THE FUTURE OF SOCIAL SECURITY FOR THIS GENERATION AND THE NEXT: PROPOSALS REGARDING PERSONAL ACCOUNTS

HEARING

BEFORE THE

SUBCOMMITTEE ON SOCIAL SECURITY

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FIFTH CONGRESS

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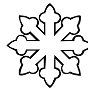

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THE FUTURE OF SOCIAL SECURITY FOR THIS GENERATION AND THE NEXT: PROPOSALS REGARDING PERSONAL ACCOUNTS

WEDNESDAY, JUNE 3, 1998

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON SOCIAL SECURITY,
Washington, DC.

The Subcommittee met, pursuant to notice, at 2 p.m., in room B–318, Rayburn House Office Building, Hon. Jim Bunning (Chairman of the Subcommittee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON SOCIAL SECURITY

FOR IMMEDIATE RELEASE CONTACT: (202) 225–9263
May 27, 1998
No. SS–17

Bunning Announces Tenth Hearing in the Series on "The Future of Social Security for this Generation and the Next"

Congressman Jim Bunning (R–KY), Chairman, Subcommittee on Social Security of the Committee on Ways and Means, today announced that the Subcommittee will hold a tenth hearing on "The Future of Social Security for this Generation and the Next." At this hearing, the Subcommittee will examine proposals regarding personal accounts. The hearing will take place on Wednesday, June 3, 1998, in room B–318 of the Rayburn House Office Building, beginning at 2:00 p.m.

In view of the limited time available to hear witnesses, oral testimony at this hearing will be taken from invited witnesses only. Also, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee or for inclusion in the printed record of the hearing.

BACKGROUND:

With the increased public debate about the future solvency of Social Security, the idea of allowing individuals to invest retirement funds in private markets has received considerable interest once again. Personal accounts are seen as a way to boost workers' savings to ensure that benefits can be paid in the future.

The 1997 report of the Advisory Council on Social Security pursued the idea of personal accounts with two detailed plans, which included portable and privately-owned personal accounts as part of total Social Security reform. Since that time, Members of Congress and the President have become engaged in a public discussion about the merits of integrating some form of personal investments into the current social insurance model.

Personal accounts and private investment systems in a variety of other nations, particularly those where return on investments has been quite positive, have further heightened the public's interest in such an approach for the United States. As part of the ongoing analysis of the future of the program, the Subcommittee has previously heard from representatives of several countries who have already begun personal accounts or are in the process of doing so.

Since the Advisory Council Report, several private individuals and organizations have authored detailed plans that recommend some sort of personal accounts. These range from 401(k) type plans administered by a central government organization to individual personal accounts similar to an IRA. The Subcommittee will be seeking detailed information from each sponsor regarding the specific workings of their personal account proposal.

In announcing the hearing, Chairman Bunning stated: “Since 1935, Social Security has changed over the years to meet the needs of this country. We must be careful, but we must challenge ourselves to think creatively about how this vital program can work best for all generations in the future. Members of the Advisory Council on Social Security, Social Security experts, and both Republican and Democrat Members of Congress are introducing proposals for Social Security reform, which provide for personal accounts. I look forward to hearing from a number of the authors of these plans on the specifics of how these personal accounts would work.”

FOCUS OF THE HEARING:

The Subcommittee will receive the views of Social Security experts on their proposals to create personal accounts. Members of the Subcommittee would like to hear from each witness regarding their views on: (1) how personal accounts would be administered, (2) how personal accounts would be financed, (3) how personal accounts would be accessed and dispersed, (4) what investment vehicles for the personal accounts are appropriate, (5) how personal accounts would be integrated with other private pensions and government benefits, and (6) how these personal accounts would work within current tax law.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit six (6) single-spaced copies of their statement, along with an IBM compatible 3.5-inch diskette in WordPerfect 5.1 format, with their name, address, and hearing date noted on a label, by the close of business, Wednesday, June, 17, 1998 , to A.L. Singleton, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Subcommittee on Social Security office, room B–316 Rayburn House Office Building, at least one hour before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be submitted on an IBM compatible 3.5-inch diskette in WordPerfect 5.1 format, typed in single space and may not exceed a total of 10 pages including attachments. Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, company, address, telephone and fax numbers where the witness or the designated representative may be reached. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are available on the World Wide Web at ‘HTTP://WWW.HOUSE.GOV/WAYS__MEANS/’.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman BUNNING. The Subcommittee will come to order if all of our guests will come in and sit down.

Today marks our 10th hearing in the series on the Future of Social Security for this Generation and the Next. The Subcommittee will examine proposals regarding personal accounts today. As Americans consider the future of Social Security, the idea of allowing individuals to invest retirement funds in private markets is receiving more and more attention.

From the Bipartisan Commission on Entitlement and Tax Reform chaired by Senators Kerry and Danforth, to the 1994–96 Advisory Council on Social Security, to private individuals and organizations, we continue to see detailed plans for Social Security reform which includes personal accounts as a way to boost workers' retirement security income.

These range from 401(k)-type plans administered by central government organizations to individual personal accounts similar to an IRA.

Today we will hear from a number of bold thinkers, the authors of personal account proposals. We look forward to learning more about their proposals and the specifics of how these proposals and personal accounts would work.

In the interest of time, it is our practice to dispense with opening statements except from the Democrat Ranking Member.

I welcome all opening statements if you will submit them for the record, and I will yield to Mr. Levin when he arrives for any statement that he would make.

The first witness we have is my good friend from the State of Michigan, Hon. Nick Smith.

STATEMENT OF HON. NICK SMITH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Mr. SMITH. Mr. Chairman, bravo to you for holding hearings on Social Security for the last 2 years. I introduced my first bill when I came to Congress in 1993 and then in the next session introduced my next bill which——

Chairman BUNNING. Nick, would you hold for 1 second?

Please come in and shut the door so we don't hear the hallway. Thank you. Go ahead.

Mr. SMITH. This Subcommittee and subsequently President Clinton and Senator Moynihan, Senators Roth and Gramm, and Congressman Porter and myself and others have introduced Social Security legislation. It is probably one of the toughest issues facing Congress, and I am excited that we are moving ahead with the agenda.

I see, number one, that there is no easy way to fix Social Security. There are three solutions. You can increase revenues by im-

proving the rate of return on contributions, you can reduce benefits, or you can increase revenues by raising taxes.

Actually the tendency of Congress and the White House has been to increase taxes. We have increased taxes 36 times since 1971, more often than once a year, and I would suggest that maybe we should rule that out as our solution as we attempt to reform and make sure that we keep Social Security solvent in the future.

Because of changing demographics, the pay-as-you-go system—Mr. Chairman, did you want me to stop for Mr. Levin?

Chairman BUNNING. No.

Mr. SMITH. It is becoming very evident that the changing Social Security pay-as-you-go system is not working and that we are going to have to consider alternatives.

In my written statement, I have a chart showing the return for individuals that have paid in their Social Security taxes. This chart shows that earlier retirees got as much as $60,000 more than they and their employers put in. However, anyone born after 1940 is going to lose money and not get back on average what they contribute.

The Tax Foundation estimates that anybody that retires after 2005 will lose on average between ½ and 1½ percent.

Another way of saying that, as my next chart shows, these are the number of years that you will have to live after retirement to break even and get back the contributions that you and your employer put in. Namely as you can see 2005, 2015, you are going to have to live 23–26 years after retirement simply to break even.

So a solution that more and more of us are looking at is a better return on that investment. My proposal gradually makes changes in the retirement age and makes changes to slow the increase in benefits for higher wage earners when they retire. To assure that no one retires in poverty, I suggest that for every $5 dollars earned from personal retirement investment accounts the traditional benefit be reduced by $4 dollars.

In my proposal we start out at 2.5 percent out of the 12.4 percent Social Security taxes for personal investment and gradually increase that over the next 60 years to roughly 10 percent.

The table that compares the investment in T-bills, bonds and stocks is interesting. With inflation adjustments, a $100 investment in 1966 would return $447 in 1996 if invested in stocks. Including the Depression years, from 1929–59, we see that the return is negative for T-bills—you actually lost money—and the return in stocks was $565, again adjusted for inflation.

The promise of personal accounts is that they can dramatically increase returns for workers, thereby improving the living standards for retirees. If workers are allowed to put even a portion of their Social Security contributions into investment accounts, the long-run return on these accounts should earn well above what Social Security payments would have earned under existing law. But the challenge is to fund the existing system that is now an estimated $4 to $7 trillion in actuarial debt. To fund that system without huge transition costs is the challenge that we face. To do this without personal investments and increasing the rate of return on Social Security taxes is going to be very difficult.

[The prepared statement follows:]

Statement of Hon. Nick Smith, a Representative in Congress from the State of Michigan

BUILDING A SOLUTION TO KEEP SOCIAL SECURITY SOLVENT

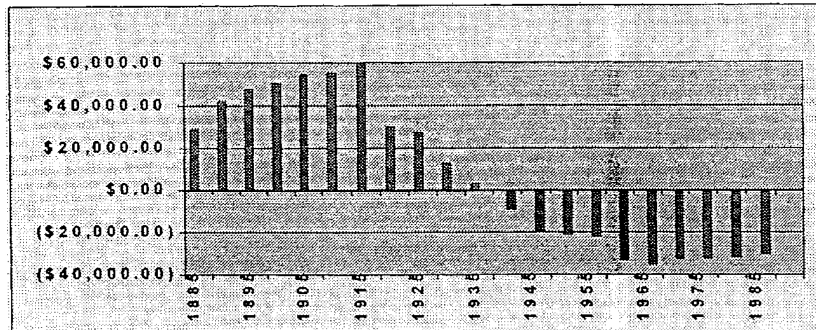
We will remember 1998 as the year that both major political parties joined together to discuss ways to save one of the most important federal programs: Social Security. President Clinton opened the debate with the first Social Security town meeting on April 8, 1998, in Kansas City. We have seen new reform proposals from Senators Moynihan, Roth and Gramm. Representatives Porter, Sanford, and I have submitted reform bills, and other members of Congress plan to introduce their recommendations later this year. As a vocal advocate of Social Security reform since 1994, I am glad to see the issue get the national prominence it deserves.

We are Learning About the Shortcomings of Pay-as-you-go

In 1935, the Social Security Act was enacted to provide a government guarantee against poverty. Unfortunately, many people believe that Social Security is backed by a trust fund filled with the surpluses from years of Social Security tax payments. Social Security was designed as a pay-as-you-go system where current workers pay taxes to fund current retirees' benefits. Since it was run as a pay-as-you-go system, the Social Security trust fund has not accumulated large surpluses. Trustees managed the system's cash flow to keep approximately one year's benefit payments available. The "surplus" cash flow that Social Security is now experiencing should be protected to help us meet the benefit commitments we are making to current workers.

Changing demographics—longer life expectancies, lower birth rates—have steeply increased the tax burden on current workers to cover retirement benefits for current retirees. Social Security is a losing proposition for most workers born after 1940, as shown in Chart One.

CHART ONE: **Under the pay-as-you-go system, Social Security Participants born after 1940 will receive less in accumulated lifetime benefits than their contributions are worth**



There is No Easy Answer

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

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

We are entering a period of bipartisan debate when we will discuss the costs and benefits of solutions using some or all of the above "fixes." I have introduced my own proposal, The Social Security Solvency Act of 1997, which brings the system into balance without tax increases. If we raise taxes, we are increasing the largest tax most American families pay. Almost 80% of families pay more in Social Security taxes than they pay in income taxes. My bill slows the increase in benefits for higher income seniors and allows individual workers to invest some of their tax dollars in their own personal retirement savings accounts.

Personal retirement accounts are becoming a feature of both Republican and Democratic plans. A plan like the one proposed in my Social Security Solvency Act uses higher returns from investment savings to maintain or improve the monthly retirement benefit without increasing taxes.

TABLE ONE: SMITH BILL (H.R. 3082), INVESTING PERSONAL ACCOUNT FUNDS IN THE STOCK MARKET, COMPARED TO CURRENT LAW

	Current Law	Smith Plan
At retirement, a 50-year-old worker could expect		
Social Security	$1,828	$1,507
Personal Account	0	371
Total Benefit	$1,825	$1,878
At retirement, a 40-year-old worker could expect		
Social Security	$2,128	$1,618
Personal Account	0	771
Total Benefit	$2,128	$2,389

Estimated retirement benefit for a worker earning the national average wage, calculated to show the inflation-adjusted retirement benefit. The 50-year-old worker retires eighteen months later than current law, and the 40-year-old worker retires in 2022 instead of 2019.

The promise of personal accounts is that they can dramatically increase returns for workers, thereby improving the living standards of future retirees. If workers are allowed to put even a portion of their Social Security contributions into investment accounts, the long-run return that these accounts should earn will keep the monthly retirement benefit in the range of what current recipients get. This can been seen by comparing projected benefits for a hybrid Social Security/personal account plan like the Social Security Solvency Act of 1997 to current law Social Security benefits (Table One).

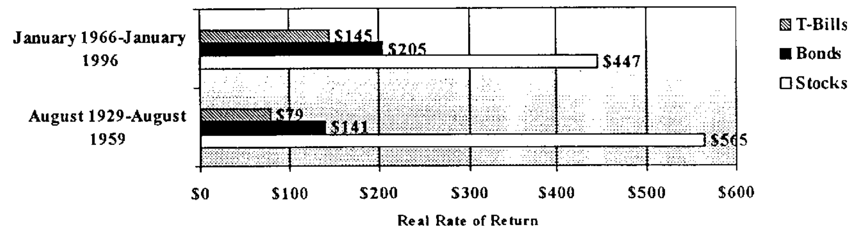
Retirement Security Depends on Having a Long-term Strategy

Retirement income has three major sources: Social Security, private pension and profit-sharing plans, and personal savings. While we are working to save Social Security, we must also create incentives to encourage saving and educate all workers on the importance of planning for retirement.

Stocks should be the investment of choice for anyone trying to build a secure retirement. Chart Two shows that, even for those who bought stocks just before the crash of 1929, investors who follow a "buy and hold" stock strategy are better off in the long run. An investor who put $100 in the stock market in August 1929 and left it there would have found that his investment had grown to $565 by August 1959, before inflation. A similar $100 put into bonds and T-bills would have been worth $141 and $79, respectively.

CHART TWO: Comparative Return for $100 Invested in Stocks, Bonds, or T-Bills

Source: Stocks for the Long Run, by Dr. Jeremy J. Siegel



These investment returns are not the result of complicated trading strategies that require advanced financial training. Today's investor can achieve these returns by purchasing shares of a diversified stock mutual fund.

IRAs and 401(k) Plans have Successfully Encouraged Retirement Saving

The Social Security Trust Fund has a balance of approximately $650 billion. By comparison, private retirement plan and IRA balances topped $5 trillion in the beginning of 1998. Obviously, workers and companies have been saving for retirement in many ways.

The Employee Benefit Research Institute conducts an annual Retirement Confidence Survey. In 1997, survey results showed that 69% of workers have started saving for retirement, many of them using 401(k) plans and IRAs. Working Americans are gaining first-hand experience, proving that regular savings invested in even conservatively managed mutual funds significantly increase in value over time. Social Security reform can build on this foundation of personal saving and investment.

A recent study presented to the 1998 Pension Research Council shows that 401(k) plans are being readily accepted by workers who have the opportunity to join. In almost all income classes, participation rates increase as workers grow older (Chart Three).

Participation in a 401(k) plan has given some workers their first exposure to the stock market. Many have watched their 401(k) balances grow rapidly during the bull market of the 1990s. Across all age and income categories, 401(k) investors are learning about investment strategies. Statistical studies, which are summarized in Chart Four, indicate that they are developing portfolios that include both stocks and bonds.

The experience gained in private investing for 401(k) plans and IRAs is a great start, but workers, especially those who are not retiring for twenty to thirty years, must learn about the benefits of long-term stock investing. This knowledge will yield real cash dividends to them when it is their turn to retire.

Immediate Action is Needed

We must find solutions to Social Security's $4 trillion unfunded liability right away. Personal accounts are becoming an accepted part of reform proposals. I have introduced H.R. 3560, legislation that would provide for a pilot program for private accounts. This would give us an opportunity to see the concept of private accounts in action, and to use real-world experience to design a Social Security system for the 21st century.

CHART THREE: PRIVATE INDUSTRY STATISTICS ON 401(k) PARTICIPATION

Source: "Making the Most of 401(k) Plans" by Clark, Goodfellow, Schieber, and Warsick
Living With Defined Benefit Plans, Mitchell & Schieber, eds.

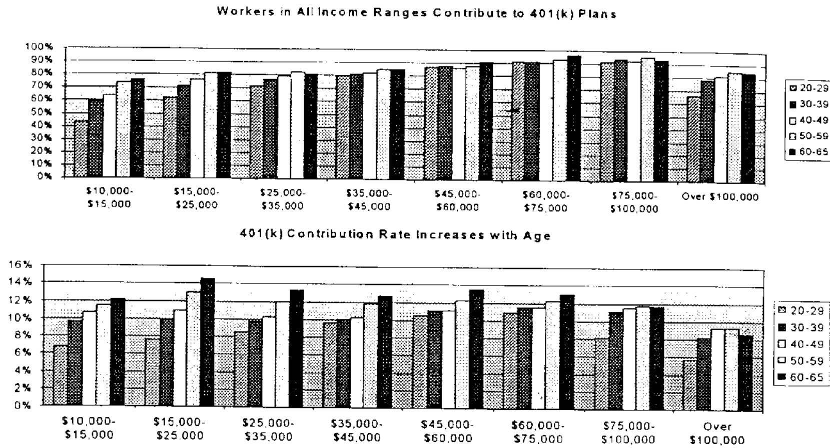
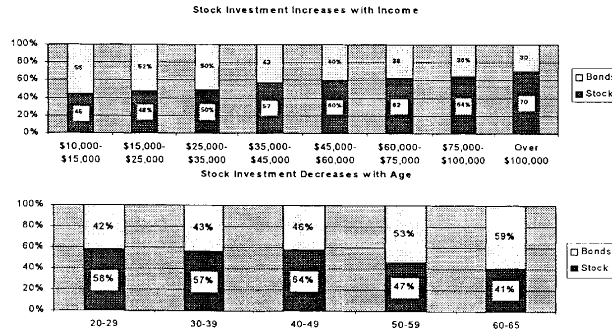


CHART FOUR: PRIVATE INDUSTRY STATISTICS ON 401(k) INVESTMENT CHOICES

Source: "Making the Most of 401(k) Plans" by Clark, Goodfellow, Schieber, and Warsick
Living With Defined Benefit Plans, Mitchell & Schieber, eds.



The Social Security Solvency Act of 1997

H.R. 3082

- No Tax Increase
- Establishes Personal Retirement Savings Accounts. Individual savings accounts (PRSAs) will accumulate considerable sums resulting in higher retirement benefits. The surpluses coming into the trust fund allow private investments (PRSAs) to start at 2.5% of payroll and increase to 10.2% percent of payroll in the year 2070.
- Social Security will have sufficient funds to honor all retirement benefit commitments as it transitions from pay-as-you-go to private savings accounts
- Gradually reduces the increase in benefits for high income retirees
- Allows private investment account withdrawals at age 59½
- Increases retirement age two additional years over fifteen years, then indexes the retirement age to life expectancy
- Balances the Social Security System for the next 75 years
- Newly hired State and local government employees join Social Security
- Couples receive a minimum of 133% of higher benefit, and widows/widowers receive minimum 110% of married benefit payment

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Social Security Solvency Pilot Program Act of 1998

H.R. 3560

Pilot demonstrations will

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

Chairman BUNNING. Thank you, Nick.

I am going to allow, Sandy, if you want to make an opening statement.

Mr. LEVIN. I'm sorry, I missed part of your presentation.

Mr. SMITH. I won't miss yours.

Mr. LEVIN. But we have discussed this before, right. Anyway, we are glad you are here.

Mr. Chairman, today the Subcommittee will take testimony on proposals to create individual Social Security accounts as part of Social Security reform. A variety of approaches have been suggested for such accounts. Some offer add-ons to current Social Security benefits while others divert a portion of current Social Security revenues into individual investments.

These approaches have very different results for each generation of workers and for different types of workers within each generation. The demographic changes we face in the next century demand that we give serious attention to proposals that will ensure the future of Social Security.

It is important therefore that we examine carefully the impact of each of these proposals. We must determine what a shift from a defined benefit program to a defined contribution program would mean for beneficiaries. Would individual accounts provide an adequate retirement income for all people regardless of work level or work history? Will low-wage workers and women with intermittent work histories be worse off?

We need to ask how the risk involved in individual accounts which rely on stock market investments would impact beneficiaries, and we need to inquire about the costs of implementing and administering a system of individual accounts.

Today's hearing will provide us an opportunity to hear from authors of several of these proposals as well as from experts who have studied the impact of privatizing Social Security.

Chairman BUNNING. Thank you.

Let me start out. In describing your Social Security Solvency Act, how do you propose to guarantee all of the benefits of the current system by taking out certain moneys to invest in private accounts? What kind of a transition period do you have or propose to have?

Mr. SMITH. Increasing the age limit by an additional 2 years takes place gradually over 17 years.

Chairman BUNNING. Starting?

Mr. SMITH. We started in the year 2000. We also have a gradual change in reducing the increase in benefits for the high-income wage earners when they retire.

Chairman BUNNING. Means test?

Mr. SMITH. You could consider it more progressive rather than means testing. As we change the bend points, we add a fourth bend point and so once you get over a $3,400 average monthly earning as an average throughout several of the earlier years, we add an additional bend point of 5 percent which makes it more progressive or has the effect of slowing down the increase in benefits for higher income retirees.

Chairman BUNNING. Do you take the high-income retirees as they go up and not allow them to pay as much into the system?

Mr. SMITH. No, but the offset would be the private investment accounts with the higher earnings and therefore the 2.5 percent, as that percentage goes up, is a greater dollar amount for their high-wage earners. So the offset in increased earnings, because of the increased personal/private investment accounts, would more than compensate for their reduced benefits on the fixed portion of the Social Security provisions.

Chairman BUNNING. The last question. Why do you allow a differential in age as far as retirement from the private account or personal investment account than you do at the Social Security account?

Mr. SMITH. Well, it is our position that any time an individual can guarantee other taxpayers that they are not going to be a burden on those taxpayers in their old age by having the kind of annuity that can guarantee retirement income greater than or equal to their benefits under the traditional Social Security system, they should be allowed to retire. As soon as they can accommodate that kind of an annuity or guarantee, I feel that they should be allowed to retire even if at an earlier age.

I think it is interesting, Mr. Chairman, when the Subcommittee has a chance to look at my statement, that we are already seeing that 69 percent of the workers in the United States are investing money in stocks, bonds, mutual funds——

Chairman BUNNING. Or having it invested for them?

Mr. SMITH. That is correct, with some options, whether thrift savings or 401(k)s or IRAs. A larger and larger percentage of our population is experiencing the creation of wealth through investment.

Chairman BUNNING. Thank you.

