those who retired before them. Future retirees simply cannot expect to maintain the rate of growth foreordained in current law.

You have asked today, Mr. Chairman, that we concentrate mainly on the assessment of a shift from a social insurance system to a privatized one. One of the main points of my testimony is simply to note that this shift deals primarily with the fourth of the issues that I raised with you, but not with many of the other three, and that it does not put aside many of the other hard choices that we have to make.

That does not mean that such a shift is not valuable. Several years ago, I suggested converting the current surplus buildup within Social Security into private accounts. This is a proposal not too far from that of Senators Kerrey and Simpson in that regard, or that of the chairman of the Advisory Commission on Social Security, if I understand how his proposal may come out.

The advantage of this type of proposal is partly that it may increase saving simply by forcing a more honest budget accounting for retirement liabilities of the Government. Currently, however, I'm also trying to develop another privatization option that might involve simultaneously making private pensions much more portable than they are today. This option would involve also some tax reduction, but only if those taxes were devoted to a private account, to which would be deposited by either employers or employees, additional private retirement savings of say, 6 or 7 percent of wages. Required benefit adjustments in Social Security would then be made in a way that left a decent base of support even for those low income individuals who could not participate in this type of private saving option.

Now, I've led a little bit through the back door to considering this type of public-private solution because of the Achilles heels that I've seen in many existing privatization options. Even with substantial reductions in the rate of growth of benefits in Social Security, there simply isn't a lot of room to withdraw large sums from the existing Social Security tax rate without threatening a basic floor of benefits for both Social Security and health care. I'm also unsure how far Congress is willing to go with an additional tax or mandate, even if it is called privatization. If one examines the most developed privatization options, such as those considered by the Social Security Advisory Council, for instance, all of them rely upon either an additional mandate or upon an additional tax to help finance the transition.

Finally, most privatization options to date have ignored issues surrounding private pension plans, including many problems having to do with portability of those plans, and the fact that private pensions today really only cover about half the elderly, those who probably are in least need of security.

The primary advantages of privatization are threefold. First, there's a good chance they would increase societal saving. Second, they involve a much more honest assessment of budgetary cost. As an example, when the Thrift Plan was added to the Federal Employee Retirement System, or FERS, in substitution for some of the benefits of CSRS, or Civil Service Retirement System, the payments into the Thrift Plan for current workers were recognized immediately as a liability of Government, rather than deferred into the future. Indirectly, this added into the measure of the deficit, thus encouraging Congress to reduce the deficit, the real long-term deficit, even more.

Finally, recognition of liabilities on a more current basis, as would be the case in many privatization options, tends to free up Government budget to address current needs.

However, Mr. Chairman, I don't want to indicate that privatization is without its own sets of dangers. We know that our own current programs for the elderly have over-promised what they can deliver by overstating the rate of growth of benefits that's promised. It would be a mistake to convert that same set of excessive promises from today's Social Security and health care systems into an excessive set of promises from a system with increased amount of privatization. In particular, Mr. Chairman, I'm objecting to those plans that claim they're going to provide the same level of benefits in the future as does our current Social Security system, merely by remanaging the way that we handle these monies.

When problems with old-age programs are put into compartments, moreover, we often confine ourselves to inadequate and imbalanced solutions. For example, we can't easily divert Social Security taxes into private accounts if in the next breath Congress increase taxes to pay for health care for the elderly.

As another example, we really can't lose our focus on the reason for Social Security in the first place: to provide some minimum base of support for the truly old and disabled, a goal that inevitably requires some redistribution that cannot be handled through private accounts.

As a final example, we cannot offset scheduled declines in human capital—the early retirement of so much of our population—by a simple increase in physical capital. Whatever its other merits, we can't build enough steel mills to offset this decline in human capital.

Two final warnings. First, I'd like to encourage the Congress to beware of magic money. Attempts to let the Government borrow at a 2 percent real interest rate, and then encourage either Government accounts or private accounts that supposedly grow, let's say, a stock market rate of 6 percent, are misleading, if not dangerous. Orange County, if you want, writ large. Magic money is being used by some to argue that hard choices simply don't have to be made.

The second warning is to watch out for the fallacy of aggregation. While I favor reducing Federal deficits or reducing Government liabilities and promises for the future, and while we should increase either Federal Social Security surpluses or put monies into individual accounts, that does not mean that we should exaggerate their effects.

In general, deficit reduction of a dollar or a deposit to a retirement account of a dollar does not increase net societal saving and investment by a dollar, partly because it is offset by some declines in private pension savings and partly because some of the gross savings that's done by individuals is simply borrowed by other individuals for consumption. If you want a proof for that, just pull your credit card and ask where all that money is coming from.

The addition of a more universal funded private savings tier into the Nation's retirement system—so-called privatization—may be a useful way of increasing societal saving, and forcing a more honest budget accounting of the costs and liabilities of Government. A wide range of options need to be considered, worked out in detail and examined in depth. They should not, however, be oversold as a solution for all the problems and goals of our programs for the elderly and near-elderly. That is, we should not merely exchange one set of excessive promises for another. A balanced assessment of both possibilities and limitations of privatization is required.

Thank you.

[The prepared statement of Mr. Steuerle follows:]

SOCIAL SECURITY AND PRIVATIZATION

Statement before the Special Committee on Aging
U.S. Senate

September 24, 1996

C. Eugene Steuerle

The Urban Institute

2100 M Street, N.W.
Washington, DC 20037

Mr. Chairman and Members of the Committee:

Despite remarkable success at reducing poverty among the elderly, Social Security and other government programs for the elderly and near-elderly have several related problems:

(1) First, they schedule and set in place a huge decline in the use of our human capability and capital. By encouraging longer and longer retirement periods relative to life spans -- the very early "putting to pasture" of a large number of extraordinarily talented people -- they reduce significantly the productive capacity of the nation.

(2) Second, our federal government increasingly favors consumption programs for the near elderly and elderly over investment in the young and in other programs that are relatively more favorable toward growth. Even ignoring potential reductions in economic output and increases in interest payments, programs for the aged are scheduled to absorb almost all federal taxes in the not-too-distant future. Devotion of increasingly larger budget shares to support higher levels of consumption and more years out of the workforce, rather than our youth and other longer-term objectives, is a prescription for national decline.

(3) Third, Social Security and other programs for the near-elderly and elderly, despite substantial resources, are very inflexible: they do a poor job taking care of the elderly poor, typically those who are truly old, and they create a large number of inequities for second earners in families.

(4) Finally, there is good reason to believe that Social Security may reduce societal saving for three reasons:

(a) the programs reduce the workforce and, thereby, leave less societal income from which to save;

(b) there are large transfers from younger savers to older consumers; and

© the pay-as-you-go nature of the system may displace saving that would be made for retirement.

Although this list of problems requires some difficult and fundamental decisions to be made in the near future, we can exaggerate the impact of change on the elderly. With adequate forethought and preparation, reform can still mean that almost all future retirees receive greater or equal lifetime benefits than those who retired before them; future retirees simply cannot expect to maintain the rate of growth foreordained in current law.

You have asked today that we concentrate mainly on assessment of a shift from a social insurance system to a privatized one. Several years ago I indicated that a partial shift of this manner may be appropriate and suggested converting the current surplus build-up within Social Security into private accounts. For reasons that I explain more fully below, one the main advantages of this type of proposal is that it may increase saving by forcing a more honest budget accounting for retirement liabilities of the government.

Currently I am developing another "privatization" option that might involve simultaneously making private pensions much more portable than they are today. This option would involve some tax reduction if those taxes would be devoted to a private account to which would be deposited (by either employees or employers) additional private retirement savings of 6 or 7 percent of wages. Of course, growth in benefits under Social Security would need to be pared over time to get that system in order as well. Much of this paring should concentrate on the age of retirement while trying to maintain basic levels of annual benefits for lower-income individuals. Required benefit adjustments would be made in a way that left a decent base of support even for those low-income individuals who could not participate in a private saving options; most middle and upper income individuals, on the other hand, would come to expect a greater percentage of their replacement wages in retirement to come out of private accounts.

I am drawn through the back door to a combined public-private solution like this because of the Achilles heels that I have seen in many existing privatization options. The number of elderly and near-elderly who are promised benefits in the future is great, and the lifetime benefits promised to them is high. Therefore, even with substantial reductions in the rate of growth of benefits there simply isn't a lot of room to withdraw large sums from the existing Social Security tax rate without threatening a basic floor of Social Security and health care benefits. I am also unsure how far Congress is willing to go with an additional tax or mandate even if it is called "privatization." All of the privatization options being considered by the Social Security Advisory Council, for instance, rely upon either an additional mandate or upon an additional tax to help finance the transition. In addition, setting up these private accounts may work better administratively if deposits are greater than 1 or 2 percent of wages. Finally, most privatization options to date have ignored issues surrounding existing private sector pension plans, which are failing to provide significant resources to about half of the elderly and often are not every portable for those who move from job to job.

Although Congress will inevitably hear advocates both for and against privatization, in truth the real work will not be in debating slogans, but coming up with viable alternatives. The difficulty of the task can be explained with some simple arithmetic. Current programs for the elderly and near-elderly are scheduled to increase by about 8 to 9 percentage points of GDP. To restore balance, Congress must decrease benefits or increase taxes by this amount simply to reduce the amount of government dissaving scheduled for the future. Congress may also wish to increase funding in private accounts (sometimes called privatization). If this involves, say, 3 percentage points of GDP, then the net benefit cuts or tax and mandate increases that are required rise to 11 to 12 percentage points of GDP. In political terms of identifying winners and losers, privatization initially adds to, rather than subtracts from, the number of ways that government must reduce its benefit commitments or add to its mandates and taxes.

Possible Advantages

The primary advantages of privatization types of proposals are threefold. First, they might increase societal saving, thus helping add modestly to our growth.

Second, they involve a much more honest assessment of budgetary costs. If Social Security taxes or some mandated contribution were to be shifted into private accounts currently, then cost would tend to be recognized more when it occurred, and the government would be less able to shift liabilities into the future. For example, when a thrift plan was added to the Federal Employee Retirement System (FERS) in substitution for some of the benefits of the old Civil Service Retirement System (CSRS), the payments into the thrift plan for current workers were recognized immediately as a cost, rather than deferred into the future when retirement checks were actually written. This added, by the way, to the measure of the deficit and encouraged Congress to act sooner to reduce that truer measure of government dissaving.

Third, the recognition of liabilities on a more current basis tends to free up the government budget to address current needs rather than being diverted to pay for unfunded promises from the past.

Possible Dangers

We know that our current programs for the elderly have over promised what they can deliver by overstating the rate of growth of benefits that is possible. It would be a mistake to convert that same set of excessive promises from today's Social Security and health care systems into an excessive set of promises from a system with an increased amount of "privatization."

Many privatization proposals fail to address many of the problems that I outlined at the beginning of my testimony. Privatization deals primarily with issue 4 © in the list I provided, but not with other issues such as how many years of retirement support is it reasonable to expect. At times, then, the debate over privatization has tended to hide or mask over the many hard choices we face -- at times hinting that excessive promises can be kept excessive if we simply change the way that Social Security funds are managed.

When problems with old age programs are put into compartments, moreover, we often confine ourselves to inadequate and imbalanced solutions. For example, we can't easily divert Social Security taxes into private accounts if in the next breath we increase taxes to pay for health care for the elderly. As another example, we shouldn't lose our focus on the reason for Social Security in the first place: to provide some minimum base of support for the truly old and disabled -- a goal that inevitably requires some redistribution that cannot be handled through purely individual accounts. As a final example, we cannot offset scheduled declines in human capital -- the early retirement of much larger shares of our population -- by a simple increase in physical capital. Whatever its other merits, simply increasing physical capital investment -- building more steel mills, if you want -- is not enough.

Let me use some numbers to clarify this potential problem of excessive promise and incomplete solution. Under current law, lifetime benefits for an average income elderly couple under various federal programs is about $1/2 million, and that figure continues to rise as we move into the future. If a couple retires at age 62, annuity payments are expected to last 25 years today, increasing to 27 or more years as we move in the future. As the share of the population receiving such benefits increases dramatically once the baby boomers begin to retire, these promises become extremely hard to maintain. "Privatizing" the promises or expectations does not make them any less excessive.

Getting the Accounting Straight

Two final warnings are necessary when doing the accounting for the add-on of private accounts or conversion of some Social Security money into individual accounts.

Beware of magic money! Attempts to let government borrow at a 2 percent real interest rate and then encourage government accounts or private accounts that supposedly grow at a stock market rate of, say, 6 percent are misleading, if not dangerous. Orange County writ large. If one really believes that all government has to do is to arbitrage some money to solve its long-term problems, then let's simply increase government borrowing even more and then invest that money, or force private savers to put money aside, in the stock market! Magic money is being used by some to argue that hard choices don't have to be made. That is, it is tempting to promise continued huge increases in the elderly and near elderly's share of the national pie simply by having their money grow faster than the economy -- that is, faster than income and consumption of everyone else. Not only is magic money often involved, but even if available it doesn't solve many of the longer term problems associated with the waste of our human capital or capabilities.

Watch out for the fallacy of aggregation! Reducing federal deficits, reducing government liabilities and promises for the future, and increasing either federal Social Security surpluses or moneys put into individual accounts may all be worthwhile efforts. But let's not exaggerate their effects. A significant portion of any increase in gross saving in one particular form will be offset by decreases elsewhere. For example, increases in mandated pension accounts will be offset in part by declines in other pension saving and by increased borrowing by consumers of additional gross deposits. In general, deficit reduction of $1, or a deposit to a retirement account of $1, leads to net societal saving and investment of less than $1.

Conclusion

The addition of a more universal funded, private, savings tier into the nation's retirement system -- so-called privatization -- may be a useful way of increasing societal saving and forcing more honest budget accounting of costs and future liabilities of government. A wide range of options needs to be considered, worked out in detail, and examined in depth. They should not, however, be oversold as a solution to all problems and goals of our programs for the elderly and near elderly -- merely exchanging one set of excessive promises for another. A balanced assessment of both the possibilities and limitations of privatization is required.

The CHAIRMAN. Thank you very much.
Ms. Phillips.

STATEMENT OF MARTHA H. PHILLIPS, EXECUTIVE DIRECTOR, THE CONCORD COALITION

Ms. PHILLIPS. When the Concord Coalition first began focusing on Social Security and entitlement programs, the word "crisis" was often used. A number of people said, it's not really a crisis. It's manageable. It's just a problem.

I began using the word "problem," and then people said, it's not even a problem. So now I suggest that maybe it's a "dilemma."

But something is wrong with our system. That has happened because of a rapidly aging population in the United States.

The CHAIRMAN. You may recall that there was an issue of a health care crisis, and then it was said, well, it's not really a crisis, just a problem.

Ms. PHILLIPS. Exactly. When I was on television and called it a problem, somebody came back and said, it's not a problem. But nevertheless, you've got people aging in this country, the baby boom generation reaching retirement age in little more than a decade. Seventy-six million boomers, when they're fully retired by 2040, will add up to double the number of seniors that we have today. There will be about two working taxpayers to support every retiree.

I don't know whether you call this a crisis, a problem or a dilemma, but it's certainly something out there that we know is coming. These people have all been born, we can count them, and we know that we have to prepare to respond to the impact they will have when they retire.

For more detail about how this is all shaping up and what it means, Pete Peterson, who is the President of the Concord Coalition, has a book coming out in 2 weeks, *Will America Grow Up Before It Grows Old*. It's a very dramatic presentation of these statistics and what they mean for Federal programs.

Back in 1983, Social Security reforms trimmed benefits, and speeded up payroll tax increases to try to build program surpluses, in large part to increase savings, increase economic growth in America and prepare our economy to have the capacity to deal with so many retirees. What the 1983 reformers didn't anticipate was that between 1983 and 1996, we were going to borrow $4 trillion. Back in 1983, people really thought that those large budget deficits of the Carter and early Reagan years were temporary aberrations, that this was very unusual, and that surely we would get back to our normal pattern of running budget surpluses or nearly balanced budgets in periods of peacetime prosperity. Nobody foresaw that we would run up such a huge public debt.

So now we're in sort of a double dilemma and the solutions are also interlocking. First of all, if we could balance the Federal budget, and even move into reasonable surpluses, roughly comparable to the amount that is added to the Social Security trust fund each year, that would increase the pool of capital available for investment in our economy and lead to more rapid economic growth eventually, gradually, but it would happen.

