S. HRG. 109–554

THE ROLE OF THE FINANCIAL MARKETS IN SOCIAL SECURITY REFORM

HEARING

BEFORE THE

SUBCOMMITTEE ON SECURITIES AND INVESTMENT

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

ON

THE ROLE OF THE FINANCIAL MARKETS IN SOCIAL SECURITY REFORM, FOCUSING ON THE FEDERAL THRIFT SAVINGS PLAN, PERSONAL RETIREMENT SAVINGS ACCOUNTS, AND RETIREMENT PLAN ADMINISTRATIVE COSTS

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C O N T E N T S

TUESDAY, JULY 14, 2005

WITNESSES

THE ROLE OF THE FINANCIAL MARKETS IN SOCIAL SECURITY REFORM

TUESDAY, JUNE 14, 2005

U.S. SENATE,
SUBCOMMITTEE ON SECURITIES AND INVESTMENT,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee met at 2:07 p.m., in room SD–538, Dirksen Senate Office Building, Senator Chuck Hagel, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF SENATOR CHUCK HAGEL

Senator HAGEL. Good morning, the hearing will come to order.

For 70 years Social Security has been one of the most successful and important Government programs in our country. Almost every American family during this time has been touched in some way by Social Security.

However, the Social Security system is actuarially unsustainable as it now exists. The Social Security system is not in crisis today, but there is clearly a crisis on the horizon.

America faces a $4 trillion deficit in Social Security over the next 75 years. In 2017, more money will be paid out of Social Security than comes in. In 2041, Social Security will be insolvent. Beyond the next 75 years there is only a black hole of unfunded liability for future generations.

The longer we wait to address this issue, the more difficult it will be to protect Social Security and the promise our Government has made to future generations of Americans.

Today's hearing will examine what role financial markets will play in Social Security reform. It is important what risks there are, how they might be managed, what kind of fiduciary responsibility would be required of Government officials, and how a personal account system might work.

The Federal Thrift Savings Plan, TSP, provides a model we can review that gives us a better understanding of these issues. Since taking effect in 1987, TSP has been a success for Government employees. Last year, returns on the different accounts range from just over 4 percent to 20 percent. And over the last 10 years, the returns have been between 5.5 percent and 12 percent. Barclays Global Investors is the investment managing firm for TSP.

Today's hearing will look at the TSP model and focus on the operational issues that the Federal Retirement Thrift Investigation Board and Barclays face in managing the TSP accounts, the different costs and fees associated with the operation of these accounts, the bidding process that TSP employs to hire private investment firms, the different investment options that TSP offers, and how effectively the TSP model could be applied to broader Social Security reform.

In assessing the role of the financial markets in Social Security reform, we need to look at the market impact for private investors. If the Federal Government became a big operator in the marketplace and had to manage 100 million accounts, then what impact would there be on the broader marketplace? What procedures would need to be implemented to ensure that this impact is minimal and managed?

In 1997, former Senate Banking Committee Chairman Phil Gramm said that without strict procedures, this would be like being in a rowboat with an elephant. When the Government moved in the boat, you would know it. How can we minimize this impact? Or can we minimize this impact?

I welcome our distinguished witnesses today that will help us explore these issues and thank them for their important contributions. Before I ask my distinguished colleague, the Senator from Connecticut, for his remarks, I would quickly introduce the panel, and then after Senator Dodd's remarks, we will address each of your testimonies.

Gary Amelio, the current Executive Director of the Federal Retirement Thrift Investment Board; Francis Enderle, Chief Investment Adviser for Barclays Global Investors; Francis Cavanaugh, Consultant for Public Finance Consulting, and the former Executive Director of the Federal Retirement Thrift Investment Board; Mike Tanner, Director of the Cato Institute's Project on Social Security Choice; David John, Research Fellow for the Heritage Foundation; and Jason Furman, Nonresident Senior Fellow at the Center on Budget and Policy Priorities, and also a Visiting Scholar at New York University's Wagner Graduate School of Public Service.

Gentlemen, we thank each of you for your time and for your contributions to this panel, and I would now ask my distinguished colleague, Senator Dodd, for his remarks.

STATEMENT OF SENATOR CHRISTOPHER J. DODD

Senator DODD. Thank you very much, Mr. Chairman, and my apologies to you for arriving a couple minutes late, finishing up our conference lunches as we do on Tuesdays around here. But I thank you for doing this.

There are a number of proposals that are kicking around, including ones that I know the Chairman has proposed, on how to address the issue of Social Security in the coming years. So, I think it is highly appropriate that this Subcommittee, which deals with securities and investment, to hold a hearing on the Social Security reform debate. It is appropriate and the right thing to do. In fact, as you have just pointed out, in 1997, when I was still a Member of this Subcommittee, Senator Phil Gramm, our former colleague, held a hearing on the very same subject matter regarding Social Security. In fact, at that hearing, Mr. Tanner, you testified in 1997.

Mr. TANNER. Yes, sir.

Senator DODD. How are you doing?

Mr. TANNER. Keeping busy.

Senator DODD. It has been a long time, 8 years. Welcome back to the Committee.

Anyway, throughout my tenure in the Senate, Mr. Chairman, I have always been interested in ways in which we can strengthen retirement security in the country, including expanding the individual retirement accounts and improving pension plans. In fact, one of the first bills I authored as a freshman Member of this body back in the early 1980's was on individual retirement accounts. I recall at the time when we offered the legislation, there was editorial comment that this was only going to serve my more affluent constituents in Fairfield County. And then Merrill Lynch did a study back in the early 1980's demonstrating that even people with incomes of $20,000 were investing in individual retirement accounts. They were doing it usually the day before their taxes were due. They were not taking it earlier in the year because of the lack of disposable income. But clearly IRAs were a wonderful vehicle for expanding and increased retirement security.

Any of these financial instruments, of course, in my view are essential to millions of Americans in helping to provide for retirement and their family's financial security. Moreover, they have helped our economy by encouraging private savings, which have become dangerously low, I might add, in recent years.

However, let me just say briefly in these opening remarks, I have deep reservations about the current proposals by the Administration and others to divert funds from Social Security into the private marketplace, and let me explain why.

I believe there is legitimacy to the concern that the Social Security Trust Fund will, over the coming decades, have some serious financial difficulties. It is altogether appropriate and not too soon to look at ways to keep Social Security strong and vibrant for future generations of retirees. However, in my view, the Administration's proposal is fundamentally flawed for at least three reasons.

First, by diverting money away from the Social Security trust fund, I believe we exacerbate the insolvency concerns rather than improve the health of the fund. Most observers believe that even under the most dire predictions, about 80 percent of the Social Security trust fund will be in place in the decades of the 2020's, 2040's, or 2050's, that we will have about a 20- to 25-percent shortfall that we will have to deal with. And certainly we need to address that, but I think by diverting funds away from Social Security, we will make that problem even more serious.

Second, the proposal of the Administration increases the national debt by over $5 trillion. Even the Vice President acknowledges that number. And I do not take lightly the thought of putting $5 trillion more of debt on our children and future generations.

Third, in my view the proposal requires a reduction in guaranteed Social Security benefits for most retirees. Social Security is critical not only to senior citizens but also to the fabric of our society. There are approximately 47 million of our fellow Americans who receive Social Security benefits of one kind or another. It is the sole source of income for one-fifth of all seniors and it is the primary source of income for two-thirds of seniors.

Social Security reduces the poverty rate among seniors from about 50 percent to about 10 percent in our Nation. Beyond its retirement benefits, Social Security provides critical support for the disabled and for the surviving family members of workers who die. Only about 30 percent of workers would have access to long-term disability benefits absent Social Security.

I believe that as we address the issues of Social Security reform, we need to keep a few basic principles in mind. One, do no harm. The goal is to strengthen Social Security. Let us agree to strengthen Social Security, not dismantle it by agreeing not to divert any money out of the trust fund.

Second, we need to create new opportunities in addition to Social Security to enhance retirement security. For Americans to save for their retirement, for one, we should do more in that area. Our national savings rate, as I mentioned earlier, is abysmally low. We should use the tax code and other means to reward and incentivize savings and help Americans with their long-term retirement needs.

Third, we need to come and to work together in a bipartisan fashion, which we are not doing enough of in this area. Providing for the retirement of future generations of Americans is far too important of an issue to become part of a game of partisan football.

Once again, I want to thank the Chairman, Senator Hagel, for his thoughtful proposals as he has attempted to address this issue and for giving this Subcommittee a chance to be heard on the issue and for inviting such a distinguished panel of witnesses to share their thoughts. I look forward to their this.

Senator HAGEL. Senator Dodd, thank you.

Let us begin with Mr. Amelio. Again, Mr. Amelio is the Executive Director, Federal Thrift Retirement Investment Board.

Mr. Amelio, welcome. Thank you.

STATEMENT OF GARY A. AMELIO EXECUTIVE DIRECTOR, FEDERAL RETIREMENT THRIFT INVESTMENT BOARD

Mr. AMELIO. Thank you. Good morning, Chairman Hagel and Senator Dodd. My name is Gary Amelio, and I am the Executive Director of the Federal Retirement Thrift Investment Board, an independent agency charged with administering the Thrift Savings Plan. I serve as the managing fiduciary of the TSP. Prior to my appointment on June 1, 2003, I had 23 years of private sector experience in the employee benefits industry. Although the Board has no expressed position regarding proposals to change Social Security, I am pleased to discuss TSP operations and investments.

Since 1987, the TSP has grown to 3.4 million participants with a total of $157 billion in account balances. I often comment that Congress could not have provided a better structure when it created the TSP, fashioning the plan with the goal of providing retirement savings for Federal employees at low administrative costs, with a limited number of funds that track broad investment markets. This simplified structure has protected the plan from political manipulation and, consequently, enabled the TSP to gain the confidence of Federal employees and become the largest and, arguably, most successful defined contribution plan in the world.

The TSP's participation rate significantly exceeds the industry average, primarily, I believe, because participants find the plan simple to grasp. The TSP participants also enjoy low administrative costs. Last year, expenses were just six basis points or 60 cents for every $1,000, which is rock-bottom in the industry. I like to say that the TSP is the most inexpensive legal investment in the world. It might also be the most inexpensive illegal investment, but we do not have any data.

Through the years, the TSP and the Congress have worked together to improve the plan. The TSP recently modernized its recordkeeping system to accommodate daily valuation, and in the next couple of months, lifecycle funds will be available to provide professionally designed asset allocation models appropriate for participants' investment time horizons.

Last year, Congress improved the plan by approving the Board's recommendation to eliminate open seasons. In 1986, the concept of allowing Federal employees to invest in a retirement savings plan, which included private securities, was untested. By mandating a sound and simple structure protected from political manipulation, Congress created a plan which passed the test, gained the confidence of Federal employees, and strengthened their retirement security.

This concludes my summary comments, and I ask that my extensive written statement be entered into the record. I would be pleased to respond to any questions.

Senator HAGEL. Mr. Amelio, thank you. Each of your written statements will be included for the record, in their entirety.

Mr. Enderle is Chief Investment Adviser, Barclays Global Investors.

Mr. Enderle.

STATEMENT OF FRANCIS ENDERLE MANAGING DIRECTOR AND CHIEF INVESTMENT OFFICER GLOBAL INDEX AND MARKETS GROUP, BARCLAYS GLOBAL INVESTORS

Mr. ENDERLE. Good afternoon, Mr. Chairman, Senator Dodd. My name is Francis Enderle, and I am the Chief Investment Officer for the Global Index and Markets Group at Barclays Global Investors, or BGI. In that role I am responsible for, among other things, the oversight of portfolio management in the United States of all of BGI's index strategies.

We are pleased to be here today to share with the Subcommittee our expertise in the management of defined contribution pension accounts, which is derived from our experience as the external asset manager for the Federal Thrift Savings Plan, or the TSP, as well as for other numerous public and private pension plans. We are honored to have served as an investment manager for the TSP since 1988, a relationship we have retained in regular, highly competitive bidding processes.

Since our founding in 1971, BGI has remained true to a single global investment philosophy, which we call "Total Performance Management." BGI manages performance through the core disciplines of risk, return, and cost management. The success of our indexing methodology results from our focus on delivering superior investment results over time while minimizing trading and other implementation costs and rigorously controlling investment and operational risks.

BGI manages four of the five investment options available for TSP participants: The C, S, F, and I funds. The fifth option, the G Fund, is managed by the U.S. Treasury. Later this year, the TSP will be launching a series of lifecycle or "target horizon" funds that use the existing five options as the asset class building blocks with allocations in each lifecycle fund across these options being determined by an external vendor.

BGI's services to the TSP are completely focused on our core expertise—investment management. We do not provide any other services. We have an extremely effective operating model developed in conjunction with TSP staff to manage the daily cashflows into or out of each of the investment options.

The key to BGI's success in index management has been our ability to minimize implementation and trading costs. High costs and expenses of investing detract from performance and investment returns; lower costs increase the investment pool and put more money long-term into the pockets of investors. Let me say a few words about how we do this.

Each of our index funds is structured to match the performance of a specific third-party-designed index. These indexes are really paper portfolios and do not include any of the trading costs that real-world investors experience. To successfully track the index as closely as possible, BGI strives to minimize the real-world costs through a variety of highly efficient trading approaches.

The average account size for our U.S. clients is $880 million. Through the size and diversity of our client base, we are able to match or offset a significant percentage of many of our clients' buy and sell orders internally, thereby reducing or eliminating market transaction costs. The internal matching of buy and sell orders is commonly referred to as "crossing" and is conducted and actively monitored by BGI pursuant to the terms and conditions of an exemption issued by the Department of Labor.

When we do trade in the markets, we utilize carefully developed and managed trading strategies. We access all possible sources of liquidity, including electronic marketplaces. And we ensure that we receive superior execution.

Indexing is the most cost-efficient and diversified way to gain exposure to various segments of the capital markets. We believe index funds are the best core investment for most investors' portfolios, whether they are the largest pension fund in the world or an individual investor.

I would now like to make a few comments regarding the investment-related issues to be considered if the Federal Government were to legislate individual investment accounts either as part of Social Security reform or through another mechanism.

Let me first acknowledge that BGI has built a substantial part of its business by offering well-managed index strategies to our clients for more than 30 years. We, therefore, have a vested interest in the continued growth of index investing. Our interests aside, we firmly believe that the reason for the success of these strategies is the simple fact that they deliver the return of the market index reliably and cost effectively. In fact, Congress recognized this itself in the enabling legislation for the TSP.

If a national system of personal accounts were to be implemented, we would encourage legislators to consider the following approach that draws on the best practices of institutional investors.

An array of low-cost, broadly diversified index funds frequently forms the core investment for institutional pension plans. For example, the current selection offered to TSP participants covers all the main asset classes, large and small capitalization U.S. equities, U.S. fixed income, international equities, and a stable value option.

We suggest consideration of index portfolios because they offer three principal benefits to investors: First, they capture the return of each asset class with a high degree of precision; second, index funds typically have low asset management fees compared to actively managed funds; and, third, index funds have lower relative transaction costs including communications, bid/ask spreads, and market impact.

The latter point is worth elaborating upon given the sizable assets that would potentially be invested in personal accounts. Investing in index funds spreads assets across the broadest possible array of securities in any asset class, thereby minimizing the impact of trading large cashflows in the market on a daily basis. This is not only important for the investment of new monies into personal accounts, but also for any trading individuals may initiated in their personal accounts to reallocate assets among their investment options over time.

Another investment option to be considered is an array of so-called lifecycle or "target horizon" funds, options that the TSP will be adding later this year, as I mentioned earlier. With lifecycle funds, potentially the only choice an investor needs to make is to select the lifecycle fund with the target horizon date that most closely matches the investor's date of retirement. Each lifecycle fund would hold an array of asset classes with each asset class being implemented with an index fund. The asset mix within each lifecycle fund would gradually become more conservative over time as the target horizon date approached.

Mr. Chairman, we believe that the investment considerations we have discussed will assist you and others on this Committee in evaluating the criteria to be used if personal accounts were to be legislated by Congress as part of revisions to the Social Security program or in another program. I thank you for the opportunity to speak with you today, and I look forward to answering any questions you may have.

Senator HAGEL. Mr. Enderle, thank you.

Now we would ask Mr. Francis Cavanaugh to present his testimony. Mr. Cavanaugh is a Consultant for Public Finance Consulting and former Executive Director of the Federal Retirement Thrift Investment Board.

Mr. Cavanaugh.

STATEMENT OF FRANCIS X. CAVANAUGH FORMER DIRECTOR, FEDERAL RETIREMENT THRIFT INVESTMENT BOARD

Mr. CAVANAUGH. Thank you, Mr. Chairman and Members of the Committee, I welcome this opportunity to discuss the role of financial markets in Social Security reform. The Administration's current proposal for Social Security individual accounts contemplates that private financial institutions would provide fund management services and probably other 401(k) plan services, such as investment education, counseling, and recordkeeping. My comments will focus on the cost of such services and the problems in providing them to employees of small businesses.

A critical question, of course, is cost. Individual accounts are proposed to provide a higher investment return than would be realized by the Social Security trust fund. On this basis, individual accounts would not be feasible for the 68 million employees of 98 percent of the businesses in the United States—that is, the 5.6 million small businesses with fewer than 100 employees.

To understand the costs of individual accounts of small businesses, we must first understand why 85 percent of them do not now have retirement plans for their employees. A major reason is that the 401(k) industry has found that it cannot profitably provide services for a company for less than approximately $3,000 a year, even though they enjoy economies of scale from combining thousands of employers in their centralized computer systems. Further significant economies of scale would not be realized by a central Federal Thrift Savings Plan-type agency because of the fixed costs of reaching out to millions of small businesses. Nor can we assume that a new central Government agency would be more efficient than the major 401(k) providers who now serve this market.

Thus, the cost per employee of a company with 10 employees would be $300, or 30 percent of the President's proposed annual individual account contribution of $1,000, and most U.S. companies have fewer than 10 employees.

Accordingly, the initial expense ratio for employees of the average size business would be more than 3,000 basis points, or 100 times the Administration's estimate of 30 basis points. Obviously, since the administrative costs of individual accounts would exceed their estimated investment returns, substantial Government subsidies would be necessary to make individual accounts attractive to employees of small business.

If all Social Security taxpayers eventually participate in the individual account program, you would find that the administrative costs would be more than $46 billion a year—that is, 155 million Social Security taxpayers times more than $300 per account—which would be a subsidy to support an uneconomic function.

In addition to the above costs, which are based on what the current providers are actually charging for establishing and servicing 401(k) plans, there are overwhelming practical obstacles to modeling individual accounts on the TSP or private 401(k) plans.

First, the TSP is administered by just one employer—the U.S. Government—with an extensive network of agency personnel, payroll, and systems staff to provide the essential employee education, retirement counseling, payroll deductions, timely funds transfers, and error correction functions. These essential employer services in 401(k) plans could not possibly be performed by small business employers or by a new TSP central agency.

Second, the TSP is computerized, like all other large plans, with investments made promptly after contributions are deducted from the employee's paycheck. With individual accounts, it would be up to 22 months after payday under current Social Security Administration procedures before individual accounts could be credited and invested.

Third, the TSP is balanced to the penny every day. Social Security is never balanced. Each year there are billions of dollars unreconciled discrepancies.

Fourth, the TSP and the Federal employee agencies have a very effective system of communication. TSP mailings consistently have reached more than 99 percent of employees, but 25 percent of Social Security Administration mailings are returned and marked as undeliverable.

Since individual accounts are certainly not feasible for employees of small business, the only practical way to give them higher returns is to invest part of the Social Security trust fund in equities. The likely increase in trust fund earnings would be an effective way to help maintain the solvency of the trust fund. Every State in the United States has authorized public retirement fund investment in stocks, which can now be done through broad-based index funds, which avoid the problem of direct Government control over particular companies. As shown in my prepared statement, there is even less Government influence over private companies under the trust fund alternative than under the TSP or the Administration's plan.

In conclusion, the Administration's plan for universal individual accounts is not feasible. The way for the Social Security system to capture the higher returns available for investments in stocks is to diversify Social Security trust fund investments. The trust fund alternative compared to individual accounts would be less disruptive of financial markets, would save tens of billions of dollars a year in administrative costs, and would be effective virtually immediately rather than the 2009 starting date proposed for individual accounts. The multitrillion-dollar transition costs of individual accounts would be avoided completely. The additional trust fund earnings would go a long way toward strengthening Social Security finances and would thus reduce if not eliminate the need for significant tax increases or benefit reductions.

Thank you for your attention. I will be happy to answer any questions.

Senator HAGEL. Mr. Cavanaugh, thank you.

Mr. Mike Tanner, the Director of the Project on Social Security Choice, the Cato Institute, an old friend of Senator Dodd's.

[Laughter.]

Mr. Tanner, welcome.

STATEMENT OF MICHAEL TANNER
DIRECTOR, CATO PROJECT ON SOCIAL SECURITY CHOICE

Mr. TANNER. Thank you, Mr. Chairman and Members of the Subcommittee, it is a pleasure to be back before the subcommittee again, and in particular, Mr. Chairman, I would like to thank you for holding this hearing. I think it is very important that we move beyond the sterile debate that we have been having about whether or not Social Security is facing a crisis or just a big problem and start discussing actual solutions to the problems that Social Security is facing. That includes a discussion of how individual accounts might be structured in ways that can maximize consumer choice and control while ensuring efficiency, low cost, and preserving an appropriate measure of worker protection.

Of course, along with my colleagues at the Cato Institute, I believe that Social Security reform must allow younger workers to save and invest some of their Social Security taxes through personal accounts. Such accounts can significantly contribute to restoring Social Security to permanent sustainable solvency. But, more important, I believe that personal accounts are essential to modernizing Social Security in keeping with such fundamental American values as ownership, inheritability, and choice.

Now, regarding the subject of this hearing, I think, in general, economic theory holds that private capital investment should provide a higher rate of return than a mature PAYGO Social Security system can provide. I believe that while there are distribution questions and certainly other issues that must be addressed, the returns from personal accounts privately invested will exceed the returns that Social Security will provide in the future to younger workers, including exceeding any offset interest rates such as those suggested under the President's reform proposal.

That said, how personal accounts are structured and the investment options available to workers can make a significant difference in the success of any personal account proposal. In short, details matter.

In designing an investment and administrative structure for personal accounts, I would urge Congress to be guided by these basic concerns.

First, simplicity and transparency. Workers should clearly understand where their money is going and what their options are. Where personal account plans have encountered difficulties, such as in Great Britain, it has been primarily due to overly opaque or overly complex schemes.

Second, balancing risk and return. While market returns, as I say, are expected to exceed Social Security returns, markets are not risk free. Of course, I would also note that the current Social Security system is not risk free. However, many of the new investors brought into the market through personal accounts will be inexperienced. Bringing these new investors into the marketplace is a good thing, but we should recognize that they will not be sophisticated investors. A personal account investment plan must offer these individuals some degree of protection without stifling consumer choice, overregulating markets, or unduly restricting the potential for positive returns.

Third, keep administrative costs low. While regulation of account fees would be unwise, accounts should be designed in ways that minimize administrative costs. The Social Security Administration estimates that accounts would cost 25 to 30 basis points to administer, and I believe this is an entirely reasonable target.

Fourth, limit Government involvement in investment decisions. Decisions about the investment of the accumulating retirement funds should be left to private markets and insulated from Government interference as much as possible. And I note that Government interference takes place to a high degree with State, county, and municipal pension funds.

Finally, avoid increased employer burden. Every effort should be made to avoid any new burden on employers, particularly small employers.

In my written testimony I have spelled out one possible structure for meeting these goals. That proposal involves a centralized colleague point, essentially the current payroll tax collection mechanism. Treasury would be responsible for holding the funds until reconciliation takes place with the funds being held in a money market account on a unitized dollar basis.

Once reconciliation takes place, Treasury would electronically transfer the funds to the worker's account. Initially, a small range of broadly diversified funds would be the only investment options available, something perhaps similar to the TSP, perhaps a series of balanced funds, perhaps a lifecycle fund, the type of options that have been discussed and are included in many of the proposals up here, including the Chairman's and Senator Sununu's. However, at some point—and I think this is essential—a broader range of investment choices should be opened up to individual investors.

Let me conclude by saying that I believe that Social Security reform is not an option but a necessity. The program will begin running a deficit in just 12 years and faces unfunded obligations of roughly $12.8 trillion in the future. The need for reform, however, presents us with an opportunity to create a new and better retirement program for all Americans, a program that gives workers ownership over their retirement funds, more choice and control over their money, and the opportunity to build a nest egg of real inheritable wealth. Therefore, any Social Security reform should include personal accounts.

That makes the work of this Committee all the more important: Getting the design and the structure of the accounts right. I believe that the structure I have set out today takes us in that direction, and I look forward to the Committee's questions.

Thank you very much.

Senator HAGEL. Mr. Tanner, thank you.

Mr. David John, Research Fellow, the Heritage Foundation.

Mr. John, welcome.

STATEMENT OF DAVID C. JOHN
RESEARCH FELLOW, THOMAS A. ROE INSTITUTE FOR ECONOMIC POLICY STUDIES, THE HERITAGE FOUNDATION

Mr. JOHN. Thank you very much for having me, and thank you for looking into this issue. This is going to be one of the key issues not just in the Social Security debate but in the overall retirement security debate. I have a 19-year-old daughter who just finished her first year of nursing school, and the simple fact is that when Meredith retires, Social Security is not going to be able to replace the same amount of her income as it does for her parents or as it will for me. Meredith, no matter what, is going to have to save and invest from day one when she first gets a job in order to come up with a decent retirement income.