Mr. LEVIN. We have talked about this before, but let me zero in on one aspect, and there are many, but raising the age of retirement—and a panel is coming after you and we will ask them that, which is the whole purpose of this year of dialog. This Subcommittee under Chairman Bunning has held a lot of hearings as part of this effort to bring the dialog to the country and the countryside.

Talking about the country and the countryside, as you know, there is a lot of resistance, the surveys all show it, to raising the retirement age, and yours is a fairly steep increase.

Do you think that resistance is irrational? Why is there resistance?

Mr. SMITH. I think there are a lot of people who would like to retire earlier, and that is why I do provide that they can retire as early as age 59, or maybe even as soon as they can have the kind of annuity that is going to guarantee other taxpayers that they are never going to be a burden on those taxpayers.

But I think rather than calling it the retirement age, it is more appropriate to say that we are increasing the age for eligibility for the fixed benefits: A person can retire whenever they want to if they have enough accumulation in private investments. And if we are averagely fortunate, even in a 7-percent real return on those investments, then there is going to be substantially more money to accommodate earlier retirement rather than a later retirement.

I add an additional 2 years where Senator Moynihan and others have suggested we go up 3 years to age 70.

Mr. LEVIN. So it is 2 years.

Mr. SMITH. So mine goes to 69.

Mr. LEVIN. And you build in an increase?

Mr. SMITH. Depending on the longevity statistics, it would increase over the years.

Mr. LEVIN. But my guess is if you in an objective way asked people who are now between, say, 40 and 60 whether they would favor

that kind of a system, with the qualifications that you mentioned, there would still be a lot of resistance to it?

Mr. SMITH. I think so.

Mr. LEVIN. Why do you think so?

Mr. SMITH. I think people would prefer not to have politicians in Washington telling them when they can retire. I think it is important that you allow the flexibility of personal retirement accounts. And I would just——

Mr. LEVIN. What about the influence of return on investments which may or may not happen? They may be retiring or reaching 60, 62, or 65 after a downturn, which will come at some point.

Mr. SMITH. First the existing system is a very high risk. It is going broke. I think for the record, Congressman Levin, when we started this pay-as-you-go system in 1935, the average age of death was a little over 61 years old.

Now, at birth, the average age for a female is 76, for a male is 74. If you reach retirement age, you are going to live another 19 years on average. Because of the tremendous medical system and because we are taking better care of ourselves, our lifespan has significantly expanded.

And as we look at converting a pay-as-you-go system which can't sustain itself with the demographics that we are now experiencing, I think it is important that you look at alternatives.

Increasing the age is a suggestion which has been consistent in almost all proposals.

Mr. LEVIN. I think we ought to look at alternatives. We do need to look at the downsides as well as the arguments for it and understand the resistance. As we have held forums and talked to people, let me mention a couple of reasons for the resistance. It is true that people are living considerably longer than when Social Security started. It also means that there are many more couples who survive 65, and that is having a dramatic effect on people's attitudes. It is not even in most cases the woman who survives but the couple, and they want to spend time together.

Second, and this has been pointed out to me and I know it from my own experience, children are marrying later and people are having grandchildren later and I think that is a demographic fact.

So as we look at suggestions to change the age, I think we have to look at all of the human and personal dimensions.

The red light is on and so I will stop with that. Thank you, Mr. Chairman.

Chairman BUNNING. Mr. Johnson.

Mr. JOHNSON. Mr. Levin, I agree with you.

Mr. LEVIN. That is because we are both grandparents.

Mr. JOHNSON. That is right.

I want to pursue that same idea, Nick. You rejected the idea of raising taxes to cover the cost of transition and yet you picked up on raising the age limit for retirement or for when they can take advantage of the Social Security system.

Can you explain why you came up with that solution?

Mr. SMITH. Well, I guess, number one, it helps accommodate some of the transition considerations. We tried to offset the increase in eligibility age for fixed benefits with a reduced age for when a person can retire and start collecting their personal invest-

ment savings. Eventually the personal investment savings are going to be the major part of that person's retirement under the Social Security system.

I think probably it is one of the more objectionable areas, but it seems to me that we have got to keep everything on the table as we look at filling the $4 trillion hole of actuarial debt to keep Social Security solvent.

Mr. JOHNSON. But are you foreclosing the retired person from Social Security at all and forcing him into strictly private accumulation?

Mr. SMITH. No, we are keeping it as an option, but hopefully the private accumulation is going to eventually be much greater than even Social Security under current law. And even if we have to find some way to continue funding that Social Security system with fewer and fewer workers in relation to the number of retirees, economists recommend some private investment.

Mr. JOHNSON. I don't disagree that we shouldn't change the system, but the age idea, there are some companies that force people out at a certain age. Airline pilots can't fly if they are 60. So if you get into some business environment where they either fire you or politely ask you to leave because you are too old, you are saying that you can't have Social Security because we are going to protect the system; is that right?

Mr. SMITH. Everything is a tradeoff and age discrimination is only legal if it is safety related.

Mr. JOHNSON. It is a tradeoff for the elderly. You are penalizing the elderly. There are not very much over 65 on this Subcommittee, and I think Levin and I might be the only two.

Mr. SMITH. The question is what are the alternatives to come up with $4 trillion, the $3 or $4 trillion that is necessary to keep this system solvent.

One area that I ruled out is increasing taxes. Now almost 80 percent of working families pay more in Social Security taxes than they do in income taxes. So it would be offensive to increase taxes to me.

Mr. JOHNSON. I agree. Thank you, Mr. Chairman.

Chairman BUNNING. Mr. Christensen.

Mr. CHRISTENSEN. Thank you, Mr. Chairman.

Nick, have you looked at the effects of all of this new money into the market and what kind of a positive or negative effect it might have on job creation, on the economy, on inflation? And then also how does your plan address who would be the stock pickers or how would you go about picking the firms choosing the investments, or would it be totally open to the market?

Mr. SMITH. We looked at the thrift savings guides, and in our bill we incorporated indexed stocks, indexed bonds, indexed cap funds and indexed global funds and any other safe investment determined by the Secretary of Treasury. So we tried to limit the investment options and that was simply because of the undue concern that maybe individuals weren't capable of investing their own money, and so we started out with safe investments as an option in our proposal.

And what was the first question?

Mr. CHRISTENSEN. The effects on the economy.

Mr. SMITH. In terms of increasing savings and investment, this kind of proposal would increase savings and investment.

A second bill that I have introduced takes the unified budget surplus, takes some of that money and starts these personal retirement savings accounts, not reducing or taking from Social Security but rather starting these accounts from using some of the budget surplus that is expected this year.

Mr. CHRISTENSEN. Do you have any ideas what kind of effect on the market this new money would have?

Mr. SMITH. Increasing savings and investment is generally going to have a positive effect on the economy.

Mr. CHRISTENSEN. Thank you, Mr. Chairman.

Chairman BUNNING. Mr. Collins.

Mr. COLLINS. No questions.

Chairman BUNNING. Mr. Hulshof.

Mr. HULSHOF. No questions.

Chairman BUNNING. Thank you, Mr. Smith.

If the next panel would step forward. Dr. Laurence Kotlikoff, professor of economics from Boston University; and Research Associate, National Bureau of Economic Research.

Hon. Edward Gramlich, member of the Board of Governors of the Federal Reserve System and Chair of the 1994–96 Advisory Council on Social Security.

Dr. Alicia Munnell, Peter F. Drucker Professor of Management Sciences, Boston College Carroll School of Management.

Hon. Robert Ball, founding Chair of the National Academy of Social Insurance and member of the 1994–96 Advisory Council on Social Security and former Commissioner of Social Security.

Hon. Fred Goldberg, executive director of the Bipartisan Commission on Entitlement and Tax Reform, member of the National Commission on Retirement Policy Center for Strategic and International Studies, former Commissioner of the Internal Revenue Service and former Assistant Secretary for Tax Policy of the U.S. Department of the Treasury.

Wow, that is a mouthful.

Dr. Kotlikoff.

STATEMENT OF LAURENCE J. KOTLIKOFF, PH.D., PROFESSOR OF ECONOMICS, BOSTON UNIVERSITY

Mr. KOTLIKOFF. Chairman Bunning and other distinguished Members of the Subcommittee on Social Security, I am honored by this opportunity to discuss with you fundamental reform of the Social Security system. I have written testimony I would like to submit for the record. Let me summarize it.

Chairman BUNNING. Without objection we will put the whole thing in.

Mr. KOTLIKOFF. Let me summarize the testimony with the following points.

First of all, the Social Security system is in much worse long-term financial shape than the Trustees are publicly acknowledging. The financial shape is at least twice as bad as is being publicly disclosed in the Trustees' Report. They are using a truncated projection horizon. Specifically, they are only looking at 75 years in thinking about the system's long-term finances.

On that basis you need a 2.2 percent of payroll tax rate increase in order to pay for benefits over the next 75 years. If you don't truncate the projection horizon, you need a 4.7-percent payroll tax hike. That is about a nickel on every dollar that we earn, and this number is coming from Steve Goss who is the Deputy Chief Actuary of the Social Security Administration. So it is not my number.

You might say, well, looking at 75 years is long enough, but we are now 15 years beyond the 1983 reform that occurred back under the Greenspan Commission, and a large part of our current problem has to do with the fact that we didn't look long term enough in 1983. Since 1983, we have added 15 years of those outyear deficits to our current 75-year projection horizon.

So I want to point out that the long-run problem of Social Security in terms of its financing is at least twice as big as is currently being made public. And I say "at least as" because I think the actuaries are using overly optimistic demographic and economic assumptions in their projections. I think we really need something like a 6-cent-on-the-dollar tax hike right now to pay Social Security benefits on a long-range basis. I am not proposing that, I am saying that the problem is much, much deeper and bigger than we are publicly discussing.

The second point I wanted to make is that, even under current law—without any new tax hikes or benefit cuts—the baby boom generation and their kids are getting treated very badly by the program. On average, about 74 cents on every dollar that they pay in contributions represents a tax. For the oldest baby boomers it is about 55 cents on the dollar. For today's kids, of every dollar being paid as a contribution, 81 cents represents a tax. So we already have a system which is basically just taxing people at a very high level. If we continue on with the same procedure that we have been following for the last 50 years of basically—allowing taxes to go up to deal with these benefit problems—we are going to end up with at least a 20-percent Social Security payroll tax, plus probably a 10-percent Medicare tax. Thus, we will probably have a 30-percent payroll tax in 20 or 30 years which is going to be devastating to our economy and our kids.

Let me propose an alternative to that scenario—a proposal for Social Security reform that I have developed together with Jeffrey Sachs who is a professor at Harvard. Our proposal has been endorsed by 65 leading academic economists around the country including 3 Nobel prize winners.

It is called the personal security system and it has seven points. I think they deal with many of the legitimate concerns that Members of Congress have raised about privatizing Social Security.

First of all, the proposal reforms just the retirement portion of Social Security; it leaves the disability and survivor portions alone.

The moneys workers now contribute to Social Security's retirement (OAI) program, would now be contributed to a private account. There is also contribution sharing—if you are married, half of your contribution goes into your account, and half goes into your spouse's account. So we are protecting spouses who may not be in the workplace. The government provides a matching contribution on a progressive basis, so we have progressivity in this proposal.

The account balances are invested in a single security. It is a global index fund of stocks, bonds, and real estate. And by investing in a single security, you ensure that nobody can time the market, that everybody gets the same rate of return on her contributions, and that everybody is fully diversified.

Between ages 60 and 70 each cohort's account balances are gradually transformed into inflation protected pensions, so you have collective annuitization of the account balances. None of the other reform proposals that I have seen actually do this, and this is extremely important because the insurance market does not function very well in the United States in the case of private annuities.

Finally, we have recognized the fact that you have to pay the benefits of the current retirees under the old system, and you have to pay the benefits the current workers have accrued under the old system when they hit retirement. So we give workers their accrued benefits when they hit retirement. We give them what they have accumulated, and we use a business cash flow tax to pay off those benefits over time.

However, we actually have a real mechanism for paying off the unfunded liabilities of the existing system, and we are very honest about the fact that we have a major fiscal problem here. We have to get everybody on board to pay off this liability, and that is what this business cash flow tax achieves. Thank you.

[The prepared statement follows:]

Statement of Laurence J. Kotlikoff, Ph.D., Professor of Economics, Boston University

Chairman Bunning and other distinguished members of the Committee on Ways and Means, Subcommittee on Social Security, I'm honored by this opportunity to discuss with you fundamental reform of the U.S. Social Security reform.

SOCIAL SECURITY'S OPTIONS—REAL REFORM OR REAL FINANCIAL DISTRESS

The U.S. Social Security System is in desperate need of reform. The system faces a long-term fiscal crisis that is roughly twice as bad as our government is publicly admitting. Continuing to pay Social Security benefits on an ongoing basis requires taxing workers another nickel out of every dollar they earn—starting now. For those born in the postwar period, Social Security already represents, on balance, a bad deal. Raising taxes or cutting benefits by the amount needed to keep the program solvent will turn a bad deal into an awful one.

Many of the same politicians and bureaucrats who under-reformed the system is 1977 and again in 1983 and, thereby, delivered us into our current mess now claim to have the answer: "Raise Social Security's retirement age, means-test Social Security benefits, increase the income taxation of Social Security benefits, change the benefit formula, bring uncovered state workers into the system, raise taxes a bit now and more later, invest the trust fund in the stock market, and partially privatize the system by compelling workers to contribute 1 to 2 percent of their wages to private accounts."

This combination of piecemeal policies is, unfortunately, the likely outcome of our national "conversation" about Social Security. Their adoption will, almost surely, deliver less than half of what is needed on the fiscal side and turn Social Security's privatization into a costly fiasco.

The real way to reform Social Security is to privatize fully its retirement program and require everyone who can to contribute to paying off the liabilities of that program. Anything short of full privatization, with full payment of the transition costs, will leave us having another "conversation" 15 years from now, but facing even worse options than those we currently face.

This article presents a plan for fully privatizing the retirement portion of Social Security. The plan was developed by myself and Professor Jeffrey Sachs of Harvard University. It has been endorsed by 65 leading academic economists, including three Nobel Laureates. The plan is simple enough to describe on a single page. It protects

existing retirees, women, and the poor, has very low administrative costs, requires full portfolio diversification of account balances, forces contributors to invest for the long-term, transforms accumulated account balances into inflation-protected pensions at retirement, and fully pays off the liabilities of the old system in a manner that is generationally equitable.

Before describing the plan, I discuss Social Security's long-term finances as well as its treatment of postwar Americans. Knowledge of both these issues is critical for judging whether or not Social Security should be privatized.

SOCIAL SECURITY'S LONG-TERM FISCAL CRISIS

According to the intermediate projection of the Social Security Trustees, paying promised benefits over the next 75 years requires an immediate and permanent 2.2 percentage point increase in the program's current 12.4 percentage point tax rate. Fixing Social Security for 75 years is not, however, fixing it for good. Each year that passes brings into the current 75-year planning horizon a year that wasn't there before. For example, we are currently 15 years beyond the 75-year planning horizon that the Greenspan Commission considered back in 1983. Recall that the Greenspan Commission was charged with the job of solving Social Security's financial problems once and for all. The mistakes underlying their failure should not be repeated. These mistakes go beyond using too short a planning horizon. They also include using economic and demographic assumptions that were far too optimistic.

Unfortunately, when the Social Security actuaries look beyond 75 years they see enormous deficits. These deficits are so large that paying Social Security benefits on an ongoing, rather than simply a 75-year, basis requires an immediate and permanent 4.7 percentage-point tax hike! This unpublished estimate comes from Steven Goss—the highly respected Deputy Chief Actuary of the Social Security Administration. Goss is also responsible for developing the 2.2 percentage point 75-year tax hike estimate.

The 4.7 percentage-point tax hike needed for true long-term solvency is, of course, more than twice the 2.2 percentage-point being announced by the Trustees in their *Trustees Report.* The Trustees' failure to allow Goss and his colleagues to publish the tax hike needed for true long-term solvency represents an incredible dereliction of duty and one that merits Congressional attention.

Unfortunately, a 4.7 percentage-point tax hike is not the limit of the tax hike we're likely to face. For starters, if the 4.7 percentage-point tax hike is not imposed immediately and if one assumes that all benefits will be fully paid, the payroll tax rate will have to be raised by more than 4.7 percentage points when the tax hike is finally implemented. Moreover the required 4.7 percentage-point tax hike is calculated based on what appear to be overly optimistic "intermediate" assumptions concerning lifespan extension and real wage growth. Top demographers, like Professor Ron Lee of the University of California at Berkeley, believe lifespan will grow by about 10 years over the next 75 years—roughly twice the increase being projected by the Trustees in their intermediate forecast. In the case of real wage growth, the intermediate forecast assumes that real wages will grow in the future at .9 percent per year—over twice the rate they've grown since 1975.

The historic use of a truncated planning horizon and overly optimistic "intermediate" demographic and economic assumptions is responsible for about two thirds of the current long-term imbalance in the program. The remaining third appears to reflect technical mistakes that the actuaries uncovered in their forecasting methodology. In this regard it's worth pointing out that the actuaries are using what they themselves view to be a rather crude method for projecting long-term benefits and taxes. Their method is crude because it is based on aggregate relationships rather than a microsimulation model that tracks the benefits received and taxes paid of individuals. Although the actuaries are currently actively involved in evaluating existing microsimulation models and developing one of their own, it will be several years until more reliable, micro-based projections become available.

Based on the current projection methodology, the incorporation of more realistic mortality and real wage growth assumptions raises the tax hike needed for long-run solvency from 4.7 percentage points to over 6 percentage points. Since the Social Security payroll tax rate is now 12.4 percent, such a tax rise would leave Americans workers paying close to a fifth of their wages to the System. Medicare faces an even more sever long-run funding problem. In combination, the two programs could eventuate in payroll tax rates of 30 percent or more. Payroll tax rates of this magnitude in conjunction with the rest of the U.S. tax structure and the need to pay interest on our large stock of official debt would have a highly detrimental impact on the U.S. economy.

The alternatives to imposing dramatically higher Social Security taxes is either dramatically cutting Social Security benefits or privatizing the existing system. In contemplating these alternatives, it's important to understand just how badly the system, based on the current levels of taxes and benefits, is treating Americans born since 1945.

SOCIAL SECURITY'S TREATMENT OF POSTWAR AMERICANS

In a recent study, I, together with five colleagues, used a highly detailed micro simulation model to examine how Social Security is treating postwar Americans.[1] In addition to considering the treatment of different postwar cohorts, the study compares the treatment of different types of individuals within each of these cohorts.

The study using two tools: CORSIM—a dynamic micro simulation model—and SOCSIM—a detailed Social Security benefit calculator. CORSIM generates a representative sample of lifetime earnings and demographic trajectories for Americans born or to be born between 1945 and 2000. SOCSIM determines the Old Age Insurance and Survivor (OASI) benefits and taxes received and paid by the CORSIM sample. These benefits and taxes are then used to a) compute the lifetime net benefits (benefits less taxes) paid to different cohorts and subgroups within cohorts of the baby boomers and their children, calculate the rate of return different cohorts and groups within cohorts are implicitly earning on their contributions to the current systemt, and c) consider the extent to which the OASI system pools risk across cohort members by reducing the variance of lifetime income.

CORSIM starts with a representative sample of Americans alive in 1960. It then "grows" this sample demographically and economically. Specifically, it ages, marries, divorces, fertilizes, educates, employs, unemploys, re-employs, retires, and kills original sample members and their descendants over the period 1960 through 2090.

SOCSIM uses completed lifetime demographic and economic experiences to determine OASI retirement, spousal, widow(er), mother, father, children, and divorcee benefits as well as OASI taxes. It does so taking into account Social Security's earnings test, family benefit maxima, actuarial reductions and increases, benefit recomputation, eligibility rules, the ceiling on taxable earnings, and legislated changes in normal retirement ages.

THE STUDY'S FINDINGS

This study's findings, culled from its executive summary, are indicated below:

Social Security represents a bad deal for postwar Americans. Moreover, the deal has gotten worse over time. Baby boomers are projected to lose roughly 5 cents of every dollar they earn to the OASI program in taxes net of benefits. Generation X'ers and today's children will lose over 7 cents of every dollar they earn in net taxes.

These losses assume no adjustment to Social Security's taxes or benefits. But, as indicated above, major adjustments are inevitable unless the system is privatized. If OASI taxes are raised immediately by the amount needed to pay for OASI benefits on an ongoing basis, baby boomers will forfeit 6 cents of every dollar they earn in net OASI taxes. Those born after the baby boom will forfeit 10 cents of every dollar they earn.

Measured as a proportion of their lifetime labor incomes, the middle class are the biggest losers from Social Security, but measured in absolute dollars, the rich lose the most. On average, postwar middle-class workers pay 8 cents per dollar earned to OASI in net taxes compared with 5 cents for the lowest paid workers and 3 cents for the highest paid workers. But in absolute terms, today's highest earners pay roughly $1 million measured as of age 65, compared to $400,000 for today's middle-class workers, and $50,000 for today's lowest earners.

As an average, out of every dollar that postwar Americans contribute to the OASI system, 74 cents represent a pure tax. The pure-tax component of each dollar contributed is 55 cents for the oldest baby boomers and 81 cents for today's newborns. The degree of pure OASI taxation is less than 50 cents on the dollar for very low lifetime earners and greater than 80 cents on the dollar for very high lifetime earners.

Men pay about 1 percent more of their lifetime earnings to OASI in net taxes than do women. The higher male net tax rates obtain even controlling for lifetime

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[1] See Caldwell, Steven, Melissa Favreault, Alla Gantman, Jagadeesh Gokhale, Thomas Johnson, and Laurence J. Kotlikoff, "Social Security's Treatment of Postwar Americans," forthcoming in Tax Policy and the Economy, NBER volume, MIT Press, 1999.

earnings. They reflect shorter male life expectancy and less frequent receipt of OASI dependant and survivor benefits.

Non whites, because of their shorter life expectancies, face slightly higher (about a third of a percentage point) lifetime OASI net tax rates than do whites. This is particularly true at lower levels of lifetime earnings.

College-educated workers face somewhat lower (about two thirds of a percentage point) lifetime OASI net tax rates than non college-educated workers, but this difference disappear once one controls for lifetime earnings.

One rationale for the OASI program is that it pools earnings, lifespan, and longevity risks through the progressivity of its benefit schedule as well as through its provision of dependant and survivor benefits. The data support this view. Across all postwar cohorts, the OASI program reduces the variance of lifetime income by 11 percent. Within each cohort, OASI reduces lifetime income variance by between 6 and 10 percent.

The internal rate of return earned by postwar cohorts on their social security contributions is very low. It's also falling. Those born right after World War II will earn, on average, a 2.4 percent real rate of return. Those born in the early 1970s will average about a 1 percent real rate of return, and those born at the end of this decade will average essentially a zero rate of return. These internal rates of return would be lower still if one factored in either the massive tax increases or benefit cuts needed to restore Social Security to long-run solvency.