A larger, more vigorous economy in the next century means more resources will be available whether through public or private means, to support such a large number of retirees, without demanding generationally unfair contributions from youth and working age citizens. We don't want to get into a zero sum game.

Politically, and practically, if you want to balance the budget and even work up to reasonable surpluses, and keep the budget in balance, then everything has to be on the table, and everything includes Social Security, to complete the circle. So Social Security has to be part of the solution. The long-term financial commitments implicit in the structure of the current program are unsustainable, and the issue is not whether the program will be revised, but when and how.

The longer we wait to address the problems of Social Security, the more limited and ultimately the more draconian the choices and options will be. Many proposals, including these privatization options that we're discussing here today, require substantial lead time in order to have a chance to achieve full impact by the time significant numbers of baby boomers reach retirement age. They need time to work.

In different meetings around the city, where people are talking about these discussions, I or somebody else inevitably asks the question, "Your plan assumes that it will take effect in 1997 or 1998, or a couple of years down the road. What if we didn't start this plan for 5 years or for 10 years?" The answer almost always comes back, "Well, then, it won't work. We won't have time for all the compounding effects and economic growth to take place before they are really needed."

The CHAIRMAN. So there's no realistic chance that we could make that kind of change in 1997 or 1998?

Ms. PHILLIPS. Well, I don't know. I'm just saying that it's really important that we speed up consideration and debate of this issue. Right now, the current Presidential campaign and most House and Senate campaigns as well, are maintaining a pact of silence on the Social Security question. Far too many candidates respond, when Social Security is raised, by pledging not to touch it. Yet these are unavoidable issues and not touching Social Security is probably the one option we do not have.

There are a whole variety of proposals for reform. Raising payroll taxes just 2 percent is one option. I'm constantly amazed that some people say that's just a really mild, easy, incremental reform. Another portion is gradually raising the eligibility age for full benefits. Another possibility is reducing the initial benefit for those who have higher earnings. That can be done through the benefit determination calculations, the so-called bend points; through a comprehensive entitlement means test, in which the Concord Coalition has been very interested; or through inclusion of benefit amounts in income for purposes of calculating income tax. Still other options include reducing cost-of-living adjustments, investing Social Security trust fund assets in higher yielding private market securities, and/or requiring workers to buildup private retirement savings in lieu of or in addition to their Social Security benefits.

These last two items have been sometimes called the privatization option, and they are getting a lot of attention and enthusiasm lately. Part of the attraction may stem from the fact that, at least at first blush, many of these proposals appear to involve neither sacrifice nor losers, two things that most politicians abhor.

Is privatization the answer to the Social Security dilemma, or is it too good to be true? Here I'd like to echo and concur with Senator Simpson's observation that there is no free lunch. I think a lot of the enthusiasm for privatization is because people haven't thought through carefully what the problems are. Chief among those problems, of course, is the transition. It's not too hard to describe a very elegant system that will work just like a clock once we get there. The problem is, how do we get from where we are today to where we are headed? At least one generation, and perhaps several generations, will be required to continue paying for the retirement of their elders while putting aside for their own retirement. This double burden can be spread out, but it cannot be avoided altogether.

The Concord Coalition does not plan to put together its own specific privatization bill or proposal. But we do believe that as these plans are discussed and promoted and considered, they should be measured against a number of criteria. For purposes today of this testimony, I have laid out a dozen of them. I will tick through them quickly. Several come under the heading of macroeconomic or fiscal concerns.

The chief concern, that almost everybody here has touched on, is would the proposed reform, whichever of the many ones that are under consideration, increase net national savings, or would it merely swap ownership of assets. Investing some or all of Government-owned Social Security assets in the stock market does not increase net savings to the economy, particularly because the Government would then have to go out and issue more bonds.

Increasing net savings would require either reducing Federal deficits by trimming non-Social Security accounts, and here most proposals become very vague, or by requiring additional mandatory contributions, which may look and feel very much like tax increases to the individuals involved. Even though you say, "Well, it's not a tax, because you're going to own your savings," they say, "Yes, but it's coming out of my paycheck." So these are very real considerations.

Increasing savings necessarily means reducing current consumption. You either spend money or you save it. A dollar saved cannot simultaneously be a dollar spent.

A second concern is whether the proposed reform retains flexibility to make adjustments down the road if events do not match current projections. You've heard several witnesses touch on how dicey a lot of these projections, and how they depend on whether or not immigration changes, whether we have recessions, and a whole number of other variables.

The CHAIRMAN. But we're going to tighten up on immigration, so you're going to have fewer people paying in.

Ms. PHILLIPS. That increases this problem, dilemma. One of the things that several various proposals include, both those proposed by think tanks and by academics, is the idea of offering some form of "recognition bonds," where you would take the people who are currently in the system and essentially pay them off, make them whole, by giving them bonds or some other Federal securities equal to the present value of their future stream of benefits. I would observe that when you do that, you're really locking in for all time what those people expect today to get in the future. Whereas we know, that the promised benefits in the Social Security program have been changed in the past, and likely will be changed in the future. Looking over the history of the Social Security system shows that from time to time we came back and said we overdid it, we can't afford to continue paying as much as we've been. I'm talking about reducing COLAs, raising retirement age, changing dependents benefits, as was done, for example, in 1983. If we had locked folks in with recognition bonds at that point, their previously promised benefits would have been frozen. So with recognition bonds, you are eliminating your flexibility to make changes down the road.

Third, does the plan provide adequate financing? Some of the plans rely on the difference, the spread, between the stock market and what the Government has to pay in interest on its bonds. If you start moving huge amounts of Government financing into the stock market and then issuing more Government debt, you might see that that spread between the yield on the two kinds of securities actually would narrow. That would confound a lot of calculations on which various plans are resting.

Your calculations about financing any system have to be realistic, even conservative. Bad news has a way of happening, and we have a way of never anticipating it.

Think about the tax consequences of the reform plan. What are you going to do about taxation of the "tail" of the existing plan, as it phases out? What about the people coming into the new plan? How do you treat their contributions? How do you treat the money that they take out? What impact would this kind of privatization idea have on IRA's and other tax advantaged savings that are already out there? What about major tax reform? What if we go to a U.S.A. Nunn-Domenici type tax, or a national sales tax or value-added tax? How does all this play into that situation?

The CHAIRMAN. It sounds to me like we would be better off having a dictatorship and just having someone make the decision. [Laughter.]

Because as you lay out all of the dilemmas that——

Ms. PHILLIPS. I'm only up to No. 5. A number of concerns have to do with benefits protections and generational fairness. How do those who are already retired or about to retire fare under these reforms? What do you do about disability? What are the intergenerational tradeoffs? How does the reform plan deal with future cohorts of retirees?

There are really three different groups involved here: those who are already retired or about to retire; the baby boomers; and the folks who come behind the baby boom generation, the Xers and Millienials who are really most at risk of any of the groups we're talking about. A reform plan should make the future beneficiaries, the younger generations, unambiguously better off than they would be under the current system. They should be better off in terms of adequacy of benefits, and they should be better off in terms of rate of return. That is a tough requirement to meet.

How does the plan deal with lower income workers? What does it do to deal with people who make poor investments and end up with inadequate retirement resources? Regarding lower income workers, a number of the plans suggest having a two-tier system with a lower tier that would provide sort of a safety net.

Other plans talk about having a universal tier. Keep in mind that any benefit you offer on a totally universal basis is going to be very, very much more expensive than benefits that constitute a safety net only for those who need them.

Last, there are administrative and fiduciary concerns. How does the reform plan deal with investment decisions? What are the restraints on what you can invest in? How does the reform plan restrict the use of privately saved funds? What are the restrictions on taking money out of your retirement savings plan? Are there hardship exceptions? There is going to be incredible pressure to get money out of these plans before retirement. What about terminal illness, serious illness, home purchase, education, unemployment, a red convertible? What is it that you're going to be allowed to take the money out for.

Administrative costs under this system are bound to be higher than the Government's current costs. How can they be minimized, and what kind of a switchboard are you going to set up to keep track of where the money is going.

These are serious problems. We have to get working on this. We don't have too much time. Younger generations are coming along and they demand that we take a look at that. Seniors are already in the system and they're worried about where it's headed and the pact of silence has to end soon.

[The prepared statement of Ms. Phillips follows:]

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Social Security Reform

Evaluating "Privatization" Plans

Testimony of Martha Phillips
Executive Director, Concord Coalition

before the Senate Special Committee on Aging
September 24, 1996

The Problem:

A rapidly aging population in the United States, as in most other industrialized nations, poses serious long term problems for the Social Security, Medicare and Medicaid programs. The huge baby boom generation will begin reaching retirement age in little more than a decade. When these 76 million boomers are fully retired, by 2040, the number of seniors will be at least double what it is today and there will be only two working taxpayers for every retiree.

The 1983 Social Security reforms trimmed benefits and speeded up payroll tax increases in order to amass program surpluses. It was expected that these surpluses would increase net national savings and thereby encourage investments that would boost economic growth and help deal with the inevitable pressures that the retirement of the baby boomers would pose.

What the 1983 reformers did not anticipate was continual large peacetime budget deficits that have resulted in $4 trillion of federal borrowing since that year. The Social Security surpluses are being used to finance consumption-driven budget deficits, not for increasing net national savings, investment and economic growth.

Interlocking solutions:

Balancing the federal budget, and then moving into budget surpluses roughly equal to the Social Security Trust Fund annual surpluses, would increase the pool of capital available for investment in increasing the rate of economic growth.

A larger, more vigorous economy in the next century means more resources will be available to provide, though some combination of public and private means, an adequate retirement for the baby boom generation without requiring excessive, or generationally unfair, contributions from youth and working age citizens.

Politically and practically, to balance the federal budget and keep it in balance, everything must be on the table—including Social Security, to complete the circle. The long term financial commitments implicit in the structure of the current program are unsustainable. The issue is not *whether* the program will be revised, but rather *when* and *how.*

The longer we wait to address these problems, the more limited and, ultimately, the more draconian the choices and options will be. Many proposals require a substantial lead time in order to have a chance to achieve full impact by the time significant numbers of baby boomers reach retirement age.

Ironically, the current presidential campaign, and most House and Senate campaigns, are maintaining a pact of silence on the Social Security question. Far too many candidates respond, when Social Security is raised, by pledging not to touch it. Yet these are unavoidable issues. "Not touching it" is the one option we do NOT have.

Proposals for Reform

The problems ahead for Social Security can be tackled in a variety of ways. Most proposals currently in circulation include one or more of the following:

- Raise payroll taxes to levels required to continue financing benefits on a pay as you go basis or to partially finance the projected shortfall.
- Increase gradually the age for full retirement benefits beyond the age 67 under current law. Age increases are an indirect way to reduce benefits.
- Reduce initial benefit levels for those with a history of higher earnings or for those who have far above average retirement incomes. Means testing could take the form of changes in the benefit determination calculations, a comprehensive entitlements means test that would explicitly reduce benefit payments for well-to-do retirees, or inclusion of all benefit amounts in income for purposes of the federal income tax.
- Reduce annual cost of living adjustments, either across the board or in a way that protects those with lowest benefit levels.
- Invest Social Security Trust Fund assets in higher yielding private market securities.
- Require workers to build private retirement savings in lieu of or in addition to their Social Security benefits.

A number of proposals involving the last, the so-called "privatization option," have generated considerable attention and enthusiasm in the last year. Part of its attraction may stem from the fact that, at least at first blush, many of these proposals appear to involve neither sacrifice nor losers. Is some form of privatization the answer to the Social Security dilemma? Or is it too good to be true?

The transition from the existing under-funded system to one that depends wholly or substantially on private savings is the greatest hurdle. At least one generation and perhaps several will be required to continue paying for the retirement of their elders while also setting aside reserves to pay for their own retirement. This double burden can be spread out, but it cannot be avoided altogether.

A number of think tanks, academics and legislators are beginning to examine privatization, or "thrift" plans, as they are sometimes called, and several have been drafted into bill form and introduced. The Concord Coalition does not plan to offer a specific proposal of its own. However, we do believe that as these plans are discussed, promoted and considered, they should be measured against a number of evaluation criteria or questions. These are outlined below:

Macroeconomic/Fiscal Concerns

1. Would the reform increase *net* national savings and income or merely swap ownership of assets?

Shifting ownership of Social Security retirement savings from government accounts to private investments would require the government to borrow more from private markets to cover its annual budget deficits.

Some plans propose issuing staggering amounts of federal debt to pay off existing implicit obligations, leading to huge debt service costs followed by payment of principal when bonds are redeemed. Issuing explicit government debt (recognition bonds, consols, etc.) to replace debt implicit in the current un- or under-funded system does not change total national savings or capital.

Investing some or all of government-owned Social Security assets in stock market or other private investments does not increase *net* savings to economy but could benefit trust fund to extent that government profits from the higher amounts that can currently be earned in the private market.

Some maintain that although a plan may increase the level of federal red ink for a number of years, that is acceptable so long as genuine national savings are increasing by several times that amount.

Increasing net savings would require either *reducing federal deficits* by trimming non-Social Security accounts (and here the proposals become very vague), or requiring additional mandatory contributions (which may look and feel very much like tax increases to many workers). Increasing savings necessarily means reducing current consumption. A dollar saved cannot simultaneously be a dollar spent.

Eventually, when the productivity-enhancing results of increased savings kick in, consumption can return to, and perhaps exceed, previous levels—at the same time that substantial savings are being tucked away. But at the beginning of this process, it is inescapable that increased savings means decreased consumption, no matter how the trade-offs are explained or masked.

Household savings behavior: Feldstein and others show strong evidence that current system reduces propensity to save by insuring against old age income loss, longevity, and inflation. Yet Mitchell & Zeldes (Wharton School) suggest that for younger people who now doubt they will get full Social Security benefits, the decreased uncertainty of a funded system would reduce their precautionary saving. Mandating additional contributions would counteract this.

2. Does the proposed reform retain flexibility to make adjustments down the road if events do not match current projections?

"Recognition bonds" lock in current implicit commitments by formalizing the implicit liabilities —issuing debt in the present value amount of what workers/retirees would receive under today's program, formally and explicitly converting those expectations into hard cash (or the equivalent in government obligations.)

But Congress has changed Social Security benefits many times in the past and is likely to do so again in response to the impact of baby boomer retirement. People's actual future benefits therefore may not necessarily turn out to be as much as the benefits they would get from the program as it is structured today.

Instead of locking in today's expected benefits by issuing recognition bonds to individual workers/beneficiaries, a reform plan could, instead, issue general debt to the public at large in order to raise any funds needed to meet transition costs. This would preserve the possibility of future reductions in real Social Security benefits to make it more affordable to pay off the debt.

3. Does the plan provide adequate financing?

Relying on the spread today between return to private stocks and return to Treasury debt is risky. If the government goes into arbitrage business by buying up large quantities of stocks and selling treasury debt to public to make up the shortfall, this will tend to close the current yield spread between the two kinds of securities.

What safeguards are needed, if any, for paying benefits when the onset of retirement coincides with a down market?

Has the financing been calculated using realistic, even conservative, assumptions regarding rates of return, present value of liabilities, behavioral responses and other factors? Plans that depend on implausibly high real rates of return should be suspect.

4. What are the tax consequences of the reform plan?

Should the remaining stream of benefits from "tail" of current system be fully taxable? If so, should the tax revenues be plowed back into retirement benefits? for current retirees? for current workers?

What taxes should apply when private savings are drawn out of the new plan upon retirement? upon disability? upon death? If lump sum? If annuity?

Should contributions by workers/employers be deductible? If so, then should benefits be taxable when received? If contributions are deductible, what impact would this have on IRAs and other tax-advantaged savings?

If a major tax reform is adopted by Congress, how would the reformed Social Security/private savings scheme work? Under a national sales tax or VAT? Under a USA (Nunn-Domenici) tax reform that permits unlimited deductions for savings?

BENEFITS, PROTECTIONS, GENERATIONAL FAIRNESS

5. How do those who are already retired or about to retire fare under the reform?

Ninety-five percent of current system's benefits go to retired workers, elderly widows/ers, and elderly spouses. Are their benefits maintained, reduced on a progressive basis, reduced selectively, or reduced across the board?