Now, we have a very effective and efficient private retirement system—401(k)'s, IRA's, et cetera, et cetera. And it is fairly simple for Meredith to save if she has a 401(k) and works in a large hospital. But if she is a private-duty nurse or if she is working essentially for herself, she is likely to have no choice in the slightest because obviously she cannot sponsor her own 401(k) plan for, frankly, reasons that Mr. Cavanaugh mentioned. So a TSP structure not only could apply to a Social Security account, but it also could be used in terms of expanding the opportunities of ordinary Americans to save for retirement.

Now, having said that, let me suggest that the TSP structure is especially useful for a Social Security account. It is vastly different from the 401(k) structure that we see in private business for the simple fact that it is administered through the tax system. The individual business owner has no participation in this. The individual business owner would provide or forward the payroll taxes and income taxes of their workers to Treasury, just as they do now, and at that point their responsibility ends. They have no additional costs. They have no additional participation. It is once the money reaches Treasury that it is then subdivided and moved into a personal retirement account, and there are mechanisms to do that efficiently, and, frankly, that can be done as easily on an annual basis as it would be on a weekly, a monthly, or a yearly basis.

Now, Social Security accounts should start slowly, with limited investment options. This is the way TSP started. Initially, there was only the G Fund, and the other investment options were added at a later date. The last two investment options are relatively recent. A study by State Street Trust, which is one of the major pension administrators in the country, looking at a system which, by coincidence, happens to be the one that most Social Security reformers are talking about, found that the costs could be somewhere between 0.19 percent of assets under management and 0.35 percent of assets under management.

Now, what that basically is a very tiny amount, one-third of 1 percent at the most. Unfortunately, there is no way of comparing the costs of a 401(k) system or the TSP system to today's Social Security because when it comes right down to it, today's Social Security does not have a trust fund of the type that traditional pension plans have, nor are Social Security benefits paid out of that trust fund. They are basically paid on a pay-as-you-go basis. So it is impossible to compare apples and oranges in this situation.

But what we can say is that a TSP account would be the lowest-cost opportunity for an individual worker to build retirement savings. The best way to do that also would be through a lifespan account—they are alternately called lifespan, lifestyle; "life" is the key element there—which automatically rebalances the investments starting out with a more aggressive investment structure when an individual is very young and moving to a much more conservative structure by the time the individual reaches retirement age.

There are 55 companies that currently offer lifespan accounts as part of their 401(k) plans. The initial estimates show that having a lifespan account actually can increase the amount of retirement savings that an average worker could have, including the lower-income workers, by roughly one-eighth. They do not have to be expensive. Vanguard has an investment in passively traded index funds, similar to the ones that were discussed earlier here, and their annual cost is 0.23 percent, roughly one-quarter of 1 percent of assets under management.

This is not a theoretical question. This is not a question of millions, billions, and trillions. This affects real people. My daughter is 19 at the moment. She will retire roughly 10 years after the Social Security trust fund disappears. Under current law, that means she stands a 30-percent benefit cut in her Social Security benefits. If we structure soon a retirement investment plan similar to the TSP system that she could participate in from day one when she goes to work, she could end up with significantly higher Social Security benefits than what she would face right now. In 2040, when Meredith is 56, under current law the Social Security system—and there will be trust funds at that point—will take 15 cents on every dollar of income tax that is collected in that year. Fifty cents of every dollar collected in income tax that year goes to Medicare.

Now, unless action is done quickly on Social Security, Meredith basically faces a choice of funding programs for her kids and her grandkids or for her parents and grandparents. That is not a situation she needs to be in.

Action is needed quickly, and practical action that actually gives her a decent chance to a secure retirement system.

Thank you.

Senator HAGEL. Mr. John, thank you very much.

Mr. Jason Furman, Adjunct Professor, Wagner Graduate School of Public Service, New York University.

Mr. Furman.

STATEMENT OF JASON FURMAN NON-RESIDENT SENIOR FELLOW, CENTER ON BUDGET AND POLICY PRIORITIES AND VISITING SCHOLAR, WAGNER GRADUATE SCHOOL OF PUBLIC SERVICE, NEW YORK UNIVERSITY

Mr. FURMAN. Mr. Chairman, Members of the Committee, thank you for the opportunity to address the Subcommittee. In considering reforms that would dramatically change the nature of Social Security, it is critical to consider how individual accounts would be administered through the financial system and how markets would react to the borrowing necessary to finance accounts.

In my comments today, I would like to focus on four points: The administrative costs associated with accounts; the Government staffing required for those accounts; what this would do to the rate of return that average Americans could expect through Social Security; and the impact of large-scale borrowing on financial markets.

First, administrative costs in a private account system would be at least 10 times as large as the costs under the current system. In some proposals, administrative costs could eat up more than one-third of final account balances. Even the sharpest critics of our current system admit that Social Security is extremely efficient. Establishing over 100 million individual accounts for Social Security contributors would entail substantial new complexities and tasks, including tracking contributions, allocating them to different investments, managing assets, and distributing balances at retirement. All of these new tasks would be in addition to everything Social Security does today.

The President's account proposal controls administrative costs by limiting choice and services to a bare minimum, including establish centralized Government management of the accounts. According to the Social Security actuaries, even this barebones system would cost 10 times more to administer than the current Social Security system. Accumulated over 40 years, 0.3 percent annual sounds very low, but if you accumulate it over 40 years, it will eat up 7 percent of your ultimate account balance because that first contribution you pay 30 cents on it year after year. That is compared to 0.6 percent under the traditional Social Security system, and these estimates do not even include the cost of starting up accounts, partially annuitizing account balances at retirement, and many of the considerations that Mr. Cavanaugh raised in his testimony.

Even if an individual account plan initially offered only a few funds, it is likely that political pressure would expand the options over time, as recommended by the President's Social Security Commission and Mr. Tanner and Mr. John at this hearing. Participants might demand more options for managing their money, and some might object to being required to invest in a Government-designated allocation of stocks, which includes companies that, for example, are perceived to harm the environment or support gay rights. If investment choices were widened even slightly to address these concerns, costs could double to about 15 percent of the final account balance.

If the President's Government-organized accounts approach is rejected and privately organized accounts, like existing IRA's, are established instead, costs would be even higher. In the United Kingdom, for example, administrative costs were eating up a staggering 43 percent of the final account value at retirement before caps on fees were recently instituted.

My second point: Establishing accounts would require a substantial increase in Government staffing, likely in the form of a new Government agency that could be about half the size of the IRS or the Social Security Administration. The Clinton Administration Treasury Department found that tens of thousands of new Government workers would be needed to answer phone inquiries and process worker choices of fund managers in a barebones system. With even slightly expanded choice along the lines of what we have heard advocated today, that number could triple.

By the end of the first decade of President Bush's proposal, administrative costs would be running at about $4.4 billion annually, according to the optimistic estimates of the Social Security actuaries, enough to support about 30,000 new Government employees in addition to other expenses. By comparison, currently SSA has a total staff of about 65,000 and the IRS has a staff of about 100,000.

My third point: When administrative costs are considered, returns from many participants under a private account system would be lower than in a reformed system without accounts. Additional administrative costs associated with individual accounts are certain. Potential gains from accounts, however, are uncertain. The President's proposal allows workers to, in effect, borrow money at the Treasury bond rate and invest it in a restricted range of funds. At the end of the day, the worker would have to pay the large administrative costs of managing this awkward system. Far superior for most workers would be simply to, if they want to increase their exposure to risk, reallocate their portfolio, and if they have no exposure to risk, to do some of the measures that Senator Dodd was talking about to encourage more investment without replacing part of the very efficient Social Security system with a substantially less efficient system.

The administrative costs for the average worker would be substantial, reducing annual benefits anywhere from $700 a year to $4,000 a year. That is on top of all the other benefit reductions the President is proposing. As a result, the Social Security system would have a lower rate of return for a large fraction of workers than a system without accounts.

Fourth, the increase in the debt associated with establishing private accounts would increase the risks facing financial markets and fiscal policies. Carveout accounts and add-on accounts that are not paid for both result in substantial increases in the debt. In the President's plan, the debt would go up by $5 trillion over the first 20 years. Economist Martin Feldstein advised President Reagan not to establish individual accounts, in part because, "to fund investment-based accounts would have required a tax increase or an even larger overall budget deficit." According to Harvey Rosen, who just last week stepped down as Chairman of President Bush's Council of Economic Advisers, diverting funds into private accounts would either drive interest rates up, stock returns down, or some combination of both.

Private accounts could create more difficulties for beneficiaries in markets than I have time to document. Instead of proceeding down that road, we can instead modify the current system to make it sustainably solvent and help make it easier and more automatic to save through existing IRA's and 401(k)'s without incurring the costs and risks associated with replacing Social Security with accounts.

I look forward to the opportunity to discuss this and other questions with you. Thank you.

Senator HAGEL. Mr. Furman, thank you.

Since there are three of us here at this point, I would ask Senator Dodd if we would do an 8- to 10-minute round, each of us. Is that acceptable? Then we will keep cycling. I suspect we may have some other colleagues as well. So we will start with 8-minute rounds of questioning. Thank you.

Mr. Amelio, in your testimony, and in the testimony of each of you, you have touched upon a fee structure and fees and the relevancy of that challenge, which I think we all agree is a big part of any kind of personal account structure. And you had noted, I believe, Mr. Amelio, that it was six basis points, 60 cents per $1,000, essentially the standard that we have now—or you have come up with, and, in fact, is the real number for TSP.

My question is this: What rules or procedures has TSP implemented to foster responsible fiduciary management and accountability in relationship to those fees and other parts of the structure that your colleagues and you have touched upon in your testimony?

Mr. AMELIO. They are 6 basis points and they are coming down. We anticipate they will possibly be 5 basis points this year. That comes to approximately $27 per participant. I think there are 4 reasons that our fees are able to be so low. One is the girth of the plan. We have a large amount of assets. That helps to keep the average of the cost sized down. Two, we use only index funds which are the least expensive investment model that I think any fiduciary could select for an institution plan. Three, although it is a daily plan where participants are allowed to move their money daily, go onto a website and see their balances, it is a simple plan and that I am very proud of. We have only 5 investment options, and even when you add the lifecycle funds they are not funds with a capital "F," they are asset allocation strategies and it is that simplicity that also helps us to maintain low cost. Fourth is self-administration. We are large enough that we are able to administer everything in house. They noted the Social Security Administration has 65,000 employees. When I came 3 years ago, we had 108 employees at the TSP. We are down to 89 now. We do have outside contractors of a couple hundred. Through good management, we have an independent board, and I think for those four reasons we are able to maintain the low cost that we have.

Senator HAGEL. I am going to ask in a moment Mr. Cavanaugh, and Mr. Furman especially, to respond to this issue because they both touched upon it and I think have some different judgments on what it would take to put 100 million or 200 million accounts online.

But what I want to do is take what you have just said now and have you respond to this question. Obviously, with a Social Security account structure we are talking about far more accounts, and as you have heard the testimony of your colleagues, specifically Mr. Cavanaugh and Mr. Furman, who touched upon the kind of administrative costs and infrastructure that would be required. It has been mentioned in a couple of the testimonies here, telephone answerers, handlers, taking inquiries. Relate their testimony and some of their observations and judgments to what you are doing now, and then in your mind, what would it take to put 100 million accounts online?

Mr. AMELIO. I need to couch my answers within the confines of the TSP. I have been advised by our counsel I cannot make any direct comments about a Social Security proposal. So, I hope you understand that.

Senator HAGEL. Let me make it easier for you and your attorneys. Let us just take Social Security out of it. What would it be, 100 million accounts? And let us just take Social Security out of it so that there is no liability for you. We do not want that.

Mr. AMELIO. Certainly, I understand, and I am not trying to be evasive.

Senator HAGEL. I understand.

Mr. AMELIO. We started out about 3 years ago with 200 telephone operators. We have 2.4 million participants. We are taking that number down probably to about 120 to 140 telephone operators. The reason we did that, most of our calls are administrative in nature, dealing with participant loans, and we toughen the standards for participants to take loans, and so therefore we were able to cut down.

If you are talking about expanding the participant base it might look more like private sector plans where the calls are more investment related. Very few of the calls we get right now are investment related about the funds. As you get more investment related, you not only increase the volume of the calls, but you also increase the length of the call from about 3 minutes on average to 6 minutes, and it necessitates in an arithmetic calculation all the more operators you need. I would have to sit down and run the numbers to see how many operators we would have to add. If we added another 80 million participants to our plan, I assume it would be a large number.

Senator HAGEL. Let me ask you this, you heard again what Mr. Cavanaugh and Mr. Furman said, and their numbers are pretty difficult to digest here as far as the reality of if we are really talking about seriously putting in place 100 million accounts, and some of the questions and the numbers that they have brought out. Do you disagree with those numbers? Do you disagree with those observations or judgments? Is this possible that we could put online 100 million accounts, and using TSP as some kind of a general model?

Mr. AMELIO. You may have apples and oranges. If you are talking about adding another 100 million participants to the plan you have to look at each of the functions. For example—and we have not really done the demographic study so I want to be careful here—you have several different segments. The easiest segment might be adding the participant account for recordkeeping itself. We have a huge computer and the IT people would work on it, but perhaps you could actually keep track of it.

If you go to the separate issue of adding telephone operators, I think that becomes more complex because you are talking about a large number of people, time zones, et cetera.

Where it gets even more complex is the collection of the contributions. Right now we have 130 payroll offices in the Federal Government. They are all computerized and they remit to us. On a daily basis we are getting payroll transactions. If you were adding 100 million people, it would not change as long as they were still in those 130 payroll offices, but if they had different payroll offices, paper submissions, it would make it a lot more complicated.

Senator HAGEL. Thank you.

Mr. Enderle, would you respond to that question since you manage the current accounts now?

Mr. ENDERLE. I think the key issues, as I think about 100 million accounts, can be split into two components. One is what Mr. Amelio just responded to as it pertains to the administration of those accounts. The second has to do with the actual asset management of those accounts. I think the key issues that we would need to think about has to do with whether or not the assets across all those accounts would be aggregated in some fashion, so that the number of accounts any money manager would manage would be limited.

So in the case of the current arrangement we have with the TSP we are currently managing four accounts on behalf of 3.4 or 3.5 million participants, and that type of arrangement is very leveraging and scaleable.

I think the key issues are how many fund options would be available and what the asset size would be for each account.

Senator HAGEL. Does that include the fee structure too that we were talking about earlier?

Mr. ENDERLE. I think the fee structure—I am not in a position to comment on the fees as it pertains to the costs associated with administering all the accounts, but more in respect to the fees that would be applicable to the asset management side of those assets.

Senator HAGEL. Thank you. My time is up.

Senator Dodd.

Senator DODD. Let us just pick up on that, because I think that is the point. You are talking about four basic accounts. It is a number of people but we have really limited choices under TSP, whereas what we are talking about here in individual accounts, the choices are far broader than what are offered under TSP. Is that not correct, Mr. Amelio?

Mr. AMELIO. The number of choices for what, Senator?

Senator DODD. Under the individual accounts that we are talking about here being proposed under the Social Security reforms?

Mr. AMELIO. I am not sure which proposal you are talking about.

Senator DODD. Let me ask Mr. Cavanaugh and Mr. Furman. We are talking about going from 3½ million to 100 million accounts, the Chairman's question, and that is a legitimate issue. But if you are dealing with limited choices there, then it is a numerical factor in terms of—where you add the element of broader choices that we are talking about here where they have a diversity of the asset management issues that Mr. Enderle talked about. Then you are adding an element here that I think goes to some of the cost issues. Maybe Mr. Cavanaugh and Mr. Furman would like to respond to the question that the Chairman asked to Mr. Amelio, and how you would respond to that question.

Mr. CAVANAUGH. I think the problem is not the 100 million accounts. The problem is, whereas the TSP is one employer, the U.S. Government, when you are talking about individual accounts, you are talking about 5.6 million employers and small businesses. You have to deal with each one of them. Part of the reason why the TSP administrative expense ratio is so low, 6 basis points, is because you have just one employer, and you have a contained environment. They are Federal employees, they are already there. When I started the plan, the first thing I did was to announce to everybody that, hey, I am a wholesaler. You Federal agencies out there in the field, you are doing the retail. They had the personnel structure. They had the payroll structure. They had the systems, electronics, and everything to do it.

And you, in your statute, when you created the Thrift Savings Plan, you instructed the Office of Personnel Management to train trainers in all of these Federal agencies so they could go back and teach all of the employees all about this plan. So we wholesaled and we had very low costs. And the agencies were already in place and there was no problem. That is essentially why, from my experience in setting the thing up, costs were so low, and they continue low. I think that is wonderful, and the agencies have wonderfully cooperated.

All 401(k) plans, including TSP, are employer-sponsored, employer-maintained, employers have the fiduciary responsibility. You cannot expect that of 5.6 million small businesses, barbershops and so on. They just cannot handle it, and no one is suggesting that they do. So who is going to do the retail? That is the critical question. It cannot be done by a new TSP-type central agency in Washington. It cannot be done by the employers, who now do all the 401(k) plans.

It would have to be done by the financial market, by the 401(k) providers that are now doing it for many companies. But the 401(k) providers, if you go on their websites, they tell you that if you have less than 10 employees, forget about it. There would not be enough employees to spread the cost over. And 60 percent of American businesses have less than 5, so it is just not doable. It is entirely different from the TSP which has nothing to do with it.

Senator DODD. One of the suggestions you make in your testimony that I think is not a bad one, as the Chairman goes forward with this, is to ask people like Citigroup and Fidelity Investments, Merrill Lynch, State Street Corporation, T. Rowe Price and others to testify because they are managing these things and you can get a pretty good read as to how have their 401(k)'s. In your testimony, you said they found that they cannot profitably provide these services for a company for less than approximately $3,000 a year even though we have for year enjoyed economies of scale from serving thousands of employers and their centralized company systems, but it would be interesting to hear what they have to say in all of that.

Let me go back to another issue, and Mr. Furman, you may want to come back and address this in a minute, but let me raise another issue if I can about the administrative costs. This is a big point here, and I appreciate you raising it here. Several of the witnesses obviously have talked about it. Mr. Cavanaugh in your testimony you go to great lengths to detail the administrative problems in the proposals of private accounts, specifically discuss the problem of timing, of placing contributions into private accounts, stating "Individual Social Security taxpayers are identified only once each year with their employer's annual income tax filings, and it would be up to 22 months after payday under the Social Security Administration proposal before the individual accounts could be credited," which pose obviously some issues.

Mr. Tanner—and if my reading is incorrect in this, Mr. Tanner, since we are old friends here, you correct me if—you generally dismiss these concerns as I read your testimony, and I quote you here in your testimony. You say that the collection of payroll taxes, including individual account contributions would continue to be handled by the employer in much the same way as today and sent to the Treasury as they are today.

How do you respond to each other? It seems to me he has raised a very serious issue, you dismiss it as being not terribly relevant.

Mr. TANNER. I actually agree with his statement. I believe in my written testimony I state exactly the same thing, that there is this problem that exists with the current Social Security system, that until after your W–2 is filed and they reconcile your W–2 with the contributions as sent in by the employer, they do not know how much you have paid.

Senator DODD. Right.

Mr. TANNER. And that is why I have suggested that there be a centralized collection point that essentially holds that money until reconciliation takes place. I have suggested that the best way to do that is to hold it in a money market account on a unitized dollar basis until reconciliation takes place and the money can be transferred to your individual account. But there is this lag, and there is going to have to be some holding pattern.

I think the centralized collection agency as well relieves the employer and all these small businesses of any responsibility for any administrative cost or anything other than what they do now, which is to pay in a lump sum to Treasury, which then assumes all the responsibility for the recordkeeping and the bookkeeping and so on.

Senator DODD. Who would hold that?

Mr. TANNER. The Federal Government would hold it, would be the administrator of this fund.

Senator DODD. Let me jump to, because there is limited time here, disabled and survivors benefits. I think roughly around 15 million of the 47 million beneficiaries of Social Security are either disabled or survivors, survivor benefits go to them. The President's proposal is to encourage, obviously, individuals to have private accounts, to which they contribute over their working lifetime. The question arises, in the case where a person's working lifetime had been cut short, either by worker's disability or death. According to the Social Security Administration over 8 million individuals received disability benefits in April of this year, and over 6.5 million received survivors benefits. What do these people do under the privatization plan? Mr. Tanner, what happens?

Mr. TANNER. Under our proposal, which has been introduced in the House by Representatives Johnson and Flake, and under most of the proposals that are proposed here, and the President's, those benefits would remain unchanged and be continued to be paid out by the Social Security Administration with no changes of any kind to those proposed——

Senator DODD. And would the Aadministration still require the clawback tax of inflation plus 3 percent on those accounts?

Mr. TANNER. Since we are old friends, just to correct you slightly on that, it is not a clawback, it is an offset, and the difference is that a clawback depends on how your account performs, and it penalizes you if your account performs well. An offset is a preset amount that you are simply giving up in exchange for your choice of moving into the private account. They have chosen 3 percent because they believe that is what Government bonds will be earning as a yield in the future. But it could be any number, and in fact, I would actually recommend a lower number than the 3 percent.

Senator DODD. Can I just ask. Mr. Furman, to make the comments on the earlier stuff and on this point as well?

Mr. FURMAN. Yes, two points. One is that TSP only bears the costs of 6 basis points, but substantial other costs are borne by Government agencies which are the first point of contact for most people. As Federal employees, most of your interchanges about the TSP are with your own office managers. You would have to mandate that for small businesses, or you would have to pay that cost in some other way. That is just one of the many tradeoffs one would have to make if one were to set up accounts.

In terms of survivors, I would have to differ from Mr. Tanner, to take Mr. Posen's proposal, for example. That reduces the benefit factors used to calculate benefits for retirees, survivors, and people with disability. It makes exactly the same percentage reduction for all three of those groups.

The President has said that he would protect people with disabilities, at least prior to them reaching their 60's, at which point something else might happen, has not said he would protect survivors, and his chief economic adviser has confirmed that the same benefit reductions would indeed apply to survivors as apply to retirees.

Senator DODD. Thank you, Mr. Chairman.

Senator HAGEL. Senator Sununu.

STATEMENT OF SENATOR JOHN E. SUNUNU

Senator SUNUNU. Thank you, Mr. Chairman.

With regard to the number of options available, I cannot speak to all the legislation that has been introduced, but let us be clear. A number of the proposals, the legislation that I have introduced, approach private accounts directly using the Thrift Savings Plan model specifically with the number of accounts offered. We could provide four or five accounts, but by limiting the number of accounts, as I do in our legislation, you achieve the scale factors that were talked about by Mr. Amelio and Mr. Enderle, and this is I think a much more manageable proposition, and a lot of the straw man approaches that had been thrown out by critics go away, and I do want to deal with a couple of those criticisms in detail.

The idea that this is far too expensive for small businesses. Mr. Cavanaugh, by the arguments that you have put forward that small businesses will be overwhelmed by the financial burden of having to sit down with employers and determine what portion of their payroll tax will be allocated toward a personal account, sent to Washington, and at a central location be allocated into one of the narrow choices that were spoken of. By that rationale, the whole idea of electing to withhold taxes and determine what the withholding allotment should be for employers should also be financially overwhelming, too complicated, and a waste of time and resources for the IRS. But that is not the case, is it?

Mr. CAVANAUGH. I am afraid it is the case because, for example, last year the Social Security Administration took in $600 billion in taxes, and about $10 billion of those were never reconciled for individual accounts.

Senator SUNUNU. I am talking about withholding taxes on personal income. Are you suggesting we should get rid of withholding because it is a waste of Government resources?

Mr. CAVANAUGH. No, what I am saying is that——

Senator SUNUNU. If that is not inefficient and a waste of Government resources, then why would electing some withholding for a personal account in those same businesses that do personal income withholding now, why would that be burdensome and a waste of resources?

Mr. CAVANAUGH. That is the critical question. There is an enormous difference——

Senator SUNUNU. That is why I am asking it.

Mr. CAVANAUGH. Right now, when the small companies do not send in the taxes in time—or we find $10 billion at the end of a couple of years that Social Security cannot reconcile because of errors on payment—it is not that critical to the Social Security beneficiaries because of the way SSA measures credits; it just does not affect them. But when you are talking about losing investment earnings, if the money is not in day to day or if it goes into the wrong fund when there is a big difference between, say, stock returns and bond returns.

I am saying that the present system with the employer just paying these taxes is not a problem now for IRS or SSA the way they operate. It is unacceptable for an investment. You cannot have a financial institution with that low a standard in terms of accuracy, nonpayment. We have 650,000 businesses go out of business every year, and when they go out, quite often the payment of Social Security taxes is at the end of the line. They have to pay their people and they have to pay their contractors and so on. How are you going to deal with that?

Senator SUNUNU. I think that the argument that you just made has nothing to do with the point you made earlier. What you are suggesting is a need for accurate accounting in the asset allocation, and I do not think anyone here would disagree with that, but that does not speak to the earlier claim you made that the financial burden would be overwhelming, and I do not accept that at all, because the best model we have for this allocation process at the employee level, at that small business level, is the election to withhold personal income taxes, which is a system that works, that is efficient. I do not disagree that we might like the accounting for that to be even better than it is, but to suggest that it is an unbearable financial burden simply is not borne out by the evidence.