PRIVATIZING SOCIAL SECURITY

As described above, the U.S. Social Security System is badly broke and is treating the vast majority of its current contributors very badly. Privatization is far from a painless panacea, but it does represent an opportunity to resolve, once and for all, most of the System's financial woes and to rationalize a program that is intragenerationally as well as intergenerationally highly inequitable, replete with inefficiencies and economic distortions, and extraordinarily uninformative about the benefits it is providing in exchange for its mandatory contributions.

Once one decides that privatization is worth doing, the next question to consider is whether one wants to fully or partially privatize the system. As suggested, partial privatization will leave the non privatized portion of the system vulnerable to periodic financial half-measures that condemn the system to ongoing financial difficulties. Equally important, partial privatization will leave us with two basic retirement systems with all the extra administrative costs that entails. Finally, partial privatization will eventuate in a large number of extremely small retirement accounts—namely those of society's lowest earners. The fixed transactions costs of transmitting and recording contributions to these accounts, sending annual reports to the owners of these accounts, and disbursing payments could wipe out much of the return these accounts could be expected to earn. In short, if privatizing a dollar of the retirement portion of Social Security makes sense, privatizing all of it makes much more sense.

THE PERSONAL SECURITY SYSTEM [2]

The Personal Security System (PSS) fully privatizes the retirement portion of Social Security. The plan has the following seven provisions:

Social Security's Old Age Insurance (OAI) payroll tax is eliminated and replaced with equivalent compulsory contributions to PSS accounts.

Workers' PSS contributions are shared 50–50 with their spouses.

The government matches PSS contributions on a progressive basis.

PSS balances are invested in a single market-weighted, global index fund of stocks, bonds, and real estate.

Current retirees and current workers receive their full accrued Social Security retirement benefits.

Between ages 60 and 70, PSS balances are annuitized on a cohort-specific and inflation-protected basis.

A federal business cash-flow tax finances Social Security retirement benefits during the transition as well as the ongoing progressive government matching of PSS contributions.

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[2] This version of the Personal Security System plan differs in two details from the original version that was endorsed by Sachs and the other academic economists. Rather than calling for just a diversified portfolio, it insists that all account balances be invested in a single security—the market-weighted global index fund of stocks, bonds, and real estate. It also calls for financing the transition with a business cash flow tax rather than a retail sales tax.

Scope of the Proposal

The PSS plan leaves unchanged the contributions paid to and benefits received from the disability and survivor insurance portions of Social Security.[3] Only those contributions currently being made to the OAI portion of Social Security (about 70 percent of total OASDI contributions) are eliminated and replaced with mandatory contributions of equal size to PSS accounts.

Earnings Sharing

To protect non-working spouses as well as spouses who are secondary earners, total PSS contributions made by married couples are split 50–50 between the husband and wife before being deposited in their own PSS accounts. Although this provision is gender neutral, it is much more important for women than for men since women remain the major caregivers for young children and have, as a result, less time to spend in formal work.

Government Matching of PSS Contributions

The federal government would match PSS contributions of low-income contributors on a progressive basis. It would also make PSS contributions through age 65 on behalf of disabled workers.

Tax Treatment of PSS Accounts

PSS contributions are subject to the same tax treatment as current 401k accounts. Contributions are deductible and withdraws are taxable.

Investment of PSS Account Balances

All PSS balances are invested in a single, market-weighted global index fund of stocks, bonds, and real estate. Participants would purchase this security from (set up their accounts with) their preferred financial institution. Although participants could choose the financial institution in which they wanted to hold their global index fund, they couldn't sell it off to purchase other securities. Forcing everyone to hold this and only this asset would ensure maximum portfolio diversification and guarantee all participants the same rate of return on their PSS contributions. It would also prevent people from playing the market; i.e., they would be forced to invest for the long term.

Annuitization of PSS Account Balances

Between ages 60 and 70, participants in each birth cohort would have their PSS balances converted into inflation-protected pensions that continued until they died. This conversion would be organized by the government through competitive bidding by the insurance industry. The insurance company winning the bid to annuitize a cohort's PSS account balances would provide each PSS participant an inflation-protected pension in proportion to his or her account balance, where the factor of proportionality would be the same for all participants; i.e., all participants would become annuitized on identical terms so there would be no cherry picking by the insurance industry. The insurance company winning the bid for a particular birth cohort would sell off a portion of the cohort's PSS global index fund holdings each day as the cohort aged between 60 and 70. This would average out the risk of annuitizing PSS account balances when financial markets are temporally depressed. In being forced to bid for the right to annuitize a cohort's PSS account balances, the insurance industry will end up providing this service at the lowest possible price.

Survivor Provisions of PSS Accounts

If contributors die prior to age 70, any non annuitized portion of their PSS accounts balances is bequeathable to their heirs.

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[3] These programs also need to be reformed to hold their costs to the levels of their tax receipts. Whether privatization of these programs is the best method to achieve this objective is, however, a subject for another paper.

Payment of Social Security Retirement Benefits to Current Retirees and Current Workers

Current recipients of Social Security retirement benefits continue to receive their full inflation-indexed benefits. When they reach retirement, workers receive the full amount of Social Security retirement benefits that they had accrued as of the time of the reform. These benefits are calculated by filling in zeros in the OAI earnings records of all Social Security participants for years after the transition begins. Since new workers joining the workforce will have only zeros entered in their OAI earnings histories, new workers will receive no OAI benefits in retirement. This ensures that over a transition period aggregate Social Security retirement benefits will decline to zero.

Financing the Transition

During the transition, Social Security retirement benefits will be financed by a federal business cash-flow tax. The business cash-flow tax would also finance the government's ongoing PSS contribution match. Over time, the PSS business cash-flow tax rate would decline as the amount of Social Security retirement benefits decline. Provisional calculations suggest that the tax would begin around 8 percent and would decline to a permanent level of roughly 2 percent within 40 years.

Advantages of the Reform

The Personal Security System would improve benefit-tax linkage, enhance survivor protection, equalize treatment of one- and two-earner couples, offset the ongoing transfer of resources from the young to the old, provide better divorce protection to non working spouses, make the system's progressivity apparent, resolve Social Security's long-term funding problem, and ensure Americans an adequate level of retirement income.

Macroeconomic Effects

Simulation studies suggest that this reform will, over time, increase the economy's output by roughly 15 percent and the capital stock by roughly 40 percent.

Impact on the Poor

A business cash-flow tax represents an indirect way of taxing consumption. The current poor elderly living on Social Security benefits will be fully insulated from the tax because their benefits are guaranteed in real terms through the System's indexation of benefits to the consumer price level. Middle-class and rich elderly as well as middle-aged and younger members of society will jointly bear the burden of the tax. For young and middle aged workers there is an overall decline in the tax burden since they no longer pay the OAI tax. For the economy as a whole, the tax change is revenue neutral with the business cash-flow tax simply replacing the OAI payroll tax.

Simulation analyses show that poor members of current middle aged generations, poor members of current young generations, and poor members of future generations have the most to gain from privatizing social security.

Intergenerational Equity

Asking the middle class and rich elderly to pay their share of Social Security's unfunded liability is intergenerationally equitable particularly given the massive transfers that have been made to the elderly through Social Security, Medicare, and other programs in the postwar period.

Conclusion

The Social Security System does lots of very useful things. If forces us to save and to insure and protects us from running out of money in old age. But the system was financed from the start on a chain-letter basis and the end of the chain is in sight. We now have two options. We can try to con our children and grandchildren into buying our inherently worthless chain letters by continuing to disguise the true nature of Social Security's long-term fiscal problems. Or we can decide to act like adults and reform once and for all a System that imperils the financial wellbeing of our offspring.

In fully privatizing Social Security's retirement program along the lines outlined above, we can change the bathwater without discarding the baby. The PSS proposal

achieves all the legitimate goals of Social Security. It forces us to save, it protects dependent spouses, it assists the poor, and it provides annuity insurance. It also gives American workers immediate access to the world capital market in a manner that precludes their trying to time or otherwise play the market. Finally, it asks all who can pay, including the middle class and rich elderly, to recognize our collective obligation to pay the liabilities of the current system so that we can ensure real social security for our children.

Chairman BUNNING. Thank you.
Mr. Gramlich.

STATEMENT OF HON. EDWARD M. GRAMLICH, PH.D., MEMBER, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM; AND PAST CHAIR, 1994–96 QUADRENNIAL ADVISORY COUNCIL ON SOCIAL SECURITY

Mr. GRAMLICH. Thank you, Mr. Chairman. I am pleased to appear before the Subcommittee to testify on Social Security reform, and I suppose it goes without saying that I am speaking in my past capacity as Chair of the Advisory Council, 1994–96, and not in my present capacity at the Federal Reserve Board.

Let me first engage in some retrospection. At the time I and other members of our Advisory Council spoke before your Subcommittee last year, our report was just out and there was publicity that we couldn't agree on a single plan but had three separate approaches. Since that time it strikes me that there has been some coalescence around the middle-ground approach that I advocated. After our report, both the Committee for Economic Development and Senator Moynihan came out with plans that were more or less similar to mine and adopted some of those features. Two weeks ago the National Commission or Retirement Policy came out with a similar plan, again adopting some of the same features. In political terms, the center seems to be holding—since our report there has been increased interest in sensible middle-ground approaches, and I would encourage this Subcommittee to work in that direction.

In trying to reform Social Security, the middle-ground approach has two goals. The first is to make affordable the important social protections of this program that have worked so well to reduce aged poverty and the human cost of work disabilities. The second is to add new national savings for retirement—both to help individuals maintain their own standard of living in retirement and build up the nation's capital stock in advance of the baby boom retirement crunch.

My compromised plan, called the Individual Accounts Plan, achieves both goals. It preserves the important social protections of Social Security and still achieves long-term financial balance in the system by what might be called kind and gentle benefit cuts. Most of the cuts would be felt by high-wage workers, with disabled and low-wage workers largely protected from cuts. Unlike the other two plans proposed in the Advisory Council Report, there would be no reliance on the stock market to finance Social Security benefits, no worsening of the finances of the Health Insurance Trust Fund.

Beginning in the 21st century, two measures would be mainly responsible for reducing the growth of benefits. There would be a slight increase in the normal retirement age for all workers, in line

with the expected growth in overall life expectancy. There would also be a slight change in the benefit formula to reduce the growth of Social Security benefits for high-wage workers.

Both of these changes would be phased in very gradually to avoid benefit cuts for present retirees and "notches" in the benefit schedule. The result of the changes would be a modest reduction in the overall real growth of Social Security benefits. When combined with a rising number of retirees, the share of the nation's output devoted to Social Security spending would be approximately the same as at present, eliminating this part of the impending explosion in future entitlement spending.

These benefit cuts alone would mean that high-wage workers would not experience rising real benefits as their real wages grow, so I would supplement these changes with another measure to raise overall retirement and national saving. Workers would be required to contribute an extra 1.6 percent of their pay to newly created individual accounts. These accounts would be owned by workers but centrally managed. Workers would be able to allocate their funds among five to ten broad mutual or index funds covering stocks and bonds. Central management of the funds would cut down the risk that the funds would be invested unwisely, cut administrative costs, and would mean that Wall Street firms would not find these individual accounts a financial bonanza. The funds would be converted to real annuities on retirement to protect against inflation and the chance retirees would overspend in their early retirement years.

Some observers have objected to mandating new retirement contributions now when there is a welcomed prospect of Federal budget surpluses. One option to deal with this might be to rely on the already extensive private pension system to fill gaps in the existing pension coverage workers. Tax qualification rules might be changed to include a provision that requires a full or nearly full participation of all corporate employees in order to qualify for favorable tax treatments.

The Social Security and pension changes together would mean that approximately the presently scheduled level of benefits would be paid to all wage classes of workers, of all ages. The difference between this outcome and the present law is that under this plan these benefits would be affordable, as they are not under present law. The changes would eliminate Social Security's long-run financial deficit while still holding together the important retirement safety net provided by Social Security. They would reduce the growth of entitlement spending. They would significantly raise the return on invested contributions for younger workers. And, the changes would move beyond the present pay-as-you-go financing scheme by providing new saving to build up the nation's capital stock in advance of the baby boom retirement crunch.

As the Congress debates Social Security reform, I hope it will keep these goals in mind and consider these types of changes in this very important program.

Thank you very much.

[The prepared statement follows:]

Statement of Hon. Edward M. Gramlich, Ph.D., Member, Board of Governors, Federal Reserve System; and Past Chair, 1994–96 Quadrennial Advisory Council on Social Security

I am pleased to appear before the Committee to testify on Social Security reform. I speak for myself, as past chair of the 1994–96 Quadrennial Advisory Council on Social Security, and not in my current status as a member of the Federal Reserve Board.

Let me first engage in some retrospection. At the time I and other members of the Advisory Council spoke before your Committee last year, our report was just out and there was much publicity about the fact that we couldn't agree on a single plan, but had three separate approaches. Since that time it strikes me that there has been a coalescence around the middle-ground approach I advocated. After our report, both the Committee for Economic Development (CED) and Senator Moynihan came out with plans which adopted some of the features of my plan. Two weeks ago the National Commission on Retirement Policy (NCRP) came out with a similar plan, again adopting some features of my plan. In political terms the center seems to be holding—since our report there has been increased interest in sensible middle-ground approaches, and I would encourage this Committee to work in that direction.

In trying to reform Social Security, the middle-ground approach has two goals. The first is to make affordable the important social protections of this program that have greatly reduced aged poverty and the human costs of work disabilities. The second is to add new national saving for retirement—both to help individuals maintain their own standard of living in retirement and to build up the nation's capital stock in advance of the baby boom retirement crunch.

My compromise plan, called the Individual Accounts (IA) Plan, achieves both goals. It preserves the important social protections of Social Security and still achieves long term financial balance in the system by what might be called kind and gentle benefit cuts. Most of the cuts would be felt by high wage workers, with disabled and low wage workers being largely protected from cuts. Unlike the other two plans proposed in the Advisory Council report, there would be no reliance at all on the stock market to finance Social Security benefits, and no worsening of the finances of the Health Insurance Trust Fund.

The IA plan includes some technical changes such as including all state and local new hires in Social Security and applying consistent income tax treatment to Social Security benefits. These changes go some way to eliminating Social Security's actuarial deficit.

Then, beginning in the 21st century, two other measures would take effect. There would be a slight increase in the normal retirement age for all workers, in line with the expected growth in overall life expectancy (also proposed by the CED, Senator Moynihan, and the NCRP). There would also be a slight change in the benefit formula to reduce the growth of Social Security benefits for high wage workers (also proposed by the CED and NCRP). Both of these changes would be phased in very gradually to avoid actual benefit cuts for present retirees and "notches" in the benefit schedule (instances when younger workers with the same earnings records get lower real benefits than older workers). The result of all these changes would be a modest reduction in the overall real growth of Social Security benefits. When combined with the rising number of retirees, the share of the nation's output devoted to Social Security spending would be approximately the same as at present, eliminating this part of the impending explosion in future entitlement spending.

These benefit cuts alone would mean that high wage workers would not experience rising real benefits as their real wages grow, so I would supplement these changes with another measure to raise overall retirement (and national) saving. Workers would be required to contribute an extra 1.6 percent of their pay to newly-created individual accounts. These accounts would be owned by workers but centrally managed. Workers would be able to allocate their funds among five to ten broad mutual or index funds covering stocks and bonds. Central management of the funds would cut down the risk that funds would be invested unwisely, would cut administrative costs, and would mean that Wall Street firms would not find these individual accounts a financial bonanza. The funds would be converted to real annuities on retirement, to protect against inflation and the chance that retirees would overspend in their early retirement years.

Some observers have objected to mandating new retirement contributions now, when there is a welcome prospect of federal budget surpluses. The NCRP, for example, uses both the surpluses and the Health Insurance Fund to help finance individual accounts. I see some problems with that approach, though it does lessen the political difficulty of mandating additional pension coverage. Another option might be to rely on the already extensive private pension system to fill gaps in the existing

pension coverage of workers. Tax qualification rules might be changed to include a provision that requires the full participation of all corporate employees in order to qualify for favorable tax treatment.

The Social Security and pension changes together would mean that approximately the presently scheduled level of benefits would be paid to all wage classes of workers, of all ages. The difference between the outcome and present law is that under this plan these benefits would be affordable, as they are not under present law. The changes would eliminate Social Security's long run financial deficit while still holding together the important retirement safety net provided by Social Security. They would reduce the growth of entitlement spending. They would significantly raise the return on invested contributions for younger workers. And, the changes would move beyond the present pay-as-you-go financing scheme, by providing new saving to build up the nation's capital stock in advance of the baby boom retirement crunch.

As the Congress debates Social Security reform, I hope it will keep these goals in mind and consider these types of changes in this very important program. Thank you very much.

Chairman BUNNING. Thank you.
Dr. Munnell.

STATEMENT OF ALICIA H. MUNNELL, PH.D., PETER F. DRUCKER PROFESSOR OF MANAGEMENT SCIENCES, BOSTON COLLEGE CARROLL SCHOOL OF MANAGEMENT

Ms. MUNNELL. Thank you. I too am delighted to be here to discuss the future of Social Security. I am not here to offer another plan but mainly to make some comments as an economist, and I actually think my comments fit nicely into what Ned Gramlich said.

I do think that the issues have sorted themselves out in the last year. Basically it comes down at this point to whether we are talking about cutting way back on Social Security to introduce individual accounts and whether we are talking about introducing individual accounts as an add-on to the current Social Security Program.

Let me make my three points. My first point is that the debate, at least among Members of this hearing, is not about prefunding or broadening the investment options for Social Security. There is considerable agreement that using the Social Security Program to increase national saving is a good idea.

There is also considerable agreement that broadening the investment portfolio to include equities is a good idea.

Rather, the debate is about not prefunding or investing in equities, but given that we want to do some prefunding and given that we want to invest in equities, should we provide people's basic retirement income through a defined benefit plan or through defined contribution individual accounts.

The second point is that the economics clearly suggest that Social Security's defined benefit plan is better than individual accounts for the basic retirement benefit. And this is true for several reasons. First of all, because Social Security has a defined benefit plan, it can share risks among all people in the population and it can share risks over time.

Second, because it pulls all investments together, it can keep transaction costs very low.

Third, because it keeps all of the money together, it avoids the possibility that people are going to ask for their money before they retire and end up with inadequate retirement income.

Fourth, it is very good at turning accumulated funds into an annuity and an inflation-indexed annuity.

And fifth, Social Security is better than the other options on the table for protecting the dependent spouse after the worker dies.

It is totally feasible to build up assets within the Social Security fund, particularly if we really take Social Security out of the budget, not the way that we have it now. And it is totally feasible to invest some of those reserves in equities. It would not destabilize capital markets and we have several institutional frameworks that will ensure that the government does not interfere in private sector activity. The Fed is one model. The Federal Thrift Savings Plan is another model.

So everyone wants prefunding, at least at this table, and everybody wants equity investment. The argument is not over those issues; rather, over whether today's modest Social Security benefits, and they are modest, should be provided through a defined benefit program or a defined contribution program.

The second point is that a funded Social Security Program with equity investment is a realistic option and by far the better way to provide the basic retirement benefit.

And my third and final point is that the argument against individual accounts applies only to the basic benefit. Once we have restored balance to Social Security to preserve most of today's promises, supplemental individual accounts are a good idea. They would encourage additional saving. They would offer individuals some choice in their investments, and they would keep administrative costs low.

So, in short, accumulating reserves is a good idea. Investing in equities is a good idea. Individual accounts are a good idea, but not if they involve major reductions to today's Social Security promises. We should be talking about adding on savings options, not about major cutbacks of existing Social Security benefits.

Thank you very much.

[The prepared statement follows:]

Statement of Alicia H. Munnell, Ph.D., Peter F. Drucker Professor of Management Sciences, Boston College Carroll School of Management

Mr. Chairman and Members of the Committee, I am delighted to have the opportunity to appear before you today to discuss the topic of individual accounts for Social Security. I would like to make three points:

- First, the debate at this hearing is not about prefunding or broadening investment options for Social Security participants. There is considerable agreement that using the Social Security system to increase national saving is a good idea. There is considerable agreement that broadening the investment portfolio to include equities is a good idea. Thus, the debate, at least among this group, is not over prefunding or investing in equities. Rather, the debate is—given prefunding and given the desire to invest in equities—whether providing basic retirement income is better done through the central Social Security trust funds or individual accounts.
- Second, the economics clearly suggest that Social Security's defined benefit plan, particularly with some prefunding and investment in equities, is better than individual accounts for providing the basic retirement pension.

—Because Social Security is a defined benefit plan, it can spread risks across the population and over generations. This means that people's basic benefits do not depend on what stocks they pick and when they buy and sell. Pooling investments in the Social Security trust funds also keeps reporting and transaction costs low, en-

suring higher net returns than individual accounts. Social Security also avoids the pressure for individuals to gain early access to their accounts, leaving retirees with inadequate retirement income. Social Security assures that accumulated funds are transformed into inflation-indexed annuities so that retirees do not outlive their retirement resources. Finally, Social Security protects dependent spouses after the worker dies.

—Building up a fund in the Social Security program and broadening the investment options to include equities is perfectly feasible. Social Security equity holdings would account for only about 5 percent of the total by 2020. Setting up an independent investment board, investing in a broad index, and delegating voting rights to fund managers should prevent interference in private sector activity.

• Third, the argument against individual accounts applies only to the basic retirement income. Once we have restored balance to Social Security to preserve most of today's promises, supplemental individual accounts would be a good idea. They would encourage additional saving, offer individuals some choice in their investments, and keep administrative costs to a minimum.

In short, accumulating reserves is a good idea, investing in equities is a good idea, even individual accounts are a good idea, but not if they involve major reductions in the protections offered through today's Social Security program. We should be talking about adding-on savings options not cutting back on existing benefits. Let me amplify on these points.

I. The Nature of the Debate

Social Security is on the national agenda because the system faces a projected long-term deficit. But things are different than they were in 1983 when Congress last acted to restore financial balance; this time the system is not facing a short-term financing crisis. In fact, government actuaries calculate that the system has an adequate flow of revenues until 2032 and can cover three quarters of promised benefits for decades thereafter. The emergence of a long-term deficit in the absence of a short-term crisis means that policymakers can consider comprehensive reform as well as incremental fixes to the system.

In considering both incremental and comprehensive reform, two relatively new considerations are playing an important role. One is the maturation of the Social Security program. Unlike earlier generations who received large benefits relative to the taxes they paid, today's workers face a sharp decline in returns that they can expect to receive on their payroll tax contributions (the so-called money's worth issue). Since raising taxes or reducing benefits will only worsen returns, almost all reform plans involve equity investment in one form or another to provide additional revenue. The second factor influencing the Social Security reform debate is concern about our low levels of national saving. This concern along with the desire to avoid high pay-as-you go tax rates in the future has spawned considerable interest in some prefunding.