Five percent of the current system's benefits go to child survivors, non-elderly disabled widows aged 50-60, and children aged 18 and under and permanently disabled children of retired workers. How are these beneficiaries provided for in the reform plan?

Some earlier plans suggested by academics would cash out current retirees and replace their stream of benefits with recognition bonds with which they could purchase annuities. This assumes that the private annuity market could and would offer a product, despite the likely adverse selection that would occur.

6. How does the reform plan deal with disability?

Some provision for disability is needed under any reform plan because it requires a long time to build up enough savings/assets to purchase an annuity. Few workers becoming disabled at, say, age 40, would have saved enough in private retirement accounts to fund adequate disability coverage.

Private disability insurance exists, so some argue that this coverage could be handled either publicly or privately. Some plans retain the disability portion of OASDI and privatize only OASI. If the private disability option is selected, should disability insurance be mandatory? Only for workers with dependents?

7. What are the inter-generational tradeoffs? How does the reform plan deal with future cohorts of retirees?

Three groups are involved: those who are retired or about to retire, boomers, and Xers and "Millennials." Each presents a different problem.

A reform plan should make future cohorts of beneficiaries unambiguously better off than they would be under the current system. This should be measured in terms of

- adequacy (both wage replacement and absolute dollar amounts)
- rate of return: people should get a better deal for their money

Both these criteria should be measured without "smoke and mirrors" using realistic, even conservative, rates of return.

8. How does the reform plan deal with lower-income workers?

Low income workers now get very favorable deal under Social Security in terms of the progressive benefit structure that provides a higher wage replacement for lower incomes than for higher.

Some reform plans would subsidize contributions to private savings for lower-income workers since their personal contributions alone would not provide adequate benefits unless they earned an extraordinarily high rate of return.

Other plans have two tiers. The bottom, basic tier provides universal modest benefits to make sure that lower income workers have adequate retirement incomes. However, making this basic tier universal is far more costly than means-tested low-income support.

Although low income workers get progressively higher benefits, on average they live fewer years after retirement and thus receive less in total than the progressive benefit structure would indicate. Some argue, therefore, that no *additional* protections or supplements are required in order to provide the same benefits for lower income workers that the current system provides.

Also, to the extent that low-income workers do not spend all their accrued assets under a reform plan, they can bequeath the remainder to their heirs, unlike the current system.

9. How does the reform plan deal with people who make poor investments and end up with inadequate retirement resources?

Some people will be unlucky. Some plans call for a public means-tested guarantee to back up the privately invested contribution accounts. Does the offering of indexed Treasury bonds eliminate the need for such a safety net?

ADMINISTRATIVE/FIDUCIARY CONCERNS

10. How does the reform plan deal with investment decisions?

Does the plan have a sensible set of regulations having to do with investment decisions, including diversification requirements and risk/safety requirements?

Do the plans offer a government default option, permitting workers to default to a "generic" investment plan operated by the federal government (like the federal workers' current "Thrift Savings Plan.)

Investor education is essential. Workers and retirees must become financially literate. How is this provided for?

Objective reporting to the public of essential features (yield, risk, etc.) of various investment plans should complement investor education. Should objective reports be provided by federal government? By a "consumer reports"-type independent board?

11. How does the reform plan restrict the use of the privately saved funds?

What restrictions are there on taking money out of the retirement savings plan? Are there any hardship exceptions that should be made? Terminal illness? Serious illness? Home purchase? Education? Unemployment? A red convertible?

Is it acceptable to permit withdrawals at any age so long as the worker uses the first dollars to purchase an annuity sufficient to provide poverty-level retirement benefits for worker and spouse?

12. What are the administrative costs under the reform system?

They will always be higher than current system. How can they minimized?

Must there be a "switchboard" entity to track contributions, investments, etc?

The CHAIRMAN. Thank you very much, Ms. Phillips.

Singapore was referred to earlier, and as I understand their system, they have a mandatory savings program, where they have savings in the range of 40 percent, 20 percent from the individual and 20 percent from the employer. Those funds are accumulated over the lifetime of that individual, can be withdrawn on three occasions only. First, you can withdraw some of the funds to purchase your first home. Second, you can use them for extraordinary medical expenses. Third, for retirement. Other than that, the money stays in the fund.

Even though it may not be returning as much as if the Government were not doing the investing, I think that they have found that they have enormous amounts of capital available for all of their infrastructure and other types of social needs. Most seem reasonably happy with the system. Of course, Singapore consists of 3 million largely Chinese people who do not have the kinds of problems that this country has, or dilemmas that we face, as far as dealing with a multiethnic, multiracial, multicultural society of 250 or 260 million plus.

Now, Dr. James would you please try to respond to all of the questions that Ms. Phillips has just raised? [Laughter.]

Ms. JAMES. I think the previous speakers have pretty well covered most of what I was going to say. Incidentally, although the Singapore scheme, has been labeled a retirement savings plan, in fact, most of the money has been used for home ownership. When people are retiring now, they are finding very little in those savings accounts for their retirement years. Unfortunately, you can't eat your homes. So this is a problem that Singapore is grappling with now.

STATEMENT OF ESTELLE JAMES, LEAD ECONOMIST, WORLD BANK

Ms. JAMES. Let me just start by saying that today I'm speaking as an individual, not as a representative or employee of the World Bank. However, I will be basing my comments on work that I did as principal author of Averting The Old Age Crisis, which is the World Bank's study of old age security plans around the world.

The CHAIRMAN. We may sell some books here today, if nothing else. [Laughter.]

Ms. JAMES. Yes, absolutely. They're available at the World Bank bookstore, $20 a copy—a very good price.

The CHAIRMAN. We have Senator Simpson's book.

Ms. JAMES. That's right.

Public pension spending increases exponentially as populations age. It now exceeds 10 percent of GNP, or 25 percent of public spending, in many countries around the world. This comes on top of the medical spending that increases as populations age.

This was our starting point—that huge sums of money are involved in these programs. Therefore how this money is generated and how it's spent can affect the entire economy, not just the old. It can affect productivity and the size of the GNP pie.

We have 2 criteria for evaluating old age security programs not 12, but I think our 2 really subsume the 12 that were just listed. First, these programs should protect the old in an equitable way, and second, they should promote or at least not hinder economic growth, which is important both for the old and for the young.

In other words, we have to keep our eye on the impact that these programs have on the broader economy. Unfortunately, when we looked around the world at many existing programs, we saw many problems and we felt that they were neither protecting the old well, especially the people who will grow old in the future, nor were they good for the broader economy.

To counter the problems that we found, we concluded that piecemeal reforms alone were not sufficient. In most countries, a new structure is needed. This structure should put greater emphasis on saving and funding, it should share responsibility between the public and private sectors, and it should give added protection to workers with low lifetime incomes.

Specifically, mandatory retirement income should come from two parts; we call the parts "pillars." One part should come from peoples' own savings, which would be privately managed, and therefore you could call this the private pillar. The other part would come from redistribution across individuals, or income groups, which would be publicly managed, therefore it's the public pillar. Both parts should be required. Of course, there could be additional savings on top of that, but I am talking about the mandatory part here.

The public part might be similar to our current Social Security system, but a much downsized version and more targeted to low wage earners.

The newest and most controversial part of our recommendation concerns the mandatory saving plans. So let me just briefly explain the rationale and how they would work in the World Bank system and in countries around the world where they've been tried.

First of all, these plans would be mandatory, so they would cover the entire population. Voluntary plans only cover a minority. They would link benefits closely to contributions, preferably through a defined contribution plan, in order to discourage evasion, to discourage early retirement, and to force retirement age to increase or benefits to decrease automatically as longevity increases. As other speakers have said, one of the major problems of current systems is that longevity increases while retirement age, ironically, goes down. A defined contribution system should deter that kind of development, without the need to make a difficult political decision each time.

They would be fully funded to make sure that a country's retirement promises do not exceed its ability to pay, to avoid dramatic tax increase as populations age, to prevent large intergenerational transfers, and to help build long term national saving.

Now, there's been a lot of talk about the savings effect. So let me just emphasize here that to have a positive savings effect is not easy. Because as the previous speaker said, to have more savings, you have to have less consumption. This is generally not popular. It concerns me that some of the proposals that supposedly will increase saving in fact don't increase taxes or contributions. It's hard to see where the positive savings effect will come from. In general the savings effect will be more positive if the mandated savings rate is relatively high, and if consumer borrowing is somehow limited or discouraged. Otherwise people will simply borrow against that savings. Also, public dis-saving, in the form of deficits, must be constrained. Preliminary evidence from Chile suggests that their new pension system, which features a mandatory saving plan, has had a positive effect on national saving. But this is just preliminary evidence, and we do have to be cautious how we interpret these data.

Now, finally, the mandatory savings account in the World Bank plan would be privately and competitively managed in order to produce the highest return on saving and the best allocation of capital. When we looked at the data, we found that during the 1980's, publicly managed pension funds in most countries actually lost money in real terms, while privately managed funds on average earned high returns.

The reason for this disparity is very simple. The privately managed funds were able to invest in a diversified portfolio of stocks, bonds, real estate, and foreign assets, based on economic criteria, while the publicly managed funds were invariably given very limited investment options. They were forced to invest in low interest government bonds, loans to failing state enterprises, or other investments that were dominated by political criteria.

Empirically, it seems almost impossible to avoid these political objectives in a publicly managed fund. I imagine, if I were a Senator, and I had these funds at my disposal, it would be difficult for me to avoid directing those investments. However, the resulting allocation of capital is bad for the pension fund and ultimately bad for the economy. It doesn't maximize productivity.

Now, over the past few years, several countries have adopted this model that I've just described. These include Chile, Argentina, Peru, Colombia, Uruguay, Australia, Switzerland, Denmark, and the United Kingdom. Many other countries are now actively considering this kind of system. So clearly, we can learn from this that fundamental change is possible in a democracy. Democracies have made these changes.

The CHAIRMAN. You don't cite Chile in that category.

Ms. JAMES. No. That's why I listed all these other countries. I think it's unfortunate that so much emphasis is put on Chile. Because people immediately say, dictatorship, no good, can't be done elsewhere. In fact, it is being done elsewhere. Although it's more difficult, definitely.

Now, most of these reformed systems are quite new. So the amount we can learn from them is limited. But we can still learn some things. First of all, they have certain important commonalities. They all include a largely funded defined contribution component—which are the mandatory savings plans. The accumulated funds are privately and competitively managed. The private management is heavily regulated by the Government to prevent fraud, excessive risk taking or under risk taking which is the opposite danger, mainly by requiring investment diversification.

The mandatory savings plans are all buttressed by a publicly managed, tax-financed, social safety net, which is designed to protect low wage earners who can't save enough to sustain themselves in old age.

Now, these plans also have important differences. In the Latin American countries, workers make the contributions into their own retirement savings accounts, and they direct the investments by choosing the investment company. On the other hand, if you look at OECD countries, typically employer and union trustees make these investment choices for an entire group of workers—a company or an occupation or industry. This is partly because employer-sponsored plans were common in these countries on a voluntary basis before they became mandatory. Giving the employer and union representatives the choice may lead to better informed decisions and to lower administrative expenses, while giving workers the choice is justified on grounds that workers ultimately bear the investment risk.

A mixture of the two may be best. For example, in the United Kingdom, employers make the choice but workers have the right to opt out of the employer's plan if they think they can do better. Australia is now moving in this direction also.

The CHAIRMAN. Could I ask, do any of these programs provide for disability or survivor benefits?

Ms. JAMES. Yes, in different ways. For example, in the Latin American countries, these benefits are actually privatized. The pension fund takes a certain amount of the worker's contribution and buys the disability and survivors insurance from a private insurance company. That's one way it has been handled. It could be handled in other ways, for example, left in the public pillar. That's one of the choice variables, one of the choices that would have to be made.

Another important difference among these plans is the way they handle the protection of the income groups under the public pillar. In Chile, a minimum pension guarantee is attached to the mandatory saving plan. In Argentina, a flat or uniform benefit is paid to all workers; this costs more. In Australia, old people are eligible for a means and asset tested benefit.

So there are different ways of handling redistribution, and there are pros and cons of these different ways. We did not feel that any one way was uniformly better.

The main point is that a wide range of alternative arrangements and relative sizes of the public and private pillars all meet our dual criteria. We recommend that of the total mandatory contribution, at least one-third but no more than two-thirds should be allocated to each pillar, the public and the private. This will permit economies of scale and risk diversification—both of these, at the same time.

Some countries, such as Sweden and Italy, are now in the process of instituting very small mandatory saving accounts based on a 2 percent contribution rate. We've also heard people mention a 2 percent contribution rate to a mandatory saving plan here today. The danger with a very small mandatory saving plan is that it's likely to simply displace voluntary saving. Therefore, not to represent a net addition to retirement income or to total national saving. People will say, well, we have this required account over here, so we can simply take our money out of this account that we have saved voluntarily over there. We may feel good and say we've done something, but in the end, we may have changed very little. So that's why we recommend that each part, the mandatory saving account and the public social safety net, should be somewhere between one-third and two-thirds of the total.

Now, on the question of the transition, countries made the transition from a dominant single pillar system to a multipillar system in somewhat different ways. Australia and Switzerland were fortunate because their public arrangements were relatively small to begin with. So they just added on a private pillar with additional contributions. They didn't really have to make a transition, it was an add-on. But most other countries will have to make a more difficult transition. Because they will have to continue to pay benefits to workers who have earned them under the old pay-as-you-go system, while part of the old contribution is diverted to a new private funded pillar. The question is, how can we cover this financing gap?

Now, the most common way of making the transition is, the clock is stopped on the old system, people are given credit for their prior service, either by issuing recognition bonds, which was the method used in Chile, or compensatory pensions as in Argentina. Ideally, all new workers would be put into the new system.

Current workers are typically given a choice between staying in the old system and shifting to the new system. When they've been given this choice, most workers under the age of 40 have opted for the new system, while many workers over the age of 40 have chosen to remain in the old system. Typically, current pensioners continue to receive most of their promised benefits.

The CHAIRMAN. If you would summarize the remainder of your statement.

Ms. JAMES. Yes, I'm at the very end.

Part of the financing gap could be covered by cutting benefits and increasing contributions. But all reforming countries so far have used some degree of debt finance for covering the financing gap, so that a heavy double burden is not imposed on the transition generation of workers. In effect, part of the implicit debt is converted to an explicit debt. In the Latin American countries, the financial markets reacted well to this because they perceived it as an indication that the public debt would not continue to expand in the future. But we don't know how that would work in the United States.

To increase the probability of a favorable outcome before issuing these recognition bonds, it's essential to reduce the implicit debt in some way by reforming the current system. In other words, reforming the current system and shifting to a new system are not substitutes, they are complements. You have to downsize the benefits, raise the retirement age, change the indexation method, before you give people their legal rights to the benefits. Otherwise, you are simply reinforcing a debt which perhaps never should have been incurred in the first place.

It's also important to have a strategy for paying off the transition debt over time through taxation. Otherwise your objective of raising saving will never be attained.

Let me finally say that, whichever method is chosen, public education is essential to convince the public that this change is both necessary and desirable. So as a citizen, I would like to thank this committee for putting these issues on the table.

[The prepared statement of Ms. James follows:]

AN INTERNATIONAL PERSPECTIVE ON REFORMING SOCIAL SECURITY:

Written Testimony for the Senate Special Committee on Aging

by

Estelle James, Lead Economist

Policy Research Department

World Bank

September, 1996

AN INTERNATIONAL PERSPECTIVE ON REFORMING SOCIAL SECURITY:

Written Testimony for the Senate Special Committee on Aging[1]

by

Estelle James

Over the next 35 years, the proportion of the world's population that is over 60 will nearly double, from nine to sixteen percent. Because of medical improvements and rapid fertility decline, populations are aging much faster in developing countries than they did in the industrial countries. As young working-age people near retirement--around the year 2030--eighty percent of the world's old people will live in what today are developing countries. More than half will live in Asia and more than a quarter in China alone (Figures 1 and 2). These countries need to develop their old age systems quickly and make them resilient to rapid demographic change. The World Bank report, Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth, was prepared with this need in mind. However, the study also has implications for industrialized countries, such as the United States, that are now reevaluating their existing systems of old age support. This statement summarizes the lessons we learned from other countries that may be relevant to the debate in the United States.