Mr. Amelio, I want to talk a little bit about lifecycle. I think it was mentioned by Mr. Enderle. Oftentimes, we hear critics of the idea of personal accounts use what I will describe crudely as the argument that Americans are not smart enough to handle the decision to set aside money into a personal retirement account, quite simply put. And that we are going to have people at or near retirement age, at the age of 62 or 63 or 64 suddenly deciding that they want to put all of their life savings in a high tech stock. I do not believe that is the case.

I think one of the things we can look to at Thrift Savings Plan is to try to understand how investors make decisions in allocating and whether or not they generally follow what would be called lifecycle investing, whereas as you get closer to retirement, do individuals tend to put their personal accounts, their personal savings in less volatile accounts like a Government bond fund or a municipal bond fund or the like, as opposed to an equity fund?

What is TSP's history with that? Can you say anything about the tendency of your customers to pursue lifecycle investing with or without any regulations or mandates?

Mr. AMELIO. I can. I can throw statistics out like crazy. I brought lifecycle funds. It is my concept and I am very proud of that. The TSP participants are very much like any 401(k) plan participant. Nobody means to insult the American public if they say they are not bright enough or do not understand the investments. What happens is most people get frustrated. It is overwhelming. They do not have the time, the desire, et cetera. What they wind up doing, for example, when I came over, 50 percent of our plan assets were invested in the G Fund. G Fund is a wonderful fund. It is simply far too conservative for you to have all of your plan assets in that.

Senator SUNUNU. So you are suggesting that actually the inclination of the broad spectrum of Government employees—we are talking about 3½ million people; I am sure there are some that are more financially literate than others—their tendency is to be too conservative. Given a limited menu of options, four or five funds, they were actually investing in a way that is too conservative.

Mr. AMELIO. The largest group were too conservative, being 100 percent invested in the G Fund. The next largest group has what we call the barbell approach. They are putting half of their account in the G and the other half in the highest risk, and nothing in the middle. They are off of what investment professionals—Mr. Enderle could describe this better than I could—as the efficient frontier. They are either assuming too much risk for their yield, or they are not getting enough yield for the risk that they have.

These lifecycle funds are automatic pilot. You go in, it is professionally managed, and it gets more diversification which will get them a better yield overall over a working life expectancy.

Senator SUNUNU. Mr. Furman, in your testimony—actually, I want to direct this question to Mr. Amelio because you have some responsibility on TSP. You suggested that if individual accounts are instituted and had the political pressure to include various types of politically oriented funds, that would be difficult for legislators or policymakers to resist. Again, I go back to TSP. Have you been able to resist the political pressure to create all sorts of politically sensitive funds within TSP?

Mr. AMELIO. I have only been here 2 years. The plan has been very successful since its inception in 1986 in doing that. I can tell you there is a lot of political pressure right now to add a REIT fund against the plan fiduciary's desires. We make no comment on REIT's, as far as it being good or bad, we just do not want to add one right now, and that is what I am calling political manipulation.

Senator SUNUNU. But you have had 20 years experience?

Mr. AMELIO. Yes.

Senator SUNUNU. There are how many funds that are currently offered?

Mr. AMELIO. Five.

Senator SUNUNU. Five. So, I think it stands to reason if we are looking at this, not necessarily as the perfect model, but trying to identify analogies. I would argue that would be pretty good insulation from an endless proliferation of politically motivated funds.

Thank you very much, Mr. Chairman.

Senator HAGEL. Senator Reed.

STATEMENT OF SENATOR JACK REED

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

Thank you, gentlemen, for your testimony.

Mr. Cavanaugh, in your written testimony you make a very interesting and important point that also concerns me with regard to the President's proposals. Specifically, you point out that the TSP program allows for emergency withdrawals and loans on contributed funds. As I understand the President's proposal, those activities would be prohibited, and I have a sense that I believe you do too, that it is very difficult to maintain such a limitation over time, particularly since the argument is being made insistently, "It is your money, it is your money."

I am just curious. Have TSP participants always been permitted to make emergency withdrawals and loans on their contributions? And if not, what caused that phenomenon?

Mr. CAVANAUGH. It started out with just loans. IRS, I think, had problems when the legislation was before the Congress with regard to withdrawals. But later on the Congress amended the statute to permit withdrawals, so we have both loans and withdrawals.

With regard to what you were referring to in my prepared statement, even though the Administration says this is just for retirement, the individual accounts will not have any loans or withdrawals, I just think it is totally unrealistic. Right now, the reason people cannot take money out of Social Security before retirement is because they do not have an account there in their name with their money, there is nothing to take. But once you have an individual account that is identified to the individual and they see the balance is building up year after year.

And then you have some national disaster where people are starving, their kids cannot go to school, and they are waiting for emergency relief, and they say, "I have $20,000 in there and I cannot wait till retirement, we are dying now." I do not see how the Congress can say no.

Senator REED. And what would be the consequences of those types of withdrawals or loans?

Mr. CAVANAUGH. They would be dire because you would be doing it on an ad hoc basis instead of having a system in place at the beginning as we did for loans and withdrawals eventually. You would have to be dealing with each case because you would not have standards. It would be an ad hoc thing, and as the constituents called into their congressman and said, "I need the money," and they had a different particular case problem, that would be sent over to the board. The board would have to sit down and try to sort it out and be fair to everybody, and not give to somebody who had the same circumstances as somebody else that did not get it. You have to set it up at the beginning.

Senator REED. Thank you. Now, Mr. Cavanaugh, there is another issue that we have all talked about. That is the administrative costs of the various proposals. From your experience, would the administrative costs of the TSP-type program increase substantially if it were modified to allow individual investors to invest specific stocks? Would those costs go up?

Mr. CAVANAUGH. If the TSP allowed specific stocks instead of just the index fund?

Senator REED. Right.

Mr. CAVANAUGH. Oh, yes, that would be much more difficult because I think the Congress would provide something in legislation to make sure people did not go crazy buying penny stocks and so on. You would have to have standards and then there would be the whole question of—since the Government is running this thing—

Government involvement in the business of which particular stocks are eligible and which ones are not. And there you would get the politics, good stocks, bad stocks and so on, and so that would be impossible.

Senator REED. Mr. Tanner, in this regard of operating costs, you cite administrative costs would be about 25 basis points, but I presume that is based upon the TSP model which has about only 5 different options. But then you go on to your testimony and talk about: At some point a wider range of choices should be made available; in part this is a simple matter of increasing consumer choices; one of the most important reasons for having personal accounts at all is to give workers more choice and control how they save for their retirement; and clearly this should be extended as much as possible.

But it seems to me that as you extend these options you have to increase to administrative cost; is that accurate?

Mr. TANNER. Yes, I think you are correct, Senator, that in this additional tier of investment options, administrative costs would be higher, but no one would be forced to go into this additional tier of options, and in fact, we expect most workers would remain in the first tier of very limited set of options, out of inertia if nothing else, and those low costs there.

In addition, as long as workers have the free choice of staying put or of moving back down if administrative costs in the upper tier become too high, we believe that the competition from this low-cost, low-choice tier would keep costs down even at the upper tier, simply because if you priced yourself too high, workers would not make those choices.

Senator REED. So you anticipate a multitier, at least a two-tier system?

Mr. TANNER. Yes. I anticipate that initially workers would be given a very limited variety of choices, either a TSP type of model or perhaps three balanced funds, which is in the legislation in the House that I think is a good model, or perhaps just a lifecycle fund, but something very limited initially with a default in case workers make no choices whatsoever, that there would simply be a default option that they would fall into. And then once a trigger is reached, say an accumulation of $10,000 or more in your account, then you would be able to move, if you chose, to a wider range of options, or stay put in that first tier.

Senator REED. Mr. Furman approaches this in a slightly different way. I think in your testimony, Mr. Furman, you say a similar point but I think a different emphasis: Estimates that show low administrative costs for accounts are based on limited choice and an unprecedented degree of Government administration, which you observe, Mr. Furman, could prove to be politically untenable over time.

So your point would be that this expansion, if multitiered, eventually would be—they would not stay in the lower tier, they would want the whole——

Mr. FURMAN. Right. Two points to make about that. It is a very good question, Senator. Sweden gives you—it still is government managed, government administrated, and very centralized—a wider range of choices along the lines of what Mr. Tanner was just recommending. The average fees there are 0.73 percent per year. Accumulate that over your retirement, eats up 15 percent of your account. That is about twice as large as what the actuaries estimate. That is the first point.

The second point is if you think about the politics, the President's Commission strongly recommended a tier 2 of funds. They said the Government picking one equity allocation for the whole country was not a good idea. A lot of advocates of accounts believe that. If you look at something like Senator Sununu's plan, it has assets in account of $80 trillion in 2079. That is 200 percent of GDP. Half of those were in the stock market. That means those accounts in Senator Sununu's plan would hold the entire United States stock market. To imagine the entire United States stock market being held in one Government chosen allocation of stocks, whether it is an index of anything else, is to me unimaginable.

Senator REED. Thank you.

A final question. Mr. Cavanaugh, you talk about the Social Security Trust Fund as an alternative investing in the market as another approach versus these private accounts. Others have advocated this, obviously. What do you think are the advantages and disadvantages as compared to private accounts, of simply, as many have suggested, allowing the Government to invest a portion of the Social Security Trust Fund into the market, getting presumably a higher return with we hope low operation overhead?

Mr. CAVANAUGH. It is a no-brainer in the sense that——

Senator REED. That is my type of plan.

[Laughter.]

Mr. CAVANAUGH. Virtually everybody would agree that a diversified portfolio is the way to go, particularly with regard to long-term pension funds, and you should have equity securities in there and all that. The only argument against the trust fund investment that is made over the years—and I used to make it when I was in the Treasury Department, I confess—is that this would amount to Government ownership of stock, the means of production, socialism, all that thing.

There might have been some merit to that years ago, but since then every State in the United States has authorized pension funds to go into stocks. We are the only ones that do not. Maybe it is because we know something about what the Fed is going to do that they do not, but I do not think so. And ever since we brought in the stock index fund, which the TSP uses that took care of the problem of Government control over any one company because you are buying a broad index, you are not buying a particular stock.

And in my prepared statement that I submitted to the Committee, there is a chart on there showing that the trust fund alternative would involve less Government control over private companies than either the TSP or the Administration's plan. I go right down the line into every particular. It would be less. I just cannot believe that old argument. Whatever we might do with individual accounts, surely, the Social Security Trust Fund should be diversified like everybody else is doing.

Senator REED. Thank you, gentlemen.

Thank you very much, Mr. Chairman.

Senator HAGEL. Senator Reed, thank you.

Mr. Cavanaugh, I want to just go back and cover one point in response to a question that Senator Reed asked. The question was about leakage, and your response that there could well be great pressure, if we had personal accounts, to open those up for family emergencies or whatever it is.

We have never had that problem at Social Security to my knowledge; is that right?

Mr. CAVANAUGH. Yes.

Senator HAGEL. For 70 years we have never opened it up for emergencies?

Mr. CAVANAUGH. Because there is no individual account to give to people, so there is nothing that they could claim.

Senator HAGEL. But we have never had that issue. I understand the definition difference, but I believe that should be pointed out as well, that when the Congress passes a law, and if we did this, we would certainly mandate what the rules would be, and I think the President's plan says this clearly. My plan does. I think the other ones do. And I just wanted to add that footnote to your response, that certainly that is a possibility, but I do not think it is a strong enough possibility to be an overriding factor.

Mr. CAVANAUGH. All I can say, Mr. Chairman, is that the Congress did, in the TSP, say in the statute "no withdrawals." But later on the pressure was such that the Congress amended it to permit the withdrawals.

Senator HAGEL. We can always amend things, as you know. But I wanted to at least get the other side of that on the record, and I appreciate your response.

Mr. Tanner, should we consider other options as we are looking at how do we reform Social Security, should we reform Social Security? We all, I think, agree that we are going to have to address the issue. Are there options other than personal accounts? Are there investment options or should we just raise taxes and continue along the course that we are on?

Mr. TANNER. I certainly think that any Social Security reform is going to have to make some effort to restrain the growth in future Social Security benefits. I believe that personal accounts are absolutely essential for the reasons that I have outlined, particularly ownership, inheritability, and choice, but they do not solve all the problems with Social Security's finances. There is going to have to be other measures taken as well. I think that means that you are going to have to restrain the growth in Social Security benefits.

But as former President Clinton said, you have very limited choices when it comes to Social Security. You can raise taxes, you can cut benefits, or you can invest privately, either through personal accounts by individuals or through the Government.

I think Government investing would be very dangerous. You have to look no further than CalPERS, for example, to see them trying to interfere with who is going to be the next Chairman of Walt Disney. Do we really want the Federal Government making those type of decisions? You can look to State pension funds and see that about 44 percent of them have targeted investment requirements saying that you must invest in certain types of investments, or that they cannot—25 percent have restrictions saying you cannot invest in certain types of things. My old friend, Senator

Dodd, would be able to tell you about Connecticut, where they forced the State pension fund to invest in Colt Industries and the problems that created both in terms of conflict of interest and in terms of the losses that they incurred because of that.

I think that when it comes down to a choice between private investing, between the individual and the Government doing it, we should definitely side with the individual, but we are also going to have to do other things as well in terms of restraining benefit cost and growth.

Senator HAGEL. I know the hearing is intended to stay focused on what we are talking about here, and I will keep within those boundaries simply because we have a lot of territory to cover that we have not yet touched upon. But I think at the end I will do a wrap-up question and ask each of you what additionally you think we need to do to deal with the solvency issue of Social Security, aside from what this hearing is about, and you just alluded to it. You did not specify what those are. Some of those things are in my bill, but I will ask each of you at the end if you would offer your thoughts on that outside of personal accounts or other options for investment vehicles.

Mr. John, let me ask you the same question that I just put to Senator Tanner.

Mr. JOHN. I kind of like the idea of Senator Tanner. It has a nice sound to it.

Senator HAGEL. Well, he is close to Dodd, you know.

[Laughter.]

Mr. JOHN. We also believe that Social Security changes must go along two courses. One is that we strongly support a personal retirement account for the simple reason that this gives my daughter the opportunity to do something more than face a world of higher taxes and lower benefits. I do not see that as being an attractive Social Security system to leave her.

Two, it is very clear that we need to change Social Security's benefits and to bring them closer to what Social Security can actually afford to pay. As I mentioned, she is going to be faced with a choice otherwise, especially with a health care system that is in serious jeopardy, of financing benefits for her kids or financing benefits for her parents.

There is no way around changing Social Security's benefit formula, and Social Security's benefit formula has been adjusted in a number of different times. It is not a program that sprung full blown from the head of Franklin D. Roosevelt in 1935. The current benefit structure or benefit calculation basically dates from Jimmy Carter's era in the late 1970's. It has been changed a number of different times and it needs to be changed again.

Senator HAGEL. Mr. Furman, I will ask you the same question, but focus as well on a comment that Mr. John made in his written comments and he just alluded to, about this generational choice that we are going to burden our next generations with? I think the reality of that is becoming clearer and clearer. I would appreciate your answer in the context of that as well.

Mr. FURMAN. There is no question that we face a Social Security challenge and that it is better to act sooner rather than later in addressing that challenge. That being said, it is better to not act at all than to do harm, and to wait and do it in the right way.

The Social Security benefits are projected to exceed Social Security revenues so you have to either reduce benefits or raise revenues. I would recommend adopting a combination of both of those approaches, as we have done historically. Historically, we generally have done both when we have gotten into trouble in Social Security.

In terms of accounts, they do not help with the problem. In fact, in the short-run they make it worse because they increase the debt and drain money from Social Security. In the long-run, they do not help either because these administrative costs we are talking about today ensure that the new system, the total amount of resources in that system is less than what the resources are in the system today because some of those resources are consumed by administrative costs.

Senator HAGEL. I suspect Mr. Tanner and Mr. John do not agree with your comment. Would you both care to respond to Mr. Furman?

Mr. JOHN. Just quickly, Senator. The Social Security Administration Actuary estimates that a personal account structured as the President would like and with that type of an investment, would return 4.6 percent after administrative costs, which would be, according to the President's calculations, assuming a 3 percent Federal bond rate, which I think is incorrect, but assuming that would mean that even after paying costs, that they would be making 50 percent more than Federal bond rate, which is definitely an advantage. I mean these administrative costs, under a system that is managed through the Federal tax system and not through the employer, would not eat substantial amounts of the investments. I mean even Mr. Furman's numbers suggest 7 percent. Now, frankly, I am willing to invest 7 percent or pay 7 percent in costs if I am going to do 50 percent better than Federal bond rate. It is a fairly simple choice for me.

Senator HAGEL. Mr. Tanner.

Mr. TANNER. I would agree. To some degree you would get what you pay for. There is no doubt that the administrative costs of the current Social Security system are extremely low, but so is the rate of return that people get. There used to be in East Germany a car called the Trevant that was essentially made of plastic, and it cost about $500. As soon as the wall fell, people stopped buying Trevants and started buying Mercedes Benzes even though they cost more. The reason was it was a better car. I think people would be willing to bear somewhat higher administrative fees if they could get a much higher rate of return from private accounts. At any rate, it would be a choice.

All the individual account proposals that I know of, I believe including the Chairman's and Senator Sununu's and those in the House are voluntary. Individuals could stay in the current Social Security system if they wished. If they were worried about these administrative fees they would be able to stay put, but people would be given the choice of earning a higher rate of return and paying a little bit more to do so.

Senator HAGEL. My bill does that as well.

Mr. Cavanaugh, would you care to comment on any of this?

Mr. CAVANAUGH. Yes, on the cost thing. You know, all of these estimates, the Administration estimate of 3/10ths of 1 percent, of 30 basis points, and the others of 50 and so on, these are based on the known world of 401(k)'s. That is where the experience is that people are looking at. What we are talking about in these proposals by the President is the unknown world of small business, where you do not have the experience of administrative costs that relate at all to what has been done in 401(k)'s. What you have is a market out there that is telling you, unquestionably, that it cost 3,000 bucks a year to go into a company and set up a plan. If you have 60 percent of businesses with less than 5 employees, that is 600 bucks a head, and 600 bucks out of the President's proposed $1,000 contribution is a 60 percent expense ratio.

This is the world we have to look at, and this is why I suggested in my statement to the Committee to bring in the 401(k) providers, all those firms I mentioned, give them a specific list of exactly what you want them to do, and based on their experience and what they are now saying on their websites, they would have to tell you it is impossible.

Senator HAGEL. Mr. Enderle, you know something about that business. What do you think?

Mr. ENDERLE. I think it is best to respond, given my area of expertise really has to do with the management of the assets as opposed to the administrative costs associated with 401(k) plans. I think it really comes down to two things. One is what type of investments are best suited for any type of private accounts, if it does go in that direction, and two what to do to minimize the investment related costs associated with those assets?

I do think that it would be in investors' best interest to have an array of probably diversified index options that are both low cost in terms of the cost of trading or the management fees associated with such index funds, and they are low risk investments as well.

The other option would be lifecycle which we talked upon as well, which also can be offered as a low-cost investment solution which has the benefit of adjusting the asset mix over time to meet an investor's time horizon.

I think the number of options that are available is going to be critical because that also would affect the assets under management for any one fund, and hence would be impacting the cost structure as well. The issue around how frequently participants would be able to change their exposure to any one fund, which would also impact the administrative costs as well as the management costs.

Senator HAGEL. I do not know of anyone's plans that would have the employer administering anything. The employer is not administering any of the plans I am aware of, and the plans I am aware of, they would be modeled after TSP, the same kind of thing. Obviously, if you have 100 million accounts, I would assume you would have to bring in others, not just Barclays, but maybe 5 Barclays. I do not know that, but respond to that, if you would. You do know something about that.

Mr. ENDERLE. Sure, I think there are two things to consider. In terms of, even if we had 100 million accounts, if the options available to those participants are the same as what is currently offered to the TSP participants, what Barclays is managing 4 out of those 5 accounts, that is certainly very manageable from our standpoint. So it is much less to do with the number of accounts that are out there and more to do with the number of investment options that are available. That would be the thing that I think would determine how many managers you would need.

Senator HAGEL. And we are talking about limited funds here.

Mr. ENDERLE. That is right.

Senator HAGEL. Same thing as we have talked about with TSP. Mr. Amelio, would you like to respond to any of these points?

Mr. AMELIO. I think I can within the overall concept of costs. I speak for every plan administrator in America when I tell you that if you are looking at creating any kind of an institutional plan, if you want to minimize cost, you cannot have early distribution options like loans and hardship withdrawals. I can tell you, I would love to ask Congress to get rid of the hardship withdrawals and loans from the plan. They are not a retirement feature. They encourage participation. It is not feasible. But they add greatly to the plan expense.

The second thing, I speak for all plan administrators I think when I say that we are able to maintain our costs because we keep the plan simple. We have 5 investment options. It is short, it is sweet. That gains the participants' confidence level. It also keeps the cost down and it keeps participants putting money into the plan, and I think that is very important.

I want to tread lightly on the last one, because I stand in two shoes. As the fiduciary to the plan, I will obviously stand up and protect the G Fund because it is a great investment vehicle for the plan participants, but we are the only plan in America that has it. No 401(k) plan does. It is Government securities. It is a special and unusually high interest rate. But as a plan participant and a taxpayer I take issue with it. It is costly. It costs the Government a lot. I guess if I were not a fiduciary but still in my role I might look at just using a regular money market fund out in the open market which would reduce the burden on the Government. But that is not my role, and as a fiduciary I will protect the G Fund, but I throw that out for your consideration otherwise.

Senator HAGEL. Thank you.

Let me ask each one of you what would be your response to the larger question which we touched on a little bit earlier this afternoon with some of my colleagues, if we were to set up 100 million accounts. How would the market react to that? No one can be certain, obviously, but what is your best guess as to what would happen and would we phase that in, or how would you do that? Is it dangerous? What kind of risk are we talking about? Give me your best assessment, realizing that there are no guarantees and there are so many unknowables, uncertainties, and uncontrollables which we factor in. But that has been a question that has been raised by many people, and I would appreciate your thoughts.

Mr. Furman.

Mr. FURMAN. Yes. I would focus in answering this question not on the number of people with accounts, but the total amount of assets in those accounts. And it is a very important question because in plans, I believe in your plan, it is about 80 to 100 percent of GDP would be held in accounts, and in Senator Sununu's it would be 200 percent of GDP. So we are talking very substantial financial holdings.

Now, there is only a fixed capital stock in the United States, a fixed amount of human capital, and when you have more money chasing the same thing, it drives the price of it up. And the way the stock market works is when the prices of stocks are higher, that is great for the people that already have them, but people just coming into the market have to pay more, and they actually get a lower rate of return going forward. This process was described——

Senator HAGEL. It depends too on the fund. There is an international fund, for example, and there are high yields and so on.

Mr. FURMAN. That is actually a very important question as to whether you would internationally diversify, and I think it is a prudent part of anyone's portfolio. This was summarized in the leading public finance textbook in economics which was written by Harvey Rosen, who as I mentioned before, just recently stepped down from the Administration. He wrote: "In order to induce private investors to accept Government bonds that would have been bought by the trust fund, their yield has to go up, increasing the debt burden on taxpayers, or the yield on stocks must fall, or both." That I think summarizes the standard textbook economics.

Senator HAGEL. Thank you.

Mr. John.

Mr. JOHN. I think there would be two effects. One is you would see a very positive effect in the markets worldwide because it would indicate that the United States is actually serious about dealing with its entitlement spending. That is something that has been a matter of major concern worldwide. If you saw what happened—I believe this was earlier this year—when the South Korean Central Bank was rumored to be diversifying out of dollars. This is the kind of signal they need.

And two, as far as assets, the amount of assets under management in these accounts, I think it would be relatively small as compared to the overall global level of assets. I mean currently globally, there is somewhere around $20 trillion in financial assets out there. There actually is not a fixed capital stock in the United States. There is a fixed capital stock on any one day. But as the *Washington Post* pointed out in one of its editorials, the value of the stock market, aside from increases or decreases due to supply and demand, actually increases and decreases regularly due to companies that merge and go out of business, companies that issue new rights and things along that line.

So this is a constantly growing pool of money, and it is really not possible to limit it to just the United States, because if you look at the New York Stock Exchange, you will find companies like Prudential PLC, which is a British investment company. You find DaimlerChrysler, which of course is worldwide, so essentially you have to look at the growth of the worldwide assets.

Mr. FURMAN. Could I very briefly insert something?

Senator HAGEL. Go ahead.

Mr. FURMAN. The $20 trillion right now is less than 200 percent of U.S. GDP, and we are talking about plans that have asset holdings of between 100 and 200 percent of U.S. GDP, so if the Ryan-Sununu plan were in effect today, it would hold 200 percent of GDP in assets. That is the equivalent of about $24 trillion. That would more than exhaust the global asset stock, and those are very important questions to think about when you are talking about accounts of that magnitude.

Mr. JOHN. But not overnight. I mean the Ryan-Sununu plan, hypothetically, if you believed Dr. Furman's numbers, would, but the thing is, this would not be a matter where on March 31 there is zero and on April 1 or April 2 there would be 200 percent of GDP. And during that period of time the amount of assets worldwide would continue to grow.