The proposals presented by people at this table respond to these concerns. Both proposals to maintain Social Security's existing defined benefit plan and proposals to institute individual accounts involve a substantial accumulation of assets. Similarly, most observers agree that those covered by Social Security should have access to the higher risks and higher returns associated with equity investment. In other words, the questions of prefunding and of broadening the portfolio are not at issue.

When making proposals people often jumble together what economists view as three very distinct issues. The first pertains to funding: "How much reserves should we accumulate in retirement funds?" The second pertains to investments: "To what extent should we invest those accumulated reserves in equities?" The third issue relates to the provision of benefits: "Should benefits be provided under a defined-benefit or defined-contribution arrangement?" These three questions are separable from an economic perspective. That is, it is possible to have a large trust fund with a diversified portfolio in a defined-benefit system or a defined-contribution system with no more than our current funding. Because it is possible to have equivalent amounts of funding in the Social Security program and in a system of individual accounts and because equity investment is possible in either scenario, the question comes down to whether defined benefit or defined contribution arrangements are better for people's basic retirement income.

II. Individual Accounts Put Retirement Income at Risk and Are Costly

The problem with defined contribution arrangements such as the IRA-type proposals is that they put much of people's retirement income at risk. Individuals' basic benefits would depend on their investment decisions. What stocks did they buy? When did they buy them? When did they sell? Uncertain outcomes may be perfectly

appropriate for supplementary retirement benefits, but not for the basic guarantee. Herb Stein, Chairman of the Council of Economic Advisers under President Nixon, summarized the argument best.

"If there is no social interest in the income people have at retirement, there is no justification for the Social Security tax. If there is such an interest, there is a need for policies that will assure that the intended amount of income is always forthcoming. It is not sufficient to say that some people who are very smart or very lucky in the management of their funds will have high incomes and those who are not will have low incomes and that everything averages out."

Retirement income that depends on one's skills as an investor is not consistent with the goals of a mandatory Social Security program. Remember that Social Security is the major source of income for two-thirds of the 65-and-over population and virtually the only source for the poorest 30 percent. The dollar amounts are not very large: the benefit for a low-wage worker who retired at age 62 in 1997 was only $450 per month or $5400 per year and for a worker with a history of average wages was $742 per month or $8904 per year. Does it really make sense to put these dollar amounts at risk?

In addition to making the basic retirement benefit dependent on one's investment skills, the IRA-type accounts would be extremely costly. The 1994–96 Social Security Advisory Council estimates that the administrative costs for an IRA-type individual account would amount to 100 basis points per year. A 100-basis point annual charge sounds benign, but estimates by Peter Diamond of MIT show that it would reduce total accumulations by roughly 20 percent over a 40-year work life. That means benefits would be 20 percent lower than they would have been in the absence of the transaction costs. Moreover, while the 100-basis-point estimate includes the cost of marketing, tracking, and maintaining the account, it does not include brokerage fees. If the individual does not select an index fund, then transaction costs may be twice as high. Indeed, costs actually experienced in the United Kingdom, which has a system of individual accounts, have been considerably higher than the Advisory Council estimate. Finally, because these transaction costs involve a large flat charge per account, they will be considerably more burdensome for low-income participants than for those with higher incomes.

Individual accounts also create a very real political risk that account holders would pressure Congress for access to these accounts, albeit for worthy purposes such as medical expenses, education, or home purchase. Although most plans prohibit such withdrawals, our experience with existing IRAs and 401(k)s suggests that holding the line might be quite difficult. To the extent that Congress acquiesces and allows early access, retirees will end up with inadequate retirement income.

Another concern pertains to the question of transforming accumulated reserves into annuities. Without such a transformation, individuals stand a good chance of outliving their savings. But few people purchase private annuities and costs are high in the private annuity market. The reason for the high costs is adverse selection: people who think that they will live for a long time purchase annuities, whereas those with, say, a serious illness keep their cash, making the provision of annuities very expensive. Moreover, the private annuity market would have a hard time providing inflation adjusted benefits. In contrast, by keeping participants together and forcing them to convert their funds into annuities, Social Security avoids the problem of adverse selection and is in a good position to provide inflation-adjusted benefits.

Finally, when evaluating a shift from Social Security's defined benefit system to individual accounts, it is important to consider not only the effect on the worker, but also on the worker's family. A defined benefit system with auxiliary benefits is very different from a defined contribution system where the annuity protection for the family is paid for by the worker and may involve choice. The evidence suggests that left on their own, workers do not always make very good choices for themselves, much less for their dependents. The small size of the current U.S. annuity market suggests that retirees do not chose to annuitize their accumulations. Evidence from the U.K. suggests that people do not purchase inflation protection even when they have the opportunity. Finally, pre-ERISA data indicate that many workers select single-life annuities with no protection for surviving spouses. Thus, without explicit provisions to protect dependent spouses, elderly widows, who already suffer very high rates of poverty, could be made worse off under a system of individual accounts.

Because the IRA-type approach is so risky and costly for the basic retirement benefit, some suggest the 401(k) or federal Thrift Savings Plan (TSP) approach. Instead of individuals holding their funds and investing them in anything they like, the government would hold the money and designate a series of investment options. In my view, this approach—when it comes at the expense of existing Social Security bene-

fits—has little to recommend it and undermines protections in the current program. First, the TSP approach introduces much of the same unpredictability into retirement income as the IRA-type alternative. Second, while its costs would be lower, it would still double the costs of the current Social Security program. Finally, for those concerned about government involvement, this approach has the government picking the appropriate equity funds and retaining control of the money. This is not a particular problem in my view, but the TSP approach does raise all the same corporate governance issues as investment by the central trust funds.

What then is the best approach?

III. Fund Social Security and Broaden the Portfolio

Accumulating reserves in the Social Security trust funds and investing part of those reserves in equities offers many of the advantages of individual accounts without the risks and costs. It has the potential to increase national saving and offers participants the higher risk/higher returns associated with equity investment. But, unlike individual accounts, a partially funded Social Security program with equity investments ensures predictable retirement incomes by maintaining a defined benefit structure that enables the system to spread risks across the population and over generations. In addition, pooling investments keeps transaction and reporting costs to a minimum, producing higher net returns on equity investments than individual accounts.

Because a partially funded Social Security program with a broad portfolio is the realistic alternative to individual accounts, it is important to emphasize that equity investment for Social Security is a feasible option. The magnitudes will not disrupt financial markets and the investments can be structured to prevent any government interference in private sector activity.

The Social Security Administration actuaries present estimates of the build-up of equity holdings under each of the three 1994–96 Social Security Advisory Council plans. To determine the impact on capital markets requires estimating the growth rate of total equity holdings. If the real value of total equities grew at the rate it grew over the period 1952–95 (5 percent), and if 40 percent of Social Security trust fund assets were invested in equities as recommended under the Maintenance of Benefits plan, then Social Security trust fund holdings would equal roughly 5 percent of the total market in 2020 (Hammond and Warshawsky 1997). (The Individual Account (IA) proposal would produce equity holding of 3 percent and the Personal Security Account (PSA) plan holdings of 11.1 percent.) In other words, the total equity market is likely to grow fast enough to absorb quite easily the build up of equity reserves in the trust funds.

Even if such an accumulation would not disrupt the markets, could it have a substantial effect on relative rates of return, perhaps driving up government borrowing costs? The portfolio restructuring should have some effect. The equity premium should decline to reflect the increased efficiency of risk bearing in the economy. Some movement would also be expected in interest rates. The one study that has estimated the effect on relative returns concluded that the shift to equities in the trust funds would lower the equity premium by 10 basis points and, and raise the interest on Treasury securities by roughly the same amount (Bohn 1998). With current levels of federal debt, this increase in Treasury rates should have a relatively small effect on the unified budget. As the economy grows and the debt declines, the effect should be negligible.

While Social Security investment in equities is unlikely to disrupt financial markets or cause major shifts in rates of return, many people are concerned that Social Security investment in equities could lead to government interference with the allocation of capital in the economy and with corporate activity.

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

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

My view is that such pressures are easy to guard against at the federal level. Much of state-local plan activity is conducted in relative secrecy, while Social Security investments would be subjected to much public scrutiny. Moreover, Social Security could build on TSP's successful example; it could set up an independent investment board of financial experts with fiduciary responsibility, invest in a broad index, delegate voting rights to fund managers, and finance its own administrative costs so it does not have to rely on Congress to appropriate funds each year. These protections should ensure efficient investments.

In short, a partially funded defined benefit plan with equity investment is feasible and can do everything that privatized accounts can do and do it at lower costs, yielding higher net returns. A recent GAO report did not identify any insurmountable hurdles with direct trust fund investment in equities. Canada should provide some confirmation about the feasibility of equity investment since is in the process of setting up a board that will oversee the investment of its Social Security trust funds in equities.

IV. Supplementary Individual Accounts

Prefunding Social Security and investing in equities not only improves the distribution of risk in the economy, it also dramatically reduces the size of the financing gap within the Social Security program. In addition, most observers agree on some further steps that are both inherently fair and would further cut the long-run deficit. These include: extending coverage to new full-time state and local government employees (about 3.7 million workers) not now covered by Social Security, making Social Security benefits taxable to the extent they exceed worker contributions (comparable to other contributory defined benefit plans), lengthening the averaging period for the Social Security benefit calculation, and improving the accuracy of the Cost-of-Living Adjustments as the BLS refines the Consumer Price Index. Many would also argue for a slight increase in the Social Security maximum earnings base to bring the proportion of earnings subject to tax more in line with the 90 percent figure established in 1983. In short, it is not difficult to close the 75-year financing gap in the Social Security program; this can be done with only a modest impact on benefits.

Once balance is restored to the existing program, it is possible to consider changes that would improve the likelihood that future retirees will have adequate incomes. One option is to introduce voluntary supplemental individual accounts within Social Security for those who would like to set aside more money. Thus, the debate is not about whether individual accounts are good or bad in general. Once people are assured basic retirement protection, individual accounts may be a perfectly reasonable addition. What opponents of individual accounts object to in the context of Social Security reform is cutting back on existing Social Security benefits and replacing those benefits with a risky and costly alternative. Introducing individual accounts as an add-on to Social Security is a good idea; substituting individual accounts for existing Social Security benefits needlessly undermines protection for retirees, the disabled, and their dependents.

V. Conclusion

Most plans being discussed today involve both prefunding and equity investment. In economic terms, the goals of prefunding and broadening the portfolio can be achieved either within the context of Social Security's defined benefit program or in individual accounts. With the possibility of funding and diversifying investments under either scenario, the question becomes which is the best benefit structure for people's basic retirement income. Here the economics are clear. A defined benefit plan allows for better risk spreading, better protection for retirees and dependents, and lower costs than individual accounts.

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Chairman BUNNING. Thank you very much.
Hon. Robert Ball.

STATEMENT OF HON. ROBERT M. BALL, FOUNDING CHAIR, NATIONAL ACADEMY OF SOCIAL INSURANCE; AND MEMBER, 1994–96 ADVISORY COUNCIL ON SOCIAL SECURITY; AND FORMER COMMISSIONER, SOCIAL SECURITY ADMINISTRATION

Mr. BALL. Mr. Chairman, to help you keep the players straight, I agree with everything Alicia Munnell just said and I can take off from that.

I am really glad to be here today because I have a new plan——

Chairman BUNNING. Would you pull that mike up so that everybody else can hear what your plan is? Thank you.

Mr. BALL. I was particularly glad to be here today because I have a new plan, and this is the first chance that I have had to describe it in public.

The plan has two parts. The first solves the long-term financing problem in Social Security.

The second establishes a supplementary savings plan on top of Social Security.

The last part is different from other supplementary savings plans because it takes advantage of a provision in present law that Senator Moynihan was successful in adding back a few years ago so that everybody over 25 will be getting automatically an annual statement estimating what their Social Security benefits are going to be, both their own and their dependents. And they will get that each year.

My proposal on the savings side is to have a mechanism as part of Social Security for the worker to tell his or her employer to deduct up to 2 percent more from earnings to be reported through the regular Social Security reports. This would entail no significant additional administrative problems, and every year we would be reminding workers: Here is what you are going to get under your individual Social Security account, and here is how you are doing on your supplementary savings. Thus, people who can and want to can add additional savings to Social Security by a simple checkoff system through their employer.

The part of the plan that deals with solving the present Social Security long-term deficit—let me describe that: Obviously you have to have more income to the system or pay less out. On the "more income" side, what I would propose is that we build up the fund, maintain a fund more like private pensions do and increase the return on those funds by investing part of it in private equities.

Those steps make a tremendous difference. Out of the 2.19-percent deficit, over half of it would be eliminated by the buildup in the fund and by investing part of it in equities.

Next on "controlling the amount going out" I would take advantage of the changes that have been made and will be made by the Bureau of Labor Statistics in the CPI that determines the cost of living adjustment.

And then last, we could reach our long-term goal of universal coverage by covering all new hires in State and local employment. Just those three things alone get the Social Security deficit down from 2.19 percent of payroll to 0.38 percent. That is way below what has been traditionally thought of as "close actuarial balance" under Social Security.

The Trustees recognized way back that you can't keep the Social Security system at zero balance all the time. There is too much involved in a 75-year estimate, so they introduced some leeway. Well, how much leeway is sensible?

They said as long as the income to the system is 95 percent of the estimated cost of the system, that is "close actuarial balance," and no new legislation is needed. You can get there without any tax increases, without any benefit cuts, and without any modifications in the basic principles of the system.

If you want to go to full balance right off instead of being content with close actuarial balance, you probably need at least minor tax increases. I have proposed increasing the maximum earnings base somewhat, the $68,000 plus that governs how much you get in the way of benefit credits and how much you pay in, and on the benefits side I have proposed a modest 3-percent cut in benefits. These steps would bring the system into full actuarial balance now.

On the other hand, it is not just a step forward to bring the system into close actuarial balance, it is a huge leap that goes most of the way. That might be enough for the immediate future, and we could restore the old advisory council system and get recommendations for bringing the system into full balance somewhat later.

Put these two things together, Mr. Chairman: A supplementary plan built on a sound Social Security system which maintains present benefits the defined benefit way and allows people through the Social Security system itself to add to savings and I believe we have a solution to our problem.

[The prepared statement and attachment follow. Additional material is being retained in the Committee files.]

Statement of Hon. Robert M. Ball, Founding Chair, National Academy of Social Insurance; and Member, 1994–96 Advisory Council on Social Security; and Former Commissioner, Social Security Administration

Mr. Chairman and Members of the Committee:

My name is Robert Ball. I was Commissioner of Social Security from 1962 to 1973. Prior to my appointment by President Kennedy, I was the top civil servant at Social Security for about 10 years, and have had a total of some 30 years of service at the Social Security Administration. Since leaving the government, I have continued to write and speak about Social Security, Medicare, health insurance more generally, and related programs.

I was Staff Director of an Advisory Council on Social Security to the Senate Finance Committee in 1948, a council which recommended the major changes that became the Social Security Amendments of 1950. I have also been a member of the statutory Advisory Councils on Social Security in 1965, 1979, 1991, and 1994–1996.

I was also a member of the small negotiating group from the National Commission on Social Security Reform in 1982–1983, the Greenspan Commission, which reached an agreement with the White House on a series of recommendations that became the basis for the important 1983 Amendments. I am the founding chair of the board of the National Academy of Social Insurance and was a senior scholar at the Institute of Medicine, the National Academy of Sciences from 1973 to 1981.

I am pleased that you have asked me to present my proposal for both bringing the present Social Security system into long-range balance and for establishing a new kind of supplementary saving plan operating through Social Security administrative arrangements. Thank you very much.

RESTORING SOCIAL SECURITY TO LONG-TERM BALANCE

There is a long-range deficit in Social Security that is, estimates of income over the next 75 years under present law fall short of estimates of the cost by an average of 2.19 percent of payroll. This deficit can be eliminated only by more income for the system or less payout or a combination of the two. On the income side, I propose principally to make the scheduled tax payments more effective by building up the Trust Funds more than would happen under present law, maintaining a substantial fund into the future, and getting a better rate of return on the investments. Although most retirement systems state and local, many Federal systems and private pensions invest their reserves partly in equities present law prohibits Social Security from investing in anything but low-yielding Federal obligations. This is not fair to Social Security participants and should be changed.

On the side of reducing the Social Security payouts, I give particular emphasis to basing future Social Security cost of living increases on the more accurate Consumer Price Index being developed by the Bureau of Labor Statistics (BLS).

I would also emphasize at last attaining the long sought-after goal of universal coverage by extending the protection of the program to all new hires in state and local employment, a move which improves Social Security financing because with new coverage the system collects contributions from younger workers for many years before they become eligible for retirement benefits.

These three changes in Social Security policy alone reduce the presently estimated long-range deficit from 2.19 percent of payroll to 0.38 percent of payroll 1.22 percent from the change in investment policy, 0.45 percent from the corrections in the CPI, and 0.21 percent from bringing under the same Social Security arrangements as for all the rest of the country those new hires in state and local employment who would not be covered under present law (most state and local employees, about 75 percent, are already under the Social Security system).[1]

These three changes do not involve increases in taxes or benefit cuts, (except to the extent the CPI changes prevent unwarranted increases in future cost of living adjustments). The result is to bring the deficit well within what is called "close actuarial balance," a concept used by the Trustees over the years to define a proper leeway from full actuarial balance before they have felt the need to recommend legislative change.

Clearly a 75-year estimate should not be required to continually show a zero balance; there are too many uncertainties. But what is a reasonable deviation from full balance? Many decades ago the Trustees fixed on a definition of a reasonable leeway that is still used: keeping estimated income up to at least 95 percent of estimated cost over the next 75 years. Today this definition of "close actuarial balance" means that a deficit anywhere below 0.78 percent of payroll would meet the test. The three steps described above bring us to 0.38 percent of payroll, about 50 percent below the maximum level of "close actuarial balance."

The three steps would bring the system fully into actuarial balance over the next 50-year period, extending the predicted date of Trust Fund exhaustion from 2032 to 2054. (It is to be recognized, of course, that Trust Fund exhaustion—a technical concept that would most certainly not be allowed to occur—is not the same for Social Security as running out of money. Dedicated income from taxes on employees, employers and beneficiaries continues after any theoretical Trust Fund exhaustion and present law, without any change would support the payment of at least three-fourths of benefits for decades.)

Bringing the system into the middle range of the leeway allowed by the concept of "close actuarial balance" would be not just a major first step toward full actuarial financing of Social Security but a leap forward that would take us most of the way

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[1] There are some interactions among these three proposals that make the change in the long-range balance slightly different from the result of adding up the individual items and subtracting them from the estimated deficit.

to the goal. We could stop there for now, perhaps, asking a new Advisory Council to evaluate the situation and make recommendations on whether and how the system might be brought the rest of the way into full balance, or we could move ahead now with a few changes that would reach the goal of actuarial balance for the whole 75 year period.

While close actuarial balance can be reached without increases in the amount of contribution, or reductions in the amount of protection promised under present law, and with the attainment of the goal of complete coverage under the system, to move to full actuarial balance for 75 years would require some increase in tax income or some reduction in benefits or both. If this is the goal we want to set for 1999, I would propose a slight increase in taxes and a slight reduction in promised benefits.

To increase taxes, I would propose a modest change in the maximum contribution and benefit base—the level of annual earnings above which earnings are neither taxed nor credited for the purpose of computing benefits. At one time 90 percent of all wages in covered employment fell below the maximum. Today the base ($68,400 in 1998) is covering a smaller and smaller proportion of earnings because wages are increasing faster for the higher-paid than for those with wages below the maximum covered. Even though under present law, the base is scheduled to increase automatically each year with increases in average wages, the percent of wages covered will continue to fall. By 2006 the base is expected to cover only 84.5 percent of earnings. It would take an additional 4 percent each year between the years 2000 and 2009 in order to bring the proportion of earnings covered back up to 90 percent. But with the base now considerably below that target, increases of the magnitude necessary to entirely close the gap may be ill-advised. Higher-income earners would be required to contribute substantially more but without being able to expect anything like a commensurate increase in benefits. Accordingly, I would propose closing only half of the gap that is, going from 84.5 to 87.3 percent over 10 years by increasing the maximum earnings base 2 percent each year above the automatic increase. The effect in any given year would ordinarily be modest as compared to the automatic increase taking place anyway. This change reduces the projected long-term deficit by about 0.28 percent of payroll.

On the benefit side, we could then bring the system into full actuarial balance if we were to slow down present law benefit increases for future beneficiaries by about 3 percent. This could be done by a change in the benefit formula, or consideration might be given to changing the wage averaging period from present laws 35 years to 38 years.

The wage averaging period, which for decades now has started for almost all workers with 1951, has been gradually increasing as wages have been posted for more and more years. In 1991, wages were being posted for 40 years and, as has always been the case with averaging, retired workers were allowed to drop the five years of lowest earnings, resulting in 1991 in basing benefits on the average of the highest 35 years. This is the maximum number required in the basic law, so the averaging period has remained at 35 years since 1991. Setting the basic limit at 35 years is entirely arbitrary. The objective is to relate the benefit to the workers career earnings, indexed to the present and with some leeway for periods of illness, unemployment, or special family obligations. With crediting of additional years of earnings since 1991, it is now feasible to relate the benefit to a somewhat longer career average while maintaining the five-year forgiveness period. Since most people work more than 35 years, counting more years would cause benefits to reflect average career earnings more accurately than they now do.

But lengthening the average period also lowers benefits for some because earnings for currently excluded years are necessarily lower on average than the 35 highest years now used in computing benefits. Thus, including more years reduces benefits somewhat for those with fewer years under the program and those who have less than full-year earnings. Raising the end point to 38 years would reduce benefits an average of 3 percent and reduce the Social Security deficit by 0.25 percent of payroll.

A good case can be made for this method of trimming benefits, but the proposal does arouse controversy. It reduces benefits somewhat more for workers with intermittent rather than steady wage records. Since women are more likely than men to go in and out of the workforce, the argument is made that this proposal is disadvantageous to more women than men. This is true to a limited extent, but because of Social Securitys weighted benefit formula, which favors those with intermittent wage records, and because of the continuance of the five-year forgiveness period, workers going in and out of the workforce would continue to receive very favorable treatment. The issue is whether to favor the intermittent worker slightly less than under present law.

These two additional changes—the increase in the maximum benefit and contribution base and the slow-down in benefit increases brings the program into full actuarial balance over the 75-year period and produces a slightly favorable balance—0.04 percent of payroll. (See Table 1)

Table 1 Proposed Steps to Restore Social Security to Long-Term Balance Expressed as a Percent of Payroll

(Long-term deficit is assumed to be 2.19% of payroll, per Trustees 1998 estimate)

Proposed Change	Reduces Deficit
Invest part of Social Securitys accumulating funds in stocks	−1.22
Adjust COLA to reflect BLS corrections to CPI	−0.45
Extend coverage to all newly hired state and local government workers	−0.21
(Close actuarial balance: revenues at 95% of costs = 0.78) Deficit remaining after making the above changes:	0.38*
Increase wage-averaging period from 35 to 38 years or in some other way slow down benefit increases by 3 percent	−0.25
Increase maximum earnings base	−0.28
Actuarial balance remaining after making all five changes	+0.04*

*Adjusted for interaction of changes
Source: 1998 Trustees Report and Office of the Actuary, Social Security Administration

Although discussed occasionally in previous years, the direct investment of a portion of Social Security funds in private equities is a new idea to most people. It is important to understand that this is not a step toward privatization. Nothing about the basic Social Security system, its policy and principles and governance would change. The sole change would be in investment policy, securing for Social Security the same opportunities for a reasonable return on what people pay in as is already available to other retirement systems and other forms of savings.