Population aging is welcome because it indicates that many people have an opportunity to live longer and healthier lives. But it also creates problems, because the working age population must now support a growing number of people who are no longer actively generating economic output. Cross-sectional analysis shows that public spending on pensions, providing income to retirees, increases exponentially as populations age. It now exceeds 10% of GNP and 25% of total public spending in some countries (Figure 3). Thus, very large sums of money are involved.

Averting the Old Age Crisis argues that how this money is generated and spent affects the entire economy, by influencing productivity and the size of the

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[1] This paper draws heavily on Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth, World Bank and Oxford University Press, 1994, of which Estelle James was the principal author. However, this paper was written by James as an individual and not as a representative of the World Bank.

GNP pie. Increasing productivity is especially important as populations age, and a relatively smaller number of workers must support a growing number of retirees. Therefore, countries should use 2 over-arching criteria for old age programs: they should protect the old (in an equitable way) and they should promote (or at least not hinder) economic growth--which is important both for the old and the young.

Growth effects are always hard to quantify and prove, so careful judgements are necessary, about both theory and evidence. If you don't buy the premise that old age systems may affect efficiency and growth, you won't buy our recommendations. But countries that do accept this basic premise will be forced to reexamine their existing programs.

The system recommended in Averting the Old Age Crisis differs from the system that was adopted by most OECD countries 40-60 years ago and is still in use today. But the world economy, the opportunities and challenges it presents, are also different. If these countries were initiating or expanding their coverage today, as are many developing countries, they might well choose a system similar to the one recommended in Averting. The chief characteristics of this system are that it puts greater emphasis on saving and funding, it shares responsibility between the publci and private sectors, and it gives added protection for workers with low lifetime incomes. We argue that, for most countries, the mandatory part of old age security should be broken into two parts or "pillars": Part of retirement income should come from a person's own saving, which would be privately managed, part from redistribution across individuals or income groups, which would be publicly managed, and these two mandatory parts would be supplemented by voluntary arrangements for those who want more protection. Hence we call this a multi-pillar system.

Although systemic change is always difficult, the experience of several countries that have already instituted these structural reforms shows that such change is possible, even in democracies, and it usually involves spreading the transition costs over several generations by swapping implicit for explicit debt that is gradually paid off.

In this paper I describe the most common problems found with dominant systems today; present the recommended framework for a reformed system; and make some comments on transitional problems that would be encountered by industrialized countries wishing to shift.

I. First, Problems With Current Systems

Most formal systems of old age security, including the United States' social security system, are publicly managed, pay "defined benefits" that depend on the worker's earnings rather than contributions, and are financed by payroll taxes on a pay-as-you-go basis (PAYG)--meaning that today's workers are taxed to pay the pensions of those who have already retired. As we studied these systems around the world, the same problems appeared over and over again, both in industrialized and developing countries. This led us to believe that these problems are not accidental design flaws; rather they stem from the politics and economics of pay-as-you-go defined benefit systems, which make it easy for politicians to promise present benefits to privileged groups at the expense of large future costs or to misuse the reserves that sometimes accumulate in the early years of a plan (see Appendix). A new system is needed that is more immune to these dangers. The problems fall into three categories: those related to efficiency and growth, distribution, and financial sustainability.

First--problems related to growth:

High payroll tax rates. In pay-as-you-go systems, when populations are young small contributions from the large number of workers make possible generous benefits to the few pensioners. However, as populations age and systems mature, these systems must charge very high payroll taxes to keep these benefit promises. Even some countries with young populations have surprisingly high payroll taxes, because of the way their systems have been abused. Thus, payroll taxes for pensions are already over 25% in Egypt, Hungary, Russia, Kyrgyzstan, Brazil, and Italy. In Germany the combined payroll tax rate (for pensions, health care, long term care, unemployment benefits and other forms of social insurance) now exceeds 40%, it will exceed 50% by 2030, and well over half of this is used for pensions. Payroll taxes are still much lower in the United States, but they will have to escalate sharply over the next thirty years unless our system is changed. High payroll taxes mean lower take-home pay if borne by workers or more unemployment if borne by employers, particularly as markets become globalized and countries with younger populations and lower tax rates compete with older ones. In OECD countries, these taxes (for pensions and medical expenses of aging populations) are likely to use up much of the productivity increase accruing in the next 30-40 years, leaving little for augmenting the standard of living of the average worker.

Evasion. In defined benefit plans payroll taxes are not linked to benefits, leading to evasion and labor market distortions. In many Latin American countries over 40% of the labor force works in the informal sector, partly in order to avoid payroll taxes, and the informal sector is growing rapidly in Eastern Europe. The underground economy and underreporting of income, particularly among the self-employed, is also common among OECD countries. Evasion undermines the system's ability to pay pensions, makes it necessary to raise payroll taxes still further, and hurts the economy, since people who work in the informal sector are often less productive.

Early retirement. Most defined benefit schemes allow workers to retire early without an actuarially equivalent reduction in benefits. In Hungary, more than a quarter of the population are pensioners and the average retirement age is 54. In Turkey many people retire below the age of 50 or even 40. In all OECD countries, including the United States, the labor force participation rate of men over the age of 55 has fallen substantially over the last couple of decades, even as longevity has been increasing. Early retirees hurt the scheme financially because they stop making contributions and begin drawing generous benefits. They also hurt the economy because they stop working and producing. Raising the retirement age may seem difficult in a context of unemployment, but actually early retirement only hides unemployment in the short run and adds to it in the long run by raising labor costs. So once again, this has not been good for the old age system and it has not been good for the economy.

Misallocation of public resources. Austria, Germany, Italy and Uruguay spend more than one-third of their public budgets on pensions. In the United States this number is 25%. If benefits are not contingent on contributions, people will regard contributions as taxes. Since the government's ability to tax is limited by economic and political considerations, high public pension spending can squeeze out government spending on growth-promoting public investments such as infrastructure, education and health services; or it can lead to inflation if the government tries to maintain this spending through deficit finance.

Lost opportunity to increase savings. Many countries, including the United States, believe they have inadequate national saving that hampers growth. One reason why people might save is to support themselves in old age, but current systems have not been used to induce people to save more and some economists believe that in fact they have induced people to save less. The impact of PAYG systems on saving is highly contentious, and in Averting the Old Age Crisis we spell out the arguments pro and con. But whether or not you think that PAYG schemes have decreased saving, it is clear that they have not increased saving. Funded systems that require people to save at a rate in excess of what they are doing voluntarily (while simultaneously constraining consumer and public borrowing) could be used as a tool to increase national saving, and this has not been done in most countries.

Now I move on to problems related to distribution:

Failure to redistribute to low income groups. Publicly-managed defined benefit systems are sometimes justified on grounds that they help the poor. But, despite seemingly progressive benefit formulas, studies of public plans in the Netherlands, Sweden, the UK and US have found little if any redistribution from lifetime rich to lifetime poor. This is partly due to design features--the failure to cover low income groups in the early years of the plan, the taxation of labor income but not income from capital, the low ceiling on taxable earnings and the tendency to base pensions on wages during the last few years of employment, which benefits those with steeper age-earnings profiles. In addition, there are important hidden reasons for the lack of lifetime redistribution in defined benefit plans, including the fact that high income people enter the labor

5 shows the implicit public pension debt--the present value of the amounts that have been promised to current retirees and workers but have not been funded--in several OECD countries, including the United States. The implicit public pension debt is much larger than the explicit conventional debt, it exceeds 100% of GNP in almost every case and sometimes exceeds 200%. (In the United States, because a small portion is funded, the unfunded amount is slightly less than 100% of GNP). Current payroll tax rates are much less than needed to pay off this debt and most countries will have a hard time raising them enough to close the gap. Pension benefits or other public goods will have to be reduced in the future. Most OECD have already taken piecemeal steps in this direction, but more will be necessary.

Thus, existing public pension plans have not always protected the old, they especially have not protected the old who are poor or people who will be old in the future, they often have not distributed their benefits in an equitable way, and they have hindered economic growth. In addition, the systems are not sustainable in their present form. They are all going to have to change, one way or another. All industrialized countries are now making their piecemeal design changes, but they should use this opportunity to consider carefully whether structural reform is also desirable.

II. A Framework for Reform

This brings me to the second point--a framework for reform. We recommend a multi-pillar system that puts greater emphasis on saving, that has separate financing and managerial mechanisms for redistribution and saving and that shares responsibility between the public and private sectors (Figure 6).

The first pillar would resemble existing social security plans in that it would be publicly managed, defined benefit and tax-financed. However, unlike most current systems, the reformed public pillar would focus on redistribution--providing a social safety net for the old, particularly the old whose lifetime income was low. This recommendation is based on a value judgment that redistribution is socially desirable and a technical recognition that redistribution is the function that uniquely requires public financing and force later and so contribute for fewer years, and live longer thereby receiving benefits for more years.

Positive transfers to early cohorts, and losses to their children. How can we reconcile this observation with the oft-noted point that social security has reduced old age poverty? The answer lies in the large intergenerational transfer that is taking place, from the young, both rich and poor, to the old, both rich and poor. Almost universally, covered workers who retire in the first 20-30 years of a pay-as-you-go scheme get back much more than they contributed, but their children and grandchildren get back less than they paid in and lower rates of return than they could have earned elsewhere. Many studies have documented that this holds true for the United States. Sometimes we may want to redistribute across generations, perhaps favoring cohorts who have lived through a depression or war. However, redistribution through PAYG takes place without a full discussion, or even without a full public understanding, of what is going to happen once the system is instituted. In many cases, the people who are being redistributed away from weren't old enough to participate in the discussion; only the gainers participated. Often the people in the older generations who have collected the most are high income groups, while today's young people, many of whom are earning low wages, are paying substantial payroll taxes to finance these benefits. Many of us would agree that this is not an equitable procedure or outcome.

Finally, financial sustainability:

As a result of all these forces, old age systems are in serious financial trouble and are not sustainable in their present form. The situation has been most acute in Latin America and Eastern Europe, whose systems have been close to bankruptcy. In the past, the most common way these countries have escaped from these unrealistic promises is to allow inflation to take place without indexing benefits. In Venezuela, the real value of benefits plummeted 60% during the 1980's due to inflation without indexation (Figure 4).

Fortunately, the United States and other OECD countries are not likely to use this solution, but we also face serious problems in the years ahead. Figure control; for everything else, we must give careful attention to market alternatives. The redistributive benefit formula could be flat, as in Argentina and the Netherlands (uniform for everyone or related to years of covered employment), means- and asset-tested (as in Australia) or could provide a minimum pension guarantee (as in Chile). Financing could be out of general revenues or a payroll tax with a floor and a high ceiling on taxable wages (the latter is desirable in developing countries where only a minority of the population is covered). Because of its limited scope and broad tax base, tax rates to support this pillar would be much lower than the public system requires in most countries today.

Such redistributive programs are sometimes attacked on grounds that they will lose political support from high income groups so that ultimately low income groups will not be protected. Recall, however, that current defined benefit plans (that are positively related to earnings) have, in fact, produced little if any protection in the form of net transfers from the rich to the long term poor. The important political economy assumption underlying this recommendation is that upper income people will be no less (and possibly more) willing to redistribute through a smaller but more targeted benefit program.

The second mandatory pillar would differ dramatically from most existing systems. It would be fully funded, would link benefits actuarially to costs, and would be privately and competitively managed through personal saving plans or occupational pension plans. Essentially, people would be required to save for their old age, and this pillar would handle their savings. Its form would differ sharply from existing social security systems, which are defined benefit, pay-as-you-go and publicly managed. Let me explain the reasoning behind these differences, and why we believe a mandatory funded privately-managed defined contribution pillar is a better way to provide the non-redistributive part of the pension.

Why mandatory? Because it will require people to save for old age, which some are too shortsighted to do, and because this is a more efficient arrangement than PAYG as a way to provide the earnings-related part of the mandatory pension.

Why link benefits to contributions? To discourage evasion and other labor market distortions, since people are less likely to regard their contribution as a tax. And those who do evade or underreport their income bear the cost in the form of lower benefits rather than passing the costs on to others and undermining the financial viability of the scheme, as when benefits and contributions are not closely linked. In addition, in defined contribution plans, in which the capital accumulation is turned into an annuity or gradual withdrawal upon retirement, each worker bears the cost of his own early retirement, in the form of lower annual benefits. This is likely to deter early retirement. It will also raise the normal retirement age or reduce annual benefits automatically as longevity increases--without requiring difficult political decision every few years.

Why fully funded? To make costs clear and payable up-front, so countries won't make promises now that they will be unable to keep later; to avoid large tax increases as populations age; to prevent large inter-generational transfers, because each generation is, essentially, paying its own way; to help build national saving, especially saving committed for the long term, that increases future productivity and wages; and to help finance future pensions out of the return to this saving.

Ironically, it has been argued both that full funding will not increase saving and that it will cause a capital glut. On the first point: There are no magic bullets to painlessly increase national saving. But requiring people to save for their retirement may be one of the few politically acceptable ways to get them to reduce current consumption, in situations where undersaving is perceived to be a problem. The positive impact on saving will be particularly large if the mandatory contribution rate exceeds the amount that people were previously saving voluntarily (to minimize crowd-out), if the opportunities for consumer borrowing against these savings are limited, and if fiscal constraint is observed so governments do not dissave an equivalent amount.

On the second point: Some analysts have argued that full funding will cause a capital glut. In reply, it is necessary to remember that only part of the overall system would be funded, the build-up of funds would be very gradual, it would not occur in all countries at the same time, some of it would be used to finance the transition to a new pension system, and some should be invested abroad in countries that have low capital/labor ratios. Thus a capital glut is not likely to be a problem in the foreseeable future.

Additionally, it is sometimes argued that past savings are irrelevant because the consumption of today's retirees can only be supported by the output of today's workers. However, this common belief, like many in this field, is overly simplistic. Past savings can enhance the productivity and therefore the output of today's workers, they can be imbedded in consumer durables that continue to provide a stream of services, and they can be invested abroad, then redeemed to finance an in-flow of consumer goods. Thus, saving can be an important ingredient of a long run strategy for providing additional domestic consumption when the dependency rate increases.

Why privately managed? To produce the best allocation of capital based on economic rather than political objectives, to earn the best return on savings, and to help countries develop their financial markets (the latter especially important for middle income countries). Figure 7 provides some of the evidence that led us in this direction. It displays data on the rates of return to publicly and privately managed pension reserves during the 1980's--data that is not generally available, for reasons that will become apparent. Most publicly managed pension reserves fared poorly and in many cases lost money throughout the 1980's, because they were required to be invested in government securities or loans to failing state enterprises--at low nominal interest rates that became negative during inflationary periods. Even in the case of the United States, Singapore and Malaysia, where the returns were not negative, they were not nearly as high as the positive returns that were earned on average by privately managed funds. Clearly this poses a problem for the financial viability of the public pension funds.

It also poses a problem for the economy as a whole if the exclusive access to these funds makes it easier for governments to run large deficits or to spend more wastefully than they could if they had to rely on more transparent and accountable sources of funds. Even if the current government is fiscally responsible future governments may not be, and the accessibility of publicly managed pension reserves enables them to spend without taxing or borrowing through the market.

Competitively managed funded pension plans, in contrast, are more likely to be invested in a mixture of public and corporate bonds, equities and real estate, thereby earning a higher rate of return. They can enjoy the benefits of investment diversification--offering opportunities to increase the yield, including yields from countries where labor is abundant and capital relatively scarce, and decrease the risk, especially the risk of country-specific shocks. These private pension funds could take the form of personal saving plans where the worker chooses the investment manager, as in Chile and Argentina, or of occupational plans where the employer and/or union chooses, as in Australia, Switzerland, Denmark and the Netherlands.

Caveats. But two caveats are essential here: First, countries must have at least rudimentary capital markets (such as a secondary market in government bonds) at the beginning--and these markets will develop further (disclosure requirements, credit rating institutions, stock exchanges) as the pension funds grow. And second, considerable government regulation and regulatory capacity are essential to require diversification and to avoid investments that are overly risky or managers who are fraudulent. Fortunately, the United States meets both these requirements.