Mr. FURMAN. Historically, it has grown with GDP, but maybe it might grow faster than GDP.

Senator HAGEL. We will let Mr. Tanner have a turn.

Mr. TANNER. Yes. I was going to say you cannot assume a static model that just assumes that we are going to have the same amount of capital stock 75 years from now that we have today.

If you look at this on a day-to-day basis, the amount of money going in, even if you took the entire amount of Social Security taxes and put it in the New York Stock Exchange, it would be roughly the equivalent of 22 minutes a day of trading. The U.S. capital markets are enormous. They are going to be even more enormous 75 years from now even with the accumulations we are assuming. I do not think we are going to swamp those markets. If you go to a worldwide basis you are talking about maybe one-half of 1 percent of worldwide capital markets right now.

I do think you would have a couple of impacts in the long-term. You would have what is simply called the "capital deepening effect," which is that capital flows first to the best returning investments and then ever lower returning investments as you go out. If you increase the amount of capital going to investments, they are going to go to further and further out to lower returning investments, and the average rate of return on all investments is going to decline.

Martin Feldstein estimates you would have about a 15 percent decline in the average return on investments, but that would not occur for about 40 or 50 years. Eventually, you would see it begin to go down somewhat in terms of average return, but that would not be an effect on any individual stock price.

What you would also get is that as you increase the pool of capital, you would actually increase the amount of liquidity in the markets, and it creates more stability in the markets because they would be insulated from some of the shock effects. You can look to Chile for an example of that, where when the Asian crisis hit, and it really socked most Latin American markets, Chile, where the accounts manage about 50 percent of GDP, suffered a much smaller decline in terms of their markets because of the insulation effect that this amount of capital in the markets had.

Senator HAGEL. Mr. Cavanaugh.

Mr. CAVANAUGH. I think your question is what would be the impact on the economy and financial markets if we had 100 million accounts. There would be no change in the total asset flow. There is no reason to assume that the money coming in for Social Security taxes would be any different from what it is now. What would happen is that instead of all of it going into Treasury securities, some of it in the individual accounts would go into market securities, which means the Treasury would have to borrow more in the market and less from the Trust Fund. It would be just a swap of securities. There would be no overall impact on capital. There would be marginal benefits in terms of a better demand for stocks because people are going in. Another point is financial institutions generally would be better off because Social Security historically has been pay-as-you-go. You just had enough money in to take care of each year. But because of the 1983 changes, we have been prefunding. It is now up to $1.5 trillion. In the next few years, it is supposed to go up to $3, $4, or $5 trillion, by different estimates.

So all of a sudden the market is interested because before, the market was not losing a lot of investment opportunities because the money was just going in and out pretty quickly. But now that it is building up, we are looking at $1.5 growing to $3 or $4 trillion, money the market is not going to be able to get. It just goes all in the Treasury securities. And so that is an important point from the standpoint of the market. But as an economist, I would have to say all we are talking about here is an asset swap. Treasury would just issue more securities in the market instead of to the Fund. And people who would have bought stocks would buy less because now these people, Social Security taxpayers, would be buying more. Not a big deal.

Senator HAGEL. Thank you.

Mr. Enderle.

Mr. ENDERLE. I think in the end it is going to be a function of the dollar amounts that are going to be affecting the various markets, and in essence, I think there are going to be four things that are going to affect the market's reaction as it relates to the dollar amount that we are talking about.

The first is whether or not the assets are going to be phased in over time, as opposed to what we mentioned earlier. It is not going to affect the market or hit the market overnight. I think that should have a muted impact on the markets.

The second is the number of options that are available, especially if we have different asset classes that are available as options, that would also provide more opportunity to spread the assets across and, hence, would have a muted impact on some markets.

The third is whether there is a decision made to implement the options through index funds, which provides the broadest diversification for any asset class and hence, would also have the most limiting impact to any particular market if implemented through a broad, diversified strategy as opposed to a narrowly defined strategy.

And then, last, it depends upon what other managers or, rather, investors are doing. For example, as we talk about baby boomers retiring and what their investment activity will be like in the future, it is quite possible that as we invest assets, say, into the equity market through the private accounts, there could be offsetting flows that are also affecting the markets at the same time, where there will be buy and sell activity such that the total amount that is hitting the markets could be quite limited as well.

Senator HAGEL. Thank you.

Mr. Amelio.

Mr. AMELIO. I will give you an analogy and limit my remarks to your example to the confines of the TSP. If we were to dramatically increase the number of participants to the TSP and, hence, the inflow of dollars in, my concern would be the ability of the funds to absorb that money, at least initially, into the more limited markets that are available right now. This would drive our transaction costs in the index funds up because we have seen it now when we get active trading with our participants. If one of the markets goes askew, they start to pull money out, or drive money in. As it drives those transaction costs up, it pushes our return off of the index. In other words, the index fund tracks an index such as the Wilshire 4,500. And to the extent our costs go up, it pushes our performance number away from the index we perform perhaps if the costs go up a little worse than the index would because of those trading costs, and that would be my concern, at least over the short term, if there was a dramatic increase of flow of capital. And that is from an administrator's perspective.

Senator HAGEL. Thank you.

Let me ask each of you a question I mentioned a few minutes ago. Aside from personal accounts and your positions that you have made very clear on personal accounts, each of you, what do we need to do to assure Social Security's solvency? We will start with you, Mr. Furman.

Mr. FURMAN. There are a few plans that I would recommend that you take a serious look at. One is by economists Peter Diamond and Peter Orszag, and another is by former Social Security Commissioner Ball. And what both of them do is increase revenues and trim benefits. They increase revenues in a very progressive manner, including raising the cap, applying a tax above the cap, or using estate tax revenue to help the solvency of Social Security. And then they make some changes on the benefit side, including correcting the Consumer Price Index that is used to adjust for the cost of living. And in the case of Diamond and Orszag, it applies longevity indexing to benefits, although it only takes half of the increase in longevity and applies it to benefits and applies the other half to the revenue side, which from my perspective is the more balanced way to deal with longevity than doing it entirely on the benefit side.

Senator HAGEL. And that would be your approach to dealing with——

Mr. FURMAN. Those are a number of options that I think would make a lot of sense in terms of coming up with a plan that is overall balanced between revenues and benefits, balanced between people today and people in the future, and progressive overall.

Senator HAGEL. Mr. John.

Mr. JOHN. If I had to take personal accounts off the table, which, of course, would be very painful——

Senator HAGEL. No. I know where you are on personal accounts. You are one who advocates that personal accounts help get you to solvency. So, in addition to that, unless you believe that that is the only answer, what in addition to personal accounts?

Mr. JOHN. In addition to personal accounts, I would suggest some form of progressive indexation similar to what the President has been talking about recently, which would basically reduce the growth of benefits for upper-income workers while leaving lower-income workers stable. I think this is also important because it would remind upper-income workers that they need to continue to participate in 401(k) and other private types or employer types of retirement plans.

The second thing I would do, frankly, is to raise the retirement age, recognizing fully that there are going to be a certain number of workers in physically demanding jobs that simply cannot work longer, and those workers are going to be placed probably on the disability rolls in some way. I would also put in some form of longevity index in there.

The one thing I have not included is taxes, and for two different reasons. Number one is that change in payroll taxes or employment-related taxes could have the result of reducing job growth, and, frankly, that would be more damaging for the economy than other things. And number two is that we always have the unspoken problem, which is Medicare, and that one is much larger, and I would be hesitant to use up all the tax options on the easy problem.

Senator HAGEL. Thank you.

Mr. Tanner.

Mr. TANNER. I guess I would associate myself completely with Mr. John's remarks here. I believe that some form of change from wage indexing to price indexing is a very fair way of approaching it. I think that probably some longevity indexing in addition would probably be a good idea. I think the overall requirement is to reduce and restrain the growth in benefits, that we simply cannot go on forever increasing the amount of benefits that we pay to the elderly both through Social Security and Medicare. There has to, at some level, be some restraint on the amount of entitlements, and simply pouring more money into the situation in order to pay ever larger entitlements I think is a mistake. And particularly I would like to warn against the idea of raising the cap or removing the cap on the amount of income subject to the payroll tax. To do so would give the United States the highest marginal tax rates in the world. We would actually have higher marginal tax rates than countries like Germany and Sweden.

I think that is a significant danger of damaging the economy and job growth, and it might even hurt overall Federal revenues since there would be an enormous amount of switching to nonwage compensation and people would simply begin to hide their income in order to avoid these huge marginal tax rates. So, I think you would actually end up getting less revenue than you expect. Even if you took this off altogether, you would gain something like 7 years of additional cashflow solvency for Social Security. It is a very high price to pay for very little gain.

Senator HAGEL. Would you include pushing out full benefit retirement age a year, or would you leave that alone?

Mr. TANNER. I think that it is certainly something that should be on the table. It is a less favored approach that I have. I do think that the problem is that for people in physically demanding jobs or for people like African-Americans with shorter life expectancies, raising the retirement age really leaves a hardship for them. I think the longevity indexing is probably a better way to approach this. It gives people more options than simply raising the retirement age would.

Senator HAGEL. Thank you.

Mr. Cavanaugh.

Mr. CAVANAUGH. I would agree, I think, with most of the options that Mr. Furman mentioned, ones that have been advanced by other economists, Peter Diamond and the Brookings Institution, Henry Aaron, that thing. These are all things that could be done that would more than offset the actuarial deficit projected by the trustees for the Social Security Trust Fund.

However, each one of them hurts somebody in terms of increasing the age, removing the cap, or bringing in State and local governments. People have problems with all of these options. The one that I think is the most desirable is if you did what I suggest with the trust fund investment. If you invested 50 percent of the Social Security Trust Fund balance in equities, with the other half in Treasuries or whatever, that would eliminate approximately one-half of the total actuarial deficit projected by the trustees.

But I must say that I think the CBO estimate is that the fund is not going to run out of money until 2052. The trustees are saying 2041. When I first began to look at this area 9 years ago, the trustees were saying 2027. And then they moved out in the last 9 years to 2041. I do not think that we can make substantial policy changes today based on moving targets like that. We have no idea what the world is going to look like in 2040 or 2052 with the growth that we have had in productivity and immigration, women in the labor force, things that we never could have projected 40 or 50 years ago.

I would be very careful to make drastic changes today based on these projections, which have proved to be way off.

Senator HAGEL. Thank you, Mr. Cavanaugh.

Mr. Enderle.

Mr. ENDERLE. Given my area of expertise, which is really to provide technical comments on investment management-related issue, I am really not, I guess, in the best position to comment on how best to address the issue of Social Security solvency type questions.

Senator HAGEL. Thank you.

Mr. Amelio.

Mr. AMELIO. The Board does not have any position on this issue, as you can imagine.

Senator HAGEL. You are a technician.

Mr. AMELIO. Yes.

Senator HAGEL. Thank you.

Let me ask one last question, and I do not know if you have any thoughts on this. But is there anything in particular we can learn, we should be paying attention to, from other countries who have gone through this? Chile obviously is an example that has been used here a couple of times this afternoon. The United Kingdom, Sweden, and other countries have had to deal with this. Some have deferred it. Some have dealt with it fairly successfully. None have gone through it, that I am aware of, without some ups and downs and adjustments and calibrations. But as the last question for the six of you, starting with you, Mr. Furman, anything in particular that we should be focused on in learning from these other nations that have gone through something similar?

Mr. FURMAN. One of the strongest lessons from international experience is that the administrative costs can tend to be very high and exceed what people originally expect for them. That is especially true in a decentralized system like Chile or the United Kingdom. Administrative costs also go way up if you give people even the limited set of Government-sponsored choices that you have in a country like Sweden.

So if there is one lessons from international experience, it is that a lot of the benefits you think you are going to get from these accounts come up against the hard reality of how complicated they are to administer and costly to administer in practice.

Senator HAGEL. Thank you.

Mr. John.

Mr. JOHN. As you look around the world, the first lesson to come up is do it now. If we look at the Japanese, the Germans, the French, and the like, who have waited much later in the demographic positioning than we have, the choices only become more and more painful. If we look at Australia and Switzerland, we find that it is actually possible to mandate savings, whether it is through a personal account attached to Social Security or some other way. And if you do it soon enough, you can build significant amounts of assets and reduce the long-term costs to your society of a pension plan.

If you look at the United Kingdom, you will discover that you can actually screw up a private pension plan, if you make it too complex or if you try to micromanage. And if you look at Germany, in particular, the Riester reforms from about 2001 or so, you find that if you come up with what is otherwise a good plan and it is far too complex, nobody is going to understand it and nobody is going to support it.

Senator HAGEL. Thank you.

Mr. Tanner.

Mr. TANNER. My comments would be very similar. I think that it is very important that any plan that is devised be transparent and easy to understand for everyone involved. I think Britain is a classic example of a plan that was overly complex, opaque; very few people had any idea where their money was going and how it worked. It was tax credits against something else, a type of thing that was not necessarily even connected with your Social Security taxes. You had to be twice removed from it. And the result led to a great many problems.

The Chilean system I think shows that it can be done. You have to remember, when Chile did this, this was back when Brezhnev was the head of the Soviet Union. We did not have computers. People did things on paper. And yet they were able to create this type of system, which is remarkably efficient. The costs today are about 65 basis points for administering these accounts in Chile, which is higher than here but quite reasonable. So, I think it proves that it can be done if you are willing to undertake it.

Senator HAGEL. Thank you.

Mr. Cavanaugh.

Mr. CAVANAUGH. In response to your question what do we learn from foreign experience, I think we learn not to do it. I have a different perception from Mr. Tanner of the Chilean experience. When that was put in, it was mandatory. Back in 1981, I think they started it. And the only people that did not have to join it were General Pinochet's officers, the military. I think they had a little insight into what the plan was about.

As I recall, 40 percent of Chileans, although they were supposed to go into this thing, opted out because there was some kind of a back-up thing like Social Security that they could take instead, and they just went against the law. And *The Wall Street Journal* did a survey of the Chilean, the British, Swedish, and others just a few months ago, and according to their figures—and I have heard the number in other places—in the Chilean individual accounts, the financial institution takes 20 percent off the top right at the beginning. I do not see how you can get anywhere with that kind of management. As to the British system, in addition to the problems mentioned by Mr. Tanner, a few months ago it was noted in the press, because of the enormous reaction to the way British financial institutions handled that, there was a class action suit that they finally settled for $24 billion. In Great Britain, that is a lot of money. And that is how bad the problem was.

So the United Kingdom is definitely not a model, and Chile, in my opinion, was a failure.

Mr. TANNER. Mr. Chairman, if I can just correct something for the record, the Chilean system that was implemented was voluntary. The military and police were forbidden to go into the system because they had something similar to a civil service pension which is linked to your rank and things like that. They were not part of the Social Security system at that time. For ordinary workers, it was voluntary. Some 93 percent of Chilean workers have voluntarily chosen to go into the system. About 40 percent of workers are not currently participating because they are in the underground economy, tax evasion being a time-honored tradition in much of Latin America. They are simply not on the books and, therefore, they are not participating in any of the system. They were not participating in the old Social Security system either since they were working under the table. But it is entirely a voluntary system under the system.

Senator HAGEL. Thank you.

Mr. Enderle.

Mr. ENDERLE. My response is essentially the same as to the previous question in that I am most qualified to respond to any investment management-related questions for any plan that may be proposed or considered.

Senator HAGEL. Thank you.

Mr. Amelio.

Mr. AMELIO. I think the universal comments that I have experienced at this hearing, other hearings, and other writings with these plans are that there have been complications and high costs. I think that only really illustrates what a great job Congress did in 1986 when they created the TSP. They put the structure in that stands today, and that is where we are. And so kudos to that Congress in 1986.

Senator HAGEL. A high point to leave this hearing on, obviously. And I know Senator Dodd was here, Senator Sarbanes, maybe others, and I shall pass on your congratulations for their wisdom and direction and leadership.

Gentlemen, you have been very helpful and made significant contributions, and we will most likely be back in touch with you at some point. But you have helped us immeasurably, and we appreciate very much your time and your thoughts.

The hearing is now adjourned.

[Whereupon, at 4:16 p.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

PREPARED STATEMENT OF SENATOR TIM JOHNSON

Thank you, Mr. Chairman, for holding today's hearing. I am proud of what this Committee has done to enhance our capital markets, which are the strongest and most efficient in the world. With comprehensive corporate governance legislation and a fairly comprehensive new regulatory scheme for the mutual fund industry under our belts, I think we've made the marketplace a more transparent and secure place. There is no denying, however, that our marketplace derives its strength on risk, and I appreciate today's opportunity to look at whether this concept of risk is appropriate in the context of retirement security.

Since President Bush began his campaign to establish private accounts within Social Security, support for his plan has declined significantly. Even members of his own party have voiced their concerns and outright objections to his plan. It seems that as Americans learn more about the structure of his plan, more and more people reject it. A recent *Wall Street Journal*/NBC poll found that a majority of Americans think that it is a bad idea to change the Social Security system to allow workers to invest their Social Security contributions in the stock market.

Private accounts from the get-go are a bad idea for the Social Security program. As I traveled recently throughout my State and held town halls, I shared my thoughts with constituents about the vast new borrowing that would be required, the inherent risks in a privatization scheme, and the alarming benefit cuts that will be experienced by all beneficiaries—irrespective of whether or not they select to have a private account. As I shared this information, over and over again I heard the people of South Dakota say—"don't privatize this program."

Now, I would guess that the hope of some here today is that this hearing will provide an opportunity to talk about the details of how private accounts would work, but in my mind, there is no need to even walk down that road. The underlying principles behind the privatization concept are flawed, and I think that is where our discussion today should begin.

As we think about the underlying principles of the President's plan, we must not forget the intent of the Social Security program—to provide insurance for unintended events that threaten financial security, and to provide a secure, guaranteed financial floor for which all other aspects of retirement planning are built upon. Some things that we need to consider as we hold this hearing today.

Foreign Debt

The vast new borrowing required by the President's privatization proposal threatens our standing in the financial markets of the world. As of the end of 2004, foreign ownership of the debt already reached almost $2 trillion, or 44 percent of the total held by the public. The addition of $5 trillion in transition costs over 10 years that is required by private accounts will threaten the stability of the U.S. economy. If foreign investors lose faith in our ability to finance this debt, this could lead to soaring interest rates, a weakening of the dollar, and even a deep recession or depression.

In the context of today's discussion on the role of our financial markets in Social Security, one cannot underestimate the threat that our current $400 billion national deficits pose to the health of our financial marketplace. Last February, the Korean central bank indicated that it planned to limit its dollar holdings and purchase different currencies instead. Following this news, stock prices fell sharply.

Several weeks later, Japan indicated it was looking at limiting its dollar holdings. What happened? Another terrible day on Wall Street. Something drastic—like Japan or China selling a large amount of U.S. dollar holdings—could have a devastating impact on our economy. I have serious concerns about whether it is prudent to give any foreign country substantial leverage over the U.S. economy, much less the retirement security of the two-thirds of our seniors that depend on Social Security as their primary source of income.

Risk and Rate of Return

While the average real return on long-term government bonds was 2.3 percent, and the annual total rate of return on large corporate stocks was 7.2 percent between 1926 and 2003, such figures do not account for the variation in returns for both types of assets over shorter periods of time. Depending on a worker's birth date, the retirement benefits relative to preretirement earnings generated from putting one's savings away for 35 years could have gone from 100 percent to less than 20 percent.

For every dollar deposited in a personal account, a worker's traditional benefit, delivered in a monthly Social Security check, would be diminished by a dollar, plus the interest rate the money would have earned in Treasury bonds. This "claw-back" requirement means that in order to come out ahead of the traditional system, an account would have to realize returns on investment of at least 3 percent above the rate of inflation.

When examining past trends, it would not be unlikely that the government will have to assume costs to bail-out a privatized system that provides too few benefits. Their will always be the chance that the market will under perform, and because whole generations would end up with too few savings in retirement in this scenario, the problem will be too large for the Government to ignore. A Government bail-out would be an extremely costly undertaking. For example, when the savings and loan crisis of the late 1980's occurred, these economic problems of the past became large enough to justify a bail-out, costing the U.S. taxpayers over $120 billion.

Administrative Risks/Costs

Most of the financial services industry in the United States is very effective and sound, but we must remember there are risks and costs involved in investing in the stock market. Not only the risks associated with putting money into stocks, but also risk involved in giving so much financial power to a small group of people. Creating privatized accounts in the Social Security system, would also lead to an increase in payments of financial fees to private financial management companies.

Britain privatized its Social Security system in 1986, allowing citizens to "contract out," which is their term for putting government pensions into the stock market. The scheme led the government pension system in Britain to the brink of crisis. Last year alone, more than 500,000 people abandoned their private accounts in favor of the state-managed Social Security system.

Securities fraud loomed large among the problems the British system faced. In the early 1990's, Britain's financial services regulator, the Securities and Investment Board, undertook random samples of paperwork from the insurance industry, which was selling the private accounts to British citizens.

The regulator found a staggering percentage of private accounts had been sold to those who would be worse off in retirement as a result. The public outcry over this "mis-selling" scandal forced the government to establish a review panel that ultimately found the insurers liable for making people worse off.

Over an 8-year period, 1.7 million people sought and received compensation that ultimately cost the insurance industry $12 billion. In addition, hundreds of millions were paid out in fines and penalties. It was the biggest financial scandal in British history to date.

According to a University of Chicago Study, Plan 2 of the President's Social Security Commission would result in fees paid to Wall Street totaling $940 billion. These fees amount to more than 25 percent of the existing deficit in Social Security over the same period. In Britain, fees to private companies managing these accounts consumed an average of 43 percent of the value of an individual account over the course of a 40-year working career.

Not an Investment Program

The President has made it a point to describe Social Security as an investment program. This message neglects to recognize that about one-third of payroll taxes go to fund disability and survivors insurance. Such insurance plans would be extremely expensive to purchase in the private market. In addition, the program provides protection against the risks of inflation by the way they are adjusted each year. It is incorrect to measure the value of an insurance plan based on a rate of return. For example, when you purchase life insurance, you do not want a good rate of return, since that money will be made available only in the event of one's own death—and few people would opt out of a guaranteed life insurance program because of what potential rate of return could be realized in the stock market.

It is Not Your Money

The President has spent a great deal of time canvassing the country telling people about the nest eggs they will be able to call their very own. The reality is that these accounts will not be "your" money.

Not only do beneficiaries have to pay a retirement tax on their benefits, but the President has not been very clear on the question of a mandatory annuity. He has indicated that you will be required to purchase an annuity upon retirement, to assure some regular minimum payment at the poverty level if your income from other sources is not adequate. The annuity payment ceases with your death. If there is anything left in the account after the claw-back has taken its share and after you have purchased an annuity, if you are required to do so, that will be yours to take as a lump sum or leave to your heirs. It is not at all clear where these annuities will come from, but it appears most likely to be the private sector.

This would mean not only a windfall for companies that were managing the funds but also mandated annuities being underwritten by insurance companies. For most people, their accounts are going to be tiny and will be eaten up by management fees. When you annuitize it, what you get is very small.

Additionally, the claw-back requirement essentially means that you are receiving a loan from Social Security for the money you want to contribute to your private account, which you have to repay upon retiring. That does not seem to me to be "your money."

Deposit Insurance

However strong our capital markets, we are all aware that risk is inherent to the marketplace. For years, I have pushed to make sure that those save for retirement have at least one completely safe investment option: A federally insured account. While there is a place and time for individuals to invest in the equity and bond markets, there is also a time and place for them to look to their banks and credit unions for insured accounts. FDIC and SHARE insurance levels have not kept place with inflation, and are woefully inadequate to cover the savings needs of today's retirees. Together with a bipartisan group of Banking Committee Members, I have advocated an increase in Federal deposit insurance up to $250,000 for retirement accounts. The demand for such coverage clearly exists. In fact, some large financial institutions with multiple charters actually promote offers of nearly a million dollars in coverage for interest-bearing, personal accounts.

Now, in the context of Social Security reform, I will state here that I am unequivocally opposed to private accounts. That is not what Social Security is about, and I believe it is a mistake to go down this path. However, if the President and the Republican-controlled Congress are determined to privatize Social Security, then they at least should make sure that participants are not required to roll the dice with their nest eggs. Insured accounts should be an integral part of any privatization scheme, and it is our responsibility to make sure that insurance levels are adequate to cover the needs of our seniors.

Priorities and In Perspective

Social Security is in need of reforms to ensure its solvency for generations to come. But major restructuring of the program is not required. To put the gravity of the problem in perspective, one should note that the Social Security shortfall will amount to .65 percent of the GDP over the next 75 years or $3.7 trillion, while the President's recently enacted tax cuts if made permanent amount to $11.6 trillion over that same period. Additionally, the Medicare Trustees project that that Medicare drug benefit will cost 1.4 percent of GDP, or $8.1 trillion over that same period.

There is an inherent disconnect in the push for privatization. The President has stated over and over that the Social Security Trust Fund is in immediate "crisis." This manufactured crisis is based in part on financial assumptions that show a weak future for our economy. At the same time that he paints this bleak picture, the President has told the American people that investing the program in stocks is the way to go because our future economic outlook is bright, with no possibilities of downturn. We cannot have it both ways.