It has not mattered very much in the past how Social Security funds were invested because the system was a pay-as-you-go system in practice and contemplated building only a contingency reserve of a year to a year-and-a-half of benefit payout. The greater rate of return from equities would not have made much of a contribution to long-range financing in any event. But now that the system is turning to partial reserve financing with a significant future build-up in the Trust Funds, how you invest the funds does make a difference.

In evaluating the three Advisory Council proposals and other proposals, the Social Security actuaries assumed a long-range real rate of return for Federal obligations of 2.5 percent and 7 percent for an indexed equity fund representative of the broad market. I would propose that Social Security be allowed to invest up to 50 percent of its funds in equities with a one-years contingency fund kept entirely in Federal bonds. The 50 percent figure would be reached gradually in the years 2000 to 2014 and maintained at approximately that level in the years thereafter.

It is very important that the fund be indexed and that the function of portfolio managers be confined entirely to maintaining a fund paralleling the index. It would not be a good policy to have representatives of the government picking and choosing individual stocks for investment or even appearing to favor certain industries, and members of Congress would need to be protected against pressure from constituents to favor particular companies or industries.

The selection of indexes and portfolio managers would be under the general direction of a Federal Reserve-type board with members appointed for long and staggered terms. Portfolio managers would be selected by bid from organizations qualified by long experience in administering large indexed private funds. Social Security or any other government agency would not be allowed to vote stock or in any other way influence the policies or practices of a company or industry whose stocks are held by the indexed fund. These arrangements in their general form have been tested by the Federal Employees Thrift Plan which has operated under similar arrangements for many years. They have worked well to protect that plan from deviations from the chosen index or from any deviations from the single-minded pursuit of the interests of the participants.

Relying on the stock market for retirement income is risky for individuals in part because they have no control over when they enter the market under the individual investment plans being proposed, workers start to buy when they go to work and they have little control either over when they convert their investments to retirement income. Replacement rates of past earnings by retirement income can be greatly affected by the timing. As Gary Burtless of the Brookings Institute has shown, for example, retirement replacement of earnings if the retirement fund is invested entirely in equities would have varied from 47 percent for a retirement in

1980 to 68 percent in 1981; then back down to 42 percent in 1993; then back up to 72 percent in 1997.[2] Variations anywhere near this magnitude would represent a serious problem for workers, whose expectations of retirement income could be abruptly undercut. Investing by Social Security directly on behalf of the whole system has no such disadvantage, and moreover, Social Security would be able generally to ride out the ups and downs of the market without major risk to long-term stability.

SUPPLEMENTARY INDIVIDUAL SAVINGS ACCOUNTS THROUGH SOCIAL SECURITY

With the basic Social Security system secured as a defined benefit plan underwritten by both law and adequate financing, I favor adding a voluntary savings plan provided through Social Security administrative arrangements. Such a plan would provide a safe, practical and efficient way for wage earners at all levels to enhance their Social Security benefits without imposing any significant administrative burdens on either employers or the government.

Specifically, I would propose that beginning in the year 2000, wage-earners would be allowed to have an additional 2 percent deducted from earnings and forwarded by their employer as part of regular Social Security reporting. Participants could chose each year to invest the 2 percent as Social Securitys portfolio is invested, or split 50–50 between stocks and Treasury bonds, or entirely in equities or entirely in Treasury bonds. Each year, when Social Security reports to all workers over age 25 on the estimated amount of Social Security benefits they may expect (as required by the Moynihan amendment now part of present law and with full implementation beginning next year), Social Security would also report to workers on the amounts accumulating in their supplemental savings plans and provide an opportunity for them to designate investments for the following year.

Depending on the workers preference, accumulated savings could be distributed, upon eligibility for Social Security benefits, as an annuity, a lump sum, or in periodic installments. At death any undistributed amount would be part of the workers estate.

The rules governing the maximum amount to be deducted, the tax status of the deductions, cashing-in procedures, and so on, would all follow present IRA rules. For the first time, workers in small companies and the lower-paid generally would have a real opportunity to build conveniently on top of their assured Social Security benefits and to participate in ownership of equities should they care to do so.

These arrangements could be expected to considerably increase voluntary savings over our present national level, and would do so without any significant additional burden on employers or the government and with the added advantage of increased convenience and safety for employees.

The essential principle of the plan is that Social Security is not in any way reduced to make room for a system of individual savings accounts. The individual accounts are entirely voluntary supplements logical add-ons to a refinanced and fully dependable Social Security system.

Social Security Plus

This plan accomplishes two goals: It restores Social Security to long-term balance; It establishes a simple, effective way for individuals to set up savings accounts supplemental to Social Security.

I. RESTORING SOCIAL SECURITY TO LONG-TERM BALANCE

- Leverage the funds being paid into Social Security by workers, employers, and taxpaying beneficiaries by investing part of Social Security's accumulating funds in equities, in a manner similar to that of most public and private pension plans.

Under this approach, a contingency reserve sufficient to pay benefits for approximately one year would be invested solely in long-term Treasury bonds. Up to 50 percent of total accumulated funds would be invested in a broadly indexed equities fund, phased in between 2000 and 2014. A Federal Reserve-type board with long and staggered terms would have the limited functions of selecting the index fund, selecting the portfolio managers by bid from among experienced managers of private indexed funds, and reporting to the nation on the overall operations of the plan. So-

[2] Robert M. Ball with Thomas N. Bethell, Straight Talk About Social Security, A Century Foundation/Twentieth Century Fund Report, May 1998, page 44.

cial Security would not be allowed to vote any stock or in any other way influence the policies or practices of any company or industry whose stocks are held by the indexed fund.

The increased revenues from investing part of Social Security's accumulated funds in equities would cut Social Security's estimated long-term deficit by more than half, from 2.19 percent of payroll to about 0.97 percent of payroll.

- Modify the Cost-of-Living Adjustment to reflect corrections to the Consumer Price Index announced by or anticipated from the Bureau of Labor Statistics. This change reduces the long-term deficit by up to 0.45 percent of payroll.
- Make the program universal by covering new hires in all state and local government jobs from the beginning of the year 2000. (About three-fourths of state and local jobs are now covered.) This change reduces the long-term deficit by about 0.21 percent of payroll.

These three changes alone reduce the estimated 75-year deficit from 2.19 percent of payroll to 0.38 percent. They would bring the system fully into actuarial balance for a 50-year period, extending the projected date of trust fund exhaustion from 2032 to 2054, and over the entire 75-year period for which Social Security estimates are traditionally made would bring the deficit well within the definition of "close actuarial balance" (i.e., with revenues estimated to be at least 95 percent of estimated costs, or in this case a long-term deficit no greater than 0.78 of payroll).

The concept of close actuarial balance, adopted by the Trustees decades ago, provides some leeway within which to assess trends before calling for corrective action. Given the inherent difficulty of forecasting anything for 75 years, bringing the system into close actuarial balance would seem to be a reasonable goal. However, two additional changes, both modest in impact, would bring the system into actuarial balance for the entire 75-year period:

- Base benefit computations for future retirees on indexed monthly earnings averaged over 38 years instead of 35 years as is done currently, or in some other way slow down present-law benefit increases for future beneficiaries by 3 percent. This change reduces the long-term deficit by about 0.25 percent of payroll.
- Increase the maximum amount of annual earnings subject to Social Security tax and credited for benefits by 2 percent a year for 10 years beyond the increase that would occur automatically under present law, raising the portion of taxable wages from 84.7 percent to 87.5 percent, halfway to the 90-percent standard of the past. This change reduces the long-term deficit by about 0.28 percent of payroll.

The following table shows the effect of the changes described above.

Table 1 Proposed Steps to Restore Social Security to Long-Term Balance Expressed as a Percent of Payroll

(Long-term deficit is assumed to be 2.19% of payroll, per Trustees 1998 estimate)

Proposed Change	Reduces Deficit
Invest part of Social Securitys accumulating funds in stocks	−1.22
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(Close actuarial balance: revenues at 95% of costs = 0.78) Deficit remaining after making the above changes:	0.38*
Increase wage-averaging period from 35 to 38 years or in some other way slow down benefit increases by 3 percent	−0.25
Increase maximum earnings base	−0.28
Actuarial balance remaining after making all five changes	+0.04*

*Adjusted for interaction of changes Source: 1998 Trustees Report and Office of the Actuary, Social Security Administration

II. Establishing Individual Supplemental Savings Accounts Through Social Security

Goal: Provide an easy, safe, practical and efficient way for wage-earners at all levels to add voluntary savings to Social Security, with funds invested in the stock market if they wish, and all without significant administrative costs or burdens on either employers or government.

Beginning in the year 2000, wage-earners would be allowed to have an additional 2 percent deducted from earnings and forwarded by their employer as part of regular Social Security reporting. Participants could choose each year to invest the 2 percent as Social Security's portfolio is invested, split 50–50 between stocks and bond, or entirely in equities or entirely in Treasury bonds. Each year, when Social Security reports to all workers over age 25 on the estimated amount of Social Secu-

rity benefits they may expect (as required by the Moynihan amendment now part of present law), Social Security would also report to the individual on the amounts accumulating in the individual's supplemental savings plan.

Depending on the worker's preference, accumulated savings could be distributed, upon eligibility for Social Security benefits, as an annuity, a lump sum, or in periodic installments. At death any undistributed amount would be part of the worker's estate.

The rules governing the maximum amounts allowed to be deducted, the tax status of the deductions, cashing-in procedures, and so on, would all follow present IRA rules.

Each year when workers are given an estimate of their future Social Security benefits, they would also be reminded of the availability of this convenient and safe way to accumulate supplemental savings to help them improve their economic situation in retirement or when disabled, or to improve their survivors' protection in the event of death. For the first time, workers in small companies and the lower-paid generally would have a real opportunity to build conveniently on top of their assured Social Security benefits and to participate in ownership of equities should they care to do so.

These arrangements could be expected to considerably increase voluntary savings over our present national level, and would do so without any significant additional burden on employers or the government and with the added advantage of increased convenience and safety for employees.

The essential principle of this plan is that Social Security is not in any way reduced to make room for a system of individual savings accounts. The individual accounts are entirely voluntary supplements—logical add-ons to a refinanced and fully dependable Social Security system.

Chairman BUNNING. Thank you, Mr. Ball.

Mr. Goldberg.

STATEMENT OF HON. FRED T. GOLDBERG, JR., EXECUTIVE DIRECTOR, KERREY-DANFORTH COMMISSION ON ENTITLEMENT AND TAX REFORM; MEMBER, CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES; NATIONAL COMMISSION ON RETIREMENT POLICY; FORMER COMMISSIONER, INTERNAL REVENUE SERVICE; AND FORMER ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY

Mr. GOLDBERG. Thank you, Mr. Chairman.

It is a pleasure to be here today, and my understanding of the topic of this hearing is less of a focus on the policy issues behind Social Security reform and more of a focus on the question of how you do private accounts.

I think an issue that was off limits and taboo several years ago is now generating enormous bipartisan support, support from a wide range of commentators and, if you believe the polls, overwhelming public support.

I think private accounts is an essential ingredient of any package of Social Security reforms. I believe those accounts should be universal. I believe they are the only way to enhance retirement income, create wealth for all workers, create a universal savings infrastructure, and to remedy fundamental inequities in the current system, especially inequities as they affect minorities, the rural poor, single parents, and two-income earner families.

But at the end of the day, I think both for policy and for political reasons, the judgment that private accounts are important and should be done is going to be overwhelming.

I think the question of whether they will happen will turn largely on the question of can it be done, how do you implement them,

how do you administer them, and can you leave the American public comfortable that they are going to work right, work right for all workers, and I think these administrative issues are going to ultimately drive the outcome in this debate.

Before getting into that suggestion, I think it is also important to keep in mind two ground rules. I think all of us tend to skip them.

The two ground rules are, first, whatever you do with private accounts, keep faith with current retirees.

And the second ground rule is that Social Security stands for a promise, and that promise is that men and women who spend their lives working in this country simply will not retire into poverty. It is not perfect, but it is close, and I don't think that we can walk away from that defined benefit commitment. Whatever we do, indeed my personal judgment is that commitment should be enhanced as part of this process.

Now, in thinking about designing a system of private accounts, it is useful to break the program down into three tasks. The first task is getting the money into the system and crediting that money to accounts. It comes in—when does any individual and how does any individual get those contributions credited, how do those funds get collected?

The second problem or challenge is to figure out how do you get those funds invested and how do you maintain individual account records, how do you report to individual beneficiaries, and it is the account maintenance phase.

The third phase is that the funds must be distributed only when appropriate and must be distributed in the manner that is appropriate. And I think breaking the tasks down into those three pieces is helpful in thinking through the challenge.

In terms of how to design a system, I think there are three design constraints.

First, it is essential to minimize administrative costs. If you are talking 2 percent of payroll and you are thinking of a kid with a summer job making $2,000, that is a tiny amount of money to be depositing in a private account.

Second, I think it is important to minimize the burden on employers.

Third, the system must be simple to administer. I think this is the most important point. The surest way to destroy private accounts is to spend your time looking for the perfect system that accommodates all options, all choices, and addresses all theoretical concerns.

Now, in addition to these constraints, first, the system needs to be universal.

Second, the participant should not have access other than to fund retirement or disability.

Third, the system should be flexible.

And fourth, the system should leave the American public comfortable that they would not be subject to the unbridled whims of the market.

In looking through these criteria, the approach that makes the most sense is to build on the existing systems. The payroll tax sys-

tem functions well. It is universal, it is understandable by the public and imposes no additional burdens on employers.

So that is the mechanism I believe for the collection of funds and crediting of accounts.

In terms of investing funds and investing options, I think the Thrift Savings Plan is the most useful model in terms of teaching limits. Limit the number of choices, the frequency of changes, and contract out the management of the investment funds to the private sector.

Third, in terms of distribution, I agree that the Social Security system is an existing mechanism that functions well in the payout and distribution of benefits, particularly in the context of annuitized payments.

This is the easy part. The last portion of my testimony lists 17 of what I think are myriad questions which need to be answered in getting into the details of making a private account system work properly.

Deciding it is a good idea, locking in on the policy, agreeing on the basic framework I believe can be done and can be done very quickly. I think resolving the details, making sure the thing works well is going to be the hard part. I am absolutely certain it can be done. Thank you very much.

[The prepared statement follows:]

Statement of Hon. Fred T. Goldberg, Jr., Executive Director, Kerry-Danforth Commission on Entitlement and Tax Reform; Member, Center for Strategic and International Studies; National Commission on Retirement Policy; Former Commissioner, Internal Revenue Service; and Former Assistant Secretary for Tax Policy, U.S. Department of the Treasury

Mr. Chairman and Members of the Committee, it is a pleasure to appear before you today to address matters relating to the design of individual private accounts ("IPAs") as part of your efforts to protect and enhance Social Security for the 21st Century. My understanding is that I have been asked to testify on this topic based on my experience as Executive Director of the Kerrey-Danforth Commission on Entitlement and Tax Reform (1993–1995), and as a member of the Center for Strategic and International Studies National Commission on Retirement Policy (1997–1998). The Congressional Co-Chairs of the CSIS Commission were your colleagues Congressmen Kolbe and Stenholm, and Senators Breaux and Gregg.[1]

Senators Kerrey and Danforth, along with several of their colleagues, endorsed IPAs in the Kerry-Danforth Commission's final report (1995), and legislation to create IPAs was subsequently introduced by Senators Kerrey and Simpson. The final Report of the CSIS Commission (May 1998) also recommends creation of IPAs. In addition, all members of the Advisory Council on Social Security supported some form of investment in private markets, and two-thirds of the Council supported some form of IPAs. More than a half dozen legislative proposals calling for the creation of IPAs have been introduced recently by your colleagues, and opinion surveys suggest that an overwhelming majority of Americans support IPAs.

I. Background

In my experience, those who feel strongly about IPAs—whether pro or con—jump in to the subject far too quickly. There are two other aspects of Social Security reform that should be emphasized and re-emphasized, over and over again: First, any changes must keep faith with current retirees. Second, any changes must maintain and enhance the so-called "safety net" features of the system. This includes not just

[1] These experiences have informed my views regarding IPAs, as did April's Social Security forum in Kansas City, co-sponsored by AARP and the Concord Coalition, where I had the honor of serving as one of the panelists. Perhaps my most relevant experience for purposes of today's hearing, however, is the time I spent as IRS Commissioner and as a Member of the Kerrey-Portman National Commission on Restructuring the IRS.

the disability and survivor benefits of current law, but the basic defined benefit features as well. The point is really simple: Social Security stands for the proposition that men and women who spend their lives working in this country will not retire in poverty.

These principles reflect sound policy and political imperatives. They also have a direct impact on the design and implementation of IPAs. For the foreseeable future, amounts going to an individual worker's IPA will be relatively small in both percentage and absolute dollar terms. For example, both Kerrey-Danforth and the CSIS Commission recommended 2% of payroll up to the FICA cap. For a full-time worker making the minimum wage (approximately $12,000), this translates to $240 per year, or $20 per month. For the millions of part time workers, students with summer jobs, and the like, the dollar amounts would be far smaller (*e.g.*, $3,000 in wages translates to $60 per year, or $5 per month). For a high wage worker (at the wage cap of about $68,000), this translates to $1,260 per year, or $105 per month. In addition, some have suggested a fixed dollar floor amount for all IPAs, and there seems to be widespread support for permitting voluntary add-on contributions to IPAs.

While today's hearing is not focused on policy issues relating to IPAs, it is worth summarizing the arguments that are generating such widespread interest and support:

- They will generate additional returns to help maintain adequate retirement income.
- IPAs will be of particular benefit to those with short life expectancies (*e.g.*, African Americans living in the inner cities; the rural poor; Native Americans). They will also benefit single individuals, single parents, and two income earner families.
- They will help create wealth for all Americans, with benefits that transcend those related directly to Social Security.
- They will put in place a universal infrastructure that can be used to facilitate and encourage savings by all Americans.
- Unlike legislated benefits that can be legislated away, IPAs will "wall off" contributed funds, and create property rights protected by the Constitution.

Finally, by way of full disclosure, I should acknowledge my bias: I think that IPAs are an essential part of any effort to preserve and protect Social Security. I also believe that—if structured properly—IPAs will someday be viewed as one of the most important and far-reaching domestic policy initiatives in many decades.[2]

Hopefully, these views make me more—not less—objective regarding the challenges you will face in legislating IPAs. While many aren't there yet, I am convinced that the case for IPAs is overwhelming—regardless of political party and ideology, from the most liberal democrat to the most conservative republican. At the end of the day, the key question will be whether they can be implemented and administered, and whether the American people will trust their elected officials to get it right. I think it will be difficult, but I am certain that it is doable.

II. Design Framework

From an administrative standpoint, a system of IPAs must accomplish each of the following: (1) It must get funds into the system and properly credit each individual participant's account. (2) It must invest funds on behalf of participants, and properly maintain each participant's IPA (*e.g.*, provide account statements, answer account inquiries, etc.). (3) It must make distributions to each participant (and his or her beneficiaries) at appropriate times as required or permitted by statute, and preclude distributions when not otherwise allowed.

Each of these three functions should be considered in light of three major design constraints: (1) The system should minimize administrative costs and distribute those costs in a manner that is perceived as fair and reasonable. This rules out, for example, allocating fixed dollar costs to each account (a $25 flat fee charged to a $400 account would consume an unacceptably large share of earnings). It may also suggest that at least some administrative costs should be funded from general revenues. (2) The system should minimize the burden on employers. (3) The system must be simple to administer, simple to explain, and easily understood by normal, everyday Americans. This last point is the most important. Our income tax system has been destroyed by complexity—a complexity caused in largely by well-meaning efforts to achieve theoretical purity, eliminate every real and imagined "abuse," and address non-tax policy objectives. I guarantee you that the surest way to destroy any hope for IPAs is to spend your time designing the "perfect" system.

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[2] In this regard, I commend you to Senator Moynihan's truly remarkable speech at Harvard earlier this year.

In addition to these three constraints, the IPA system should satisfy a number of other criteria. First, it should be universal, rather than optional. This is the only way to realize the intended benefits of IPAs. Second, like Social Security itself, participants and their beneficiaries must not be able to access IPA funds prior to disability or retirement (or death of the participant, in situations where funds are available for the participant's beneficiaries). Third, the design should provide flexibility to permit the following: (a) regulation of investment alternatives; (b) required annuitization of IPA balances on retirement; and (c) apportionment of any claims on IPA funds between the participant and his/her current/former spouse(s) . Fourth, the design should leave the American public comfortable that—while workers will own and control their IPAs—they will not be subject to the unbridled whims of the markets (and Wall Street) without any safeguards or protection.

III. Some Alternatives

Three reference points are useful in thinking about design alternatives: (1) An employer-based system (*e.g.*, 401(k) Plans), under which all employers would be required to set up and maintain IPAs for all of their employees. (2) A worker-based system (*e.g.*, IRAs), under which each individual worker would be responsible for setting up and maintaining his or her own IPA. (3) A system that builds on the existing payroll tax and Social Security systems.

There are, of course, arguments in favor of both employer- and worker-based systems. Nonetheless, there seems to be a widely-shared view that these approaches would violate one or more of the three major design constraints and would be less likely to accommodate the other criteria noted above. For example, an employer-based system would impose substantial additional burden on employers. In a worker-based system, it would be difficult to minimize administrative costs and distribute those costs in a fair and reasonable way. It would also be difficult to assure universal participation in a worker-based system.

The preferred way to implement IPAs is build on, and learn from, existing systems—while recognizing that a primary objective should be to design a system that can be modified and enhanced, once it is up and working smoothly. In terms of the three IPA functions noted above:

(1) Collecting Funds and Crediting Accounts.—The current payroll tax system already covers all participants and collects the information and funds necessary to credit and fund individual worker accounts.[3] While it certainly can and should be improved, the payroll tax system generally functions quite well. Using this structure should impose no incremental burden on employers and minimize the administrative costs of collecting funds and crediting accounts. Because all workers already participate in the system, it should impose no additional burden on participants and should be relatively easy to understand.

(2) Investing Funds and Maintaining Accounts.—The retirement plan for more than 3 million Federal employees (the Thrift Savings Plan, or TSP) provides a useful frame of reference for designing how to invest funds and maintain accounts. When originally introduced, the key features of that system were: (a) participants were given a limited number of investment choices; (b) they had limited opportunities to change their investment choices; and (c) the government contracted out for the investment of funds and the maintaining of individual participant accounts. The Federal government would distribute information to participants regarding their investment options, participants would select from among those options (*e.g.*, in connection with filing their tax returns), and there would be a default option for participants not specifying an investment choice.