Of course, it is possible that the regulation will become excessive and, in effect, direct the investments, almost as much as in publicly managed pension funds. However, a countervailing force has been set up as private pension funds grow--the funds themselves, their clients, and the private sector enterprises that gradually come to depend on them as a financing source. Thus, an important political economy assumption underlying this recommendation is that mandatory privately managed pension funds are more likely than publicly managed funds to be insulated from political pressures in choosing their investment strategies.

Finally, a third pillar would offer additional protection, through voluntary occupational pension or personal saving plans, for people who want more in their old age. An important public policy issue here: Should governments offer tax incentives for voluntary saving and annuities? The answer depends on whether such incentives are consistent with the country's over-all tax policy toward consumption versus saving. A piecemeal approach offering special incentives for retirement accounts could be regressive (since voluntary plans are used mainly by upper income groups) and could simply lead people to shift their retirement savings from taxed to non-taxed forms, with little net increase in voluntary saving for the individual or for the economy as a whole.

The insurance function would be provided jointly by all 3 pillars, since broad diversification is the best way to insure in a very uncertain world. Remember the old adage that modern finance has rediscovered --don't put all your eggs in one basket. In the system just described, each mandatory basket would carry between one-third and two-thirds of the total mandatory eggs for covered workers as a group. That is, if the total required contribution rate for pensions is 15%, somewhere between 5 and 10 percentage points each should be allocated to the public and private pillars. The voluntary basket would carry additional varying amounts, depending on personal preferences. Insurance against specific risks such as longevity, disability and dependent survivors would be provided by each pillar and, moreover, the three pillars together would co-insure against unknown risks by diversifying across types of management (public versus private), sources of funding (income from labor versus capital), and investment strategies (equities versus bonds, domestic versus international). Whatever unpredictable disasters occur in the future--as they surely will--this diversified system is most likely to continue providing protection for the old.

Empirical evidence. The growth effects of a system that includes mandatory defined contribution plans, full funding and private management are hard to prove and quantify empirically, in part because relatively little experience and data are available and in part because it is difficult to build models that capture all the complex dynamic interactions, so results can always be challenged by changing the specification. For example, imperfect capital markets, evasion, labor shifts between formal and informal sectors, and financial market development have been left out of many frequently cited simulations--but these are the very conditions that justify the positive growth effects of pension reform. Limited evidence from Chile indicates that the new pension system increased national saving and deepened Chilean financial markets, which in turn enhanced its economic growth, in the 1980's and 1990's. But ultimately, in recommending policy in this area, I believe we have to apply our best judgement according to the criterion of "preponderance of theory and evidence," rather than "beyond reasonable doubt", because the latter can rarely be satisfied empirically. In this context of uncertainty, the risk diversification argument strongly supports the multi-pillar approach.

Reforming countries. For the reasons discussed above, variations on the recommended multi-pillar scheme have recently been adopted in Chile, Argentina and other Latin American countries, which used an abrupt transition toward mandatory saving plans in their second pillar; and Australia and Switzerland, which are gradually building mandatory occupational plans. In the Netherlands and Denmark collective bargaining has made funded occupational plans quasi-mandatory. In Japan employers are now permitted to opt out of the earnings-related part of the public program into their own decentrally controlled funded plans, while in the UK employers can opt out of the state program, workers can opt out of their employer's plan into their own personal retirement plans and the state earnings-related plan is disappearing as a result.

Countries that--are not anxious to increase their rate of national saving, or have other easier ways of accomplishing this; are already investing abroad in economies with lower capital/labor ratios and high rates of return; are not worried about evasion, wage stagnation or unemployment; find it politically easy to adjust their retirement age upward periodically; are willing to distribute the burdens and benefits unevenly across generations; and weight the disadvantage of capital market volatility more than the advantage of risk diversification--will see little reason to consider this new path. But most countries have the concerns listed above, and will find themselves reevaluating their old age security systems with these effects in mind.

IV. How to Make the Transition

The kind of system described above is most easily adopted by countries that have regulatory capacity and functioning capital markets, but do not yet have a large implicit pension debt. Many middle income countries fall into this category, as did Australia, Switzerland and the UK when they started their second pillars. It is important for developing countries with only limited coverage now, to make the transition before coverage expands and a large debt builds up.

But how could the United States and other OECD countries make this transition, given the large implicit public pension debt that they have accumulated? At least two methods are available--an abrupt or a gradual transition.

Under the abrupt transition the clock would be stopped on the old system, giving people credit for their service under the old system (as by the "recognition bonds" that were issued in Chile or the compensatory pensions in Argentina) and putting all entering workers plus all workers under a specified age into the new system. (Workers above the specified age might be given a choice). The abrupt transition has been used in all reforming countries so far.

Since the benefits promised current pensioners and older workers under the old system will continue to be paid for many years, while part of the payroll taxes are diverted to funded individual accounts, revenue outflows will exceed inflows for some time. This financing gap can be covered through increased taxes or by diverting a surplus from the general treasury (as in Chile), but in most cases some degree of debt finance will be involved, so that a heavy double burden is not imposed on the transition generation of workers. Some of this debt will undoubtedly be purchased by the new pension funds. In effect, part of the implicit pension debt is converted into an explicit debt.

While this may place such countries on an improved long-term path, it may also involve upheaval and uncertainty in the short run. For example, we do not know for sure how the financial market will react to the conversion of implicit into explicit debt, implicit into explicit debt servicing. On the one hand, it may not react at all if full information was incorporated into previous decisions; on the other hand, it may react negatively if the transition suddenly makes people aware of how large the implicit debt is or hardens the obligations; or on the third hand it may react positively if this signals that the future debt and fiscal burden will contract instead of continuing to expand. In all the reforming Latin American countries, where the public system was virtually bankrupt, the financial markets reacted well to the switch, but in many industrialized countries the uncertainty involved may inhibit the willingness to make an abrupt transition.

Some of the strategies that may be used to increase the probability of a favorable outcome are:

Before making the transition, reform the old system by downsizing benefits, raising retirement age and penalties for early retirement, tightening eligibility for disability benefits, and changing the indexation method to price indexation, so the outstanding debt, whether implicit or explicit, will be smaller (most OECD countries are now in the process of doing this);

If there is a pre-existing surplus in the social security system (as in the United States), use it to pay off part of the debt;

If some public enterprises are being privatized, use some of the proceeds to pay off the pension debt (as is now planned in Peru)--a cancellation of long term assets against long term liabilities;

Keep part of the old system going, in a more redistributive form, as the public pillar of the new system, so that only part of the implicit debt becomes explicit;

Spread the redemption of the debt over a long period of time, so the disruptive effects of taxes for redemption at any one point are minimal--but remember that taxes and redemption are ultimately necessary if part of the object is to increase national saving available for productive investment (the latter two points are included in the Scheiber-Weaver proposal of the Social Security

Advisory Council);

- Educate the public so that they understand why change is both necessary and desirable, for them and for the economy as a whole.

Nevertheless, even if these strategies are adopted, political and economic fears associated with explicit debt are likely to inhibit an abrupt transition to a new system in many industrialized countries. In addition, policies such as the Maastricht Treaty in Europe and Gramm-Rudman in the US, which target on explicit deficits and debt, ignoring implicit debt, make rationale trade-offs between the two and choice of pension system based on long run effect difficult and in some cases impossible.

An alternative that may be used under these circumstances is a **gradual transition**. Under the gradual transition, the clock does not stop on the old system and implicit debt is not converted to explicit debt. Instead, a plan is developed for reducing the implicit debt by gradually downsizing and flattening out benefits and raising the retirement age in the old system, so it becomes the much smaller public pillar in the recommended multi-pillar system. If wages are growing, this can be partially accomplished by setting a real cap on benefits so that, over time, public pension expenditures fall relative to the wage bill. At the same time, a second funded pillar is started immediately out of incremental contributions and is gradually augmented out of resources saved in the public pillar. Benefits from the private pillar increase as benefits from the compressed public pillar decrease. Hopefully the incremental contributions that start this off will be less distortionary, more politically acceptable and in the long run smaller if allocated to a funded defined contribution pillar rather than to a PAYG defined benefit pillar.

This strategy places a relatively heavier burden on the current generation of workers, in the form of lower benefits from the public pillar and/or higher contribution rates over-all. It does not spread the transition cost over many generations, but correspondingly, it avoids the build-up of explicit debt. It is most easily applied in countries (such as Canada and the US) that currently have relatively low contribution and benefit rates. But for all countries, the sooner they start building the second pillar, the less painful the transition can be.

V. Final Thoughts

The major message of the World Bank report for developing countries is: The system that seemed best for industrialized countries 50 years ago is not the best system for you today; you can learn from their mistakes and do better. Once a PAYG system has been adopted and coverage is widespread, it is very difficult to change. So think carefully before you start or expand your systems in this direction.

The major message for industrialized countries is: The world has changed dramatically over the past 50 years, closing some opportunities but opening others. Real wage growth has slowed down and population growth has come to a halt in OECD countries, so that tax rates will have to go up sharply if the pay-as-you-go system is retained. It has become increasingly important to minimize work disincentives and to increase labor productivity through capital accumulation, which the public pillar alone is not well suited to do. Financial markets are better developed than they were before and are global in nature, allowing funded plans to benefit from international diversification. Under these changed conditions, the PAYG payroll-tax-financed system that seemed right to many in the past is not necessarily right for the future.

In addition, in the past poverty among the old was reduced without much lifetime redistribution from rich to poor, largely because the entire retired generation benefitted from a positive income transfer through the old age security system. But that positive transfer has now come to an end and is about to turn negative. Unless both the benefit and contribution structure of the public pillar become more targeted, old age systems will contribute to the growing polarization of income among workers and will fail to avoid poverty among the old. Under the recommended multi-pillar system, tax reductions for the public pillar could be concentrated on low wage workers, while continuing their benefits, and all workers would receive part of their pension income through the mandatory funded pillar.

When today's retirees entered the labor force 50 or 60 years ago, the economy was very depressed, but it got better over their lifetimes and now they are one of the wealthiest groups in the population, enjoying a comfortable old age. Will today's young workers fare similarly well? Are they worried about the availability of jobs? Are they optimistic about wage growth? How will they feel if their net disposable income and therefore their standard of living increases little over their working lives, as contribution rates demanded by PAYG pension, health and social insurance systems rise? Relatedly, how will they feel when they realize that they are getting back a low, perhaps even a negative, return on their lifetime contributions? How can the old age security system be changed to become part of the solution, instead of part of the problem?

Averting the Old Age Crisis argues that old age security systems that contain a large funded component, have decentralized competitive management of these funds, give workers ownership rights over the funds, and also include a social safety net that is a downsized and more redistributive version of current plans, are most likely to address these concerns--by promoting growth, protecting low wage earners and diversifying, thereby reducing risk. While every country may not choose this path, every country should give these arguments careful thought.

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Appendix: Myths and realities about old age security

Myths abound in discussions of old age security. Consider the following:

Myth 1. Old people are poor, so government programs to alleviate poverty should be directed to the old.

Fact. The old are better off than the young, when comparisons are based on (expected) lifetime income rather than current income. Why? Because people with higher incomes are more likely to live long enough to become old, whereas people with low incomes are more likely to have many children and die young. Targeting young families with children, or reducing payroll taxes of these groups, is a better measure for alleviating poverty than targeting the old.

Myth 2. Public social security programs are progressive, redistributing income to the old who are poor.

Fact. Empirical studies in countries such as Sweden, the Netherlands, the U.K. and the U.S. show little or no redistribution from the lifetime rich to the lifetime poor. Even in countries where benefit formulas look progressive, four factors neutralize most of this effect: The first people covered by new plans are invariably middle- and upper-income groups, and they typically receive large transfers. Ceilings on taxable earnings keep the lid on tax differences between rich and poor. When benefit formulas are based on earnings near retirement upper-income groups benefit even more. And finally, the rich tend to have a longer life expectancy, hence collect these benefits for more years.

Myth 3. Social security programs insure pensioners against risk by defining benefits in advance.

Fact. Benefit formulas have been redefined frequently, so substantial political risk remains.

Myth 4. Only governments can insure pensioners against group risks, such as inflation, and most do so.

Fact. Most developing countries do not index pensions for inflation in their publicly managed programs, and some privately managed plans do index benefits.

Myth 5. Individuals are myopic but governments take the long view.

Fact. Governments have repeatedly made decisions about old age programs based on short-run exigencies rather than long-run effects. Pay-as-you-go programs, overly-generous benefits and early retirement provisions are prime examples.

Myth 6. Government action is needed to protect the interests of unborn generations.

Fact. Most public pay-as-you-go pension schemes provide the largest net benefits to workers who are 30 to 50 years old when the schemes were introduced. The unborn children and grandchildren of these workers are likely to receive negative transfers as the system matures and the demographic transition proceeds.

Myth 7. The consumption of today's retirees can only be supported by the domestic output of today's workers, so past saving is irrelevant.

Fact: Past saving can enhance capital accumulation, hence make today's workers more productive, some past saving can be embedded in consumer durables that continue to provide a stream of services for many years, and some can be invested abroad; when these are redeemed they finance an inflow of consumer goods produced by foreign workers. For all these reasons, past saving enhances current domestic consumption capacities, which is especially important as the dependency rate rises.

Figure 1 Percentage of the Population Over 60 Years Old, by Region, 1990 and 2030

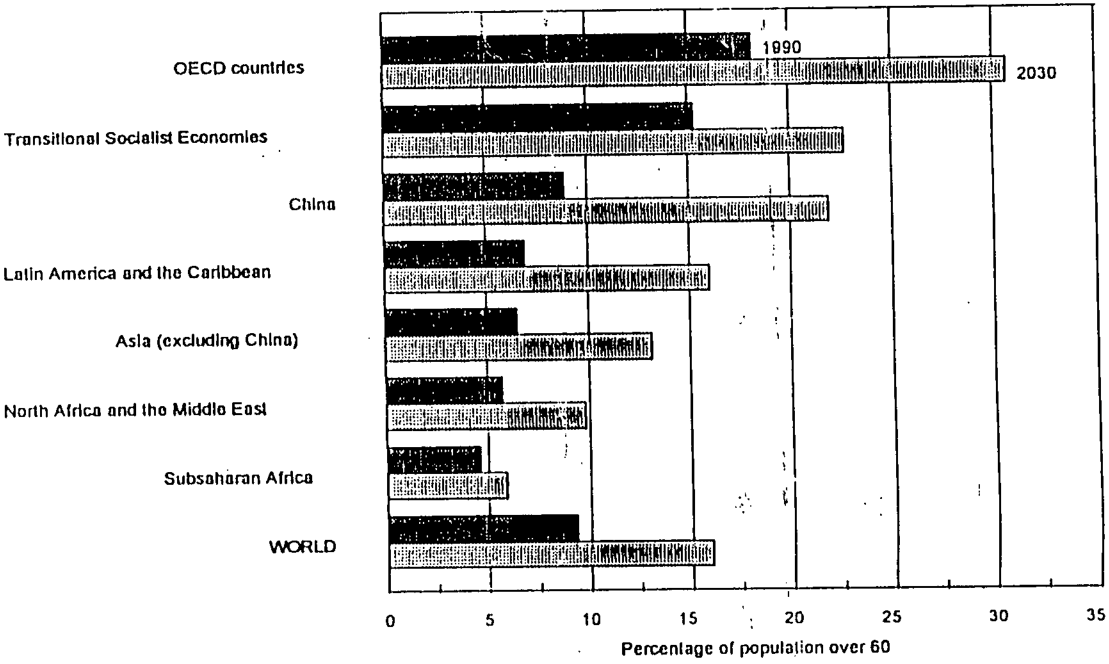
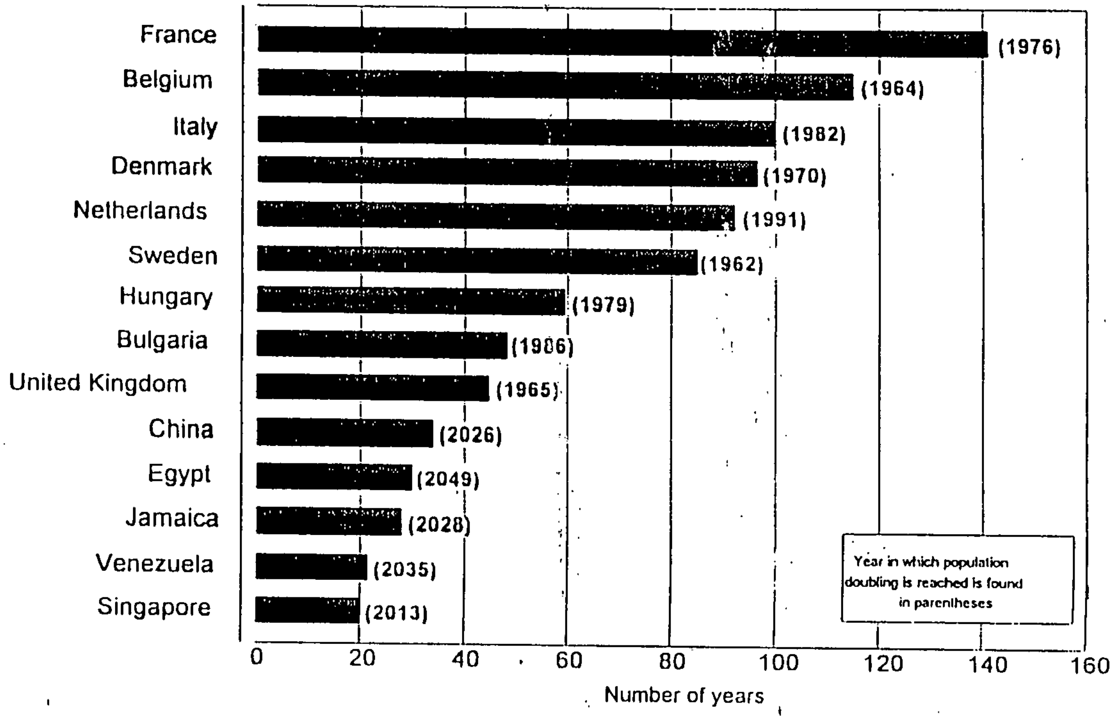


Figure 2 Number of Years Required to Double the Share of the Population over 60 from 9 to 18 Percent, in Selected Countries



Source: European Historical Statistics, World Bank population data base projections.