PREPARED STATEMENT OF GARY A. AMELIO

EXECUTIVE DIRECTOR, FEDERAL RETIREMENT THRIFT INVESTMENT BOARD

JUNE 14, 2005

Good morning, Chairman Hagel and Members of the Subcommittee, my name is Gary Amelio. I am the Executive Director of the Federal Retirement Thrift Investment Board and, as such, the managing fiduciary of the Thrift Savings Plan, or TSP, for Federal employees and members of the uniformed services. I welcome this opportunity to appear before the Subcommittee on behalf of the Board.

You have invited my testimony as part of your consideration of the role of the Financial Markets in Social Security Reform. Although the Board has expressed no view regarding any proposals to change Social Security, our experience with the TSP may provide some useful information for the Subcommittee. I am pleased to describe how the TSP functions in a number of key areas and to discuss how the Congress addressed important TSP issues in the Federal Employees' Retirement System Act of 1986 (FERSA).

The TSP is a voluntary savings and investment plan that allows Federal and postal employees (and, since 2002, members of the uniformed services) to accumulate savings for their retirement. It offers employees of the Federal Government the same types of savings and tax benefits that many private corporations offer their employees under Internal Revenue Code Section 401(k) retirement plans. The TSP currently has approximately 3.4 million individual accounts. The Thrift Savings Fund has grown to $157 billion. Each month, participants add more than $1.4 billion in new contributions. Participants may invest in any individual, combination, or all of five investment funds; transfer their monies among the funds; apply for loans from their accounts; transfer money into their accounts from other eligible employee plans or individual retirement accounts; and receive distributions under several withdrawal options. TSP administrative expenses are borne by the participants, not by the taxpayers.

The Government-wide Federal Employees' Retirement System (FERS) employee participation rate is 86.2 percent. TSP participation by Civil Service Retirement System (CSRS) employees is currently about 66 percent. Additionally, after only 3 years, nearly half a million members of the uniformed services also now have TSP accounts.

Plan Structure

Employees who are covered by FERS, CSRS, or members of the uniformed services contribute via payroll allotment to the TSP. The maximum percentages they may contribute are prescribed by law. These limits are scheduled to increase next year to $15,000 annually for most employees and $20,000 annually for those age 50 and over.

FERS employees receive an automatic contribution to their TSP accounts, paid by their employing agency, which is equal to 1 percent of their basic pay each pay period. Their employing agency also matches the first 5 percent of basic pay contributed—dollar-for-dollar on the first 3 percent and fifty cents on the dollar for the next 2 percent. CSRS employees and members of the uniformed services receive the same tax benefits as FERS employees, but receive no automatic or matching contributions from their agencies.

Governance and Administration

The TSP is administered by the Federal Retirement Thrift Investment Board, which was established as an independent Federal agency under FERSA. There are approximately 90 employees of the Agency. Governance is carried out by six individuals who serve as fiduciaries of the Plan. Five are part-time Presidential appointees (confirmed by the Senate) who serve 4-year terms, and the sixth is a full-time executive director. The latter is selected by the appointees and serves an indefinite term. Each of these persons is required by FERSA to have "substantial experience, training, and expertise in the management of financial investments and pension benefit plans." 5 U.S.C. § 8472(d). With input from the executive director and Agency staff, the Board members collectively establish the policies under which the TSP operates and furnish general oversight.

The executive director carries out the policies established by the Board members and otherwise acts as the full-time chief executive of the Agency. The Board and the executive director convene monthly in meetings open to the public to deliberate policies, practices, and performance.

FERSA provides that all monies in the Thrift Savings Fund are held in trust for the benefit of the participants and their beneficiaries. As fiduciaries, the executive director and the Board members are required to act prudently and solely in the interest of TSP participants and their beneficiaries. This fiduciary responsibility gives the Board a unique status among Government agencies.

Congress wisely established this fiduciary structure because it recognized that all Plan funds belong to the participants, not the Government, and thus must be managed for them independent of political or social considerations.

The Conference Report on FERSA, House Report 99–606, dated May 16, 1986, states in the Joint Explanatory Statement of the Committee of Conference:

> Concerns over the specter of political involvement in the thrift plan management seem to focus on two distinct issues. One, the Board, composed of Presidential appointees, could be susceptible to pressure from an Administration. Two, the Congress might be tempted to use the large pool of thrift money for political purposes. Neither case would be likely to occur given present legal and constitutional restraints.
>
> The Board members and employees are subject to strict fiduciary rules. They must invest the money and manage the funds solely for the benefit of the participants. A breach of these responsibilities would make the fiduciaries civilly and criminally liable.
>
> The structure of the funds themselves prevents political manipulation. The Government Securities Investment Fund is invested in nonmarketable special issues of the Treasury pegged to a certain average interest rate. The Fixed Income Investment Fund is composed of guaranteed investment contracts, certifi-

> cates of deposits or other fixed instruments in which the Board contracts with insurance companies, banks, and the like to provide it with a fixed rate of return over a specified period of time. The Board would have no knowledge of the specific investments.
>
> Finally, the stock index fund is one in which a common stock index such as Standard & Poor's 500 or Wilshire's 5000 is used as the mechanism to allocate investments from the fund to various stocks.
>
> The investment approach chosen by the conferees is patterned after corporate, State, and local government, and the few existing Federal pension funds. Political manipulation is unlikely and would be unlawful.
>
> As to the issue of Congress tampering with the thrift funds, the inherent nature of a thrift plan precludes that possibility. Unlike a defined benefit plan where an employer essentially promises a certain benefit, a thrift plan is an employee savings plan. In other words, the employees own the money. The money, in essence, is held in trust for the employee and managed and invested on the employee's behalf until the employee is eligible to receive it. This arrangement confers upon the employee property and other legal rights to the contributions and their earnings. Whether the money is invested in Government or private securities is immaterial with respect to employee ownership. The employee owns it and it cannot be tampered with by any entity including Congress.

H.R. Conf. Rep. No. 99–606, at 136–37 (1986), *reprinted in* 1986 U.S.C.C.A.N. 1508, 1519–20.

In keeping with the intent of Congress that the Plan be administered in accordance with fiduciary standards derived from those applicable to private sector employee benefit plans—as distinct from the usual administration of an executive branch agency—Congress exempted the Board from the normal budget and appropriations processes and the legislative and budget clearance processes of the Office of Management and Budget. The Plan's independence is critical to ensure the fiduciary accountability envisioned by FERSA. So long as the Plan is managed by the fiduciaries named in FERSA (the members of the Board and the executive director) in accordance with the statute's strict fiduciary standards, Federal employees and members of the uniformed services can be confident that their retirement savings will not be subject to political or other priorities which might otherwise be imposed by these clearance processes.

FERSA protects the Thrift Savings Fund through more than just the independent fiduciary governance by the Board members and the executive director. Additional safeguards to protect TSP participants include the provisions in FERSA relating to (1) the role of the Secretary of Labor in establishing a program of fiduciary compliance audits; (2) the requirement that the Board contract with a private accounting firm to conduct an annual audit of the TSP on the basis of generally accepted accounting principles; and (3) the participation of the 15-member Employee Thrift Advisory Council, which includes representatives of the major Federal and postal unions, other employee organizations, and the uniformed services.

The Board has benefited greatly from hundreds of audits conducted by the Department of Labor over the past 17 years. These audits, which have covered every aspect of the TSP, are reported to the Congress annually under the Inspector General Act of 1978, as amended.

The accounting firm retained by the Board has conducted annual reviews as required. The result has been eighteen unqualified audit opinions.

The Advisory Council meets with the executive director and advises on investment policy and the administration of the TSP. These meetings are very helpful in providing the Board with insights into employee needs, attitudes, and reactions to the various programs undertaken by the Board.

The TSP also benefits from the cooperation of every agency and service in the Federal establishment. Although the Board is an independent body, successful administration of the TSP is highly dependent upon all Federal agencies and the uniformed services, which have direct responsibilities under FERSA for the administration of the TSP.

Plan Services and Benefits

Employees and service members who participate in the TSP are served primarily by the personnel, payroll, and other administrative employees in their own agencies. The agencies are responsible for distributing TSP materials, providing employee counseling, and accurately and timely transmitting participant and employer contributions and necessary records to the TSP record keeper. TSP recordkeeping services are currently provided by the National Finance Center (NFC), which is part of the Department of Agriculture. The TSP Service Office in New Orleans performs a wide variety of services for TSP participants.

In addition, the TSP maintains parallel call centers at NFC in New Orleans, Louisiana, and in Cumberland, Maryland. Participants with questions may call a toll-free number which routes calls to participant service representatives at one of these sites. Further, we maintain a primary data center and a back-up data center.

Actively employed participants may borrow their own contributions and earnings from their accounts according to rules established by the executive director and regulations of the Internal Revenue Service. Participants repay the loans, with interest, and the money is reinvested in their TSP accounts. A $50 fee is charged to cover the costs of loan processing.

The other major benefit program is the TSP withdrawal program. Participants may withdraw funds from their TSP accounts before separation after reaching age 59 or in cases of financial hardship. Upon separation, a participant may:

- withdraw his or her account balance in a single payment (and have the TSP transfer all or part of the payment to an Individual Retirement Account (IRA) or other eligible retirement plan);
- withdraw his or her account balance in a series of monthly payments (and, in certain cases, have the TSP transfer all or part of each payment to an IRA or other eligible retirement plan);
- receive a life annuity; or
- keep his or her account in the TSP, subject to certain limits.

Participants may also elect a combination of these withdrawal options.

Communications

The Agency maintains its communication program on a number of levels within the Federal establishment in order to achieve employee understanding of the investment choices, benefits, and the administration of the program. This is especially important given the voluntary nature of the Plan and the participants' degree of individual control over investments and benefits.

The communication effort is initiated by the Board for eligible individuals through the issuance of a "new account letter" to each new participant after the employing agency establishes his or her account. Employing agencies distribute program information, including the *Summary of the Thrift Savings Plan for Federal Employees,* which provides a comprehensive description of the Plan, as well as booklets describing the loan program, withdrawal programs, and annuity options for employees to review at the time they are examining those benefits. Investment information is provided by the TSP Fund Sheets and the Managing Your Account leaflet which discusses operations. Copies of these publications are also available on our website at *www.tsp.gov* or through the ThriftLine.

In addition, we issue materials related to specific events. For example, the *TSP Highlights* is a newsletter issued with the quarterly participant statement. Copies of the newsletters, which address topical items and convey rates of return, are provided on our website. Participants can also obtain their daily balances from the website, request contribution allocations and interfund transfers or, in some cases, loans and withdrawals, and use various calculators located there as convenient planning tools.

A TSP video is available explaining the basics of the TSP in an animated format. TSP Bulletins are issued regularly to inform agency personnel and payroll specialists of current operating procedures. The ThriftLine, the Board's toll-free automated voice response system, also provides both general plan and account-specific information.

In connection with new Lifecycle funds we plan to introduce this summer, we will revise all of our communications materials and feature the benefits of the asset allocation approach used in "Life" funds as discussed below. We have budgeted $10 million for this major overhaul of our communications materials.

The Agency also conducts quarterly interagency meetings. These have proven to be an effective means of communicating program and systems requirements to Federal agency administrative personnel. These meetings also allow the TSP to hear and address representatives' concerns and to incorporate their suggestions in the establishment of TSP policies and operations.

Investment Funds

The TSP is a participant-directed plan. This means that each participant decides how the funds in his or her account are invested.

As initially prescribed by FERSA, participants could invest in three types of securities—U.S. Treasury obligations, common stocks, and fixed income securities—which differ considerably from one another in their investment characteristics. In

1996, on the Board's recommendation, Congress authorized two additional investment funds, which allow further diversification and potentially attractive long-term returns. The Small Capitalization Index Investment Fund and the International Stock Index Investment Fund were first offered in May 2001.

The Government Securities Investment (G) Fund is invested in short-term non-marketable U.S. Treasury securities guaranteed by the full faith and credit of the U.S. Government. 5 U.S.C. § 8438(b)(1)(A), (e). There is no possibility of loss of princi-pal from default by the U.S. Government and thus no credit risk. These securities are similar to those issued to the Social Security Trust Funds and to other Federal trust funds. *See* 42 U.S.C. § 401(d) (Social Security Trust Funds); 5 U.S.C. § 8348(d) (Civil Service Retirement and Disability Fund).

The Fixed Income Index Investment (F) Fund, which by law must be invested in fixed income securities, is invested in a bond index fund, chosen by the Board to be the Lehman Brothers U.S. Aggregate (LBA) index. The LBA index represents a large and diversified group of investment grade securities in the major sectors of the U.S. bond markets: U.S. Government, corporate, and mortgage-related securities.

The Common Stock Index Investment (C) Fund must be invested in a portfolio designed to replicate the performance of an index that includes common stocks, the aggregate market value of which is a reasonably complete representation of the U.S. equity markets. The Board chose the Standard & Poor's 500 (S&P 500) stock index in fulfillment of that requirement. The S&P 500 index consists of 500 stocks representing approximately 78 percent of the market value of the U.S. stock markets. The objective of the C Fund is to match the performance of that index.

The Small Capitalization Stock Index Investment (S) Fund must be invested in a portfolio designed to replicate the performance of an index that includes common stocks, the aggregate market value of which represents the U.S. equity markets, excluding the stocks that are held in the C Fund. The Board chose the Dow Jones Wilshire 4500 Completion index, which tracks the performance of the non-S&P 500 stocks in the U.S. stock market. The objective of the S Fund is to match the performance of the Wilshire 4500 index. The Wilshire 4500 index represents the remaining 22 percent of the market capitalization of the U.S. stock market. Thus, the S Fund and the C Fund combined cover virtually the entire U.S. stock market.

The International Stock Index Investment (I) Fund must be invested in a portfolio designed to track the performance of an index that includes common stocks, the aggregate market value of which represents the international equity markets, excluding the U.S. equity markets. The Board chose the Morgan Stanley EAFE (Europe, Australasia, Far East) index, which tracks the overall performance of the major companies and industries in the European, Australian, and Asian stock markets. The objective of the I Fund is to match the performance of the EAFE index. The EAFE index was designed by Morgan Stanley Capital International (MSCI) to provide broad coverage of the stock markets in the 21 countries represented in the index.

This summer, the TSP will introduce Lifecycle Funds. The Lifecycle Funds will be invested in various combinations using the five existing TSP funds. Participants will benefit from having professionally designed asset allocation models available to optimize their investment performance by providing portfolios that are appropriate for their particular time horizon. This is known in the financial world as investing on the "efficient frontier." We are very excited by the prospect of providing these funds to participants this summer. We have placed preliminary information regarding the Lifecycle Funds on our website, and will be issuing much more over the coming months.

One likely concern associated with a Federal agency's investing in equities is the potential for the Government to influence corporate governance questions and other issues submitted to stockholder votes. FERSA provides that the voting rights associated with the ownership of securities by the Thrift Savings Fund may not be exercised by the Board, other Government agencies, the executive director, a Federal employee, Member of Congress, former Federal employees, or former Members of Congress. 5 U.S.C. § 8438(f). Barclays Global Investors (BGI), the manager of the C, S, and I Fund assets, has a fiduciary responsibility to vote company proxies solely in the interest of its funds' investors.

The fund assets held by the F, C, S, and I Funds are passively managed indexed funds; that is, they are invested in portfolios of assets in such a way as to reproduce market index returns. The philosophy of indexing is that, over the long-term, it is difficult to improve upon the average return of the market. The investment management fees and trading costs incurred from passive management through indexing generally are substantially lower than those associated with active management.

Passively managed index funds also preclude the possibility that political or other considerations might influence the selection of securities.

The manager of the assets held by the F, C, S, and I Funds has been selected through competitive bidding processes. Proposals from prospective asset managers were evaluated on objective criteria that included ability to track the relevant index, low trading costs, fiduciary record, experience, and fees.

The Board has contracts with BGI to manage the F, C, S, and I Fund assets. BGI is the largest investment manager of index funds in the United States, which had over $1.36 trillion in total assets under management as of December 31, 2004.

The centralized management of TSP investments was carefully considered in FERSA by Congress. According to the Joint Explanatory Statement of the Committee of Conference quoted earlier:

> Because of the many concerns raised, the conferees spent more time on this issue than any other. Proposals were made to decentralize the investment management and to give employees more choice by permitting them to choose their own financial institution in which to invest. While the conferees applaud the use of IRA's, they find such an approach for an employer-sponsored retirement program inappropriate . . . .
>
> The conferees concur with the resolution of this issue as discussed in the Senate report (99–166) on this legislation:
>
> As an alternative the committee considered permitting any qualified institution to offer to employee[s] specific investment vehicles. However, the committee rejected that approach for a number of reasons. First, there are literally thousands of qualified institutions who would bombard employees with promotions for their services. The committee concluded that employees would not favor such an approach. Second, few, if any, private employers offer such an arrangement. Third, even qualified institutions go bankrupt occasionally and a substantial portion of an employee's retirement benefit could be wiped out. This is in contrast to the diversified fund approach which could easily survive a few bankruptcies. Fourth, it would be difficult to administer. Fifth, this "retail" or "voucher" approach would give up the economic advantage of this group's wholesale purchasing power derived from its large size, so that employees acting individually would get less for their money.

H.R. Rep. No. 99–606, at 137–38, *reprinted in* 1986 U.S.C.C.A.N. 1508, 1520–21.

Investment Returns

By law, TSP investment policies must provide for both prudent investments and low administrative costs. From the beginning of the G Fund's existence (April 1987) and the beginning of the F and C Funds' existence (January 1988) through December 31, 2004, the G, F, and C Funds have provided compound annual returns net of expenses of 6.7 percent, 7.7 percent, and 12.1 percent, respectively. The related BGI funds closely tracked their respective markets indexes throughout this period. Because the S and I Funds were introduced in May 2001, the Board has no long-term history for them. The indexes which they track, however, have produced compound annual returns of 11.9 percent and 5.6 percent, respectively, for the 10-year period ending December 2004.

In order to make the performance of the TSP funds more easily comparable, I have attached a chart which displays the growth of $100 invested in the underlying indexes for 20 years. The chart also includes the growth related to G Fund securities as well as inflation.

For calendar year 2004, the net Plan administrative expenses were .06 percent. This means that the 2004 net investment return to participants was reduced by approximately $.60 for each $1,000 of account balance. The expense ratio would be approximately .01 percent higher in the absence of account forfeitures, which offset expenses. These costs compare very favorably with typical private sector 401(k) service provider charges.

In summary, I believe that the Thrift Savings Plan has effectively and efficiently realized the numerous objectives Congress thoughtfully established for it 19 years ago. To the extent that our experience is useful to the Subcommittee, I welcome the opportunity to provide any additional information you may require. I would be pleased to respond to any questions you or other Members of the Subcommittee may have at this time.

PREPARED STATEMENT OF FRANCIS ENDERLE

MANAGING DIRECTOR AND CHIEF INVESTMENT OFFICER,
GLOBAL INDEX AND MARKETS GROUP, BARCLAYS GLOBAL INVESTORS

JUNE 14, 2005

Good afternoon, Mr. Chairman and Members of the Committee, my name is Francis Enderle and I am the Chief Investment Officer for the Global Index and Markets Group at Barclays Global Investors (BGI). In that role I am responsible for, among other things, the oversight of portfolio management in the United States of all of BGI's index strategies.

We are pleased to be here today to share with the Committee our expertise in the management of defined contribution pension accounts, which is derived from our experience as the external asset manager for the Federal Thrift Savings Plan (TSP) as well as for numerous other public and private pension plans. We are honored to have served as an investment manager for the TSP since 1988, a relationship we have retained in regular, highly competitive bidding processes.

I will begin by discussing our investment philosophy and our structure, both of which are focused on delivering highly reliable, low cost investment results to institutional investors like the TSP. By "institutional" I refer to defined benefit and defined contribution pension plans sponsored by corporations or public agencies, and to endowments, foundations, and other similar pools of capital. I will then say a few words about the services we provide to the TSP, and elaborate on how we keep the costs associated with trading and investing as low as possible. I will conclude by turning to the investment related issues to be considered if the Federal Government were to legislate individual investment accounts either as part of Social Security reform, or through another mechanism.

Barclays Global Investors was founded in 1971 as part of Wells Fargo Bank in San Francisco, California. Today, we are owned by Barclays PLC, one of the world's leading financial service providers. We are headquartered in San Francisco with approximately 1,100 employees in California and elsewhere in the United States and 1,100 more employees worldwide serving the needs of our global clients. With more than $1.3 trillion in assets under management, BGI, together with its affiliates, is the world's largest index manager. BGI created the first index strategy in 1971, just one of many financial innovations we have pioneered.

Since our founding, BGI has remained true to a single global investment philosophy, which we call *Total Performance Management.* BGI manages *performance* through the core disciplines of *risk, return, and cost* management. The success of our indexing methodology results from our focus on delivering superior investment returns over time while minimizing trading and other implementation costs and rigorously controlling investment and operational risks. This approach helps us avoid investment "fads" or a dependence on "star managers" or "stock pickers." It has been the foundation for the way we have managed money for over 30 years and we believe it has served our clients very well.

As I noted earlier, since 1988 one of those clients has been the TSP. BGI manages four of the five investment options available for participants—the TSP C Fund (based on large-capitalization U.S. equities), the S Fund (based on mid- and small-capitalization U.S. equities), the F Fund (based on the Lehman Aggregate Long-term Bond index) and the I Fund (based on the MSCI Europe Australia Far East (EAFE) index of non-U.S. equities). The fifth option, the G Fund, is managed by the U.S. Treasury and invests in U.S. Treasury securities. Later this year, the TSP will be launching a series of lifecycle or "target horizon" options that use the existing five options as the asset class "building blocks" with allocations in each lifecycle fund across these options being determined by an external vendor. I will describe shortly the structure of these new options, as well as the benefits they will provide to plan participants.

BGI's services to the TSP are completely focused on investment management. We do not provide any other services. We have an extremely effective operating model developed in conjunction with TSP staff to manage the daily cashflows into or out of each of the investment options. Each day we receive an instruction for each fund that aggregates the transaction instructions of all TSP participants placing orders on that day. In this way, the orders for participants buying or selling from the same fund are netted against each other and only a trade for the residual order is placed.

Management of payroll contributions, recordkeeping (for example, changes made by participants in investment elections), distributions and communications to participants are handled directly by the TSP or its other vendors. This is also true for most of our other clients—our core expertise is investment management, and our comments are provided principally from this perspective. Minimizing transaction costs in all our investment activities is a central element, Mr. Chairman, in how we do our business. In fact, the key to our success in index management has been our ability to minimize implementation and trading costs. High costs and expenses of investing detract from performance and investment returns; lower costs increase the investment pool and put more money long-term into the pockets of investors. Let me say a few words about how we do this.

Each of our index funds is structured to match the performance of a specific index. These indexes (such as the S&P 500 or the MSCI EAFE) are designed by third-party index providers. However, these indexes are really "paper portfolios" and do not include any of the trading costs that real-world investors experience. Thus to successfully achieve the performance target—that is, to track the index as closely as possible—BGI strives to minimize the "real world" costs through a variety of highly efficient trading approaches.

Through the size and diversity of our client base we are able to match or offset a significant percentage of our clients' buy and sell orders internally, thereby reducing or eliminating market transaction costs. The internal matching of buy and sell orders is commonly referred to as "crossing," and is conducted and actively monitored by BGI pursuant to the terms and conditions of an exemption issued by the Department of Labor.

When we do trade in the markets, we utilize carefully developed and managed trading strategies and we access all possible sources of liquidity, including electronic marketplaces. Our trading activities are supported by a dedicated trading research team, whose sole job is to develop new trading techniques and strategies to minimize trading costs. We execute our trades through broker-dealers who have been prescreened for credit-worthiness, and we rigorously monitor the prices at which our trades are executed relative to a number of market-related benchmarks to ensure we are receiving superior execution. We also use our scale to negotiate low per share commission rates.

The majority of our assets are managed for large institutional clients such as the TSP and the average account size for our U.S. clients is $880 million. BGI is able to charge lower investment management and administrative fees to its institutional clients than a mutual fund firm geared toward retail investors, where the average account size is comparatively small. And in dealing with institutional investors we do not have the costs of retail administrative services (including shareholder communications and recordkeeping), which also serve to raise the costs of retail fund managers. By way of example, the average fee for large-capitalization U.S. equity index portfolios of $100 million in size that are managed for institutional clients is 0.05 percent versus retail-oriented equity index mutual funds where the fees average 0.69 percent,[1] more than 10 times greater than our expense ratios.

Over the course of a long-term investment, lower management fees and expenses (including trading commissions) can translate into considerable savings for any investor. Indeed, index investing remains the most cost-efficient and diversified way to gain exposure to various segments of the capital markets. We believe index funds are the best core investment for most investors' portfolios—whether they are the largest pension fund in the world, or an individual investor.

I would now like to make a few comments regarding investment management considerations if personal accounts are adopted as part of any future changes to the Social Security program.

Let me first acknowledge that BGI has built a substantial part of its business by offering well-managed index strategies to our clients for more than 30 years. We therefore have a vested interest in the continued growth of index investing. Our interests aside, we firmly believe that the reason for the success of these strategies is the simple fact that they deliver the return of the market index reliably and cost effectively. In fact, Congress recognized this itself in the enabling legislation for the TSP, which provides that the four public market options be invested in portfolios designed to replicate the performance of an index that is "commonly recognized" as reflecting the performance of each asset class (that is the S&P 500 Index for large capitalization U.S. equities).