While the orders of magnitude are many times greater (3 million versus more than one hundred million), the same principles should apply. By limiting investment options and frequency of changes, the IPA administrative costs can be held to a minimum, and those costs can be allocated in a "fair and reasonable" way (*e.g.*, as a percentage of the account balance, or funded from general revenues). Likewise (for better and for worse), there would be no "marketing" costs of the type that concern some critics of private accounts. By contracting out for the investment of funds and maintenance of accounts (albeit on a much larger scale), the government can minimize costs and minimize the risk of government meddling in the capital markets. Finally, this approach should meet the criteria of simplicity and reasonable security from the standpoint of individual participants. While workers are given meaningful

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[3] This is clearly the case if IPAs are funded through a "carve-out" from the existing payroll tax. Alternatively, the IPA system could be funded through an "add on" to the current payroll tax. If IPAs were funded from general revenues, the payroll tax reporting system would provide the information necessary to credit individual accounts.

control and investment alternatives, those choices are limited to prevent confusion and to define a reasonable range of risk-taking alternatives.

(3) Distribution of Benefits.—Social Security provides an existing—and effective—mechanism for the distribution of benefits, and there appears to be some agreement that distributions from IPAs should piggy back on this system. Once again, this should impose no incremental burden on employers, minimize administrative costs, and allow participants and beneficiaries to deal with a system that is familiar and perceived as reliable.

This approach addresses the three design constraints and other criteria noted above. Moreover, it has the added virtue of flexibility. For example, participants could be given broader investment choices and distribution options over time (including roll-overs to regulated private funds and the purchase of annuities tailored to meet their particular needs and objectives); the system could accommodate voluntary contributions, administered through either the withholding or income tax systems. Having said as much, however, I encourage you to take it slowly. Don't try to do too much, too soon. Once again, the keys are simplicity and a system that reassures the American public.

IV. The Devils in the Details

While the foregoing is widely viewed as the most practical and viable framework for implementing IPAs, it leaves many, many critical details unanswered. This leads me to the one suggestion I have for you and your colleagues. I urge you to encourage those interested in IPAs to begin with this framework, and set about the difficult task of identifying the myriad practical questions and the viable options that must be resolved before IPAs can become a reality.[4]

By way of illustrating this point, following are a few of the many issues that should be addressed.

1. When and how to credit IPAs (should data be taken from tax returns or W–2s; whether/how earnings should be attributed for the period between the end of the year and the time accounts are credited, which could take up to a year or more)
2. What are the consequences when funds are not withheld or deposited by an employer; by a self-employed individual
3. What are the investment options
4. How are participants advised of their investment options, and how do they make their choices
5. What is (are) the default option(s)
6. How, and how frequently, should participants be permitted to change their investment choices
7. How to structure contracting out the investment of funds and maintenance of accounts
8. Should some (or all) investment options guarantee a minimum return
9. Can/should the investment options limit risk of volatility as participants approach retirement age
10. Whether, how and when the system should accommodate voluntary additional contributions
11. Whether, how and when the system should permit participants to roll-over their IPAs to privately managed investment funds
12. What rights do spouses, and former spouses, have in a worker's IPA
13. Should participants be required to annuitize some or all of their IPA at retirement; if less than all, how much
14. Whether, when and how participants may chose from more than one type of annuity with respect to the portion that must be annuitized
15. Who should bear what risks (market and mortality) with respect to annuitized amounts
16. What, if any, early withdrawal rights are there with respect to IPAs (*e.g.*, disability); how should they be structured
17. How should distributions from IPAs be taxed (if at all)
18. Effective dates

[4] I recognize that there is some support for the other basic approaches to IPAs: an employer- or worker-based system. My own view is that the former is completely unrealistic for a variety of political and practical reasons. While it is possible to design a worker-based system, I think it would be difficult to implement and administer in the context of universal (as distinguished from optional) IPAs. Nonetheless, those who favor either of these approaches should go through the same exercise: figure out the overall framework, and then identify and resolve the myriad practical issues of implementation.

VI. CONCLUSION

In closing, Mr. Chairman, I would like to congratulate you and your colleagues for your foresight in addressing issues relating to Social Security reform and IPAs. I am convinced that universal IPAs can and should be an important part of Social Security in the 21st Century. That's the easy part. The hard part will be designing a system that works. Above all, my advice is to start slowly, build on existing systems, and keep it simple.

I am a partner in the law firm of Skadden, Arps, Slate, Meagher & Flom. A number of the firm's clients are interested in matters relating to IPAs. In addition, I have been engaged by Merrill, Lynch & Co. to study issues relating to the implementation and administration of IPAs. I am appearing today in my individual capacity and the views herein are solely my own.

Chairman BUNNING. I thank the panel for their participation. I just want to ask a couple of questions.

Doctor, you said something about both spouses contributing—in other words, if one spouse contributes and works, that 50–50 should go into——

Mr. KOTLIKOFF. Right.

Chairman BUNNING. Does that work both ways?

Mr. KOTLIKOFF. The income of the couple is combined and divided in half.

Chairman BUNNING. If the working spouse is female, she also would share her Social Security with her working spouse who is male?

Mr. KOTLIKOFF. Absolutely, yes.

Chairman BUNNING. That is an interesting concept.

Somebody mentioned the CPI being changed, and that would assist us in funding Social Security for a longer period of time. I think it was you, Mr. Ball. When do you think that is about to happen?

Mr. BALL. Mr. Chairman, it has been happening over the last several years. The Bureau of Labor Statistics has given very intensive study to updating, changing, improving the measure and they have done a lot already. And they have announced an additional change which has not yet been incorporated in the Social Security estimates, another 2-percent cut actually in the CPI itself which translates in percentage of payroll, which are the numbers that we are using for Social Security, to about 3 percent.

And there are other things under consideration, like updating the market basket more frequently, for example, which would improve the Social Security situation by not having the cost of living go up unreasonably.

I want to emphasize that the cost-of-living provision in the Social Security Act is one of the most important parts of Social Security. Being able to keep the benefits up to date as the price level rises is absolutely essential to making Social Security a good system——

Chairman BUNNING. It has been 8 years since we have had an adjustment.

Mr. BALL. No, they are making changes in the basic measure and every year, Social Security benefits are changed to respond to changes in the CPI every year——

Chairman BUNNING. Absolutely. But I am talking about the changes in the basket that——

Mr. BALL. The market basket? That is priced only once in 10 years. So they are wrong one way for 5 years and wrong the other way for another 5.

Chairman BUNNING. It should be updated more often.

Mr. BALL. Maybe it should be done every couple of years. It is not that big an expense, and so many things are dependent on it. That is not even a policy issue. If you supplied the money, they could do it.

Chairman BUNNING. You all are suggesting that there ought to be some private accounts; all generally are in agreement. It is how it is done, it is whether we keep the present Social Security benefits at the level they are. It is the age when seniors retire.

Under current law, the retirement age is gradually increasing to age 67 for workers who reach age 62 in 2022. If we just would continue on that same pattern, another maybe 15 or 20 years, we could get to age 70 as the retirement age. Whether that is right or wrong, I am not going to get into that discussion, but that is a way to help ensure the program's long-term solvency.

The main thing is how private accounts are handled, whether we add them on top of or whether we supplement them in relationship to a reduction allowing certain age groups to choose to get in or out, or allowing all age groups to get in or out if they choose.

But you, Fred, say that they should be handled by the government? The government should be the entity that handles the private investment accounts?

Mr. GOLDBERG. I believe the government should perform certainly the administrative functions.

Chairman BUNNING. Much like the 401(k)?

Mr. GOLDBERG. The Federal thrift plan covers all Federal workers. I start by believing that these accounts should be mandatory. Cut your tax and go to your local broker, that is a very different system. But if you think that they ought to be mandatory, the challenge is to take this over 100 million workers and figure out how do I get all of this money collected and credited to accounts in a way that doesn't impose recordkeeping burdens on the private sector and ensures that everyone is participating. I think we have a vehicle to do that. The payroll tax system works well. So the government does the first step, gets the funds and figures out how much money goes into each account.

Chairman BUNNING. I don't think that we have any trouble getting the money, for Social Security I'm talking. We get the money, but the process after that——

Mr. GOLDBERG. You get the money and credit the money to the account of the individual. I hate to be very technical, but the IRS does not know who put in how much money until a year after the money comes in, and that is a real technical point, but how you deal with that is a very important point.

Chairman BUNNING. None of you mentioned using the surplus.

Mr. KOTLIKOFF. I would be happy to.

Chairman BUNNING. In my opinion, that is one area that we could supplement what we use for individual accounts.

Mr. KOTLIKOFF. In my view, that is a complete inaccuracy.

Chairman BUNNING. The fact that we are going to have one?

Mr. KOTLIKOFF. The surplus is there. We have a surplus, but also an enormous liability. If you spend the surplus, the assets to cover the surplus are not there anymore—the assets to cover the liability are no longer there.

So yes, it is nice to think of ideas how to spend money, but it is not like we got this gift from Mars.

If you look at a present-value calculation of the problems of this system and the entire fiscal enterprise of the U.S. Government, we have an enormous generational problem here, and inventing money when it is not really there is not a way to approach it.

This proposal that I am offering is the only proposal that is really honest about the size of the problem and gets everybody, old and young, middle aged alike, to alleviate the problem. It is the only proposal that is really coming out clearly and saying we need a tax that everybody pays to retire the unfunded liabilities of the old system.

Ms. MUNNELL. Actually we did talk about the surplus, if not explicitly. Any proposal that involves investing the trust fund in equities, given the current budgetary treatment of an equity investment, involves spending the surplus and essentially making it disappear.

Mr. GRAMLICH. I would like to get an oar in on this, too.

There is what economists would call a stock and a flow problem with this. If you are going to have individual accounts, you want to set up the system so there are contributions to those individual accounts indefinitely. That way there will be individual accounts for people who are 50 or 40, who are 20 and who are not born yet and so forth. So you have to plan on these contributions happening indefinitely.

The surplus is going to be around for 10 years or so, and then under even the latest forecast of CBO it is gone. So if you set up Social Security in the long run to rely on individual accounts, you really have to come up with some other mechanism.

Mr. GOLDBERG. I didn't understand a lot of those words, but the simple point is right now we are running a surplus. Forgetting the fact that money is fungible, the money is coming out of the Social Security funds.

The hardest part is setting this thing up, I believe. You could take the current surplus, you could use that current, quote, "surplus" to fund private accounts. Without changing anything else in Social Security, you could have some offset mechanism running between those private accounts and Social Security payments down the road to deal with the long-term financing issues; but what you will have accomplished is put the mechanism in place for creating the kind of wealth for individual workers. So I think you can do something with the surpluses; and if that is the best you can go, that is what you ought to do.

Chairman BUNNING. Thank you very much.

Sandy.

Mr. LEVIN. We are due on the floor.

Chairman BUNNING. We have a bill on the floor, and I apologize. We have the ticket to work bill on the floor which I am supposed to manage and the rule is up right now. So if you don't have any more questions—I am going to submit some questions to you in

writing because I have a lot more questions that I want to ask, but I apologize for going to the floor but——

Mr. LEVIN. Never apologize for that. I will ask just a few questions and then join Mr. Bunning.

Without a change, the financial picture is dramatic; but without Social Security there is hardly—there is no surplus without it, and even with it there isn't that grand of one, so I think we better be very cautious and get at this problem first. I think the President is correct.

I think the discussion today has been most constructive, and I think this kind of an interchange sets a good example of an honest exchange of not choosing up sides reflexively, of trying to find the common ground.

Part of the debate, though, means not to skim over issues. So while there is considerable common ground among you, I think there are considerable differences.

Private accounts are something very different from privatization, and I think that we need to have the discussion about how we get a larger return on the investment, and there really is among you some important differences as to how we do that. And if we are going to have a meaningful debate, we have to have civility and also controversy. Again, I congratulate you because I think this is the kind of discussion that we need to have.

Everybody agrees that we need to have a larger return. I think the restriction on the investment of Social Security in the thirties was very natural. Social Security was set up after the crash. I don't think that we should have expected that anyone suggest that we invest in securities in 1935.

Mr. KOTLIKOFF. I would have. The price was low.

Mr. LEVIN. The risks seemed dramatic, right? And it would be interesting to go back in the debates to see if anyone suggested that. I would doubt that the person who suggested that served more than one term or was reelected.

Now, there is a suggestion that we have individual accounts which would be controlled by individuals, and I am not sure any of you go very far on that. Some of you do with some government restraints, and then others of you suggest there be an investment of present funds, and some of you suggest that there be some add-on that would be individually invested.

So let me just ask a couple of questions about that common ground that has a lot of differences.

Dr. Munnell, you are the one who touched on having the government invest in the stock market to put it in simple terms, and Dr. Gramlich, you may want to comment from an economist's viewpoint as well.

What kind of risk is there? If you have considerable investment by a government entity, you seem to think that it is minimal, a minimal risk?

Ms. MUNNELL. Congressman Levin, I am worried there may be too much decorum here. I don't like Ned's plan because he cuts back 30 percent on Social Security and I really don't like the CSIS plan because they cut back 40 percent on Social Security, so I just want to make sure that when we leave this hearing that there is not all that much agreement.

Mr. GOLDBERG. We also ought to clarify that is a complete mischaracterization of the CSIS plan.

Ms. MUNNELL. Investing the Social Security Trust Funds in equities, is not the only proposal to invest in equities. Everybody's proposal involves equity investments. Ned's involves equity investments. His is similar in that the government maintains control of the funds and designates appropriate options. So it is not a question of equities or no equities. It is rather a question of where the equities should be held, and people like me who support holding them in the central trust fund do so because they think that it would spread the risks better over the population and also allows us to spread risks between generations. So it is a better risk spreading mechanism.

Mr. GRAMLICH. I think there are two problems with that as long as we are going to take off the gloves here.

One is that usually plans like these, as described by both Alicia and Bob, don't involve any real changes in Social Security, no changes in taxes or benefits, and so that means that the equity investment does not come out of new saving. There is a kind of giant asset shift going on in the economy where Social Security holds more stock than people, and average people hold less stock, so the country is no richer.

And I think a first point is if we are going to devote new funds to the market, we ought to do it out of new saving.

The second thing is if you don't do it through individual accounts, if you have the regular trust fund hold all of the stocks, it turns out to be a huge amount. It builds up to something like a trillion dollars of stock, and then you have got a situation where you really do come close to changing the balance between the public and private sectors in this country. I think just about every corporation would have Social Security be its largest stockholder. And if you do it through individual accounts, there would be a lot of funds, maybe 5 or 10, individuals would be electing bonds or stocks, and I think you would keep the firewalls, as they are called, between the public and private sector better constructed than if you had Social Security fund itself holding a huge amount of equity. That is the problem that I have with that particular approach.

Mr. LEVIN. My time is up.

Mr. CHRISTENSEN [presiding]. I think we ought to let Dr. Kotlikoff respond.

Mr. KOTLIKOFF. I appreciate that.

I think the way to characterize the difference is we have some people advocating that we basically do nothing and this will of course get us into hotter and hotter water.

Mr. LEVIN. I don't think that they would agree with that.

Mr. KOTLIKOFF. You're right, they've deluded themselves into believing they are advocating real reform when they are really doing nothing of the kind.

Some people, Ned and others, are advocating doing what I would say is far too little.

And we have one party here who is advocating doing it the right way, and that frankly, is me. In my view, you do it the right way or you forget it.

The real issue is that we can only harm Social Security's funding by taking the surplus and giving it away. And we can get rid of our liabilities by taking the trust fund and putting it into stocks. Frankly, that is just a sham transaction and any decent economist knows it.

As Ned was just saying, the trust fund will hold the stocks and the public will hold the bonds and it will just be a portfolio swap.

The real issue is whether you pay off this liability and who is going to do it. Who is going to pay off that liability? Are you going to get the current elderly, the current middle aged and the current young and the future generations collectively to pay it off or are you going to put a bigger and bigger burden on future generations so they end up with a much worse fiscal mess than we are already providing them?

Our proposal is not a Democratic proposal or a Republican proposal. It is coming out of academia; first of all it recognizes the liability—that we can't use magic or smoke and mirrors accounting or sham transactions to pay it off. Let's pay it off with a comprehensive business cash flow tax which is effectively, a consumption tax, but one which insulates the poor elderly, because they are living off Social Security and their real incomes would be fully preserved. Let's privatize Social Security at a large enough scale so we don't eliminate all of the gains of privatization through transaction costs. Let's protect dependents. Let's do it on a progressive basis, let's make sure that there is a single security so that people can't play the market.

Mr. CHRISTENSEN. I am going to let Congressman Becerra get in here on these questions.

Mr. BECERRA. Thank you, Mr. Chairman. Actually, I don't mind letting you finish.

Mr. KOTLIKOFF. I think we have to recognize that there is nothing free here. This is not a free lunch. We have an enormous problem. It is twice as big as the Trustees are disclosing. The actuaries will disclose it if you call them up on the phone. The Trustees are only looking out 75 years, which sounds like a long time to look out, but there is an enormous train wreck in year 76 and year 77 and those outyears. So if you do the calculation correctly, you find that the problem is twice as big as is being advertised.

Mr. BECERRA. Regarding your business cash flow tax, you say that it amounts to a consumption tax and the elderly will be shielded. What about the working poor or middle class to low middle class who will not be shielded by any governmental program, who are not yet retired?

Mr. KOTLIKOFF. Under our program you are getting rid of a payroll tax, the payroll tax for the OAI Program, and you are replacing it with a consumption tax.

Mr. BECERRA. It is a wash?

Mr. KOTLIKOFF. In terms of aggregate revenue, it is a wash.

Mr. BECERRA. In terms of the tax on the individuals?

Mr. KOTLIKOFF. On the individuals we have done simulations, and the individual poor young workers would be better off. Because you are getting more of the fiscal burden being paid by older people, rich and middle class older people, you are going to have a smaller effective tax on younger workers. We also——

Mr. BECERRA. But with a consumption tax, the more wealth you have, the smaller percentage your tax will be relative to your wealth because you consume typically the same amount whether you are rich or poor or middle class. But if your wealth is great, the actual amount of consumption——

Mr. KOTLIKOFF. I would characterize that as a misunderstanding of the consumption tax.

Mr. BECERRA. Let me follow up on that. You are rich and I am middle class. You probably weigh about the same as I do. You probably consume about the same amount of food. You purchase about the same amount of clothes. You probably buy a more expensive car than I do.

Mr. KOTLIKOFF. How does the tax hit me more than you?

Mr. BECERRA. Yes.

Mr. KOTLIKOFF. First of all, if I am rich I am taking vacations, buying yachts, and having a $2 million yacht party in the New York harbor, as a member of the Forbes family recently did.

Mr. BECERRA. And you pay on that yacht.

Mr. KOTLIKOFF. That $2 million party is a consumption item.

Mr. BECERRA. You tend to write it off as a business expense.

Mr. KOTLIKOFF. Not under the consumption tax that I am advocating.

One of the ways that we pay for consumption is out of our wealth, and the other is out of our labor earnings. So when you are taxing consumption, you are really taxing wealth plus labor earnings.

Now, you are saying correctly Bill Gates can't spend all his wealth, but when he leaves it to his kids——

Mr. BECERRA. It is investment income.

Mr. KOTLIKOFF. If we have a 10 percent or 8 percent consumption tax, the consumption that he does will be taxed, and when he leaves his money to his kids when they spend it on consumption, it will also be taxed.

Mr. BECERRA. That doesn't mean that——

Mr. KOTLIKOFF. Mathematically it is equaling out to a one-time wealth tax of 10 percent.

Mr. BECERRA. He has two cars, I have one, and he is paying more tax, but he is paying more tax because he has two cars.

Mr. KOTLIKOFF. How much tax is he paying under the payroll tax on his wealth? Zero.

Under a consumption tax, which is what we are advocating, he will—if we are talking about an 8 percent consumption tax, be taxed to the tune of 8 percent of his wealth.

Mr. BECERRA. Not all of his wealth.

Mr. KOTLIKOFF. If it is spent on consumption——

Mr. BECERRA. Is all of his wealth going to be spent on consumption?

Mr. KOTLIKOFF. When he leaves it——

Mr. BECERRA. What is Bill Gates worth?

Mr. KOTLIKOFF. When he leaves it to his heirs, to his kids and grandchildren, they will pay the consumption tax.

Mr. BECERRA. We have to wait 50 years for his grandchildren to spend it so we can pay for the benefits, so that retirees who retire right now can get the full amount of their benefits?

Mr. KOTLIKOFF. If he is not spending his assets on consumption, that is a positive thing for the economy. When he does——

Mr. BECERRA. When he bought a home which is worth how many million dollars, he is consuming.

Mr. KOTLIKOFF. A consumption tax would tax imputed rent on his house if set up correctly.

Mr. BECERRA. If I owned that house, I would be willing to let them tax me on that as well.

What I was saying is still accurate, that a consumption tax hits someone who is less wealthy harder than someone who is wealthier, simply because the wealthier person doesn't increase his consumption at the same rate he increases his wealth.

Mr. KOTLIKOFF. I respectfully disagree. We are talking about going from a payroll tax to an equal revenue consumption tax. A consumption tax taxes wages and wealth. A payroll tax just taxes wages. When you go from a wage tax to a consumption tax, you are lowering the tax on workers.

Mr. BECERRA. My time has expired. I would challenge you on your definition of wealth.

Mr. KOTLIKOFF. This is the common definition in public finance. Let me just point that out.

Mr. CHRISTENSEN. Mr. Portman.

Mr. PORTMAN. Go ahead.

Mr. GRAMLICH. Just on this issue, in these halls there have been many long and complicated debates on consumption taxes. The issues are tangled.

Without taking a position on that tax, the consumption tax only comes up in Larry's plan because when you have a big scale privatization switch, you need transition expenses.

The other plans that we have talked about here, whether they are good or bad, don't have any transition taxes and so the issue of whether we have a consumption tax or not, which we don't now at the national level, would not arise.

So this is only an issue if you get into big scale privatization plans. It is not an issue in some of these other more gradual type plans.

Mr. PORTMAN. I was enjoying Dr. Kotlikoff's segue into tax reform.

Fred Goldberg talked earlier about his characterization of the CSIS plan, and perhaps you wanted an opportunity to respond or rebut what was said earlier?

Mr. GOLDBERG. First of all, I think it is correct to say if you look at the defined benefit feature, there is a reduction. I think that is fair to say. But if we have a reasonable discussion about it, there is also a system of mandatory private accounts. And if you assume that those accounts all fall to zero, it is a 40-percent reduction. But depending on what sorts of rates of return, it may or may not be a reduction at all.

Second, if you look at some of the changes in the defined benefit features as they relate to——

Mr. PORTMAN. Let's assume a rate of return on a historical rate of return.