Figure 3

Relationship Between Percentage of the Population over 60 Years Old and Public Pension Spending

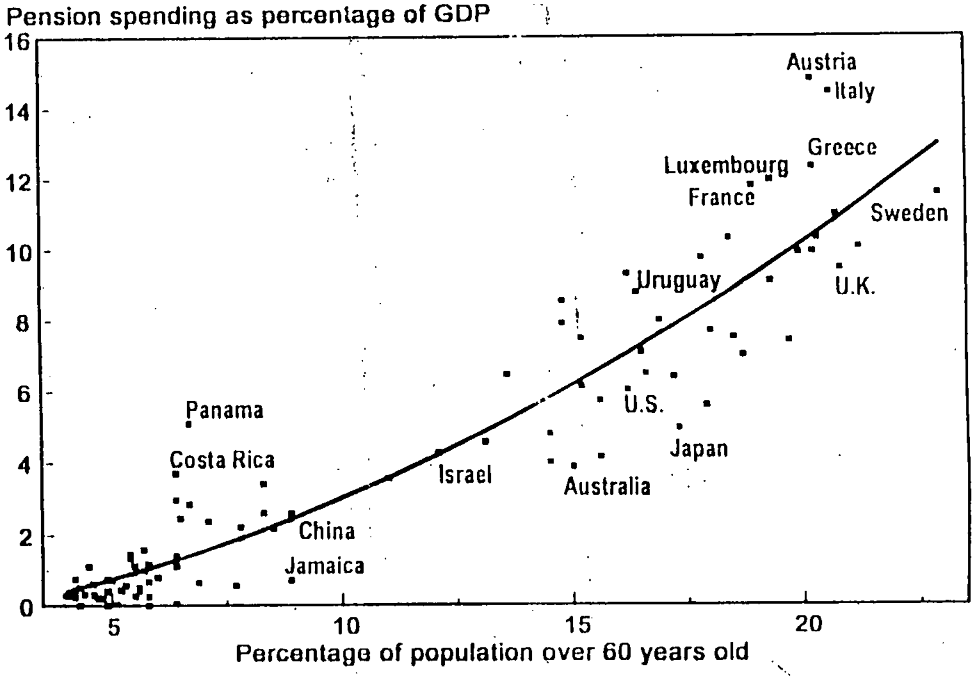
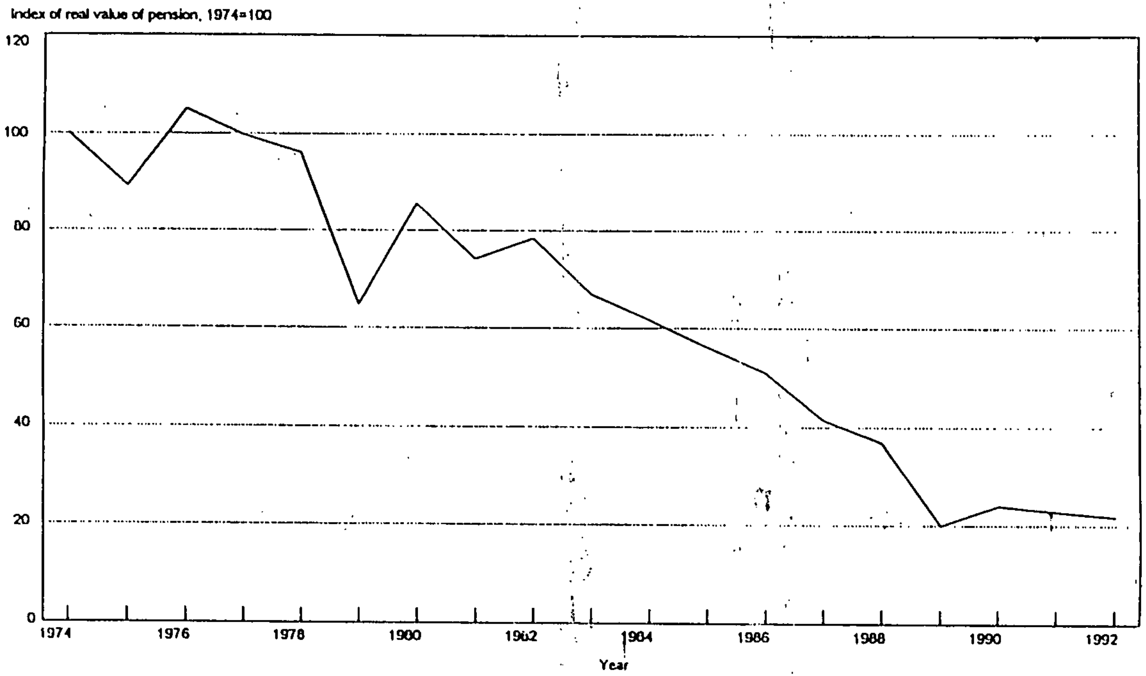


Figure 4 Real Pension Levels in Venezuela ,1974 - 92



Source: Marquez (1992)

Figure 5 Implicit Public Pension Debt, 1990

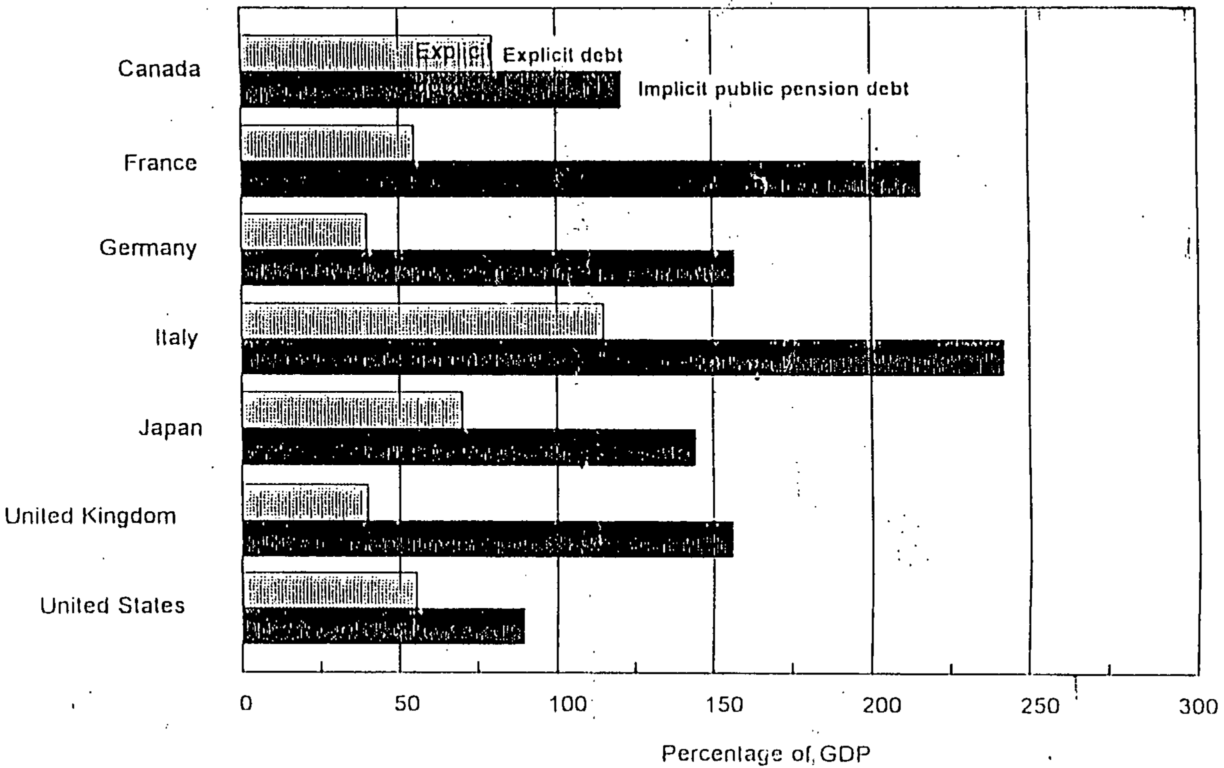


Figure 6 The Pillars of Old Age Income Security

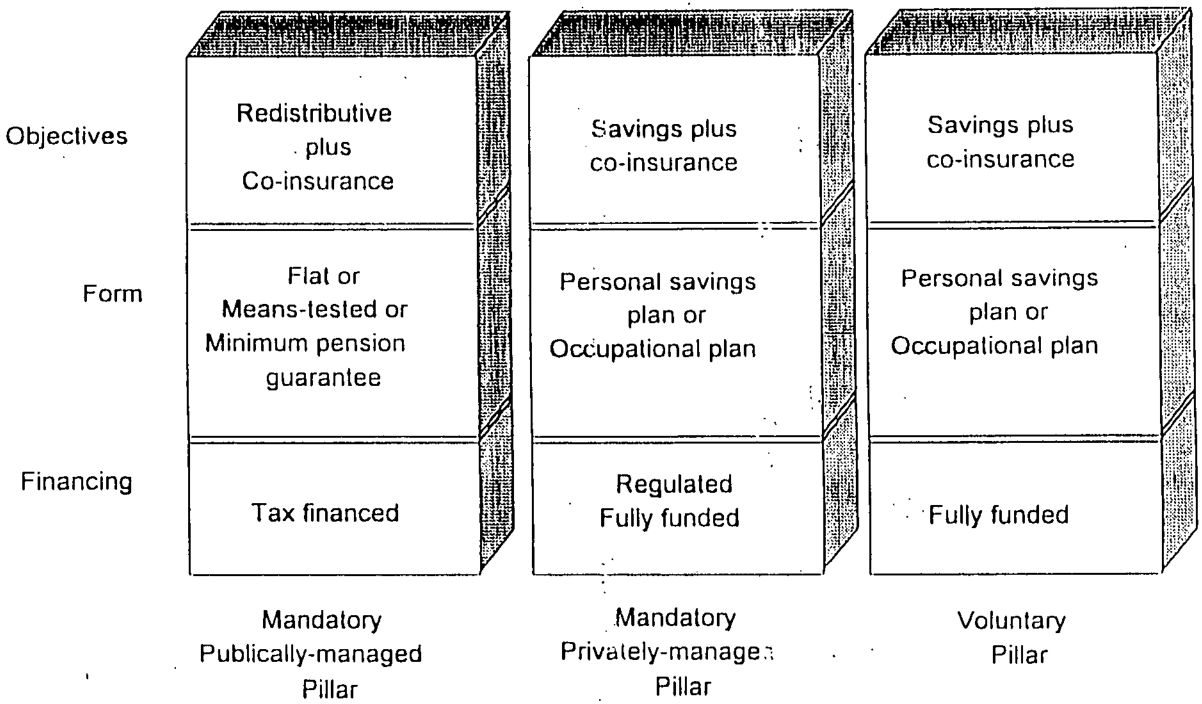
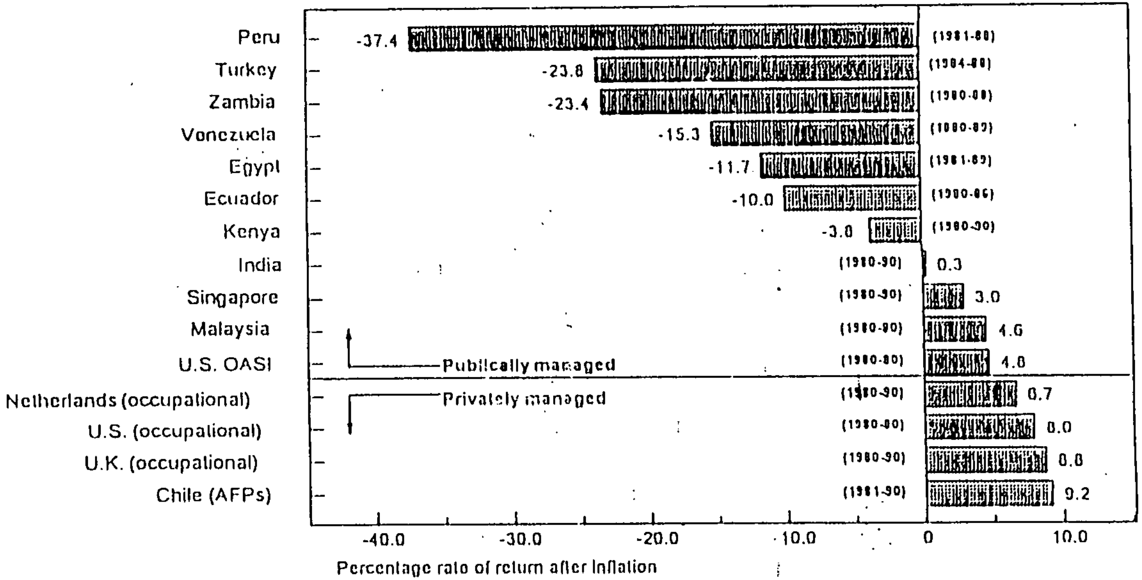


Figure 7 Gross Average Annual Investment Returns for Selected Pension Funds, 1980s



Note: Simple averages for countries with at least five years of data during the 1980s. Malaysia, Singapore, Kenya, India and Zambia are publically managed provident funds. Rates reported are returns credited to worker accounts. Peru, Turkey, Venezuela, Egypt, Ecuador and the U.S. are publically managed reserves of partially funded pension plans. Amounts reported are gross returns to the funds. In many cases data on administrative costs are not available. The Netherlands, U.S. and U.K. are privately managed occupational plans; estimated average net returns have been reported by subtracting one percentage point from simulated average gross returns. Actual average net returns, after all administrative expenses, are reported for the Chilean AFPs; average gross returns were 12.3 percent. For the Occupational plans and AFPs actual returns and expenses varied by fund.

Source: Averting the Old Age Crisis, p.95.

The CHAIRMAN. Thank you very much, Dr. James.
Dr. Yakoboski.

STATEMENT OF PAUL YAKOBOSKI, RESEARCH ASSOCIATE, EMPLOYEE BENEFIT RESEARCH INSTITUTE

Mr. YAKOBOSKI. Thank you, Mr. Chairman.

I'm pleased to appear before you this morning to discuss issues regarding the future of the Social Security program. My name is Paul Yakoboski, I'm a research associate at the Employee Benefit Research Institute, a non-profit, non-partisan public policy research organization based here in Washington.