If a national system of personal accounts were to be implemented, we would encourage legislators to consider the following approach that draws on the best practices of institutional investors.

An array of low cost, broadly diversified index funds frequently forms the core investment for institutional pension plans, both defined benefit and defined contribution structures. For example, the current selection offered to TSP participants covers all the main asset classes—large and small capitalization U.S. equities, U.S. fixed income, international equities and a stable value option. Other asset classes

[1] Source: Morningstar, BGI 2/05.

could be included but these options would provide the basic "building blocks" and coincide with what one would typically see in a well-constructed institutional portfolio.

We suggest consideration of index portfolios because they offer three principle benefits to investors:

- They capture the return of each asset class (as represented by a benchmark index such as the S&P 500) with a high degree of precision;
- Index funds typically have low asset management fees as compared to actively managed funds;
- Index funds have lower relative transaction costs including commissions, bid/ask spreads and market impact. This is because index fund investments are spread across a large number of securities thereby reducing the impact of a portfolio trade on an individual security relative to what would occur in a more concentrated portfolio.

The latter point is worth elaborating upon given the sizeable assets that would potentially be invested in personal accounts. Investing in index funds spreads assets across the broadest possible array of securities in any asset class thereby minimizing the impact of trading large cashflows in the market on a daily basis. This is not only important for the investment of new monies into personal accounts but also for any trading that individuals may initiate in their personal accounts to reallocate assets among their investment options over time.

Another investment option to be considered is an array of so-called lifecycle or "target horizon" funds, options that the TSP will be adding later this year, as I mentioned earlier. With lifecycle funds, potentially the only choice an investor needs to make is to select the lifecycle fund with the target horizon date that most closely matches the investor's date of retirement. Each lifecycle fund would hold an array of asset classes with each asset class being implemented with an index fund. The asset mix within each lifecycle fund would gradually become more conservative over time as the target horizon date approached. For example, a participant who is 30 years of age today and a set retirement of, for example, age 65 would be invested in a lifecycle fund with a target horizon date of 2040.

As with the index fund options described earlier, a lifecycle fund option could also be structured as a very low cost solution to investors. While a lifecycle fund would not necessarily need to be invested in index funds, index funds likely provide the lowest cost solution for each asset class, and assure that the return of each selected asset class is reliably captured. Participants in each lifecycle fund would benefit from the fund's gradual evolution to a more conservative investment risk profile as the participant approached retirement.

Mr. Chairman, we believe that the investment considerations we have discussed will assist you and others on this Committee in evaluating the criteria to be used if personal accounts were to be legislated by Congress as part of revisions to the Social Security program, or in another program. I thank you for the opportunity to speak with you today and I look forward to answering any questions you may have.

PREPARED STATEMENT OF FRANCIS X. CAVANAUGH

FORMER EXECUTIVE DIRECTOR, FEDERAL RETIREMENT THRIFT INVESTMENT BOARD

JUNE 14, 2005

Mr. Chairman and Members of the Subcommittee, I welcome this opportunity to discuss the role of financial markets in Social Security reform. The Administration's current proposal for Social Security individual accounts (IA) contemplates that private financial institutions would provide fund management services and probably other 401(k) plan services, such as investment education, counseling, and record keeping. My comments will focus on the cost of such services and the problems in providing them to employees of small businesses.

I am a public finance consultant, but I speak only for myself. I have no clients with an interest in Social Security individual accounts. From 1986 until 1994, I was the first Executive Director, and thus the Chief Executive Officer, of the Federal Retirement Thrift Investment Board, the agency that administers the Thrift Savings Plan (TSP) for Federal employees. Before that, I was a financial economist in the Treasury Department for 32 years, and was the senior career executive responsible for developing Federal borrowing, lending, and investment policies, including those for the Social Security and other Federal trust funds.

The Administration's Proposal

While there is no specific proposal before your Committee, the Administration's current broad proposal, according to White House statements and press reports, provides a basis for at least a preliminary analysis of its feasibility.

The following features of the Administration's approach would have significant impacts on its feasibility:

- Social Security individual accounts (IA's) would be voluntary for all Social Security taxpayers under age 55, but would be mandatory for employers of employees who chose IA's.
- A major purpose of IA's would be to encourage savings by young and low-income workers and employees of small businesses who do not now have 401(k)s or other pension plans.
- The maximum amount of an individual's initial annual contribution to an IA would be $1,000, which would increase by $100 a year, to 4 percent of pay eventually. It would take more than 30 years for the highest income individuals to be able to contribute the full 4 percent of pay.
- Eligible investments for IA's would be Treasury securities and stock and bond index funds, which would be similar to eligible investments of the TSP.
- IA's would be centrally managed, apparently by a TSP-like agency with a part-time board, appointed by the President with the advice and consent of the Senate, and a full-time executive director and CEO appointed by the board. Following the TSP model, the board members and the executive director would be independent of the administration, and would be fiduciaries required to act solely in the interests of the holders of the IA's and their beneficiaries.
- Unlike contributions to 401(k)'s or to the TSP, IA contributions would not be eligible for matching contributions or exclusion from taxable income, and loans or withdrawals before retirement would not be permitted.

Cost Analysis

A critical question, of course, is costs. IA's are proposed to provide a higher investment return than would be realized by the Social Security Trust Fund. Thus IA's would not be feasible if their administrative costs were so high as to offset the advantage of diversified investments in stocks and other securities that yield more than the Treasury securities in the Social Security Trust Fund.

The Administration assumes that IA's would earn an average investment return of 4.9 percent after inflation, and that administrative costs of .3 percent, that is, 30 basis points, would reduce the net return to 4.6 percent, or 1.6 percent more than the assumed net return of 3 percent on the Treasury securities in the Social Security Trust Fund. Thus, if one accepts the Administration's assumptions, IA's would outperform the Trust Fund investments so long as the administrative costs were less than 1.9 percent. In my view and that of many other economists, the 4.6 percent assumption is much too high; indeed, the Congressional Budget Office's estimate of the net return is reportedly only 3.3 percent.

The Administration's estimate of 30 basis points is optimistically low; even the Cato Institute, a leading advocate of individual accounts, estimates IA expenses at 55 basis points. Yet this higher estimate is also too low. Like so many others I have heard, these estimates are based mainly on experience with large 401(k)s for large organizations, like the TSP,[1] with economies of scale and comprehensive payroll, personnel, and computerized systems support.

They have little relevance to the likely costs of a universal system of IA's. More than 85 percent of the 5.6 million small business employers in this country offer no pension plans at all and, accordingly, have *none* of the administrative apparatus to service them.

To understand the costs of bringing IA's to employees of small businesses, we must first understand why 85 percent of them do not now have retirement plans for their employees. Fortunately, the 401(k) industry has already done part of the job for us. Companies like Citigroup, Fidelity Investments, Merrill Lynch, State Street Corporation, and T. Rowe Price have been competing for two decades to provide investment, record keeping, counseling, and other 401(k) plan services to small businesses. They have found that they cannot profitably provide these services for a company for less than approximately $3,000 a year, even though they have for years enjoyed economies of scale from serving thousands of employers in their centralized computer systems.[2] Further significant economies of scale would not be re-

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[1] The administrative cost, or expense ratio, of the TSP is 6 basis points.

[2] Francis X. Cavanaugh, "Feasibility of Social Security Individual Accounts," AARP Public Policy Institute, Washington, DC, Sept. 2002, pp. 4–6. The $3,000 charge is still common today.

alized by a central TSP-type agency, because there would still be millions of small businesses or workplaces to be reached. Nor can we assume that a new central government agency would be more efficient than the major 401(k) providers who now serve this market.

Thus the cost per employee of a company with 10 employees would be $300, or 30 percent of the President's proposed annual IA contribution of $1,000—and most U.S. companies have fewer than 10 employees.[3]

Even the largest business that is classified as a "small business," one with 100 employees, would therefore have an expense ratio of at least 3 percent, which would be 10 times the Administration's estimate of 30 basis points. And for the 60 percent of employers in this country that have fewer than 5 employees, the initial expense ratio would be more than 60 percent, that is, 6,000 basis points. In fact, commercial 401(k) providers routinely discourage small businesses from establishing 401(k) plans if they have fewer than 10 employees and, in some cases, fewer than 25 employees.

Obviously, substantial and continuing government subsidies would be necessary to make IA's attractive to employees of small businesses. If all Social Security taxpayers participated in the IA program, the administrative costs would be more than $46 billion a year (155 million participants times more than $300 per account), which would be a subsidy to IA administrators for performing an uneconomic function. These figures are reinforced by a number of studies, including those cited in a review of administrative costs by the Employee Benefit Research Institute.[4]

I recommend that your Committee secure the testimony of individuals from financial institutions that are actually providing 401(k) services to the Nation's businesses, large and small. Give them a specific set of assumptions to cost out that reflects the makeup of our country's 5.7 million employers subject to Social Security—of which 98 percent are small business employers of 68 million employees.[5] Then and only then will you know whether the Administration's proposal—or anything similar—will produce reasonable net investment returns, or, in the alternative, how much of a Government subsidy would be necessary to achieve them.

Critical Administrative Problems

In addition to the above costs, which are based on what the current providers are actually charging for establishing and servicing 401(k) plans, there are overwhelming practical obstacles to the creation and maintenance of IA's. Because President Bush seemed to idealize the Thrift Savings Plan—the largest of all 401(k)-type plans—as the model for IA's in his February 2005 State of the Union message—and because many others have done so as well—I would like to point out the considerable dissimilarities between the TSP and the administration's proposal. (Most of these dissimilarities would hold true for a comparison between any large corporate 401(k) plan and the proposal.)

Too Many Small Employers. The TSP is administered by just one employer—the U.S. Government—with extensive personnel, payroll, and systems staffs to provide the essential employee education, retirement counseling, payroll deduction, timely funds transfers, and error correction functions. The Thrift Investment Board is only a wholesaler of services; the Federal employing agencies deal with the individual employees participating in the plan. In fact, the TSP statute directs the Office of Personnel Management to provide for the training of TSP counselors for each Federal agency.

The Administration's plan is intended to reach all employees, but it makes no provision for the performance of what are now essential employer functions in 401(k) plans. They could not possibly be performed by small business employers who are now responsible only for the relatively simple payroll deduction and transmission of Social Security taxes to the IRS. Since most businesses have fewer than 10 employees, they do not have the experience or administrative resources to support the new plan. These are barbershops, beauty salons, garages, restaurants, laundries,

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See "Big Fees Hit Small Plans: Costs Take Huge Toll on Retirement Accounts of Firms With Fewer Than 50 Employees," *Wall Street Journal*, Oct. 31, 2004, p. D1.

[3] *See generally* U.S. Department of Labor, Pension and Welfare Benefits Administration, "Study of 401(k) Fees and Expenses,"Apr. 13, 1998. The study found that average charges by 17 major 401(k) providers for plans with 100 participants and $2 million in assets ranged from $114 to $428 per participant, and averaged $264. Id. at 51. Charges obviously would be much higher for much smaller plans.

[4] *See, for example,* Employee Benefit Research Institute, Issue Brief No. 23, Nov. 1998. *See also* Ellen E. Schultz, "Poodle Parlor Retirement Plans," *Wall Street Journal*, Nov. 13, 1998, p.C1.

[5] Patrick Purcell, Congressional Research Service, "Social Security Individual Accounts and Employer-Sponsored Pensions," Feb. 3, 2005, pp. 3, 5.

lawn services, households, nanny services, and other very small businesses that could not be expected to meet the high fiduciary standards required of those responsible for educating and counseling employees, for presenting a new plan in the context of the employer's existing pension or other benefits, and for the timely and accurate transfer of funds for investment. The new TSP-like agency obviously could not provide such employer-type services to deal with tens of millions of diverse employees, either directly or on a contract basis.

Consider, as but one example of several profound administrative and legal issues, that about 650,000 businesses go out of business *each year.* By whom and how would the enforcement of contributions by delinquent or bankrupt employers be prosecuted? (Judicial remedies for denial of TSP benefits must, in general, be pursued by the affected individual TSP participant in the Federal court system.) For that matter, by whom and how would breach-of-fiduciary-duty suits be brought against "mom-and-pop" fiduciaries? Can the employer of a housekeeper or a manicurist be expected to exercise the "care, skill, prudence, and diligence" demanded of every 401(k) plan fiduciary by current law?[6] What would be the measure—and the limit—of their personal liabilities, say, for untimely or inaccurate investment of their employees' contributions? These questions only scratch the surface of the inevitable pathology of plan administration—pathology that, even if represented in small percentages among 155 million Social Security participants, would result in enormous absolute numbers.

Untimely Investments. The TSP is computerized, like all other large plans, with investments made for each employee's account on the same day that contributions are deducted from the employee's paycheck. Social Security taxes are deducted on paydays, but many small businesses send them to the IRS only once each quarter. In 2003, 72 percent of employer reports to the Social Security Administration were submitted *on paper.* Moreover, individual Social Security taxpayers are identified only once each year, with their employer's annual income tax filings; and it would be up to 22 months after payday, under current SSA procedures, before individual IA's could be credited.

Furthermore, the Administration's proposal is to pay IA's the same annual return, regardless of when contributions were actually made during the year. Thus a contribution in January would not earn any more than a contribution of a similar amount in December. During a year of highly volatile markets, the attempted explanation of this provision to millions of outraged participants with irregular tax payments, because of illness, seasonal, temporary, or other periods of unemployment, would be a daunting challenge to the plan's telephone counselors.

Unbalanced Accounts. The TSP is balanced to the penny every day. The Social Security system is never balanced. Each year there are billions of dollars of unreconciled discrepancies between Social Security taxes paid to the IRS and reported to the SSA. These discrepancies are tolerated because they generally have little impact on the ultimate calculation of employee benefits. Such discrepancies are never tolerated by financial institutions responsible for timely investment of individual funds. Theoretically, IA contribution errors might be largely corrected by a rigorous examination of employer records. Yet the error correction procedures, including retroactive adjustments of investment gains or losses in volatile markets, could bring the entire system to a screeching halt.

Inevitable Account "Leakage." Unlike the TSP, the Administration's plan would prohibit loans and emergency withdrawals, and would require individuals to purchase annuities on retirement. I find it inconceivable, however, that Congress—or an Administration—would long be able to resist calls for emergency access to funds before a worker's retirement, and in lump sum amounts. Suppose, for example, that an individual has suffered a devastating personal financial loss, such as thousands experienced in last year's Florida hurricanes in the destruction of their homes. Would these persons be told that they may not access their IA balances to mitigate such dire misfortunes? What about a catastrophic illness, leaving a family's breadwinner unable to work? Could such persons be denied their account balances to sustain spouse and children? I do not think so. There are, of course, scores more such examples, and with 155 million potential participants, you can be sure that they all would arise. Administering the inevitable emergency withdrawal or loan program would add enormously to the cost of the Administration's plan.

Communication Problems. The TSP has a very effective communications system, because it can rely on the Federal employing agencies to distribute plan materials and to educate and counsel their employees. Even so, the TSP found it necessary to have the central recordkeeper for its 3 million accounts maintain a staff of more

[6] *See* Employee Retirement Income Security Act (ERISA), 29 U.S.C. § 1104(a); Federal Employees' Retirement System Act (FERSA), 5 U.S.C. § 8477(b)(1).

than 200 telephone counselors to respond directly to questions from individual participants. Since more than 200 million Social Security taxpayers and retirees eventually would be eligible for IA's, the required number of telephone counselors would be more than 13,000, based on the TSP experience, and probably much higher because of the special IA deficiencies noted above.[7] Also, TSP mailings consistently have reached more than 99 percent of participants, but 25 percent of SSA mailings are returned as undeliverable.

Congress would undoubtedly insist that every effort be made to advise all Social Security taxpayers of the IA benefits Congress intended to provide them. The TSP sent summary plan documents to all 3 million eligible employees, which required 18 trailer trucks of printed materials. Similar documents would have to be sent eventually to the more than 200 million Social Security-covered employees and retirees.

The eventual costs of such massive efforts at this point are unknown, but they clearly would have a significant impact on IA expenses.

Small Employer Antipathy. Even if small businesses were able to perform normal employer functions for IA's, would they want to? IA's would be voluntary for employees but, if employees elect to have IA's, mandatory for their employers.

The TSP and 401(k) plans generally are enthusiastically sponsored and supported by the large employers who offer them as a major benefit for their employees, and as a means to move away from defined benefit retirement plans that require employers to bear substantial investment risks. The major attractions of the TSP and 401(k)'s generally are the matching employer contributions and the immediate tax benefit from excluding employee contributions from taxable income. The ability to borrow or withdraw funds to meet emergency needs is also a significant benefit. IA's, as currently proposed, would offer none of these benefits, and would be a relatively unattractive product that employers might be reluctant to support, especially small employers who do not have any pension plans. Moreover, it would be unrealistic to expect small-business employers to act as large corporate employers do in assuming the costs of investment losses because of, say, employer error in transmitting funds for timely investment of 401(k) accounts, or for myriad other commonplace employer errors. These serious concerns for small businesses would have to be addressed during congressional hearings on IA proposals.

The Trust Fund Alternative

Since IA's are certainly not feasible for employees of small businesses—the vast preponderance of the business community—the only practical way to give them the higher returns available from equity investments is to invest part of the Social Security Trust Fund in equities. That way, the overwhelming administrative costs and practical problems of the Administration's plan would be avoided. The total administrative cost of having the Social Security Trust Fund invest in the private funds proposed for IA's would be no more than one basis point, based on the actual costs of market investments by the Thrift Savings Plan. The likely increase in Trust Fund earnings would be an effective way to help maintain the solvency of the Trust Fund without having to resort to significant increases in Social Security taxes or reductions in benefits.

Every State in the United States has authorized public retirement fund investment in stocks. Yet the Federal Government still clings to the old notion that governments should not have an ownership stake in private companies, which made some sense when individual stocks were involved. Today's broad based index funds, however, remove the investor from direct control over particular companies. Small business employees should not be denied the benefits of portfolio diversification in the Social Security Trust Fund simply because the Federal Government has not kept up with the States in understanding the evolution of financial markets.

Less Government Influence Over Private Companies. As shown in the following chart, there is even less Government influence over private companies under the Trust Fund alternative than under the TSP or the Administration's plan.

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[7] Fidelity Investments, a major 401(k) provider, has estimated that the administration of a 401(k)-type plan for Social Security taxpayers would require a total staff of 100,000. *See* Employee Benefit Research Institute, Issue Brief No. 23, Nov. 1998, p. 166.

Government Influence Over Private Companies

	Thrift Savings Plan	Administration Plan	Social Security Trust Fund Alternative
Selection of stock and bond index funds	Government decides	Same	Same
Selection of fund managers	Government decides	Same	Same
Selection of private record keeper	Government decides	Same	N/A
Selection of auditors and consultants	Government decides	Same	N/A
Selection of annuity providers	Government decides	Same	N/A
Selection of allocations among index funds.	Individuals decide	Individuals decide	Government decides

N/A—not applicable. (There would be no need for private recordkeepers, auditors, consultants, or annuity providers for trust fund investments.)

Special Benefits for Trust Fund. Unfortunately, some political leaders have convinced many of the public that the Social Security Trust Fund is not really invested because it has been "looted," and that the Trust Fund consists of "worthless IOU's." Nothing could be farther from the truth, and such statements betray an apparent ignorance of Federal finance in our highest circles of government. The Trust Fund is fully invested in the best securities in the world—U.S. Treasury obligations. Private trust funds invest in Treasury securities in the open market, but the Social Security Trust Fund buys its Treasury securities directly from the Treasury, which is more efficient than if the Treasury were to issue the securities in the market and then buy them back for the Trust Fund.

Moreover, the Trust Fund actually gets a much better deal than the private funds that buy Treasuries in the market. The Trust Fund, by law, may redeem its securities before maturity at par value, rather than at the sometimes deep market discounts suffered by private investors during periods of rising interest rates. Also, since the Trust Fund gets its securities directly from the Treasury, it avoids the market transaction costs which private investors must pay. Finally, the law requires the Treasury to pay the Trust Fund an interest rate on all of its investments in Treasuries equal to the average yield on long-term Treasury marketable securities. This is a significant benefit to the Trust Fund, since long-term rates are generally much higher than short-term rates. Thus in recent years, private investors have been earning about 2 percent on their short-term Treasuries, while the Social Security Trust Fund was earning about 4 percent on effectively the same maturities. The public seems to be totally unaware of these subsidies to the Social Security Trust Fund, which have been there for many decades.

Trust Fund Dedicated to Social Security. The assets of the Social Security Trust Fund consist of investments in Treasury securities solely for future beneficiaries. Yet political leaders from both parties complain that the Treasury has "spent" the Trust Fund surplus on Government programs. What on earth do they expect the Treasury to do with the money—bury it in the Treasury's back yard? The Treasury also spends the money it raises by issuing Treasury securities in the market. Does that mean that the private investors in Treasuries are also being "looted" by the Treasury? Of course not. The scandal would be if the Treasury left the Trust Fund uninvested and not earning interest. Then the Secretary of the Treasury would be in effect saying "I don't owe you," and that indeed would be a worthless IOU.

So why do Government officials find fault with perfectly sound financial practices? From ignorance, as I suggested earlier?—or is it is because they are trying to hide the real problem, which is the unique way the Social Security program is treated in the budget? Social Security expenditures are excluded from the budget and thus from the restraints on other Government spending, which is proper since they are entitlements, and cannot be restrained under existing law. But the Social Security surplus is then, inconsistently, included in the calculation of the overall budget deficit, for the sole purpose of appearing to have achieved deficit, and thus spending, reduction. Then, having committed this accounting farce, officials have the audacity to complain that the misleading budget treatment of the Trust Fund surplus—which they could change—makes it available to finance other programs. The problem here is not the financing of the Trust Fund, but the political gimmickry of its budget treatment.

Conclusion

In conclusion, the Administration's plan for universal IA's is not feasible, and it should not survive the process of responsible Congressional hearings. The only practical way for the Social Security system to capture the higher returns available from investments in stocks is to diversify Social Security Trust Fund investments. The

Trust Fund alternative, compared to IA's, would involve less Government influence over private companies, would be less disruptive of financial markets, would save tens of billions of dollars a year in administrative costs, and could be effective virtually immediately, rather than the 2009 starting date proposed for IA's. The multi-trillion dollar transition costs proposed by IA proponents would be avoided. The additional Trust Fund earnings would go a long way toward strengthening Social Security finances, and would thus reduce, if not eliminate, the need for significant tax increases or benefit reductions.

Thank you for your attention. I would be pleased to answer any questions.

PREPARED STATEMENT OF MICHAEL TANNER

DIRECTOR, CATO PROJECT ON SOCIAL SECURITY CHOICE

JUNE 14, 2005

Mr. Chairman, distinguished Members of the Committee, I would like to thank the Committee for holding this hearing and for giving me the opportunity to appear. In particular, I appreciate that the Committee is moving beyond the standoff over whether Social Security reform should or should not include personal accounts to consider how such accounts might be structured in ways that can maximize consumer choice and control, while ensuring efficiency, low costs, and preserving an appropriate measure of worker protection.

Of course, along with my colleagues at the Cato Institute, I believe that Social Security reform must allow younger workers to save and invest some of their Social Security taxes through personal accounts. I believe that such accounts can significantly contribute to restoring Social Security to permanent sustainable solvency. More importantly, I believe that personal accounts are essential to modernizing Social Security in keeping with such fundamental American values as ownership, inheritability, and choice.

In particular, regarding the subject of this hearing, economic theory holds that private capital investment should provide a higher rate of return than a mature PAYGO Social Security system. If one accepts the Social Security Administration's assumptions about future bond and stock returns, a balanced portfolio (50 percent stocks, 30 percent corporate bonds, and 20 percent Government bonds) could be expected to yield a return of 4.9 percent. Subtracting 25 basis points of administrative costs provides a net yield of 4.65 percent. Shifting the mix slightly in favor of equities should raise the expected return to roughly 5 percent. This clearly exceeds the return available from Social Security, and also significantly exceeds the offset interest rate suggested under the President's reform proposal.

This is not to say that personal accounts can perform miracles. They cannot, by themselves, solve Social Security's entire $12.8 trillion funding shortfall. However, workers who choose the personal account option—and I note that personal accounts are voluntary under all the major reform proposals—can expect to receive more in retirement benefits than Social Security can actually pay them.

That said, how personal accounts are structured and the investment options available to workers can make a significant difference in the success of any personal account proposal. In short, details matter.

Any retirement system has four important administrative functions: Collection, transmission, recordkeeping, and money management. First, there must be a system to collect the retirement funds from the worker. Next, the funds must be transmitted to an administrator. The administrator is responsible for keeping records of each worker's contribution to the retirement program and the benefits that each worker will eventually receive. Finally, the money has to be invested and managed between the time it is received and the time it is disbursed.

In designing an investment and administrative structure of personal accounts, you should be guided by these basic concerns:

- *Simplicity and Transparency.* Workers should clearly understand where there money is going and what their options are. Where personal account plans have encountered difficulties, such as in Britain, it has been primarily do to overly opaque or complex schemes.
- *Balancing Return and Risk.* While market returns can be expected to exceed Social Security returns, markets are not risk free. In particular, they offer increased volatility. In addition, many of the new investors brought into the market through personal accounts will be inexperienced. A personal account investment plan must offer these individuals some degree of protection without stifling consumer choice, over regulating markets, or unduly restricting the potential for positive returns.