Mr. GOLDBERG. If you assume reasonable positive rates of return, it turns out that most cohorts will do substantially better.

If you get into policy behind private accounts, are they voluntary or mandatory, and are they add-ons or carve-outs, it is sort of easy to see what those choices are. I believe you can make reasonable, good arguments for any of those choices. That is your box, mandatory or voluntary, carve-out or add-on. That is all you need to decide, and then you can get about designing the system.

Mr. PORTMAN. Let's assume that it is a carve-out. What is wrong with having the Social Security account that is left, let's assume 3, 4, 5 percent would be taken out in terms of a personal savings account of some kind, investing in a prudent way in the capital markets as well as having this ability in your own account, within parameters, to take advantage of some of that wealth creation? Is there a reason that we could not do both?

Ms. MUNNELL. I am concerned about Fred cutting back roughly 40 percent on the defined benefit Social Security Program and substituting an individual account, which is defined contribution, because I don't think the defined contribution individual account will do as good a job as the defined benefit that we have in place now.

There are a host of reasons, but I think the primary one is if you tell people they have these defined contribution accounts and it is their money, then when they get sick, they are going to want access to that money, quite reasonably.

If they want to buy a house, they are going to try to get access to that money. I am afraid that money is going to be taken out before retirement and people are going to end up with close to the 60 percent that they have left in the defined benefit plan and they are going to have inadequate retirement incomes.

Mr. PORTMAN. Do you think that it is politically impossible to draft legislation which would require that it be pulled out for retirement only after 59½, and only then on an actuarial basis? In other words, you get less benefit if you retire early? Why couldn't we do that?

Ms. MUNNELL. I think that it will start that way and I think that it will end up looking like the IRAs and 401(k)s where you can get at the money. I think it is just very hard to prevent access.

Mr. PORTMAN. We should repeal all of those IRAs.

Mr. GOLDBERG. I think we are making our best judgments about very important questions. If Alicia is right, that over time all of these private accounts disappear, I think that is a serious if not fatal problem.

On the other hand, I believe to suggest letting the government collectively invest in the capital markets, which is the suggestion, and to say I believe it is easy to prevent political interference is dead wrong.

I think the notion that you are going to be able to avoid questions about excluding tobacco companies from the index or excluding companies dealing with China from the index, inevitably that kind of pile of money is going to draw those kinds of pressures, and I think the chances of resisting those pressures is zero. It is a risk. We may place different weights on it. I think that would be a fatal mistake.

Mr. PORTMAN. Mr. Chairman, with your indulgence, Mr. Ball had a comment.

Mr. BALL. I was going way back to a much earlier point, if that is acceptable, Mr. Chairman.

That is, I hate to leave the record the way that it was on the issue of whether what we propose is only a big exchange of assets without any meaning behind it. What we are suggesting—having the central fund invest in the market—does have meaning.

The first point is that as far as national savings are concerned, that doesn't come out of in our judgment, from the way the investments are handled. The effect on national savings comes out of whether you decide to build up the trust funds toward partial reserve financing, which Ned and I agree you should do.

That is his higher tax rates—he says no taxes but additional money out of workers' earnings—and our measures to increase the funds, these are what creates the real savings.

Allowing Social Security to invest in stocks isn't primarily to create more national savings beyond that; it is an issue of fairness.

If the Social Security system is kept from doing what other retirement systems and other savings plans do, Social Security participants are at a disadvantage and that is a fairness issue. Under present rules, Social Security participants are at a significant disadvantage in terms of rate of return; and then you hear all of the criticisms about Social Security having such a low rate of return. It can be evened up, and whatever you can do about savings through private accounts can be done through Social Security. And I must say the distinction between the government investing on behalf of people who have chosen individual funds which the government is going to invest for them and investing directly for them in Social Security escapes me. All the problems that Mr. Goldberg suggests are there also if the government is the one that is going to invest the proceeds of individual accounts. Individuals decide they are going to put it in this fund or that fund but the government makes the investment decisions—selects the index.

Just like the Federal employees savings plan now, the government investing the private accounts, should be subjected to whatever pressures are now foreseen for Social Security direct investment. Well, I am told that, yes, the Federal employees savings plans has been the object of pressure to invest this way or that, but since the legislative record was clear, those pressures were resisted and it was possible to continue with that system without having to give into the pressures. That is the test and it has already been met.

I think you would have to have investment in the central fund, set up in a way through the index funds that protected Members of Congress from being pressured by their constituents to put my company in the index, take that guy out. I want to get my industry favored.

I don't think that you would ever pass a bill that subjected you to that kind of pressure about individual components of an index because it would be very disadvantageous to you to have your constituents pressuring you this way or that. It would have to be clear that the plan would stick to an index, that a government appointed board could not change although, of course, Congress as a whole could.

Mr. CHRISTENSEN. I want to go back to a question that Nick Smith brought up earlier. He mentioned the idea of the retirement age. I want to get your input, and I will go to Mr. Becerra after that.

Mr. KOTLIKOFF. Under our proposal, we give current workers their accrued benefits under the old system when they retire. Specifically, their earnings record is filled in with zeros after the time of the reform. So, under our plan, you can start collecting at age 62 or 65; there is no increase in the retirement age, you just get a smaller benefit because your earnings base includes these zeros that would not otherwise be there.

On the other hand, you have this private/personal account to fall back on as well. So I don't think that there is any need to raise retirement ages as part of a privatization scheme.

Is it possible to just reply really quickly to——

Mr. CHRISTENSEN. Did anyone else want to comment on that?

Mr. BALL. I think we ought to stop thinking of these proposals primarily as a change in the retirement age. Social Security provisions don't really control the retirement age. They control how much money people get if they retire or have to retire at different ages.

Raising the "normal retirement age" is really a big benefit cut. The biggest benefit cut in several of these plans is to make people wait longer before getting their full benefits—wait, say, until age 70. And the plans that raise the age keep going after age 70, say, and index it to longevity. I wouldn't give up so much control of the total system so everything is indexed and automatic. You should make decisions as experience dictates.

Let's see how the present system works. We are just beginning to have an extension of this so-called retirement age beginning in the year 2000 to move up to 67. Let's see how it works. I don't think that the American people even know about it yet.

I think as it goes on, rising gradually as the years pass, you can see whether employers are going to make jobs available, whether workers will be willing to work at them until they are older. We have no reason to rush in and change now it to 68 off in 2022 or some such date.

Let's see how it works through the long period of time that we have going to 67 under present law. If it turns out that it is a good idea, jobs are there, surely, you can move it up. But why now, before we have had any experiences?

Ms. MUNNELL. As you know, most people grab the Social Security benefit as soon as they can get it, namely at age 62. And when you look at these early retirees, they break into two groups. One is wealthy and healthy and with a good private pension. The other is not so healthy, low income, and has been unemployed just before they have actually claimed their Social Security benefit. For the wealthy, healthy people, it is perfectly reasonable to say, look, you are going to live for a long time, why don't you work longer, and they can adjust their retirement pattern to accommodate this cut in benefits.

What we are worried about are those people who are not in such good shape, who may not have a job available, and who may not be able to change their retirement age at all. What they are going

to see is a big benefit cut, so it can be a benefit cut on the most vulnerable people.

Mr. CHRISTENSEN. Dr. Gramlich.

Mr. GRAMLICH. Two issues. One is on the stock market investment, there are basically two approaches here. One is, the thing that Goldberg and I are recommending, is what we might call the TSP approach, where you do it through centrally managed funds. And the kind of thing that Bob and Alicia are talking about would be where the Social Security Trust Fund actually holds the stock. And Bob was just saying there wasn't much difference there. I think there are important differences.

There is, first, the firewall of having consumers choose the stock fund to invest their money in that you wouldn't get in their approach. The second is that TSP has been tried and is working well; it has for 10 years. And so you are trading in something that you know is working well for something that you don't know, and has actually worked badly for several State governments and in other countries.

The second thing. On the retirement age, nobody wants to raise the retirement age. It is a benefit cut, as Bob said, and nobody wants to raise it. It is just that if you feel as I do that we do have to trim benefits somehow or another, because I don't think the option is there to invest in stocks, and nobody seems to want to raise taxes, then you have to do something, and that is on the benefit side. It strikes me as one sensible component of a reduction in benefits. It is not that we want to do it, and it will cause problems and it will be a benefit cut, but what is your alternative?

Mr. CHRISTENSEN. Fred.

Mr. GOLDBERG. I think it is important to think about that age. It is a hard issue, and if you are thinking about the one group that Alicia described, you shouldn't touch it at all. If you are thinking about the other group, maybe you ought to.

I disagree with Bob. I think we have an entire structure inside Social Security and inside the tax system that effectively tells people they ought to stop working in their mid-sixties, and I think it is part of a larger and very serious problem in terms of how employers view workers, in terms of how individuals view themselves and their opportunities. And I think this is part of a bigger problem. Social Security penalizes you if you keep working past 70. I think that it is a very difficult issue.

The piece on going back to this investment in the markets thing, it seems to me that if you design a system that has individual accounts over time, you have the opportunity to let people roll directly into the private sector, you have far greater latitude.

I also think that if you are concerned about the sick and the poor and the low-income workers in this country, unless you have a defined contribution piece, if you do not have that you are telling Native Americans with a life expectancy of 55, you are telling African-Americans with a life expectancy of 62, you will pay 10 percent off the top into a system and you will get nothing. And I think that if we are concerned about fairness here, it seems to me for that group of individuals who, in fact, work for 40 years and 35 years, who, in fact, die before they collect any benefits, this is not a fair system at all.

Mr. CHRISTENSEN. Mr. Becerra.

Mr. BECERRA. If I can follow up on that, what about the poor individual who lives until 90, and earned under $20,000 a year, and will get to collect Social Security for those 25 years?

Mr. GOLDBERG. I think it is essential, absolutely essential that any system maintain a federally run defined benefit program that will cover that individual for all 20 years and will give them benefits that keep them out of poverty.

Mr. BECERRA. But the defined contribution program would not address the needs of that working person who——

Mr. GOLDBERG. I agree with that. That is why the primary feature of the program should remain defined benefit. The defined contribution piece should be a small piece that is a subsidiary to a defined benefit component, and you ought to do more for the folks you are describing, not less.

Mr. KOTLIKOFF. If I can comment quickly on that, I think that is a completely inaccurate assessment of how you can set up a defined contribution plan. Our proposal has people contributing about 8 percent of their salary into a defined contribution system, on a progressive basis, into this single global index fund. At retirement age, between 60 and 70, each cohort's balances are collectively annuitized and transformed into defined benefits, so there is nothing incompatible about annuity insurance and having a privatized defined contribution system. To say that you can't have these two things together is just not correct.

Mr. BECERRA. That assumes, of course, that the defined contribution will have been sufficient to provide the person with an annuity that will pay over the long term of that person's life, while in retirement, is enough to sustain the person.

Mr. KOTLIKOFF. Well, absolutely, and that is why when you are concerned about——

Mr. BECERRA. If my parent's first investment was to put money into a housing deal where they were told they would get a 20-percent return, and they put their $3,500 in savings with this real estate investor and lost all of it, if that was the best judgment made——

Mr. KOTLIKOFF. That is precisely why our plan doesn't allow for that to happen. Our plan is the only plan of all current privatized proposals that mandates everyone hold the same single security, so everybody gets the same deal; it's not that your parents get a lousy deal and somebody else's parents get a great deal, everybody gets the same deal. We are setting this up for the average Joe. Everybody should get the same deal, the same rate of return, and everyone should be invested in the same global index funds of stocks, bonds, and real estate, which ensures that they are fully diversified. Under our plan, you can't play or time the market and you are forced to hold the market for the long term. And there is also progressive benefit contribution match by the government to protect poor people.

Mr. BECERRA. Who pays for the progressive match?

Mr. KOTLIKOFF. This is all financed out of the cash flow business tax.

Mr. BECERRA. Dr. Munnell, may I ask a question with regard to women? Is there a difference between how women will be affected

by any system we come up with, whether it is a private account system or just an expanded Social Security Trust Fund system, vis-a-vis men?

Ms. MUNNELL. I am actually surprised this hasn't turned into more of a women's issue. It is very different to have a defined benefit plan with protections for dependent spouses than to have individual accounts where the protection depends on the decisions of the individual. People can decide whether or not they want to annuitize their amounts, they can decide whether or not they want a joint annuity or a single annuity. With a single annuity, benefits don't continue after their death.

People in England, where they could choose inflation index annuities, tend not to. So people don't make very good decisions when left on their own, not only for themselves always, but also for their spouses.

The widows in this society, elderly widows, are one of the groups with the highest rates of poverty, and I think that it is a major concern of most people involved in this debate, that they are going to be left without the protections they need, and their situation could worsen unless special provisions were put in for them. And that has been left out of the debate up until this point.

Mr. BECERRA. Thank you, Mr. Chairman.

Mr. GOLDBERG. I agree, again, with Alicia. I think if you were going to go to private accounts, you would want to design exactly those kinds of safeguards. But I also think if you are going to talk about this, you ought to look at the actuarial return on two-income-earner families where in most cases, or at least a significant number, the woman tends to be earning a lesser income and the actuarial value is zero.

So I agree with the need to safeguard the widow. It is a terribly important issue. It is very difficult, but I also think, again, a defined contribution piece, if it is small, does something to rectify current inequities as it relates to two-income-earner families and working women in particular.

Mr. KOTLIKOFF. Can I interject? You don't have to make it small to do what's needed to protect widows. In our proposal, you have earning sharings, so first of all, each spouse has got the same account. In our proposal, you don't touch the survivor insurance I part of Social Security, so the survivor insurance part of the Social Security is still there. There is actually more protection for widows under our proposal than under the current system.

Mr. CHRISTENSEN. I will let the last statement be by the dean of the panel, Mr. Ball.

Mr. BALL. That is quite a responsibility, Mr. Chairman.

Just so we don't end with sweetness and light, I want to disagree strongly with Mr. Goldberg on one thing but agree with him on another. Alicia said earlier that one of the main problems with these individual accounts is that sooner or later they would be loosened up and people would spend the money before they got to retirement age. There is another big problem. What she said is absolutely correct, in my judgment, but there is another problem. That is, people who support these individual accounts to take the place of part of Social Security rely on averages. They give you numbers that say, in effect, yes, it is a 40-percent cut in the Social Security part, but,

look, you invest in stocks—the individual puts at least half in stocks and half in bonds, and he turns out to be better off. But that's the average. Some will get average returns, some won't.

The point is, Social Security is not very much. It is only a base, but that ought to be a certain defined benefit amount. Supplementary savings, surely, we can take some risk with those, but don't cut back 40 percent on Social Security and then substitute something that depends on how good your investment returns are.

The thing I want to agree with Mr. Goldberg on, though—that was the disagreement. The thing I want to agree with him on is his emphasis upon the administrative aspects of these private accounts is terribly important, and that gets very little attention. He and I both have career experience with administering very large government programs, the Internal Revenue Service, and the Social Security Administration.

Mr. Goldberg said that he thought the individual account plans would stand or fall on administrative issues. I would just like to leave you with that thought. The administrative issues—the problems—with the individual account plans are very big.

Mr. CHRISTENSEN. Well, thank you. It is often impossible for our Subcommittee to cover every issue we are interested in during this hearing and therefore we may be submitting additional questions to each of you in writing for you to answer on the record.

I would like to thank our witnesses today for their extensive and thoughtful testimony and thank you for your participation. This hearing is adjourned.

[Whereupon, at 3:45 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

Statement of Bond Market Association

The Bond Market Association appreciates the opportunity to comment on issues related to reforming the Social Security system. The Bond Market Association represents securities firms and banks that underwrite, trade and sell debt securities both domestically and internationally.

Reforming the Social Security system has evolved into a prominent political and policy issue. Not long ago, Social Security was considered the "third rail" of politics. Today, Congress and the administration are actively studying alternatives to modifying the system in fundamental ways. In our view, this is a positive development. It is inarguable that the system cannot be left alone. In the coming years, demographic trends will threaten the ability of Social Security to continue to provide income to beneficiaries. Simply raising taxes or reducing benefits does not appear to be an attractive or viable solution.

One approach to Social Security reform that has been studied in various forms would permit or require participants in the program to divert a portion of their Social Security tax to privately-owned, self-directed investment accounts. This approach is attractive for a number of reasons. First, it would permit retirement savings dollars accumulated through the Social Security system to be invested more actively and efficiently than currently. Second, this approach would, depending on how it is structured, address the dangerous demographic trends now facing the program. Third, and perhaps most important, personal investment accounts have the potential to offer program participants a greater level of retirement security than the current program. Put simply, it is likely that under a personal investment account approach, retirees would have more money and would be able to live more comfortably than under the current system.

This is not to suggest that Congress should move hastily to reform Social Security. Social Security affects the lives of individuals perhaps more than any other federal government program. Over the past 60 years, people have come to depend on the system to provide vital retirement income. Congress should continue to study carefully all the implications of reforming Social Security—as Chairman Bunning has done in convening this hearing and for which we commend him and other members of the subcommittee—before taking action. When you do, we believe that you

will find that an approach to Social Security reform involving personal investment accounts to be a very attractive alternative to the current system.

In this statement, we focus on two issues before the subcommittee. First, we would like to dispel the myth that under the current system, the Social Security trust fund is "invested" in bonds and that bond investments are somehow less attractive than stock investments. Second, we would like to discuss the value of bond investing in long-term retirement savings and urge that in establishing a "menu" of investments for personal investment accounts, bonds be offered together with other options.

THE CURRENT TRUST FUND

Under the current Social Security system, payroll taxes paid by employees and employers are remitted to the Treasury Department like all tax collections. The cash collected from payroll taxes is intermingled with other cash held by the federal government and is used to pay general federal obligations. It is important to note that cash collected from the Social Security payroll tax is not earmarked to pay Social Security benefits. Indeed, Social Security tax collections are used in the same manner as other sources of federal revenue to pay whatever obligations the government incurs.

To the extent that Social Security payroll taxes collected in a given period exceed the amounts needed to meet program obligations, an accounting entry is made to credit the excess to the Old-Age, Survivors, and Disability (OASDI) Trust Fund. The trust fund balance is increased by an amount equal to the excess tax collections. At the same time, a second accounting entry is made debiting the trust fund's cash account and crediting its Treasury securities account. This second accounting entry is often likened to "investing" the trust fund's assets in U.S. Treasury securities. However, there is no investment in a true, economic sense. The trust fund holds no assets which are salable in the open market. Even more important, the trust fund's liabilities—future payments to Social Security beneficiaries—are backed only by the federal government's promise to pay. There are no assets in the Trust Fund that can be sold to meet the Fund's obligations, as is the case with trust funds and pension funds generally. In around 2013, when, under current projections, Social Security payroll tax collections will stop exceeding payments, the only way for the federal government to continue to meet obligations will be from general government revenues generated through taxation or by borrowing from the public.

The current system for "investing" the Social Security trust fund has been criticized for generating anemic returns. However, because the Trust Fund is not truly "invested," it is inappropriate to think of the phantom interest "paid" to the Fund as a return on investment. After all, when the Trust Fund is "paid interest," no money actually changes hands. The government simply pays itself. Nevertheless, for the purpose of discussion, it is useful to look at the trust fund as if it really were operated like an investment account. With that in mind, there are two points regarding the trust fund's "investment return," that the subcommittee should consider.

First, the trust fund's investments are not actively managed. Typically, investors who manage portfolios of Treasury securities buy and sell securities on a regular basis to maximize their returns. The U.S. Treasury securities market is very active and liquid. Every day, managers of portfolios of Treasury bonds buy and sell securities to take advantage of market conditions. Active portfolio management can greatly increase the return on a Treasury securities portfolio. The trust fund does not benefit from active management.

Second, although the interest rates on the special series of non-marketable Treasury securities purchased by the trust fund bear some relation to interest rates on marketable Treasury securities, the rates are not the same. Specifically, the rates on trust fund securities are averages of market rates on outstanding Treasury securities with times-to-maturity of longer than four years. It is not possible for the trust fund to earn the highest rate of interest paid by the government on its long-term marketable securities.

One approach to Social Security reform suggests that any future shortfall in trust fund assets could be addressed today by investing a portion of the trust fund's assets in higher-yielding, marketable securities like stocks. The same, basic structure of Social Security as a guaranteed-benefit system would be retained, but the trust fund's assets would be diversified. While this approach would likely have the effect of raising the rate of return on trust fund assets, it also raises numerous questions. If a portion of Social Security's annual surplus were invested in stocks rather than Treasury securities, the federal government would be forced to borrow more from the public than otherwise. In essence, the federal government would be borrowing

in order to finance an investment in the stock market. Is it appropriate for the federal government to borrow for that purpose? Who would choose which stocks to buy, and would politics influence investment decisions? What would be the market effect of such a large investor as the OASDI trust fund moving into and out of individual equities and the market as a whole? What would happen to stock prices as the trust fund began to sell assets to pay benefits?

PERSONAL INVESTMENT ACCOUNTS AND THE BOND MARKET

Perhaps the most discussed approach to Social Security reform involves diverting all or a portion of each person's payroll tax to a personal investment account, similar to a defined-contribution retirement savings plan like a 401(k). Each person would make his or her own investment decisions from a "menu" of permitted investments. Under various proposals, this menu has ranged from one as limited as the current federal employees' Thrift Savings Plan to one including any of the nation's thousands of registered mutual funds. Under this approach, benefits under the traditional Social Security system would be reduced to account for retirement income to be derived by beneficiaries from the investment account system.

Although we have not yet developed a detailed position on how a personal investment account system should be structured, The Bond Market Association in general believes such an approach offers many benefits to the Social Security system, to its beneficiaries, and to the economy as a whole. Although significant questions still need to be answered, we believe that conceptually, this is the correct approach for policy-makers to take in reforming Social Security.

One of the attractions of personal investment accounts is that it would allow funds that would otherwise be used for current government spending to be invested according to the individual preferences of all the participants in the Social Security system. Presumably, the overall returns on these investments would be significantly higher than we see currently for the OASDI trust fund. When policy-makers and taxpayers look at recent returns in the stock market compared to "returns" on the trust fund, it is difficult to resist the attractiveness of equities. Indeed, stocks should comprise a significant portion of most individuals' long-term retirement savings. However, for almost everyone, bonds, too, should comprise a significant portion of long-term investments. A Social Security system involving personal investment accounts that limited permissible investments to equities alone would run counter to the interests of plan participants.

It is true that over long periods of time, diversified portfolios of stocks have generally outperformed diversified portfolios of bonds and other fixed-income investments. However, ongoing portfolio management research suggests that diversified portfolios including both stocks and bonds have outperformed both all-stock and all-bond portfolios on a risk-adjusted basis.[1] (Adjusting for risk involves considering the volatility of securities prices as well as overall investment performance.) Although portfolio managers disagree on the appropriate mix of stock and bonds, there is widespread agreement that in almost all cases, long-term investors should have a portion of their portfolios in bonds as well as stocks. This becomes even more true when a retirement investor begins to approach the time when he or she will sell assets to finance current spending.