Through our research, we strive to contribute to the formulation of effective and responsible health and retirement policies. Consistent with our mission, we do not lobby or advocate specific policy recommendations.

A clear understanding of the investment decisions that workers are currently making in their 401(k) plans and how these decisions vary among workers is important for policy purposes. In particular, for evaluating the implications of proposals that would to some degree privatize the Social Security system with individually directed accounts. Until recently, data rich enough to provide this type of information has been sorely lacking. As part of EBRI's ongoing Defined Contribution Project, we have collected plan-specific data that allows such analysis.

We recently published an EBRI Issue Brief based on an analysis of data provided by three large 401(k) plan sponsors with an average of 60,000 participants per plan. We looked at worker investment decisions and how these decisions varied with worker demographics, such as age, salary, and tenure. The three plans used in this analysis have well developed educational programs designed to assist workers in making appropriate decisions regarding their participation in these plans.

We are currently analyzing a data base provided by a plan service provider that consists of over 1,000 plans with more than 100,000 participants. Today I will discuss our findings from these four data sources.

Many analysts have focused on average allocations in past studies. While informative, data on average allocations mask much of the detail regarding the variation in investment preferences among workers. Our analysis indicates that a significant fraction of plan participants, particularly younger ones, are heavily diversified into equities, while at the same time a large percentage of their peers hold zero equity investments in their accounts. The data indicate that low earning younger participants may not appreciate the advantages of diversifying their 401(k) portfolio to include equities when investing for a retirement that is decades in the future.

For example, in one large plan, 21 percent of participants had none of their account balances invested in any equity based funds. It is particularly noteworthy that 17 percent of participants in their 20's and 18 percent of those in their 30's had none of their account balances invested in the equity options. On the other hand, 21 percent of all participants had over 80 percent of their account balances invested in equity funds. Twenty-seven percent of participants in their 20's and 22 percent of participants in their 30's had heavy equity investments.

Relatively few low earning participants were heavily invested in equities with their 401(k) money. At higher income levels, about one-quarter of plan participants had over 80 percent of their assets invested in equities. Higher income participants were also much less likely to have zero equity investments. Again, this is a plan that has an extensive participant education program.

Findings from the other two large plans were similar, especially with regards to younger workers. In all three plans, there is a sizable fraction of younger participants with zero equity investments ranging from 17 percent to 34 percent. At the same time, in two of the three plans, there were even larger fractions of workers in the same age groups who invested heavily in equities.

Our recent analysis of the data base consisting of over 1,000 broad based plans again provides similar findings. In this data base, almost half of all plan participants had none of their account balances invested in equity based funds. Among workers in their 20's, 41 percent had no equity investments. Among workers in their 30's, 45 percent had no equity investments.

These findings highlight real differences in allocation behavior among workers within similar demographic groups. Situations occur within a plan where a sizable fraction of participants has no equity allocations, and simultaneously, another fraction has very heavy equity allocations. These findings make clear the need to focus on distributions and not merely averages when discussing asset allocation. Averages mask crucial information for plan design and policymaking.

As regards education and education's impact on workers' decisions, according to the 1995 EBRI/Greenwald Retirement Confidence Survey, 95 percent of 401(k) plan participants utilizing educational material provided them reported that the material included a description of the investment options available in the plan and nearly 70 percent reported that the material covered the principles of asset allocation and diversification. Almost one-half, 46 percent of these workers, reported that the material led them to reallocate their money among the options available in the plan. According to our 1996 Retirement Confidence Survey, which will be released next week, 24 percent of workers were very confident in their ability to invest wisely for retirement, 47 percent are somewhat confident, and 29 percent are not confident.

Our research indicates that education can have an impact in terms of leading workers to reallocate their 401(k) savings investments. At the same time, we see that even in plans with relatively sophisticated education and communication programs, there exists a real dichotomy in the asset allocation behavior among workers within similar demographic groups. Variations in decisions will naturally lead to variations in retirement income results. EBRI has undertaken a Social Security simulation modeling project designed to capture such variations. The EBRI project will provide a two-phase analysis of the present system and the consequences of alternative reforms. As results become available in early December, we will be happy to share them with members of this committee.

Thank you.

[The prepared statement of Mr. Yakoboski follows:]

EBRI
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BENEFIT
RESEARCH
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Statement Before

The Senate Special Committee on Aging

Hearing on

The Future of the Social Security Program

by

Paul J. Yakoboski, Ph.D.
Research Associate
Employee Benefit Research Institute

Washington, DC

24 September 1996

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STATEMENT OF PAUL J. YAKOBOSKI
EMPLOYEE BENEFIT RESEARCH INSTITUTE

SUMMARY

A clear understanding of the investment decisions that workers are currently making in their 401(k) plans and how these decisions vary with worker demographics is important for policy purposes, in particular, for evaluating the implications of proposals that would to some degree privatize the Social Security System with individually directed accounts.

Many analysts have focused on average allocations in past studies of worker investment decisions in 401(k) plans. While informative, data on average allocations mask much of the detail regarding the variation in investment preferences among workers with differing demographic characteristics. Our research indicates that a significant fraction of plan participants, particularly younger ones, are heavily diversified into equities, while at the same time a large percentage of their peers hold zero equities in their accounts. The data indicate that the low earning, younger participants may not appreciate the advantages of diversifying their 401(k) portfolio to include equities when investing for a retirement that is decades in the future.

For example, in one large plan 21 percent of participants had none of their account balances invested in any equity-based funds (not including company stock). It is particularly noteworthy that 17 percent of participants in their 20s and 18 percent of those in their 30s had none of their account balances invested in the equity options. On the other hand, 21 percent of all participants had over 80 percent of their account balances invested in equity-based funds. Twenty-seven percent of participants in their 20s and 22 percent of participants in their 30s had heavy equity investments (greater than 80 percent of account balances). Relatively few low earning participants were invested heavily in equities with their 401(k) account balances. At higher income levels, about one-quarter of plan participants had over 80 percent of their assets invested in equities. Higher income participants were also much less likely to have zero equity investments. This was a plan that had an extensive participant education program.

According to the 1995 EBRI/Greenwald Retirement Confidence Survey, 95 percent of plan participants utilizing educational material provided to them reported that the material included a description of the investment options available in the plan, and 69 percent reported that the material covered the principles of asset allocation and diversification. Almost one-half (46 percent) of these workers reported that the material led them to reallocate their money among the options available in the plan. This effect was slightly more likely among those with a high school degree or less (50 percent) than among those with more education (45 percent).

Our research indicates that education can have an impact in terms of leading workers to reallocate their 401(k) savings investments. At the same time we see that, even in plans with relatively sophisticated education and communication programs, there exists a real dichotomy in the allocation behavior of workers within similar demographic groups. Variations in decisions will naturally lead to variations in retirement income results.

STATEMENT OF PAUL J. YAKOBOSKI

RESEARCH ASSOCIATE

EMPLOYEE BENEFIT RESEARCH INSTITUTE

BEFORE THE SENATE SPECIAL COMMITTEE ON AGING

SEPTEMBER 24, 1996

Mr. Chairman:

I am pleased to appear before you this morning to discuss issues regarding the future of the Social Security program and specifically the asset allocation decisions that workers make when they participate in 401(k) plans. My name is Paul Yakoboski. I am a Research Associate at the Employee Benefit Research Institute (EBRI), a nonprofit, nonpartisan, public policy research organization based in Washington, DC.

EBRI has been committed, since its founding in 1978, to the accurate statistical analysis of economic security issues. Through our research we strive to contribute to the formulation of effective and responsible health and retirement policies. Consistent with our mission, we do not lobby or advocate specific policy recommendations.

<u>Worker Investment Decisions</u>

A clear understanding of the investment decisions that workers are currently making in their 401(k) plans and how these decisions vary with worker demographics is important for policy purposes, in particular, for evaluating the implications of proposals that would to some degree privatize the Social Security system with individually directed accounts. Until recently, data rich enough to provide this type of information has been sorely lacking. As part of EBRI's ongoing Defined Contribution Project, we have collected plan-specific data that allow such analysis. We recently published an *EBRI Issue Brief* (August 1996) based on an analysis of data provided by three large 401(k) plan sponsors with an average of 60,000 participants per plan.

We looked at worker investment decisions and how these decisions varied with worker demographics such as age, salary, and tenure. The three plans used in this analysis have well developed educational programs designed to assist workers in making appropriate decisions regarding their participation in the plans. We are currently analyzing a database provided by a plan service provider that consists of over 1,000 plans with more that 100,000 participants. I will discuss the results based on these four data sources today.

Many analysts have focused on average allocations in past studies, but while informative, data on average allocations mask much of the detail regarding the variation in investment preferences among workers with differing demographic characteristics. Our analysis indicated that a significant fraction of plan participants, particularly younger ones, are heavily diversified into equities, while at the same time a large percentage of their peers hold zero equities in their accounts. The data indicate that the low earning, younger participants may not appreciate the advantages of diversifying their 401(k) portfolio to include equities when investing for a retirement that is decades in the future. This puts them at risk of accumulating insufficient assets to fund a desired retirement lifestyle or being unable to retire when they desire.

For example, in one large plan 21 percent of participants had none of their account balances invested in any equity-based funds (not including company stock). It is particularly noteworthy that 17 percent of participants in their 20s and 18 percent of those in their 30s had <u>none</u> of their account balances invested in the equity options. On the other hand, 21 percent of all participants had over 80 percent of their account balances invested in equity-based funds. Twenty-seven percent of participants in their 20s and 22 percent of participants in their 30s had heavy equity investments (greater than 80 percent of account balances). Relatively few low earning participants were invested heavily in equities with their 401(k) account balances. At higher income levels, about one-quarter of plan participants had over 80 percent of their assets invested in equities. Higher income participants were also much less likely to have zero equity investments. Again, this is a plan that has an extensive participant education program.

Findings from the other two large plans were similar, especially with regards to younger workers; in all three plans there was a sizable fraction of younger participants with zero equity investments (ranging from 17 percent to 34 percent). At the same time, in two of the three plans there were even larger fractions of workers in the same age groups who invested heavily in equities (more than 80 percent) (see chart 1). These findings highlight real differences in allocation behavior among workers within similar demographic groups. Situations occur within a plan where a sizable fraction of participants has no equity allocations and simultaneously another fraction has very heavy equity allocations.

Our recent analysis of the database consisting of over 1,000 broad-based plans again provides similar findings. In this database, almost one-half (49 percent) of all plan participants had none of their account balances invested in equity-based funds (not counting employer stock). Among workers in their 20s, 41 percent had no equity investments. Among workers in their 30s, 45 percent had no equity investments.

At the same time, there is evidence within the three large plans of workers matching their investment patterns with their time horizons in a textbook manner, e.g., older workers having larger allocations devoted to nonequity investments than their younger colleagues. Chart 2 shows that in the three plans analyzed, the percentage of participants with more than 80 percent of their account balance invested in nonequity-based options increased consistently with participant age.

These findings make clear the need to focus on distributions and not merely on averages when discussing asset allocation. Averages mask crucial information for plan design and policymaking. For example, in this analysis examining averages would show greater nonequity investments among older participants, but it would mask the occurrence of both zero and heavy equity investments among young participants.

Other Research

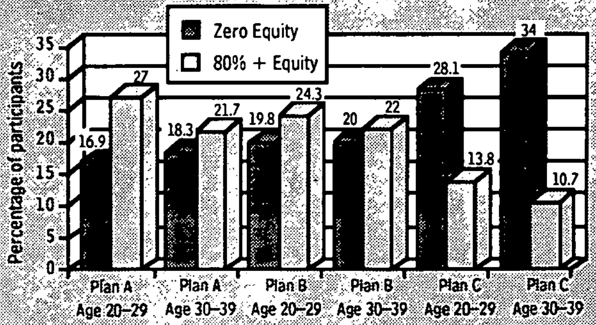
According to the 1995 EBRI/Greenwald Retirement Confidence Survey, 95 percent of plan participants utilizing educational material provided to them reported that the material included a description of the investment options available in the plan, and 69 percent reported that the material covered the principles of asset allocation and diversification. Almost one-half (46 percent) of these workers reported that the material led them to reallocate their money among the options available in the plan. This effect was slightly more likely among those with a high school degree or less (50 percent) than among those with more education (45 percent).

According to the 1996 Retirement Confidence Survey, which will be publicly released next week, 24 percent of workers are very confident in their ability to invest wisely for retirement, 47 percent are somewhat confident, and 29 percent are not confident. Workers with college degrees and those earning over $50,000 are the most likely to be very confident.

Conclusion

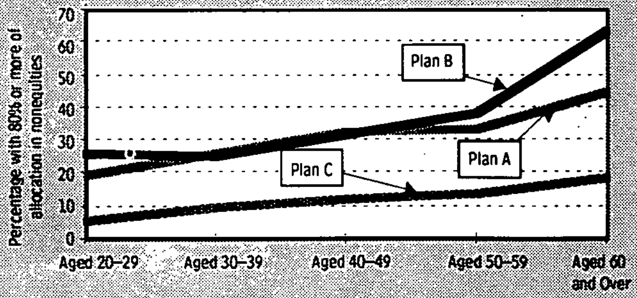
Our research indicates that education can have an impact in terms of leading workers to reallocate their 401(k) savings investments. At the same time, we see that, even in plans with relatively sophisticated education and communication programs, there exists a real dichotomy in the allocation behavior of workers within similar demographic groups. Variations in decisions will naturally lead to variations in retirement income results. EBRI has undertaken a Social Security simulation modeling project designed to capture such variations. The EBRI project will provide a two-phase analysis of the present system and the consequences of alternative reforms. Our project is unique in that it will not only estimate the reforms' effects on the U.S. population, the U.S. economy, and the Social Security program but also explore the implications of reforms' effects for employment-based plans. As results become available in early December, we would be happy to share them with the members of this committee.

Chart 1
EQUITY INVESTMENT PATTERNS AMONG YOUNG PLAN PARTICIPANTS



Source: Employee Benefit Research Institute.

Chart 2
HEAVY[a] NONEQUITY INVESTMENTS BY PARTICIPANT AGE



Source: Employee Benefit Research Institute.
[a]Greater than 80 percent of account balances.

The CHAIRMAN. Thank you very much, Dr. Yakoboski.

Senator Grassley mentioned before the fine work that the committee has done over the years, and he especially referred to our staff. I would like to take this occasion, before further discussion, to publicly thank Mary Gerwin, who is sitting behind me, and Liz Liess, both of whom have worked very hard on preparing this hearing on short notice. Mary Gerwin has been the staff director and really the driving force behind so many issues that have a profound impact upon our senior citizens.

We also have Ken Cohen, no relation, who has been serving as the acting minority staff director. Senator Pryor could not be here today, he is returning from Arkansas, having attended to one of his son's illnesses. But he expressed his apologies for not being with us here today.

I have a number of questions and we'll never finish by noon, since it's almost noon now, if I ask them. But I will submit them to you for the record, several questions. I won't burden you with a plethora of profound questions it will take you days to answer, but perhaps just a few questions that would help for the record itself.

A couple of observations I would make: Ms. Phillips, you raised the issue of, what if, we have 12 questions that have been submitted by the Concord Coalition, on behalf of the Concord Coalition. Just to deal with one of those will take days, if not months, of wrangling on Capitol Hill, not to mention the full 12.

One writer who wrote a piece, I think it's now a book, referred to the word demosclerosis, that we indeed have a democratic system that seems sclerotic in terms of all of the interest groups that fill up the arteries of activity here on Capitol Hill, so that virtually no progress is possible, no change, no fundamental change, not even incremental or marginal change is possible without a group marshalling its resources to defeat something which they see as being inimical to their particular interests.

So that's a serious issue for all of us to contend with, and certainly for the future Congresses.

You mentioned the pledge not to touch Social Security. I've tried to be as gentle in my criticism as possible, to make sure this committee stays bipartisan, but I must tell you, I've been very disappointed with the Administration's failure to deal with the Medicare issue, other than to exploit it during an election year. I fully expect that as soon as the elections are over, there's going to be the formation of a commission to deal with the issue of Medicare. It has to be reformed. It's not going to happen this year.

But it's not only partisan sniping on my part. I go back to the days of Ronald Reagan. During his second debate with Walter Mondale, Ronald Reagan took a pledge. He said, "I pledge not to touch Social Security under any circumstances."