- *Keep Administrative Costs Low.* While regulation of account fees would be unwise, accounts should be designed in ways that minimize administrative costs. SSA estimates that accounts would cost 25–30 basis points to administer. This seems like an entirely reasonable target.
- *Limit Government Involvement in Investment Decisions.* Decisions about the investment of the accumulating retirement funds should be left to private markets and insulated from Government interference as much as possible.
- *Avoid Increased Employer Burden.* Every effort should be made to avoid any new burden on employers, particularly small employers. Possible sources of additional employer burdens would include higher tax payments, greater complexity in tax calculations, more extensive recordkeeping requirements, or a requirement to report information more frequently.

Cato's Project on Social Security Choice has devoted considerable time and study to these issues. As a result of our work, we believe that the following structure provides the framework for meeting these concerns. I do not, by any means, assert that it is the only acceptable administrative structure. But I believe that any workable administrative structure that deals with these issues will contain many or most of the following elements.

First, at least initially, the collection, recordkeeping, and transmission functions should be handled centrally. The U.S. Treasury Department through its existing tax collection capabilities is well-suited for this role. Therefore, I would propose that the collection of payroll taxes, including individual account contributions, would continue to be handled by the employer in much the same way as today and sent to the Treasury as they are today. The only difference would be that the employer would tell Treasury how much of the total payment is from employees who have chosen the personal retirement account option.

One little known facet of the current Social Security system is that although payroll taxes are collected and paid by employers throughout the year, the Federal Government will not actually know how much money was paid on behalf of any particular worker in 2005 until about September 2006! This makes little difference under the current Social Security system, but can matter a great deal with an investment-based system. There will have to be some mechanism to hold the funds until the contribution is reconciled to the individual's name using the worker's W–2 form. Moreover, this holding pool should not be dependent on market timing. The best solution would be for Treasury, which is already operating as a centralized collection to transfer all funds designated for account investment to a private-sector custodian bank, which then invests the total amount in a money market fund that is always priced at one dollar, a standard industry convention. The following year, when the contribution is reconciled to the individual worker the fund's shares are distributed to each worker representing his contributions and interest credit, and electronically transferred to the worker's personal account as specified.

Second, because a system of personal accounts would extend investment opportunities to millions of Americans who do not now participate in private investment, and are therefore likely to lack education and experience in choosing investments, a consensus has developed among account proponents that initial investment options should be limited both in number and in the amount of risk a worker may assume. Therefore, most personal account plans call for investment options to be initially limited to a small number of broadly diversified funds. This can be done in a number of ways, such as:

- A small number of index funds each composed of a different type of investments. For example, the Federal Thrift Savings Plan, which President Bush has cited as an example, offers a fixed income fund, a common stock fund, a "small cap" stock fund, a Government bond fund, and an international stock fund. The Chairman's proposal, S. 540, is also built around this model.
- A small number of balanced funds, each composed of a different mix of stocks, Government bonds, corporate bonds, and cash. This option is included in HR 530 among others.
- A lifecycle fund that automatically adjusts the mixture of investments as a person ages. Younger workers would be more heavily invested in stocks, with the mix changing more heavily to fixed income assets as the worker nears retirement. The president has raised the possibility of this option, as has the Chairman. And I believe it is included in S. 857, sponsored by Senator Sununu.

To make things even simpler for the unsophisticated or apathetic worker, there should be a default option that would require the worker to make no decisions whatsoever.

Management of funds should be handled by the private sector on a contract/bid basis, similar to the way the TSP is currently handled. Given the amount of investments involved, it may be worth considering breaking up the management into several pieces each of which would be put up for bid.

Finally. while it makes sense to limit investment options initially, at some point a wider range of choices should be made available. In part, this is a simple matter of increasing consumer choice. One of the most important reason for having personal accounts at all is to give workers more choice and control over how they save for their retirement. Clearly, this should be extended as much as possible to the array of available investments.

There is also a larger economic reason for eventually expanding the range of investments. The flow of investments to different sectors of the economy provides important signals to the economy as a whole. Creating a large flow of investments that are essentially "homogenized" would deprive the market of these vital signals.

Therefore, once a worker has accumulated a "trigger" level of funds, the worker should be free to participate in a much larger range of investment options, closely approximating the options currently available under traditional 401(k) plans. Management of funds at this level would again be through the private sector, with entry open to any company offering qualified funds. ERISSA offers a reasonable framework for determining participation and regulation.

This three tier structure—a central collection point and holding pool, a limited set of initial investment options, and a eventual expansion to a wider array of investments—can provide workers with the greatest amount of security while maximizing consumer choice and control. It would keep administrative costs and the burden on employers as low as possible. And it would minimize Government interference with investment decisions.

Works should be able to switch investments, between and within investment tiers on an annual basis. While an "open season," similar to that of the FEHBP health plan, is perhaps the most simple approach, that could lead to an excess of market "churning" over a limited period. An alternative approach would be to allow a worker to switch investments within a designated period centered on his or her birthday.

There is one other additional point to keep in mind, at all three tiers, the accounts would be the property of the worker. This ownership is one of the perhaps the most important reasons for reforming Social Security, and it is vital that it be maintained as part of any administrative structure.

Let me conclude by saying that I believe that Social security reform is not an option, but a necessity. The program will begin running a deficit in just 12 years and faces unfunded obligations of roughly $12.8 trillion. The need for reform presents us with an opportunity to create a new and better retirement program for all Americans, a program that gives workers ownership of their retirement funds, more choice and control over their money, and the opportunity to build a nest egg of real inheritable wealth. Therefore, any successful Social Security reform should include personal accounts.

This makes the work of this Committee all the more important: Getting the design and structure of the accounts right. I believe that the structure I have set out today takes us in that direction. I look forward to the Committee's questions.

Thank you.

PREPARED STATEMENT OF DAVID C. JOHN

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JUNE 14, 2005

I appreciate the opportunity to appear before you today to discuss appropriate investments for Social Security Personal Retirement Accounts. This is an extremely important subject, and I would like to thank both Chairman Hagel and Senator Dodd for scheduling this hearing. Let me begin by noting that while I am a Research Fellow at the Heritage Foundation, the views that I express in this testimony are my own, and should not be construed as representing any official position of the Heritage Foundation. In addition, the Heritage Foundation does not endorse or oppose any legislation.

PRA's should be managed through a simple, low-cost administrative structure that uses the current payroll tax system and professional investment managers.

A simple and effective administrative structure is essential to the success of a PRA system. Probably the simplest and cheapest structure would be to use the existing payroll tax system. Under today's Social Security, the employer collects and sends to the Treasury Department both the payroll taxes that are withheld from an employee's check and those that are the responsibility of the employer. The payroll tax money from all of the firm's employees is combined with income taxes withheld from their paychecks and sent to the Treasury. The money collected is allocated annually to individual workers' earnings records after worker income tax records have been received.

Adapting this existing administrative structure to a PRA system would be easier to implement than other options. Under a PRA system, the employer would continue to forward to the Treasury Department one regular check containing payroll and income taxes for all of the firm's employees. The Treasury would continue to use its existing formula to estimate the amount of receipts that should be credited to Social Security and to reconcile this amount annually with actual tax receipts.

Once the Treasury determines the amount to be credited to Social Security, it would estimate the portion that would go to PRA's and forward that amount to a holding fund managed by professionals who would invest the amount in money market instruments until it is credited to individual taxpayers' accounts. The money would go to individual workers' accounts upon receipt of their tax information. It would then be invested in the default fund, except for workers who have selected (on their income tax forms) one of the other investment options, in which cases it would be invested accordingly.

Using Professional Fund Managers. Rather that having the Government trying to invest PRA money, the agency overseeing the accounts (which could be the Department of the Treasury, the Social Security Administration, or an independent board) should contract out fund management to professional fund managers. This investment management system is currently used by the Federal Employees Thrift Investment Board, which administers the Thrift Savings Plan, a part of the retirement system for Federal employees.

Under this system, management of the specific investment pools would be contracted out to professional fund managers, who would bid for the right to manage an asset pool of a certain size for a specified period of time. The manager could invest the money only as directed by the agency. The agency would also contract out to investor services such tasks as issuing regular statements of individual accounts, answering account questions, and handling transfers from one investment option to another.

Advantages of this Administrative Structure. Building on existing structures and contracting out investment management and services should keep costs to the lowest level possible. In addition, employers would not have to change their current payroll practices. Using one central government entity to receive PRA funds also means that employers would not bear the cost of writing individual checks or arranging for individual fund transfers for each employee. In addition, this method allows the PRA contributions of workers who have multiple jobs to be based on their total income without placing any additional burden on either the worker or the employers.

From a worker's standpoint, this should be the lowest-cost structure available. In addition, because workers' PRA contributions would be distributed to their chosen investment plans only after their tax information has been received, workers with several jobs during a year should see contributions based on their total annual incomes.

Developing a simple personal retirement account system with very low administrative costs would be relatively simple.

State Street Trust, one of the largest managers of retirement savings, has estimated that administering a personal retirement account would cost from $3.55 to $6.91 per person annually, based on proprietary data that the bank accumulated from its experience in managing a host of pension plans. In terms of the percentage of assets under management, the annual fee would be only 0.19 percent to 0.35 percent. This fee assumes an annual contribution per worker equal to 2 percent of his or her gross earnings. The cost would drop significantly if that contribution increased to an amount equal to 4 percent of earnings or higher. State Street Trust's findings were reviewed and accepted by the Government Accountability Office as accurate.

This low level of administrative fees would certainly not reduce the benefits of a PRA. In addition, history shows that administrative costs are highest when a system is first implemented and start-up costs must be covered. As time passes, administrative costs decline significantly. This has been true for 401(k) accounts, the Thrift Savings Plan (TSP) for Federal employees, and even Social Security. For example, the administrative costs of 401(k) plans have decreased over time, despite the plans offering an increasing number of investment options and a higher level of personal service. Although the costs of specific plans vary according to each plan's complexity, size, and the types of investments, many large companies have been able to keep their administrative costs as low as 0.3 percent by offering only a limited number of broad-based funds.

The Federal Thrift Savings Plan, a privately managed retirement plan open only to Federal employees, has experienced a dramatic 76 percent reduction in administrative costs since the system started in 1988. Today, participants pay annual administrative fees that are below 0.1 percent of assets under management. TSP's extremely low administrative costs are significant, given that many experts expect that a PRA system would closely resemble the structure and investment choices found under TSP.

The Social Security system experienced similar reductions in administrative costs during its formative years. In 1940, when the system first began to pay benefits, its administrative costs equaled 74 percent of all Old-Age and Survivors Insurance benefits paid. In 1945, this figure had declined to 9.8 percent. Today, administrative costs make up only 0.5 percent of payments from the OASI Trust Fund. Even though this is not a perfect comparison with the other two examples, given that Social Security's structure has changed over the years, it does suggest that fees could be very low.

PRA's should be invested in more than just stocks, but stocks are an essential part of the investment strategy.

Studies that purport to show either PRA's or the Social Security Trust Fund would have lost money over the past few years if they had been invested in stock assume that 100 percent of the Trust Fund would have been invested in stocks, rather than a diversified portfolio that would have balanced stock losses with gains on bonds or other investments. They also focus on only the short-term market trends, ignoring the gains that would result from longer-term investments.

Morningstar, Inc., an independent market data and analysis firm, estimates that the value of mutual funds invested in diversified U.S. stocks declined 12.1 percent during the second quarter of 2002. However, not all types of investments went down. Mutual funds containing lower-risk instruments such as taxable bonds (which are routinely held by those nearing retirement) rose an average of 1.4 percent over that same period, while funds invested in tax-exempt bonds rose 3.2 percent. Thus, in one of the worst quarters for stock investment, PRA's invested in a diversified portfolio would remain strong.

Over the long-run, all of these investments did even better. Over a 5-year period including the second quarter of 2002, mutual funds invested in stocks earned an average of 3.9 percent per year, while mutual funds invested in taxable bonds and tax-exempt bonds earned an average of 5.0 percent a year.

PRA's should not be invested solely in stocks. They should instead be invested in a diversified portfolio of stock index funds and different types of bond index funds. The default investment for PRA's should be a lifestyle fund that automatically reduces the proportion of stocks as the worker gets older, thus locking in past gains and sharply reducing the chance of major losses in the years approaching retirement.

A carefully controlled set of investment options should be developed that includes an appropriate default option.

The investment options available to PRA owners should be simple and easily understood. While an increasing number of Americans are investing their money for a wide variety of purposes, a voluntary PRA system would bring in millions of new investors who may not have any previous investment experience. In addition, experience from both the 401(k) retirement plans and Federal employees' Thrift Savings Plan shows that costs are far lower if the plan starts with only a few investment options and then adds more once the plan is fully established.

Carefully Controlled Investment Options. All investment options available under a PRA plan should be limited to a diversified portfolio composed of stock index funds, government bonds, and similar assets. Even if they so desire, workers would not be allowed to invest in speculative areas such as technology stocks or to choose specific stocks or bonds. Money in a PRA is intended to help to finance a worker's retirement security, not to be risked on speculative investments with the hope that taxpayers will support the worker if the investment fails.

Initially, workers would be allowed to put their PRA contributions into any one of three balanced and diversified mixes of stock index funds, government bonds, and similar pension-grade investments. Although the exact mix of assets would be determined by the central administrative agency, one fund might consist of 60 percent stock index funds and 40 percent government bonds, while another might be 60 percent government bonds and 40 percent stock index funds.

The third fund, which would also act as the default fund for workers who failed to make a choice, would be a lifestyle fund. These are funds in which the asset mix changes with the age of the worker. Younger workers would be invested fairly heavily in stock index funds, but as they age, their funds would automatically shift gradually toward a portfolio that includes a substantial proportion of bonds and other fixed-interest investments. This is designed to allow the portfolios of workers who are far from retirement to grow with the economy and to allow older workers to lock in that growth by making their portfolios predominantly lower-risk investments.

Workers would be allowed to change from one investment fund to another either annually (by indicating their choice on the income tax form) or at other specified times (by completing a form on the Internet). They would also receive quarterly statements showing the balance in their accounts. As with today's Social Security, PRA accounts are intended strictly for retirement purposes, and no early withdrawals would be allowed for any reason.

Structuring Accounts to Keep Fees Low. Under a successful PRA plan, all investments must be approved by the central administrative agency as being appropriate for this level of retirement investment. That agency would also ensure administrative costs are kept as low as possible by awarding contracts to manage investment pools through competitive bidding and through direct negotiation with professional funds managers.

Research by State Street Global Investors shows that administrative costs are lower if workers put all their money in one diversified pool of assets rather than attempting to diversify their portfolio by dividing it among several types of assets. For example, a worker who puts all of his or her money in one fund consisting of 50 percent stock index funds and 50 percent Government bonds would earn the same as a worker who places half of his or her money in a government bond fund and half in a separate stock index fund. However, the first worker would incur significantly lower administrative costs.

Additional Choices for Larger Accounts. Once a worker's PRA account reaches a certain size threshold (determined by the central administrative agency), he or she would have the option to move its management to another investment manager if that manager offered better service or potentially higher returns. However, only investment managers who had meet strict asset and management quality tests would be allowed to receive these accounts, and the managers would be sharply limited in the types of investments they could offer. In the event that the worker is dissatisfied with either the fees or the returns from these individually managed accounts, he or she could switch back to the centrally managed funds at any time.

PRA's should be invested in lifespan accounts unless the account owner chooses another investment.

A key feature of President George Bush's recently announced Social Security plan is that workers' personal retirement accounts (PRA's) would be invested automatically in a lifespan fund unless a worker expressly asked for another arrangement. Lifespan funds adjust (or "rebalance") a worker's investments as he or she ages. For younger workers who are far from retirement, a lifespan fund would invest most of their money in stock index funds—safe funds reflecting the broad stock market. As these workers grow older, their lifespan funds would gradually and automatically shift more money into even safer bonds and other less volatile investments. In short, lifespan funds allow younger workers to take advantage of the higher returns that stock investments offer while making sure that the portfolio gets safer and safer as the worker gets closer to retirement.

Lifespan funds are designed to allow the portfolios of workers who are far from retirement to grow with the economy and to allow older workers to lock in that growth by moving their portfolios into predominantly lower-volatility investments. This means that if the stock market suddenly declined, workers who invested in a lifespan fund and were near retirement would have only a tiny part of their PRA's invested in stocks and thus would not see a significant last-minute change in the value of their PRA's.

As an example of how these funds would protect workers who are close to retirement, Morningstar, Inc., an independent market data and analysis firm, estimated that the value of mutual funds invested in diversified U.S. stocks declined 12.1 percent during the second quarter of 2002—one of the worst quarters in recent history. However, not all types of investments went down. Indeed, mutual funds containing lower-risk instruments such as taxable bonds (a common investment for those nearing retirement) actually rose an average of 1.4 percent over that same period, and funds invested in tax-exempt bonds rose an average of 3.2 percent.

Because a lifespan account would have automatically moved a worker's PRA almost entirely into bonds when that worker reached retirement age, a worker with a PRA who retired in the first quarter of 2002 thus would have seen his PRA grow during that last quarter before retirement. He or she would not have faced losses, even though the stock market as a whole experienced major declines during that period.

Lifespan funds have been gaining popularity in employer-sponsored retirement plans, such as 401(k)'s, because they automatically make the kind of portfolio adjustments that investment professionals recommend for all workers nearing retirement. At the end of 2004, about 55 companies offered lifespan accounts as part of their 401(k) plans. Currently, the biggest players in the field are Fidelity Investments, with a 33 percent market share, and The Vanguard Group, with about 17 percent. Administrative fees depend in a large part on whether the funds are actively or passively managed. Fidelity, which consists totally of actively managed funds has an administrative fee of 0.81 percent of assets under management, while Vanguard, which consists totally of index funds has fees of 0.23 percent of assets under management. Passively managed index funds are much more suitable for Social Security accounts than are funds that pick and choose individual stocks.

For many years, investment advisers have advised workers to structure their retirement accounts so that more funds are shifted into fixed-income investments as they age. Advisors recognize that decreasing the proportion of investment in stocks reduces the potential for short-term loss. Although younger investors are better off investing most of their assets in stocks to get higher returns, those who are closer to retirement need to reduce the likelihood that a sudden market shift will affect them. Lifespan funds make this rebalancing process continuous and automatic and would let workers with PRA's approach retirement with confidence.

Conclusion

Again, thank you for the opportunity to testify before you today. The success of Social Security personal retirement accounts as a way for individuals to build sufficient savings to fund a portion of their retirement benefits will in large part depend on the investment choices that are available. A simple, low-cost administrative platform would improve the ability of these accounts to assist individuals in meeting their retirement goals. Such a system is both feasible and realistic.

Thank you.

The Financial Costs of Individual Accounts

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Testimony Before the Subcommittee on Securities and Investment
of the U.S. Senate Committee on Banking, Housing, and Urban Affairs
June 14, 2005

Mr. Chairman and other members of the Committee, thank you for the invitation to address you today. Social Security is an exceptionally efficient administrative system for collecting payments and distributing retirement benefits. The Social Security Administration (SSA) is consistently ranked by the Office of Management and Budget (OMB), Congressional Committees, and outside observers as one of the best-managed government agencies. Administrative costs account for only 0.6 percent of total retirement and survivors benefit payments.[2] If Social Security's retirement program were operated like a mutual fund, that would be equivalent to an annual charge of about 0.03 percent of assets under management. In contrast, the average annual charge for a mutual fund is 1.09 percent.[3]

Establishing over 100 million voluntary individual accounts for Social Security would complicate the system and be substantially less efficient than the current system. Individual accounts would require a wide-range of tasks that go well beyond the scope of what SSA does today, including tracking contributions, allocating them to different investments, managing the assets, answering questions about the accounts, providing general financial education, handling assets in the case of premature death or divorce, distributing benefits at retirement, and monitoring and enforcing all the new regulations. Many of these tasks would require a substantial number of new personnel who would likely be organized in a new government agency. In my testimony I will make four points:

- First, administrative costs in a private accounts system would be at least ten times as large as the costs under the current system. In some proposals, administrative costs could eat up more than one-third of the final account balance.

- Second, establishing accounts would require a substantial increase in government staffing, likely in the form of a new government agency that could be about half the size of the Internal Revenue Service (IRS) or SSA.

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[1] The views expressed in this testimony are mine alone.
[2] In 2004, administrative expenses for OASI were $2.4 billion and total benefits were $415 billion. See Board of Trustees, Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, *The 2005 Annual Report of the Board of Trustees of the Federal Old-age and Survivors Insurance and Disability Insurance Trust Funds,* ("2005 Trustees Report").
[3] Congressional Budget Office, "Administrative Costs of Private Accounts in Social Security," March 2004.

- Third, when administrative costs are considered, returns for many participants under a private accounts system would be lower than in a reformed system without accounts.

- Fourth, private accounts generally result in a large increase in debt held by the public and would increase the risks facing financial markets and fiscal policy.

First, administrative costs in a private accounts system would be at least ten times as large as the costs under the current system. In some proposals, administrative costs could eat up more than one-third of the final account balance.

Establishing over 100 million individual accounts for Social Security contributors would entail substantial new complexities and a wide range of new tasks. All of these new tasks would be *in addition* to everything Social Security does today.[4] Replacing portions of the extremely efficient Social Security benefit with a considerably less efficient private account would make little economic sense.

Policymakers would face a tradeoff between encouraging choice and high-quality service and holding down administrative costs. If accounts are established for Social Security, policymakers will have to decide:

- Whether to organize record keeping and account management through a central agency or privately, on a decentralized basis like 401(k)s and IRAs.
- How much choice to give participants about their investments. Are they limited to just a few government-selected funds or allowed to invest in a wider-range of privately managed funds or even individual stocks and bonds?
- How long participants must wait between making a tax payment and allocating their contribution to a chosen investment.
- How often participants can change allocation between funds.
- If accounts are voluntary and how often, if ever, individuals can opt in and out of accounts?
- How many options there are for withdrawal from the funds at retirement. Is there one mandated payout option or a range of choices that include lump-sums and annuities?
- What level of service to provide for account holders. Is there a website? Or an 800 number? How long are the hold times and how high-quality is the information? How often are account values updated?
- How to educate participants so they can understand the different investment choices and withdrawal options at retirement.

Based on these choices, the ultimate cost of accounts could range greatly as shown in Table 1.[5]

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[4] Large benefit reductions that nevertheless keep the existing Social Security structure intact would not reduce the costs of administering Social Security.

[5] A substantial portion of the cost is a "fixed cost" that depends on the account size. These estimates are generally applicable to accounts in the 2 to 4 percent of payroll range.

Table 1

Costs of Alternative Account Options		
Investment Option	**Annual Cost (% of assets)**	**Total Cost (% of account at retirement)**
Social Security	0.03%	0.6%
Government organized (limited choice, SSA actuaries)	0.30%	7%
Government organized (more choice, Swedish experience)	0.73%	15%
Privately organized (limited choice, SSA actuaries)	1.00%	20%
Privately organized (more choice, UK experience)	2.05%	36%

Note: Costs do not include the charges for annuities at retirement.

Estimates that show low administrative costs for accounts are based on limited choice and an unprecedented degree of government administration that could prove to be politically untenable over time. This section focuses on the most important choice: the choice between centralized government organization of the investment accounts and private, decentralized management.

Administrative costs of government-organized accounts

The President has proposed government-organized accounts with very restricted investment options. The President's proposal would establish a central administrative authority modeled on the government's Thrift Savings Plan (TSP). According to the White House description of the proposal,

> A centralized administrative structure would be created to collect personal retirement account contributions, manage investments, maintain records, and facilitate withdrawals at retirement… The central administrator would answer questions from account participants and distribute periodic account statements.[6]

The TSP is one of the best administrated funds in the world, with a cost of only 0.06 percent of assets in 2004.[7] The administrative burdens associated with individual accounts would be far greater. As former TSP Executive Director Francis X. Cavanaugh has stressed, the TSP only covers one employer with a sophisticated electronic payments system and a relatively stable workforce.[8] Expanding the system to millions of employers – including small business, part-time employers, and high-turnover workers – would greatly increase costs. Furthermore, TSP accountholder's employer agency serves as the principal point of contact for the TSP plan and is responsible for any associated financial education or other information. As a result, these substantial costs are borne by the agencies and are not reflected in the TSP administrative costs. Replicating TSP services would require far larger administrative costs or a costly employer mandate.

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[6] White House, "Strengthening Social Security," February 2005.
[7] Thrift Savings Fund, "Statement of Assets Available for Benefits As of December 31, 2004 and 2003," March 4, 2005.
[8] Francis X. Cavanaugh, "Feasibility of Social Security Individual Accounts," AARP 2002-14, September 2002.