Bonds are important for a number of reasons. Bonds are less volatile than stocks, i.e., they offer more consistent rates of return. The bond portion of a portfolio tends to stabilize and "smooth out" the more varied returns on stocks. Bonds are also important because they generate income. Although some stocks pay dividends, the dividend yield on stocks overall is significantly lower than the income yield on bonds. Income is especially important to investors like retirees who spend, rather than re-invest, a significant portion of their returns. Finally, bonds are safer than stocks. They are the best way to ensure a full return of principal.

It is also important that investors have access to a wide variety of bond and fixed-income investments. Consider, for example, the federal employees' Thrift Savings Plan retirement system. Under this plan, which operates similarly to a 401(k), federal employees self-direct their retirement savings into any of three investment options. One invests in short-term Treasury obligations. The second invests in a diversified portfolio of common stocks. The third, known as the "F" fund, invests in a diversified portfolio of government and corporate bonds and mortgage-backed securities. While the availability of bond investments is extremely valuable to federal employees, it is interesting to note that the F fund does not invest in non-mortgage

[1] See, for example, Clifford S. Asness, "Why Not 100% Equities" (Institutional Investor, Winter 1996, page 29) and Kenneth L. Fisher and Meir Statman, "Investment Advice from Mutual Fund Companies" (Journal of Portfolio Management, Fall 1997, page 9).

asset-backed securities or even in "private label" mortgage-backed securities. It also does not invest in high-yield corporate bonds. While these securities may not be appropriate for all investors, they certainly have a place in certain long-term portfolios. It is unfortunate that federal employees do not have access to a complete menu of bond investments.

CONCLUSION

We are greatly encouraged by the direction of the debate over reform of the Social Security program. We believe that a system where individuals are permitted to direct their own retirement investments offers great benefits. As Congress continues its examination of alternatives to Social Security reform, we urge you consider issues related to the proper diversity of investments in a retirement savings portfolio. You will discover that bonds are a vital component of a properly structured portfolio. A Social Security system involving self-directed investing that did not include a wide variety of bond investments would be against the interests of the hundreds of millions who will depend on Social Security for their retirement income.

We look forward to working with members of this subcommittee as the debate over Social Security progresses. We would be happy to provide any additional information that you may need.

Statement of Charles G. Hardin, President, Council for Government Reform

Mr. Chairman, on behalf of the 350,000 members of the Council for Government Reform (CGR), thank you for this opportunity to discuss the various proposals to redesign Social Security for the next generation using personal retirement savings accounts. CGR's members appreciate your interest in this crucial issue and welcome your continued examination into America's looming retirement income crisis.

As you are aware, Americans generally have a misconception regarding the current state of Social Security. Many of the seniors that I talk to are convinced that the government has been saving for their retirement and has placed their money in an account from which they are drawing their Social Security benefits.

We know that this is not the case.

In fact, the Supreme Court in Nestor v. Fleming ruled that individuals have no right to Social Security benefits based on their lifetime contributions. Congress is the sole arbiter of how much retirement income millions of Americans will receive.

In a nation conceived in liberty, allowing politicians total control over how we will live after we retire is not acceptable.

American taxpayers cannot continue to pour 12.4 percent of their earnings into a "public investment" program that already provides a negative rate of return for far too many future retirees. Maintaining the status quo will lead to a lower standard of living. To reverse this course, Congress must allow Americans to invest some of their payroll tax dollars in investment instruments where they can achieve greater rates of return.

This can only be accomplished if Congress breaks the old mold of tax hikes and benefit cuts and casts a new mold by increasing the rate of return on dollars invested in Social Security. And CGR supports a practical solution to this critical problem.

Personal Savings Accounts (PSAs) would provide a far superior alternative to our antiquated pay-as-you-go Social Security system. They would increase income for retirees and would also reduce the amount of money needed to invest to ensure a secure retirement. Even more important, PSAs would allow workers to own real assets for their retirement and even create a nest egg that could be passed on to their children and grandchildren.

How do PSAs achieve these policy goals? They simply bring the power of the private markets to bear.

Right now, Social Security faces a huge unfunded liability that future taxpayers and retirees must cover. Any PSA option would reduce this actuarial imbalance and ease the tax burdens of our children and grandchildren.

CGR is fully aware that Congress cannot just switch Social Security from a pay-as-you-go to an advance funded system without incurring costs. But Congress must also acknowledge the cost of maintaining Social Security as it is. In fact, if Social Security and Medicare were carried on our nation's account books as a normal business would, the national debt would rise from $5 trillion to $17 trillion! Moving Social Security to an advance funded system would eliminate nearly all of the program's unfunded liability.

Congress must consider other transition aspects as well. CGR strongly believes that any PSA option must protect current retirees' benefits. These workers have been promised a certain level of benefits, have planned their retirement around them, and are too late in their working careers or retirement to change their retirement income source structure. Any PSA plan must recognize this fact and provide financing for the current level of benefits until a new system is in place. That way Social Security will continue, without pause, for everyone who is currently dependent on it.

Clearly, Congress cannot wait until 2029 to save Social Security, as some would suggest. The Social Security Trust Fund is projected to begin running a deficit as soon as 2012 when many current retirees will still be collecting benefits. To provide for adequate lead-time to make a smooth transition, the choices must be made well before then. It is still possible to adopt a reform plan that achieves long-term solvency for Social Security by making the relatively modest change of increasing the rate of return of the money invested in the program by providing individuals with PSAs.

If Congress waits until Social Security nearly collapses, effective reform may not be possible due to the panic created by the imminent collapse of the Social Security behemoth. I fear that the nation would turn to drastic measures that could alter the fundamental principles of the program with dramatic costs to taxpayers and loss of benefits to recipients.

Social Security is too important to the millions who rely on it to continue to ignore its problems. American seniors should fear continued inaction on this crisis. That's why I and the members of CGR appreciate your interest and attention to this matter, Mr. Chairman.

The Council for Government Reform is a 501(c)4 non-profit citizens lobbying organization that seeks to encourage greater responsiveness by government and to reduce its overall size and scope at all levels. CGR seeks a lower tax burden, improved security for our senior citizens, and a less costly system of government for ourselves and future generations.

Statement of Kelly A. Olsen, Research Associate, Employee Benefit Research Institute

The Employee Benefit Research Institute (EBRI) appreciates the opportunity to submit written comments on several questions delineated by the Subcommittee about the focus of this hearingnamely, how personal accounts would be administered and financed, how they would be integrated with other private pension plans, and how they would work within current tax law. Our contribution addresses these issues from an employer perspective.

Traditional Social Security reforms—cutting benefits and raising taxes—have well-known implications for employers. Benefit cuts create pressure for enhancements to employment-based pensions and require plan adjustments; tax increases add to business costs and slow the growth of cash compensation. However, public opinion surveys reveal little support among a significant percentage of voters for these traditional fixes relative to adding a system of individual Social Security accounts [1]—an unprecedented reform with uncertain employer consequences.

Individual Social Security accounts could affect employers in many ways. Most obviously, employers would be affected by any change in the Social Security payroll tax if they are required to match employee contributions, as under current law. Second, the effects of individual accounts on retirement decisions and employee demand for private plans could affect pension design and offerings. In addition, individual accounts would certainly influence plan design features and pension offerings of employers who have retirement plans that are integrated with Social Security (i.e., the employers of approximately 7.7 million workers in medium and large establishments).[2] Finally, individual Social Security accounts could impose additional admin-

[1] In the 1996 Retirement Confidence Survey, a majority of workers under age 54 supported investing Social Security in the markets rather than raising taxes or cutting benefits. In 1991 and 1995, the EBRI/Gallup Organization, Inc., poll found that one-half of respondents believe they could make more money by investing their Social Security in the private sector than they could from contributing to the current Social Security system.

[2] EBRI tabulation from the U.S. Department of Labor, Bureau of Labor Statistics, Employee Benefits in Medium and Large Private Establishments, 1993 (Washington, DC: U.S. Government Printing Office, 1995). In fact, the total number of employers who would have to readjust

istrative costs and burdens on employers, depending on the extent to which individual accounts contributions would be made within the framework of current tax law. This testimony discusses each in turn and is largely based on the article, "Potential Consequences for Employers of Social Security 'Privatization': Policy Research Implications" (Risk Management and Insurance Review, 1997) (Exhibit 1), as well as the forthcoming EBRI Notes article, "Administrative Costs for Individual Social Security Accounts."

A. Employers as Reporters of Payroll Contributions

Recently, the National Council on Retirement Policy (NCRP) recommended that a system of individual Social Security accounts be designed to work "within the current payroll tax structure." In the current tax framework, employers send the U.S. Treasury aggregate Social Security (FICA) taxes (employee contributions plus employer matching contributions) relatively frequently, depending on employer size. However, employers must reconcile only once a year which portion of the aggregate FICA contribution has been paid on behalf of each employee (through the W–2 form). Because they have largely not addressed the issue, it is unknown whether other groups recommending individual Social Security accounts would concur with NCRP's recommendation that the current tax structure be used. Were the current tax structure maintained for individual Social Security accounts, a lapse of over one year would occur between the time when contributions are made on behalf of an employee and the time when those contributions are credited to the employee's individual account.

While options exist for having the government retrospectively credit contributions made on behalf of individuals to individual investment choices in individual accounts, such a time lapse would nonetheless stand in contrast to current 401(k) plan operation. Therefore, staying within the current tax structure may be unacceptable to those who view private 401(k) plans and minimal government responsibility as guideposts for any reform. As a result, some reformers might insist on an increased number of deposit transactions over the year. Depending on frequency, additional transaction requirements would inflate administrative expenses because of the additional work imposed on employersespecially smaller ones. On top of these costs, additional administrative costs for employers could arise if employers were responsible for keeping track of employees' investment choices or voluntary contribution rates. Further costs would be added if employers were required to send individual account contributions on behalf of each employee to a range of service providers available under different investment options.

B. Employers as Pension Providers

Individual Social Security accounts could affect the design of existing pension arrangements in two broad ways. First, almost one-half of workers in medium and large establishments are covered under defined benefit plans whose formula is integrated with Social Security (U.S. Department of Labor, 1995). When determining the benefit levels that an employment-based retirement plan must provide to workers of different preretirement incomes in order to replace—in combination with Social Security—a target percentage of preretirement income, integration formulas for defined benefit pension plans adjust for the fact that Social Security's benefits provide higher replacement rates for low-income workers. In addition, an unknown number of employers offering defined contribution plans informally take Social Security benefits into account when determining benefit provisions for workers of different income groups.

Most proposals for adding individual Social Security accounts call for reducing Social Security's defined benefit. If Social Security defined benefits are reduced, benefits levels needed from an employment-based plan using an integration formula would increase,[3] adding to compensation costs and possibly slowing the growth of cash wages. Alternatively, the employer might not pay these costs and instead adjust the integration formula to provide smaller replacement rates to retirees. This would create an administrative expense for adjusting the formula and ensuring all government regulations for the plan as a whole are still met after the adjustment. Moreover, if employers were to try to integrate their pension plans with a Social Security system that has a defined contribution component, integration to achieve

is even higher, as the above figure does not include employees of small private firms or of the government, who may also be participating in integrated pension plans.

[3] This assumes that neither the employer's plan formula nor the pertinent tax code (IRC Section 401(l)) and attendant regulations change.

desired replacement rates could not be done as precise under Social Security's defined benefit system (because of the uncertainty of investment performance).

A second way that employment-based pension design could be affected depends on workers' confidence in the system of individual accounts. If employees expected to receive larger Social Security benefits per dollar of contribution under a reformed system than under the status quo, confidence in the Social Security system might increase. Presumably, the more confidence younger workers have in Social Security, the less pressure they will place on employers to enhance employment-based retirement plans. Under a system of individual Social Security accounts, depending on the reform features, confidence in Social Security could also result in less employee demand for employer-based defined contribution plans. For example, if highly compensated employees are able to defer their preferred level of salary without the need of a qualified 401(k) plan, employers may be less inclined to offer matching contributions to motivate nonhighly compensated employees to increase their participation/contribution rates. If that were to happen, meeting the required nondiscrimination requirements might become problematic for 401(k) plans.

On the other hand, loss of part of the defined benefit guarantee under Social Security could result in more pressure on employers to provide guaranteed benefits. Because such guarantees can be promised only through defined benefit plans, employers would likely experience additional administrative costs (Hustead, 1997) and increased exposure to market risk if they responded to such employee demand. In addition, if individual account reforms left many without enough retirement income under Social Security, employers might be called upon to make up the difference by increasing their benefits for retired workers.

C. Employers as Payroll Taxpayers

One of privatization's primary potential advantages to employers is its potential to maintain Social Security benefits at current levels without raising employer payroll taxes or reducing benefits by leveraging higher returns from the equities markets for Social Security contributions. Assuming that the equity premium will persist, returns on Social Security funds invested in the equities market will generate additional program revenue, obviating the need for future tax increases to supplement program shortfalls. Some individual account plans (such as the 1994–96 Advisory Council's Individual Accounts Plan) would raise program revenues in this way by requiring additional contributions on the part of workers but not employers. The Individual Accounts Plan supported by Ed Gramlich and Marc Twinney, for example, mandates payroll contributions of 1.6 percent of taxable payroll from workers' wages. As described above, tax increases on employers and benefit reductions are likely to increase compensation costs, slow the growth of cash compensation, and increase pressure for enhancements to employment-based retirement plans. Insofar as Social Security privatization can avert tax hikes and benefit reductions, it will benefit employers.

D. Employers as Employers of Older Workers

Under certain designs, a privatized system of individual accounts could make it more difficult for employers to retire older workers. For example, if employees near retirement age have a large enough amount of their retirement security tied to the equities market through an employment-based plan as well as through Social Security, then a downturn in the market might delay retirement. Alternatively, since individual accounts allow workers to reap direct benefits from account contributions under favorable investment performance, older workers might respond to this incentive by remaining in the labor force longer. The influence of market returns on retirement decisions could make the retirement patterns on which employers base their pension and salary scales unpredictable. In addition, older workers' decision to remain employed during a market downturn would occur just when employers might most need to downsize their work force, particularly their higher paid employees, in order to cut costs. While these retirement issues already exist for employers with defined contributions plans, individual Social Security accounts could exacerbate these concerns by linking an increasing portion of retirement security to market performance.

Conclusion

In summary, employers potentially have much to gain or lose under a system of individual Social Security accounts, depending on reform details. Important details include how the individual account reform would handle taxation and administration, as well as the extent to which the reform would increase employees' reliance

on market performance for retirement security and affect employee demand for employment-based pension offerings. Most obviously, employers would be affected by any change in the Social Security payroll tax if they are required to match employee contributions. Plus, the effects of a system of individual accounts on retirement decisions and employee demand for private plans could affect pension design and offerings. In addition, individual accounts would certainly influence plan design features and pension offerings of employers whose retirement plans are integrated with Social Security (i.e., the employers of approximately 7.7 million workers in medium and large establishments).[4] Finally, individual Social Security accounts could impose additional administrative costs and burdens on employers, depending on the extent to which individual accounts contributions would be made within the framework current tax law.

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[Attachments are being retained in the Committee files.]

Statement of Gray Panthers Project Fund

There is a deep anxiety about Social Security's future. It is important to recognize that we must attend to the possible projected Social Security Trust Fund deficit even though many highly credible economists dispute the forecasts. Those pessimistic projections are based on the assumption that the economy will grow at only HALF its historic average. In fact, even using these conservative data, those who project a Fund short fall have had to increase the year when the deficit is estimated to begin from 2029 to 2032 because of today's economy.

While we acknowledge that there should be certain changes to the system, two important issues should be made clear: contrary to pessimists and alarmists, *Social Security is not in crisis and unless it is undermined by profiteers or others who would gamble with its funds, it will never be bankrupt.*

Fundamental to any change in the system must be a renewal of our commitment to the principles of Social Security: a *guarantee* that workers and their families can retire with dignity and that no one should live in poverty because of disability or the death of a family's sole income producer.

For more than 60 years Social Security has provided vital and important benefits for Americans. It is the foundation of retirement income and it stands as a guaranteed base against poverty for American workers and their families. It is also the principle insurance against family poverty due to death or disability. Today, approximately 44 million workers and family members receive benefits. These benefits are the major source of income for two out of three elderly beneficiaries and are the *only* source of income for almost 20% of our elderly.

Without Social Security more than of our elderly would live in poverty. In 1959, less than 40 years ago, more than ⅓ of our seniors lived in poverty. Today, mostly because of Social Security, that number has dropped to 11%.

[4] EBRI tabulation from the U.S. Department of Labor, Bureau of Labor Statistics, Employee Benefits in Medium and Large Private Establishments, 1993 (Washington, DC: U.S. Government Printing Office, 1995). In fact, the total number of employers who would have to readjust is even higher, as the above figure does not include employees of small private firms or of the government who may also be participating in integrated pension plans.

We should also remember, Social Security is more than a retirement program. It is a program for our most vulnerable citizens, those, who are disabled, widowed and orphaned. Disability and survivor benefits make up more then 30% of the beneficiaries.

Today, there is a cry for radical change in the Social Security system. This cry comes from Wall Street profiteers who want to gamble with the Fund's future for their own advantage. Although some projections show that Social Security faces genuine, though relatively modest, long-term financing problems, these deficits can be avoided without submitting to the radical proposals of profiteers.

The Gray Panthers say that before we experiment with any radical proposal to overhaul the system or compromise its integrity we should look at the most obvious, fair, and common sense opportunity available. The Gray Panthers say the most direct and fair proposal to strengthen the Social Security system is to simply *lift the cap on earned income, currently set at $68,400, that is subject to the social security tax for both the employees and employers. This common sense proposal would virtually eliminate any of the projected deficits and would make the Social Security tax more fair and less regressive. This proposal grows from the principle of economic and social fairness and a socially responsible society.*

Our richest workers currently have an elite privilege. There is a ceiling on taxes on wages above $68,400. Simply requiring the rich to pay their fair share of taxes would do two things. By using projections of the Advisory Council on Social Security, we realized that this policy would produce sufficient funds to extend the viability of the Social Security Trust Fund to almost the end of the next century—well beyond 2032, the doomsday date now being projected as the last year the fund would be solvent.

The second advantage eliminating the cap would do is make Social Security taxes less regressive. Asking the rich to pay their fair share is progressive; asking the poor to pay an unfair share is regressive. Regressive taxes only benefit the rich.

Two primary arguments support this proposal of fairness. Social Security is a national program for all its citizens and all its citizens should contribute equally to the program. As the Social Security tax policy is now defined, an elite set of wage earners, those who make *over* $68,400, are given special privilege and are exempted from paying into the system with any wages over this amount. This elite group is only 16% of the work force and were they to be taxed equally as those who make less, this share would bring in almost all of the funds needed to make Social Security totally solvent. Keep in mind, this higher income group also has substantially more savings as well as more unearned income sources, which reduces the impact of this tax on their overall income.

The second argument supporting a progressive and fair Social Security tax is that a precedent has already been set with Social Security's sibling program: Medicare. The ceiling on taxes that contribute to the Medicare program was lifted several years ago and had significant positive impact on the fund without major outcry or economic impact on the wealthy or employers. There is no reason why the Social Security tax should not also be made more progressive.

Contrary to those who try to use misinformation, fear, and pessimism as strategies to pit generation against generation, the Gray Panthers, who for over 27 years have dedicated our work to inter-generational cooperation and made our motto Age and Youth in Action say *there is NO crisis in Social Security.* The Gray Panther position is simple: To correct any future short fall in the Social Security Trust Fund, we must first do the fair and common sense thing: eliminate privileges for the highest income class and make the Social Security tax progressive. *We simply ask that the rich pay their share—it's the fair thing to do.*

Statement of Joel D. Joseph, Made in the USA Foundation

GIVE AMERICA WHAT IT NEEDS: A RAISE WHILE MAKING THE ECONOMY MORE COMPETITIVE AND SHORING UP THE SOCIAL SECURITY TRUST FUND

The Social Security Tax is the most regressive tax that we have, taxing the poorest among us at a higher rate than the rich. This tax is our only flat tax, but it is not flat enough. Most flat tax proposals do not have a cap like social security does. Now, incomes over $68,400 are subject to no addition social security tax. I propose that we exempt from income the first $15,000 from the social security tax and remove the cap. This will bring additional revenue to the Social Security Trust Fund and make America more competitive.

I am an economist and serve as Chairman of the Made in the USA Foundation. The Made in the USA Foundation is a non-profit, tax-exempt organization dedicated to promoting American products in the United States and overseas with 60,000 members.

I am proposing a tax reform plan that makes American companies more competitive, reduces paperwork and helps those earning less than $30,000 per year. It does all of these and increases the budget surplus as well. At the same time it also provides an increase in the minimum wage without increasing unemployment. It may sound impossible, or even magical—I call it "trickle up economics."

My proposal is quite simple: modify the social security tax by creating an exemption and eliminating the ceiling. For someone earning $15,000 per year the social security tax bite is a whopping $2,295, half paid by the employee and half by the employer. The first $15,000 of income would be exempt from social security and medicare taxes, for both workers and employers. According to the Tax Foundation (a non-profit think tank that studies taxation issues), this exemption will cost the U.S. treasury $40 billion, while pumping $20 billion into the hands of those needing it most, plus another $20 billion into their employer's pockets.

Social security and medicare taxes currently are imposed only on the first $68,400 of wages. Those earning one million dollars per year pay no more in social security taxes than a taxpayer earning $75,000 annually. This tax ceiling is illogical and unfair.

Even Steve Forbes' flat tax did not have a ceiling. By eliminating the ceiling on wages subject to social security taxes, the Tax Foundation estimates that we will raise $64 billion in new revenues. The $24 billion surplus in year one can be retained by the treasury to build up the Social Security Trust Fund. In future years the amount will increase.

This tax reform will also end the "nanny tax" problem for those employing childcare workers at home: If a nanny is paid less than $15,000 per year (and most are) she (or he) will get more take-home pay and her employer will save money and not be required to file quarterly tax forms.

In the real world, where American factories compete with those in Mexico and Korea, this reform will make the United States much more competitive. Take, for example, an assembly worker paid $7.50 an hour to put electronic products together. He or she now makes $15,000 in gross salary, and nets several thousand dollars less because of taxes, including a substantial social security tax bite of $1,122.50, nearly $100 a month. The employee will get an immediate raise in take-home pay. At the same time, the employer will save an equal amount for each employee. With 100 employees, a tidy $100,000 will be added to the employer's bottom line. The employer will thus improve its profitability and be more likely to keep its plant in the United States open for business.

Who else will this reform benefit? Students are often paid under $7.50 per hour. Restaurant workers, many in the textile industry and in general those in semiskilled occupations will benefit. Those earning more than $68,400 per year will pay more social security taxes, but even the rich will benefit by saving taxes (and paperwork) for their nannies, servants and chauffeurs. And if they own a business, the rich will benefit from the new exemption. This change will give America what it needs, a raise, while benefiting the economy and the Social Security Trust Fund at the same time.