Immediately after the election was over, there were a group of us who met in the Senate Cloakroom. We had tried to put together a budget proposal. It was passed by a single vote when then-Senator Pete Wilson was in the hospital recovering from an emergency appendectomy. He was wheeled into the Senate floor and he rose up on his gurney, and he said, Mr. President, what is the question.

Of course, the question was, would he vote for a so-called Republican budget and it passed by one vote.

Before the echo of his vote had faded from the chamber, President Reagan indicated he would not support such a measure, because it dealt with Social Security and it would violate his own pledge.

That, Ms. Phillips, was the birth of not the blues, but Gramm-Rudman. It was in the wake of that reaction on our part, we sat in the Cloakroom and said, what do we do now. We had a couple of Senators, Gramm, Rudman, Hollings, who also joined in that effort, and there were about five or six of them who then came up with the Gramm-Rudman-Hollings proposal, and said, we've got to do something. Of course, that has long since been abandoned as a vehicle to do that.

So we all have our, I guess our obligations here that we have failed to measure up to on both sides. The point that I wanted to make is, we can't defer dealing with Medicare much longer. We can't defer dealing with Social Security much longer. We have to take action. I must say that both parties, all of us, have failed to be honest with the gravity of the situation with our constituents. We have promoted no pain, always gain. What you're suggesting is, the body builder's suggestion, you have enough pain, there is no gain.

I don't know how we deal with the credit card mentality. This requires a vast educational effort on our part. But how do you change the notion that we just pull out the card and keep charging and charging, well, we'll deal with the 18, 19, 20 percent interest rates down the line. If you immediately start talking about changing that mentality, of course you have our business community saying, wait a minute, how do we survive, we've got to have more consumerism, not less consumerism, more consumption, not less consumption. Otherwise, it will kill the economy, we won't have growth rates that we would like to see.

So it's not going to be easy. We have to develop a sound fiscal policy. We have to develop a consensus. There's a word that has fallen into disfavor in recent years. Bob Dole, when he was running in the Republican primaries, was accused of being what? A compromiser. He compromised in order to make things work. So that was seen as a negative during the primaries in his particular campaign. Of course, those of you who have watched the political process realize you have to have compromise, you have to have consensus. This is not going to be easy to achieve. It's not going to be easy to achieve. If we listen to Pete Peterson, you've quoted from him, I recall reading a piece that he wrote in the Atlantic Monthly, actually it was one of his previous books, in which he advocated that, go out and look into the eyes of your children and grandchildren, and then you'll realize there's not a moment to wait, or to waste. In fact, I'm going to quote from Pete Peterson, he has a piece that came out in the Atlantic Monthly last spring, as I recall, May 1996.

Ms. PHILLIPS. Actually, this book is an expansion of that article.

The CHAIRMAN. Well, I'm going to put this in the record, not his book. [Laughter.]

But this belongs in the record. I just want to quote to you what he said at the very end. He said, "I believe that this generation is capable of doing the right thing, and that politicians might well discover that it's better to appeal to their nobler instincts than to pander to their baser ones. People who have made a tradition of quick gratification must now be asked to focus on the requirements of a society graced with the patina of age, on saving rather than consumption, on prudence rather than desire, on collective restraint rather than individual satisfaction. As Americans grow older, they will have to recognize that the live for today attitude that may be endearing or at least understandable in youth is not judge unseemly, but ruinously dysfunctional at the far end of life. They would do well to heed the 18th century French moralist, Joseph Geubert, who warned, "the passions of the young are the vices of the old."

It's a good warning for all of us to look at. I think that Pete Peterson's wisdom is contained in this piece and presumably expanded in that book. It would serve us all well if we take the time to think about it.

But we have to make haste, not slowly, Mr. Myers is still here, but wisely. We have to take action reasonably soon. How do we do that in an environment in which we have such a polarization of effort now? In the House of Representatives, in the Senate to a lesser degree, but nonetheless, it seems to me that that's something that we have to resolve as a society to lower the angry rhetoric, to find ways in which we can come back to the center.

I know that politically this is perhaps challengeable by some groups. But I don't know how you make democracy work, unless we have a society that's willing to say, we're going to give complete control to the majority House, the Senate, the White House, and let that majority run the country for 4 years or 8 years. Then I don't know how we take concerted action.

I was joking with you before that a dictatorship can take quick action. Governments in Singapore and perhaps other Asian countries can take quick action. We can't take quick action. We have to take quicker action if we're going to deal with the problems.

But it's going to take a lot of good will on the part of many people in this society of ours to say, we have to have consensus, we have to have people who are willing to abandon the extremes and come back to the center. We're seeing it. I'm at least encouraged, we're seeing that in the Senate. When I said before 46 members of the U.S. Senate came up with a balanced budget proposal, it took some pretty tough political steps. People who are still running for re-election, who are not simply retiring. Senator Simpson and myself, another 11 are retiring this year. But there are many in that group who are not retiring. It's completely bipartisan, saying, now we've got to change it. So I am more encouraged than discouraged, but it's going to take a good deal of education, a word that you've used, everyone has used, a good deal of educating the public about what the real choices are.

I was involved in the debate on Medicare. I recall going back to a group and talking about the need to change Medicare. Because the trustees have said in just 7 years, and they've revised that, Mr. Myers, now it's 6 years. So the exponential growth of the problem continues, that we have to make these changes. I had one person who came to me and said, just don't do anything for the next 7 years. That's about as long as I'll live, and I'll be taken care of.

I don't know if that was reflective of the entire group, but it can't be. We've got to take action in the next, I would say, couple of years, 2 years.

Ms. PHILLIPS. I very much concur with what you're saying. Recently a newspaper columnist called up the Concord Coalition and was very angry with us, asking us to defend ourselves because we've been so bipartisan and have been urging bipartisan compromises. "What's the matter with you people," he said. "Don't you understand? This is a battle for control." He said that when you're in a war, you have to take sides. Poor misguided people who keep hoping that somehow both ends of the spectrum, both sides of the debate can work together for the common good just don't understand what this city is all about.

Of course, Concord disagrees. I am absolutely convinced that you are on the right track. We must look at these problems and issues on a bipartisan basis and do what we can agree to do. We may not agree on the total vision or the total ideal plan. But there are a lot of things on which everybody can reach consensus. Let's do that much, see how it works out and then decide where to go from there.

The CHAIRMAN. Well, let's just look at the numbers in our system. If, for example, the Republicans maintain control of the Senate and the House, assuming we maintain a 53 margin, possibly a 55 margin, it could be great expectations on my part, but let's assume we get a 60 margin, that might be different. But assuming we don't hit 60, still in the 50, the mid-50 range, how do you really accomplish the goals of anyone's agenda if you've got 43 or 45 Democrats who take a different point of view? We've seen that you can't take action in the Senate, because one or two or three or five members of the Senate can tie up legislation indefinitely. That's our system as it works.

So unless you're willing, again, to give a large majority to a governing party as such, and let them run much like a parliamentary system, then there is no choice. Either you have that or you will have paralysis. You will have continued stalemate. You will have breakdown. You will have shutdowns. You will have angry people, and nothing will get done.

So I really don't see any option, unless the people are willing to say, we'll give the Democratic party complete control and dominant control, that it can have a veto-proof President, I don't see how we really proceed to solve these problems, which are looming, coming at us, and as Senator Simpson said, you know it, I know it, we all know it. But we're unwilling to deal with it.

So I think you're going to find that by force of circumstances, there will be elements within both parties who will have to come back to the center, or else I think we'll witness the formation of another party, a viable other party, and a third, maybe a fourth. Once you start down the line to multiple parties, there's no reason to say we should only have three, you can have four and five and six.

So hopefully, in this process of educating ourselves and our constituents, we will find the necessity and hopefully the willingness to come back toward the center and disagree on other issues. But on something as fundamental as the Social Security system in this country, the Medicare system, a balanced budget, those are key issues for us to really resolve. It's not going to be done on a partisan basis as far as I can see. It's got to be bipartisan, hopefully that will be the case in the coming years.

Mr. STEUERLE. Senator, I have the advantage sometimes of speaking to groups where I'm not expected to come as a partisan participant. Sometimes they've been with Members of Congress. For instance, I went to New Mexico with Senator Domenici, one time. I find if the audience is not expecting a partisan debate, they themselves become non-partisan. They're quite willing to face up to these issues. In fact, many of the elderly, when you tell them that their benefits, their own benefits are not really threatened, the real issue is what happens to the baby boomers' benefits, and the children of the baby boomers' taxes, they realize that that's where the focus is.

With respect to the Congress itself, I had the advantage a number of years ago of coordinating the tax reform project for Treasury. There is, I think, ways of organizing to deal with some of these problems, among which is to be able to put responsibility on particular individuals. In that process, for instance, we went from Jim Baker having responsibility to Dan Rostenkowski to Bob Packwood.

There came a point at every one of those transition periods where if they didn't get the job done, they would have borne responsibility for not getting it done. The way we organize a lot of our commissions and structures today, we set it up so no one can bear responsibility. You can always blame the other side for not getting it done.

So I think there are organizational ways of tackling this problem. But they're difficult.

The CHAIRMAN. I must tell you, one of the frustrating aspects of sitting in the U.S. Senate, and prior to that in the House, is that every time we run into a tough problem, we say, let's form a commission. What are we doing? Why are we here? Why don't we just have commissions run the Government?

But you see, that's what we've done on virtually Social Security back in the early 1980's, that's what we will do on Medicare, we'll do that on Social Security. We'll do that on campaign finance reform. Virtually every problem that involves tough choices, we're ducking our responsibility. We're not willing to say, we'll take the heat. It's important for us to go out and educate our constituents. We're unwilling to take the heat in terms of what it means by telling people what they have to know, rather than simply what they want to hear.

So I suppose we're going to see a proliferation of commissions. Whether they have power as such, if we structure them along the Base Closure Commission, saying, OK, it's up or down, and you've got a choice, here are our recommendations, take it or leave it, then you explain to your constituents why you've left it in this mess. Maybe under those circumstances you'll have some action taken. But if it's just a question of passing it off to another commission to make a recommendation, which will then come back 5 years later and say, well, things have changed and maybe we can just make some marginal changes around the edges, that won't be sufficient, given the numbers as they are marching toward us.

Anyway, I've already extended time well past the hour of 12. I thank all of you for your testimony. This is certainly just the beginning of the debate. My only hope is that we will intensify the debate. We'll begin it early next year. We will have courageous legislators on both sides. I put Bob Kerrey in that category, Pat Moynihan and others on the Democratic side who are willing to work in a bipartisan fashion to deal with these tough issues.

The committee will now stand adjourned.

[Whereupon, at 12:13 p.m., the committee was adjourned, to reconvene at the call of the chair.]

APPENDIX

TESTIMONY OF MICHAEL R. LOSEY, SPHR

PRESIDENT AND CEO

THE SOCIETY FOR HUMAN RESOURCE MANAGEMENT

BEFORE

THE SPECIAL COMMITTEE ON AGING

U.S. SENATE

SEPTEMBER 24, 1996

Mr. Chairman and Members of the Special Committee, my name is Michael R. Losey, and I am submitting testimony on behalf of the Society for Human Resource Management (SHRM). SHRM is the leading voice of the human resource profession, representing the interests of more than 73,000 professional and student members from around the world. As the professionals with responsibility for administering and providing employee benefits to workers, SHRM strongly supports the efforts of the Special Committee on Aging to address the problems facing America's public and private retirement systems.

Today most individuals are able to retire in a manner that meets their needs. On average, workers, retire earlier and live longer than in the past. However, a number of trends in the economy and workplace suggest that it will become increasingly difficult for American workers to meet their needs for adequate retirement income.

The U.S. population is aging rapidly and the elderly live longer. The most recent statistics from the U.S. Census reveal that in 1990, 13 percent of the population was aged 65 or older, compared to 10 percent in 1970. The Department of Labor predicts that by the year 2050, 22 percent of the population will be aged 65 or older.

Employees are likely to change jobs several times over their careers. Those frequently changing jobs, not always voluntarily, may be less likely to have adequate retirement income and employer-sponsored retiree health care since many traditional retirement plans base benefits on length of service.

In addition, the self-employed and owners of small businesses are the sectors that are creating many of the new jobs available in today's economy. These employers, however, are far less likely to provide retirement benefits than larger companies. According to the Employee Benefit Research Institute, in 1991, 19 percent of workers in firms with fewer than 25 workers were covered by an employer-sponsored retirement plan. In comparison, 78 percent of employees in companies with 1,000 or more employees were covered under an employer-provided retirement plan.

Although Congress through the passage of the Small Business Job Protection Act has addressed some of the problems facing employers desiring to provide pension benefits, the demographic and social trends mentioned above still provide a warning sign for the American people. The retirement of the baby boom generation will impose severe pressure on Social Security, Medicare and Medicaid. At the same time, the financial condition of government trust funds is poor. The Board of Trustees for the Social Security Trust Fund advised in their 1995 Report that the Federal Old Age and Survivors Insurance (OASDI) Trust Fund will be able to pay benefits for about 36 years. Of more urgency is the funding of the Medicare Trust Fund, which its trustees estimate will be depleted within the next 5 years. That is why today's hearing is so vitally important. Given the demographic trends, protection of the public pension system and expansion of private sector retirement plans should be one of the top issues for Congress to consider.

SHRM advocates the following three fundamental principles as a road map to get America started on the path to sound retirement planning:

I. Individuals Must Have Primary Responsibility for Retirement Financing

Mr. Chairman, individuals must prepare for their own retirement. In previous times, employees looked to their companies to do the planning, make the investment decisions, and to ensure that an adequate income stream would be available upon retirement. However, times have changed and we must think differently. Employers still provide plans voluntarily. The difference is that employees are more mobile, less likely to stay with one employer for their entire career, and live longer after retirement. As a result, workers must make the crucial decisions of determining to save for retirement, how much to save, and how to invest pension contributions.

The advantage for workers under the newer model of retirement funding is portability. Workers may now take their retirement benefits with them when they move from job to job. SHRM encourages this flexibility and advocates that policy makers facilitate portability. However, portability has its own risks. Policy makers must strike a delicate balance. Workers should be allowed to take their benefits with them, but they must be discouraged from spending their retirement nest egg on current consumption. SHRM believes that the law should restrict use of retirement funds so that retirees will have the resources available at the time the money is needed.

II. The Government Must Share Responsibility for Providing a Reliable Floor of Retirement Income and Medical Coverage

As workers save for retirement, it is critical that the government continue to provide some floor of retirement benefits. In order that current workers and work force entrants will be assured of some minimal retirement income and retiree health care, the Social Security and Medicare trust funds, and/or their successors, must be maintained on a financially sound basis. We cannot close our eyes to the problem, and hope it goes away. A balanced approach must be considered by Congress, without shifting the burden substantially to employers through increased taxes.

According to the Congressional Budget Office (CBO), the Social Security Program represents almost 22 percent of the total federal entitlement spending for 1995. With entitlement spending taking up a larger and larger share of available federal dollars, reluctance to address these federal programs will cause our already imposing budget challenges to become progressively worse.

SHRM believes that among the proposals being considered, special weight should be given to plans that would empower Americans by giving each worker individualized accounts. Although there will be additional administrative costs under this approach, privatization and personal empowerment combined with aggressive education programs represent the most effective way to increase savings in the short term and to meet the need for adequate retirement income streams in the future.

III. Employers Must be Assisted in Their Efforts to Provide Retirement Benefits

Lastly, employers should be assisted in their efforts to provide retirement plans to workers. The best assistance that employers can be given would be simplification of the pension law. The complexity of existing retirement plan regulations and the substantial administrative cost of complying with them discourages employers from establishing and maintaining retirement plans. A 1991 survey conducted by the American Academy of Actuaries found that among those actuaries who had been involved in a plan termination in the previous year, the largest single reason (30 percent) cited for termination of defined benefit plans was complex rules, increasing costs of compliance and frequent changes in the pension plan law.

As Congress moves forward to address retirement issues, we urge you to promote individual responsibility for planning for retirement, ensure adequate funding of the public retirement programs, and enact measures that will assist, rather than hinder employers in their efforts to voluntarily provide adequate retirement benefits.

Thank you for the opportunity to submit testimony on the critical issue of pension policy. We stand ready to assist you as you address this vitally important issue.

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