In the case of the President's proposal for government-organized accounts with limited choice, the Social Security's Office of the Chief Actuary "assumed that the ultimate administrative expenses would be about 0.30 percent of IA assets."[9] At this expense rate, on average, administrative costs would eat up about 7 percent of the ultimate retirement benefit. *That is more than ten times as much as the administrative costs in the current Social Security system.*

The ultimate administrative costs are sometimes called the "charge ratio" – the difference between the total assets in the account at retirement with administrative costs and without administrative costs. The charge ratio substantially exceeds the annual expenses because it reflects the accumulation over a number of years. For example, suppose a person puts $1,000 in an account for 40 years at a 0.30 percent annual cost. The person would pay $3 annually to manage the contribution – or $120 (or 12 percent) over 40 years. In contrast, if the contribution were just made for one year it would only cost $3 (or 0.3 percent). The total charge ratio of 7 percent is close to the average of these two extreme cases.

The Social Security actuaries' estimates are likely to understate the administrative costs of the accounts for several reasons. First, the actuaries estimate is only for the "ultimate" administrative expenses. The initial costs of setting up an account are orders of magnitude higher than the ultimate management of the account. Factoring these in would raise the total cost. Second, as discussed in more detail below, these estimates do not include the cost of partially annuitizing accounts at retirement.

More fundamentally, expanded investment choices would lead to higher costs. Under the President's proposed accounts, participants would have a choice of only about five diversified mutual funds modeled on the TSP. The President's Social Security Commission, however, concluded that, "The centralized approach is sensible to implement in the short term but is probably not the best approach in the long run" and recommended that participants be allowed to invest balances above $5,000 in a potentially unlimited roster of certified private-sector funds.[10] This approach has been followed in a follow by several other plans. If these private-sector funds were managed, their fees could be comparable to the 1.09 percent average fees on mutual funds today, or 21 percent of the account balance at retirement.[11]

Even if an individual account plan initially offered only a few funds, it is likely that political pressure would expand the options over time. Some have raised concerns that government investment in equities could result in political interference in equity markets. Exactly the same set of concerns would apply in a centralized system with limited choices. Although workers could choose the allocation between stocks and bonds, they would not have any choice about the allocation within equities. Furthermore, under many accounts proposals, accounts would hold a substantially larger share of the total equity market than has ever been proposed in the case of government investment of the trust fund.

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[9] Stephen Goss, Chief Actuary, Social Security Administration, "Preliminary Estimated Effects of a Proposal to Phase In Personal Accounts," February 3, 2005.
[10] President's Commission to Strengthen Social Security, *Strengthening Social Security and Creating Personal Wealth For All Americans*, December, 2001.
[11] Congressional Budget Office, "Administrative Costs of Private Accounts in Social Security," March 2004.

Most government equity investment plans are limited to 15 percent of the total equity market (including the plan proposed by President Clinton and the more recent plan from former Social Security Commission Bob Ball). In contrast, 4 percent private accounts would hold more than 40 percent of the equity market. Some plans have even larger account sizes and would hold equity portfolios equivalent to the *entire* current valuation of the market.

In the case of government investment, many of these political concerns could be allayed by having an independent board modeled on the Federal Reserve Board or the Federal Retirement Thrift Investment Board that oversees the TSP. The political economy of individual accounts would make this solution less sustainable.

Advocates of accounts tout the benefits of choice, ownership and control. This could lead to momentum for expanded choice in investment options based on the contention that it would give participants a shot at higher returns than participants would have with a limited choice of TSP funds.

In addition, many participants may not want to invest in companies they consider socially problematic – whether it is because the company makes cigarettes, produces pornography, supports gay rights, or invests in countries that violate human rights. Today a range of mutual funds from Christian mutual funds to environmental mutual funds cater to a variety of tastes in ownership. If individual accounts are instituted the political pressure to include these types of funds would be difficult for legislators and policymakers to resist.

The closest parallel to the President's plan for government-organized accounts with a range of investment choices is the Swedish system. In Sweden, workers can invest in up to five certified funds chosen from more than 500 funds offered by private managers. Under the Swedish system, a government agency like the President's proposed central administrative authority, collects all the contributions, communicates with participants, conveys the investments collectively to the fund managers, and distributes benefits. The Swedish system allocates contributions to specific investments up to two years after they are earned and only allows participants to change the allocation once a year. The default fund established by the Swedish government costs 0.3 percent of assets and private fund fees range from 0.2 percent to 3.97 percent.[12] Most Swedish participants choose lower-cost funds, and the average participant pays 0.73 percent of assets in administrative fees, or 15 percent of the account balance at retirement.[13] Furthermore, additional administrative costs may be covered by the Swedish government.

Another study conducted for the World Bank found costs for government-organized accounts in other countries have ranged from 0.15 percent to 0.8 percent annually.[14]

[12] John Turner, "Individual Accounts: Lessons from Sweden," AARP Issue Brief No. 60, May 2003.
[13] Mårten Palme, Annika Sundén, and Paul Söderlind, "Investment Choice in the Swedish Premium Pension Plan," Center for Retirement Research at Boston College, April 2005.
[14] Estelle James, James Smalhout, and Dimitri Vittas, "Administrative Costs and the Organization of Individual Account Systems: A Comparative Perspective," in Robert Holzmann and Joseph E. Stiglitz (eds), *New Ideas About Old-age Security*, World Bank, 2001.

Administrative costs of privately-organized accounts

An alternative to the President's government-organized approach would be privately-organized accounts like existing IRAs and 401(k)s. Under a privately-organized plan, individuals would set up an account at a financial institution and make choices about how to allocate assets. The financial institution would keep track of each individual's account and would be responsible for communicating with accountholders. A decentralized system would also entail choices about whether to limit investment options and trading frequency (as Chile has done) or permit a broader range of choices (as the United Kingdom has done).

Towards the low end of cost estimates, the *Report of the 1994-96 Advisory Council on Social Security* projected that privately-organized accounts could be established for 1.0 percent of annual assets, or about 20 percent of the ultimate account. This is similar to estimates by MIT economist Peter Diamond.[15]

The experience of 401(k)s and other countries shows that the costs could be considerably higher, especially if participants are given more choices. A survey by the Department of Labor's Pension and Welfare Benefits Administration (PWBA) found 401(k) costs ranging from 0.3 percent to 3 percent.[16] The Congressional Budget Office (CBO) estimates tend towards the middle of this range.[17]

Chile and the United Kingdom both have very high administrative costs. According to testimony by James B. Lockhart III, the Deputy Commissioner of Social Security, "[s]ome countries, such as the United Kingdom and Chile, have experienced relatively high costs in administering accounts."[18] In the Chilean system, administrative costs have been estimated to cost 1.36 percent annually,[19] reducing the final account balance by 26 percent. Other estimates have found even higher fees in Chile.[20] Administrative costs were even higher in the UK system: before reforms that limited fees they were running at a level that would have reduced ultimate account balances by 36 percent or 43 percent including the cost of annuitizing balances at retirement.[21] That is equivalent to an annual charge of about 2.0 percent of assets.

Cost estimates for setting up privately-organized accounts in the United States are comparably high. For example, a study by the Kelly Olsen and Dallas Salisbury of the

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[15] Peter Diamond, "Administrative Costs and Equilibrium Charges with Individual Accounts," in John B. Shoven (ed.) *Administrative Aspects of Investment-Based Social Security Reform*, University of Chicago Press, 2000.
[16] Cited in GAO, "Administrative Costs for Individual Accounts Depend on System Design," GAO/HEHS-00-131, June 1999.
[17] Congressional Budget Office, "Administrative Costs of Private Accounts in Social Security," March 2004.
[18] James B. Lockhart III, "Testimony for the Hearing Before the Senate Committee on Ageing, Strengthening Social Security: What Can We Learn From Other Nations?" May 18, 2004.
[19] Estelle James, James Smalhout, and Dimitri Vittas, "Administrative Costs and the Organization of Individual Account Systems: A Comparative Perspective," in Robert Holzmann and Joseph E. Stiglitz (eds), *New Ideas About Old-age Security*, World Bank, 2001.
[20] Indermit S. Gill, Truman Packard, and Juan Yermo. *Keeping the Promise of Social Security in Latin America*. Washington, DC: World Bank, 2005.
[21] Mamata Murthi, J. Michael Orszag, and Peter R. Orszag, "Administrative Costs Under a Decentralized Approach to Individual Accounts: Lessons from the United Kingdom," in Robert Holzmann and Joseph E. Stiglitz (eds), *New Ideas About Old-age Security*, World Bank, 2001.

Employee Benefit Research Institute (EBRI) found that workers "would receive 40 percent to 42 percent lower IA benefits under high administrative cost assumptions than under low-cost assumptions."[22]

The costs of privately-organized accounts would represent windfall revenues to financial institutions. This is also true of some of the costs under government-organized accounts with private fund managers. Estimates by Austan Goolsbee of the University of Chicago Business School found that under some account designs, "the [financial managers'] fees would be the largest financial windfall in American history."[23]

Additional costs for annuitizing accounts and other complications

In addition to the administrative costs associated with managing worker's account balances, there could be substantial costs associated with annuitizing the accounts at retirement. Currently, annuities purchased in the private market generally cost about 15 percent of total assets relative to a fair price for the average person. About 10 percentage points of the 15 percent cost of annuities is due to adverse selection, healthier people sign up for annuities because they expect to live longer and collect more money. The other 5 percentage points are due to other factors like administrative expenses and imperfect competition in a small market.[24] If individual accounts led to more annuitization, the market could become thicker and these costs could come down somewhat. Nevertheless, the cost of purchasing a private annuity would substantially add to the administrative costs shown in Table 1 – more than doubling the costs in a government-organized system.

Alternatively, the government could provide the annuity, as proposed by the President.[25] This would reduce many of the costs faced by purchasers of annuities because it would create a much larger market with economies of scale and the government would not make a profit on the transaction. But, unless the individual accounts plan required full annuitization, the government would face the same adverse selection problems that private annuity providers do because healthier seniors would annuitize more of their accounts. These seniors would live longer than average and collect more money from their accounts. If the annuities were not subsidized, the government would need to reduce annuity payouts to reflect the longer-living populations which purchase them. And if the government offered an actuarially fair annuity, it would have to subsidize the adverse selection costs out of general revenue. As a result, these costs would be borne by accountholders through their income taxes rather than out of their accounts directly.

Individual accounts could result in complications that add to administrative costs and reduce account accumulations. A voluntary account system such as the one that the President

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[22] Kelly A. Olsen and Dallas L. Salisbury, "Individual Social Security Accounts: Issues in Assessing Administrative Feasibility and Costs," EBRI Issues Brief 203, November 1998.
[23] Austan Goolsbee, "The Fees of Private Accounts and the Impact of Social Security Privatization on Financial Managers," September 2004.
[24] Olivia S. Mitchell, James M. Poterba, Mark J. Warshawsky, and Jeffrey R. Brown, "New Evidence on Money's Worth of Individual Annuities," *American Economic Review* 89(5), December 1999.
[25] According to a background briefing by a senior administration official on February 2, 2005, "the federal government would do the purchasing of the annuity contracts… People wouldn't be out there shopping on their own for a private-sector annuity."

has proposed requires more education and administrative tasks than a mandatory system. Very few countries have voluntary accounts systems. In one of the few that does, the United Kingdom, the administrative costs are very high.

In addition, the distribution of individual accounts raises a number of other costly administrative issues in cases of divorce, pre-retirement death, and alternative options for distribution at retirement. Many of these issues were addressed by a National Academy of Social Insurance (NASI) study *Uncharted Waters: Paying Benefits from Individual Accounts in Federal Retirement Policy* (January 2005).

Second, establishing accounts would require a substantial increase in government staffing, likely in the form of a new government agency that could be about half the size of the Internal Revenue Service (IRS) or SSA.

Establishing private accounts would require substantial new government employment and could require a new government agency to handle account administration. Cavanaugh has extrapolated from the TSP's experience to estimate that "there would be a potential need for more than 10,000 highly trained telephone counselors" just to answer account inquiries.[26] A detailed study by the Clinton administration's Department of the Treasury found that,

> "[B]are-bones accounts… could be run at an annual cost of $20 to $30 per account, while accounts with service similar to that in current 401(k)s (though not including loans) would be two or three times as expensive. With roughly 180 million accounts, total annual costs could exceed $5 billion a year in today's dollars (more than half as large as the current budget of the IRS and therefore more than half the cost of administering the entire federal tax code) and tens of thousands of new government workers would be needed to answer phone inquiries and process worker choices of fund managers."[27]

An SSA study found that accounts would require between 8,000 and 34,000 new employees just at SSA. The study did not attempt to estimate increased employment at other agencies.[28]

If 4 percent accounts are phased-in as proposed by the President, then at the end of 10 years they will hold nearly $1.5 trillion in assets. At the 0.30 percent cost assumed by the actuaries, that would be $4.4 billion expended on individual account administration and asset management fees.

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[26] Francis X. Cavanaugh, "Feasibility of Social Security Individual Accounts," AARP 2002-14, September 2002. This could understate the number of personnel needed for Social Security since much of the TSP information is provided by agencies, not the TSP itself.
[27] Douglas W. Elmendorf, Jeffrey B. Liebman, and David W. Wilcox, "Fiscal Policy and Social Security Policy During the 1990s," in Jeffrey A. Frankel and Peter R. Orszag (eds.) *American Economic Policy in the 1990s*, Cambridge, MA, MIT Press, 2002.
[28] Lawrence E. Hart, Mark Kearney, Carol Musil, and Kelly Olsen, "SSA's Estimates of Administrative Costs Under a Centralized Program of Individual Accounts," January 9, 2001.

According to the White House, "Most of these administrative costs are for recordkeeping which would be done by the government, not investment management done by Wall Street."[29] That would represent enough for about 30,000 new government employees, assuming two-thirds of this total cost is for personnel. Additional government employees to provide financial education and other services could end up being paid for by general revenue, meaning that workers would pay the administrative costs out of their taxes rather than account balances. If participants were provided even a slightly greater range of choices (like the choice of investing in certified mutual funds) and greater services, the required government employment could easily exceed 100,000 annually.

By comparison, currently SSA has a total staff of about 65,000 (of which 20,000 administer the retirement and survivor's program) and the IRS has a staff of about 100,000.

Third, when administrative costs are considered, returns for many participants under a private accounts system would be lower than in a reformed system without accounts.

Additional administrative costs associated with individual accounts are certain. Any potential gains from accounts, however, are uncertain. In recognition of this uncertainty, CBO uses what is known as "risk adjustment" in estimating the returns on private accounts established under Social Security plans. This means that CBO adjusts stock returns to reflect the higher risk that stock investments carry. The result is that, on a comparable basis to Social Security, accounts are assumed to earn the same return as Treasury bonds minus administrative costs. This is the same assumption used by the Office of Management and Budget in accounting for equity investment by the Railroad Retirement system.[30]

For a worker that has a portfolio of stocks and bonds, the option of an individual account does not offer any additional benefits. The President's proposal would allow the worker to effectively borrow money at what is intended to be the Treasury bond rate and invest it in a portfolio that includes equities.[31] In the process, the worker would incur the additional administrative costs on the private accounts established with, in effect, borrowed funds. If there are truly additional benefits to investing in stocks, workers who own bonds could capture them by not participating in the accounts and instead selling some bonds and using the proceeds to invest in stocks. This latter course would not entail any additional administrative costs.

In a private accounts system the government is essentially borrowing money at the Treasury rate and lending out to investors who only get the Treasury rate minus administrative costs. As a result, on a comparable risk-adjusted basis, a Social Security system with private accounts would have a lower rate for return for a large fraction of workers than a system without

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[29] White House, "Strengthening Social Security," February 2005.
[30] For more details see Jason Furman, "Would Private Accounts Provide a Higher Rate of Return than Social Security," Center on Budget and Policy Priorities, June 2, 2005.
[31] Specifically, in the President's plan, contributions to accounts are accumulated at a 3 percent interest rate above inflation and subtracted from the traditional defined Social Security benefit at retirement. This is the "benefit offset."

accounts. Table 2 shows a range of estimates of this loss for workers retiring in 2055, with annual losses ranging from $706 to $3,792.

Table 2

Effect of Alternative Administrative Cost Assumptions on Participants
(inflation-adjusted 2005 dollars, annual values)

	Annual Admin. Costs	Account Value at Retirement (annuity)	Social Security Benefit Offset for IAs	Net Change
Centralized system (limited choice)	0.30%	$10,057	-$10,763	-$706
Centralized system (more choice)	0.73%	9,140	-10,763	-1,623
Decentralized system (limited choice)	1.00%	8,616	-10,763	-2,147
Decentralized system (more choice)	2.00%	6,971	-10,763	-3,792

For lower-income workers who are not fully diversified, accounts are one way to increase their exposure to equities. Without adjusting for risk, the benefit of investing in equities is measured by the equity premium: the difference between the average rate of return on stocks and the average rate of return on bonds. Financial experts project that the equity premium will be anywhere from 1 to 4.5 percent going forward.[32] After adjusting for risk, however, the benefits of diversification for lower-income workers are considerably smaller than the equity premium and could be more than outweighed by the additional administrative costs. In addition, there are other ways to increase equity exposure for undiversified workers without increasing overall retirement risk by reducing Social Security benefits. For example by making it easier and more automatic to save through IRAs and 401(k)s.[33]

The costs shown in Table 2 are solely those associated with the accounts. In addition, workers would see their annual benefits reduced by thousands of dollars in any plan that, like the President's, relies principally on benefit reductions to restore solvency.

<u>Fourth, establishing private accounts generally result in a large increase in debt held by the public and would increase the risks facing financial markets and fiscal policy.</u>

Carveout private accounts take payroll taxes that are currently used to pay benefits (or augment the trust fund) and divert them into accounts. The government is forced to borrow money to make up for the diverted funds resulting in a substantial increase in debt held by the public. Many add-on accounts also require substantial borrowing to fund the account contributions directly or to fund tax incentives for contributors to accounts. These large, and in

[32] The 4.6 percent estimate is from the Social Security actuaries. The 1 percent is the bottom of the range in a survey of 10 leading financial economists by the *Wall Street Journal*. The median equity premium in that survey was 1.8 percent. See Mark Whitehouse, "Social Security Reform Plan Leans on Bullish Market," *Wall Street Journal*, February 28, 2005.

[33] See the work of the Retirement Security Project at www.retirementsecurityproject.org.

some cases permanent, increases in the debt augment the risks facing financial markets and fiscal policy.

As Harvard economist Martin Feldstein explained in a paper he wrote in 2001, he had advised against President Reagan establishing individual accounts in part because "the overall budget was in substantial deficit, starting to fund investment-based accounts would have required a tax increase or an even larger overall budget deficit."[34]

According to the Social Security actuaries, the President's accounts would cost $743 billion over the first seven fiscal years (from 2009 to 2015). Even this estimate is not fully reflective of the fully phased-in cost because the accounts would only be available to all workers for the last four of these seven years.[35]

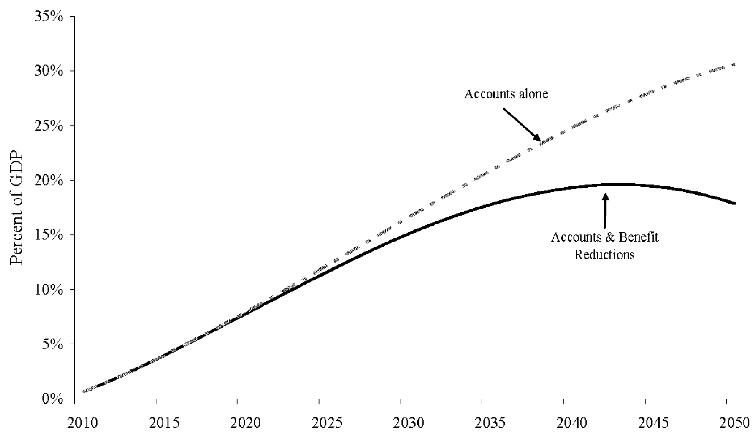
Over longer periods, the effect on the debt would be far greater. The President's accounts would add $1.5 trillion to the debt over the first ten years that the plan is in effect (from 2009 to 2018). The accounts would cause the debt to increase by another $3.8 trillion in the decade after that, for a total of $5.3 trillion over the first twenty years.

The sliding-scale benefit reductions that the President is proposing would reduce the debt by relatively modest amounts in coming decades. Over the first twenty years, those benefit reductions would reduce the debt by $400 billion. The combined effect of the accounts and the sliding-scale benefit reductions the White House is proposing would add $4.9 trillion to the debt over the first twenty years.

The debt would continue to rise after twenty years, both in dollar terms and as a share of GDP, as shown in Figure 1. The accounts, by themselves, would lead to *permanently* elevated debt. Although the sliding-scale benefit reductions would eventually start to bring that debt down, the debt would remain elevated through 2067. This would lead to higher interest payments on the debt, increasing the burden for future taxpayers.

[34] Martin Feldstein, "Comments on Fiscal Policy and Social Security Policy During the 1990s," in Jeffrey A. Frankel and Peter R. Orszag (eds.) *American Economic Policy in the 1990s*, Cambridge, MA, MIT Press, 2002.
[35] The accounts would not be available to all workers until 2011 and they would not be phased fully in until 2041. That is the year in which the cap on the maximum amount that could be diverted to a private account each year would rise to a high enough level so that all workers could contribute a full 4 percent of their taxable earnings to the accounts.

Figure 1. Additional Debt Held by the Public



Source: Author's calculations.

The additional debt associated with accounts would have a significant impact on financial markets, lowering stock returns and increasing bond rates.[36] According to Princeton economist Harvey Rosen, who recently stepped down as the Chairman of the Council of Economic Advisers, "In order to induce private investors to accept government bonds that would have been bought by the Trust Fund, their yield has to go up (increasing the debt burden on taxpayers), or the yield on stocks must fall, or both."[37]

Some have argued that the additional debt associated with the accounts would not harm financial markets or the economy more broadly. They argue that, over an infinite horizon, this debt diminishes or disappears and that as a result even the initially high levels of debt should be considered neutral from an overall fiscal position. Accounts causing no fiscal harm is the best case scenario. No one has argued that the debt associated with the accounts has any direct fiscal benefits.

There is a significant probability that the debt associated with the accounts would harm the economy.[38] The borrowing to pay for the accounts would take the form of "explicit debt," that is government bonds. These bonds cannot be defaulted on and must be rolled over or serviced on an annual basis. This explicit debt would replace "implicit debt" in the form of

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[36] Note, accounts could initially drive up stock prices conferring a windfall on existing equity holders. But with stocks more expensive, the future returns would be lower.
[37] Harvey S. Rosen, *Public Finance,* Seventh Edition, 2005, p. 208.
[38] For an extended discussion of these issues see Jason Furman, William G. Gale and Peter R. Orszag, "Should the Budget Rules Be Changed To Exclude the Cost of Individual Accounts," *Tax Notes* January 24, 2005.

reduced future Social Security obligations. Implicit debt, however, is very different from explicit debt. It does not need to be rolled over or serviced on an annual basis. The total amount of implicit debt is based on projections and is not legally binding, unlike the tangible debt issued in the form of Treasury bonds.

Financial markets, both in the United States and abroad, are likely to be more troubled by the explicit debt than they currently are by the implicit obligations of the U.S. government. Federal Reserve Chairman Alan Greenspan testified that if financial markets did not distinguish between implicit and explicit debt, then the borrowing associated with accounts would have no impact on the market. But he went on to say, "But we don't know that. And if we were to go forward in a large way and we were wrong, it would be creating more difficulties than I would imagine."[39]

The record is replete with nations undergoing fiscal crises because of explicit debt. No nation has undergone a fiscal crisis because of implicit debt.

Furthermore, rational financial markets would understand that the eventual repayment of the debt associated with the President's accounts would be decades in the future and would depend on large and potentially politically unsustainable benefit reductions. To the degree that financial markets partially discounted these benefit reductions or factored in the possibility of a government bailout in the event of a major stock market crash, this added debt would have a significant impact.

In summary, the accounts portion of the President's plan would result in *permanently* higher debt than the same plan without accounts. Even when combined with sliding-scale benefit reductions, the debt would be elevated for more than sixty years. It is important to remember that even from the vantage point of 2067, when the debt would be the same as under current law, the proposal would be judged a failure. The goal of Social Security reform is not to leave the debt the same as under current law, it is to significantly reduce the debt in order to help relieve future fiscal pressures. The debt associated with the President's accounts proposal would have no upside benefits and substantial downside risks.

In conclusion,

I have outlined the financial ramifications of private accounts, in particular the substantial "hidden costs" associated with administration and new government staffing. These costs would lower the rate of return in a reformed system. At the same time, the debt associated with accounts poses new risks for financial markets and the economy.

These are only some considerations in establishing individual accounts, elsewhere I have gone into more detail about other issues.[40] Accounts do not help restore solvency and even hurt solvency over a finite horizon or even over an infinite horizon if the accounts are subsidized.

[39] Alan Greenspan Testimony, February 16, 2005.
[40] For a summary, see Jason Furman, "Evaluating Alternative Social Security Reforms," Testimony Before the Full Committee of the House Committee on Ways and Means, May 12, 2005.

Accounts, by themselves, do not raise national savings and might even reduce national savings. Finally, if accounts are combined with deep benefit reductions to help restore solvency, the result is a radically transformed Social Security system, a large increase in risk in the secure tier of retirement income, and a reduction in the overall retirement benefit.

A better Social Security reform would modify the current system to make it sustainably solvent. In addition, there is substantial scope for encouraging genuinely new savings and financial investment *without* the need for any new government staff or large new fixed costs associated with establishing additional accounts. Specifically, this could be done through making it easier and potentially more rewarding to save through existing vehicles like 401(k)s and IRAs.